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MINORITY SHAREHOLDER PROTECTION IN TAKEOVERS:
PRIVATE ACTIONS

by

Joseph C H Lee

PhD Thesis
Institute of Advanced Legal Studies
University of London
2005
DECLARATION

I declare that the work presented in this thesis is my own.

London
November, 2004
ABSTRACT

Minority Shareholder Protection in Takeovers: Private Actions

PhD Thesis, Institute of Advanced Legal Studies

by

Joseph C H Lee

There are limits on minority shareholders' rights to initiate proceedings against the controllers (directors or controlling shareholders or both) of the company. Minority shareholders have traditionally only had rights of action on grounds of fraud on the minority, and directors' illegal, and ultra vires acts. Minority shareholders have been deprived of the opportunity to have their grievances heard by the courts in takeover situations. This lowers the threshold of accountability of the controllers. Alternative models of control and accountability, the internal control model, the market control model, and the regulatory model, do not provide sufficient protection of minority shareholders' legitimate expectations in takeover situations.

Courts in England have been reluctant to recognise that the controllers of the company owe a fiduciary duty to the minority shareholders where change of corporate control is in question. Although statutes were passed in order to remedy the inadequate protection of minority shareholders, the judicial interpretation of these statutes imposes restrictions on the rights of minority shareholders to initiate court actions. The remedies available to minority shareholders are limited to the buy-out remedy often combined with a conservative approach in share valuation. Experience in other jurisdictions shows how shareholders there are entitled to a broader range of remedies in takeover situations. In England, however, neither the Human Rights Act 1998 nor the European Directive on takeover bids are likely to bring about significant changes in the range and scope of the judicial remedies available to minority shareholders.

This thesis advocates the development of a private action model in English law. It argues that the area of fiduciary duties owed by the controllers of the company to the minority shareholders should be expanded. In a takeover situation, where change of control is in question, those who exercise actual control over the company should owe a duty to the minority shareholders to act fairly so as not to harm their legitimate interests and expectations. Furthermore, this thesis makes recommendations for the introduction of a pre-action protocol for shareholders disputes and the relaxation of the law on contingency fee arrangements in contentious matters.
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CHAPTER I

INTRODUCTION AND METHODOLOGY

A. THE PROBLEM

This thesis addresses the problem of minority shareholder protection in takeovers. While there has been a wealth of research and cases on minority shareholders' protection in small private companies, there is little research on the legal basis of minority shareholders' protection in public and listed companies. The general view appears to be that in a listed company the most appropriate remedy for minority shareholders should be to rely on the stock market, where they can sell out their shares at the current share value if they do not want to maintain their investment in the company. The City Takeover Code provides a certain level of protection. The Takeover Panel may also grant certain remedies for minority shareholders. Courts in England have not been regarded as the appropriate forum for the resolution of minority shareholders' disputes in listed companies. Especially in takeovers, courts refrain from intervening in transactions. As a result, minority shareholders are normally not being provided with the opportunity for their cases to be heard before the court. However, as the development of the common law in the US shows, this is not necessarily the only possible solution to the question of how
best to protect the interests of minority shareholders. Nor is it necessarily the most
desirable solution in the light of the need for enhanced accountability of company
directors and majority shareholders.

The existing common law does provide a fertile ground for the development of minority
shareholders' protection based on the controller's fiduciary duty towards the minority
shareholders. Although the doctrine of corporate legal personality remains the biggest
obstacle in granting minority shareholders the right to bring an action against the
controllers of the company, this thesis suggests that the legal systems of modern
democratic capitalist societies should provide protection to parties who are in a position
of weakness or disadvantage in business transactions. The law should protect the interests
of minority shareholders. In fact, there are sound social and economic theories justifying
the protection of minority shareholders in takeovers. Takeovers and other corporate
control transactions are established business practices in most capitalist economies. Such
practices foster economic progress but give also rise to malpractices that cause unfairness
and inequalities. Appropriate legal intervention should remedy such unfairness and
inequalities.

This introduction provides some basic ideas and methodological tools that serve as a
framework for the analysis in the following chapters. First, it will offer a sociological
interpretation and explanation of the conflict between the controllers of the company and
the minority shareholders. This will set the scene and explain why the conflict occurs and
why it should be regulated by conferring rights on the weaker parties. Secondly, it will
set out the theoretical bases that justify the protection of minority shareholders. This is the necessary premise and starting point of the analysis. Thirdly, it will examine four models of control of takeovers that will be applied throughout the analysis to understand the forms and techniques used to regulate takeovers and protect the actors involved. Finally, it will set out the structure of the analysis and the contents of the following chapters.

B. SOCIOLOGICAL PERSPECTIVE

This thesis addresses the problem relating to the conflict between the controllers of a company, including the incumbent directors and the controlling shareholders, and the recalcitrant minority shareholders when change of corporate control is in issue. The conflict between the controllers of the company and the minority shareholders can be seen a struggle for power to survive in the corporate society.  

1 H Collins Marxism and Law (Clarendon Press Oxford 1982). Marx suggested that all the social institutions of a community including its structures of political authority and its laws arise from and adapt themselves to the nature of the relations of production. The laws are determined in their form and content by the relations of production by the material base. In a conflict develops between the political and legal super-structure and the requirements of the relations of production then severe dislocation will result.

2 F Engels 'Principles of Communism' in K Marx and F Engels (eds) Collected Works V-VI (Lawrence and Wishart London 1975). It was said that ' The bourgeoisie having thus annihilated the social power of the nobility, annihilated their political power as well. Having become the first class in society, the bourgeois proclaimed itself also the first class in the political sphere. It did this by establishing the
Berle and Means identify the fundamental issue that arises from the separation of corporate ownership and corporate control whereby the incumbent directors have control over the proprietary interests of the minority shareholders. Because the directors retain the power, the directors are elevated to the level of being a 'state' that makes rules for the corporate world. This is liable to marginalise the concerns and interests of the minority shareholders who provide the capital to the company. To maintain public confidence in the markets and financial stability, the State makes regulations that purport to supervise the directors by making them accountable to a higher authority. However, a two-fold problem arises. On the one hand, minority shareholders and investors rarely have a say in the rule-making process. The State is likely to consult, and be lobbied by, the very corporate elite that the regulation purports to supervise. On the other hand, the corporate elite, constituted of the directors of contemporary corporations, in fact, often forms the authority to which the controllers of the company are made accountable.

It would be incorrect to assume that rules made by the controllers of the company do not protect minority shareholders at all. Indeed, the corporate rules often contain provisions that have the aim or effect of protecting the minority shareholders. However, the idea of protection of minority shareholders is quite different from the principle of empowerment

representative system, which rests upon bourgeois equality before the law and legal recognition of free competition'; K Marx ' Economic and Philosophic Manuscripts ' in K Marx and F Engels Collected Works V-VI (Lawrence and Wishart London 1975).

of minority shareholders. In fact, any paternalistic protection\(^4\) given to minority shareholders can be regarded as an alternative to empowering them. This is sometimes justified on the ground that such empowerment would cause obstruction to the operation of the company. It is possible to draw an analogy with the process of empowerment of the powerless classes in the Nineteen Century. Many regimes in the Nineteen Century resisted the movement to give (or surrender) the right (power) to the powerless classes on the grounds that it was necessary to do so in order to avoid public unrest. This Nineteen-Century concept has hardly faded away. Such thinking has been inherited by the current corporate rulers and has been used for the purpose of power consolidation in the process of forming and reforming the structure of corporate governance, and to institutionalise the structure for the conflicts that may arise in a company. This corporate philosophy can be used to understand the current English judicial and legislative approaches to company law and the protection of minority shareholders. Such approaches appear to be paternalistic and aimed at safeguarding the interests of minority shareholders rather than empowering them by giving them ‘rights’.\(^5\) Under this approach, the state, either the judiciary or the legislature, undertakes the responsibility to set and enforce standards of conduct for directors and controlling shareholders. The presumption is that stability within the corporation is key to corporate expansion. The result of this paternalistic approach to minority shareholders’ protection is that in a conflict between the incumbent controllers and the recalcitrant minority shareholders, the state exercises the power on behalf of the minority shareholders. However, the state cannot be considered a ‘trustee’ of the minority shareholders nor is there an abstract ‘social’ contract between the state

and the minority shareholders. This is because under the current situation, the state is not accountable to the minority shareholders who have stakes in the conflict.

It is the conclusion of this thesis that the appropriate way to solve the conflict between controllers and minority shareholders is to give the latter ‘rights’ enforceable in the courts directly against the controllers or the company. The only approach that would make a significant impact on the protection of the minority shareholders is one that focuses on reshaping the ‘balance of power’ within the company itself. Changes obtained through regulatory intervention will not make a real difference to minority shareholders. This is because the conflict is between the directors and the minority shareholders. The intervention of a regulatory body to solve the conflict without the parties being entitled to present their own case and obtain adequate remedies is insufficient.

In order to be able to exercise ‘rights’ conferred upon them, minority shareholders must be entitled to obtain corporate information. Non-transparent decision-making processes affect minority shareholder’s proprietary interests because it prevents them from making an informed decision about how best to protect their proprietary rights. The current law provides the directors with the shield of the business judgement rule. Directors are thus protected from the attacks by the minority shareholders. This shield can be withdrawn if the exercise of business judgement is corrupted. The question remains as to how it is possible to ascertain whether such judgement is corrupt or uncorrupted; who should take on the job to remove the directors’ protection from the minority shareholders’ attacks;

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and more importantly, who should attack. This is an issue of rights and remedies. Investigations by public authorities are not a solution. Minority shareholders have standing to complain to the authority but have no right to compel the authority to conduct a full investigation and arrive at a decision. When a public investigation has been launched, the minority shareholders have only limited powers to scrutinise the investigation although the investigation significantly affects their interests. A paternalistic approach to protecting the minorities and the powerless in a society leaves the minorities powerless despite any protection bestowed upon them. To give power is different from giving protection. In law, the best way to empower a person is to give him rights.

The need for a rights-based protection is particularly acute where corporate control is being transferred from one powerful entity to another. If the minority is empowered, it will be able to have influence in the power struggle between the two entities. It will be in a position to negotiate with the two parties to the corporate transaction to protect its own interests.

C. THE THEORETICAL BASES FOR THE PROTECTION OF MINORITY SHAREHOLDERS

A number of cumulative theoretical bases for the protection of minority shareholders can be established under the current legal framework and applying extra-legal theories.
The first theoretical basis relies on the concept of proprietary interest. Minority shareholders hold proprietary interests in the investment in the company. Such proprietary interests should be guaranteed and protected by rights conferred by the law. To say that the shareholders are 'owners' is not an accurate description of the reality. The word 'owner' in relation to the shareholders is not intended to convey the notion of full ownership with which we are familiar when we consider ownership of other types of property, such as land. Berle and Means raised the issue of whether shareholders should have the same property rights as owners of other kinds of property and concluded that shareholders should remain passive owners and residual claimants, having surrendered the power of control. On the contrary, it is possible to argue that shareholders, as one category of the stakeholders, should take an active part in the affairs of the corporation. Such a concept is in line with the concept of property which consists of a bundle of rights such as the right to possess, the right to use, the right to disposition, the right of exclusion of others, and the right to management and control. The derivatives of these rights include the right to capital, the right to dividends, the right to vote, the appraisal right, the right to a fair and equal treatment, and the right to be consulted and to bring lawsuits. If

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minority shareholders are regarded as holding a property right in the company, these
derivative rights can be upheld by the courts by way of interpretation. This conclusion is
stronger if the right to property can be construed as a fundamental right of the
shareholders.

The second theoretical basis for the protection of minority shareholders is founded on the
nexus of contracts paradigm, or the contractarian theory. Shareholders are deemed to
enter into voluntary and unanimous agreements with the company. All the terms in the
corporate arrangements are contractual, in the sense that they are fully priced in
transactions among the interested parties. This means that if the contractual terms are not
favoured by the shareholders or investors, fewer investors will purchase company’s
shares carrying these contractual terms, and this will depress the price of the company’s
shares. If the contractual terms are favoured by the investors, the price will appreciate due
to increased demand for the shares. Market forces will decide what terms are favourable
to the investors. The investors will not choose a contract which is against their interests.
It is this idea that justifies economic liberty and none state-intervention. However, there
are ‘mandatory terms’ in the contract. For instance, managers may not contract out the
‘duty of loyalty’. These ‘mandatory’ terms can be regarded as the background terms of

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10 D Votaw Modern Corporation (Prentice-Hall Inc New Jersey 1965); Thomas Donaldson and Lee E
11 FH Easterbrook and DR Fischel The Economic Structure of Corporate Law ( Harvard University Press
Cambridge Massachusetts 1996); P Burrows and CG Veljanovski ‘Introduction: The Economic Approach
to Law’ in P Burrows and CG Veljanovski (eds) The Economic Approach to Law (Butterworths London
1981); RP Malloy Law and Economics: A Comparative Approach to Theory and Practice (St Paul Minn
1171 1195-8; P Burrows ‘Contract Discipline: In Search of Principles in the Control of Contracting Power’
(1995) 2 EurJofL and Econ 127, 128-30; A Ogus Regulation: Legal Form and Economic Theory
the contract which can save the cost of contracting. The fiduciary principles enforced by
the courts fill in the blanks with the terms that people would have bargained for had they
anticipated the problems and been able to transact without cost in advance.

The third basis for the protection of minority shareholders relies on the concept of trust.
Under trust law, it is possible to establish a fiduciary duty owed to the minority
shareholders by the management and the controlling shareholders. Trust law encourages
fiduciaries to self-deal up until the point at which the costs outweigh the benefits, that is,
the point at which shareholders sue. This state of affairs leads shareholders to be less
trusting, and results in litigation on the suspicion of misconduct, in the hope of forcing
directors to settle even unmeritorious suits.\textsuperscript{12}

The fourth theoretical basis for the protection of minority shareholders is based on the
notion of total wealth creation.\textsuperscript{13} The function of the company is to create total wealth.
More active participation of minority shareholders in the company is a means to this end.
One strategy is to encourage shareholders to participate in the company rather than rely
on the 'exit' strategy. This will promote shareholder activism, which has the effect of
strengthening corporate governance. It can be argued that the notion of corporate
governance is based on the concession theory which regards the company as owing its
existence to an exercise of state power. The state is viewed as having made a concession

(\textsuperscript{12} Lawrence E Mitchell ‘Trust, Contract, Process’ in LE Mitchell (ed) \textit{Progressive Corporate Law} 185
\textsuperscript{13} J Parkinson \textit{Corporate Power and Responsibility, Issues in the Theory of Company Law} (Clarendon
Press Oxford 1993) 41.)
or have bestowed a privilege on the individuals to benefit from incorporation. Therefore, minority shareholders should take part in promoting corporate governance that contributes to the creation of wealth. Certain rights and protection must be conferred on the minority shareholders to carry out these objectives.¹⁴

The fifth basis for the protection of minority shareholders relates to the proper functioning of corporate democracy. Minority shareholders should be protected from damages caused by the abuse of majority rule. The legitimacy of the majority rule has been questioned on the grounds of the coercive effect of the majoritarian rule. Constitutional theorists have asked the question as to whether the majority should be able to trump the will of the minority legitimately. Under the theory of deliberative democracy,¹⁵ the majority rule becomes politically legitimate when it is the product of rational deliberation among political equals on grounds acceptable to all the participants. The grounds on which the democratic deliberation is based are acceptable if they can be established by democratic values such as fairness, equality, good faith, and respect. Hence, if the interests of the minority shareholders are not duly taken into account in the deliberative process, the majority rule will be considered to administer aggressive democracy and should not be accepted as a norm in a democratic society.

¹⁴ G Graham 'Regulating the Company' in L Hancher and M Moran (eds) Capitalism, Culture and Economic Regulation (Clarendon Press Oxford 1989) 199. It is argued that society is entitled to insist that companies are equipped with governance structures adequate to enforce a commitment to profits on the part of management and to promote the efficient operation of the business. Making profits for shareholders must be seen as a mechanism for promoting the public interest, and not as an end itself. TF McMahon 'Models of the Relationship of the Firm to Society' (1986) 5 J Bus Ethics 181.

The sixth basis for the protection of minority shareholders is the ethical theory of the company. A virtues-based model for good citizens offering a system of behaviour for corporations, is an alternative to the model based on rights and duties. Virtues include compassion, recognition of, and care for, the needs of others, and trust. This ethical philosophy is the pursuit of a model of social justice that incorporates respect and toleration. Business-ethics scholarship has suggested the Aristotelian theory of virtues as a way of remoulding the behaviour of corporations. Wheeler suggested that 'the corporation should be integrated into an Aristotelian-type as an individual actor in its own right. The corporation becomes an entity which is required to perform according to the virtues. The company may develop an ethical policy for internal governance in which minority shareholders would be 'included' in the community and be encouraged to participate in the company's affairs. This ethical approach can also be the moral basis for behaviours such as the report of corporate misconduct by the insiders. The elements of the ethical behaviour have to be 'incorporated' into the corporation as a holistic and potentially perpetual structure if they are to have any significant impact. The virtues

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19 As Aristotle requires individuals to look beyond their own position to that of others.

practiced by shareholders can be a building block of the idea of a broader collective social corporate responsibility towards the community.\textsuperscript{21}

The seventh basis for the protection of minority shareholders is the notion of distributive justice. This notion may be used to remedy the unfair allocation of resources which results from market failure. Liberal economists, such as Adam Smith, argue that markets can function efficiently through the forces of supply and demand without state intervention. State intervention creates waste and inefficiency.\textsuperscript{22} In a competitive market, companies and resources suppliers, seeking to further their own self-interest and operating within the framework of a highly competitive market system, will simultaneously, as though guided by an invisible hand, promote public and social welfare. Under this theory, an individual’s economic autonomy or freedom is guaranteed, free from arbitrary collective or individual power.\textsuperscript{23} Hence, any legal constraints beyond the basic guarantee of economic freedom will be considered excessive. However, the market system can fail to perform efficiently. It can fail to create social wealth. The role of distributive justice is to determine how the benefits created by social co-operation ought to be divided among the various groups of society.\textsuperscript{24} If the company is taken as a small

\begin{thebibliography}{99}
\item C Jenks T H Green, The Oxford Philosophy of Duty and the English Middle Class" (1977) 28 Brit J of Soc 481, 485; Also see G Thomas The Moral Philosophy of T H Green (Oxford University Press Oxford 1987) 39.
\end{thebibliography}
community, minority shareholders are considered as stakeholders of the community and are entitled to the fair returns for their contributions. The law should prevent unjust enrichment by the persons in control of the company at the expense of the minority shareholders. If such an unjust enrichment occurs, the controlling persons should make restitution to the minority shareholders.

These theories form the basic ideology for the protection, or the enhancement of the protection, of the minority shareholders. The law, including common law, statutory law, and non-statutory regulations, should incorporate the idea that minority shareholders should be adequately protected. This thesis will identify the areas where the protection offered by the law and by the traditional enforcement of duties and rights is not adequate. This thesis will also challenge the misconception that minority shareholders have been well protected by market forces through 'exit' strategies and, therefore, no additional protection is needed or can be administered efficiently. This thesis does not argue for a replacement of the existing legal framework. Rather, it advocates for an adjustment of the existing legal rules by 're-interpretation'. This view is reinforced by the comparative analysis which draws upon the discussion of the law in the United States.


26 RC Clark, Corporate Law (Little, Brown and Co Boston 1986); L Bebchuk 'The Case for Empowering Shareholders' (Working Paper Harvard University March 2004) as Professor Bechuck argued that U.S. corporate law (UK law bears similar resemblance) has long precluded shareholders in such companies from directly intervening in any major corporate decisions and to provide shareholders with the power to intervene can significantly address important governance problems that have long occupied the attention of
D. FOUR MODELS OF CONTROL IN TAKEOVERS

This section discusses four models for dealing with the problems of takeovers. None of these models is exhaustive and self-standing. However, legal systems have favoured one or more models against the others. This thesis argues that the private actions model is under-developed in England and necessary for the proper functioning of the system of control of takeovers and protection of minority shareholders. Before analyzing these models in detail in the following chapters, it is necessary to describe their structure and ideological justification.

1. Internal Control Model

Under the internal control model, control of takeover transactions is exercised through mechanisms internal to the company. The board meeting and the general meeting are the internal mechanisms through which the board of directors and the shareholders decide matters of importance regarding takeovers. The rights and duties of the board of directors and the shareholders are provided for by the general company law.27 Directors and shareholders' rights and duties have also been established, or developed, by the courts.28

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Under this model, rights conferred on the shareholders and duties imposed on the directors do not serve the purpose of control on takeovers efficiently. This is attributable to two factors. The first is the tradition and ideology behind English company law which adopts a non-interventionist approach based on notions of contractual freedom and party autonomy. The second is the attitude of the judiciary that hesitates to develop a recognised formula identifying the relationship between the shareholders and the board of directors in takeover situations. This non-interventionist approach means that the development of rights and duties under company law relies on the organic development of the law on a case-by-case basis. The basic principle under this model is that a company is the owner of its assets and the directors owe fiduciary duties to the company, not to the individual shareholders. The board of directors decide most of the corporate matters. However, through collective decision at the general meeting the shareholders can, in some circumstances, influence the decision of the board of directors.29 However, it is the general meeting that has the right or power to control the board of directors. Shareholders have rights in the context of the operation of the general meeting but they do not have direct rights against the board of directors. The right to participate in the general meeting does not give rise to the right to bring an action against the board of directors.

The right to bring judicial proceedings against directors is conferred on the company, and only in exceptional circumstances, shareholders may bring derivative actions against

directors. Derivative actions can only be brought under the doctrine of fraud on minority, a doctrine developed by the court under *Foss v Harbottle*.30

In England and Wales, to compensate for the inadequate protection of minority shareholders as a result of the doctrine in *Foss v Harbottle*, the minority shareholders are given the right to petition to the court for the court to exercise its discretion in awarding damages under section 459 of the Companies Act 1985 and section 122 of the Insolvency Act 1986. These are rights to bring petitions and do not have the same legal nature and legal effect as the right to property, the right to hold the directors accountable, and the right to obtain an effective remedy. The sell-out and buy-out rights under the Companies Act 1985 are post-takeover remedies. These rights do not exist at common law, and it is not clear on what basis these rights are conferred and whether these rights are for the protection of minority shareholders or for the benefit of the acquiring company.

2. Regulatory Control Model

Because of the inadequate protection provided by the common law and related company law statutes, the State makes, or endorses, regulations as a remedy to the deficiency of the common and statutory law in controlling takeovers.31 The State confers the function of

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30 For instance, in the recent Marks and Spencer takeover saga, if Mr Rose, the director of Marks and Spencer, in breach of his director’s duty, launched a campaign against the offer made by the Acquiring Company, the predator company led by Mr Green, the minority shareholders would not be able to obtain an injunction against the Mr Rose. This is not the only model available. For instance, in exactly the same scenario, shareholders would have been able to apply for an injunction under the law of the State of Delaware, USA.

control to public authorities. Such public authorities exercise powers to enforce the law or regulations. Unless the shareholders are also given the power to enforce the regulations and obtain remedies as a result of the breach of such regulations, regulatory control is an external control model.32

Although the regulatory control model may have the effect of protecting members of the company, the aim and purpose of the regulation focus on broader public interests that can be in conflict with the private interests, such as shareholders’ interests. In fact, the regulatory model can deprive shareholders of rights conferred under the internal control model or distort the exercise of such rights. An example of how regulations impact on shareholders’ rights is the Takeover Code, a self-regulatory code of practice for takeovers now having a certain degree of statutory force. The Takeover Code in effect limits the minority shareholders’ freedom to bring actions before the courts to assert their rights, including, for instance, their right to receive an offer without directors’ interference. The control or power shifts from the internal model to the external model.

Regulation is prone to arbitrariness and can lead to distortions. Regulatory rules often lack a clear basis for regulating certain activities. For instance, the mandatory offer rule under the Takeover Code requires anyone who obtains control of the target company to

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32 H Collins Regulating Contracts (Oxford University Press Oxford 1999); DTI Company Law Review Steering Group, Modern Company Law For a Competitive Economy (Final Report London 2001); P Davies The Regulation of Takeovers and Mergers (Sweet & Maxwell London 1976); S Deakin ‘Regulatory Competition versus Harmonisation in European Company Law’ (2000) ESRC Centre for Business
make a public offer for the remaining shares. It is not clear who this rule is to protect. The management may be protected by this rule as the bids will become more expensive to the acquirer who will need to prepare more capital available to bid for the remaining shares. However, without such clause, minority shareholders may suffer from not being able to receive the ‘control premium’ from the acquirer. The Financial Services and Markets Abuse Act 2000 gives powers of enforcement to the Financial Services Authority, including powers of investigation, the power to bring judicial proceedings, and the power to impose sanctions. However, the relationship between the members of the company, or investors, and the regulatory authority, is not clear. For instance, it is not clear what impact proceedings brought by the FSA have on shareholders’ actions against the controllers of the company, and whether the shareholders can have access to materials or evidence obtained by the public authorities for the purpose of bringing civil actions. Furthermore, it is not clear whether shareholders have a remedy against public authorities for failing to supervise or regulate if such failure causes losses to the shareholders.

3 Market-mechanism Control Model

In the definition of market control, market means the stock market, or capital market, where shares and debentures are freely traded without government intervention and market manipulation. Under this model, the market mechanism will decide the way that a company should behave according to the forces of buy and sell. Through the free trade

market mechanism, the share price of the company indicates the performance of the company. Better corporate profits forecasts result in demand for the company’s shares, which in turn results in higher share prices. On the other hand, badly managed companies cause the share price to depress. The effect is to invite predators into the market to buy out the shares at the low price. In these circumstances, the consequence of the takeover of the company is the re-election of directors or removal of the whole board.34

There are three remarks to be made on the market control mechanism. First, the shares traded in the market must amount to a significant amount of the company’s total shareholdings. Secondly, shareholders must be able to sell their shares without restraints.35 Thirdly, directors must fear the threat of takeover. It is necessary to examine these three points in turn.

The first point refers to the need for control to be contestable for there to be some form of market control. In the People’s Republic of China state-owned shares and legal-person-owned shares amounting to two-thirds of total shareholdings in the state owned enterprises (SOEs) are not tradable, and tradable shares only represents one-third of the SOEs’ total shareholdings. Therefore, control is not contestable. The market control model is not workable or even thinkable.


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The second point refers to the fact that shareholders must be free to sell the shares without constraints. Shareholders may not be free to sell the shares to buyers because of lock-in agreements or approval required for the sale of shares, or because the selling side of the market is greatly distorted.

Thirdly, directors must fear the consequences of the takeover. This will not be the case if they have the discretion to register shares or have the power to refuse to resign from the board pursuant to an agreement with the company or protection afforded by employment law.

There is some truth in the arguments in favour of the market control mechanism. The market can certainly have an impact on corporate affairs. However, it is not clear whether it can achieve efficiency through contestability of corporate control. Market efficiency is achieved in a perfect market. In other words, non-perfect market control could result in market inefficiency. The three conditions for effective market control are often provided for by company law and other regulations with respect to public companies. On the other hand, regulations can also be employed to remedy instances of market failure that have an effect on the three conditions in question.\(^{36}\)

4. Private Action Model

The private action model is the model that this thesis advocates for. Minority shareholders do not receive proper protection under the internal control model, the regulatory control model, and the market-mechanism control model. Minority shareholders are only empowered when rights are conferred on them. Rights can be conferred on them under the internal control model, under the regulatory model, and under the market-mechanism control model. Under the internal control model, minority shareholders should have the right to bring actions against 'controllers' of company, including the majority shareholders or the board of directors. However, under the internal control model, the right to bring actions against the controllers is a derivative one. Under the private actions model, the right to bring a suit belongs to shareholders in the form of a harm-based action. Minority shareholders should also have the right not to be unfairly prejudiced by the 'controllers' of the company or by the operation of the system, rather than the right to petition to courts on the basis of unfair prejudice. The right to receive just and equitable treatment should also be conferred on shareholders against inequitable and unjust treatment by the controllers of the company. The rights guaranteed by the Human Rights Act 1998 can also provide a good basis for the courts to develop a new doctrine under general company law that enhances minority shareholders' rights. Under the regulatory model, 'rights' or powers should be given to minority shareholders to demand or request public authorities to initiate investigations into corporate malpractices.

Evidence obtained through administrative investigations should be made accessible to minority shareholders to pursue private actions. Proceedings by public authorities should not hinder the right of minority shareholders to bring civil actions to receive redress and just compensation. Minority shareholders should also be able to bring actions against public authorities when their rights are infringed by failure of supervision by public authorities. Furthermore, legal systems should provide minority shareholders with the means to bring proceedings. Greater liberty in the methods of financing litigation should be granted to minority shareholders. Fee arrangements between clients and lawyers would provide incentives both to lawyers to process claims seriously and to minority shareholders to exercise their rights vigorously, thereby performing an internal supervisory role over corporate affairs.

E. STRUCTURE OF THE ANALYSIS

In chapter two, the author intends to define the concept and the meaning of corporate control. The importance of this analysis follows from the fact that takeover is a corporate control transaction. Therefore, the protection of minority shareholders in takeovers extends to the situation of any corporate control transaction. The advantages and disadvantages of takeovers will be discussed in order to support the theory that takeover fosters the economy as well as malpractices.
Chapter three examines the methods of takeovers and corporate control transactions. The term ‘takeover’ may at times be misleading and evoke the scenario of the ‘hostile takeover’. In fact, hostile takeovers are only one form of corporate control transactions. The bidder, or the buyer of the corporate control, chooses the form that suits him best. Therefore, the law should provide protection to the minority shareholders whatever the form of corporate control transaction chosen by the buyer.

In chapter four, the author intends to explore the theories legitimising minority shareholders protection in takeovers. According to one theory, the company should be organised in a democratic structure. Minority shareholders may be regarded as citizens in the company. The democratic model is the basic structure for the decision-making process. Ethical considerations can be incorporated into this democratic model. According to another theory, which is not necessarily alternative to the democratic model but may well coexist with it, minority shareholders’ protection is based on rights conferred upon them in light of the fact that they are members of the company. This right-based theory argues that minority shareholders are entitled to the right to capital, the right to vote, the right to dividend, the right to information, the right to management, and the right to equal and fair treatment as a consequence of them being members of the company.

Chapter five will discuss the English common law protection, especially as regards the issue of the entitlement of minority shareholders to derivative action and personal action. Special attention will be given to the implications of the Human Rights Act 1998 on the
development of the company law principles at common law as well as other areas of statutory or non-statutory law. In particular, it will be discussed to what extent the Act protects minority shareholders’ rights and whether this can be a way forward for minority shareholders’ protection in takeovers.

In chapter six, the focus is on the protection offered by statutory law and non-statutory codes of practice. The two most important statutory provisions in this regard are the ‘unfair prejudice’ provision under section 459 of the Companies Act 1985 and the ‘just and equitable winding up’ provision under section 122 of the Insolvency Act 1986. In addition, the author will also examine the protection given to the minority shareholders in various forms of voluntary arrangements both under the Companies Act 1985 and the Insolvency Act 1986. The non-statutory Takeover Code will be examined in this chapter, especially its mandatory offer rules.

Chapter seven will examine remedies currently available to minority shareholders. These remedies include interim remedies such as prohibitory injunctions and interim payment orders, and final orders such as buy-out and sell-out orders, cost orders, and permanent injunctions. The summary judgment will also be analysed. The issue of costs and the funding of the proceedings will be discussed with particular reference to the practice in the United States, which provides an interesting comparator to the English rules.

In chapter eight, the author will discuss the criminal sanctions and civil statutory offences under statutes that provide designated authorities with enforcement powers in the public
interest. The analysis will focus on the investigative powers of the Department of Trade and Industry (DTI), the powers conferred upon the Financial Services Authority (FSA) by the Financial Services and Markets Act 2000, and the effects and consequences thereof on the minority shareholders’ rights and the protection.

In chapter nine, the focus will be on the law in the United States, including the federal law protection, and the analysis of the state laws of Delaware and New York. A crucial point is the discussion of the controversy regarding the majority shareholder’s fiduciary duty owed to the minority shareholders. Such controversy gave rise to conflicting cases in different state courts. Appraisal rights will be examined in order to consider whether it could be feasible to incorporate them into English law.

In chapter ten, based on the analysis undertaken in the previous chapters, the author intends to recommend a legal approach that can sufficiently protect the minority shareholders’ interests under the English legal system and that will ultimately serve the purpose of corporate governance.
CHAPTER II

CORPORATE CONTROL AND TAKEOVER

A. INTRODUCTION

The previous chapter identifies the theoretical justifications for protecting minority shareholders in transactions where there is a change of control. In this chapter, the discussion focuses on the meaning of control and its relevance to the analysis of corporate transactions. The concept of control is crucial because the protection of minority shareholders analysed in this thesis relates to situations where there is a change of corporate control. Furthermore, this chapter also weighs up the advantages and disadvantages of a change of corporate control. The importance of this analysis derives from the fact that once the concept of control, including change of control, has been identified, the protection of minority shareholders could result in limitations on the change of control in the corporation. It is, therefore, necessary to understand whether a change of control is, on balance, more advantageous than not in the modern economic context. The conclusion will be that takeovers have advantages that outweigh the disadvantages and should, therefore, not be unduly impaired. The crucial point that will constitute the basis for the further analysis is that minority shareholders' protection should not make changes of control in the company unduly burdensome or expensive.
The analysis in this chapter is the necessary premise for the discussion of the techniques of takeovers and the ways in which they affect minority shareholders’ rights. This dimension will be the subject of the next chapter.

This chapter is structured as follows. First, it offers a definition of corporate control. Secondly, it examines the different types and categories of corporate control. Thirdly, it analyses the ways in which corporate control may be constrained and how the power of constraint can be another form of corporate control. Fourthly, it discusses the advantages and disadvantages of takeovers. Finally, conclusions will be drawn.

B. DEFINITIONS OF CONTROL

Why is a definition of control of fundamental importance in the analysis of the protection of minority shareholders in takeovers? This study addresses the problem of minority shareholders’ protection in takeovers. Some 107 years ago, the House of Lords determined the nature and the effect of private limited companies in England and Wales in the Salomon case so as to provide limited liability for the director and shareholders by mere compliance with form and procedure.\(^1\) The controllers of the business were to obtain instant and complete limited liability. The case also established the principle of separate legal personality. This principle creates potential obstacles to the protection of minority shareholders against actions of the controllers. Identifying controllers is also significant to the enforcement of directors’ duties, because the rule of ratification would not operate to exonerate directors’ wrongdoings

\(^1\) O Kahn-Freund ‘Some reflections on Company Law Reform’ (1944) 7 MLR 54.
if such ratification was effected by virtue of a majority vote of the shareholders which are the controllers of the company.\(^2\)

‘Control’ is a term used in many disciplines. It relates to the power and capacity to initiate, constrain, circumscribe, and terminate action directly or indirectly.\(^3\) The Oxford dictionary defines ‘control’ as the power of directing, commanding, and restraining. If A has the ability to cause B to behave in a manner intended by A and in which B would not have behaved without A’s intervention, then A is said to have control over B. Therefore, if A is able to cause a company to perform in a way intended by A, and the company would not have so performed without A’s intervention, then A is said to have control over the company. A has corporate control of the company.

Corporate control includes family-control, state-control, block-holder-control, cross-holding control, minority-control, management-control, committee-control, supervisory-board control, market-control, creditor-control, family relations and coalition control, and legal control. Because control can take all these different forms, in changes of corporate control, it is not easy to define whether a corporate transaction is a ‘takeover’ or ‘merger of equals’. It is because the structure of the company varies from company to company and from country to country.\(^4\)

The concept of control in company law includes the concept of accountability. When control is at stake, then the accountability of the controller becomes a fundamental

\(^2\) H Hirt ‘Ratification of breaches of directors’ duties: the implications of the reform proposal regarding the availability of derivative actions’ [2004] Company Lawyer 197.

\(^3\) Herman Corporate Control, Corporate Power (University of Cambridge Press Cambridge 1981) 17.

\(^4\) Tracinda Corporation (a Nevada Corporation) v Daimlerchrysler AG (a Federal Republic of Germany corporation) In the United States District Court for the District of Delaware.
issue. Without the controller's accountability in a company, it would be unnecessary to emphasise the relationship between control and ownership.\(^5\) Berle and Means pointed out the significance of separation of ownership and control in that, without accountability, the controllers would be unbridled in managing the property of owners who lack the power of control. \(^6\) Therefore, the nexus between ownership and control is one of accountability. However, this theory also has its limitations. Ownership is a proprietary concept, whereas control is something more than a property right. \(^7\) The word 'separation' suggests the different nature and functions of these two factors. In the discussion of accountability, control should include \textit{de jure} and \textit{de facto} control. The accountability of the controller does not depend on ownership of the controlled.

Berle and Means' model of separation of control and ownership has been explained by the corporate evolution of share dispersion, which caused the shift from the family control model to management control model. What Berle and Means did not explain in detail was the nexus between a controlling owner and another controlled owner, including the duties owed by majority shareholders to minority shareholders. Furthermore, the model did not consider the later emergence of a trend of convergence of control and ownership that has an impact on the controller's accountability as is the case for the obligation of institutional shareholders of monitoring corporate affairs for the investors. \(^8\) Although they convincingly explained that the need for capital to be used for corporate expansion caused share dispersion,

\(^5\) As Zeitlin argued that '...at the end of the day the concept of control is "essentially relative and relational: how much power, with respect to whom?"'. M Zeitlin 'Corporate Ownership and Control: the Larger Corporation and the Capitalist Class' (1973-74) 79 American Journal of Sociology 1073.


\(^7\) As Herman puts forward a theory of control based on the importance of strategic position. E. Herman \textit{Corporate Control, Corporate Power: A Twentieth Century Funds Study} (Cambridge University Press Cambridge 1981).

Berle and Means did not consider the role that the degrees of structural protection of shareholders played in the process of share dispersion. It is possible to argue that the willingness of the controlling family shareholders to release shares to outsiders could have been significantly influenced by their perceived economic and legal strength *vis-à-vis* the outside shareholders. Conversely, the willingness of outsider shareholders to buy shares in a previously closely-held company may have been influenced by their perception of the protection that they would enjoy within the company.9

Politics determine corporate control in the corporate structure. The question is whether the corporate structure is determined by the political situation in a given environment or is determined by the protection provided through direct legal control. Professor Roe10 argued that politics determine a country’s corporate structure and its governance. He came to this conclusion on the basis of research focused on corporate control and share dispersion in relations to several social factors. Professor Cheffins also argued that politics do trigger the initial share dispersion but added the important qualification that a legal structure must be established to facilitate the continuation of this process.11 Under the politics determinant theory, a distinction is drawn between left versus right politics, in which left is identified as pro-labour and socialist oriented politics, which is generally to be found in continental Europe, whereas right refers to the more capitalistic and free market oriented politics which has its archetype in the

9 The importance of minority shareholders protection in the public company whose shares are traded on a stock exchange will be one of the leading themes of this study.
United States. The particular focus is on labour protection and the way in which it discourages the dispersion of shares, with the consequence that control remains with the controlling family. On the other hand, low protection of the labour force encourages the dispersion of share ownership, hence achieving social capitalism where company's shares are held by the general public.

By contrast, the 'law matters' theory argues that good corporate law, providing protection to minority shareholders, encourages the controlling family to transfer the shares to others, while remaining protected as minority shareholders in the company. In this sense, protection of minority shareholders is protection of the controlling shareholders against the controlled majority shareholders. This identifies the paradox of minority shareholders' protection, as the term 'minority' must be read against the meaning of corporate control which includes decision-making power and power of constraint. Under the politics determinant theory focusing on labour protection, strong labour protection also strengthens the family-control position in the company. Therefore, the development of labour law will distort the development of the law of minority shareholders' protection. This demonstrates the influence of the political and legal safeguards of the labour force in a company. Such influence is not taken into account in models, such as that developed by Berle and Means, that rely on the separation of ownership and control since the labour force neither owns nor controls the company. This further identifies the need to re-think the model. Although there is no evidence to suggest that development of minority shareholders' protection will diminish the protection of the labour force, the relationship between the two groups of persons, to which some scholars refer as stakeholders, is that of accountability, which

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is the nexus Berle and Means did not explain.

Berle and Means' model focuses on the control exercised within the company (internal control) rather than on the influences coming from outside of the company, such as state intervention or the control exercised by a shadow director (external control). The distinction between internal and external control was not identified in the model. Even in internal control, the model did not look beyond the structure of an individual company. This shows further weaknesses of the model. For instance, intra-group shareholding may provide a misleading picture of separation of ownership and control since it creates, in substance, several controlling owners who act as checks and balances amongst themselves within the corporate group. In this situation, there may be no single controlling member but several owners in the company.

Berle and Means also pointed out the agency problem arising out of the separation of ownership and control. Agency costs to the owner occur in monitoring the controller, and the underperformance of the controller is also a cost to the owner. Agency costs may be significant in public companies. However, in a family-controlled company where the family is the only owner of the company, there will be no agency costs as there is no separation of ownership and control. The family runs and owns the company. This is also true of a family-controlled company in which an outsider owns a minority shareholding. In such a case, it appears that the real issue is not the agency costs incurred by the shareholders in monitoring the controllers, but the expropriation

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of the minority shareholder’s interests. This is because if the outsider minority shareholder only possesses a small percentage of the shares in the company owned and controlled by the family, he cannot be regarded as the owner of the company. Even if the family-controlled board may be regarded as the agent for both the family shareholders and the outsider minority shareholder, its duty is to minimise the agency costs to the owner of the company, and the family shareholders are those said to be the true owners. However, this model does not take into account the fact that company law may confer significant powers on minority shareholders even though they only own an insignificant percentage of shares. Therefore, the agency theory should include the analysis of the legal framework, under which the links between ownership and control may be framed.

Furthermore, the Berle and Means model did not explain the relationship between the degree of separation of ownership and control and the company’s performance. Agency theory explains that the higher the degree of separation of ownership and control, the worse the company’s performance, due to the higher agency costs. Therefore, a monitoring system, also known as corporate governance, must come into play to minimise the costs. This monitoring system is not itself without costs. If monitoring costs exceed agency costs, the company’s performance is lower. However, the agency cost theory concentrates on the correlations between owners and controllers, rather than the total wealth generated by the company, for instance by providing work opportunity, consumer welfare, and environmental well-being. Agency costs could be an indicator to the wealth of the company only if the scope of the terms ‘controllers’ and ‘owners’ is sufficiently wide to cover all the stakeholders in

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the company.

This analysis will result in difficulty in crystallising the relationships between controllers and owners in terms of accountability. The distinction drawn between the profit maximisation and wealth maximisation of a company is based on recognition of owners and controllers in a company. Wealth maximisation of the company will generate more income for the work force, whereas the shareholders are interested in profit maximisation and a higher return on share capital. The objection to the employee-included governance points out that the cost of such a monitoring system will exceed the optimal agency costs and will produce lower value of return on share capital to the shareholders. Under Professor Roe's theory, countries, in which employees are entitled to a greater recognition of their rights, tend to have large block shareholding by family. That is to say that the agency costs for worker's participation is lower in a family-controlled company than that in a highly share-dispersed company or, at least, the level of agency cost is at an acceptable level to the owners of the company.

Controlling family-owners seek stable long-term returns on capital rather than an immediate short-term profit realisation.\(^\text{17}\) The immediate profit realisation in a share-dispersed company demonstrates a low agency cost or an expropriation of worker's interests. On the other hand, such high agency costs in a family-controlled company resulting in lower return of share capital also represent expropriation of smaller shareholders' interests in a company. This means that but for the high agency costs, shareholders could seek immediate high return on capital. The position of the

\(^{17}\) Weinberg & Blank *Weinberg & Blank on Takeovers and Merges* (Sweet and Maxwell London 1989) 4125.
controlling owners is rather peculiar as they stand between the workers and the
minority shareholders, as well as between creditors and other stakeholders. Although a
controlling owner cannot be his own agent, the owner can be agent for other owners.
Therefore, it is difficult to perceive the agency costs from the owners' point of view.

This section has defined the concept of control. It has then identified the three main
features of corporate control in the separation of ownership and control, the concept
of accountability of the controllers, and the agency costs deriving from the need for
the owners to monitor the controllers. The following discussion categorises different
forms of corporate control focusing on the key features of separation of ownership
and control, accountability, and agency costs.

C. CATEGORIES OF CORPORATE CONTROL

1. Family-Control

Family-control is a control by the dominant family. The family, holding an influential
amount of shareholdings in the company and being in the centre of decision-making
power, is able to direct the corporate affairs. Family-control may appear in the form
of blockholder-control, cross-holding-control, minority-control, management-control,
and other forms that guarantee the influence of the dominant family. In situations
where a family has the control over a company, it generally appears to be the largest
shareholder but not necessarily the majority shareholder. Family is identified as a

18 DW Kim 'Interlocking ownership in the Korean chaebol' Corporate Governance 2003.
group of shareholdings distinguished from non-family held shareholdings such as state-owned shareholdings, institutional shareholdings, and individual shareholdings. Controlling family-shareholders are likely to be in the minority position, opposing the majority shareholders such as the state, other institutions such as banks or family owned companies, or individual shareholders. The controlling shareholders from a family may also be able to obtain control through another company, which is owned by the family, and, at the same time, has shareholdings in the family-controlled company. Family identity can disappear in the complex shareholdings structure. Therefore, there is a need for transparency in the shareholdings in a company regarding the identity of the real owners.\(^\text{19}\) Furthermore, if the majority shareholders of a family-controlled company are without voting rights, the company is then a minority-controlled company. The issue of whether the shares are with or without voting rights is a crucial element in the process of establishing control.

In a family-controlled company, the board of directors is generally not independent, and follows the directions of the controlling family, which has the power to remove the directors of the company, with or without cause. Although a management structure is in place, family shareholders are in control of the company rather than the management. Therefore, the company’s articles of association and the bylaws regarding appointment and removal of the directors are of crucial importance.\(^\text{20}\) The service contracts with the directors can also be a means of family-control over the

\(^{19}\) P Davies Gower and Davies’ Principles of Modern Company Law (7th edn Sweet & Maxwell London 2003) 605.

\(^{20}\) Table A 1985, art 73. It is customary to empower the directors themselves to fill a causal vacancy and to appoint additional directors within the maximum prescribed by the articles (art. 79). Normally directors appointed by the board come up for re-election at the next AGM. Under section 303 of the Companies Act, it would not be in breach of any mandatory rule for the constitution to provide that none of the directors should be required to stand for re-election and that the existing directors, again without shareholder sanction, should choose any replacements for directors who resigned or were removed. In other words, shareholders could be wholly written out of the appointment process.
State-controlled, or government-controlled, companies appear mostly in the public utility industry. Examples are energy companies, telecommunication companies, mining companies, railway companies, airline and airport companies, and other industries in which the state has particular interests, such as the banking industry or the high-tech industry.

State ownership is widespread in socialist economies. The following analysis will focus on state control in the People’s Republic of China in order to identify the basic features of this form of corporate control. Obviously, state control is not limited to China and is a relevant feature (or at least was until not very long ago) of most Western economies as well. However, the Chinese system is particularly interesting because it offers a clear overview of the various types of control that state and state-owned banks exercise on companies.

In China, most companies are state-controlled through blockholder-control, which can be in the form of majority or minority-control, financial-control, supervisory-board-control, or legal control. The significance of the example of China’s economy lies in the relatively recent process of transformation of state owned

21 Read v Astoria Garage (Streatham) Ltd [1952] Ch 637, CA; The family may control the terms of the contract.

22 For instance, governments can hold golden share to be able to have absolute control over some serious issues such as mergers, acquisitions, and transfer of shares. Golden shares are generally held in the utilities companies which are of public concerns.
enterprises (SOEs) into shareholding enterprises. This process started in 1984. However, state shares and legal persons’ shares are not tradable on the market, and they amount to two-thirds of the total shares in the SOEs. Those shares can only be transferred by the approval of the China Securities Regulatory Commission (CSRC). The high concentration of ownership, combined with the relatively small portion of tradable shares, implies that few, if any, of China’s listed companies have contestable control. Because of the large state shareholdings in the SOEs, the state exercises control over the appointment of directors. Since shares cannot be traded and there is no real threat of takeover in the market, profit and loss are not the main concern as regards the appointment of suitable individuals to the board of directors. Instead, the appointment and re-appointment of the directors or managers may be arbitrary or subjective, based on indicators such as political correctness, and the discharge of social obligations.

The result of the structure of control in the SOEs is that Chinese boards have relatively little decision-making power within the existing legislative framework, while government ministries, commissions, and securities regulatory authorities enjoy substantial decision-making powers. This creates the anomaly of the state being owner and regulator at the same time, which goes to the heart of the issue of accountability. With regard to the financial control, the four state banks control the SOEs through a system of soft loans. Local governments also exercise some form of control through granting subsidies to the majority of SOEs. Besides this, the local governments use their power to influence credit decisions in order to localise the benefits and socialise the risks of investment projects. This causes high level of

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nonperforming loans in the banking system. Furthermore, prosecutors and judges favour local companies in the context of a biased justice system. It is often the case that even if judgment has been given against a company, the company can escape its legal consequences as local authorities, having appointive and financial power over judicial and law enforcement departments, obstruct the enforcement of court orders.

3. Blockholder Control

It is difficult to specify the level of shareholding for blockholder-control. Blockholder can appear as family-control if the family name can be identified, as state control if the shareholder is the state, or as financial control if the shareholders are the banks or securities firms providing financial assistance to the companies. Generally, blockholder means the largest shareholder in the company, whether having majority or not, as opposed to the individual shareholder who holds an insignificant amount of shareholding in the company. Without any other form of control and social influence, a blockholder with more than 50 per cent of the shares will be able to appoint half of the board and exercise half of the voting rights at the shareholders’ meetings. However, blockholder control can be obtained with less than 50 per cent of the total shareholdings if there is absence of organised opposition and other forms of control such as state-control. With a strong and organised opposition able to counterbalance the blockholder’s action, the blockholder is restrained by the exercise of control by others.24 If the countervailing force is strong enough to neutralise the blockholder’s control, the blockholder may be reduced to the position of a minority shareholder. Therefore, three factors must be identified for there to be blockholder-control in a

company. First, the blockholder must be the largest shareholder in the company. Second, there must be absence of organised opposition against the largest shareholder. Third, there must be lack of other influences that would otherwise counterbalance the blockholder’s control.

4. Cross-holding Control

Cross-holding-control is a form of control obtained through shareholdings in a number of companies which also hold shares in the company in question. For instance, X holds thirty per cent of shareholdings in company A, which holds twenty per cent of shares in company B. Y holds thirty per cent of shareholdings in company B, which also holds twenty per cent of shares in company A. X, as controller of company A, holds another ten per cent of the shares in company B, and Y, as controller of company B, holds another ten per cent of the shares in company A. The real shareholding in company A is 32.175 per cent for X and 17.5 per cent, for Y and 17.25 per cent, for company A. The pattern of shareholdings is the same as for company B. In such a situation, X and Y control the two companies by almost half of the shareholdings. This results in concentrated corporate ownership structure rather than dispersed ownership structure. To avoid the weaknesses in the concentrated ownership corporate structure, voting rights may be removed from cross-holding shares by corporate law.

A sophisticated cross-holding structure may enable a small shareholding to obtain control of a corporate group. This is called ‘controlling minority structure’. To illustrate this, suppose that group X comprises companies A, B, and C and the controlling family owns ten per cent of the shares of each company. Furthermore,
suppose that A holds thirty per cent of the shares of company B and company B holds thirty per cent of the shares in company C, which holds thirty per cent of shares in company A, instead of B holding thirty per cent of the shares in company A directly. As a result, the family owns forty per cent of voting rights in companies A, B, and C.

5. Minority Control 25

Minority-control is the control by shareholders holding less than 50 per cent of the shareholdings when there is no collective action by the other shareholders in the company. Majority control is the control by a shareholder who holds more than 50 per cent of the shareholdings. The reason for minority control is the absence of collective action by the shareholders who together hold more than 50 per cent of the shares in the company. Another instance of minority-control, discussed in the previous section, occurs when minority shareholders hold more than the apparent shareholdings in the company through cross-holding devices.

Minority shareholders may obtain control not through voting rights but through other arrangements such as financial assistance, contractual agreements entered into with the company, or the support of the government. It must be noted that in the discussion of the protection of minority shareholders, the minority shareholders are those without control.

6. Management Control

The board of the company is the brain of the company that decides on the day-to-day business of the company. The powers conferred on the directors are the powers to run the company unless otherwise stated by the law or other arrangements, such as the articles of associations, requiring the decision to be referred to general meetings. Instances of decisions to be referred to general meetings are decisions as to whether to take action against the director, decisions to refer matters to delegated committees, or decision related to general corporate governance issues such as directors’ remuneration. Under section 241A of the Companies Act 1985, an ordinary resolution is required to approve the directors’ remuneration.

The directors of the board are generally elected by the shareholders at the general meeting. However, the current practice, at least in the UK, is that the directors are nominated by the board and approved by the shareholders of the company. In that sense, the shareholders do not elect their directors. How the directors are appointed or elected may differ from country to country, depending on the legal system in question. In principle, a 50 per cent approval is required to elect a director. The method of removal serves as a strong constraint on the director’s power. The exercise of the power of removal becomes another source of corporate control.

In the absence of other regulations, directors are allowed to enter any contracts on

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27 Dodd and Berle ‘For Whom are Corporate Managers Trustees?’ (1934) 45 HarvLRev 1145; A Berle ‘For Whom Corporate Managers are Trustees: A Note’ (1932) 45 HarvLRev 1365.
behalf of the company if there is no element of illegality, \textit{ultra vires}, and gross negligence. Apart from building the corporation through contracts and agreements, the board also has the power to re-structure the company by manipulating corporate capital, for instance by increasing the corporate capital for the purpose of issuing company shares to their allies in order to strengthen their control over other shareholders such as the family, the state, or financial institutions. The board also has the power to decide who the allies are regardless of shareholders' opinions about the corporate direction. The board also has the power to schedule the distribution of dividends and to access corporate resources to engineer a proxy fight at the shareholder's meetings.\textsuperscript{29}

If there is no collective action on the shareholders' side to counterbalance the directors' control, restraint may come from other committees or supervisory boards, forms of market-control, creditor-control, or legal constraints such as administrative or criminal sanctions.\textsuperscript{30} These measures are there to combat the recognised problem of agency costs explained before. Lower agency costs can be achieved by closing the gap caused by the separation of ownership and control, for instance by requiring the board of directors to maintain a certain level of shareholdings in the company.\textsuperscript{31}

\textsuperscript{29} I Bolodeoku 'A Critique of the Theories Underpinning Proxy Solicitation by the Board of Directors' [2001] JBL 377.
7. Committee Control

Committees are different institutions within the company, independent of the board of directors and the shareholders’ general meetings. The purpose of setting up committees is to resolve the problem of conflict of interests resulting from the directors’ position. Committees can be set up for reviewing directors’ compensation packages and decisions to merge with or to take over another company, for deciding whether to allow minority shareholders to initiate a suit against the board of directors, or for acting in circumstances where there is no collective action at the general meetings and there is a need for abstinence of the board. The alternative is the appointment of non-executive directors to the board to neutralize the potential conflict of interests of the executive directors. The problems with committees and non-executive directors are the appointment of the members, the terms of their contract, and the obligations owed to the company. It was suggested in the Higg’s report that non-executive directors should be half of the directors on the board and the chairman of the board should be an outsider, ie an executive director or non-executive director should not be promoted to be the chairman of the company. This is to ensure that the chairman is independent within the board and will be able to act as a supervisor. However, the chairman is normally nominated by the board. Therefore, to ensure the independence of the chairman, the principle of conflict of

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32 The Cadbury Committee’s Code of Best Practice requires that the remunerations of the directors should be subject to the recommendations of a remuneration committee and the board should establish an audit committee of at least three non-executive directors. The Greenbury Committee recommended that directors’ remuneration be determined by an independent remuneration committee directly accountable to shareholders and consisting exclusively of non-executive directors; The Hampel Committee recommended that a remuneration committee should be established and made up of independent non-executive directors to develop a policy on remuneration and devise remuneration packages for individual executive directors. Each company should establish an audit committee of at least three non-executive directors, and that the audit committee should keep under review the overall financial relationship between the company and its auditors.

33 D Higgs Review of the Role and Effectiveness of Non-executive Directors (DTI January 2003).
interest should be incorporated into the procedure of nomination.

8. Supervisory Board Control

A supervisory board, independent of the board of directors, generally comprises different stakeholders within the company such as the directors, creditors, labour unions, family minority shareholders. Although the decision-making power is vested in the board of directors, a supervisory board may withhold the approval of important corporate decisions in issues such as mergers and takeovers, plant closures, and directors’ remuneration.

The day-to-day business is carried out by the board of directors. However, the board’s power in negotiating a merger may be diminished by the need for the approval by the supervisory board. In Germany, a merger plan must receive approval from the supervisory board, which makes takeovers more difficult and more time consuming. For the purposes of corporate restructuring, control shifts from the board of directors to the supervisory board. In Germany, it is a constitutionally guaranteed right to have representatives from different interest groups in the public company (Aktiengesellschaft) sitting on the supervisory board.

This kind of company structure has been criticised as a structural barrier to financial liberalism as in a free market capital should be allowed to move freely. A company is required to set up a supervisory board if the company intends to have its headquarters in Germany. The effect of this structure in the European Union common market is

34 P Davies Gower and Davies’ Principles of Modern Company Law (7th edn Sweet & Maxwell London 2003) 137.
likely to be that companies' headquarters will be set up in countries without such a requirement, for instance in the United Kingdom, in order to be able to carry out business operations in Germany without the need to set up a supervisory board. The German law requiring a company to register in Germany while it has set up its headquarter elsewhere, was challenged in the European Court of Justice as violating Community law. Although there is immense pressure on the German government to reform its company law to liberalise its market, the supervisory board is a constitutional requirement and not a statutory obligation. Therefore, any change to this constitutional principle will require substantial political support.

9. Creditor Control

Financial institutions, by providing capital through loans to a company, may control a company’s performance through monitoring clauses in the loan agreement whereby the financial institutions are entitled to withdraw the loans and to force the company to renegotiate the terms of any borrowing arrangement upon defaults on clauses of the loans. Upon default, the company could be requested to restructure, either by re-electing the board of directors or by closing plants as an alternative to the withdrawal of the loans that may ultimately result in the liquidation of the company. Creditor control is more common in continental European companies rather than Anglo-american companies. In some continental European countries, financial institutions providing loans to the company also have representations on the


supervisory board, which strengthens their control over the company's board. If the financial institutions are state-owned, creditor control can be another form of state control. However, to ensure efficient creditor control the civil justice system must guarantee the enforcement of the creditor's rights in order to provide 'teeth' to the control system.¹⁰

10. Coalition Control

Coalition control occurs where two or more shareholders agree to vote in a certain way in order to achieve control. The agreement need not be in writing. An understanding between two parties is sufficient. In law, the concept of 'concerted practice' is used to combat the problems created by coalition control whereby control is obtained without the related accountability. For instance, the UK Takeover Code requires a person who obtains the control of the company, ie a person who holds more than 30 per cent of the company's shareholdings, to make an offer to all the shareholders in the company at the same price as in the last offer made to obtain the shareholdings. Without the concept of 'concerted practice', a person could escape the obligation to make such an offer by agreeing with another shareholder to exercise their voting rights in a concerted way. Even if the two shareholders together hold more than 30 per cent of shares, if each of them holds less than 30 per cent of the shareholdings, there would be no requirement for a mandatory bid. The Takeover Code rightly applies the concept of 'concerted practice' to this situation.

Control will be obtained if a coalition is in place without a single controlling

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shareholder. The meaning of concerted practice is difficult to determine and it gives rise to practical difficulties. For instance, X holds 25 per cent of the shares in company A, which is also 25 per cent owned by company Y, which is 51 per cent owned by Z, who also holds 20 per cent of company W. Company W also holds also 20 per cent of Z and is 5 per cent owned by X. Even without a written agreement or any evidence of agreement of any kind, X could have the control over Y because Y is majority owned by Z, which is cross-owned with W, which is minority-owned by Z, which in turn is minority-owned by X. This can be complicated even more if the real shareholders or director are disguised in instances of 'head-borrowed' shareholders for the purpose of shareholdings and shadow directors. Therefore, the definition based on 'shareholdings' and 'agreement' for the purpose of concerted practice will not be able to cover the above mentioned scenarios.

Furthermore, a creditor, through providing loans to both companies X and Y, may, through a stipulation in the loan agreement or in the process of re-negotiating the terms of the contract, require X and Y respectively to act in a certain way to gain control over company A, even without 'agreement' between X and Y. In practice, the investigation into the 'agreement' could prove to be costly in law enforcement terms. The enforcement agency will need to rely on 'tip off' to have a reasonable suspicion of such an 'agreement' in order to exercise its powers of investigation. A whistleblower, ie a person who comes forward to the enforcement agency to report the concerted practice, is generally needed to provide information vital to the investigation. Therefore, the legal framework and practice should include provisions aimed at encouraging and protecting persons reporting infringements and malpractices to regulatory bodies.
D. CONSTRAINT

Constraint is defined as the act or result of constraining or being constrained; a restriction of liberty; a limitation on motion or action. Constraint is distinguished from control, which is the power of directing, and command. In the corporate sense, if control means decision-making power, then constraint is the restriction or limitation on such a decision making power. The distinction, in practice, is not easy to draw because one element may serve both as control and constraint. For instance, a minority shareholder holding 25 per cent of the shares may be able to appoint a quarter of the board of directors to secure partial control of the management. On the other hand, it may withhold its approval for a resolution needing more than 75 per cent of votes in the company to authorise the board to commence an action. In the latter instance, the minority shareholder is acting as a constraint on the controlling force. Such a constraint can also be a controlling force if, in the above situation, the minority shareholder negotiates with the board to be rewarded with a corporate contract or pre-emptive rights on the issuance of new shares as quid pro quo for voting in favour of the resolution. A creditor, re-negotiating with the board of directors the terms of the loan agreement upon default on the existing loan, may require the board to change the corporate capital structure by issuing shares to the creditor in lieu of the loan repayment. The loan agreement is a constraint on the board’s control, and upon default of the loan or re-negotiating of the loan, the creditor has the power of control over the company’s affairs by threatening the withdrawal of

The free market mechanism is also a constraint on the power of control if the market does not dictate the controller's behaviour; at least, it is one of the factors to be taken into consideration when decisions are to be made. Depending on how the board's appointment and removal are governed, majority shareholders not having the direct power to dictate the board's action may exercise constraint by threatening to use the power of removal and re-appointment of directors with or without cause.

Other kinds of constraint, such as trade union representatives on the board, non-executive directors, market mechanisms where financial institutions play big roles, must be taken into account in determining the question of market efficiency. These forms of constraint are not mutually exclusive to each other. Rather, they influence and compete with each other pursuant to their own interests.

Negotiations between the forces of constraint and control may also take place. Such a situation is mostly likely to occur in corporate re-structuring where the board, the creditors, shareholders in different classes, and trade unions come to the negotiation's

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table to agree on a solution to preserve the company while pursuing their interests. In this sense, the market does play an important role in influencing how these constraints and controls behave. However, it may not have the power to dictate the outcome of the process as it may do in situations where the board and the market are the only players on the scene.

The greater the power of constraint, the lower the power of control. This scale measures the relationship between constraint and control. Because of the relationship between constraint and control, if a higher power of control is accompanied by a higher power of constraint, the two powers acting in competition may reach the point of equilibrium. If the presumption of market efficiency is to let the best controller control the company, then, the other side of the coin should be to let the best constraint counterbalance the control. This means that the controller will run the company most efficiently with the most efficient power of constraint. Under this presumption, Anglo-American corporate structure points out that the board of directors is the best controller of the company and the market is the best constraint to such control. In continental Europe, the board of directors and the blockholders representing family influences are the best controllers of the company, and constraints are from stakeholders such as creditors and trade unions, which can efficiently supervise the company. Market inefficiency is the situation when a controller does not run the company efficiently and constraints are not in place to supervise the controller.

The law and legal infrastructure are significant in defining the roles of control and constraint in the company in respect to power and responsibility. The law and legal infrastructure will also reveal what the perception of market efficiency is in a given
country. For instance, under the market control and constraint argument, the company’s affairs and directions will be dictated according to market forces. In particular, the threat of takeover is regarded as a strong market constraint to the management. The process of hostile takeover in the UK, USA, and most continental European countries is a regulated activity. That is to say, that no matter what kinds of control and constraint are favoured in a particular corporate environment, law and legal structures will have a role to play.

So far, the discussion on control and constraint focused on non-legal norms. However, the law itself also controls and constrains the company through legal concepts such as that of fiduciary duty. Under the private action model, company law imposes a fiduciary duty on the controller of the company to exercise reasonable duty of care to the beneficiaries. Upon the breach of such a duty, the controllers are accountable to the beneficiaries. In legal terms, they can be sued for compensation. Accountability is achieved through the threat or the process of litigation. The law should clarify the controller’s duty towards the controlled, and the controlled’s duty towards the controller and the company. Who owes the duty and to whom? And what is the nature of such a duty? The law may impose fiduciary duty on the person exercising majority control towards minority shareholders or creditors, or on the minority shareholders towards the workforce. The duty could be other than that of a fiduciary

45 As Justice Frankfurter put it, 'to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?' See SEC v Chenery Group 318 US 80, 85-86 (1943).
nature, such as a mandatory duty imposed on the controller because of public interest considerations. This is a growing trend in the area of financial regulations.

E. LEGAL CONSTRAINTS ON CORPORATE CONTROL

The law determines the very structure of control and constraint in a company. The technique used to this end is to impose duties on the controllers of the company. What constitutes control depends on how the law defines it and, therefore, changes in different jurisdictions and even in different situations within the same jurisdiction. The following examples will explain this notion.

New York corporation law requires only 50 per cent of the votes for removal of pre-emption rights.46 By contrast, the Companies Act 1985 in the UK requires a 75 per cent majority of the votes for the removal of pre-emption rights.47 Therefore, minority shareholders holding 25 per cent of the shares in the UK, collectively, secure control over removal of pre-emption rights, while their counterparts in New York do not have such control.

In the UK, the Rules Governing Substantial Acquisitions (the SARs) restrict the rate at which a person can acquire shares in a company in any period of seven days. A cap of 10 per cent of the voting rights is imposed on the acquisition, if such acquisition would result in the acquirer holding the voting rights between 15 per cent and 30 per

47 The Companies Act 1986 ss80 and 80A.
cent in the company. Furthermore, if the acquisition results in the acquirer holding more than 15 per cent of the voting rights or increasing its existing holding by more than 1 per cent, the acquirer must inform the company, the markets, and the Takeover Panel by noon of the day following the acquisition. The law imposes constraints on the controller in the process of his obtaining control – defined as 30 per cent control. Without these rules, other forms of non-legal constraints may still re-act to the controller though it would be difficult for such constraints to operate effectively if the identity of the controller is not known, and the persons exercising the constraint are not aware of the situation and, therefore, unable to organise a collective action.

The legal definition of control depends on the purposes intended by the law. In law, control has been categorised into de jure control, by right or in law, and de facto control, control existing in fact whether legally recognised or not. A person may have a de jure control without de facto control. On the other hand, he may have de facto control without the de jure control. Under the UK Takeover Code control means a holding, or aggregate holdings, or shares carrying 30 per cent or more of the voting rights of a company. This is a form of de jure control since the relevant provisions of the Code apply irrespective of whether the holding gives de facto control over the company or not. Under the Code, persons acting in concert have been defined as persons who, pursuant to an agreement or understanding whether formal or informal, decided to vote in a certain way. A person or persons acting in concert can acquire such control. A different definition of control is to be found in Article 2(1) (d) of the EU Directive on takeover bids. Article 2(1)(d) adopts the concept of concerted

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48 Substantial Acquisition Rules r 1.
49 Substantial Acquisition Rule r 4.

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practice and states that 'persons acting in concert' means natural or legal persons who cooperate with the offeror or the offeree company on the basis of an agreement, either express or tacit, either oral or written, aimed respectively at obtaining control of the offeree company or frustrating the successful outcome of a bid.\textsuperscript{52} This definition catches both \textit{de jure} and \textit{de facto} control.

In group companies, a parent company with subsidiary companies is deemed a single company for the purpose of group accounts. Under section 258 and Schedule 10A\textsuperscript{53} of the Companies Act 1985, a parent-subsidiary relationship is established if any undertaking (the parent) holds a majority of voting rights in another undertaking, or is a member of the other undertaking and has the right to appoint or remove a majority of its board of directors, by virtue of provisions in the constitution of the other undertaking or in a written ‘control contract’, permitted by that constitution, or has a right, recognised by the law under which that undertaking is established, to exercise a ‘dominant influence’ over that undertaking (by giving directions to the directors of the undertaking as to its operating and financial policies with which those directors are obliged to comply whether or not the directions are for the benefit of the undertaking), or is a member of another undertaking and alone controls, pursuant to an agreement with other members, a majority of the voting rights in that undertaking, or has a ‘participating interest’ in another undertaking, that is an interest in its shares which it holds for the purpose of securing a contribution to its (the parent’s) own activities by the exercise of the control or influence arising from that interest) and actually exercises a dominant influence over it or there is a unified management of both

\textsuperscript{52} Takeover Directive Art 2(1)(d).

\textsuperscript{53} Inserted by the Companies Act of 1989. In Taiwan, the definition of 'Control' in relation to Parent-subsidiary under Article 369 of the Company Act is different from the concept of 'control' under Article 4 of the Financial Holding Company Act.
undertakings.

For matters other than financial disclosure, such as prohibited transactions within the parent-subsidiary companies, a different definition applies. Under section 736(1) of the Companies Act 1985, a ‘holding’ company is a company which holds a majority of the voting rights in the subsidiary company, or is a member of the subsidiary company and has the right to appoint or remove a majority of the subsidiary’s board of directors, or is a member of the subsidiary and controls alone, or pursuant to an agreement with other shareholders or members, a majority of the voting rights in it. In addition, the definition includes the situation of a company, which is a subsidiary of another company which is itself a subsidiary of the ‘holding’ company. These definitions under section 258 and section 736 demonstrate how the same concept of ‘corporate control’ can vary according to the relevant legislation and the different purposes to which the definition applies. The reason for not extending the section 258 definition to all purposes is that ‘to apply the whole of the extended definition to other cases would introduce an unreasonable degree of uncertainty.’ These two provisions recognise that what counts is “control” and not majority shareholdings which, in cases such as non-voting shares or weighted voting, will not necessarily afford control.

The examples in this section show that the law lays down provisions that serve the purpose of exercising constraint on the controllers of the company. Legal constraint is, therefore, as essential as any other form of constraint. In the definition of what constitutes control, however, different pieces of legislation and rules in the same, or in different, legal systems adopt different concepts of de iure or de facto control that are,

to a certain extent, arbitrary and dictated by policy decisions rather than the analysis of the underlying economic reality.

**F. DISADVANTAGES OF TAKEOVER**

Takeovers may be seen as a social ‘evil’ because of their impact on the company’s stakeholders. On this analysis, takeovers are generally unfair and harmful to management, shareholders, creditors, and employees of successful companies that are an attractive target. Ultimately, takeovers may cause a loss to societal welfare.

One of the reasons for considering a takeover as a social ‘evil’, a socially undesirable phenomenon, is the method of the takeover. As will be discussed in following chapter, different methods of takeover do not have the same effects on the shareholders, creditors, employees, consumers, and society. The effects on these constituents depend on both the corporate structure and societal structure. The ‘bad’ method of takeover is the hostile takeover. Hostile takeovers are deemed to be ‘ungentlemanly’, as the bidder is able to buy out the target company without an agreement or negotiation with the target company, which results in an unfair process for the controllers of the latter. The post-takeover era will see a board reshuffle that could affect shareholders’ existing dividends and benefits, managerial employment, trade union influence, continuing employment of the workforce, subsidiary companies remaining with the corporate group, consumers’ protection, society’s interests, and government control over the business community.
In a minority-controlled company, the bidder company, with strong capital backings, can make an offer to purchase the shareholdings in the company without entering into negotiation with the minority controlling shareholders, and obtain control of the company without paying the right price, which is the value of the company as a going concern. The arguments against this form of takeover are that the original management, starting off as a family business and flourishing after a long period of successful management, builds up a successful operation with promising business objectives including stable relationships with creditors, contractors in the business community, and with workers, managerial personnel, and shareholders internally. Due to the corporate evolution, the original management retains a small percentage of the shares while continuing to run a stable business operation. The bidder company is able to obtain the control of the company resulting in changing relationships with the shareholders, creditors, managerial personnel, business partners, workforce, community, subsidiary companies, and the government. The original management will be forced out and become ordinary shareholders without direct influence on the company's business. Suppose that the shares of the target company are traded at £1 per share with 100,000 total shareholdings and 10,000 controlling shareholdings. The bidder only needs to spend £10,000 or more to obtain control of the company rather than £100,000 for the total shareholdings. However, had the bidder negotiated with the controller, the price for obtaining such a control could have been higher than £10,000 and more restrictions could have been imposed in the agreement, such as the bidder's undertaking to continue to employ the current managers and workforce, to continue certain contractual obligations with the business partners, and informal commitments to community interests. The bidder in this situation is said not to pay the real price for the control of the company. Therefore, the shareholders, other than those who sold shares to the bidder, are said to suffer a loss by not being offered the
opportunity to tender their shares to the bidder. On the other hand, the shareholders who tendered shares to the bidder are said to have sold their shares at a discount, since through a collective bargain the tendering shareholders could have realised more than the price for which the shares have been sold to the bidder. The bidder company is said to make profits at the expense of the shareholders, expropriating shareholders’ wealth.

Once the board control has been obtained, the board will enjoy the prerogative to initiate certain reforms of the company’s capital structure, such as manipulating the company’s fund, increasing share capitals, removing pre-emptive rights, in order to strengthen control through shareholdings with a view to initiating actions which require majority votes. Through obtaining control of the board, the bidder company is able to direct corporate business. The board has the power to terminate existing contracts, despite the risk of possible lawsuits, and to make new contracts with business partners favoured by the board. Acting upon the instructions of the new controlling shareholders, the board could sell the company’s existing properties considered to be unprofitable or even profitable operations to increase the company’s cash flow. The cash realised may be re-invested in the parent company or for the parent company’s use. With both the control of the board and control of the general meeting through the strong backing of the parent company, ie the bidder company, majority corporate restructuring such as plant closures and redundancy could also be decided. In these circumstances, the target’s capital remains the same as in the pre-takeover era with minor adjustments. The bidder may then decide to break off with the subsidiary by selling out the controlling shares on the market, and in this way releases its connection to the subsidiary company. The bidder would have made gains through such a process, utilising takeover as a means of looting and asset stripping.
The business partners would lose contracts with the overtaken company, employees would be made redundant, creditors would lose their stable earnings from interests on loans, and the remaining shareholders would lose their stable dividends or even their capital in a worst-case scenario. The business may have no choice but to face liquidation or await the opportunity of a rescuing package by a willing bidder either through a friendly merger or a hostile takeover.

Specific problems may arise in relation to changes of control in public utilities companies. The following considerations apply both to the privatisation of state controlled companies and to subsequent takeovers that may result in restructuring and profit-maximising strategies that are not mindful of the public interests involved. Companies providing public utilities such as energy services, telecommunications, transport, are prone to takeovers. Historically, public utility companies have been controlled by the government as the state has a particular interest in maintaining a basic infrastructure for the economy. However, with the growing trend of privatisation, governments started to release shares to the private sectors. Some governments may retain influence by controlling shareholdings, and some release most of the holdings but rely on regulatory authorities to supervise the privatised undertaking. The reason for maintaining government control through regulatory authorities and initiatives is to curb the negative effects resulting from privatisations. A privatised or private utility company is interested in conducting the business operation according to the logic of profit and loss. Therefore, if one operation does not reach the company’s profits target, in the interests of the company, the board may decide to terminate such an operation. Because of the huge capital requirements, it may not be easy to find an alternative service provider. As a consequence, the community may lose essential public services. Through government regulatory systems based on public interest, private business
operation would be supervised to maintain required levels and standards in public services in order to protect consumer welfare. In public utilities companies the very logic of takeover, which is profit maximising and creates instability for the company and its stakeholders, may appear inimical to the public interest.

Arguments have also been put forward against takeovers across different jurisdictions. Cross-boarder takeovers have emerged through the force of globalisation and regional integration such as the European Union and ASEAN. Through a cross-boarder takeover, a company will be able to build up a multi-national company in a short period of time. With a parent company residing in one country and holding subsidiary companies in other countries, the parent company would be able to command the subsidiary companies according to the interests of the parent company in line with the national interests of the country where the parent company is based, at the expense of the national interests of the country in which the subsidiaries reside. There will be greater political intervention and exposure to international conflicts. Internally, a multi-national company is likely to introduce the parent company’s corporate culture to the subsidiary companies having different social and ethic backgrounds from those of the parent company, which will result in an unstable relationship between subsidiary companies and parent company.

G. ADVANTAGES OF TAKEOVER

Trade synergy, a one plus one equals three presumption, is the main drive for mergers
and acquisitions. Under the theory of economies of scale, a merged company will lower the basic costs and increase the profits of the business. A merged company will be able to utilise the resources of the company more effectively. For instance, in a vertical takeover, company A may need an input that could not be efficiently obtained through the market from its manufacturer, and company B manufactures such input. Through the merger of A and B or a takeover of B by A, A will be able to secure the source of supply of the needed input. An example of horizontal takeover will involve two companies which produce essentially the same products or services which compete directly with each other. The merger will reduce the costs derived from over-competitiveness in an industry.

A takeover that does not involve either vertical or horizontal takeovers would form a conglomerate where there are no important common factors between the two or more companies in production, marketing, research and development, or technology. There are specific advantages in conglomerate mergers as well. The parent, or holding company staffed by professional managers exercising management control over a substantial number of subsidiaries in a wide range of industries, would be able to engineer the finance of the conglomerate more effectively.

Any takeover, however, may have an impact on the market from a competition law point of view. This aspect will be scrutinised by the competition authorities. This does not undermine the basic assumption that most vertical, horizontal, and conglomerate mergers are beneficial to the companies and enhance social welfare.

55 M Weinberg & M Blank *Weinberg & Blank on Takeovers and Merges* (Sweet & Maxwell London 1979)1029.
In the era of globalisation and free trade, national markets are open to foreign competitors backed by strong finance and sophisticated operational structures. As a consequence, a consolidated and efficient domestic industry is needed to compete with foreign businesses. This can be achieved through mergers and takeovers. If the domestic industry is not competitive, it faces losing out. From a corporate governance point of view, a losing out firm is prone to looting and asset stripping since the management perceives that the business is going down and may not be interested in rescuing the undertaking. However, a loosing out firm could be an invaluable asset for a company in the same industry or a conglomerate. A merger would thus ensure continuation of business rather than liquidation. In addition, a conglomerate or a group company is less likely to be taken-over by the foreign competitor.

In the several scenarios mentioned above, a takeover can be the most effective way to acquire control of a company either in a particular industry sector or in a particular country. Instead of starting off a business operation afresh, facing the barrier of market entry and risks of failure, it is easier to run and expand an already successful company, as large companies dislike 'greenfield' operations. This can be illustrated by the interplay between the economic and legal dynamics in the area of takeovers in Europe. Since the early Ninety-nineties, companies based outside the EU were anxious to make acquisitions in the EU to obtain a field of operation within the free trade area of the EEC. In order to facilitate takeovers within the EU, in 1996 the Commission presented to the Council and to the European Parliament a new proposal for a Thirteenth Directive on company law concerning takeover bids. The proposal was a 'framework' directive drawn up in the light of consultations with the Member

56 Proposed 13th Directive OJC 162, 6.6.1996, 5; For the explanatory memorandum, see COM (95)655 final.
States and setting out general principles but not attempting detailed harmonisation. In 2000, the Council adopted its common position, and in December 2000, the European Parliament proposed a number of amendments that were not approved by the Council, but later conciliated in June 2001. The Directive, however, did not receive the required majority by the European Parliament in July 2001 for political reasons. The Commission has presented a new proposal for a directive that meets the concerns of the European Parliament without compromising the basic principles approved by the Council in June 2000.\textsuperscript{57} In April 2004, the Directive was adopted. A more detailed analysis of the relevant provisions of the Takeover Directive will be carried out in the following chapters. In the context of this chapter, it is important to underline that the attempts to bring about harmonisation in takeover law by way of European legislation demonstrate the importance attached to trans-border mergers and acquisitions for a successful economy.

Management incentives, such as personal incentives and prestige, are important reasons for takeovers. The success of a takeover may be followed by an increase in salary or benefits to the directors either through shares or share options, hence ensuring management’s diligence in managing the company. On the other hand, bad management will cause depression to the company’s share prices exposing the company to takeover. Therefore, a takeover works as optimal deterrence for the incumbent management. From a market efficiency point of view, a more efficient management replacing the incumbent management will ensure a more efficient allocation of resources. The new management would be able to bring a successful corporate culture to the target company, especially in cross-border takeovers. The

\textsuperscript{57} See the Report by the Group of High-level Company Law Experts, European Commission, Brussels, 10.1.2002.
standards of corporate governance of a successful company can be introduced into the company which has been taken over in the less advanced country together with employment training, technology transfer, job creation, and further community benefits such as primary education.

From a target shareholders' viewpoint, in a takeover shareholders are offered an opportunity to realise their capital with immediate profits by the bidder company making an offer at a premium, ie a price higher than the market price. However, the target company's shareholders may be making a gain at the expenses of the shareholders in the bidder company if the price offered is excessively high. Furthermore, to obtain an immediate gain, the target company's shareholders must receive cash as consideration for the shares rather than shares. For the bidder company, minority shareholders' shareholdings can be further diluted by the acquisition of the target. Therefore, in some countries, a shareholder's resolution may be required in order to proceed with the acquisition.

The advantages of takeovers examined in the present section are such that they outweigh the disadvantages discussed in the previous section. Furthermore, the disadvantages of takeovers can be efficiently dealt with under the models of control of takeovers analyzed in the introduction. It appears that, on balance, takeovers should not be unduly impaired. This means that the protection of minority shareholders should not result in the imposition of undue burdens or costs that would ultimately discourage takeovers. In the protection of minority shareholders, a balance should always be struck between the protection of individual rights and the efficiency of the corporate dynamics.
H. CONCLUSION

‘Corporate control’ can appear in many different forms and the current legal definitions of ‘corporate control’ are insufficient to cover all the situations in corporate transactions in which a person exercises control over another person. As a consequence, the accountability of the controllers that the law attempts to achieve cannot be fully realised. Therefore, when the law attempts to hold the controllers accountable in corporate control transactions, ‘corporate control’ must be examined against the social and economic backgrounds of that particular transaction. This chapter analyzed the meaning of control and constraint in its legal, economic, sociological, and historical dimensions. Corporate control is a power of direction and command. Because of the separation between ownership and control in the company, the concept of control includes the concept of accountability. On the other hand, the power of control can only be understood in the light of the constraints that the controllers of a company face, bearing in mind that the power of constraint can itself become control.

This chapter also analysed the advantages and disadvantages of takeovers. Because the advantages outweigh the disadvantages, the conclusion of the analysis is that minority shareholders’ protection should be balanced against the need to ensure the smoothness and efficiency of the takeover process. However, in order to safeguard the confidence of investors and uphold individuals’ rights, a mature legal system should ensure that in corporate control transactions, minority shareholders’ interests will not be compromised without just compensation.
The following chapter deals with the techniques of takeovers. This is necessary because the forms of the prejudice to minority shareholders and the degree of protection may vary depending on how the takeover is implemented. Therefore, the analysis of the takeover techniques must precede the discussion of the legal protection of minority shareholders.
CHAPTER III

METHODS OF TAKEOVER

A. INTRODUCTION

This chapter analyses the methods of takeover. A takeover affects minority shareholders' interests. However, the effect of a takeover on minority shareholders' interests depends on the takeover technique employed in the specific case. Before addressing the issues of the legitimate expectations of minority shareholders and the levels of protection of their interests in the UK and the US, it is therefore necessary to explain how the different takeover techniques are carried out and how they impact upon minority shareholders.

There are several techniques that enable a person, legal or natural, to obtain corporate control. They include tender offers, share transfer by agreement, statutory schemes of arrangement, and statutory insolvency rescuing packages. Each method can develop into a complex structure that involves different motive and purpose; time scale; types of consideration; parties involved; and could bring different results. The different methods will have an impact on the stakeholders in the company. Each method impacts in a different way on shareholders' rights, creditors' contractual rights and obligations, employees' right to work, and the composition of the board of directors. The different methods of takeover also reveal the nature of corporate control in the
particular corporate structure, whether there is a balance of power or absolute control within the company. This analysis also helps identify the weakness of the market control model in which shareholders in either the offeror company or the target company can be the cost bearer in the takeover.

B. TENDER OFFER

A bidder company, or offeror, willing to obtain control over the target company, or offeree, can make an offer to all the shareholders for the whole or part of their shareholding in the company. If the offeror is already a minority shareholder in the target company, he may only need to make an offer for a small percentage of shares to obtain minority control. On the other hand, a higher percentage may need to be tendered if there has been long-standing family control and the family exercises control both through substantial shareholdings and financial devices that would enable it to initiate a proxy fight. In a company where there is strong state control, for instance because the government retains golden-shares, a tender offer for control may not be the most economical choice.

The consideration for a tender offer can be cash, shares, other financial instruments such as corporate bonds, or a combination of these means. In theory, the offeror may make an offer in relation to the percentage that it wishes to purchase. However, the law may impose conditions on such an offer, which restrict the freedom of contract. For instance, the offeror may make an offer conditional upon him obtaining 90 per cent of the shares in the company as a result of acceptance by shareholders, which, in
the UK, will give the offeror right to purchase the remaining 10 per cent.\(^1\) However, such an offer may be made unconditional at a later stage if the offeror has acquired or agreed to acquire a certain minimum percentage of shareholdings.\(^2\)

As far as the bidder company is concerned, in general, the decision to make an offer rests with the directors without a resolution from the general meeting, unless there are concerns about a possible breach of directors’ duties such as in a conflict of interests situation, which could be pre-ratified by a shareholders’ resolution. The board of the target company may adopt defences to fend off the offer or force the offeror to negotiate with the board of directors, which will then have control of the structure of the offer and the style of the merger. The power to adopt defensive measures can be restricted. In the UK, when an offer has been made or is imminent, the power to adopt defensive measures, except in pursuance to a contract entered into earlier, is subject to approval by the shareholders at the general meeting.\(^3\)

In a cash-for-all offer, the offeror offers to acquire from the shareholders of the target company, at a stated cash price, all the equity shares of the target, except for any already held by or for the offeror and its subsidiaries. Because of the trouble that could be caused by the residual shareholders after the takeover, the offer is generally made conditional upon its acceptance, by a specified date, by the holders of not less than 90 per cent in value of the share to which the offer relates. This is to ensure that the offeror will acquire the right of compulsory purchase of the remaining shares related to the offer. The offeror will, however, reserve the right to declare the offer unconditional notwithstanding the fact that acceptances may relate to a lower

\(^1\) Companies Act 1985 s 430A.  
\(^2\) Takeover Code r. 14.1. See the analysis below.  
\(^3\) Takeover Code r 21.1.
percentage of shares only. Such a right is subject to the condition that the offeror, together with shares acquired before or during the offer, obtains a 50 per cent majority shareholding.

Shares are divided into voting shares and non-voting shares; an offer for non-voting equity share capital may not be made conditional upon any particular level of acceptances unless the offer for the voting share is conditional on the success of the offer for the non-voting share capital. This is to protect the non-voting shareholders' right to receive a control premium together with the voting shareholders. If the offeror offers to acquire more than one class of shares of the target, the offer for each class must be expressed to be a separate offer and the offeror may only exercise its power of compulsory acquisition in respect of each class of shares on a separate basis. Different classes of shares receive different benefits. Non-voting shares receive stable or higher dividends. Voting shares carry the right to cast votes at the general meeting and wider rights of access to corporate information in exchange for higher risks in respect of dividends.

The difference between classes reflects on the need to ensure fair and equal treatment within the class but does not necessarily extend to equal treatment of the different classes. For instance, an offer may be made to acquire all the voting shares at the same price. Once the offeror has acquired voting shares that are more than 90 per cent of the shares to which the offer related, the offeror can acquire the non-voting shares without offering a higher price for them. Shareholders will be treated fairly and equally within the same class but not necessarily across different classes.

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4 Takeover Code r 14.1.
The offeror may decide not to acquire all the shareholdings, but instead to offer to acquire from the shareholders of the target, at a stated cash price, a specified number, but not all, of the voting equity shares of the target not already held by the offeror or its associates. This is also called partial bid.\(^5\) Under the Takeover Code, if the offeror, and persons acting in concert with it, acquire more than 30 per cent of the shareholdings, they are required to make the same offer, that being the highest in the previous twelve months, to all the shareholders in the company. The Takeover Panel, the administering body of the Takeover Code, has been reluctant to allow a partial bid because of its impact on the interests of the minority shareholders. A person who succeeded in a partial bid may be able to exercise effective control over the company. Having obtained a controlling majority, the controller will be able to initiate virtually all the issues to be discussed at the general meeting and secure the necessary resolutions. Even if a proposed course of action requires approval by super-majority vote, the controller could issue a proxy fight that will easily overpower the minority shareholders, who are without a collective voice. Notwithstanding these implications, more recently, the Takeover Code has recognised that, subject to certain safeguards, partial bids are, in general terms, unobjectionable.\(^6\) The Panel is unlikely to give its consent for a partial offer for shares carrying voting rights in the target of more than 30 per cent. However, even if the Panel does give its consent to a partial bid for the target’s equity share amounting to more than 30 per cent, the offeror will be required to make a comparable offer for all classes of the target’s equity share capital.\(^7\) The consent will not be given if the offeror, or persons acting in concert with it, have

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\(^6\) Takeover Code r 36.

\(^7\) Takeover Code r 36.8.
acquired shares in the target either selectively or in significant numbers during the preceding twelve months or at any time after the partial offer was reasonably in contemplation. This is to prevent the bidder obtaining the 30 per cent control defined by the Code, either by itself or with concerted parties, without paying the fair price for such control. Once consent has been given, the offeror, and the persons acting in concert with it, may not, during the offer period, purchase any shares in the target.

To further restrain acquirer’s behaviour in the aftermath of the takeover, after consent has been given, the offeror, and persons acting in concert with it, are barred from making any purchase of the target shares for a twelve months period. All these rules aim to prevent the bidder acquiring control of the company without paying the ‘control premium’ to the shareholders in the company. This may increase the bidder’s costs for corporate control. Therefore, a technique combining a partial bid and the issue of a block of shares is a variation designed to give the offeror a double chance of obtaining control where the board of the target favours the takeover. This technique involves the offeror bidding for 51 per cent of the voting capital of the target. This offer may stipulate a minimum level of acceptance, such as 35 per cent, but is conditional upon the target at the general meeting creating new authorized capital, and authorizing the directors to issue to the offeror shares building up to 51 per cent of the existing issued voting capital. If acceptances are received in respect of at least 51 percent of the issued voting capital of the target, the offeror obtains control. In this instance, shareholders may have reasons for not tendering shares to the offeror, either because the price is too low or because they desire to remain in the company.

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8 Takeover Code r 36.2.
10 Takeover Code r 36.3.
However, this practice would dilute the minority shareholders' influence in the company.

In tender offers, minority shareholders' interests may be affected in two ways. First, they may sell their shares at a price which does not incorporate the control premium. Secondly, if they do not sell their shares, their shareholding may be substantially diluted. Clearly, the internal control model cannot protect minority shareholders' interests efficiently. The market control model is also inapplicable because the minority shareholders' interests are affected exactly because of the free market mechanisms. This section has shown that the regulatory model provides a certain degree of protection. However, it will be argued in the following chapters and in the conclusion that the controllers of the company, including directors and majority shareholders, should be directly liable to minority shareholders if they harm their interests in certain situations.

C. SHARED-FOR-SHARE BID FOR ALL

In this bid, the offeror offers to acquire from the shareholders of the target in exchange for the issue of shares in the offeror all the equity shares of the target, except those already held by or for the offeror. The difference in consideration will also have an impact on the interested constituents in the post-takeover era, especially the minority shareholders. An offer generally is made conditional upon its acceptance by a specified date by the holders of not less than 90 per cent in value of the shares to

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11 For instance, two shares in the offeror company for every one share held in the target.
which the offer relates or such lower percentage as the offeror in its discretion may decide to accept. This is to make sure that control will be obtained. The effect will be that the former shareholders of the target become shareholders of the offeror company, together with the pre-existing shareholders of the offeror company. The target company becomes a wholly-owned subsidiary of the offeror. The result of obtaining control depends not only on the acceptance of the offer, but also on the size of the target. If the offeror is far larger than the target company, the target shareholders will own a lower percentage of shares in the parent company and, therefore, their ability to influence corporate decisions or exercise constraint in the subsidiary, ie the overtaken company, may be significantly diminished. On the other hand, if the target is far larger, the effective control of the offeror may be shared between the former controller of the offeror and the former controllers of the target, or may even pass to the former controllers of the target alone.

In a share for share bid for all, the directors of the offeror company need to obtain the authority either by shareholders resolution or the articles of association to make an issue of the offer capital. Since those shares are issued for the purpose of a takeover bid, shareholders of the offeror company do not have the pre-emption right over those shares under the Companies Act 1985 or the regulations of the London Stock Exchange, the so called Yellow Book. Shareholders of the offeror company are not afforded the protection of an independent valuation of the target shares being acquired. In Park Business Interior v Park, it was held that where there was a valid contract into which the directors had entered in good faith to allot shares the court would not in general investigate the adequacy of the consideration for the shares provided that it

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12 The London Stock Exchange's Yellow Book.
was not manifestly inadequate. The Yellow Book only requires an ordinary resolution, a 50 per cent plus one vote, of the shareholders of the offeror at the general meeting if it is necessary to create more authorised share capital of the offeror for the purpose of a takeover.

The consideration of the offer can be share-plus-share, share-plus-loan stock or shares and/or loan stock with cash option. The offeror will have to consider the relative quoted prices, dividends yield, earnings cover, growth prospects, gearing, security of capital, voting strength, and the net asset values. If the target is far larger than the offeror, then the offeror may not have enough cash or shares to offer to the target shareholders to obtain control. In such a case, the offeror, acting upon the recommendations of its financial advisers, will need to arrive at a suitable balanced solution if the consideration in the form of shares in the offeror company is not enough. The offeror may add cash, loan stock, or loan stock convertible into further ordinary shares, which is loan stock carrying the right at a future date to subscribe for ordinary shares in the offeror company. If the offeror secures a merchant bank to underwrite a large shares and loan stock offer for cash on behalf of the offeror, the offeror will be released from finding the cash as the risk of cash finding shifts to the merchant bank for an ‘underwritten commission’. If they accepted an offer with a mixed consideration, the target shareholders would lose, at least in part, the rights they had before, such as the right to vote, the right to information, and right to participate in general meetings. Instead of voting shares, they receive a pure financial instrument which does not carry with it the means to exercise the power of control.

If the offeror wishes to issue rights as part of the offer, the approval of the independent shareholders of the offeror is needed. This is because once the rights
holder exercises the rights to purchase the shares of the offeror, this would have the effect of diluting existing shareholders' pro rata share of equity without those rights being first offered to the existing shareholders. The underwriter which holds more than 30 per cent of the shares will need the Takeover Panel's dispensation to avoid making a mandatory offer under Rule 9 of the Code.

The risks for minority shareholders if this technique is employed are the same as in a tender offer with the difference that the shareholders affected may be those of the offeror or the offeree company, or of both companies.

D. REVERSE BID

The reverse bid is normally used when the boards of the target and offeror companies agree on the terms of a merger or a takeover, the offeror company is an unlisted company, and there are disagreements within the shareholders of the two companies. In a reverse bid, the target at the instigation of the controllers of the offeror makes a share-for-share bid for the whole of the equity capital of the offeror company, for instance five shares in the target company for one share in the offeror company. Once the bid is accepted by 90 per cent of shareholders of each class, it will trigger the target's right of compulsory acquisition of any outstanding minority shares. The effect is that the former shareholders of the offeror company will end up as the majority shareholders in the enlarged target company and the pre-existing shareholders of the target will hold minority interests in the enlarged target company.
The offeror will become a wholly-owned subsidiary of the target. It is said that such a method can be frustrated by shareholders’ action as the shareholders may prefer not to tender their shares in response to such an offer. If the offer was not accepted by 90 per cent of shareholders in each class, shareholders of the offeror could remain as a majority in the offeror company, which defeats the purpose of the takeover. Therefore, in the valuation of the share prices, it is generally necessary to pitch a bid at a level that slightly favours the ‘offered’ shareholders, the offeror shareholders in this instance, in order to secure 90 per cent acceptances. This may be a disadvantage to the shareholders of the target company.

E. OFFER BY THE NEW COMPANY

In this takeover technique, a new company is created for the purpose of the takeover. The new company addresses the shareholders of the offeror and the target, respectively, an offer to acquire, in exchange for the issue of shares in the new company, all the issued equity shares of the offeror and the target. The offer will be made conditional upon its acceptance by a specified date by at least 90 per cent shareholdings of each class of the target company and is further conditional upon the offer of the other offeree company, the real offeror company, becoming unconditional. To avoid a situation where a new company becomes a subsidiary company of either company, the offer will not be made unconditional unless the new company has acquired voting control of both the offeror and the target. Once the new company has acquired 90 per cent of the shares in value of each class, it will be able to exercise the right of compulsory acquisitions of the remaining shares in both the offeror and target
companies. Both companies will then become wholly-owned subsidiaries of the new company, which is the holding company. If the new company failed to exercise the right of compulsory acquisition, the remaining shareholders in both companies may compel the company to purchase their shares if they do not wish to become minority shareholders in their companies. The court’s approval is not required, but an action may be brought to restrain compulsory acquisition, or in connection with the price payable to the remaining shareholders, if the new company does not wish to exercise such a right. This method was used in the Air France and KLM merger in 2003. A holding company was created to purchase the shares of the two companies. After the merger, Air France shareholders owned 81 per cent of the combined holding company, which owned 49 per cent of KLM. The remaining 51 per cent shareholding of KLM was to be owned by two Dutch trusts and the Dutch government for three years from the date of merger. The KLM shareholders were being offered a 40 per cent premium on the share price. These arrangements ensured that former KLM shareholders would still retain control of the company for a period of time before the company becomes a majority-owned subsidiary by Air France.

F. OFFER BY SUBSIDIARY OR ASSOCIATED COMPANY

A holding company may have a number of unwanted shareholders or directors who do not enjoy the controller’s approval or support. The controller may instigate a subsidiary to make an offer to the holding company in order to remove these shareholders and the directors on the board. The offer may be structured so as take

14 ‘Open skies and flights of fancy’ The Economist October 4th 2003 79.
advantage of the compulsory acquisition provisions by offering to purchase total share capital at a low price as the controller may tender the 90 per cent shares already owned to the subsidiary, to make a ‘hollow sham’\textsuperscript{15} takeover at the expenses of the minority shareholders in the parent company. Therefore, by virtue of section 430E of the Companies Act 1985, shares already owned at the date of the offer by the offeror or a subsidiary of the offeror are to be disregarded in calculating the requisite 90 per cent in value. The definition of ‘association’ becomes significant because whether the controller’s shareholding is disregarded will depend on how much influence and control the controller enjoys on the parent company.

G. MANAGEMENT BUY-OUT

Management Buy-outs (‘MBOs’) occur when a group of managers of a company, through the backing of a group of financial bankers and after buying a ready-formed ‘off-the-shelf’ company or incorporating a new company which makes the offer, purchase a significant shares in the company with which they are involved.\textsuperscript{16} The newly incorporated company or the ready formed company will address the shareholders in the target company, in which the managers are involved, an offer to purchase the shares, perhaps conditional upon acceptances by 90 per cent of the shares to which the offer relates. The shares in the new company will be owned by the management group, usually the executive directors of the company, and by a small group of investing institutions. The MBO company may exercise the right of

\textsuperscript{15} See Re Burgle Press Ltd [1961] Ch270 CA 288.
compulsory acquisition to have the target wholly-owned by the MBO company. The target company will be de-listed by the MBO company. The controllers normally inform those members of the board who did not participate in the MBO of their intentions. Those board members then form an independent committee and obtain independent advice from an adviser newly brought in to assess the MBO proposal.

H. PRIVATE SALE OF SHARES

Controlling shareholdings can be obtained through private sale or through share purchasing on the stock markets without making a public offer. The offeror, by agreement, can request the target company to issue its shares to the offeror, which will then obtain control of the target. The offeror can purchase the whole or part of the total shareholding for different types of considerations such as cash, shares, bonds, or any combinations of those, or any other financial instruments such as options and futures. The offeror may obtain shares through private negotiation with different individual shareholders. Once the offeror has secured enough votes attaching to the shares, the offeror will be able to secure the appointment of its own nominees as directors in place of the existing directors or some of them, subject to legal constraints in the articles of association or the company’s bylaws. However, if the offeror does not acquire shares constituting sufficient control, the offeror will not be able to obtain the replacement of the existing board. Therefore, the offeror will need to co-operate with the existing board to appoint its nominees or use proxy mechanism to pass an ordinary resolution in a general meeting for the reconstitution of the board. Although the transaction is through a private sale, the purchase of a large enough block of
shares may in some cases be regarded as an offer for the target as a whole and not simply as the purchase of a block by private deal,\textsuperscript{17} especially where the purchases are not strictly confined to purchases made from controllers. If the transaction triggers the mandatory offer requirements under the Takeover Code, the offeror would need to make an offer to the remaining shareholders other than the shareholders with whom the offeror privately negotiated. This restriction will be relaxed if either the acquisition immediately proceeds and is conditional upon the person acquiring the shares announcing a firm intention to make an offer, which is publicly recommended by the board of the target to the shareholders, or the acquisition is made with the agreement of the board of the target. If the person making the acquisition has already announced a firm intention to make an offer for the target, which has been recommended by the board of the target, the restriction will also be relaxed.

Private sale or purchase through the stock markets poses a risk to existing shareholders of being locked in as minority shareholders in the target company. On the other hand, once the existing board has been made aware of the offeror’s intention, in order to protect their own position in the company they may also purchase shares in the market, with the effect of increasing the cost of obtaining control and making the calculation as to the percentage of shares required for control more difficult to the offeror.

The private deal between the offeror and the target shareholders can be to acquire a block of shares form the existing controllers of the target by a share-for-share acquisition. The offeror then uses the block of shares carrying actual and effective

\textsuperscript{17} See the Panel Statement of November 17, 1988, on Irish Distillers Group Plc, where it was held that the actions of Pernod Richard in seeking irrevocable undertaking from directors of Irish Distillers.
control of the target to secure the appointment of its own nominees as directors. The problem which arises here is that the controllers of the target may owe a fiduciary duty to the company while negotiating the private deal with the offeror. Furthermore, the controllers of the target may be in a conflict of interest.

I. ACQUISITION OF MINORITY-HELD SHARES OF A SUBSIDIARY

Acquisition of minority-held shares of a subsidiary can be effected by private negotiation or a tender offer. However, if the parent company has sufficient control over the subsidiary, the parent company may be in potential conflict of interest. The company may be able to reduce the capital by making a repayment to the shareholders. This will normally require a shareholders’ resolution or the alteration of the articles of association.

The articles of association may empower the directors or the holders of a certain class or prescribed majority of shares to require certain shareholders, such as minority shareholders, to sell their shares at a price fixed by, or determined by, a procedure laid down in the articles. In *Sidebottom v Kershaw, Leese & Co*, the court held that a company is allowed by special resolution to insert such a provision into its existing articles of association, provided the alteration is made *bona fide* for the benefit of the company as a whole. Therefore, even if the offeror did not receive acceptances of

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19 It was also held in *Shuttleworth v Cox Bros & Co* [1972] 1 KB 9, 24 CA, that this is a subjective test provided the conduct is not such that no reasonable man could so regard.
90 per cent of the shares, which gives rise to the right of compulsory acquisition, provided the offeror controls enough votes to pass a resolution by special majority to insert such a clause in the articles of association, the offeror will be entitled to require the minority shareholders to sell these shares to the offeror, the majority holder, at a fair price.\(^{20}\) Once the offeror acquires control of the management, it is not difficult for it to represent that the alteration of the articles is for the benefit of the company. As Berle and Means point out ‘if put to their trumps, a management can usually make a showing of ‘business exigency’; and if it is far-seeing, it can set the stage to indicate such business exigency long in advance.’ To insert a compulsory clause in order to buy-out the remaining shares requires the offeror to act bona fide in the interests of the company. However, if the offeror wishes to rely on the statutory buy-out provisions, the related offer must receive a very high percentage of acceptance.

### J. SHARE BUY-BACK

Share buy-back is not a takeover technique but a defence technique against a hostile takeover. Since 1981, companies in the UK have been able to purchase their own shares and to issue redeemable equity shares, a privilege that American and most continental companies have enjoyed for many years. Until 1981, this practice was illegal in the UK on the grounds that it would amount to a reduction in capital. Under the Companies Act 1985, the repurchase of shares must be authorized by the company’s articles of association and the terms on which specific purchase of shares

can be made must be approved by the company in a general meeting, by a 50 per cent majority of votes for a 'market purchase' and by a 75 per cent majority of votes for an 'off-market purchase'. Share buy-back must be financed out of distributable profits, or out of the proceeds of a fresh issue made for the purpose. The shares redeemed or repurchased must be cancelled and cannot be reissued. Companies are required to establish a non-distributable capital redemption reserve by transferring from their distributable reserves an amount equal to the nominal value of the amount of share capital repurchased. This is to protect the creditors' position from being prejudiced by such a reduction.

K. SCHEMES OF ARRANGEMENT

It is possible to acquire control over a target company's control through the statutory scheme of arrangement under sections 425 – 427 of the Companies Act 1985. This is a private negotiation which, however, must be sanctioned and is administered by the court. The shares in the target company will be cancelled. In return, the shareholders in the target company will receive shares issued by the offeror as compensation for their shares. A reserve is created in the target company by the cancellation of the shares and all shares that are capitalised and applied in paying up further shares in the target which are issued to the offeror in lieu of those cancelled. The result is the same as in the share-for-share bid takeover by the offeror for all outstanding capital of the target, with the exercise of the right of compulsory acquisition. The former shareholders of the target become shareholders of the offeror

21 Companies Act 1985 s 425 (6).
together with the pre-existing shareholders in the offeror. The target will become a wholly-owned subsidiary of the offeror. In this method, the offeror will be able to save the stamp duty to be paid in the share-for-share transfer. However, this practice has its legal restraints such as the approval of the offer by the target by special resolution, and the sanction of the court, which is needed to carry out this arrangement.\(^2^2\)

In addition to share acquisitions, the offeror can acquire the undertaking of the target through the scheme of arrangement. The target transfers all or part of its assets or liabilities to the offeror by means of a simple vesting order. In return, the offeror will issue shares to the shareholders of the target as compensation for the assets and liabilities transferred. If the target is without further assets or liabilities, the company will be dissolved. This is a share-for-asset takeover by the offeror. The final result is the same as if the target company had transferred its undertaking to the offeror in consideration of the issue of its shares in the offeror. The undertaking of the target becomes vested directly in the offeror. The target does not become the wholly-owned subsidiary of the offeror as the target will be a shell-company without assets and liabilities and it will be dissolved. A majority of the three-fourths of the value of the voting shares in each class of shareholders of the target is needed to carry out the arrangement, hence a lower threshold than that required for the alteration of the articles of association. The right given to the dissenting shareholders under the Insolvency Act 1986 can be avoided. The offeror will not be confronted with the obligation of mandatory offer required by Rule 9 of the Takeover Code. The speed and comparative certainty of timetable associated with procedure under section 425 of the Companies Act 1985 will apply. The offeror will save a great deal of labour and expenses in carrying out the normal formalities. However, the procedure will be

\(^{22}\) Companies Act 1985 s 425.
A new company can be set up for the purpose of acquiring the shares or the undertakings of both the offeror and the target. As discussed in section E, the new company can acquire the shares in the offeror and the target companies thus becoming the holding company of the two. Alternatively, the new company, set up by the offeror, can acquire the undertakings of the offeror and the target. In return, the shareholders of the two companies will receive shares issued by the new company as compensation.

A scheme of arrangement has an impact on minority shareholders in that it may include a proposal for an agreement between the target, which will be controlled by the offeror, and its members, the minority shareholders, for cancelling the minority-held shares in return for the shares of the offeror company. In this way, stamp duty can be saved. However, the minority shareholders in the target will be regarded as a separate class of shareholders for the purpose of the scheme of arrangement under the Act, so that the arrangement would require the approval of a majority in number of the shareholders holding three-fourths in value of the minority-held shares.

The discussion of the court’s role and the protection afforded to minority shareholders will be conducted in more detail in chapter 4.
L. RECONSTRUCTION AND AMALGAMATION UNDER THE
INSOLVENCY ACT 1986

Under this takeover technique, both the offeror and target companies are placed in voluntary liquidation with the passing of special resolutions of the shareholders. The liquidators authorised by the special resolutions of the two companies will be able to accept shares in a new company as consideration for the sale of the undertaking of the two companies in accordance with their rights on a winding up. This does not involve an application to the court for confirmation nor does it afford dissenting shareholders a statutory right to apply to the court. The disadvantage is that the dissenting shareholder may require the liquidator to abstain from carrying the special resolution into effect or to purchase his interest at a price to be determined by agreement or by arbitration.

M. CONCLUSION

The analysis in this chapter focused on the methods of takeover. There are several methods for obtaining corporate control, and hostile takeovers are only one of the ways to achieve such a purpose. Even in a takeover bid, there may be different techniques depending on how the offer is structured. Relevant factors are the percentage of the shares that the offeror offers to purchase, the considerations to be

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23 Insolvency Act 1986 s 110 (6).
24 *Griffith v Oagat* (1855) 5 ChD984.
received by the target shareholders, the size of the offeror and the offeree, and whether the takeover if in a form that requires the intervention of the court.

Minority shareholders of the target company may be affected in a takeover situation through dilution of their shareholdings. As a consequence of such a dilution, the constraint exercised by non-controlling shareholders over the controlled is diminished in the post-takeover scenario. It is also possible that shareholders tendering their shares are not paid a price which incorporates the appropriate control premium. On the other hand, the decisional powers of the minority shareholders in the takeover process may be very limited. Often, their only choice is whether or not to tender their shares and this decision is influenced by the information that the controllers of the offeror and the offeree make available to them.

This chapter has shown that the market control model alone does not provide minority shareholders with adequate protection in takeovers. The internal model does provide an answer to some of the problems by requiring shareholders’ approval for certain action by the directors to be taken or for certain transactions to be carried out. However, in many situations minority shareholders do not have a real say on the takeover and, even if a resolution is required, the majority rule means that minority shareholders are likely to be outvoted. The regulatory control model is largely applied and the UK Takeover Code is an illustrious example. However, it still falls short of granting minority shareholders a remedy that can be administered at their behest if their interests are unjustly compromised. This would respond to the logic of the private action model. The analysis in this thesis will show that the private action model is undeveloped in England. It is, however, well developed in the US and delivers good results in terms of safeguarding shareholders rights. Before analyzing
the law in England and then comparing it with US federal and State law, a further question must be clarified. What is the basis on which it is possible to claim that minority shareholders should have a right to a remedy in situations where their interests have been unjustly or unfairly compromised? This is the subject of the next chapter on minority shareholders’ legitimate expectations.
MINORITY SHAREHOLDERS’ LEGITIMATE EXPECTATIONS IN TAKEOVERS

A. INTRODUCTION

In this chapter, the intention is to discuss the social, political, and economic expectations of minority shareholders in a modern democratic society in the context of takeovers. The legitimate expectations of minority shareholders are rooted in their being capital providers. As such, minority shareholders have certain rights that are the immediate consequence of their being capital providers, namely the right to capital, to right to dividends, the right to vote, and the right to supervise. This is the basis for the shareholders’ expectation that their rights will be protected. However, in the company, the majority rule may limit shareholders’ rights. The focus of the shareholders’ expectations shifts from the substance to the process. The third dimension is the standing of the shareholders to bring proceedings to enforce their rights. The analysis will demonstrate that in the current corporate structure shareholders have an expectation that certain fundamental interests will be protected as of right and that it will be possible for them to bring proceedings when: 1) their rights have been violated; 2) the democratic deliberative process is flawed. The theory of corporate social responsibility provides support to the idea that minority shareholders interest should be protected and shareholders’ activism should not be discouraged.
This chapter analyzes the rights of the shareholders that derive from the right to capital. It then discusses the models of deliberative and aggressive democracy as applied to the corporate structure. It illustrates the model of corporate democracy by examining the application of the democratic model in the context of the approval of the merger plans and defensive measures. The chapter then examines the appraisal right and the rights to fair and equal treatment. The expectation that where their rights have been violated shareholders will have standing to bring proceedings to enforce their rights or obtain redress is then discussed. While shareholders' expectations are mainly based on the shareholders being capital providers, this chapter also explains that the same conclusion is warranted under the theory of the company as a nexus of contracts. Finally, the implications of the theory of corporate social responsibility for shareholders' expectations are analysed and conclusions are drawn. The remainder of this introduction deals with the concept of 'minority' in the context of the analysis in this chapter.

When addressing the issue of minority shareholders' expectations, it is important to understand the origins of the debate. To this end, it is useful to analyse the term 'minority' and its ideological connotation. The term 'minority' refers to persons that are marginalised in the decision-making or negotiating process, and are likely to face abuses by the majority. This is the basis for the protection afforded to minorities in a democratic society whatever the distinctive features of the minority may be, whether disability, wealth, race, sexual orientation, and other social disadvantages. Traditionally, ethics have been the reason for protecting minorities as well as, in more recent times, fairness, equality, and social justice.
Modern thinkers advocate for a fair society that will bring prosperity to all. Cultural and social backgrounds determine the degree and extent of the protection of the minorities as certain social disadvantages may not be regarded as legitimate while others are considered justified. Therefore, the issue of the protection of the minority can be an ideological fight rather than an economic debate. Even in democracy, the majority rule is the cornerstone of the decision-making process. This has the effect of forcing the minority to accept the outcomes of the process without other considerations. However, in a developed democracy, there will be safeguards against the persecution of the minority by a majority acting through the democratic process, for instance in the case of the expulsion of the minority from their territory or expropriation of the minority's property. For drastic action to be taken lawfully against a minority, there must be very strong reasons, reasonable or unreasonable in the eyes of natural law, such as national security, in the case of expulsion of a minority, or economic planning policy, in the case of expropriation of proprietary rights, and often additional safeguards such as due process or just compensation for expropriation of property. Otherwise, the society is said to be under the dictatorship of the majority, which would be able to shift resources, to which the minority is entitled, from the minority to the majority. In the corporate world, minorities could be workers, creditors, shareholders, or other stakeholders in the company.

The overview of the reasons and mechanisms for the protection of minorities in modern democratic societies casts light on the issue of protection of minority shareholders. In this analysis, minority shareholders should be protected as long as they are a minority, i.e. in the position of the minority with the connotation of being powerlessly marginalised. A minority shareholder, by definition a shareholder holding less than 50 per cent of the share capital in a company, may be the controller of the
company. The minority controller may fall within the ambit of ‘minority’ in the social context only if he is unable to exercise the power of control because of the constraint exercised by the other shareholders, whose collective action is sufficient to override the decision of the minority shareholders and dictate the directions of the management of the company. However, what is crucial is that the term ‘minority shareholders’ must be understood, for the purpose of the analysis undertaken in this chapter, as those shareholders who are without control.

**B. RIGHTS OF MINORITY SHAREHOLDERS**

1. Right to Capital

A shareholder, contributing capital to a company, has a share in the company. Upon specific events taking place, either dissolution or selling, the shareholder will be entitled to the return of the capital.¹ This notion derives from the law of partnership, where a partner is entitled to his capital at any time. The reason the shareholders cannot demand the capital in a company at any time is the legal innovation of the legal personality of a company. In a partnership, a partner with less capital enjoys the same right and control over the partnership as a partner who made a greater capital contribution. In a company with a few individual shareholders, such as a closely held company, shareholders may demand the return of the capital subject to finding a buyer and the controller willingness to register the shares. Even if there are grounds that

¹ WA Klein and JC Coffee *Business Organisation and Finance* (5th edn NY Foundation Press Westbury 1993) 8, 45,218, as members are the company’s ‘residual claimants’.
could justify the winding up of the company, the shareholder is not at freedom to ask for the winding up without further qualifications.

If the company’s shares are traded on stock exchanges, shareholders will be free to demand their capital through the market mechanism. In a partnership, a partner is entitled to the return of the capital, while in a closely held company and in a listed company the shareholder is only entitled to sell his shares in return for the capital. Even in a closely held company, the shareholder’s right to sell could be subject to other qualifications such as the approval of the general meeting. However, in listed companies, the right to sell is protected to maintain the market mechanism. The right to sell is essential to maintain market liquidity, without which a stock market could not function properly. In a partnership, the right to capital is a proprietary right, whereas the same right in a closely held company is a contract-oriented one. In a listed company, the right is beyond the consideration of the two parties, the company and the shareholder, instead it serves the public interest of maintaining market liquidity. The right to capital in a company cannot be exercised by demanding the company to return the capital to its shareholders either by way of share buy-back or compensation. The right to demand the capital from the company is subject to other legal restrictions, such as the provision of a buy-back right.

2. Right to Dividends

The shareholders’ right to dividends from the company’s profits is a derivative benefit

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of the shareholdings. The lender, though as a capital provider, is not entitled to the profits made by the company as a matter of proprietary right. In a partnership, a partner, as a capital provider, is entitled to the profits upon resolution. A shareholder in a closely held company is also entitled to profits and revenues generated by the company in proportion to their shareholdings. In a listed company, the shareholder is entitled to the dividends subject to the controller’s decision. Therefore, the right to dividends is not as absolute as the right to capital. The exercise of the right to capital may in some circumstances be a remedy to the denial of the right to dividends. Other capital providers such as lenders who will take the position as creditors, and the physical capital providers such as employees whose interests are not considered part of the stake of a company, are not entitled to a share in the profits of the company. Lenders and workers receive returns for their capital on a periodic basis regardless of whether the company is making profits or not. However, the shareholders’ right to dividends will be subject to the company’s profits and loss balance. Shareholders in some cases may be able to receive dividends regardless of whether the company is making a profit or not. In this situation, shareholders generally compromise other benefits in return for receiving a guaranteed dividend such as giving up the right to vote.

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3. Right to Vote

(a) The Structure of the Right to Vote

The right to vote derives from the right to capital and can be bargained for other benefits, such as a guaranteed dividend. Whether the lender or the worker has such a right, depends on different considerations. On a proprietary basis, both types of capital providers are said to be the stakeholders of the company, hence they should be entitled to the management of the company. However, even in continental European countries where companies have a workers’ participation programme in place, worker’s unions and financial institutions have limited involvement in the management, generally in the form of representation on a supervisory committee. Workers are never entitled to attend and vote at the general meetings in the same way as the shareholders are. Even the leading financial institutions do not have votes according to the capital provided to the company. Instead, the lender’s right to vote at the board or at the supervisory board is based on a contractual arrangement. The same considerations apply to the workers’ position as participants in the company’s affairs.

A shareholder’s right to vote can be exchanged for a guaranteed dividend. On the other hand, a shareholder may be entitled to a multiple vote by holding shares belonging in a particular class and which are sold at a higher price or receive lower dividends. Shareholders do not have the right to vote at board meetings but they use the vote to elect directors representing their interest on the board. The directors exercise their duties and powers of management for the benefit of the company.\(^5\) It is

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\(^{1}\) Companies (Tables A to F) Regulations 1985, SI 1985/805, Table A, (hereinafter Table A) m art 70; JE Parkinson Corporate Power and Responsibility: Issues in the Theory of Company Law (Clarendon
important to underline that because of the legal innovation of corporate personality, directors elected by the shareholders do not exercise control on behalf of shareholders, but for the company as a whole. Directors are the agents of the company not of the shareholders. Therefore, while the shareholders elect the members of the board in exercise of direct democracy, the democratic model fails in that the board is not accountable to the shareholders as in law the directors owe duty to the company rather than the shareholders themselves.

(b) Appointment of Directors and Supervision

Directors, either elected or appointed by the shareholders, control the daily business of the company. Directors may represent a particular institution holding blocks of shares such as a bank or a family business. However, in a widely share-dispersed company, directors may not represent a particular group or family. They simply represent the shareholders as a whole.

Directors are seen as agents for the company or the shareholders. Although the Companies Act 1985 does not define the term ‘director’, there are a number of provisions in the Act expressing the meaning of director, including ‘any person occupying the position of director by whatever name called’, someone who acts as a director but is not actually appointed as such, that is a de facto as opposed to a de jure director, or a shadow director, who is a person in accordance with whose directions or instructions the directors of a company are accustomed to act. Director is an agent

6 Companies Act 1985 s 74(1). This means persons described as governors or managers rather than as directors, but performing the same function.
8 Companies Act 1985 s 741(2). A person is not a shadow director simply because the director acts on
of the company but is rather more than that as in practice he is not subject to much control by his principal, ie the company acting through the shareholders in general meetings.

The relationship between shareholders and the directors is not that of owner and servant. Shareholders may be unable to supervise the directors both through the general meeting and by bringing actions in the courts. Although shareholders have the power of removing directors from the board, in practice, it is difficult to organise such an action, and even if shareholders succeed in removing the directors, the directors may not necessarily suffer any detriment as a result. Without effective supervision, directors have unfettered powers in running the company. This may cause higher costs for the company.

When control or constraint is not effective, agency costs arise. The director may be an agent, trustee, or employee of the company, and the cost that arises through those positions can also be termed as agency costs. Shareholders may remove the directors from the board upon securing an ordinary resolution by a majority of 50 per cent of the votes plus one. However, the director may claim compensation from the company for breach of the service contract. The compensation is a form of agency cost. On the other hand, a tighter constraint on the directors could limit what directors can actually achieve, hence also increase the agency cost. This is why the court has refused to allow the general meeting to take the conduct of the business out of the directors' hands, or to compel them to adopt a particular line of action, such as sealing a draft deed or effecting a sale of the company's property⁹, or discontinuing legal

the advice given by him. Shadow director does not include holding company.

⁹ Automatic Self-Cleansing Filter Co v Cunninghame [1906] 2 Ch 34 (CA); Gramophone and
proceedings commenced in the name of the company on the instructions of the board\textsuperscript{10}, or to interfere in the exercise of the directors' power to appoint a managing director.\textsuperscript{11} The more controversial issues regarding agency cost include the director's decision to adopt defensive measures in takeovers, management buy-out, and a director's refusal to pursue an action in the name of the company against another director.

C. MAJORITY RULE

In a company, the democratic majority rule principle can be analysed on a proprietary and contractual basis. The majority shareholders provide more capital than the minority shareholders, therefore, on the proprietary basis the majority can legitimately decide the issues according to this principle. On a contractual basis, the minority shareholders contract with the organisation to be bound by a contract of which the majority rule is a term. The problem is whether the majority rule can be used to exclude the right to capital, the right to vote, the right to dividends, and the supervision of the management. In some instances, minority shareholders can be on an equal footing with the majority shareholders without violating the majority principle. Shareholders may be given a cumulative voting right in order to secure a representation at the board that they could not have achieved otherwise. In modern company law, the majority rule cannot be used to forfeit minority shareholders shares,

\begin{footnotesize}
\textsuperscript{10} Typewriter v Stanely [1908] 2 KB 89, 105 (CA); Salmon v Quin & Axtens Ltd [1906] AC 442 (HL) \\
\textsuperscript{11} John Shaw & Sons (Salford) Ltd v Shaw [1935] 2 KB 113 (CA); Scott v Scott [1943] 1 All ER 582 (CA); cf Marshall's Valve Gear Co v Manning, Wardle & Co [1909] 1 Ch 267, as said could be the case for upholding shareholders right to commence proceedings when the board refuses to do so. \\
\textsuperscript{12} Thomas Logan v Davis (1911) 104 LT 914, 105 LT 419.
\end{footnotesize}
or expropriate their shares without just compensation. Therefore, the areas where the majority rule does not determine the outcome can be regarded as the fundamental structure of a democratic company. There are two points to be borne in mind in this respect: first, issues which cannot be decided by majority may not necessarily require unanimous approval; secondly, the basic structure may be modified by a democratic process. For instance, pre-emptive rights can be removed by a super-majority vote.

The legitimacy of the majority rule has been questioned on the ground of the coercive effect of majoritarian rule. Constitutional theorists have been asking the question as to whether the majority should be able, apparently by strength of numbers alone, to trump the will of the minority legitimately. According to a line of argument, the majority rule is coercion: it is, no less than dictatorship or oligarchy, rule by the will of some over the will of others. The only difference is that the rulers in a majoritarian system outnumber the ruled. In what sense can this be called a democracy? This is the majoritarian difficulty. Suppose that democratic legitimacy relied at least in part upon a conception of ‘political equality’, by which each citizen has an equal chance to influence policy. In this sense, political equality is defeated by the majority rule as members of minorities by definition have no influence on policy while members of majorities by definition have decisive influence.

Contemporary theorists of deliberative democracy suggest a possible solution to the majoritarian difficulty. The theory suggests that the majority rule becomes

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politically legitimate when it is the product of rational deliberation among political equals on grounds acceptable to all the participants. Those acceptable grounds can be established democratic values such as fairness, equality, and respect. When these conditions are met, the majority rule is not simply a means of imposing majority beliefs or preferences upon the dissenting members of the minority. On a deliberative democratic view, the procedural features of free and equal participation in political decision-making, and of justification of decisions by reference to mutually acceptable grounds, transform a majority decision into a decision of which every member of the community is the decision-maker. Deliberative democracy, as opposed to aggressive democracy, emphasises collective reasoning as the basis for a common decision; it requires action to be based on good-faith beliefs about the common good and relies on the possibility that participants’ existing views may change as a result of discussion.\textsuperscript{14}

\textit{Aggressive democracy} emphasises atomised voting to reach decisions; it permits, and even assumes, action based solely on the participants’ self-interest and discounts the possibility that pre-existing preferences might change. Deliberative decision-making leads to legitimate political decisions proceeding from public discussion among citizens based on mutually acceptable grounds. Only on a deliberative conception can a political decision that arises from disagreement, and binds members of a dissenting minority, be considered truly collective and thus legitimately coercive.

The implications of this discussion for minority shareholders’ protection are that the majority rule in a company should become closer to a model of deliberative rather than aggressive democracy. Therefore, control over the process is as important as

control over the outcome. Furthermore, the accountability of the majority as controller of the company to the minority is a vital part in a model of deliberative democracy where all the players participate in good faith and on equal footing, although with different strength due to the operation of majority rule, in the decision making process affecting the interests of all.

D. APPROVAL OF THE MERGER PLAN

The board of directors has the power to decide whether a merger plan should go ahead. Shareholders may play a role in the process by removing the directors from the board or outvoting the merger plan. Shareholders’ action, however, is generally unlikely to succeed in changing the plan of the merger as it takes time for shareholders to organise the action. Under the market control theory, this does not cause any problem since it is believed that shareholders can express their opinions by either withholding or tendering their shares to the offeror. However, problems do arise because the shareholders can find themselves trapped in the prisoner dilemma or there may be coercion\(^\text{15}\) manifested in market control defects. If companies A and B decide to merge into a new holding company which will result in company A being the majority shareholder of the new company, B’s shareholders do not have a say on whether B’s board should agree with the merger plan. If an ordinary resolution is required by B’s company in order to proceed with the deal, it would create more hurdles in the negotiations. A company may need to increase the offer in order to persuade the

\(^{15}\) M Lipton ‘Corporate Governance in the Age of Finance Corporatism’ 136 U PaLRev 1, 18-20 (1987); V Brudney and M Chirelstein ‘Restatement of Corporate Freezeouts’ 87 Yale LJ 1354, 1359-65 (1978); See also Brudney and Chirelstein ‘Fair Shares in Corporate Mergers’ 88 HarvLRev 297 (1974).
majority shareholders to tender the shares rather than simply rely on the support of the board, who may not be acting in the best interest of the shareholders.

**E. DEFENSIVE MEASURES**

In a hostile takeover, the board of directors may decide to adopt defensive measures to fend off the bid either for the good of the company or for their own entrenchment. Even if the majority shareholders decide to accept the offer to realise the value of their capital, due to the board’s action, they could be prevented from doing so. In this sense, the shareholders are said to have been deprived of their opportunity to obtain the capital and profits of the company.

**F. APPRAISAL RIGHT**

The appraisal right is a right entitling the shareholders to demand that the company purchases the shares at a price determined by the court.\(^\text{16}\) The right can arise when the shareholders do not agree on the merger plan. If companies A and B negotiate an agreement to form a new company X, the shareholders disagreeing with the agreement may, before or after the merger, demand that the new company purchases their shares. Generally, appraisal rights are limited to cases of closely held companies.

\(^{16}\) There are other possible definitions and explanations of appraisal rights. However, the definition given in the text will be assumed as the basis for further discussion in this chapter.
If the shares are listed on the national stock exchanges, such rights may not apply as it is considered that a remedy awarded by the court is not appropriate if the market mechanisms work effectively.\textsuperscript{17} If the shareholders have the right to vote on the approval of the merger plan, the appraisal right may be seen as a remedy for the remaining shareholders. In the above example of a takeover by a new company, some of B's shareholders may decide not to accept the offer. As a result, they become the minority shareholders of the de-listed company B owned by the holding company X, which is a listed company. B's shareholders may demand that company B, controlled by C, purchases the shares as a going concern or on any other valuation the court thinks proper.

G. RIGHT TO A FAIR AND EQUAL TREATMENT

The law protects the shareholder's right to capital. However, the protection of the right to capital may not be sufficient to safeguard all legitimate interests of the shareholders. An individual shareholder may receive, upon demand for the capital, cash or shares which do not represent the value of the capital or represent a less favourable deal compared to the other shareholders. In a private shares sale, the offeror may offer the majority shareholders a favourable price to obtain control without offering the same price to the remaining shareholders. The remaining shareholders have not lost their right to capital as there has been no expropriation of their shares. However, they are being treated unequally. If the controlling shareholders

\textsuperscript{17} FH Easterbrook and DR Fischel \textit{The Economic Structure of Corporate Law} (Harvard University Press Cambridge) 149; H Kanda and S Levmore 'The Appraisal Remedy and the Goals of Corporate Law' 32 UCLARev.
or the board offers the remaining shareholders a good price for their shares at a later stage, the treatment is then said to be unequal but fair.\(^{18}\)

On the other hand, equal treatment may conflict with the concept of fairness. If a hostile bidder makes an offer far lower than the intrinsic value of the shares, the offer is deemed unfair to the shareholders if the bidder is able to obtain control at such a price. However, since the offer is being made to all of the shareholders, their treatment is equal. The remaining shareholders may not allege, after the bidder acquires control, that the offer resulted in unequal treatment. Since there has been no discriminatory treatment of the shareholders, the other grounds on which the offer could be said to deny their legitimate expectations is that of unfairness. It is difficult to assess whether an offer is fair or not. Because of that, the focus generally shifts to the fairness of the process. Under English law, the duty of directors is not to act for an improper purpose, legitimate purpose being defined by reference to the articles.\(^{19}\) The duty is owed to the company and not to the individual shareholders. However, the incorporation of the concept of fair and equal treatment into the definition of ‘improper purpose’ could strengthen the minority shareholders’ rights in the company if used as the basis for a fiduciary duty owed directly to them. If the incidental result of the acceptance of a bid was to deprive a shareholder of his voting majority, this would amount to unfairness to the shareholders. Such unfairness would constitute ‘improper purpose’.

The principle of fairness may be applied to any situation where minority shareholders’

\(^{18}\) Weinberger v UOP Inc 457 A2d 701 (Del 1983); Rosenblatt v Getty Oil Co 493 A 2d 929, 939-940 (Del 1985); Cede & Co v Technicolor, In., 542 A2d 1187 (Del1988); Cavalier Oil Corp v Harnett 564 A2d 1137, 1144 (Del 1989).

\(^{19}\) Principle 1 of the statement of directors’ duties proposed in the Draft Clauses by the addition to the obligation to act in accordance with the company’s constitution of the obligation to exercise those powers ‘for a proper purpose’; Re Smith and Fawecett Ltd [1942] Ch 304, 306, it is held that whether a particular purpose is proper is a matter of construction of the articles of association.
interests are significantly affected. If the 75 per cent controller of a company decides
to de-list the company or transfer the company’s listing to a different exchange system
which offers a lower threshold of minority shareholders’ protection, the individual
shareholder should be, before such drastic change, treated fairly and equally by the
controller in order to legitimise whatever action the controller wishes to take. The UK
Financial Services Authority recognised this problem by proposing a provision which
will require a 75 percent voting approval for the transfer the company’s listing from
the primary market to the secondary market.

H. SHAREHOLDER’S STANDING, _LOCUS STANDI_

The problem of shareholders’ standing is closely linked with the protection of their
rights. The rights conferred upon the shareholders by the legal and regulatory system
would be moot if the shareholders did not have standing to bring enforcement action
against the company or the controllers of the company when their rights have been
denied. It is, therefore, necessary, to determine the proper forum for the resolution of
shareholders’ disputes. While there is a need for an institution to enforce the rights to
which shareholders are entitled, such an institution does not need to be the court.
Other institutions having the nature of an independent tribunal could have the same
function as the traditional judiciary. Furthermore, administrative authorities such as
the UK Financial Services Authority should also play an active role in protecting
minority shareholders and, in some instances, give redress to the persons whose
interests have been harmed by abuses of the markets. The main point is that
shareholders must have direct access to these institutions. Were it otherwise, there
would be a risk that nobody would initiate proceedings in the interest of the shareholders. Public authorities or the board of directors may be in a better position, in terms of resources and information, to enforce the rights of the shareholders or duties of the directors. Nevertheless, public authorities still need evidence and 'tipping-off' from the shareholders to launch an investigation, and the directors may be in a position of conflict of interests in bringing the case. Therefore, the question of standing can be broken down into three issues. The first is what the consequences of alternative remedies for court proceedings are. The second is what the requirements for individual shareholders are for them to have standing in all the different contexts. The third is what the duties of the regulators are, ie whether they act in the general interests or in the interests of individual shareholders. These questions will be discussed throughout this thesis. It appears, however, that a necessary component of minority shareholder protection must be the standing to bring court proceedings.

It can be argued that a shareholder, as a capital provider, is entitled to the right to bring proceedings to protect his rights directly or to enforce the duty of the directors, which will indirectly protect his rights. When the law confers rights upon legal and natural persons, the standing to enforce these rights is essential to the very essence of the democratic deliberative process. If the process impinges upon these rights, the system must provide an avenue for redress.

It is an undeniable fact that individual shareholder’s trivial litigation should not distort a company’s operation. An individual shareholder should not be able to bring a case against the board of directors for alleged unfair conduct towards him, which caused minimum injury. An example could be an action brought on the grounds that the shareholder was not able to ask questions at the general meeting due to time constraint.
There must be a balance between the interests of the company, represented by the board, and the interests of the shareholders. On the other hand, if the board’s conduct amounts to a manifest capital expropriation, an individual shareholder is justified in bringing the case in court. The application of the balance of interests test serves the purpose of preventing floodgate litigation brought by small shareholders against the board.

The conclusion of the analysis of the link between *locus standi* and shareholders’ rights is that shareholders should be entitled to bring a suit as of right in two circumstances: 1) when their rights have been violated; 2) when the democratic deliberative process is flawed. This corresponds to their legitimate expectations in a democratic society. However, a balance of interests test, which incorporates public policy considerations, may limit these legitimate expectations.

### I. NATURE OF A COMPANY

As an individual capital provider, a shareholder owns his share of capital in the pool of fund. Through contractual arrangements, the capital provider delegates his right of management to the director of the company. The contractual arrangement is made between the director and the capital providers and amongst the capital providers. The directors with the delegated right to management from the capital providers may enter into contracts with other persons. On this analysis, a company is a nexus of
contracts. If the pool of fund is to be given a title of entity such as X, all the capital providers are said to own X collectively. However, it is difficult for each of the capital providers to claim a particular piece of ownership over X. The capital providers may, through contractual arrangement, appoint a representative to take care of their capital, and such a representative may have the right to decide how to use this capital in the best interest of these capital providers. The representative, i.e., the director, is said to be the trustee for the capital providers, the beneficiaries. Therefore, X is owned by the capital providers who appoint the director to manage their capital. An individual shareholder does not own a particular piece of X. The director is only responsible to the capital providers collectively rather than individually.

The company is a nexus of contracts. In addition to the contractual arrangements between shareholders and the board of directors, the board, on behalf of the shareholders, contracts with the employees for physical capital, the creditors for their capital, other persons, or business entities for the supplies. Furthermore, a company with benevolent objectives may have informal or formal arrangement with the community to provide benefits such as education, scholarship, or joint community projects. Therefore, these 'contractors' are called the stakeholders in the company and their interests are to be part of the interests of the company. A director would also need to maintain a good relationship with the employees, creditors, suppliers, and community, in order to ensure the stability of the nexus, hence the stability of the company.

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Minority shareholders, as stakeholders in the company, have the expectation that the directors will take into account their interests in the management of the company. Should the internal control model fail, shareholders have the expectation that their interests will be protected by the legal system.

J. CORPORATE ETHICS AND SOCIAL RESPONSIBILITY

Some scholars argue that a company, being authorised by the government to carry out business activities, should ultimately be responsible to society. Some argue that there are legal authorities supporting the view that social benefits are the ultimate end of a company. In fact, there is literature suggesting that a company incorporating social responsibility in its agenda performs better compared to other companies. The common goal of these theories is to scrap the age-old authority that the director’s duty is to maximise shareholders' value rather than stakeholders' interests, with the society being one of stakeholders. Within social capitalism, every citizen providing capital to the company will receive benefits from the success of the company. There is some evidence of a changing trend in the utility sector, where economic activity can be carried out by a private-public partnership (the ‘PPP’). The PPP receives funds and directions from both the public and private spheres. In this partnership, the ‘company’ will not be able to focus only on shareholder’s value but will focus on a broader scope of community interests.

Under Gidden’s theory of the Third Way, humanity comes from respect towards others. Therefore, to incorporate humanity into the community of the corporation, the
controller needs to show respects to other stakeholders. Communitarians argued that 'the construction of a moral culture through discussion about values rather than interests or wants will provide a new set of behaviours'\textsuperscript{22} Therefore, a dialectic process in the community is needed to construct a good corporate moral infrastructure. To realise such a goal, minority shareholders must be given the right to have their voice heard and obtain a fair representation at the top end of the decision making process as well as the power to enforce their rights should the democratic process fail.

Business-ethics scholarship has suggested the Aristotelian theory of virtues as a way of remoulding the behaviour of corporations. Aristotelian ethics pointed to the structures for living life through virtues, these virtues including compassion, recognition of, and care for, the needs of others, and trust. This ethical philosophy is the pursuit of a model of social justice that incorporates respect and toleration.\textsuperscript{23} Wheeler suggested that 'the corporations, under the Aristotelian theory, should be integrated into an Aristotelian-type as an individual actor in its own right,...thus it becomes an entity which is required to perform according to these virtues if it is to be part of a reconstructed society in the era of post post-fordism.'\textsuperscript{24}

Virtues ethics are distinguished from Kantian ethics and utilitarianism through its focus on the individual's values and motives. Character developed by pursuing the virtues is what produces the framework for actions and decisions not rules and principles.\textsuperscript{25} By contrast, Bauman's view of contemporary society is that individualism is a fate not a choice, because individuals do not come together to

\textsuperscript{22} A Etzioni \textit{The New Golden Rule} (Profile Books London 1997) 34-5.
\textsuperscript{24} S Weeler \textit{Corporations & The Third Way} (Hart Publishing Oxford)167.
\textsuperscript{25} W Spohn 'The Return of Virtues Ethics' (1992) 53 Theological Studies 60.
negotiate the meaning of common good and common principles of conducting life. Bauman concludes, clearly under the influence of Ulrich Beck's ideas on living within a 'risk society', that individuals coalesce together in communities from fear of addressing shared worries and anxieties in order to find short-term solutions to current problems.

Between Aristotle and Bauman, MacIntyre introduced the idea that in a life structured by the virtues the individual stands not alone but alongside others. He suggested that the life of an individual is a life in a localised community. The localised community helps to sustain the individual and the individual brings to the community an identity inherited from tradition and history. The individual is not constrained by the bounds of this community, indeed individual identity is a fluid construct as are community virtues which form and reform over time. This theory results in the appeal of localism and cultural relativism. There are ways out of cultural relativism, while still pursuing an ethical foundation to life. These are provided ostensibly by devices such as voluntary codes, standard setting legislation, and hypothetical social contracts purporting to embody propositions capable of universal recognition. The critique of this approach argues that it is bound to fail because it seeks to impose a rights-based structure in a world that has yet to recognize or to remember its ethical commitment to the other.\textsuperscript{26}

The application of the virtues themselves concentrates on creating a new blueprint for the performance of individual corporate executives in relation to the internal governance of the corporation. In this way, the choice between maximisation of shareholder's values in the short term or long term and maximisation of company's

\textsuperscript{26} C Douzinas \textit{The End of Human Rights} (Hart Publishing Oxford 2000).
values may be dismantled. If the corporation is seen as a ‘citizen’, the controller of the corporation must pursue its good virtues. Therefore, recognition of minority shareholders in the community and the care towards their interests are considered an element of the pursuit of virtues ethics. Fraser, who developed the Aristotelian sense of aristocratic government into the field of corporate governance, suggested that corporate governance should be undertaken by active and committed shareholders.  

These active and committed shareholders will constitute an aristocracy, a civic elite, and in order to encourage participation and debate in shareholder senates, voting should be distributed not as part of the rights attached to shares but as a personal right to each investor. This suggests a greater involvement for institutional investors. Therefore, the polis must be structured in furtherance of this purpose. Minority shareholders must be integrated into the management scene.

K. MINORITY SHAREHOLDER’S RESPONSIBILITY

In pursuing virtues ethics and being committed shareholders, minority shareholder should focus on the interests of a broader spectrum of stakeholders.  

If the action of the board is in breach of directors’ duties and it harms the company, it may not be in the best interest of the minority shareholders to initiate a complaint against the directors, even though it is virtuous for the shareholders to pursue the goal of


remedying the situation. On the other hand, shareholders should not act out of the purpose of ‘gold digging’, holding a suit as ransom against the board of directors, nor should they be opportunistic by facilitating a coup against the company.

It is not easy to implement these principles in practice. In the ITV merger saga\textsuperscript{29}, the minority shareholder Fidelity organised a collective shareholders’ action to force the would-be chairman in the merged ITV company to step down. The reasons were that he had breached the Code of Best Practice recommended in the Higg’s Report, which stated that a chief executive officer is not suitable for the appointment to the position of executive chairman. However, the minority shareholder, Fidelity, did not raise the question in the merger process while Carlton and Granada were in the process of negotiation. Therefore, the merger agreement, approved by the shareholders or at least not questioned by them, was in place subject to two other conditions irrelevant for the purpose of the present discussion. However, after the merger, Fidelity was in protest, together with other shareholders, of the appointment of Michael Green, as the new chairman of ITV, the merged company. Ethically speaking, Fidelity, although it appeared to be acting in the best interest of the company, seemed to have ‘backstabbed’ the chairman. The other minority shareholders from Carlton claimed that such an action would amount to a takeover of Carlton by Granada, which should the pay the ‘control premium’ to the shareholders in Carlton. A ‘control premium’ is not paid in a friendly merger. Shareholder activism is a way to fulfil the company’s social responsibility. However, the tactics used in this case are not ethically based on corporate governance.

\textsuperscript{29} J Treanor ‘Investor Hone ITV Merger Axe’ The Guardian (9 August 9 2003).
L. CONCLUSION

This chapter examined minority shareholders' legitimate expectations from the perspective of a rights-based theory. There are several rights identified in this chapter that the minority shareholders are entitled to, including the right to capital, the right to vote, the right to dividends, the right to management, the right to information and, arguably, the appraisal right, the right to a fair and equal treatment, and the right to bring a claim or standing. From an economics point of view, minority shareholders' rights serve the function of reducing the agency cost, because minority shareholders can increase the degree of the controller's accountability.

The majority rule principle cannot, ipso facto, legitimise the decision of the general meeting. The model of democracy must incorporate the concept of deliberative democracy in which the majority shareholders owe a duty to contemplate the minority shareholders' interests while casting their votes on issues affecting them. Shareholders' legitimate expectations also include the expectation that the deliberative process in the company will be fair and not biased against them.

Both the rights-based theory and the principle of deliberative corporate democracy receive support by scholarly thinking on company law and corporate governance based on the ideas of corporate ethics and company social responsibility. Although these theories may not always be easily translated into practice, and it may not always be desirable to do so, they do provide authoritative support to the thesis that minority shareholders' rights and the standing to enforce such rights are justified on grounds of legitimate expectations and serve the purpose of enhancing the standards of corporate
governance and social responsibility of the company.

It is the conclusion of the analysis in this chapter that minority shareholders have the expectation that: 1) their interests as capital providers will not be unfairly or unjustly compromised; 2) the democratic deliberative process in the process will be fair. If these legitimate expectations are not upheld under the internal control model, then minority shareholders have a legitimate expectation that they will be able to obtain redress by bringing legal proceedings against the company, the directors, or the controlling shareholders as the case may be. The fundamental role of the private action model becomes evident. These principles will be used to assess whether the law upholds minority shareholders' legitimate expectations. The analysis will be carried out in the following chapters.
CHAPTER V

COMMON LAW PROTECTION AND THE HUMAN RIGHTS ACT 1998

A. INTRODUCTION

This chapter analyses the rights of minority shareholders at common law and the impact on the likely development of the common law of the Human Rights Act 1998. The common law protection of minority shareholders is inadequate in that it does not recognize a duty of the directors and the controlling shareholders towards the minority in a takeover situation. The courts have favoured the internal control model and the market control model over the private action model by imposing limitations on minority shareholders bringing a suit against the directors or the controlling shareholders. However, this falls short of the legitimate expectations of shareholders as capital provides in the company.

This chapter also analyses the impact of the Human Rights Act 1998 on the likely development of the common law. The reasons why the Act is examined in this chapter rather than in the chapters on the statutory protection of minority shareholders or on remedies are the following. The significance of the Act is not that it confers new rights or remedies to minority shareholders. The jurisprudence of the European Court of Human Rights upholds the doctrine of legal personality of the corporation and limitations on shareholders' standing. However, a more rights-based and purposive
approach in the protection of the minority shareholders' right to property under Article 1, Protocol 1 to the European Human Rights Convention can lead the courts to grant minority shareholders rights of a personal as opposed to derivative nature more readily. The harm-based and duty-based rule advocated in this chapter receives support by the analysis of the Human Rights Act 1998 and the rights-based thinking that it introduces into the English legal system.

B. COMMON LAW PROTECTION

1. A Distinctive Right

Minority shareholders' rights can be divided into two categories: personal rights and derivative rights. The basis of the distinction drawn is not clear, and case law does not show consistency in the area. The way to approach this question could be to analyse what triggers minority shareholders to bring actions either for themselves, for the company, or for third parties. It is seldom debated whether minority shareholder's standing to bring lawsuits is a procedural right or a substantive right. However, it has been conceded by some commentators that such action is part of civil procedural law.

(a) Personal Right

The seminal case in this area is Foss v Harbottle. It established two principles: first,
it is the right of the majority shareholders to bar a minority shareholder’s action whenever the majority shareholders may lawfully ratify the alleged misconduct; and, secondly, normally it is the exclusive right of the company to sue upon a corporate cause of action. In this respect, the decision to bring a suit against the director ought to be taken by the majority of shareholders at the general meeting. However, there are limitations and exceptions to this rule that allow the minority shareholders, shareholders with less than 50 per cent of voting rights or unable to gather the 50 per cent of votes at the general meetings, to bring proceedings. These exceptions are: 1) shareholders’ personal claims; 2) claims against ultra vires actions or illegal transactions; 3) claims in respect of transactions requiring a special majority; 4) cases of 'fraud on the minority'.

It would be wrong to assume in the light of the exceptions to the rule in Foss v Harbottle that actions against illegal transactions, actions against ultra vires act, and actions against fraud on the minority cannot be personal rights. The Foss v Harbottle rule does not apply to a situation when the individual is claiming a personal right.

Asquith LJ in Edwards v Halliwell stated that:

When in circumstances such as I have described a remedy is sought by an individual, complaining of a particular act in breach of his rights and

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4 *Pender v Lushington* (1877) 6 ChD 70, in which the refusal of a chairman to recognize the votes attached to shares held by nominee shareholders was held to infringe their personal rights.

5 *MacDougall v Gardiner* (1875) 1 ChD 13 in which the decision of the chairman of the shareholders’ meeting wrongfully (ie in breach of the articles) to refuse a request for a poll was held to be an internal irregularity.

6 *Smith v Croft* (No2) [1988] Ch 14.

7 *Edwards v Halliwell* [1950] 2 All ER 1064, 1066a.
inflicting particular damage on him, it seems to me the principle of *Foss v Harbottle*... does not apply either by way of barring the remedy or supporting the objection that the action is wrongly constituted because the union is not a [claimant].

Personal rights are free from the ‘majority rule’ and ‘proper plaintiff principle’. In *Re Company*[^8^], there was no breach of the articles of association, but there was an abuse of power, which constituted breach of the director’s duty in that he improperly issued the shares. Hoffmann J said that ‘the true basis of the action is an alleged infringement of the petitioner’s individual rights as a shareholder.’ It is not clear whether the claimant’s ultimate success in improper purposes actions against the directors is dependent on the views of the majority shareholders.[^9^] If it does depend on the view of majority shareholders, then the right would not distinctively belong to the minority shareholders.

In the case of ‘fraud on minority’, an exception created by *Foss v Harbottle*, it is not clear whether the right to sue is a personal unqualified right belonging to minority shareholders. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,[^10^] the court held:

There is an exception to the rule [in *Foss v Harbottle*] where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders’ action on behalf of themselves and all

On the face of the ruling, the right is a qualified personal right which only exists if the wrongdoer was in control. Although the shareholders in the *Prudential* case asserted that the directors were liable in the tort of conspiracy as against the members of the company as well as the company itself, there seems to be no reason against construing this action as a personal right. This right, however, has not been recognised by the courts to be distinctively personal\(^{11}\), although Lord Davey did say in *Burland v Earle*\(^{12}\):

> [W]here the persons against whom the relief is sought themselves hold and control the majority of the shares in the company, and will not permit an action to be brought in the name of the company, [i]n this case the courts allow the shareholders complaining to bring an action in their own names... The cases in which the minority can maintain such an action are, therefore, confined to those in which the acts complained of are of a fraudulent character or are beyond the powers of the company.

It appears that not only in situations where the majority’s action is tainted with fraud but also in situations where the action is beyond the powers of the company such as in the case of *ultra vires* or illegal transactions, minority shareholders have the right to sue. In addition, minority shareholders, by virtue of being members of the company bound by its articles of association, have a contractual right to sue for breaches of the

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11 In *Hogg v Cramphorn* [1967] Ch 254, the individual shareholder was allowed to sue but judgment in his favour was suspended whilst a general meeting of the shareholders was called to consider approving the director’s action, which they in fact did so that the litigation was ultimately fruitless. In *Bamford v Bamford* [1970] Ch 212, CA, it was held that the improper issue of shares was ratifiable.
12 *Burland v Earle* [1902] AC 83, 93.
articles. However, the nature of the company’s articles of association has been debated. Under the current law, even if the court recognised the contractual rights of the minority shareholders, there are restrictions both in law and in practice to bringing the suit against the controller who committed the alleged wrong.

(b) Derivative Right

In some circumstances, minority shareholders can only step into the company’s shoes to enforce the rights of the company. This is a derivative right. *Foss v Harbottle* is part of the law of civil procedure. Therefore, the real issue is one of the standing to bring the action (*locus standi*). In *Wallersteiner v Moir (No2)*, the court introduced from the law of the United States the phrase ‘derivative action’ in situations where the individual shareholder is enforcing a right which is not his but rather is ‘derived’ from the company. The presumption here is that the wrong was done to the company, hence only the company may sue for the damages caused to it.

(c) Personal and Derivative Right

A personal action may be joined with a derivative action insofar as double recovery is

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13 *MacDougall v Gardiner* (1875) 1 ChD 13; *Pender v Lushington* (1877) 6 ChD 70.
14 In *Devlin v Slough Estates Ltd* [1983] BCLC 497, the court refused to recognize that the particular article in question, relating to the preparation of the company’s accounts, conferred a right upon individual shareholders (as contrasted with ‘the company’).
15 *MacDougall v Gardiner* (1875) 1 ChD 13; *Pender v Slatington* (1877) 6 ChD 70.
16 As the shareholders may not be assured that the relief sought will be consonant with the right asserted.
18 *Wallersteiner v Moir (No2)* [1975] QB 373 CA.
19 *George Fischer (Great Britain) Ltd v Multi Construction Ltd* [1995] *BCC 310*, per Glidewell LJ, 315.
not to be imposed. Beside the consideration of double recovery, there are differences between personal and derivative actions. First, the derivative action is a way of enforcing the corporate rights. Therefore, there will be no restrictions as regards the time when the matter sued upon occurred. A shareholder can bring the action even if he becomes a member after the matter occurred. On the other hand, if the right is personal to the shareholder, only the member who has suffered harm is entitled to bring the action. A derivative action is an invention by equity law to allow enforcement of the company's rights, and it is available only as a matter of the court's discretion. This means that the claimant must come with 'clean hands'. His claim will be barred if he was involved in any wrongdoing with regard to the case in question.

(d) Minority Shareholder as Prime Enforcer of the Rights

If the wrongdoers are in control, the minority shareholders become the prime enforcers of the law against the wrongdoers. Currently, there are criteria to be satisfied before instituting an action under *Foss v Harbottle*. First, the individual shareholder may not bring an action to enforce the company's rights if the wrong in question is one, which is ratifiable by the company. Secondly, even in the case of 'fraud on the minority', the action may not be brought unless the wrongdoers are in control of the company and in the case of any non-ratifiable wrong unless the majority of the independent shareholders support the bringing of the action. These two criteria are based on the majority's rule that requires the dissatisfied shareholders to go to the general meeting to try to persuade the company to commence the litigation. This does

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20 *Prudential Assurance Co. Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, 303-304; In the US, the action may be dismissed and allowed to re-plead. See the analysis in the chapter of US law. P Davies and J Lowry 'Companies in General' [2003] JBL 420.

21 *Smith v Croft (No2)[1988]* Ch 114.
not mean that the wrong must be ratified. The majority can ratify the wrong even in the middle of the litigation commenced by the minority shareholders, and this may result in a waste of time and resources. If the wrong is not ratifiable, the issue is to decide on the appropriate person to commence the action against the wrongdoers. This is the so-called ‘proper plaintiff’ rule. The wrongdoers can be in control of the company, and the decision to commence the action can go to the ‘the majority of the independent minority’, as held in a recent decision in the first instance. If the wrongdoers are not in control, the corporate body may be left to decide whether to litigate or not over the wrong.

(e) Representative Suit

In some jurisdictions, minority shareholders have the right to bring a representative suit, whereby shareholders holding a certain percentage of shares for a certain period will be able to bring action against the directors. The percentage of shares and the period of time will be based on what is considered appropriate and, to a certain extent, are arbitrary numbers. Under the Article 204(2) of the Company Act of the Republic of China, Taiwan, a shareholder holding more than 3 per cent of the total of the share capital for a period of more than one year is entitled to bring an action on behalf of the company. In the usual situation of breach of director’s duty, under Article 213 and Article 214(2) of the Company Act, it is for the statutory supervisor of the company to bring an action on the company’s behalf against the directors. However, the supervisor

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22 Vinelott J. at first instance in the Prudential case was in favour of ratification as the test, but neither the authorities nor the Court of Appeal in that case support him. In Hogg v Cramphorn Ltd [1967] Ch 254 the plaintiff shareholder was allowed to sue, even though the wrong was ratifiable. However, this seems to have been a personal action.

23 Smith v Croft (No2) [1988] Ch 114.

24 The Company Act, ROC, Taiwan Article 214 (2).
may not be willing to bring an action against the director and, in the worst situation, may connive with the wrongdoers. The representative suit is regarded as a protection for the minority shareholders. There are several requirements to be satisfied before a representative suit can be instituted: first, the shareholder or shareholders must make a request in writing to the statutory supervisor of the company to bring the suit against the directors; second, if the supervisor does not bring the requested suit within 30 days, an action could then be taken by the shareholders. The law also requires the shareholders bringing the suit to provide a security in order to prevent abuses of the right to sue. The security covers the damages to the directors in case the court rules that the allegation is ‘unfounded’ when deciding the merits of the case. The damages suffered by the directors include the legal fees and other fees. The losing party will also bear the court costs. In addition to damages suffered by directors, representative shareholders may be liable for damages to the company. Representative shareholders are liable for the company’s loss if they lose the case. However, the loss does not need to be based on an ‘unfounded allegation’ as in the situation of the damages to the directors. If the case is decided against the directors in the end, the directors will be held liable for the damages caused to shareholders.

This form of representative suit has not received recognition in the UK. An action which has some elements of a representative suit is an action under CPR, r 19(6). If the defendant’s action, of which complaint is made, infringed the rights of a number of shareholders and not just the claimant’s rights, the claimant may sue in representative

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25 Company Act, ROC, Taiwan, Article 214 (1).
26 Company Act, ROC, Taiwan, Article 214 (2).
27 Company Act, ROC, Taiwan, Article 215 (1).
28 Civil Code, ROC, Taiwan, Article 78.
29 Company Act, ROC, Taiwan, Article 214 (2).
30 Company Act, ROC, Taiwan, Article 215 (2).
form on behalf of himself and all the other similarly situated members, under CPR, r 19(6).

2. Rights Based on Ratifiability

Ratification deprives the company of the right to bring proceedings in respect of the wrong committed by the controller, hence it bars the derivative action. As Jenkins LJ said in Edwards v Halliwell, the case which provided the best modern formulation of the rule, 'where the alleged wrong [done to the company] is a transaction which might be made binding on the company or association of persons and all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter…'. This dictum is in line with the majority principle. However, without some restrictions on the ability of the majority to act in their own interests but contrary to the interests of the company, the very viability of the corporate form would be threatened, since it would be too risky to invest in a company in which the directors had, or might obtain, unfettered voting control. In Edwards v Halliwell, the wrong was directed to the

31 P Davies Gower and Davies' Principles of Modern Company Law 454. See also footnote n58, it is said that in relation to CPR 1998 that the court has powers to control the representative litigation. A judgment or order will bind the represented parties, but may not be enforced against them without the permission of the court.


company rather than individual shareholders and, therefore, it fell under the derivative action category. If the wrong is aimed directly at the individual shareholders, it could give rise to both personal and derivative actions.

Bu way of comparison, in the Republic of China, Taiwan, in addition to the representative suit, shareholders may, through the general meeting, elect a representative to bring an action on behalf of the company against the directors.\(^6\) The representative cannot be a member of the board of directors.\(^7\) This form of action is, however, subject to the resolution of the general meeting and is not a form of minority shareholders’ action.

(a) Identification of Wrongs

The restrictions to the application of the rule in *Foss v Harbottle* can be summarised in three categories. These can be best explained by analysing the *Edwards* case. In that case, there were three wrongs that could not be ratified, as they amounted to *ultra vires* act, act requiring special majorities, and act amounting to ‘fraud on minorities’.

At the time the case was decided, *ultra vires* acts could not be ratified at all, but nowadays they can be ratified by a special resolution.\(^8\)

In the case of corporate decisions requiring a special majority, including acts done outside the company’s objects clause, the exception to *Foss v Harbottle* has been justified on the grounds that otherwise ‘the effect would be to allow a company acting

\(^{36}\) Company Act, ROC, Taiwan, Art. 213.

\(^{37}\) Company Act, ROC, Taiwan, Art 223.

\(^{38}\) Companies Act 1985 s.35 (3).
in breach of its articles to do *de facto* by ordinary resolution that which according to
its own regulations could only be done by special resolution.\(^{39}\)

In the case of ‘fraud on the minority’, the wrong must be identified in relation to
individual shareholders, even though the wrong is ratifiable by the majority.\(^{40}\) The
term ‘fraud’ is not used in the narrow sense of deceit, but is attributed a wider
meaning which embraces both fraud in a strict sense and breach of fiduciary position
which confers a benefit on the directors or third parties.\(^{41}\) The act of ‘fraud’ can be
intentional, unintentional, fraudulent, or negligent, as long as the aim was to benefit
the controllers themselves at the expense of the company.\(^{42}\) The mere existence of
damage is not enough, since the principle operates only where there has been an
enrichment of the majority at the minority’s expense, as where the majority have
‘directly or indirectly [appropriate] to themselves money, property or advantages
which belong to the company, or in which the other shareholders are entitled to
participate’.\(^{43}\) Fraud is not only fraud at common law but also fraud in the wider
equitable sense, as in the equitable concept of fraud on a power.\(^{44}\) These situations
include the diversion of contracts by the directors in breach of their duties,\(^{45}\) a
contract for sale by directors of worthless mines at an exorbitant price to a company
formed for the purpose, where directors concealed a true fact,\(^{46}\) an attempt by the

\(^{39}\) Edwards v Halliwell [1950] 2 All ER 1064, 1067; Cotter v National Union of Seamen [1929] 2 Ch
58.

\(^{40}\) J Poole and P Roberts ‘Shareholder Remedies- Corporate Wrongs and the Derivative Action’ [1999]

\(^{41}\) Cook v Deeks [1916] 1 AC 554, PC; Alexander v Automatic Telephone Co [1900] 2 Ch 56, CA.

\(^{42}\) Daniels v Daniels [1978] Ch 406, 414a-e per Templeman J.

\(^{43}\) Burland v Earle [1902] AC 83, PC, 93; Atwool v Merryweather (1976) 9 Eq 350; Menier v
Hooper’s Telegraph Works Ltd (1874) 9 Ch App 350; Cook v Deeks [1916] 1 AC 554; Daniels v

\(^{44}\) Estmanco (Kilner House) Ltd v Greater London Council, per Megary V-C [1982] 1 WLR 2, 12f-g;
Also see Daniels v Daniels [1978] Ch 406; Edwards v Halliwell [1950] 2 All ER 1064.

\(^{45}\) Cook v Deeks [1916] 1 AC 554, PC.

\(^{46}\) Atwool v Merryweather (1867) LR 5 Eq 464n; Mason v Harris (1879) 11 ChD 97.
majority to seek to benefit themselves at the expense of the minority;\textsuperscript{47} the obtaining of an advantage by directors who hold the majority of the shares without making disclosure of the fact though \textit{bona fide} and without deceit;\textsuperscript{48} the procuring of the passing of a resolution at a general meeting of the company instructing the directors to discontinue proceedings commenced by the company against the majority shareholder, where the discontinuance would be to the advantage of the majority and to the disadvantage of the minority because it would stultify the purpose for which the company was formed.\textsuperscript{49} It is not possible to ratify breaches involving the misappropriation of company assets or analogous breaches, but the ratification of negligence is permissible,\textsuperscript{50} regardless of the extent of the loss, because the element of differential treatment of majority and minority will normally be lacking.\textsuperscript{51}

(b) Ratification

The issue is what amounts to ratification and the equivalent of ratification.\textsuperscript{52} If the wrong directed to the company is ratified by the majority shareholders, the wrong is said to be forgiven, hence the action is barred.\textsuperscript{53} However, even where the wrong is not ratifiable, the courts have not accepted that an individual shareholder should be free to initiate litigation on the company’s behalf, for there may still be an appropriate

\textsuperscript{47} \textit{Menier v Hooper's telegraphy Works} (1874) 9 Ch App 350.
\textsuperscript{48} \textit{Alexander v Automatic Telephone Co Ltd} [1900] 2 Ch 56.
\textsuperscript{49} \textit{Estmanco (Kilner House) Ltd. v Greater London Council} [1982] 1 WLR 2, 12f-g.
\textsuperscript{50} For an extreme statement of this idea, see \textit{Pender v Lushington} (1877) 6 Ch D 70, 75-6.
collective body which can be entrusted with this decision. If this is the case, there must be some element barring minority shareholder's action.

For the minority shareholders to be able to bring an action for fraud on minority, English law has never insisted that a general meeting be called upon, and be shown to have refused to institute proceedings, provided that the wrongdoer's control could be demonstrated in other ways. That is to say if the majority shareholders would have ratified or waived the right to sue, then the minority shareholders rights to sue will be barred.

If the wrongdoer is the controlling person, ratification of the wrong would give the minority shareholders ground to bring proceedings based on fraud on minority. In considering what constitutes control, the cases do not speak in the same tone. To establish the necessary degree of control, the minority shareholder does not need to show formal application to the company to instigate proceedings and rejection of that application, or that he has procured the summoning of a general meeting to consider the question which has then rejected this request. In Pavlides v Jensen, the judge seemed to think of control in terms of de jure control, ie control of at least a majority of the votes capable of being cast at a general meeting. In the Prudential case, the Court of Appeal referred to control in much more wide-ranging and realistic terms, as embracing 'a wide spectrum extending from an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy'.

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54 Atwool v Merryweather (1867) LR 5 Eq 464; Mason v Harris (1879) 11 ChD 97, 108; Alexander v Automatic Telephone Co [1900] 2 Ch 5669.
55 Atwool v Merryweather (1867) LR 5 Eq 464n; Mason v Harris (1879) 11 ChD 97, 108.
57 Prudential Assurance Co Ltd v Newman Industries Ltd (No2) [1982] Ch 204, 222-224.
The word ‘control’ was deliberately placed in inverted commas by the Court of Appeal in *Smith v Croft (No2)*\(^{58}\) because it was recognised that voting control by the defendants was not necessarily the sole subject of the investigation. However, that does not mean to say that mere *de facto* control is enough for the minority shareholders to be able to bring an action.

It will not be difficult to demonstrate control where the defendants are registered in the company’s register of members as a holding majority. However, if the defendant holds less than a majority of the voting shares, further evidence will be required to establish control. The court will be prepared to examine the underlying circumstances to determine whether the defendants do exercise *de facto* control.\(^{59}\) There is, however, a ‘revisionist’ account of ratification which, contrary to the ‘orthodox’ view given above, casts doubt on the validity of self-interested absolution.

In the *Prudential* case, Vinelott J expressed the view that ‘fraud’ lies not in the character of the act or transaction giving rise to the cause of action, but in the use of voting power by the interested shareholders to prevent a remedy from being obtained.\(^{60}\) Although the judge conceded that negligence could be ratified by the majority shareholders, on his redefinition of the fraud on the minority principle, this is exposed as an anomaly.\(^{61}\) As Megarry V-C said in *Estmanco v GLC*, ‘it may be’ that the guiding principle underlying the rule ‘may come to be whether an ordinary resolution of the shareholders could validly carry out or ratify the act in question.’

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\(^{58}\) *Smith v Croft (No2)* [1988] Ch 114, 185a.

\(^{59}\) *Pavlides v Jensen* [1956] Ch 565.

\(^{60}\) *Prudential Assurance Co Ltd v Newman Industries Ltd (No2)* [1981] 1 Ch 257, 3907.

If the individual shareholder met the standing requirements established in *Foss v Harbottle*, he does not have the right to initiate litigation if the majority of the independent minority of shareholders are against the litigation.\(^{62}\) The cases show that the legal basis of the decision is the distinction drawn between ratifying a breach of duty and deciding not to sue in respect of the wrong. The old law accepted that deciding not to sue was the functional equivalent of ratification, so that the same rules should determine in both cases whether action by the individual was permitted or collective decision-making was required.\(^{63}\)

3. Rights Based on Utility

The courts' views about the utility of the derivative action have undergone a fundamental shift.\(^{64}\) In the *Prudential* litigation the Court of Appeal's opinion was that the shareholder had embroiled the company in litigation to enforce its rights, which was a misconceived use of resources and left the company worse off, even though its rights were vindicated. The derivative action is not to be regarded as a normal part of the enforcement apparatus of the law, but as a weapon of last resort.\(^{65}\)

The judge rejected the argument that the exception to the rule in *Foss v Harbottle*, such as fraud on minority, should operate when 'justice' so required.\(^{66}\) If the argument was right, then equally the court should not determine whether it should proceed on the basis of the company's interests as this determination should be left to the business judgement rule at the board or the general meetings.


\(^{63}\) P Davies *Gower's Principles of Modern Company Law* (7th edn Sweet & Maxwell 2003) 675.

\(^{64}\) P Davies *Gower's Principles of Modern Company Law* (7th edn Sweet & Maxwell 2003) 675.

\(^{65}\) P Davies *Gower's Principles of Modern Company Law* (7th edn Sweet & Maxwell 2003) 676.

This approach correlates with the ‘proper plaintiff’ rule, which says that the day-to-day business affairs of the company, including the enforcement of the company’s rights, should be a matter for the board and appropriate general forums, rather than for the courts’ intervention on behalf of minority shareholders.67 However, the utility argument is only limited to the action where there was no improper conduct by controllers. That is to say in some cases the board or even the general meeting cannot be regarded as a proper body to take the decision, normally because they are in some way participating in the breach of duty in question.68 The method of ‘self-help’ can be the best way to solve the matters which are left to be regulated by the company’s constitution, and disputes can be settled by procedures and persons specified by the company’s constitution or bylaws. However, this approach presumes that the minority shareholders had fair bargain and willingly took the risk when they entered into the company. Despite this line of argument, the Law Commission upheld this principle based on the principle of ‘sanctity of contract’69 as a basis for refusing minority shareholders’ action.

The costs of litigation is one consideration that the court had in mind in Foss v Harbottle, because even where an action is well-founded, the remedy that is ultimately awarded may not justify the expense of litigation and the other costs to the

69 However, many companies are bought ‘off the shelf’, with ready-made articles. The courts rightly do not assume in such cases that the minds of the parties were directed to every point which later comes up. Ebrahimi v Westbourne Galleries [1973] AC 360, 386 F-G, per Lord Cross. The Commission also recognises that discretionary relief from the rigour of this principle may be necessary under section 459, Law Com Report 1.9.
company, such as lost management time and adverse publicity involved.\textsuperscript{70} The utility argument is also connected with ratifiability, which is based on the assumption that if the majority shareholders have chosen not to sue, they must be content that no remedy should be sought. If the minority shareholders were to be allowed to bring an action, the proceedings would be rendered pointless,\textsuperscript{71} because the majority shareholders can always ratify the act. This principle also shows that the court is inclined to believe that the enforcement of the company's rights is a matter to be determined through the company's 'democratic' channels. If a minority shareholder seeks to bypass these channels, damage to the company is likely to result.\textsuperscript{72} This approach is subject to the critique that if shareholders' democracy is to be upheld by the courts, the courts' obligation is to supervise the process. The court must consider the voting behaviour, the bargaining power between two sides, and whether there has been an abuse to achieve purposes beyond what is authorised by the general principles of law.\textsuperscript{73}

4. Harm Based Rule\textsuperscript{74}

(a) Identification of Harms

\textsuperscript{70} J Parkinson \textit{Corporate Power And Responsibility} (Clarendon Press Oxford 1993), his analysis in n.34 that 'The avoidance of litigation which is likely to be prejudicial to the company forms at least part of the justification for the rule in \textit{Foss v Harbottle}': See KW Wedderburn 'Shareholders' Rights and the Rule in \textit{Foss v Harbottle} [1957] CLJ 194, 195.


\textsuperscript{73} The Higgs Report on director's duty suggested that more than half of the directors should be non-executive directors, who will be in direct supervision of the executive directors of the board. Such a composition of the board will change the view of the court in shaping the rights of minority shareholders in their role regarding the enforcement of director's duties. The court will be less willing to give minority shareholders the chance to litigate against the directors or controllers of the company if the objectives of supervision are being achieved by the non-executive directors. If that is the case, then the failure to put such a mechanism in place should justify giving minority shareholders the right to litigate against the directors for the purpose of enforcing director's duties.

\textsuperscript{74} See \textit{Heron International Ltd v Lord Grade}, where, in the context of a proposed takeover, the Court of Appeal distinguished between the harm inflicted on the company's assets by the assumed recklessness of the directors (recoverable only in a derivative action) and the harm suffered directly by the shareholders individually though their resulting inability to accept a higher takeover offer for their shares.
The distinction between personal rights and company's rights (derivative rights) is often drawn, and a personal right can also be combined by a derivative action in the same proceedings. A shareholder may combine in the same proceedings a claim about the insufficiency of the content of notice of resolutions to be proposed at an extraordinary general meeting (which would be enforced by means of a personal claim) and about the result of the resolutions which allegedly amount to a fraud on the minority.\(^\text{75}\) The principle in the *Prudential* case is said to be that where the damage is suffered by the company and the only loss suffered by the shareholder is a diminution in the value of his shares reflecting the damage suffered by the company, a personal claim will not be available. If the damages were greater than the diminution of the value of the shares reflecting the damages to the company, then a personal claim would be allowed to proceed against the wrongdoers.\(^\text{76}\)

The DTI's Consultation Paper on Modern Company Law suggested that the legislature should introduce a non-exhaustive personal right which can be enforced by the individuals. This right should be excluded where breach of duty does not involve any individual harm to the particular member, but only an indirect harm suffered as a result of damage done to the company as a whole. Legislation should provide these rights as a supplementary criterion for determining whether particular rights should be regarded as personal.\(^\text{77}\) Hence, if there were 'irregularities' which did not give rise to individual harm, the court should have the discretion to dismiss an action which


\(^{77}\) DTI *Modern Company Law* (DTI 2000).
satisfied the other criteria where the breach was trivial, or could be readily remedied by proper action by the company, such as reconvening a meeting at which the shareholder’s vote was not counted and where there was a clear majority against him.\textsuperscript{78} Knox J in \textit{Smith v Croft (No 2)} also said that ‘where what is sought is compensation for the company for loss caused by \textit{ultra vires} transactions the wrong, in my judgement, is a wrong to the company, which has the substantive right to redress. Where the minority shareholder is seeking to prevent an \textit{ultra vires} transaction or otherwise seeking to enforce his personal substantive rights, the wrong which needs redress is the minority shareholder’s wrong.’\textsuperscript{79} 

There is, therefore, authority to the effect that the courts should take into account the harm caused by the conduct complained about as a criterion to allow shareholders’ actions.

(b) Differential Treatment

Differential treatment may be a prima facie case to establishing harm. In \textit{Estmanco (Kilner House) Ltd v GLC},\textsuperscript{80} Sir Robert Megarry V-C held that it was an abuse of majority voting power to surrender a cause of action where this had the effect of discriminating between different groups of shareholders. The difference between the transitional concepts of fraud on the minority and the discriminatory treatment between groups of shareholders lies not in the breach of duty but in the release of the right to redress. There is also a school of academic opinion advocating that it is not the character of the wrong that explains the inability to ratify, but the impropriety of

\textsuperscript{78} DTI Consultation \textit{Modern Company Law} (DTI 2000) para 2.97, 117.
\textsuperscript{79} \textit{Smith v Croft (No 2)} [1988] Ch 114, 170.
\textsuperscript{80} \textit{Estmanco (Kilner House) Ltd v GLC} [1982] 1 WLR 2.
the wrongdoers using their voting power to exonerate themselves and leave the minority without a remedy.\textsuperscript{81} Hence, to leave the company without a remedy to which it would otherwise be entitled is considered to be a form of harm directed at the minority shareholders, and a waiver of such right to sue by the majority is henceforth actionable by the minority shareholders.

If the harm-based rule develops as the basis for minority shareholders’ personal claims, it is possible to argue that minority shareholders have standing to obtain interim remedies to prevent harm occurring to them. The threat of such a pre-emptive action will have the effect of strengthening corporate governance. Minority shareholders would be able to claim that there would be an irreparable harm to them if the action by the controllers was not enjoined. In mergers and acquisitions, if the offer was too low, or the process was unfair, an individual may apply to the court to enjoin the process, as a merger may not be rewound when it has been completed. The availability of interim injunctions to minority shareholders to enjoin the takeover is an important element of US law but totally absent in English law. The development of a harm-based rule in England would open up the possibility for minority shareholders to obtain interim remedies in this jurisdiction.\textsuperscript{82}

5. Proprietary Right or Contractual Right

The separation of ownership and control means that the shareholders have the proprietary interests in the company but have no control over the company.\textsuperscript{83}


\textsuperscript{82} The comparative analysis is carried out in ch 9 while remedies are studied in ch 7.

\textsuperscript{83} A Berle and G Means \textit{The Modern Corporation and Private Property} (New York: Harcourt, Bracc & World 1968). See also generally ‘Symposium, Corporations and Private Property’ 26 JL 7 Econ
Minority shareholders have proprietary interests in the company. As a result, they have ‘legitimate expectations’ to a degree of protection of their interests. This theory of ‘legitimate expectations’ based on the shareholders being capital providers was developed in chapter 4. Under English law, this theory received some support in cases decided under section 459 of the Companies Act 1985. This section protects the ‘legitimate expectations’ of the petitioner. However, other cases support the theory of shareholders’ rights as contractual rights. The courts have been unwilling to impose new rights or obligations to intervene in internal affairs, and the articles of association are always the ‘starting point’ of the analysis. If the court found that ‘it can safely be said that the articles of association are adequately and exhaustively laid down in the articles,’ and the petitioner cannot show that there are informal agreements or arrangements existing outside the articles of association, the petitioner will fail. On the other hand, the courts abandoned illegality as the touchstone of unfairness. In the Ebrahimi case, the court held that the equitable considerations do not flow simply from the nature of the company as a quasi-partnership. It requires ‘something more’ in the shape of proof of the existence of an informal agreement concerning, for example the participation by the minority in the management of the company. If the ‘internal standard’ is the criterion for bringing the claim, it can be then said that the right is somewhere between proprietary and contractual. It is not based on ownership of the share per se, but on the agreement with the company or the majority shareholders either expressly or by implication.

235-496 (1983), assessing the significance of this book.


(a) Contractual Arguments on Section 14 of the Companies Act 1985

Contractual arguments can also be based on section 14 of the Companies Act 1985. The fundamental issue is what the judicial nature of a company’s constitution is. Section 14 of the Companies Act 1985, which says that the members must observe the provisions of the memorandum and articles, establishes the statutory contract. Hence, if the minority shareholder’s rights have been infringed under the articles of association or memorandum, he will be able to initiate a suit as under English law the breach of any term in a contract gives the innocent party the right to seek a remedy. However, this construction has received criticism for being obscure and misleading. It is because, first of all, it does not explain whether the company is bound by it or not, although this has been widely but not universally accepted; secondly, it does not explain why the new members are bound by it without the need for a separate agreement. Many of the normal contract law rules do not apply to a section 14 contract: the courts will not imply provisions into it to give business efficacy; nor order rectification; nor rescind for misrepresentation. Finally, section 14 does not draw any distinction between personal rights, and corporate rights, nor is there mention of the enforceability of these rights.

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87 Admittedly, the sanctions for breach may be weak, especially where the parties have not yet recommended performance, PS Atiyah An Introduction to the Law of Contract (5th edn Clarendon Press Oxford 1995) 417-9.

The uncertainties mentioned above make section 14 less reliable for minority shareholders to establish their rights. In fact, case law indicates that shareholders do not have an unqualified right to seek relief in court. It is said that one limitation which follows on from the 'capacity as a member' principle is that an investor cannot bring an action to the courts if what is involved is simply a matter of internal corporate structure rather than conduct affecting him as a shareholder. As a consequence, a minority shareholder can compel payment of a dividend which has been duly declared but cannot bring an action requiring a director to retire in accordance with the articles of association. It is because the latter situation is considered to be a corporate right which only the corporate body can enforce. Another limitation is that minority shareholders do not have the right to enforce a term provided for 'outsider rights', although there have been a number of academic writings arguing that case law provides support for the proposition that a member is always able to obtain relief where this is necessary to ensure that his company operates in accordance with the corporate constitution. The rationale behind those limitations is that shareholders will benefit if the judiciary allows those managing a company some discretion to decide unilaterally whether an infringement of the

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91 *Mozley v Alston* (1847) 1 Ph 790 (Hct of Ch). Cases involving rights as a shareholder have included *Wood v Odessa Waterworks Co* (1889) 42 ChD Cases 636 (ChD) (dividends) and *Re British Sugar Refining Co* (1857) 3 K&J 408 (Ct of Ch, V-C) (entitlement to be registered as a member and to receive share certificates, though the case involved a statutory provision, not a clause in the corporate constitution).
93 Professor Wedderburn first developed this terminology, see 'Shareholders' Rights and Rule in *Foss v Harbottle*' (1957) 16 CambLJ 194, 212.
with standing to sue. Unless a specific language is imposed, various issues concerning a member’s right to sue will remain unsolved, including whether a member has standing to sue for each breach of the corporate constitution.

6. Director’s Duty to Minority Shareholders’ Rights

(a) Fiduciary Duty

It is established that directors must act in good faith in what they believe to be the best interests of the company; they must not exercise the powers conferred upon them for purposes different from those for which they were conferred; they must not fetter their discretion as to how they shall act; and without the informed consent of the company, they must not place themselves in a position in which their personal interests or duties to other persons are liable to conflict with their duties to the company.101

A mere breach of the director’s duty does not give right to an action by the minority shareholders under the rule of Foss v Harbottle because the majority shareholders are entitled to ratify the wrong committed by the directors. In addition, it is also an established rule that the directors owe a fiduciary duty to the company, not the shareholders of the company.102 In Pervical v Wright,103 where directors purchased shares from their members without revealing that negotiations were in progress for a sale of the undertaking at a favourable price, the court held that the directors owed no

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102 Percival v Wright [1902] 2 Ch 421.
103 Percival v Wright [1902] 2 Ch 421.
fiduciary duty to the shareholders.\textsuperscript{104} The decision was much criticised.\textsuperscript{105} In any event, the rule does not mean that directors can never stand in a fiduciary relationship with the shareholders; they may be liable if the directors are authorised by the shareholders to negotiate on their behalf with a potential takeover bidder.\textsuperscript{106} Hence, if the facts show that the directors hold themselves out as agents for the minority shareholders, a fiduciary duty arises.\textsuperscript{107}

(b) Improper Issuance of Shares

If the directors issue shares to create or destroy a majority in the company, this would be actionable as it amounts to an improper use of their power to issue shares.\textsuperscript{108} It is immaterial whether the directors are acting in good faith. This principle was summarised by Lord Wilberforce in \textit{Howard Smith Ltd v Ampol Petroleum Ltd}:

Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders... so it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority, which did not previously exist.

It is paradoxical to say that the director owes a duty to the company to exercise their

\textsuperscript{104} Equally, the directors do not owe duties to third parties: \textit{Bath v Standard Land Co Ltd} [1911] 1 Ch 618.
\textsuperscript{105} Although the principle has been reaffirmed in \textit{Re chez Nico (Restaurants) Ltd.} [1992] BCLC 192 at 208h.
\textsuperscript{106} \textit{Allen v Hyatt} (1914) 30 TLR 444; See also \textit{Briess v Wolley} [1954] AC 333.
\textsuperscript{107} \textit{Platt v Platt} [1999] 2 BCLC 745, 754-756c.
powers of allotment in a proper manner, and on the other hand, to allow the minority shareholders, ex-majority shareholders, to issue the proceedings against the directors where there was no illegality or ultra vires transactions. A better explanation is that, as there is authority for this proposition,\textsuperscript{109} an abuse of fiduciary powers granted to the board by the articles of association is an infringement of a member's contractual rights under the articles. Hence, it is a personal right that enables a minority shareholder to bring proceedings against an improper exercise by the directors of their power of allotment.

(c) Competing Bid

The directors may owe a fiduciary duty to shareholders where there are competing bids for a company.\textsuperscript{110} In \textit{Heron International Ltd v Lord Grade},\textsuperscript{111} the Court of Appeal said:

\begin{quote}
Where directors have decided that it is in the interests of a company that the company should be taken over, and where there are two or more bidders, the only duty of the directors, who have the powers such as those contained in Art 29, is to obtain the best price. The directors should not commit themselves to transfer their own voting shares to a bidder unless they are satisfied that he is offering the best price reasonably obtainable. Where the directors must only decide between rival bidders, the interests of the company must be the
\end{quote}

\textsuperscript{109} \textit{Re Sherborne Park Residents Co Ltd, Re a Company} (No 005136 of 1986) [1987] BCLC 82, sub nom \textit{Re Sherborne Park Residents Co Ltd} 2 BCC 99, 528, 99, 531; \textit{Punt v Symonds & Co Ltd} [1903] 2 Ch 506; \textit{Howard Smith Ltd v Ampol Petroleum Ltd} [1974] AC 821 was not, apparently, a derivative claim.


\textsuperscript{111} \textit{Heron International Ltd v Lord Grade} [1983] BCLC 244 at 265c-e; \textit{Re a Company} (No 008699 of 1985) [1986] BCLC 382d; \textit{John Crowther Group plc v Carpets International plc} [1990] BCLC 460.
interests of the current shareholders. The future of the company will lie with the successful bidder. The successful bidder can look after himself, and the shareholders who reject the bid and remain as shareholders do so with their eyes open, having rejected that price which the directors consider to be the best price reasonably obtainable....

Although this analysis is subject to the particular article of association in question, it is difficult to see how the court would hold otherwise in respect of different forms of articles of association.\textsuperscript{112}

(d) Director's 'conscience' or Minority Shareholder's Injury?

If the directors' breach of duty is ratifiable and the process is not regarded as an abuse, the minority is left without recourse. It is because in law the court does not consider that the directors can owe a fiduciary duty to minority shareholders absent special circumstances in which agency relationship is manifested. However, if the harm to the minority is so great as to give the suspicion of being inequitable in the conduct of directors, the court may intervene. This is best demonstrated in cases concerning section 459 of the Companies Act 1985. The courts have said on several occasions that they look at the equitable principles to formulate the term 'unfair prejudice'. Under section 459 of the Companies Act 1985, the director's conduct can be 'unfairly prejudicial' to the minority shareholders regardless of the breach of the fiduciary duty, and the court will interpret the phrase 'unfair prejudice' in line with the equitable principles. The court focuses on the impact on the minority rather than the 'mind' of the directors. Therefore, if the minority shareholders were manifestly put in a position

of disadvantage, the court would allow the minority shareholders to bring an action regardless of whether the directors were in breach of the fiduciary duties.

7. The Majority's Duty towards the Minority

There is no case suggesting that majority shareholders owe a duty to the minority shareholders. Majority shareholders can be in some situations owe a duty to the company when they are the controlling mind of the company.

In *Allen v Gold Reefs of W Africa*, Lindley MR held that members must exercise their votes 'bona fide for the benefit of the company as a whole.' This is said to be a misleading statement in suggesting that members are subject to precisely the same basic principles as directors. It has been repeatedly laid down that voting rights are proprietary rights, to the same extent as any other incidents of the shares, which the holder may exercise in his own selfish interests even if these are opposed to those of the company. Members may even bind themselves by contract to vote or not to vote in a particular way, and this contract may be enforced by injunction despite having the effect of disregarding the interests of minority shareholders. The general meeting is regarded as having power to act in place of the board if for any reason the board cannot function. If there is a deadlock or the quorum is not obtainable, the general meeting may act instead. In some circumstances, the

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114 *Allen v Gold Reefs of W Africa* [1900] 1 Ch 671.
115 *North-West Transportation Co. v Beatty* (1887) 12 App Cas 589, PC; *Burland v Earle* [1902] AC 83, (PC); *Goodfellow v Nelson Line* [1912] 2 Ch 324.
116 *Greenwell v Proter* [1902] 1 Ch 530; *Prudential v Leith* [1916] 1 Ch 200, in which a mandatory injunction was granted.
117 *Barron v Potter* [1914] 1 Ch 895. *Foster v Foster* [1916] 1 Ch 532 ; *Alexander Ward & Co. Ltd v Samyang Navigation Co Ltd* [1975] 1 WLR 673 (HL); *Breckland Holdings Ltd v London & Suffolk...
general meeting can authorise or ratify what would otherwise be a breach of the
director’s duties. If the majority shareholders have the *de facto* control of the general
meeting, the power of control is hence vested in the majority shareholders rather than
the directors.

In *Shuttleworth v Cox Bros. Kid*, a case concerning not expropriation of shares but the
removal of an unpopular life director, the Court of Appeal, in upholding the validity of
a resolution inserting in the articles a provision that any director should vacate the
office if the board so decides, held that it was for the members not the court to decide
whether the resolution was for the benefit of the company and that the court would
intervene only if satisfied that the members had acted in bad faith. Bad faith is
determined according to the standard of a reasonable man. Therefore, if a reasonable
man would not have purchased the minority shareholder’s shares at an obvious
undervalue, it can be said that the majority shareholders acted in bad faith, hence, a
proposal to be made is whether the majority must act bona fide to the minority
shareholder in order to justify the act in the interests of the company rather than the
minority shareholders.

An Australian court in *Peter’s American Delicacy Co Ltd v Heath*,\(^{118}\) refused to
regard the ‘bona fide in the interests of the company’ test as a useful one in the
context of a conflict between two groups of shareholders as to how their respective
rights and liabilities should be adjusted. Ratification is not possible if the breach of
duty involves the expropriation of corporate property or acting by the directors with
actual dishonesty, as it would amount to fraud on the minority. It can be argued that

\(^{118}\) *Peter’s American Delicacy Co Ltd v Heath* (1939) 61 CLR 457.
the interests of the minority are protected by depriving the majority of the power to ratify certain acts. However, it is unclear whether in these cases the shareholders cannot act at all or whether, as is submitted ought to be the case, unanimity is required.

In contrast with the majority shareholder’s power to alter the articles of association, the question is how far the majority, in taking their decisions, are subject to some version of the duty to act bona fide for the benefit of the company as a whole. In other words, even if the act amounts to expropriation, the majority’s act is not completely prohibited, but subject to a form of judicial review of the majority’s reasons.

In *Brown v British Abrasive Wheel Co*, the majority shareholders holding 98 per cent of the shares passed a resolution to alter the articles of association to the effect that any shareholder was bound to transfer his shares upon a request in writing of the holders of 90 per cent of the shares. The 2 per cent minority shareholder applied for an injunction, and the injunction was granted on the ground that the provision was done for the benefit of the majority not the company as a whole. The court drew a distinction between the interests of majority shareholders and that of minority shareholders. In *Sidebottom v Kershaw, Leese & Co Ltd*, the Court of Appeal held that the company passing a special resolution to empower the directors to require any shareholder who competed with the company to sell his shares at a fair value to nominees of the directors was beneficial to the company. In *Dafen Tinplate Co v*
Llanelly Steel Co,\textsuperscript{122} the court held at the first instance that a resolution inserting a new article empowering the majority to buy out any shareholder as they thought proper was invalid as it was not in the interests of the company. However, the court was equally unwilling to leave the issue to the majority rule, coupled with a requirement of good faith on the part of the majority. The court also declined to follow the ‘English authority’ as ‘it does not attach sufficient weight to the proprietary nature of a share.’\textsuperscript{123} However, should the case have distinguished between harm and benefit in upholding the validity of the act of the majority shareholders?

An act may advance interests of the company with or without harm to the majority shareholders. Harm to the company may be an interest to the minority shareholders. It would be wrong to uphold the invalid act but surely there will be a factual question as to who will bring the action against the act if the minority agreed to it. There may be other stakeholders who are able to challenge the validity of the act. However, it may be that nobody will sue in these circumstances. Therefore, the argument based on ‘interests of the company’ fades away. In \textit{Greenhalgh v Arderne Cinemas Ltd},\textsuperscript{124} concerning the majority shareholder passing a resolution to circumvent the pre-emptive rights by the minority shareholders with the view to selling the company to an offeror, the minority shareholder applied for an injunction on the ground of fraud on the minority. Evershed MR said:

\begin{quote}
[... ] in the first place, I think it is now plain that “bona fide for the benefit of the company as a whole” means not two things, but one thing. It means that the shareholder must proceed on what, in his
\end{quote}

\textsuperscript{122} \textit{Dafen Tinplate Co v Llanelly Steel Co Ltd} (1907) [1920] 2 Ch 124.
\textsuperscript{123} \textit{Dafen Tinplate Co. v Llanelly Steel Co Ltd} (1907) Ltd [1920] 2 Ch 124.
\textsuperscript{124} \textit{Greenhalgh v Arderne Cinemas Ltd} [1951] Ch 286, CA and [1950] 2 All ER 1120 where the judgment of Evershed MR is reported more fully.
honest opinion, is 'for the benefit of the company as a whole' does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporations; it means the corporations as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit.'

It was criticised as unrealistic to apply this reasoning in the situation other than a small family-held company with directors voting as members at general meetings, because in a large company, the members can always say that the voting was in their honest opinion for the benefit of the company as a whole. Evershed MR went on to say:

I think that the matter can, in practice, be more accurately and precisely stated by looking at the converse and by saying that a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders, so as to give the former an advantage of which the latter were deprived.

It is a clear intention of the court to give right to the minority shareholders.

In *Re Holders Investment Trust*,125 concerning a capital reduction scheme requiring confirmation of the court, the confirmation was refused on grounds that the resolution of a class meeting of the preference shareholders had been passed as a result of votes of trustees who held a large block of the preference shares. In upholding the resolution, Megarry J considered that he must be satisfied that the resolution of the preference shareholders.

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125 *Re Holders Investment Trust* [1971] 1 WLR 583.
shareholders had been validly passed bona fide in the interest of that class. The case confirms that view that, in relation to class meetings, it is the interest of the class rather than that of 'the company as a whole' that has to be considered. In *Clements v Clements Bros Ltd*¹²⁶, a case concerned with the passing of a resolution to deprive the claimant's of her 45 per cent shareholding and of her negative control in blocking a special or ordinary resolution and reducing the value of her pre-emptive rights under the articles if another shareholder wished to sell, Foster J set aside the resolution and said, 'They are specifically and carefully designed to ensure not only that the plaintiff can never get control of the company but to deprive her of what has been called her negative control. Whether I say that these proposals are oppressive to the plaintiff, or that no one could reasonably believe that they are for her benefit, matters not.' It was argued that what Foster J had in mind was the term 'unfair prejudice', influenced by the section 201 of the 1948 Act, the predecessor of the present section 459.¹²⁷ Was the term 'unfair prejudice' similar to the concepts of 'fraud on minority' and 'bona fide in the interests of the company'? If it was the case, once the minority shareholders are unfairly prejudiced, the majority shareholders are not acting bona fide in the interests of the company, despite the fact that they genuinely thought they were.

C. PROTECTION UNDER THE HUMAN RIGHTS ACT 1998

1. Introduction

¹²⁶ *Clements v Clements Bros Ltd* [1976] 2 All ER 268.
The Human Rights Act 1998 offers a new opportunity for the development of the common law through the interaction between the principles of company law and the 'rights' of its shareholder.\textsuperscript{128} Although the Human Rights Act 1998 is an Act of Parliament, it is neither strictly an Act of Parliament designed to protect the shareholders nor is it enacted to create new statutory rights for the minority shareholders additional to or different from their common law rights. The following section intends to look at the dynamism of the Act, and minority shareholder's rights in the perspective of the Human Rights Act 1998.

2. Corporate Legal Personality

A company has its separate legal personality.\textsuperscript{129} It is significant that the concept of separate legal personality is recognised under the Human Rights Act 1998. This means that even under the Act, minority shareholders may be barred from pursuing a claim because of the doctrine of separate legal personality of the company.

A company is not entitled to all the claims under the Human Rights Act 1998 (HRA 1998). A company cannot claim the right to life, the right to marry, and the right to freedom from torture. However, a company can only claim the rights which are of less human orientation. The European Court of Human Rights has always accepted that the corporation is a 'person' for the purpose of the victim status under Article 34 of the European Convention on Human Rights.\textsuperscript{130}

\textsuperscript{130} \textit{Auronic AG v Switzerland} (1990) 12 HERR 485.
In *R v Broadcasting Standards Commission, ex p BBC*, the BBC applied for judicial review contending that the BSC set up by the Broadcasting Act 1996 was acting *ultra vires* in upholding the complaint by Dixons that its privacy had been infringed by the BBC and that the infringement had been unwarranted. In this case, Dixons had been secretly filmed by the BBC. One of the issues before the court was whether Dixon’s could enjoy the right to privacy under the Act. Lord Woolf MR said:

[I] t does not in my judgement provide the answer to the issues, which I have to determine. I, therefore, propose to do no more than to refer specifically to the opinion of Advocate General Mishco...[H] e conducts a wide ranging survey of the law of Member States and indicates that at the time of his opinion those Member States and indicates that at the time of his opinion those Member States do not speak with one voice as to whether concepts such as privacy are capable of applying to commercial enterprises but finds that “...a general trend is discernable in the national legal systems towards the assimilation of business premises to a home.

The Master of Rolls did not think that there were authorities compelling him to decide on this point. However, he was inclined to look at other Member States’ approaches in the application of the right to privacy. Lady Justice Hale took a more courageous approach and said that:

[T]he infringement consists in depriving the person filmed of the possibility of refusing consent. If this is so for an individual, I cannot see why it should not also be capable of being so for a company. The company will have its own reasons (good or bad) for wanting or not wanting to object and the secrecy of

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131 *R v Broadcasting Standards Commission, ex parte. BBC* [2000] HRLR.
the filming has deprived it of the opportunity to do so.\textsuperscript{132}

Lord Mustill showed a strong disinclination to accept the concept of corporate right to privacy and said that:

I do, however, wish to emphasize the degree to which this conclusion is dependant on the language and purpose of this particular structure, for in general I find that the concept of a company's "privacy" hard to grasp. To my mind, the privacy of a human being denotes at the same time the personal 'space' in which the individual is free to be itself... [A]n infringement of privacy is an affront to the personality, which is damaged both by the violation and by the demonstration that the personal space is not violate...[I] do not see how it can apply to an impersonal corporate body, which has no sensitivities to wound, and no selfhood to protect.

The reason for the refusal to recognising this privacy right to corporation is based on the argument that the right is of human orientation hence not enjoyed by corporations. However, Lord Templeman did consider that the company had a 'conscience'.\textsuperscript{133}

The court is inclined to recognise corporate legal personality under the Human Rights Act 1998. Therefore, it is reasonable to expect that the court can raise the 'proper plaintiff' rule in dismissing minority shareholders action whether the claim was about their proprietary right, or their right to access to justice.

\textsuperscript{132} \textit{R v Broadcasting Standards Commission, ex parte BBC} [2000] HRLR para43.  
\textsuperscript{133} \textit{Winkworth v Edward Baron Development Co Ltd} [1987] 1 All ER 114,118.
3. Current English Law

The English court has been reluctant to lift the corporate veil to protect shareholders rights. However, there are several cases in which the court recognised the need to pierce the corporate veil. In *Littlewoods Stores v IRC*,\(^{134}\) Lord Denning said:

> [T]he doctrine laid down in Salomon’s case has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit.

In *DHN Ltd v Tower Hamlets*,\(^{135}\) the court also said that:

> [T]his group is virtually the same as a partnership in which all three companies are partners. They should not be treated separately so as to be defeated on a technical point. They should not be deprived of the compensation which should justly be payable for disturbance. The three companies should, for present purposes, be treated as one, and the parent company D.H.N. should be treated as that one.

In *Re A Company*,\(^{136}\) the Court of Appeal stated that 'the court will use its power to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal

\(^{134}\) *Littlewoods Stores v IRC* [1969] 1 WLR 1241.

\(^{135}\) *DHN Ltd v Tower Hamlets* [1976] 1 WLR 852, 860.

\(^{136}\) *Re A Company* (1985) 1 BCC 99, 421.
efficacy of the corporate structure under consideration’. Only majority shareholders can bring an action against a third party. It is because the majority shareholder is able to bring an action on behalf of the company in the company’s name. Minority shareholders are unable to do so unless they successfully obtain the approval from the majority shareholders or company directors to bring suits in the name of the company in the form of a ‘derivative action’. Whether or not the minority shareholders can bring a suit will depend on the decisions of the majority shareholders or the directors. The minority shareholders have to resort to the claim under s 459 of the Companies Act 1985 to obtain relief if the court feels that their rights have been unfairly prejudiced.

4. Early Strasbourg Case Law

The Strasbourg case law lays down a rule on standing according to which the minority shareholders can bring a claim under the Convention only if they are victims and their rights have been interfered with. In Yarrow v United Kingdom, it was held that if the acts complained of were directed against the company and not against the shareholders’ personal interest, the minority shareholders would not normally fulfil the requirements of victim status. The Commission continued to say that the majority shareholders could fulfil the requirements for the victim status as their direct personal interest that had been affected by an act directed at the company and the reality of the situation was that the majority shareholders were merely carrying on a business through the medium of the company. Hence, a violation aimed at the company will

mean that the majority shareholders will qualify as ‘victims’. Even if the articles of association stipulated that the right to bring an action must be passed by a resolution of 75 per cent majority, in theory, a simple majority of 50 per cent is able make a claim under the Convention. In Pine Valley Developments Ltd v Ireland,\footnote{Pine Valley Developments Ltd v Ireland (1991) 14 EHRR 319.} the Commission also recognised that persons who have ‘interests’ in the land and are the shareholders of the companies which held the land in question, have standing. It is because the companies are merely vehicles for the claimants. This case suggests that only those who are directly affected can claim victim status. In Agrotexim v Greece,\footnote{Agrotexim v Greece (1995) 21 EHRR 250.} where six Greek limited companies with a shareholding in another Greek company with limited liability claimed violation of Article 1 of Protocol No 1 to the European Convention on Human Rights because the expropriation of the land infringed Article 1 of Protocol No 1, the European Court of Human Rights found that the shareholders had no \textit{locus standi} to bring their claims before the Court, and ‘the piercing of the ‘corporate veil’ or the disregarding of a company’s separate legal personality will be justified only in exceptional circumstances, in particular where it is established that it is impossible for the company to apply to the Convention Institutions through the organs set up under its articles of incorporation or in the event of liquidation through its liquidator’.\footnote{Agrotexim v Greece (1995) 21 EHRR 250 para65-66.} In \textit{G v Luxembourg}\footnote{G J v Luxembourg 26/10/2000 Application no. 21156/93.} the Court said:

\begin{quote}
[D]isregarding a company’s legal personality as regards the question of being the "person" directly affected by the act or omission which is in issue will be justified only in exceptional circumstances, in particular, where it is clearly established that it is impossible for the company to apply to the Court through the organs set up under its articles of incorporation or- in the event of liquidation- through its liquidators.
\end{quote}
The Agrotexim model is substantially the same as the English position on corporate standing established in Foss v Harbottle to the effect that only the majority shareholders can bring actions in the name of the company against third parties. The application of this principle appears limited to cases solely involving Protocol No 1, Article 1.

(a) Shareholders' Standing under Protocol 1, Article 1

The approach of the European Court of Human Rights is twofold. First, the court will consider whether the claimant's possession has been interfered with. If so, the Court will look at whether there is nevertheless a 'fair balance' between the interests of the public and those of the individual claimant. The second question is that of proportionality, which is to ask whether the measure is proportionate to the aim pursued. The word 'property' does not actually appear in the first part of Protocol 1, Article 1. The word 'possession' has been defined widely by the European Court of Human Rights include movable property, incorporeal interests such as shares, patents, contractual rights including rights in leases, the right to exercise a profession, judgement debts, and established legal claims. If the claimant qualifies for victim status, meaning they satisfy the Agrotexim test, their proprietary interests have been interfered with, and the measure is not proportionate to the aim pursued, the claimant will succeed in the claim under the Convention. In Sporrong and Loennroth v Sweden, it was held that interference could take the effect of actual or de facto

142 Sporrong and Loennroth v Sweden (1982) 5 EHRR 35.
deprivation such as the loss of use but not title to land,\textsuperscript{143} even if the possession is subject to control such as planning\textsuperscript{144} and rent controls.\textsuperscript{145} The second question the Court will consider is the ‘fair balance test’. This test looks at whether the interference results in a ‘fair balance’ between the interests of the wider community and those of the applicant. The Court, in considering the fair balance test, will have regard to the reasons for the interference and the proportionality of the interference itself. The availability of an effective remedy and compensation for the applicant is highly relevant when assessing whether there is a ‘fair balance’ justifying state interference.\textsuperscript{146} The Strasbourg Court will apply the doctrine of the margin of appreciation. However, the margin of appreciation has no application in the domestic court.\textsuperscript{147} It may be predicted that the English courts will apply the test of proportionality in these cases.

Article 1 of Protocol No 1 is not concerned with relationship of a purely contractual nature between private individuals.\textsuperscript{148} It applies where the state itself interferes with property rights, or permits a third party to do so.\textsuperscript{149} If the state adopts laws that require one individual to sell his property to another individual, or fixes prices for private sales or rent, then a \textit{prima facie} interference is established. The state is not generally responsible for the regulation of private law rights, unless the state has used its governmental authority in some way to affect the exercise of those rights. Although a private law dispute resolved by way of judicial determination does not necessarily give rise to interference by that state, it can be argued that if a domestic court fails to

\textsuperscript{143} Papamichalopoulos \textit{v} Greece (1993) 16 EHRR 440.
\textsuperscript{144} Pine Valley Developments \textit{v} Ireland (1991) 14 EHRR 319.
\textsuperscript{145} Mellacher \textit{v} Austria (1989) 12 EHRR 391.
\textsuperscript{146} Holy Monasteries \textit{v} Greece (1994) 20 EHRR 1; Lithow \textit{v} United Kingdom (1986) 8 EHRR 329.
\textsuperscript{147} James \textit{v} United Kingdom (1986) 8 EHRR 123.
\textsuperscript{148} Gustafsson \textit{v} Sweden (1996) 22 EHRR 409 (para.60).
\textsuperscript{149} \textit{S v United Kingdom} App No 1074/84; 41 DR.
interpret the law in the light of the Human Rights Act, this constitutes a violation of the relevant Convention right.

5. Approach to be Adopted by the English Courts under section 459 of the Companies Act 1985

Because in the domestic court there is no space for the application of the doctrine of margin of appreciation, the protection of the right under Protocol 1, Article 1 will be more solid than that afforded by the Strasbourg Court. The immediate problem faced by the English courts regards the compulsory expropriation under the company’s reorganisation and recapitalisation scheme. Under Section 459 of the Companies Act 1985, a member of a company may apply to the court by petition for an order on the ground that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial. The remedy normally granted is the acquisition of the shareholder’s shares at the market value. If the compensation is not sufficient to satisfy the ‘fair balance’ test, the shareholders will have a claim under Protocol 1, Article 1. Under sections 280 and 430F of the Companies Act 1985, if the offeror has acquired more than 90 per cent of the shares offered, the offeror acquired the right to acquire compulsorily the rest of the shares offered. In these circumstances, the minority shareholders may bring an action under Protocol No 1, Article 1, and/or Article 6 of the European Convention on Human Rights, providing for the right to fair trial. The court will need to interpret the legislation on compulsory purchase compatibly with the Convention rights under section 3 of the Human Right Act 1998. The court will need to rule on the
reasonableness of the price offered to the shareholders. If the company inserted a clause in the articles of association whereby the majority of the shareholder can expropriate the minority’s shares in the circumstances provided, the purchase will not be compulsory because section 14 of the Companies Act says that the memorandum and Articles ‘shall, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member’. However, if the articles are inserted afterwards, the minority shareholder can raise the issue under the Human Right Act 1998.

6. Variation of Class Rights

Section 125 of the Companies Act 1985 is concerned with the variation of the rights attached to any class of shares in a company whose share capital is divided into shares of different classes. It requires a 75 per cent majority to approve the variation of the scheme. If a holder of 15 per cent of the shares in that class objects to the variation, they can apply to the court under section 127 to have the variation cancelled. Under English law, only when the enjoyment of the rights is affected, the shares may be commercially less valuable. However, minority shareholders could argue that their ‘business’ right, which constitutes ‘possessions’ as interpreted by the Strasbourg Court, has been interfered with, and the law must provide a fair balance by providing adequate compensation.

7. Company Reconstruction, Administration, and Liquidation

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150 Greenhalph v Arderne Cinemas Ltd [1946] 1 All ER 512.
When the company is in crisis, the court must act compatibly with the Convention rights. The officials appointed by the court will have to act compatibly with the Convention rights. Whether the claimant is likely to succeed in the action against the court-appointed official would depend on the court applying a 'fair balance' test and the test of proportionality. In *Re Equitable Life Assurance Society*, a case concerned with Article 1 of Protocol No 1, the minority shareholders claimed that they had been unjustly deprived of their property rights by way of the scheme of arrangement under section 425 of the Companies Act 1985. Lloyd J said:

> [I]t seems to me plain that, given the terms of section 425 and the case law that has been established concerning its application, there is no possible argument for saying that the approval of a scheme under section 425, so as to bind dissentients among the relevant classes, breaches the rights afforded by Article 1 of Protocol 1.... the Scheme does both in law and in fact involve exchange of rights and thus consideration. No arrangement capable of being approved under section 425 could, in my view, amount to a confiscation such that Article 1 would be infringed.

Lloyd J based his judgment on the contractual theory. If there is exchange of rights, there will be no breach so long as the law does not create such inequality that one person is arbitrarily and unjustly deprived of the property in favour of another. There is no further need to say more on the point of 'arbitrary'. However, Lloyd J seems to equate 'unjustly' with 'contractually'. The problem is that minority shareholders can seek to argue that they must be treated as a different class from majority shareholders.

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152 *In The Matter of the Equitable Life Assurance Society And In the Matter of the Companies Act 1985*, para 86.
shareholders because their interests are dissimilar from the majority shareholders which approve the scheme. The question which arises here is whether the shareholders hold different interests in the eyes of the law. In Hawk Insurance Company Limited concerning the separation of different classes of creditors of the scheme of arrangement under the Companies Act 1985, Chadwick LJ relied on the ratio laid down by Bowen LJ in Sovereign Life Assurance Company v Dodd:

The scheme proposed may be regarded as single arrangement with those creditors whom it is intended to bind if, but only if, the rights of those creditors are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. If the rights of those creditors whom the scheme is intended to bind are such as to make it impossible for them to consult together with a view to their common interest, then the scheme must be regarded as a number of linked arrangements. In the latter case, it will be necessary to have a separate meeting of each class of creditors; a class being identified by the test that the rights of those creditors within it are not so dissimilar that as to make it impossible for them to consult together with a view to their common interest.

If this principle is to be applied to shareholders, it is then possible to argue that the minority shareholders have different proprietary interests than those of the majority shareholders. As a consequence, they may have a claim under Article 1, Protocol 1.

In Re Waste Recycling Group Plc, where the purpose of the scheme of arrangement was to carry through the recommended takeover of a company and the shareholder claimed that compulsory acquisition of shares infringed his rights under Convention, the court held that the approval of the scheme of arrangement under section 425 of the
Companies Act 1985 did not infringe Convention rights under the European Convention on Human Rights 1953 Protocol 1 Art 1.\textsuperscript{153}

**D. CONCLUSION**

The analysis of this chapter has highlighted a number of circumstances where minority shareholders do not receive adequate protection under the current law. The distinction between personal right and derivative right often raises unwarranted obstacles to private actions by minority shareholders. This is due to the fact that English courts have so far favoured the market control model and the internal control model. The private action model is undeveloped. This approach has been adopted to solve the floodgate problem. However, it appears that the courts are able to dismiss unwanted actions by applying the doctrine of abuse of process and using their powers under the CPR. There is no need to place limitations on the standing of minority shareholders especially where a personal right based on harm to the shareholder can be identified. If the harm to the minority shareholders is not insignificant and there is a clear evidence of differential treatment or unfair prejudice, the court should give standing to minority shareholders to bring actions against the controllers of the company, including directors and controlling shareholders. The harm must be caused by the wrongs of the wrongdoers, but it should not depend on whether the wrong was ratifiable or has been ratified. The next step is to identify the wrongdoers, be it the company itself, directors, majority shareholders, or even third parties. The relationship between the wrongdoers and the minority shareholders can be fiduciary,

\textsuperscript{153} Re Waste Recycling Group Plc (Ch D) Chancery Division 28 July 2003, unreported.

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contractual, or of proximity in the tortuous sense. The wrongdoers will be able to raise the defence of ratification, in which they must prove that in the process of ratification there is no abuse of power that renders the process undemocratic.

Under the Human Rights Act 1998, more relaxed rules on minority shareholders’ standing in respect of their property rights would appear to be in line with the ‘harm-based’ approach advocated in this chapter. However, because of the doctrine of legal personality and standing requirements upheld by the European Court of Human Rights, which mirror the equivalent restrictions at common law, claims under the Convention will still be residual in the area of minority shareholders’ protection in takeovers.

The real significance of the Human Rights Act 1998 is that courts have a duty under the Act to construe and apply the law in a way which is, as far as practicable, consistent with Convention rights. This means construing and applying the common law and the statutes protecting minority shareholders so as to give effect to their proprietary rights. This may give rise to a more harm-based and rights-based jurisprudence on shareholders’ actions than has been the case so far.
CHAPTER VI

STATUTORY PROTECTION OF MINORITY SHAREHOLDER

A. INTRODUCTION

The previous chapter has shown that the right of minority shareholders to bring a private action in their own name or on behalf of the company has been narrowly construed.¹ This chapter examines the aspects of the regulatory model that relate to statutory protection and self-regulatory systems backed by statutory endorsement.

Several statutory provisions are in place to remedy the unsatisfactory outcome generated by the common law restrictions on minority shareholders’ private actions. Section 459 of the Companies Act 1985 was enacted to give the minority shareholder the right to bring a suit against the company or the controller based on the concept of ‘unfair prejudice’. However, the term created ambiguity and confusion with another term, ‘just and equitable’, used in section 122 of the Insolvency Act 1986.

Besides section 459 of the Companies Act 1985 and section 122 of the Insolvency Act 1986, provisions on the schemes of arrangement under the Companies Act 1985 also provide a framework for corporate rescue. Although the scheme is based on voluntary negotiation through the democratic corporate procedure, ‘reasonableness’ is the

¹ See Chapter V above.
ultimate test in giving validity to what is agreed by the court.²

Finally, it is the Takeover Code that governs the contested bid in the free capital market. The protection given to minority shareholders under the Code is of a different type from that afforded by the common law or statutes. To understand the minority shareholders’ position, the Code will need to be examined in line with City practice. In such a self-regulatory system, the court is of little assistance to the interpretation of the Code.³ However, the protection afforded by the Code is important in that it seeks to provide a solution to the inadequate protection given by the common law to investors in the modern capital market.⁴

B. CONCEPT OF ‘UNFAIR PREJUDICE’⁵

1. Meaning of the Term

Section 459 of the Companies Act 1985 provides that members of the company may petition⁶ to the court for judicial relief if the conduct of a particular group or

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² Companies Act 1985 s 425 to 427A.
⁵ O’Neil v Phillips [1999] 2 BCLC1 in which for the first time the House of Lords has had the opportunity to consider the scope of the unfair prejudice remedy. Lord Hoffmann gave the reasoned judgment in which his Lordship traces the principles on which the court decides the alleged conduct is unjust, inequitable or unfair back to 18th century cases such as Bisset v Daniel and the distinction between the legal and equitable approach to the use of powers.
⁶ The procedure for petitions is governed mainly by the Companies (Unfair Prejudice Applications) Proceedings Rules 1986 (SI 1986 No. 2000), but also by the Rules of the Supreme Court, the Country Court Rules and the practice of the High Court, where not inconsistent with the 1986 Rules. For earlier
members of the company amounts to 'unfair prejudice'.\textsuperscript{7} There are two historical aspects of the statute, which affect the later interpretation of the term. The first is that prior to amendment, it was ‘oppressive’ conduct rather than ‘unfair prejudice’ that allowed the petition.\textsuperscript{8} The second is that the prior statute provided that the conduct must affect the members of the company, while the present wording refers to ‘members or part of the members of the company’. The word ‘oppressive’ signifies a higher degree of malpractice than the meaning of ‘unfair prejudice’. Even by literal interpretation only, it is clear that any oppressive conduct would amount to ‘unfair prejudice’. The intention of the statute is to give more protection to the designated party or parties. Slade J gave the following explanation of the term ‘unfair prejudice’:

\begin{quote}
Without prejudice to the generality of the wording of the section, which may cover many other situations, a member of a company will be able to bring himself within the section if he can show that the value of his shareholding in the company has been seriously diminished or at least seriously jeopardized by reason of a course of conduct on the part of those persons who have had \textit{de facto} control of the company, which is unfair to the members concerned. The test of fairness must, I think, be an objective, not a subjective one. In other words, it is not necessary for the petitioner to show that persons who have had \textit{de facto} control of the company have acted as they did in the conscious knowledge that this was unfair to the petitioner or that they were acting in bad faith; the test I think is whether a reasonable bystander observing the consequences of their conduct would regard it as having unfairly prejudiced the petitioner’s interests.\textsuperscript{9}
\end{quote}

\textsuperscript{7} Companies Act 1985 s 459.
\textsuperscript{8} Report of the Company Law Committee (Cmnd 1749, HMSO, London, 1962). The Jenkins Committee’s proposals for a new ‘unfair prejudice’ remedy were, after a long delay, implemented by section 75 of the Companies Act 1980. The most important reform proposed was that the key concept on which relief should be founded should become ‘unfair prejudice’ to shareholders rather than ‘oppression’.
\textsuperscript{9} Re RA Noble (Clothing) Ltd [1983] BCLC 273, 290-1 where Nourse J cited the passage of Slade J from the judgment in Re Bovey Hotels, unreported, 31 July 1981.
As regards the second historical aspect of the statute, which relates to the persons affected by the ‘unfair prejudice’, there is a deliberate distinction between members and part of the members. This distinction demonstrates the discrimination envisaged by the statute, whereby minority shareholders as part of the members affected by the conduct can petition to the court. Prior to the 1989 amendment, a petition under section 459 of the Companies Act 1985 could only be brought where the company’s affairs were being conducted in a manner unfairly prejudicial to the interests of ‘some part’ of the members. This was construed to mean that a petitioner had to show discrimination.\(^\text{10}\) Harman J in *Re A Company (No 0370 of 1987)*\(^\text{11}\) held that the board’s failure to declare a dividend was not discriminatory between shareholders, given that all members were affected equally. Therefore, he refused an interlocutory application for leave to amend the section 459 petition. The amendment of section 459 effected by the Companies Act 1989\(^\text{12}\) directly reversed the requirement of discrimination, which gave statutory effect to the decision of Peter Gibson J in *Re Sam Weller & Sons Ltd*,\(^\text{13}\) who in refusing to follow Harman J, held that the failure to declare adequate dividends could amount to unfairly prejudicial conduct notwithstanding that all of the company’s shareholders were affected.

Having examined the reasons and implications of the 1989 amendment of s 459, it is necessary to focus on the concept of ‘unfair prejudice’. Even if it is possible, by

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\(^{10}\) *Re Carrington Viyella plc* [1983] 1 BCC 98, in which it was held that a breach of director’s duties could not support a s 459 petition because the conduct in question affected all of the company’s shareholders.


\(^{12}\) Companies Act 1989 s145 and Schedule 19, para 11, which came into force in 1991.

\(^{13}\) *Re Sam Weller & Sons Ltd* [1990] Ch 682.
comparing the wording of the statute before and after the amendment, to maintain that 'unfair prejudice' includes conduct that would not have been 'oppressive', this does not offer us a clear indication of the degree of seriousness, which may give rise to the action.

The starting point in the analysis is that the concept of 'unfair prejudice' consists of two limbs: 1) the concept of 'unfairness'; and 2) the effect of 'prejudice'. The two limbs must be kept separate. It has been rightly pointed out that unfair conduct may not necessarily have prejudicial effect on the minority shareholders; vice versa, a prejudicial effect on the minority shareholders does not necessarily warrant the inference that the conduct complained of is unfair on the alleged party. In fact, in a number of cases the courts have stressed that section 459 requires prejudice to the minority, which is unfair, and not prejudice per se.14

The remainder of this section examines the first limb of the test and how it impacts on the level of protection of minority shareholders. The second limb will be examined in the next section.

'Fairness' is a word of art. The definition of the concept of fairness is the question that every legal system seeks to determine when drawing the line between permitted and prohibited conduct, not only in company law but in many other areas. The Jenkins Committee considered it to be 'a visible departure from the standards of fair dealing and a violation of the conditions of fair play on which every shareholder who entrusts

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his money to a company is entitled to rely.\textsuperscript{15} Prejudice to the members is permitted under this section so long as it satisfies the fairness requirement. If this definition of ‘unfairness’ is adopted, the problem becomes essentially of problem of proof.

It seems that ‘unfairness’ could be established via two legal routes. Under the first, both elements must be proved by the claimant to establish the cause of action. Under the second route, once the petitioner establishes prejudice, there is a presumption of unfairness, which may be rebutted by the respondent. The second route strengthens the protection of minority shareholders by distributing the burden of proof between the petitioner and the respondent.

The authorities suggest that the test of whether the prejudice was unfair is an objective one,\textsuperscript{16} but this means no more than that unfair prejudice may be established even if the controllers did not intend to harm the petitioners.\textsuperscript{17} Hoffman J questioned the objective determination of unfairness in \textit{Re Saul D Harrison}. He said:

\begin{quote}
For one thing, the standard of fairness must necessarily be laid down by the court. In explaining how the court sets about deciding what is fair in the context of company management, I do not think that it helps a great deal to add the reasonable company watcher to the already substantial cast of imaginary characters which the law uses to personify its standards of justice in different situations. An appeal to the views of an imaginary third party makes the concept seem vaguer than it really is.\textsuperscript{18}
\end{quote}


\textsuperscript{17} \textit{Re Bovey Hotel Ventures Ltd}, unreported, but this view is set out and approved at [1983] BCLC 290; \textit{Re Saul D Harrison \\& Sons plc} [1995] 1 BCLC 14, 17.

\textsuperscript{18} \textit{Re Saul D Harrison} [1995] 1 BCLC 12 17 per Hoffmann LJ.
The authorities also suggest that the petitioner must allege and prove the unfair conduct, which must be re-examined through the lenses of common law and equity.\textsuperscript{19} In law, if there is a breach of contract or tortuous conduct towards the minority shareholders, the unfairness is said to be presumed. The same principle may also apply in equity where there is a violation of equitable principles such as breach of trust, breach of confidentiality, or breach of fiduciary duty. However, the courts did not adopt such a principled approach to categorising the situations that may amount to ‘unfairness’. Instead, the law developed on a case-by-case basis. For instance, in equity, \textit{mala fide} is an essential element to allege the wrongfulness of the action of the fiduciary. However, in the case of a section 459 petition, the court stated that this element is not required.\textsuperscript{20} Symmetrically, good faith on the part of the respondent is not necessarily a good defence. So far, equity arguments seem to be providing little guidance in the application of section 459.

Inventively, the court introduced the concept of ‘legitimate expectation’ borrowing it from public law to lend aid to the exegesis of the concept of ‘unfairness’ under section 459.\textsuperscript{21} As Hoffmann J observed in relation to this section:

\begin{quote}
[I]t enables the court to protect not only the rights of members under the constitution of the company, but also the ‘rights, expectations and obligations’ of the individual shareholders \textit{inter se}. In the typical case of the
\end{quote}

\textsuperscript{19} \textit{Re Westbourne Galleries Ltd} [1973] AC 30.
\textsuperscript{20} AJ Boyle \textit{Minority Shareholders’ Remedies} (Cambridge Press Cambridge 2002) 98. It is said that Lord Hoffmann used the term ‘good faith’ (to cover it seems both ‘just and equitable’ and ‘unfairness’) is perhaps unfortunate.
\textsuperscript{21} \textit{Re Saul D Harrison & Sons plc} [1995] 1 BCLC 14, 19 per Hoffmann J.
corporate quasi-partnership, these will include the expectations that the member will be able to participate in the management of the company.22

The court also stated that the ‘legitimate expectation’ must be read in the light of other contractual and equitable principles. Hoffmann J concluded that legitimate expectation ‘should not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the transitional equitable principles have no application.’24

2. Categorising Unfair Prejudice

A case-by-case approach is the preferred methodology to understand the term ‘unfair prejudice’ rather than theorising it in to a general norm. However, there are several situations, including a breach of formal or informal agreement, breach of fiduciary duties by the controllers, breach of some other corporate code of honour, and

22 Re A Company (No 003160 of 1986) BCLC 391, 396; J Lowey ‘Mapping the Boundaries Of Unfair Prejudice’ n 8 in J de Lacy (ed) The Reform of United Kingdom Company Law (Cavendish Publishing Limited London 2002), which says ‘In seeking to define the limits of legitimate expectation, some assistance can be derived from other legal disciplines, notably public law and the flexible concept of estoppel that pervades our legal system. For, in those areas as opposed to its use in company law, such phrases have become terms of art, skillfully used by judges and practitioners. There are distinct analogies that can be drawn. For example, see Lord Diplock’s analysis in Council of Civil Service Unions v Minister for the Civil Service [1985] AC 374, 408.

23 As Lord Hoffmann’s approach in O’Neil and Re Saul D Harrison was seen that notions of fairness are founded upon settled principles referable to the commercial force underlying corporate relationships; Also see D Sugarman ‘Is Company Law Founded on Contract or Public Regulation’ (1999) 20 Company Lawyer 162; R Riley ‘Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts’ (1992) 55 MLR 782.


unreasonable corporate policy,\textsuperscript{28} on the basis of which the petition may be presented to the court. The analysis of the main categories of unfair prejudice is carried out in the following sections.

(a) Exclusion of Management\textsuperscript{29}

A minority shareholder can hold a non insignificant shareholding in the company. If this is the case, the shareholder can be represented by a director on the board. The director, either \textit{de facto} representing the minority shareholders or elected by the minority shareholders, has the right to participate in the daily business of the company, which is guaranteed by the articles of association. If the director is excluded from the management, such conduct clearly amounts to unfair prejudice as it is against the formal or informal understanding\textsuperscript{30} that the director represents the collective rights of the minority shareholders. A minority shareholder can also be a director. A director representing the minority shareholders (or a minority shareholder serving as director) is entitled to manage the company on the board. In a takeover situation, if such a director is removed after the merger without proper re-election procedure, this may give rise to unfair prejudice.

\textsuperscript{28}P Davies \textit{Gower’s Principles on Modern Company Law} (Sweet & Maxwell London 2003) 746.

\textsuperscript{29}It is the most common allegation of unfairly prejudicial conduct in a survey conducted by the Law Commission, ‘Shareholder Remedies- A Consultation Paper’, Appendix E,237.

(b) Dilution of Minority Shareholding

A company may issue shares resulting in the dilution of minority shareholders' rights, or reducing the majority shareholders to the minority. In *Re A Company (No 002612 of 1984)*, the majority shareholder was restrained from a planned rights issue, because it was established that he pursued the rights issue only in order to increase his interest in the company, while he knew that the minority shareholder was in financial difficulties. This conclusion was reached although there was no bad faith and the issuance was in the interests of the company. This could also amount to unfair prejudice. Hoffman J said:

If the majority know that the petitioner does not have the money to take up his rights and the offer is made at par when the shares are plainly worth a great deal more than par as part of a majority holding (but very little as a minority holding), it seems to me arguable that carrying through the transaction in that form could, viewed objectively, constitute unfairly prejudicial conduct.

From a contractual obligation point of view, the principle is that there is an informal agreement between the shareholders and the controller, that the controller will not increase the share capital, *mala fide*, for the purpose of diluting the shareholding of a particular group of shareholders. In *Re DR Chemicals Ltd*, where the director had secretly allotted shares to himself and thereby reduced the petitioner's shareholding from 40 per cent to 4 per cent, it was held by Peter Gibson J that there had been no

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commercial need for raising additional capital, and that even if the company had had a need for new capital, the company’s director would have caused unfair prejudice in allotting shares without offering them also to the minority shareholder. In most situations, shareholders will have pre-emptive rights which give them the opportunity to purchase shares to maintain the proportion of their shareholding in the company. Share issuing is also subject to procedural requirement. However, the financial weakness of the minority shareholders may not always guarantee a fair game on a level-playing field.

Minority shareholders can be prejudiced by their own financial weakness. However, unless there is a clear indication that there is an intention to squeeze out the minority shareholders, which amounts to improper purpose, it is difficult to prove unfairness under section 459. In such instance, the minority shareholders will have two choices: first, to let his shares be diluted; second, to negotiate with the company for the purchase of their shares. Although it is difficult to prove the true intention of the controllers in issuing new shares, unfair prejudice can occur during the process of negotiation and purchasing. If the minority shareholders choose to have their shares diluted, the new share price must not be substantially lower than the value of the asset. If the minority shareholders decide to sell the shares, the price offered to buy-out the minority’s shares must not be so low as to make it possible to infer unreasonableness and inequity in the process.

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(c) Failure to Consult the Petitioner or to Provide Information

Some cases suggest that there is an informal agreement that a shareholder is entitled to relevant information about the company’s affairs and to be consulted in some matters. In *Re Cumana Ltd*, there was an express agreement between the petitioner and the individual respondent that the petitioner would be consulted on all major matters concerning the company, and that the application of the company’s profits would be discussed and agreed between the petitioner and the respondent. The breach of the agreement was held to amount to unfair prejudice. In other cases the agreement is rather an informal understanding. In *Re Regional Airports Ltd*, where the controlling shareholder sought to propose a rights issue which would have involved payment in cash by all of the company’s shareholders apart from himself, it was held that there was an ‘understanding’ rather than an express agreement that the petitioner would be consulted or receive the information he needed according to the circumstances. The understanding was derived from ‘exactly that kind of mutual trust and confidence which justifies the superimposition of equitable principles in its analysis’. However, the presumption in that case was that each of the shareholders would be ‘entitled to a reasonable flow of management information concerning the company and any trading subsidiaries and to be consulted on broad strategic issues’. This reasoning may be taken further. Other non-statutory provisions or codes of honour may, albeit impliedly, give the right to the minority shareholders to be

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34 *Re Regional Airports Ltd* [1999] 2 BCLC 30, 80.
35 *Re Regional Airports Ltd* [1999] 2 BCLC 30, 80.
consulted on certain matters. This may amount to an 'understanding' between shareholders or between controllers and minority shareholders. If the theory based on 'legitimate expectations' can be developed further in this direction, it could provide the foundation to clarify the legal implications of non-statutory provisions and understandings that give rise to a cause of action for the minority shareholders.

(d) Misappropriation of Corporate Opportunity or Assets

In private share sales, majority shareholders may agree to sell a controlling shareholding at undervalue. The minority shareholders may not be able to purchase those shares either because they are short of cash or because they do not have pre-emptive rights. If the price is ridiculously low, minority shareholders may petition the court under section 459 of the Companies Act 1985.

In Re Elgindata, the petitioners established that the majority shareholder had used the company's money for his personal benefit and for the benefit of his family and friends. Warner J held that '[B]y its very nature the misapplication of a company's assets by those in control of its affairs for their own benefit or for the benefit of their family and friends, is unfairly prejudicial to the interests of minority shareholders. Equally, even if there is no family interests involved, the issue is rooted in the problem of conflict of interest which if proved such as transactions involving the company's assets which benefit another company in which the majority shareholders (but not the minority) have proprietary interest may constitute unfairly prejudicial

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36 Meiner v Hooper's Telegraph Works (1874) LR 9 Ch D 350; Cook v Deeks [1916] 1 AC 544; Regal Hastings Ltd v Gulliver [1942] 1 All ER 378.
Therefore, a controller must not take for his own, or indeed, for anyone else's benefit, any property, information, or opportunities of the company without either the prior consent of the shareholders in the general meeting or of the non-involved members of the board. In a friendly merger case, the directors may refer the deal to another company in which he or she is also a director. In these circumstances, the director has diverted the opportunity of the benefits that could have been brought by the merger plan to another company. This problem arises from interlocking directorship situations. Generally, such problems may be dealt with as breaches of fiduciary duties and shareholders can sue only under the exceptions in *Foss v Harbottle.* If a director of a potential target company offers a 'bribe' to the bidder for a standstill agreement, as long as that director foresaw a benefit to the company for the acceptance of the bid, he will be held liable to the company to account by an action that could be brought by the minority shareholders as a derivative action.

(e) Mismanagement of Company's Business

Managerial decisions cannot be challenged in court unless they amount to gross breach of directors' duties. This is because, first, the judge is 'ill-qualified' to resolve the disagreement between the directors and the petitioner over a commercial matter,

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39 *New Zealand Netherlands Society v Kuys* [1973] 1 WLR 1127, PC, para. 6 and Note 1.

40 P Davies Gower's Principal of Modern Company Law (7th edn Sweet & Maxwell London 2003) 422.

secondly, it is an essential part of the bargain under which a shareholder acquires shares in the company that he takes the risk that the management will be less than sound. Warner J said in *Re Elgindata Ltd*[^2]:

[A] shareholder acquires shares in a company knowing that their value will depend in some measure on the competence of the management. He takes the risk that the management may prove not to be of the highest quality. Short of a breach by a director of his duty of skill and care (and no such breach ...was alleged) there is *prima facie* no unfairness to a shareholder in the quality of the management turning out to be poor. It occurred to me during the argument that one example of a case where the court might nonetheless find that there was unfair prejudice to minority shareholders would be one where the majority shareholders, for reasons of their own, persisted in retaining in charge of the management of the company’s business a member of their family who was demonstrably incompetent. That of course would be a very different case from this. [The petitioner] deliberately invested in a company controlled and managed by [the respondent] [...] [Counsel for the petitioner] submitted that [the petitioner] had a right to expect a reasonable standard of general management from [the respondent]. In my view, he had no such right. He took the risk that [the respondent’s] management of the company might not be up to the standard that he ...had hoped and expected.

However, Warner J also spelled out an exception to this rule this being that serious mismanagement would constitute conduct, which was unfairly prejudicial to the interests of minority shareholders.[^3] Arden J also adhered to this *ratio* as stated in *Re Marco (Ipswich) Ltd*:

[^2]: *Re Elgindata Ltd* [1991] BCLC 959, 993i-994d.
[^3]: *Re Elgindata Ltd* [1991] BCLC 959, 993i.
With respect to alleged mismanagement, the court does not interfere in questions of commercial judgment, such as would arise here if (for example) it were alleged that the companies should invest in commercial properties rather than residential properties. However, in cases where, what is shown is mismanagement, rather than a difference of opinion on the desirability of particular commercial decisions, and the mismanagement is sufficiently serious to justify the intervention of the court, a remedy is available under [the CA, 1985.] s 459.\(^4\)

The acts that fall under the category of mismanagement include diversion of commissions, failure to obtain competitive tenders for repair work to properties, failure to inspect properties so that defective work went unnoticed and builders were overpaid, failure to let properties on the best terms available, and overpayment of management fees. It is not clear whether breach of duty is required for managerial decisions or behaviour to amount to mismanagement, or whether the majority's ratification prevents such a petition. However, it is certain that mismanagement must be an act of a prolonged practice, which was neglected and ignored by both directors and the majority shareholders. Minority shareholder's silence over the period can be treated as adherence to the policy, unless there was a long history of protest by the minority shareholders over the matters concerned. However, mismanagement may not become known until the share price goes down suddenly thus attracting a takeover bid, or, in the worst-case scenario, leading to the liquidation of the company. If the minority shareholders have been protesting for a long period against mismanagement by the directors and have been ignored for a long time so as to have the effect of discouraging bids in the market, minority shareholders suffer harm, in the form of loss of opportunity to tender the shares.

\(^4\) *Re Marco (Ipswich) Ltd* [1994] 2 BCLC 354, 404i-405a.
(f) Mismanagement of the Company’s Internal Affairs

Company’s internal affairs are said to be a rather procedural matter, such as the holding of meetings, the conduct of meetings, filing or issuing of the annual reports. In *Re A Company (No 00789 of 1987), ex p Shooter*, the majority shareholder and controlling director conducted the affairs of the company in an ‘entirely irregular’ manner, including failing to cause the company to hold annual general meetings, failing to ensure that accounts were laid before the general meeting, procuring the convening of extraordinary general meetings on short notice, failing to ensure that accounts and annual returns were properly filed, and managed the company ‘with a very nearly total disregard of the requirements of the Companies Act and of the articles as to meetings and so forth’. Harman J stated that ‘conduct, not the absence of filing but the conduct in depriving members of their rights to know and consider the state of the company and its directorships, and to ask questions of its directors, is conduct which, inevitably, must be prejudicial to the interests of members...The result is that there are plainly serious irregularities which, in my judgment, do amount to conduct unfairly prejudicial to the interests of members’45 This is clearly procedural conduct by the management required by the law and the articles of association, and prejudicial effect to the shareholders is based on the theory of breach of an express agreement between the management and the shareholders.

3. Mediation for Section 459

A minority shareholders’ petition under section 459 petition can result in litigation, the

45 *Re A Company (No00789 of 1987), ex parte Shooter* [1990] BCLC 393h-i.
costs of which exceeds the company’s assets in issue.\textsuperscript{46} Harmann J observed in \textit{Re Unisoft Group Ltd (No 3)}:\textsuperscript{47}

Petitions under section 459 have become notorious to the judges of this court- and I think also to the Bar- for their length, their unpredictability of management, and the enormous and appalling costs, which are incurred upon them particularly by reason of the volume of documents liable to be produced. By way of example on this petition there are before me upwards of 30 lever-arch files of documents. In those circumstances, it befits the court, in my view, to be extremely careful to ensure that oppression is not caused to parties, respondents to such petitions, by allowing the parties to trawl through facts, which have given rise to grievances but which are not relevant conducts within even the very wide words of the section.

Mediation can be an effective method of alternative dispute resolution to deal with section 459 disputes.\textsuperscript{48} Mediation is a system designed to benefit both parties to achieve a ‘win-win’ situation as opposed to the liability-based system of adversarial litigation in which one benefits to the other’s detriment.\textsuperscript{49} Besides being stuck between the choices to proceed with the case, the costs of which are not proportionate to the value of the assets at issue, or to strike out a genuine case which needs redress, the court has discretion to order the parties to enter into a meditation. This discretion can be exercised by the court in line with the overriding objective of the CPR.\textsuperscript{50}

There are several issues that arise in respect of the mediation process. The first is

\textsuperscript{46} Barrett v Duckett [1995] 1 BCLC 243 (CA).
\textsuperscript{47} Re Unisoft Group Ltd (No3) [1994] 1 BCLC 609, 610-611.
\textsuperscript{48} Mediation is not only suitable for s 459 disputes but, in principle, for any company law dispute.
\textsuperscript{50} CPR, 1.1. The court has the power to stay proceedings to allow the parties to try to settle the case by alternative dispute resolution under CPR, 26.4.
whether the evidence produced to the mediator should be kept confidential at trial if the case is not settled. The best solution is probably to treat the documents exchanged in the mediation on a 'without prejudice' basis. The second problem relates to further losses that may accrue to the minority shareholders during the mediation. If the parties lose more in the fluctuating stock market, who should bear the risks of the mediation? This question cannot receive a definitive answer but clearly the parties can always apply to the court for interim relief. Therefore, the mediation, in this respect, is not more harmful than lengthy court proceedings.

It appears that alternative ways of resolving the dispute between minority shareholders and controllers should be encouraged under the CPR. This is possible in the context of case management, where the court has wide powers to achieve the overriding objective to deal with cases fairly and justly.

Alternative dispute resolution has already been used in many areas of commercial disputes. Mediation of shareholders disputes under section 459 would serve not only the objective of solving the dispute more quickly and cheaply but would also focus on a different agenda from that on which the court concentrates. Mediation can be 'interests' based, in the sense that it is not merely trying to provide a remedy to the wrong on the basis of which relief is sought. Mediation balances the different views of the petitioner and the respondents, and it tries to settle the case on the balance of their interests rather than their rights. In this way, the remedies granted are more relevant to the needs of the parties.
C. CONCEPT OF ‘JUST AND EQUITABLE’

Under section 122(1)(g) of the Insolvency Act 1986, minority shareholders can petition to the court for an order to wind up the company if it is ‘just and equitable’ to do so. The question as to the meaning of ‘just’ is similar to the question as to the meaning of ‘fairness’. To answer these questions, it is necessary to rely on other concrete principles. The term ‘equitable’ suggests that its basis is equity. Hence, if there is a break down in the relationships between shareholders or directors and shareholders that results in the loss of confidence and trust, equity will intervene to resolve the matter. However, this does not necessarily mean that the person against whom the petition is made must have done something in breach of equitable principles or committed any other violation. As long as the petitioner alleges some facts such as the withholding of dividends, or different opinions as to the company’s business plan which lead to the breakdown of the partnership for which trust and

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51 Petitions may also be brought by creditors, directors or the company itself, though such applications are rare. The Secretary of State may petition under s, 124A on the basis of information received as a result of an investigation into the company’s affair. A fully paid-up shareholder provided he or she has a tangible interest in the winding up, which is usually demonstrated by showing that the company has a surplus of assets over liabilities, though that will not be required if the petitioner’s complaint is that the controllers failed to provide the financial information from which that assessment could be made: see Re Rica Gold Washing Co (1897) 11 ChD 36; Re Bellador Silk Ltd [1965] 1 All ER 667; Re Othery Construction Ltd [1966] 1 WLR 69; Re Expanded Plugs Ltd [1966] 1 WLR 514; Re Chesterfield Catering Ltd [1977] Ch 373, 380; Re Land and Property Trust Co plc [1991] BCC 446, 448; Re Newman & Harward Ltd [1962] Ch 257; Re Wessex Computer Stationers Ltd [1992] BCLC 366; Re A Company [1995] BCC 705. The Jenkins Committee recommended (para. 503(h)) that any member should be entitled to petition, presumably on the grounds that this remedy was aimed primarily at protecting minorities rather than at winding up companies; S Acton ‘Just and equitable winding up: the strange case of the disappearing jurisdiction’ [2001] Company Lawyer 135.

52 It is said that Ebragimi v Westbourne Galleries Ltd, as a winding up case, is the most prominent instance in the company law context where a court has looked beyond what the parties have explicitly agreed as defining their rights and duties. Fesner v Farrad Properties Ltd [1993] BCLC 1032 (Court of Session); Vujnovich v Vujnovich [1990] BCLC 227 (PC); Re Yenidje Tobacco Co [1916] 2 Ch 246 (CA); Re Sailing Ship Kentemere Co [1897] WN 58; Re American Pioneer Leather Co [1918] 1 Ch 556.

confidence are essential, the petitioner is said to have overcome the first hurdle. This seems to be very much a subjective test on the part of the petitioner. However, the court also takes a more objective view in that it looks at whether other factors also justify the court to order such drastic measure as the winding up of the company. This is because the winding up affects not just the minority shareholders as in the buy-out order, but essentially all the business constituents such as other shareholders, creditors, employees, and perhaps the community as a whole. If the effect on other constituents is to their detriment and the benefit to the petitioner can be served in some other way, the order will not be granted because it is not 'just and equitable'. Therefore, it can be rightly inferred that the term 'just' requires the court to embark upon a balancing exercise between the interests of various constituents likely to be affected by the order substantially.

When a 'buy-out' statute allows the court to order the accused shareholders to buy-out the aggrieved shareholders when trust and confidence are lost in the partnership, the court will consider exercising this power as an alternative to the granting of a winding up order. The court will dismiss the winding up petition on 'just and equitable' grounds if the minority shareholder relies on the buy-out provision. There are several instances in which the court will dismiss the petition; first, where the offered price to buy-out the minority's shares is a fair value, despite the discounted effect, on pro rata basis; secondly, where the offer price has received independent valuation from an expert; thirdly, where the petitioner has the same access to the information received by the controller or the majority shareholders. The court only looks at whether

55 Jesner v Jarrad Properties Ltd [1993] BCLC 1032 (Ct of Sess); Re Pauls Federated Merchants Ltd (30 July 1976) unreported, where Brightman J applied the Westburne decision to a company which was not a quasi-partnership.
fairness in procedure has been safeguarded and does not look at the merit of the outcome.

Section 122 of the Insolvency Act 1986 affects the court's perception of 'unfair prejudice' under section 459 of the Companies Act 1985.\(^{57}\) Professor Davies explains it in the following passage:

> Despite its remarkable substantive development, the provision always suffered from a weakness at the remedial level: if the company was prospering, presenting a 'just and equitable' petition was tantamount to killing the goose that might lay the golden egg. So long as the alternative remedy was hobbled by the restrictive wording and interpretation of section 210 of the Companies Act 1948, the winding-up petition was better than nothing. But, with the introduction of the unfair prejudice remedy, one may wonder what its appropriate role in the scheme of things now is.\(^{58}\)

Because section 127 of the Insolvency Act 1986 requires the court's consent for any disposition of the company's property after the petition is presented, the result of a petition may be the paralysis, or at least disruption, of the normal running of the company's business. This adds to the negotiating strength of the petitioner but is hardly legitimate if a section 459 petition could give him or her all that is required.\(^{59}\)

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\(^{58}\) P Davies Gower's Principles of Modern Company Law (7th edn Sweet & Maxwell London) 750.

\(^{59}\) P Davies Gower's Principles of Modern Company Law (7th edn Sweet & Maxwell London) 750.
D. SCHEMES OF ARRANGEMENT

Schemes of arrangements are practical instruments to be used in corporate rescue, although they are not limited to this purpose. The scheme involves more constituents than internal arrangements such as voting agreements, proxy agreements, director’s agreements, or the articles of association. The arrangement essentially ‘unveils’ the company to the extent that creditors as capital providers will have their say regarding the proposed scheme. The question of the effect of the arrangement, ie the question as to who is affected by the arrangement, is related to the problem of the persons that can approve the arrangement. Whether the binding effect reflects on the power to approve the scheme is the core issue in the area. The employees do not have power of approval. However, they are affected by the arrangement if, for instance, a plant of the company, essentially an asset of the company, is to be transferred to another company. Creditors are bound by the arrangement because they have the power of approval. Therefore, they will be bound by the arrangement voted for. The dissenting creditors are bound by the arrangement despite the non-approval.

The most pressing question is the divisions and categories of creditors. In legal terms, the question is which ‘class’ of creditors will be bound by the arrangement. This analysis belongs in the area of insolvency law, where different classes of creditors are entitled to different treatment. Procedurally, creditors are entitled to a ‘notice’ from the board regarding the arrangement. Different classes of creditors are expected to receive different notices to assert their legal rights. If the notices are not properly

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60 Companies Act 1985 s 425-427A.
given to the creditors, this may amount to a procedural irregularity affecting the 
validity of the arrangement.

To apply the same concept to the shareholders, different classes of members of the 
company will deserve separate consideration, such as preferential shareholders, 
non-voting shareholders, minority shareholders, and director shareholders. 
Shareholders are different in their interests and agendas, as well as the leverage and 
power they can exercise. The words ‘compromise’ and ‘arrangement’ indicate that 
there are different interest groups within the company. The court perceives that the 
schemes of arrangement are often used to resolve a dispute without litigating before 
the courts. Therefore, before the court can sanction the privately resolved dispute, it 
must review whether the ‘agreement’ approved could properly be seen as a 
‘compromise’ or ‘arrangement’. It is certain that a one-sided agreement is not a 
compromise or arrangement. However, the statute does not contain any express 
provision to guide the court in the same way as the concepts of ‘unfairness’ under 
section 459 of the companies act 1985 and of ‘just and equitable’ under section 122 of 
the Insolvency Act 1986 do. The authorities seem to suggest that the test is that of 
‘reasonableness’. If the agreement is so unreasonable in its terms as to affect minority 
shareholders’ interests without the element of give-and-take, it would not be fair to 
say that the agreement is a ‘compromise’.

It is interesting to see that although there is no express provision specifying minority 
shareholders as a class of members different from majority shareholders, the court is 

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61 As to the approval of members in the case of a company limited by guarantee, see Re NFU 
Development Trust Ltd [1972] 1 WLR 1584. Brightman J held that in such a company each member 
had in law the identical financial stake in the company. Thus a three-quarters majority of those present 
and voting satisfied the requirements of section 425 (2).
willing to recognise the division. Despite the articles of association requiring the approval by a supermajority vote, the court is still inclined to recognise the minority within the minority, meaning shareholders holding together less than 25 percent of the shareholding.

The reduction of company's capital will need the approval from the court in the exercise of its discretion. The court will not grant consent if it does not appear to be 'fair and equitable' to do so. In consideration of this, the court will have to take into account the interests of the members as well as the creditors. It must satisfy itself that every existing creditor has consented or that his debt or claim has been discharged on such terms and conditions as it sees fit.\(^\text{62}\) As far as members of the company are concerned, the court is unlikely to withhold its consent even if the application appears to be unfair, or even if it does not treat classes of shareholders in accordance with their rights.\(^\text{63}\) If the case is blatantly unfair, it is unlikely that the court will grant the consent,\(^\text{64}\) although it is not easy to find any English reported case in which consent has been refused on the sole ground of unfairness.\(^\text{65}\)

\(^\text{62}\) Companies Act 1985 s 137(1).
\(^\text{64}\) Re MacKenzie & Co [1916] 2 Ch 450 where the effect of the special resolution, passed without the class consent of the preference shareholders, was to reduce the amount payable as their preferential dividend to the benefit of the ordinary shareholders.
\(^\text{65}\) House of Fraser plc v AGCE Investments Ltd [1987] AC 387 (HL); Re Waste Recycling Group (Ch D) Chancery Division 28 July 2003, unreported.
Chapter three analysed the methods of takeover. A voluntary liquidation leading to a takeover of the liquidated company by another company is used both in the US and in Europe as a takeover method. Under this kind of rescue arrangement, minority shareholders who did not vote in favour of the special resolution may, within seven days of its passing, serve a notice on the liquidator requiring him either to refrain from carrying the resolution into effect or to purchase their shares at a price to be determined either by agreement or by arbitration. Hence, the minority's opposition poses a great risk to the utility of the company re-organisation, as one of its advantages is the absence of the court's confirmation. This right to have the shares bought at an agreed value or a value which is independently determined is rare under UK law, but common in some other common law jurisdictions, thereby protecting dissenting members by granting them 'appraisal rights'. The courts will not permit the company to deprive members of their appraisal rights under the Insolvency Act 1986 by purporting to act under powers in its memorandum and articles to sell its undertaking in consideration of securities of another company to be distributed in specie.⁶⁶

⁶⁶ Bisgood v Henderson's Transvaal Estates [1908] 1 Ch 743 (CA).
F. VOLUNTARY ARRANGEMENT UNDER THE INSOLVENCY ACT 1986

Under this rescue package known as company voluntary arrangement (the 'CVA'), the minority shareholders' issue only arises when they have enough strength to disrupt the CVA process in such a way which makes the CVA no longer a reasonable prospect. If this situation occurs, the nominee of the CVA should withdraw the consent to act and thus bring the arrangement to an end. This mechanism is to protect the interests of the creditors who consented to the arrangement by a 75 per cent majority, which in due course creates a moratorium against the enforcement of any claims of the creditors.
In a takeover, the Companies Act 1985 allows the bidder to purchase the remaining shareholding if the acceptance of the offer is more than 90 per cent. This is a protection for the bidder, who became the controller of the company, from the disruption that may occur because of a minority shareholders’ revolt. Under the current company law, a shareholder does not have the right to remain in the company, but he has the right to his capital. Once the bidder decides to exercise his right of compulsory purchase, minority shareholders must submit to such compulsion for the same price as the offered price. Even if the share price rises to a level higher than the offer, or even if the shareholders consider the price too low, they are not allowed to receive such a windfall and they are left without redress. This is because the law does not specify what amounts to a fair price.

At European level, Article 14 of the Takeover Directive introduces a squeeze-out right for the offeror. A controlling shareholder is given such a right by Article 14(2): (i) when he holds securities representing not less than 90 per cent of the capital carrying voting rights and 90 per cent of the voting rights of the offeree company; and (ii) where he has acquired or firmly contracted to acquire, following the acceptance of the bid, securities representing not less than 90 per cent of the voting rights comprised in the bid.

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67 Companies Act 1985 ss429 and 430.
68 European countries, other than the UK, may not provide the right connected with such an event such as under Dutch, Belgian, French or German law. Articles 327a-327f of the German Aktiengesetz concern a squeeze-out procedure, under which a squeeze out of minority shareholders is possible against adequate compensation if the majority shareholder has acquired at least 95 per cent of the shares; Also
H. SELL-OUT RIGHT

The sell-out right constitutes the other side of the coin, for the benefit of the minority shareholders, of the compulsory acquisition for the benefit of the majority shareholder. Minority shareholders enjoy a sell-out right under sections 430A and 430B of the Companies Act 1985. These provisions provide for a right of the non-acceptors, the minority shareholders, to have their shares bought out by the bidder. The right accrues if at the closure of the offer the holdings of the offeror amount to 90 per cent or more of the company total shareholding.69

Arguments were advanced that the sell-out right should be granted even if the 90 per cent is not achieved in the situation of a takeover offer. The CLP rejected this argument,70 partly, as said,71 because of the difficulty of establishing a satisfactory valuation in the absence of a public offer.

When the sell-out right accrues to the minority shareholders, the offeror is bound and entitled to acquire the minority shareholders' shares 'on the terms of the offer or on such terms as may be agreed'.72 If the parties cannot agree on the terms of the offer, then either side may apply to the court and the court will decide the terms 'such as the

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69 Companies Act 1985, s 430A (1) and (2).
71 P Davies Gower's Principles of Modern Company Law (7th edn Sweet & Maxwell London) 744.
72 Companies Act 1985 s 430B.
court thinks fit'. The court will need to face the problem of the valuation of minority shareholders' shares. Some commentators contend that the minority shareholder's shares must not be taken *pro rata* and should be taken at a discounted price. This is so because minority shares are said to have less value than the majority shares, which give the shareholder control over the company.

The Takeover Code gives effect to the sell-out right regulated by the Companies Act 1985. Under the Code, the offeror is required to keep the offer open for a further fourteen days after it has become unconditional as to acceptances. Within one month of the closure of the offer, the offeror must give notice in the prescribed manner to each shareholder who has not accepted the offer, of the sell-out rights exercisable by him under the Companies Act 1985. If the notice is given before the closing date of the offer, it must state that the offer is still open for acceptance.

SA sell-out right is also contained in the Takeover Directive. Article 15 of the Directive provides that Member States should enable minority shareholders to require the majority shareholders to buy their shares following a successful takeover bid for all the shares. The circumstances in which this right may be exercised are the same as those set out in Article 14(2) of the Directive. Where a voluntary bid was made, the price is deemed to be fair when it corresponds to the consideration offered in the bid, and the offeror has acquired through acceptance of the bid shares representing not less than 90 per cent of the share capital carrying voting rights comprised in the bid.

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73 Companies Act 1985 s 430C(3).
74 The Takeover Code r 31.4.
75 Companies Act 1985 s 430A(3).
I. THE TAKEOVER CODE

The Takeover Code, also known as the City Code,\textsuperscript{77} prescribes various regulations in dealing with shares in the stock markets. The provisions relating to the timing of offer and acceptance, consideration, disclosure, filing, and structure of the bidding, directly benefit the minority shareholders.\textsuperscript{78} The most important and controversial feature of the Code from a minority shareholder’s view is the mandatory bid.\textsuperscript{79} General Principle 10 provides that when the control of a company is acquired by a person, or persons acting in concert, a general offer to all other shareholders is normally required, and that a similar obligation may arise if existing control is further consolidated.\textsuperscript{80} This is a corollary to the concept of ‘equal treatment’, which is the corner stone of the Code. Minority shareholders should not be precluded from sharing the benefits deriving from the ‘control premium’. As Professor Davies pointed out:

Underlying the principle is the view that the prospects of minority shareholders in a company depend crucially upon how the controllers of the company exercise their powers and that the provisions of company law proper, even after the enactment of the new ‘unfair prejudice’ provisions of the Companies Act, are not capable of protecting minority shareholders

\textsuperscript{77} Alarmed by what was happening in the 1950s and 1960s where bidders took full advantage of their freedom, a City working party published in 1959 a modest set of ‘Queensberry Rules’ entitled Notes on Amalgamation of British Businesses, which was followed in 1968 by a more elaborate City Code on Takeovers and Mergers and the establishment of a Panel to administer and enforce it; Lord Alexander of Weedon QC ‘Takeovers: The Regulatory Scene’ (1990) JBL 203; G Morse ‘Securities Regulation’ [2003] JBL 314.
\textsuperscript{78} M Andenas ‘European Take-over Regulation and the City Code’ [1996] Company Lawyer 150.
\textsuperscript{79} Takeover Code r3.
\textsuperscript{80} Takeover Code General Principle 10.
against unfair treatment, at least not in all cases.\textsuperscript{81}

The significance of this rule is to prevent the two-tier front-end type of bid in which the minority shareholders will not be ‘locked-in’ by the bid. The controlling shareholders’ ‘control premium’ will be shared by the remaining shareholders, including minority shareholders, because the purchaser of the block will know that the Code requires him to offer the same price to all shareholders. Therefore, the purchaser is forced to divide the consideration for the company’s securities rateably among all the shareholders.\textsuperscript{82}

A partial bid by the offeror to acquire shares that will increase the bidder’s shareholdings to more than 30 per cent of the total shareholdings of the company, is directly against the Code. However, the bid can receive approval by the Takeover Panel, the body which administers the Code and adjudicates the disputes between the parties arising out of the Code. There are four situations where the Panel’s consent will be granted. First, if the offer could not result in the offeror holding 30 per cent or more of the voting rights of the target company.\textsuperscript{83} Second, if it could result in the offeror holding more than 30 per cent but less than 100 percent, consent will not normally be granted if the offeror or a party acting in concert with him has acquired, selectively or in significant numbers, shares in the target company during the previous 12 months or if any shares were acquired after the partial offer was reasonably in

\textsuperscript{81} P Davies \textit{Gower’s Principles of Modern Company Law} (7th edn Sweet & Maxwell London 2003) 792.

\textsuperscript{82} Takeover Code r 16 prevents the offeror from circumventing this rule by attaching non-pecuniary advantages to the offer made to some shareholders, which are not available to all shareholders.

\textsuperscript{83} ie those in which the offeror bids for a proportion only of the shares or a class of shares.
contemplation. Third, if the offer is one which could result in the offeror holding not less than 30 per cent and not more than 50 per cent of the voting rights, the offer must state the precise number of shares bid for and must not be declared unconditional unless acceptances are received for not less than that number. Fourth, an offer which results in the offeror holding shares carrying over 49 per cent of the votes must contain a prominent warning that, if the offer succeeds, the offeror will be free to acquire further shares without incurring an obligation to make a mandatory offer.

Because of the nature of the Code and the Panel, minority shareholders can present their own case to the Panel but any decision is only subject to judicial review. Even if the decision is somehow defective, the court would be reluctant to nullify the Panel’s decisions, and would normally content itself with a retrospective review in order to give guidance on how the Panel should proceed in future cases. It is also suggested that the court should not remedy any unfairness done in the exercise of the Panel’s disciplinary functions. This is because it is claimed that the provisions of the Code are expressed in broad and general terms and are considered to ‘represent the collective opinion of those professionally involved in the field of takeovers as to

84 Takeover Code r 36.2.
85 Takeover Code r 36.4.
86 Takeover Code r 36.6.
87 The Panel operates under the auspices of the Governor of the Bank of England and is comprised of representative from eight City organizations. The Chairman, Deputy Chairman, and further non-representative members of the Panel are appointed by the Governor of the Bank of England; R v Panel and Takeovers and Mergers, ex parte Guinness PLC (1988) 4 BCC 714, 718 (CA); J Coffee ‘Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Control Governance’ 84 ColumLRev 1145, 1260 (1984), it is said that a body like the the Takeover Panel with the free-ranging powers and authority accorded Britian’s Panel on Takeovers and Mergers would ever be accepted within the United States’ institutional and legal structure.
89 R v Takeover Panel Ex p Guinness Plc [1990] 1 QB 146, CA.
good business standards and as to how fairness to shareholders can be achieved.\(^{90}\) However, such collective view seems to exclude the view of minority shareholders. The concept of ‘unfair prejudice’, ‘just and equitable’ principles, legitimate expectations, and minority shareholders rights, should also be incorporated into the spirit and provisions of the Code.

Under Article 5 of the EU Takeover Directive,\(^{91}\) Member States must ensure that the takeover rules require a mandatory bid for a company if a person (or persons acting in concert with him) acquires shares that, when added to any existing holdings of shares, result in that person having a specified percentage of the voting rights of the company giving him control of it. ‘Control’ is not defined. The percentage of voting rights that confers control is to be determined by the takeover rules of the Member States where the offeree company has its registered office. The member states do not need to specify the same percentage threshold and there is no maximum threshold.

Under the EU Take-over Directive, a mandatory bid must be made at an equitable price, which is the highest price paid by the offeror or parties acting in concert with him for the same shares during a period of between six and twelve months prior to the bid. However, the supervisory authorities can be given discretion to adjust the price. If before the mandatory bid closes the offeror or any party acting in concert with him purchases shares at above the offer price, the offeror must increase its offer to not less than that price. Such a price will not be paid to those whose shares were bought

\(^{90}\) Johnson *The City Takeover Code* 148 (1980), stating that the City Code represents ‘a convenient statement of the best City practice. It is also claimed that the Code represents good standards of business practice in takeovers has often been recognised by the courts; *Hinchcliffe v Crabtree* 1972 AC 725, 730 (1971); *Dunford & Elliot Ltd. v Johnson & Firth Brown Ltd* [1977] 1 Lloyd’s LR 505, 510 (CA 1976).

\(^{91}\) Takeover Directive Article 5.
during a period of between six and twelve months before the bid was made public. This rule will ensure that the shareholders of the offeree company will receive equal treatment and share the 'control premium'.

To protect the minority shareholders’ right to accept the offer by restricting the power of the directors to adopt defensive measures against a takeover bid, the Takeover Code, under General Principle 7, severely restricts the director’s ability unilaterally to adopt defensive measures once the target directors have reason to believe that an offer might be imminent. In these situations, defensive measures can only be adopted with the approval of the company’s shareholders in general meeting. A fundamental principle of UK takeover regulation under the City Code and the English common law is that directors may not use their powers to preclude the majority shareholders’ 'constitutional right' to decide whether or not to accept a takeover offer. However, minority shareholders are precluded from tendering their shares to the offeror if the majority shareholders approve the defensive measures to be adopted by the board of directors.

Article 9 of the Takeover Directive provides that Member States must ensure that rules are in force requiring that, at least after the announcement of the bid, and until the result of the bid is made public or the bid lapses, the board of the offeree company should not take any action, other than seeking alternative bids, that may result in the frustration of the offer, unless it has the prior authorisation of the general meeting of the shareholders given for this purpose. If the board has a two-tier structure, such as

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boards in German companies, the restriction applies to both the management and the supervisory board. However, under Article 12 of the Directive, Member States can decide to opt out of this prohibition.

J. CONCLUSION

A number of statutory provisions at national and European level, and the regulatory provisions of the Takeover Code, protect minority shareholders and complement the protection at common law. The concept of ‘unfair prejudice’ under section 459 of the Companies Act 1985 protects minority shareholders against exclusion from the management, dilution of their capital, failure of consultation, and mismanagement by the board. As regards the winding up order under section 122(1)(g) of the Insolvency Act 1986, although the concept of ‘just and equitable’ provides a good weapon for minority shareholders against discrimination by the controller, the court will balance the interests of the other stakeholders against the interests of the minority shareholders who bring the case to the court. This is because the relief of a winding up order is fatal to the company. In the voluntary schemes of arrangement and voluntary reorganization, minority shareholders will be protected against ‘unreasonable’ behaviour and ‘unreasonable’ terms which defeat the spirit of a fair bargain which should be manifested in a ‘compromise’ or ‘arrangement’.

Buy-out and sell-out rights under UK and European law also safeguard minority shareholders.
UK statutes, the European Takeover Directive, and the UK Takeover Code regulate minority shareholders' rights in takeovers. Section 459 of the companies Act 1985 and section 122 of the Insolvency Act 1986 demonstrate the benefits of the private action model. The courts are able to give effective relief and, more importantly, to develop concepts that influence the internal control model. By giving relief, the courts establish standards of conduct that the controllers of the company must follow. The Takeover Code contains a number of provisions aimed to protect minority shareholders but their enforcement falls short of the effectiveness of the private action model. The provisions of the Code are enforced by the Takeover Panel, whose decisions are subject to judicial review.
CHAPTER VII

MINORITY SHAREHOLDERS' REMEDIES

A. INTRODUCTION

Minority shareholders have personal rights, derivative rights, and rights to petition under section 459 of the Companies Act 1985 and section 122 of the Insolvency Act 1986. The possible defendants or respondents are the company, the controlling shareholders, or the directors as the case may be. This chapter focuses on the remedy that minority shareholders can obtain.

The analysis of the remedies is of fundamental importance. The remedy awarded determines what the shareholders may obtain or recover as a result of a breach of their personal rights or, in a derivative action, what the company may obtain or recover, with the consequence that shareholders will benefit as capital providers in the company. The previous chapter examined the conditions for the protection of minority shareholders under section 459 of the Companies Act 1985. This chapter analyses the relief that the court may grant under that section.

Remedies under EC will also be discussed. There are two dimensions to this analysis. The first relates to the Takeover Directive and any change it may bring about in the area of shareholders' remedies. The second relates to the liability of public authorities
for breaches of Community law, including failure to implement a Directive.

The analysis of remedies in this chapter includes remedies granted during the proceedings, ie interim remedies such as interim injunction, summary judgment, striking out orders, and security for costs,¹ final orders, including damages, buy-out orders, and permanent injunctions, and the funding of the litigation.

It is the conclusion of this chapter that for the private action model to be developed in England and Wales some fundamental reforms to practice and procedure are needed. In particular, this chapter advocates for a wider use of finding arrangements between clients and their legal representatives and for the introduction of a pre-action protocol for shareholders' disputes, including disputes between shareholders themselves with respect to corporate affairs, and disputes between the shareholders and the directors, and the shareholders an the company.

**B. PRE-ACTION ISSUES**

There is no pre-action protocol for minority shareholders proceedings. PD – Protocols, paragraph 4 sets forth the conduct that is expected of the parties before commencing any action not covered by any of the protocols currently in force.² The parties to a potential dispute are expected to follow a procedure suited to their case and including the following key elements: 1) claimant’s letter of claim giving details of the claim; 2)

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¹ A Boyle ‘Derivative Actions in Respect of Public Listed Companies’ Amicus Curiae (1997) 2.
² PD – Protocols, para 4.
defendant’s acknowledgement of the letter of claim; 3) defendant’s full detailed response; 4) genuine and reasonable negotiations with a view to settling the claim economically and without court proceedings. The Practice Direction gives detailed guidance on the contents of the letter of claim, the defendant’s acknowledgment, and the defendant’s response. The court has the power to penalize in costs and in any award of interest a party who did not comply with the spirit of the pre-action behaviour described in PD – Protocols, paragraph 4. The court will also take the pre-action conduct of the parties into account when giving case management directions.

It is also noteworthy that the law on pre-action disclosure has been relaxed as a result of the Woolf reforms and an aggrieved minority shareholder can now apply for disclosure before commencing proceedings, which could prove to be a useful weapon and save costs in the subsequent proceedings. Pre-action disclosure allows the prospective claimant to find out whether or not he has a cause of action. However, the court will only make an order for pre-action disclosure if it is desirable to dispose fairly of the case, to assist the dispute to be resolved without proceedings, or to save costs.

The emphasis on pre-action conduct in order to avoid unnecessary litigation or, if the dispute cannot be settled out-of-court, to facilitate and speed up the conduct of the anticipated proceedings is an important feature of the civil justice system in England and Wales. If the private action model for the resolution of minority shareholders’

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3 PD – Protocols, para 4.2.
4 PD – Protocols, para 4.3
5 PD – Protocols, para 4.4
6 PD – Protocols, para 4.5
7 PD – Protocols, para 2.2.
8 CPR, rr 3.1(4) and (5) and 3.9(e).
9 Supreme Court Act 1981, s 37, as amended by SI 1998, No 2940; CPR, r 31.16.
disputes is to be developed, attention should be given to the pre-action phase of the proceedings. A pre-action protocol suited to the specific features and needs of shareholders’ disputes could be brought into effect. This would allow the parties to get a better understanding of their case at an early stage, to attempt to settle it in a more structured way, to focus on the issues that are really in dispute, and, if legal proceedings are unavoidable, to conduct the litigation in a way that is the least disruptive to the company.

C. INTERIM REMEDIES

1. General

Interim remedies are remedies granted during or before the proceedings. These remedies may be granted in favour of the minority shareholders. They can also be used by defendants and respondents against the claimant or petitioner in the proceedings. There is no specific set of provisions dealing specifically with minority shareholders proceedings. General case law, court practice, and the Civil Procedure Rules (the ‘CPR’) are the main sources of the law in this area.

2. Injunction

Court proceedings in a contested takeover bid or friendly bid are rare in the UK, partly because of the nature of the Takeover Panel and the Takeover Code. The takeover cases in Delaware show that the minority shareholders may have an interest
to apply to the court for an injunction against the directors' defensive measures, on the basis of the directors' breach of their duty to the shareholders or the company. This may have the effect of discouraging the bid.10

In a friendly merger, the situations where minority shareholders can apply to the court for a preliminary injunction are: a) when the price is too low and/or there is no adequate information regarding the offer, including cases of lack of independent valuation and advice; b) where there is a sudden alteration of a company's articles of association without proper procedure or for improper purpose, or which is likely to amount to an 'unfair prejudice' to the minority shareholders. The problem is whether the loss that may occur to minority shareholders in these circumstances is in the nature of an irreparable harm. This requirement, necessary, among others, for obtaining an interim injunction, may not be easy to prove by the applicants. It is necessary to examine the conditions for the grant of an interim injunctions and how they apply to minority shareholders' actions.

The leading authority on interim injunctions is *American Cyanamid v Ethicon*.11 The case lays down three requirements that the applicant must prove and the court must consider before an interim injunction can be granted: first, whether there is a serious issue to be tried; second, if so, whether damages would be an adequate remedy for the party injured by the grant, or refusal to grant, an injunction12; third, if not, whether the 'balance of convenience' lies in favour of or against the granting of an injunction. It

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10 See Chapter IX.
11 *American Cyanamid Co v Ethicon Ltd* [1975] AC 396.
12 But see *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8, 15d-e where Hoffman J suggested that, in relation to s459 petitions, the question should be whether financial compensation under the CA 1985, s 461, rather than damages, would be an adequate remedy.
was held in *Re Posgate & Denby (Agencies) Ltd*\(^{13}\) that the *Cyanamid* principles cannot be applied literally to an unfair prejudice petition under section 459 of the Companies Act 1985, since the common law remedy of damages is not available to the petitioner. The court must consider the adequacy of its wide powers under section 459 to compensate the petitioner financially, such as the buy-out order. The court also expressed its inclination, in principle, to maintaining the *status quo* of the company in the case of a petition under Part XVII of the 1985 Act. As Harman J said, *obiter*:

I would add that, as it seems to me, in cases of litigation under s 75 [of the 1980 Act] it is most desirable that the position of the company be not altered or disturbed more than is absolutely essential, between the presentation and the hearing of the petition. The existing share structure, the existing contractual rights, the present service contracts and so forth, should in my judgment be maintained as they are pending the determination of the litigation. There might be circumstances where change was essential, but if possible the existing position should be preserved. In my judgment, that is a factor which in these matters arising under contributories patterns is particularly powerful and has more than the normal ‘*Cyanamid*’ force in favour of preserving the status quo, since it is the very nature of this matter that the status quo must affect the remedy which may be available.

Cases suggest that judges may not be willing to grant interim remedies that have an impact on the *status quo*.\(^{14}\) This may not be a complete obstacle to the minority shareholders. In *Re A company (No 003300 of 1991), ex p Holden*,\(^{15}\) the petitioner,

\(^{13}\) *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8.
\(^{15}\) *Re A company (No003300 of 1991), ex p Holden* [1991] BCLC 84; *Hall, Petitioner 1999 GWD* 1-11.
who had been dismissed as an employee of the company, petitioned to the court for a just and equitable winding up order. The petition was subsequently amended to add a claim under the section 459 of the Companies Act 1985. The board voted to exercise their power under the company's articles of association to require the remaining shareholders to exercise their right of compulsory purchase of the shares of the former employee. This would have two effects: first, to deprive the shareholder of his standing to petition, as an ex-shareholder does not have the right to petition under section 459 of the Companies Act 1985; second, to require him to accept a valuation by the auditor or (at the auditor's discretion) by an independent accountant. The court held that there was an arguable case, and that on the balance of convenience an interim injunction should be granted to restrain the respondents from invoking the compulsory purchase provisions of the company's articles pending trial.

The difficulty faced by the minority shareholders applying for an interim injunction is that their petition will amount to disruption of the company's business. Therefore, the balance of convenience would probably work against the grant of an injunction. However, in takeovers or friendly mergers the preservation of the status quo may weigh in favour of enjoining the transaction. Furthermore, the argument that minority shareholders' actions disrupt the conduct of the business of the company should be put in context. The court should also incorporate in its reasoning and give proper weight to the role of minority shareholders' actions as an element of corporate governance. To impose undue limitations on the development of the private actions model weakens the internal control model. For the internal control model to work well, directors and controlling shareholders should be accountable to the minority shareholders through, inter alia, private actions. This analysis counterbalances the arguments to the effect that the company's business should be disrupted as little as
possible. The role of minority shareholders and their legitimate expectations should be taken into account in the application of the test derived from equity, ie the balance of convenience.

3. Summary Judgment and Interim Payment Orders

Claimants may apply for a summary judgment to the court if, under CPR, Pt 24, the respondent 'has no real prospect of successfully defending' the issue, and there is 'no other reason why the issue should be disposed of at trial.' In most cases concerning the application of section 459 of the Companies Act 1985, the issues are hotly disputed and thus, the petitioner is unlikely to show that the respondent has no real prospect of defending the claim or issue in question.

The petitioner will also face difficulty in obtaining part payment in the proceedings. The first difficulty is that the amount of the payment will always depend on an evaluation of the shares and the assets of the company, which needs to be supported by facts. The second difficulty is that, when the relief sought is to buy out the petitioner’s minority shares, the petitioner will still be a shareholder when the order has been made against the majority to pay part of the amount of the share value to the petitioner. The problem arises as to who should have the right to vote attaching to these shares pending the outcome of the case. It was held in Ferguson v MacLennan Salmon Co Ltd, which was decided before the CPR, that the court could make a conditional part payment order on the petitioner transferring the shares to nominees with the power to exercise the voting rights on behalf of the respondents. The position

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16 CPR Part 24.
17 Ferguson v MacLennan Salmon Co Ltd [1990] BCC 702.
is unlikely to be different under the CPR.

In a derivative action, summary judgment is unlikely to be granted, due to the fact that the factual and legal basis will be very controversial. This is even more so as it is unclear when the minority shareholders have standing to bring a derivative action. Hence, summary judgment is more likely to work against the minority shareholders. However, if the court does allow the minority shareholders to proceed with the case, part payment may prove to be a useful weapon for the minority shareholders. For instance, in an alleged improper finance to the directors, if the respondent 'has no real prospect of successfully defending' the issue, and there is no other reason why the issue should be disposed of at trial, it appears to be open to the petitioner to apply for summary judgment for an order under section 461 of the Companies Act 1985 requiring the respondent to reimburse the company for the amount of the improper expenditure.

In a contested takeover bid, there will be an overwhelming volume of evidence, especially about the value of the shares, and the court may need to conduct an investigation into the company's history before coming to any conclusion. Therefore summary judgment is unlikely to be a weapon for minority shareholders. The courts are reluctant to interfere with business judgments. This would work in favour of the respondent in applications for summary judgment by the minority shareholders, who are unlikely to be able to tender persuasive evidence due to their limited access to corporate information.

4. Preliminary Issues
The court has the power to direct a preliminary hearing or to decide which issue should be decided first. In most cases, the issue of valuation under section 459 of the Companies Act 1985 can be determined before the issue of conduct being decided.

A decision on the valuation will give an idea to the minority shareholders whether or not it is worth pursuing litigation at all. This may result in early disposition of the case before large legal costs are incurred. On the other hand, early valuation could be cost-wasting to parties in the proceedings for two reasons: first, parties often have to prepare several valuations on alternatively assumed bases because they do not know the terms on which any purchase order will be made; secondly, if it is later proved that the conduct has not been unfairly prejudicial, or if the court is unwilling to make a purchase order, the costs of any valuation will have been unnecessarily incurred.

The suggested solution is that the court's approach will depend on the circumstances of the particular case. It has also been pointed out that the court must ensure that a hearing or trial on a preliminary issue will shorten the time of the proceedings rather than prolonging them.

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19 But see Re Bird Precision Bellows Ltd [1986] Ch 658 where the parties sought, in a consent order, to focus solely on the valuation of the shares. Oliver LJ said that "[u]nless unfair prejudice was proved, the court was simply being asked to undertake a sort of arbitration in vacuo, which it had no jurisdiction to do". 672.
20 In particular the basis of valuation, the date on which the valuation is to be made, and any adjustment, which may be ordered to take account of misappropriation of assets or mismanagement; see Consultation Paper No 142, paras 10.13-10.22.
21 Quinlan v Essex Hinge Co Ltd [1996] 2 BCLC 417 where the court directed the issues should be determined in the following order: (1) whether or not there has been unfair prejudice; (2) what remedy is to be ordered; (3) if the remedy is purchase of shares, (i) the basis of valuation, (ii) the date of valuation, and (iii) any adjustments to be made in valuation.
22 At least, if they are decided in one way; see Carl Zeiss Stiftung v Herbert Smith & Co [1969] 1 Ch 93; R Reed ‘Derivative claims: The application for permission to continue’ [2000] Company Lawyer 157.
D. FINAL ORDERS

1. Derivative Action

In a derivative action, if the minority shareholder wins the case, the court can order the respondent to pay damages, compensation, or any sum of money, based on tort, contract, or equitable principles. However, any sum of money will be paid to the company since the minority shareholder enforced a right on behalf of the company. When any sum of money is paid to the company as a result of an action brought by minority shareholders, it does not follow that the minority shareholders will have a right to the money, neither do they have the right to compel the board to distribute the amount awarded to the shareholders. If, however, the shareholder enforced a personal right and brought an action based on a harm caused to him by the conduct of the controllers, the minority shareholders are entitled to recover the loss suffered, subject to the principle against double recovery.

If a personal right of the minority shareholder has been infringed by the conduct of the majority shareholders, the minority shareholders' losses are equally caused by the majority shareholders, whether or not they have de jure control. In a hostile takeover, if the directors and majority shareholders, in breach of their duties to the company, implement a poison pill to fend off a bid, a successful challenge to it will result in invalidation of the defensive measure. However, if the invalidation is not conceivable, directors and majority shareholders may be required to pay damages to the company. Under the current law, minority shareholders would need to apply to the court for an order that damages be paid directly to the minority shareholders out of the pocket of
the directors and the majority shareholders, rather than out of company’s accounts.

The Law Commission stated in its 1996 consultation paper on Shareholders’ Remedies that the remedy of buy-out of the minority shareholders’ shares should not be granted by the court as a personal benefit to the shareholder bringing the derivative action. However, if the shareholders are not to be awarded any benefits for their effort in bringing the action, either for their own sake or for the benefit of the company, shareholders will prefer to sit quietly than to run the risk of a large legal bill.

It is suggested that a *pro rata* recovery in a derivative action should be allowed. This approach has been adopted for a long time by the American courts. The Law Commission’s paper was in favour of the traditional view that recovery should only be allowed for the company. This view prevails in the UK. However, this has been criticised as being similar to a successful conclusion to a statutory derivative action, which hands back the proceeds of the judgment to a private company wholly controlled by shareholders actively involved in the wrongdoing and likely to repeat the performance.

2. Section 459

Remedies under section 459 of the Companies Act 1985 are at the discretion of the court. The court should take into account the situation during the proceedings,
rather than the situation at the time of the petition. Under section 416(2) of the Act, orders which may be granted by the court include: first, orders regulating the conduct of the company’s affairs in the future; second, orders requiring the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained that the company has omitted to do; third, orders authorising civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct; fourth, orders providing for the purchase of the shares of any members of the company by other members or by the company itself; and, lastly, in the case of an order providing for the purchase of shares by the company itself, the reduction of the company’s capital accordingly.

The remedies sought will depend on the motivations of the minority shareholders in making a petition. If the minority only wishes to be compensated by selling their shares at a premium, the only remedy they will be interested in is a buy-out order. The other remedies will prove to be futile. On the other hand, if the minority shareholders wish to stay with the company, for instance because they also are employees of the company, then a buy-out order will be a last resort for them and orders requiring the company to act or not to act in a certain way or authorising civil proceedings will be more useful to them.

27 McGuinness v Bremner plc [1988] BCLC 673, ordering a single meeting to be held; Re HR Harmer Ltd [1959] 1 WLR 62 (a case under the Companies Act 1948, s210) setting out a comprehensive code for the future conduct of the company’s business; Re Marco (Ipswich) Ltd [1994] 2 BCLC 354, 408, ordering one or more persons be involved in management.

28 Re Whyte Petitioner (1984) 1 BCC 99, 144, company refrained from holding a meeting. Companies Act 1985, s 461 (4), altering the company’s memorandum or articles; Companies Act 1985, s 461 (3), requiring company to make (or not make) any or any specified alteration to its memorandum or articles and, if it does so, the company cannot make any alteration in breach of that requirement.

29 Under the Companies Act 1985 s 462 (2) (c), the court may ‘authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct. The remedy will be granted even without satisfying the requirements under Foss v Harbottle.'
The problem with a share purchase order is that of valuation. The petitioner will wish the share to be purchased at least at *pro rata* basis. By contrast, majority shareholders will wish to see the petitioner's shares bought at a discounted price. The argument for the petitioner is based on the principle of equal treatment whereby each share represents the proportional value against the value of corporate assets. However, majority shareholders will argue that control represents additional value and carries with it a control premium. On this basis, the petitioner's share value represents a minority shareholding without impact on the control of the company; hence the value should be discounted. The case for the petitioner is stated in *Re Bird Precision Bellows*\(^3^0\) by Nourse J:

I would expect that in a majority of cases where purchase orders are made under [the CA 1985, s 459] in relation to quasi-partnerships the vendor is unwilling in the sense that the sale has been forced on him. Usually he will be a minority shareholder whose interests have been unfairly prejudiced by the manner in which the affairs of the company have been conducted by the majority. On the assumption that the unfair prejudice has made it no longer tolerable for him to retain his interest in the company, a sale of his shares will invariably be his only practical way out short of a winding up. In that kind of case it seems to me that it would not merely be unfair, but most unfair, that he should be bought out on the fictional basis applicable to a free election to sell his shares in accordance with the company's articles of association, or indeed on any other basis, which involved a discounted price. In my judgment, the correct course would be to fix the price pro rata according to the value of the shares as a whole and without any discount, as being the only fair method of compensating an unwilling vendor of the equivalent of a partnership share.

\(^3^0\) *Re Bird Precision Bellows Ltd* [1984] Ch 419, 430g-431e.
However, he continued by saying that a discounted price might be appropriate in two circumstances:\footnote{Elliott v Planet Organic Ltd [2000] BCC 610 where the petitioner deserved his exclusion; Re Elgindata Ltd [1991] BCLC 959, 1007g-h, but see h-l; Re A Company [1986] BCLC 310 where petitioner had purchased the shares as an investment or at a discount.}

Suppose the case of a minority shareholder whose interests had been unfairly prejudiced by the conduct of the majority, but who had nevertheless so acted as to deserve his exclusion from the company. It is difficult to see how such a case could arise in practice, because one would expect acts and deserts of that kind to be inconsistent with the existence of the supposed conduct of the majority ... [Counsel for the respondents] submitted that the petitioners did act in such a way as to deserve their exclusion from the company. He further submitted that it would therefore be fair for them to be bought out on the basis, which would have been applicable if they had made a free election to sell their shares pursuant to the articles, ie at a discount. Assuming, at present, that the respondents can establish the necessary factual basis, I think that [this] further submission is correct. A shareholder who deserves his exclusion has, if you like, made a constructive election to sever his connection with the company and thus to sell his shares....[I]n the case of the shareholder who acquires shares from another at a price which is discounted because they represent majority it is to my mind self-evident that there cannot be any universal or even a general rule that he should be bought out under [the CA 1985, s459] on a more favourable basis, even in the case where his predecessor has been a quasi-partner in a quasi-partnership. He might himself have acquired the shares purely for investment and played no part in the affairs of the company. In that event it might well be fair- I do not know- that he should be bought out on the same basis as he himself had bought, even though his interests had been unfairly prejudiced in the meantime. A fortiori, there could be no universal or even a general rule in a case where the company had never been a quasi-partnership in the first place.
This judgment shows that a very important element in the valuation of the shares is that of participation in the management. It is true that in the modern public listed corporation, minority shareholders rarely take active part in the management of the company. Nevertheless, if the minority shareholders actively participate in the general meetings, so called shareholder activism, a valuation pro rata basis can be appropriately granted to them. On the other hand, if the shares are purchased for the sole purpose of investment with little participation in corporate affairs, the shares will be rightly purchased at a discounted price. This kind of argument can be contrary to the modern principle of equal treatment, although it may be a ‘fair deal’. Under the internal control model, this principle will encourage shareholders to participate in general meetings to pay more attention to governance issues. On the other hand, in ordering the appropriate basis for valuation, the court may consider an involvement in the corporate affairs by the minority shareholders which amounts to a disruption of the efficient conduct of the business of the company.

It must be pointed out the court has wide discretion and is not just given the alternative between pro rata and discount valuation. Rather, it has power to order a valuation applying an intermediate discount. In Re Marco (Ipswich) Ltd, Lady Justice Arden split the control premium between the petitioner and the respondent 35 to 65 in favour of the petitioner.\(^{32}\) In Richards v Lundy,\(^{33}\) the deputy judge said that ‘in any event, there may be cases where neither a pro rata valuation nor a minority shareholding valuation is fair, and I do not accept the submission that it would be ‘palm tree’ justice to find a middle course, or if it would be, then the width of the

\(^{32}\) Re Macro (Ipswich) [1994] 2 BCLC 354, 410e.

\(^{33}\) Richards v Lundy [2000] 1 BCLC 376, 398d-f.
statutory discretion justifies it.'

In many cases, courts have used adjustments to the valuation based on factual assumptions, which are designed to put the petitioner in the position he would have been in but for the unfair prejudice. This approach mirrors the calculation of tortious damages.\(^{34}\)

The date of valuation can be crucial. There are three distinct options, which are the date before the conduct of unfair prejudice,\(^{35}\) the date of the petition being made,\(^{36}\) and the date of order.\(^{37}\) Once the date has been chosen, any evidence produced to prove a value of the shares at a time subsequent to the chosen date will not be admissible. This is particularly important with respect to shares traded on the stock exchange, the price of which changes from minute to minute. In the case of implementation of a 'poison pill' by the directors to deter a takeover bid, if a minority shareholders' petition under section 459 for a buy-out order is successful, the dates of valuation could be the date when the poison pill was implemented, the date when a bid was made, the date when the petition was filed with the court, and, finally, the date when the final order was made. At each stage the price of the shares may be different. It is certainly difficult for the court to choose a date. The guiding principle should be, however, that the date should be such that it can be assumed that the unfairly prejudicial conduct had not (yet) had any negative impact on the value of the shares.

\(^{34}\) Re London School of Electronics Ltd [1985] BCLC 273, 282b-d.

\(^{35}\) Re OC (Transport) Services Ltd [1984] BCLC 251; Scottish Co-operativ Wholesale Society Ltd v Meyer [1959] AC 324.

\(^{36}\) Re A Company (No 002612 of 1984); Re London School of Electronics Ltd [1985] BCLC 273, 282b.

\(^{37}\) Re A Company (No 005134 of 1986), ex p Harries [1989] BCLC 383, 399e; Re Elgindata Ltd [1991] BCLC 959, 1007a; Richards v Lundy [2000] 1 BCLC 376, 398g, where the order was made because the petitioner had been locked into the company without any payment of dividend.
A final point is that the court may be willing to take into account the rules of accountancy, such as P/E ratio to evaluate the shares.\textsuperscript{38} This may help reach a fair decision on the valuation issue although may also add to the costs of the proceedings if expert evidence is needed and it is not practicable to appoint a joint expert.

**E. REMEDIES FOR BREACH OF EU LAW**

This section examines the question of shareholders’ remedies for any loss or harm caused to them by a breach of EC law by the corporate controllers, the supervisory authorities, or the State. The issue is what impact, if any, the Takeover Directive has on shareholders’ remedies.\textsuperscript{39} If there is a breach of any of the principles or provisions in the Directive or in the implementing national measures, on what basis, whom, and for what can the shareholders sue?

The negotiations of the Takeover Directive have been notoriously difficult. One of the concerns has been that EC legislation would provide incentives for the parties to a bid to issue proceedings in the courts to litigate complex and novel issues of EU law. That would have a nefarious effect on the economy. Article 4(6) of the Directive expressly

\textsuperscript{38} Nicholas Landon Reid v Michael John Averre de Vollum Reid, John Reid & Sons (Strucsteel) Limited 2003 WL 1935311 Ch D (Companies Ct) [2003] 2 BCLC 319.

provides that the Directive does not affect the power of the Member States to designate judicial or other authorities responsible for dealing with disputes and for deciding on irregularities committed in the course of bids or the power of Member States to regulate whether and under which circumstances parties to a bid are entitled to bring administrative or judicial proceedings. Furthermore, the Directive does not affect the power which courts may have in a Member State to decline to hear legal proceedings and to decide whether or not such proceedings affect the outcome of a bid. Finally, the Directive does not affect the power of the Member States to determine the legal position concerning the liability of supervisory authorities or concerning litigation between the parties to a bid. Therefore, the directive does not affect the standing of the shareholders to bring a personal or derivate action under English law nor does it affect the liability of the supervisory authority under national law. It would appear that the Directive while ‘instructing’ Member States to confer rights on, and afford protection to, minority shareholders, does not have the effect of allowing them to rely on such rights and protection in litigation before the national courts in order to obtain an effective remedy for breach of their rights.

The conclusion that shareholders cannot rely on rights conferred upon them under the Takeover Directive in litigation before the courts directly is not the end of the matter. The Directive can limit its scope by leaving to Member States to regulate issues of standing, procedure, and remedies. It cannot, however, exclude the application of the doctrine of State liability for failure adequately to implement a Directive. Under this doctrine, as developed by the Court of Justice, persons who have suffered loss as

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41 Failure to implement a Directive may also result in infringement proceedings brought by the Commission of the European Communities against the Member States before the Court of Justice: Case 61/81 Commission v UK [1982] ECR 2601.
a result of failure to implement a Directive may be able to sue the State for damages provided that: first, the result required by the Directive involved conferring rights on individuals; secondly, the content of the rights can be determined from the Directive; and thirdly, there is a causal link between the failure to implement the Directive and the damage suffered by those affected. A Directive may only be directly effective, meaning conferring rights on individuals, provided it is clear, precise, and unconditional. A Directive is only vertically effective and creates rights on natural and legal persons against Member States.

A State is liable to breaches of Community law. In Brasserie du pêcheur and Factortame, it was established that there must of a 'serious breach' of Community law for the right to reparation to arise. Failure to implement a Directive is per se a serious breach. This means that a Member State must have manifestly and gravely disregarded the limits on the exercise of its discretionary powers. However, if a Member State transposes directives incorrectly, whether the breach is serious will involve an enquiry around discretion, good faith, reasonableness, and the behaviour of related actors, namely, the Commission and other Member States. Furthermore, the condition of causation between serious breach and damages must be satisfied. There must be direct causal link between the breach of an obligation resting on the State,

43 A Directive, unlike Treaty Articles, Regulations and Decisions, cannot have horizontal direct effect, ie cannot create rights and obligations that natural and legal persons can enforce in the national courts against each other.
45 Joined Cases C-46 and 48/93 Brasserie du pêcheur and Factortame, para 55.
such as late or incomplete transposition of Community law, and the loss or damage suffered by injured parties.\textsuperscript{48} However, on the issue of causation, the Court has not elaborated any systematic principles but has approached the issues that arise on a case-by-case basis. The case law also demonstrates that it is for the national court to establish whether a breach is serious.\textsuperscript{49}

A regards the defendant, the liability extends to the Member State and ‘organizations and bodies that are under the control of the State or have special powers beyond those which result from the normal rules applicable to relations between individuals’.\textsuperscript{50} It would appear that if Member states designate an authority competent to supervise bids under Article 4(1) of the Takeover Directive, such an authority would be an emanation of the State for the purposes of the Community law doctrine of State liability whether the designated authority is an administrative body or a self-regulatory organization recognized by national law. The doctrine of State liability would, therefore, apply to the UK Takeover Panel if it is designated under Article 4(1) of the Directive.

The remedy of damages under the Community law doctrine of State liability is an important weapon of last resort for minority shareholders but should be seen as a residual and exceptional remedy. The reality is that the Takeover Directive, the outcome of a compromise between Member States, does not have any significant impact on the private actions model. It remains neutral in this respect. Article 4(6) clearly provides that issues of private law standing, procedure, and remedies are not

\textsuperscript{48} See, eg, the Factortame case, para 51; Case C-127/95 Norbrook Laboratories Limited v Ministry of Agriculture [1998] ECR I-01531.

\textsuperscript{49} Some commentators take the view that the Court of Justice may intervene selectively: T Tridimas ‘Liability for breach of community law: growing up and mellowing down?’ in D Fairgrieve, M Andenas and J Bell (eds) Tort Liability of Public Authorities In Comparative Perspective (British Institute of International and Comparative Law London 2002) 149; Case C-222/02 Peter Paul v Germany

\textsuperscript{50} Case C-188/89 Foster v British Gas plc [1990] ECR I-3313, para 19.
affected by the Directive. Any development of the private action model is, therefore, left to national law.

F. FUNDING THE PROCEEDINGS

1. Legal Costs

Costs sanction can be an effective measure for the court to manage proceedings effectively and discourage wasteful litigation. In the pre-CPR era, the Court of Appeal had held in *Re Elgindata (No2)*[^51] that the court could not order a successful party to pay the costs of an unsuccessful party in respect of an issue, which had failed, unless the issue had been unreasonably or improperly raised by the successful party. The only sanction was to disallow part of the successful party’s costs.[^52] The Court of Appeal also disapproved of the approach of the trial judge in treating different categories of complaints of unfairly prejudicial conduct as separate issues for the purposes of awarding costs, and in disallowing costs in respect of those which he regarded as ‘thin’.[^53] It was then suggested by the Law Commission that the law of

[^51]: *Re Elgindata (No2)* [1993] BCLC 119; See also the case of *Roston v Elliot* 7 June 1996 (unreported, Court of Appeal).

[^52]: The ruling was based on RSC, O62, r10, which provides: (1) Where it appears to the Court in any proceedings that anything has been done, or that any omission has been made, unreasonably or improperly by or on behalf of any party, the Court may order that the costs of that party in respect of the act or omission, as the case may be, shall not be allowed and that any costs occasioned by it to any other party shall be paid by him to that other party.' The Court of Appeal considered that it was implicit in the principles derived from this rule that a successful party who neither improperly nor unreasonably raises issues or makes allegations on which he fails ought not to be ordered to pay any part of the unsuccessful party’s costs; [1993] BCLC 119, 125.

[^53]: Nourse LJ commented: ‘[Counsel for the respondents] sought to treat the four categories of complaints of unfairly prejudicial conduct as separate issues and even to go further and sub-divide them into the individual allegations made in the petition. I wholly reject that approach.' [1993] BCLC 119, 126. Beldam LJ also stated: ‘In my view it is only if it is possible so as to isolate the issue in the case that it can properly be said that it is unnecessarily pursued as having no hearing on the real questions in the suit that it would be proper to deprive the successful party of all costs of that issue.
Elgindata should be reversed and the court should conduct more effective case management to weed out the unwanted litigation by being more willing to award costs sanctions. Indeed, following the recommendations in Lord Woolf’s Interim and Final Reports on Access to Justice, under the CPR, the courts have wider powers to make costs order in respect of the outcome of the separate issues that have been litigated. Lord Woolf said in AEI Rediffusion Music Ltd v Phonographic Performance Ltd that ‘[t]he most significant change of emphasis of the new Rules is to require courts to be more ready to make separate orders which reflect the outcome of different issues’.

These wider powers under the CPR can be effectively exercised to discourage wasteful litigation and focus the court’s resources on the cases that deserve its full attention.

The importance of the issue of costs is linked to the issue of the funding of the litigation. Litigation can be very expensive. Legal costs may be a disincentive to bringing proceedings. The following sections examine the different options open to minority shareholders to fund private actions.

2. Derivative Action

In a derivative action, the minority shareholder is said to enforce the right of the company rather than his own right. As a consequence, legal aid will not be available because it is only available to an individual, which does not include a corporate entity. However, since a derivative action is brought by a shareholder on behalf of the

Otherwise a more general assessment should be made.’ He went on to give the following example: ‘The compliant of lack of consultation, though thin, was neither immaterial nor could it be said to be irrelevant. It may have been exaggerated, but that in itself is no ground for depriving the party making the allegation of all the costs’ 129.

54 AEI Rediffusion Music Ltd v Phonographic Performance Ltd [1999] 1 WLR 1507, 1523.
company to address a wrong conducted by the directors or majority shareholders, the minority shareholder is entitled to be indemnified by the company at the end of the trial for any costs he has incurred, provided he acted reasonably in bringing the action, even if it fails. Buckley LJ said in *Wallersteiner v Moir (No 2)*:

> Where a shareholder has in good faith and on reasonable grounds sued as a plaintiff in a minority shareholder’s action, the benefit of which, if successful, will accrue to the company and only indirectly to the plaintiff as a member of the company, and which it would have been reasonable for an independent board of directors to bring in the company’s name, it would, I think, clearly be a proper exercise of judicial discretion to order the company to pay the plaintiff’s costs.

Shareholders, however, are not totally free from the burden of legal costs. Walton J held in *Smith v Croft* that a shareholder’s ability to finance the action himself will be relevant to the question of whether the court will make a costs order against the company. He continued to say that, if an order was made, a percentage of the costs should still be paid by the shareholder, even if he was impecunious. Such a requirement would be a financial spur to ensure that the claimant proceeded diligently with the action.

### 3. Contingency and Conditional Fees Arrangements

As a means of funding the proceedings, a shareholder may enter into a conditional fees agreement with his lawyers. Conditional fees agreements are regulated by section 58 of the Courts and Legal Services Act 1990 and statutory instruments made under
that section. Under conditional fees agreements, if the party wins the case, he must pay his solicitor's fees and any disbursements (expert's reports and barrister's fees). If the party loses, he needs pay no fees to his solicitor. However, he may have to pay his opponent's legal costs and both sides' disbursements. Conditional fees agreements are different from contingency fees agreements. Under a contingency fee agreement, if the party wins the case, his solicitor is entitled to a percentage of the damages or other sum of money awarded to his client. Contingency fee agreements in respect of contentious matters are still illegal in England and Wales. In *Wallersteiner v Moir (No2)*, Lord Denning MR was prepared to agree, in principle, that contingency fees could be used as a mechanism to fund derivative actions.\(^5\) However, Buckley and Scarmann LJJ disagreed on this issue expressing the view that the court had neither the power nor good reason (given the jurisdiction to make indemnity orders) to sanction a contingency fee agreement.

Contingency fees have been permissible in the USA for many years. Under a contingency fees agreement, the lawyer will be able to charge a percentage of the award received by the plaintiff if he wins the case and reduced fees or even no fees if he loses the case. If the contingency fee agreement contains a 'no win, no fee' clause, minority shareholders will have to pay no costs if they lose the case. In fact, in the US each party bears his/her own the costs regardless of the outcome of the case. Therefore, litigation can be risk-free for a minority shareholder. At the same time, lawyers have a strong incentive to take on and pursue minority shareholders' actions because of the percentage of the final award that they will charge if the case succeeds.

\(^5\) Provided the agreement had received ‘...the permission, first of the Council of the Law Society and next of the courts’, see *Wallersteiner v Moir (No2)* [1975] QB 373. 396.
In England and Wales, contingency fees agreements in respect of contentious matters are illegal. However, under conditional fee arrangements, the parties may stipulate that, if the client succeeds, the normal fees are paid with the addition of a fee ‘uplift’ agreed in advance and currently required not to exceed 100 per cent of the normal fees. The fee uplift is based on the lawyer’s fees, rather than the level of damages. Solicitors have operated a voluntary cap on the fee uplift of no more than 25 per cent of the damages awarded as recommended by the Law Society. Enhanced fees provide an incentive for lawyers who act under a conditional fee agreement. Costs order made by the court can include ‘fees payable under a conditional fee agreement which provides for the payment of enhanced fees’. Enhanced fees are recoverable.

4. Section 459

Petitioners under section 459 of the Companies Act 1985 are not entitled to be funded by a company by way of indemnity. However, as individuals, they are in principle eligible for legal aid although, under the current criteria, they are most unlikely ever to qualify for legal representation. In a petition under section 459, the petitioner seeks relief on his own behalf. However, section 461 provides that a petitioner may be authorised by the court to bring a derivative action as a remedy to be granted under section 459. In Re A Company (No 005136 of 1986), Hoffmann J suggested that where the petition does seek relief on behalf of the company rather than the petitioner personally, the petitioner may be in a position to obtain an order for an indemnity to

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57 Legal Aid Act 1988 s 14 (1) (a); Mills v Mills [1963] 329; R v Legal Aid Committee No1 (London) Legal Aid Area, ex parte Rondel [1967] 2 QB 482 as to the width of the term ‘proceedings’ and, in particular, the fact that it extends to matters commenced by petition.
his costs.\textsuperscript{58}

G. THE EXIT CLAUSE

This section examines the impact that an exit clause in the company's articles of associations has on the remedies that can be obtained by minority shareholders. The exit clause gives the shareholder the right to have his shares bought out by the company.

The Law Commission is in favour of the inclusion of an exit clause in Table A of the company's articles of association.\textsuperscript{59} The proposal is mainly designed for smaller private companies, though not limited to any particular number of shareholders. The contents of the clause will specify the circumstances when the right is exercisable and state how the 'fair price' is to be calculated. There are two proposed circumstances when exit rights are exercisable: first, the removal of a shareholder who is a director from his office as a director of the company other than where he is in serious breach of his duties as a director; second, the death of a shareholder.\textsuperscript{60} Neither of these


\textsuperscript{60} The Commission acknowledges, however, the danger of including a list of circumstances in the articles, as they may not be appropriate for the exit clauses to arise.
events would trigger a petition under section 459 of the Companies Act 1985. Furthermore, they are unlikely to give rise to any problem for minority shareholders in takeover transactions. An exit clause is, however, significant when a listed company, after a successful takeover, decides to be de-listed from the market, which will result in the dissenting shareholders being locked up in the company.

If an exit clause is included in Table A of the company’s bylaw specifying the right and procedure for the buy-outs, this will give the shareholder a contractual right to have his shares bought back. The remedy is stronger than a section 459 petition. The clause will set out the general principles and/or specific circumstances which trigger the minority’s rights to sell out their shares to the company or to the majority at a price to be determined by agreed method of valuation, for instance by appointing an independent accountant or auditor.

In a closely-held company, the exit clause may be the most effective way for shareholders to obtain their capital. However, unless the clause is clearly drafted and the facts clearly establish the case, litigation may not be easily avoided. Therefore, it is generally advisable to include an additional arbitration clause providing that all disputes relating to the meaning and implementation of the clause be referred to binding arbitration.

For listed companies, the exit clause is said to be an inappropriate measure. This is for two reasons: first, shareholders can freely sell their shares on the market; second, the price in the market is said to be a fair price, in respect of which the court should not intervene. Full reliance on the market control model not always does justice to minority shareholders. The market price may be below the historical average of the
company shares in circumstances where minority shareholders have no other alternative to selling their shares.\textsuperscript{61} If the intrinsic value is higher than the market price, the minority shareholders make a loss. Although it is difficult in this situation to show that the controller of the company expropriates minority shareholders benefits, this becomes evident if the company has a plan of buy-back takeover. In this case, when shareholders sell their shares on the market and do not benefit from the plan, this may amount to expropriation of part of the value of the shares.

The inadequacy of the market control mechanism led to the introduction of sell-out rights. The City Code’s equal treatment and mandatory bid rules are a good example. However, if the Takeover Panel fails to enforce these two principles, minority shareholders make a loss, absent an exit clause, in a share for share, or share for loan takeover. The court, because of the nature of the Code and the Takeover Panel, has a very limited role in these situations. Exit clauses prove to be useful in such situations as shareholders can decide to realise their investment rather than continuing their investment in the unwanted merged company. An exit clause generally includes a method of valuation not only based on nominal compensation but including additional compensation for the loss of value the shares.\textsuperscript{62}

The analysis of exit clauses has been carried out to demonstrate the importance of contractual remedies as opposed to remedies that depend on the discretion of the court such as a petition under section 459 of the Companies Act 1985. This concludes the

\textsuperscript{61} B Cheffins \textit{Company Law, Theory Structure, and Operation} (Clarendon Press Oxford 1997) 469. The author rightly points out that: '[S]til, for an investor, selling will usually be, as compared with litigating, a much more cost-effective way of responding to a situation where a company is not being run in accordance with his expectations'.

\textsuperscript{62} This method of valuation will also deter the executive members of the board to increase their cash-flow rights and control rights, which have the effect of decreasing the market valuation.
examination of shareholders’ remedies under English and Community law. Before analyzing the relevant statutory criminal and regulatory offences, it is useful to draw the conclusions from the analysis of the remedies carried out in this chapter.

**H. CONCLUSION**

This chapter analyzed the remedies available to minority shareholders. The following conclusions can be drawn.

If the private action model is to develop, it is important to set up a pre-action protocol for disputes between shareholders, or shareholders and the company or the controllers of the company. A pre-action protocol should deal with issues of exchange of information and pre-action disclosure to ensure that cases will be conducted on an equal footing and minority shareholders will not be prejudiced by lack of accessibility to corporate information. A pre-action protocol also serves the purpose of facilitating early settlement of the dispute and, if proceedings arise, exchange of information between the parties prior to the litigation will help the court in its case management.

Among interim remedies, interim injunctions are particularly important. Interim injunctions should be more easily obtainable in favour of minority shareholders. It may be difficult for shareholders to satisfy the three-limb test laid down by the *American Cyanamid* case. More often than not, the sought injunction amounts to disruption of the company’s business. Therefore, the balance of convenience would probably come down against the grant of an injunction. However, in takeovers or
friendly mergers the preservation of the status quo may weigh in favour of enjoining the transaction. Furthermore, our analysis has come to the conclusion that courts should give proper weight to the role of minority shareholders’ actions as an element of corporate governance. To impose undue limitations on the development of the private actions model weakens the internal control model. For the internal control model to work well, directors and controlling shareholders should be accountable to the minority shareholders through, _inter alia_, private actions. This analysis counterbalances the arguments to the effect that the company’s business should be disrupted as little as possible. The role of minority shareholders and their legitimate expectations should be taken into account in the application of the test derived from equity, ie the balance of convenience.

As regards final remedies, the scope of the final orders should be broader, taking into account the needs of the minority shareholders and the difficulties in the enforcement of orders such as mandatory injunctions or a court order to compel the management to behave in a certain way. If buy-out is the only realistic remedy, the method of valuation should take into account the interaction of the minority shareholders and the company. The more involved the minority shareholders are in the management of the company, the more favourable to the minority shareholders the valuation method should be. This will encourage and reward shareholders’ activism. The rationale for this is that shareholders’ activism is a fundamental tool of corporate governance.

The Takeover Directive does not have any significant impact on shareholders’ remedies except in the area of State liability for breach of Community law. The liability of the State for failure adequately to implement the Directive would extend to any authority designated under Article 4(1) as competent to supervise the bid,
including self-regulatory bodies. However, the Community law remedy of damages against the State and emanations of the State is a weapon of last resort for shareholders. It can be defined as a residual and exceptional remedy. The reality is that the Takeover Directive is based on the regulatory model. It does not affect the private actions model, the regulation of which is left to the Member States.

Finally, the issue of the funding of the proceedings is crucial to the development of the private actions model. Fee arrangements such as contingency fee arrangements, currently illegal in contentious matters in England and Wales but widely used in the US, should be made available to minority shareholders as a means to fund their proceedings. It also appears that contribution to the costs incurred by minority shareholders should be more readily available not only when they bring a derivative action, but also when they bring a personal action or a petition under section 459 of the Companies Act 1985. For instance, even if the proceedings under section 459 are strictly not an action on behalf of the company, the court should be more willing to allow the minority shareholder’s request for contribution to the costs by the company.
CHAPTER VIII

THE IMPACT OF CRIMINAL LAW AND PUBLIC ENFORCEMENT ON MINORITY SHAREHOLDERS' RIGHTS AND REMEDIES

A. INTRODUCTION

This chapter examines the impact of criminal law and administrative and regulatory enforcement on shareholders' rights and remedies. Criminal law and regulation form the regulatory model, a model under which standards of conduct are set by the State and its agencies and enforced by public bodies. The objective of the analysis is two-fold. The first is to explore whether the regulatory model can, on its own, provide exhaustive protection for minority shareholders. The answer to this question is that the regulatory model is not self-standing but must be complemented by the private action model. The second objective is to analyze the interaction of the regulatory model and the private actions model. Do private and public enforcement conflict or do they complement each other? The answer to this question will be that the regulatory model and the private actions model are not alternative but complementary to each other.

This chapter is structured as follows. First, it will explain why a regulatory model is necessary at all and review the criminal and civil statutory offences relevant in takeover situations. Secondly, it will analyse the interaction between the regulatory control model and the market control model showing the inadequacy of the regulatory control
model when redress for minority shareholders is left to the market mechanism alone.

Thirdly, it discusses the powers of the FSA, DTI inspections, and independent enquiries.

Fourthly, it examines issues of concurrent proceedings. Finally, conclusions are drawn.

B. CRIMINAL AND PUBLIC OFFENCES IN TAKEOVERS

1. Common Law

Criminal law at common law is inadequate to combat modern financial crime. This is why most jurisdictions adopt a regulatory approach in combating the ‘social evil’ in financial transactions.\(^1\) The ‘social evil’ may not be considered as ‘crime’ under the traditional principles of the common law or the criminal codes in most continental legal jurisdictions. In financial markets, market confidence needs to be maintained in order to attract transactions into the market.\(^2\) Some measures are taken to control the ‘irregularities’ of the transaction, which will undermine market confidence. It is under this presumption that the ‘social evils’ are defined, and laws are passed to regulate these ‘social evils’.\(^3\) One difference between the criminal law at common law and regulatory offences is that common law criminal law focuses on the ‘dishonesty’ of the perpetrator, whereas the regulatory offences concentrate on the effect of the conduct on the market.

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\(^3\) B Cheffins Company Law Theory (Clarendon Press Oxford 1997) 146.
as a whole. On this analysis, investors in the market will benefit from regulations that are intended to maintain market confidence. Furthermore, the common law of evidence imposes a very high burden of proof on the prosecutor, who must prove the elements of the crime beyond reasonable doubt. When a regulatory approach is adopted, the burden of proof can, in some cases, be reversed back to the perpetrator to disprove the crime or regulatory offence, as long as this does not violate the perpetrator's rights, including the presumption of innocence and the privilege against self-incrimination.

Although common law offences may not be particularly useful in governing modern corporate transactions, they remain significant in two aspects: first, they provide some basis for regulation; second, they can add further deterrent effect as common law offences may carry a heavier penalty. At common law, conspiracy to defraud is defined as a conspiracy between two or more people to the commission of a wrongful act, which usually involves a fraudulent misrepresentation, with the intention to defraud. In *R v De Berenger*, the accused began a false rumour that Napoleon had been killed, knowing that this would cause the price of Government bonds to rise, enabling them to deal at a profit. In *Bedford v Bagshaw* the defendants made false representations to a broker so as to obtain a listing for their shares. The plaintiff, who dealt in these shares and suffered a loss when the shares turned out to be worthless, was able to make a claim against the defendants. In these two cases, there was clear evidence of 'fraudulent

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5. P Davies *Gower's Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) 781, as he said 'successful deployment of the criminal law on a wide scale against insider dealing and market abuse has proved impossible, and the move towards a regime based on administrative penalties was driven by the desire to address two of those obstacles, namely the need to show intention or mens rea, at least in relation to insider dealing'.
dealing’, which led to the conviction of the defendant or to a judgment for the plaintiff. However, cases where dishonesty is less clear will need additional circumstantial evidence to prove the intent to defraud. For instance, in *Sanderson and Levi v British Westralian Mines and Share Corporation (Limited)*, an agreement was entered into between a jobber and two companies where the jobber would ‘make a price for, and buy and sell at the price so made certain shares of which the defendants were then possessed’. The defendants agreed to provide funds to ‘buy-up’ surplus shares and then to relieve the plaintiff of any surplus shares so purchased. The court found that there was no intention to defraud, as the defendant did not use fraudulent means to induce others to purchase, and the price set was a fair market value.

In the case of ‘market-rigging’ where parties are to obtain benefits by manipulating the market by making of false representations as to the genuineness of the bidder and as to his opinion of the value of the goods being auctioned, the common law considers that no unlawful act is committed. For instance, if a bidder makes an agreement with some other shareholders to sell the shares at a ‘knock down’ price, and then to distribute the spoils that being the difference of the real value and the price which the non-participating shareholders tender, this would be lawful at common law. It would be unlawful, if sham dealing had been set up to push up the bidding and thereby achieve a price far in excess of the value of the shares being traded. The rationale behind the law is that it is lawful for a person who genuinely sells or buys the shares to do so to bring about changes in price of the shares.

In all the common law cases in which a conspiracy to defraud is found, the ‘sole’ or

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8 *Sanderson and Levi v British Westralian Mines and Share Corporation (Limited)* 82 F 2d 845 (DC Cir, 1936).
‗ultimate‘ object or intention of the acts of the conspirator is that people should be defrauded or deceived, and in no case was the ‗deception‘ a means to a legitimate end or purpose, such as, for example, the creation or stabilisation of a market in the shares. The deception itself must be fraudulent and wrongful.⁹ At common law no offence is committed by persons buying up the shares in one of the offeror companies so as to strengthen the price of that company’s shares. Nor is an offence committed by selling a large number of shares in the target company or in a rival offeror company so as to depress the value of those shares and, thus, strengthening the position of a competing offeror.

The common law is inadequate to deal with the modern market structures and the imperative of investors’ confidence in the market. As a result, a number of statutory offences, both criminal and civil, have been introduced.

2. Statutory Offences

(a) Insider Dealing

Certain dealings and other activities, both before an offer is made and during the bid

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⁹ Weinberger & Blank Weinberg & Blank on Takeovers and Mergers (Sweet & Maxwell London 1971) 5065. A recent US case shows how fraud can arise in a takeover situation. The case involves a former minority shareholder’s claim against the merged parent company for fraud based on common law and Rule 10b-5 of the Securities Exchange Act 1934, the plaintiff, the largest shareholder in the pre-merged company, Chrysler, contended that the director of the parent company, DaimlerChrysler AG’s chairman, had engineered a fraud to avoid paying the full value for Chrysler. The plaintiff asked the court for $1 billion in compensatory damages. It was alleged in that case that the director knew that the real state of affairs was a ‘takeover’ rather than a ‘merger of equals’, as stated in merger agreement. Therefore, the plaintiff was defrauded into agreeing to the merger and suffered a loss as a result as the shares were traded as low as less than a half of the price at the time of the merger. The director contended that the plaintiff never cared about the company’s management structure until he started losing money, hence there was no fraud. The trial began on the first of December 2003; G Schneider ‘Trial Opens In Lawsuit On the Sale Of Chrysler’ Washington Post Staff Writer (2 December 2003).
period, constitute a criminal offence. This is so even when the offer has later been withdrawn. Insider dealing is defined as a situation where a person who is an insider of the company possesses price-sensitive information about the company or the industry and uses this information to deal with the securities in the market prior to making the information public or without doing so. Because of the legal definition of the 'qualifying person', ie the insider, under the relevant provisions of the Criminal Justice Act 1993, a person employed by the target company may well fall outside the scope of the law, and a taxi driver unconnected to the takeover may be liable to the offence if the requirements are fulfilled. In general, the persons mostly likely to have confidential price-sensitive information affecting the securities of a company are the directors and officers of the companies involved.

If company directors or other officials of the companies involved in a takeover commit an insider dealing offence, such persons will also be in breach of their duties to the company and be liable to account for any profit they have made. However, in practice, it is unlikely that the company will call them to account for the profits, unless and until there is a change of control. If this occurs as a result of takeover, those who benefit from any recovery of the profits are the successful bidders and not the members who tendered the shares of the company at the time when the directors' breach of duty occurred.  

If the directors owe a fiduciary duty to the shareholders, any insider dealing would be a breach of duty and amount to a sufficient deterrent. In a small company takeover,
directors may place themselves in the position of acting as agents negotiating on behalf of the individual shareholders and, therefore, they owe fiduciary duties to the shareholders.\textsuperscript{11} In listed companies, however, this is unlikely to happen because the directors would deal with the securities through a nominee on a stock exchange so that no seller would be able to link up any sale with a purchase by a director.\textsuperscript{12} This effectively means that the principle of fiduciary duty cannot serve as an effective deterrent.\textsuperscript{13}

The primary legislation governing insider dealing is the Criminal Justice Act 1993, which prohibits dealing in price-affected securities on the basis of inside information, the encouragement of another person to deal in price-affected securities on the basis of insider information, and knowing disclosure of insider information to another. Criminal liability for each offence may only attach to an individual because the term ‘individual’ is defined to exclude corporations and other entities. However, a company could be liable for insider dealing by committing the secondary offence of encouraging another person to deal.

Minority shareholders can also be found guilty of insider dealing. This will make them think twice as to whether they prefer to have access to the corporation’s sensitive information or rely on their own research only. This is because, especially for institutional shareholders, once they have access to corporate information, they are likely to possess price sensitive information. This means that they may need to restrain themselves from dealing unless they make the information public.

\textsuperscript{11} \textit{Percival v Wright} [1902] 2 Ch 42.
\textsuperscript{12} Although it is an offence under the insider dealing legislation and a breach of the Stock exchange’s \textit{Model Code} and of the \textit{Code on Takeovers and Mergers}.
\textsuperscript{13} P Davies \textit{Gower’s Principles of Modern Company Law} (7\textsuperscript{th} edn Sweet Maxwell London 2003) 445.
(b) Market Abuse

There are three situations that are likely to fall within the definition of market abuse under the Financial Services Market Act 2000 ('FSMA 2000'). These are: 1) misuse of information that is not generally available to users of the market; 14 2) the dissemination of false and misleading information; 3) market distortion. In determining whether an act amounts to market abuse, there are three requirements which must be satisfied. First, the behaviour must be based on information which is not generally available to those participating in the market, but which, if available to a regular user of the market, would be regarded by him as relevant when deciding the terms on which the investment transaction should be effected. Secondly, the behaviour must be likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments. Thirdly, market abuse can only be established if a regular user of the market would, or would be likely to, regard the behaviour as such which would or would be likely to distort the investment. 15 Furthermore, the marker abuse regulations impose a new duty on market participants to make sure the markets are fairly run. 16 Therefore, in takeovers, directors and those who possess the information relevant to the takeover must not use such information in a way described above. 17

Insider dealing also falls within the definition of market abuse as it may occur when

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14 FSMA, Financial Services And Markets Act 2000 s 118.
market participants have improperly used relevant information which is not generally available, created a false or misleading impression, or distorted the market. Directors may issue misleading information about the company in the wake of a bid that affects the price of the shares of the company. In this case, the director may not only be in breach of his fiduciary duty but also guilty of insider dealing. The difficulty here is not only definitional but also evidentiary.

In a management buy-out, shareholders will receive a fairness opinion statement which states that, in the opinion of the investment bank, the price of a transaction is fair to the shareholders of the target company. However, the independence of the investment banks may be questionable, because the banks are only paid if they have completed a deal and they can only complete a deal if they state that a transaction is fair. Whether the regulator should investigate matters of this kind is a question which not only rests on the technical construction of the statute but also on whether administrative bodies have sufficient resources to pursue such matters.

The Financial Services Authority (FSA), the authority entrusted with enforcement powers under FSMA 2000, may be able to intervene in situations where the persons whose interests have been harmed by market abuse have no other forms of redress. For instance, if there was a conflict of interests by company directors in a takeover bid, a civil suit can be brought against them by shareholders on behalf of the company. However, for those who have tendered the shares and are no longer the members of the company, it may not be possible to maintain their standing to sue. The ex-members,

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18 For instance, directors may publish misleading information regarding the profits forecast about the company, which has the effect of pushing up the share price of the company so as to increase the cost of the bid causing the offeror’s bid to fail.
19 R Clow and D Wells 'Spitzer urges moves over fairness issue' Financial Times (5 March 2003) 32.
without legal standing and cause of action to bring a suit against the directors or the
company, are able to seek assistance from the FSA for redress. However, it must be
noted that the new enforcement powers given to the FSA should not be overstated as the
tenor of the regime is first and foremost about setting standards rather than giving
redress in individual cases.\(^{20}\) This is why the central issue to all of the offences are the
standards expected of the 'regular user',\(^{21}\) that is a hypothetical user.

3. Other Offences

Other criminal offences that may arise in takeover transactions are illegal loans to
directors and illegal financial assistance in buy-out situations.\(^{22}\) If a target company
provides financial assistance to the offeror company enabling the offeror company to
buy the target's shares, this would amount to a financial assistance. Financial assistance
is 'a practice which is open to the gravest abuses which have continued to this day
despite prohibition legislation.' Two classic examples may be given to illustrate this
point. The first situation occurs when the offeror finances the takeover by a 'bridging
loan' and immediately repays it by raiding the coffers of the cash-rich overtaken
company.\(^{23}\) A more sophisticated abuse is where the target company lends money to, or
indemnifies against loss, known sympathisers who buy its shares or where, on a
share-for-share offer, either or both the target and predator companies do so to maintain

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\(^{20}\) On these issues see B Rider, K Alexander & L Linklater Market Abuse and Insider Dealing
(Butterworths London 2002); M Filby 'The enforcement of insider dealing under the Financial Services

\(^{21}\) FSMA 2000 s 118 (1)(c).

\(^{22}\) Companies Act 1985 s 151; Brady v Brady [1989] 1 AC 755; Robert Chaston v SWP Group [2002]
EWCA Civ 1999; MT Realisation v Digital Equipment [2003] EWCA Civ 494; W Charnley and Brigid

\(^{23}\) Selangor United Rubber Estates v Cradick (No3) [1968] 1 WLR 1555; Karak Rubber Co v Burden
(No.2) [1972] 1 WLR 602; Wallersteiner v Moir [1974] 1 WLR 991 CA (pet.dis) [1975] 1 WLR 1093
(HL); H Hirt 'The scope of prohibited financial assistance after MT Realisations Ltd (in liquidation) v
or enhance the quoted price of their own shares. It is the latter scenario that caused the enactment of legislation to prohibit such an abuse.\textsuperscript{24} Under the present law, where a person is acquiring or is proposing to acquire shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place. The law also does not favour a transaction which may involve the target company being given financial assistance, particularly where the target company is required to make payments or meet expenses incurred in connection with the acquisitions or where the target company is required by the vendor to pay off debt or other obligations owed to the vendor's group the discharge of which would not otherwise have been required. It is now a criminal offence to do so and the directors will be liable to a fine or imprisonment or both.

Another way of giving prohibited loans to directors likely to occur in a takeover is when the financial terms of the buy-out include some form of deferred consideration. The transaction may be caught by section 320 of the Companies Act 1985, which prohibits loans to directors. Provided the transaction does not involve an injection of new cash by the seller as an advance by way of loan to the buy-out vehicle, the section would only apply if the transaction was a 'credit transaction' for the purpose of the section 331(7) of the Act. The law is not clear as to whether a sale of shares constitutes a disposal of goods and services so as to constitute a buy-out sale involving a share sale and deferred consideration in a 'credit transaction'. The second requirement is that the transaction must be entered into with the directors or persons connected with the directors. For this purpose, director also includes shadow directors. A transaction entered into with a

\textsuperscript{24} This was mainly alarmed by the two cases: \textit{Belmont Finance Corp v Williams Furniture Ltd (No 2)} [1980] 1 All ER 393 CA; \textit{Armour Hick northern Ltd v Whitehouse} [1980] 1 WLR 1520.
person connected to the shadow director of the company is difficult to discover in practice, unless there is a tip-off from the insider.

C. IMPACT ON SHAREHOLDERS

1. Introduction

This section examines the impact of the commission of criminal or regulatory offences, and enforcement action by public authorities, on the trading of the shares. The objective is to show that in these circumstances shareholders, and in particular minority shareholders, suffer a loss if the care of their interests is left to the market. The combination of the regulatory control and the market control models is unfair to minority shareholders. The regulatory model must be complemented by the private actions model.

Shares listed on the stock market are volatile due to external factors relating to the industry and market sectors, or internal factors relating to the company. The impact of criminal and regulatory enforcement on the shareholders can be looked at in two ways. First, violations of the criminal and regulatory provisions analysed in this chapter affect the trading in the market. Secondly, violations of these provisions invite possible investigation, leading to administrative, criminal, and civil sanctions, which affect the company's existing and future trading. In the most extreme cases, corporate restructuring or insolvency may follow as a result of offences committed by the directors and the management of a company, as demonstrated by the recent cases of
Enron, WorldCom, and Ahold.

2. Insider Dealing

The economic implications of insider dealing have long been debated, but there is no clear theory which demonstrates that a loss to shareholders necessarily occurs as a result of insider dealing. In fact, shareholders can benefit from the practice. The negative impact of insider dealing on shareholders relates to losses caused by the previous trading of the shares. Whether there will be losses in the existing trading will depend on, inter alia, whether constructive remedial action has been taken such as the removal of the directors and the avoidance of adverse publicity.

Once the shareholder learns that insider dealing as occurred, if the shareholder sells out the shares to avoid future losses, he loses the standing to bring a derivative action. Furthermore, if the inside information has not been made public, when the shareholder tries to avoid the loss by selling the shares, he commits an insider dealing offence. When a criminal investigation is launched and the matter becomes public, the price of the shares is likely to be depressed. In these circumstances, the shareholders have two options: they can sell their shares immediately to avoid future losses, running the risk that they will be found guilty of insider dealing, or remain with the company hoping that the company survives the investigation, and that there will be a cash injection by civil suits against the wrongdoer or from the contribution of the regulatory authority by way of a fine imposed on the wrongdoers.

In the wake of a bid, the share price is more likely to be affected by other types of behaviour such as misleading information, market manipulation, and market abuse,
rather than insider dealing. Even if it is later discovered that insider dealing took place, shareholders could have, by the time of the discovery, either sold their shares, or remained as minority shareholders in the new company facing possible squeeze out or buy-out. If the shareholders have sold their shares, they will not have *locus standi* to sue the directors or the controlling shareholders by way of derivative action. If the shareholders did not sell and remained in the company, the company, with new management and new controlling shareholders, will be in the better position to take action. It is hard to argue that there is fraud on the minority shareholders by the newly elected board and controlling shareholders. Although unfair prejudice may be pleaded against the existing board, if the new board did not benefit from the old board’s violation, it is hard to argue that the case of unfair treatment has a prejudicial effect on the minority shareholders.

3. Market Abuse and Market Manipulation

The possible techniques likely to be deployed in takeovers that may amount to market abuse and market manipulations are mostly related to the use of corporate information. This will depend on the regulatory provisions relating to issues such as the categories of relevant information and the methods of disclosure. Misleading information may cause the shareholders to sell at a misprice or not to sell at all based on the information or advice provided by the board. Misleading information can be used to push up the price of the company, depress the price of the bidding company, and/or

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25 The criminal investigation may have an impact on the decision of the shareholders whether or not to remain in the company. The Takeover Panel has stated that the launch of an investigation will not cause the bid to lapse. In such a case, however, shareholders may be inclined to sell their shares rather than remaining in the company.

26 FSA and the Panel on Takeovers and Mergers *Operating Guidelines Between the Financial Services Authority and the Panel on Takeovers and Mergers on Market Misconduct* 30 November 2001 www.fsa.gov.uk/pubs/other/marjet_conduct.
persuade the shareholders to sell or to hold their shares. There are also other methods of
price pushing or price depressing that cause the bid to lapse, for instance producing an
unforeseen increase in costs to be incurred by the offeror using the tactics of 'boiler
room'. The board may also spread rumours about the offeror company for instance
about its looting behaviour and asset-stripping tactics, and conduct that is likely to
invite criminal investigation into corporate affairs. These tactics may be held to be
'conduct having the frustrating effect on the bid' by the Takeover Panel. As such, they
are prohibited by the Takeover Code as well as by FSMA 2000.

Another form of market abuse or market manipulation occurs if the board resorts to a
white knight or management buy-out for a share-for-share bid coupled with a fairness
opinion favouring the bid from the white knight or the management buy-out company.

If the statements were misleading, shareholders will suffer a loss as a result.

4. Corporate Governance

The concept of corporate governance focuses on the systems under which companies
are directed and controlled. The system is the 'relationship among various
participants in determining the direction and performance of corporations'. The

29 Corporate Governance theory and practice focuses on the systems under which companies are directed
and controlled. See Report of the Committee on the Financial Aspects of Corporate Governance and the
Code of Best Practice (hereinafter 'the Cadbury Report'), 1992, London: Gee, para 25; Sigurt Vitol
'Varieties of Corporate Governance: Comparing Germany and the UK' in Peter A Hall and David
University Press Oxford 1999)
30 E Veasey 'The Defining tension in Corporate Governance in America' (1997) 52 Business Lawyer 393,
401; A Dyck 'Privatisation and Corporate Governance: Principles, Evidence and Future Challenges'
(2000) 16 World Bank Research Observer 59-60; J Salacus 'Corporate governance in the new century'
primary participants are shareowners, management, and the board of directors.31 The concept of shareholder activism invites shareholders, both the controlling shareholders and the minority shareholders, to be part of the mechanism of corporate governance and risk management.32 Shareholder activism will be more efficiently organised if access to information is provided. This will promote corporate transparency in the board’s decision-making process, and, as a consequence, reduce the abuse of a controller’s power in corporate affairs.33

Institutional minority shareholders have their own targets to meet. Fund managers must achieve the performance target and the success of the fund depends on the client’s willingness to stay with that particular fund. A long-term investment would be a strategy, as opposed to short-term investment. In a long-term investment, institutional shareholders would need to take on a greater role in corporate governance than in a short-term investment.

Market confidence and corporate governance are strongly related. Without corporate governance and market confidence there will be no efficient market mechanism which determines, for the institutional shareholders, which stock to pick, and for the investors, which funds to buy.

31 R Monks and N Minnow Corporate Governance (Blackwell Oxford 1995).
D. THE FSA'S POWERS OF INVESTIGATION AND ENFORCEMENT

1. Offences

The offences that trigger an FSA investigation include the offences under FSMA 2000 and violations of the City Code (the ‘Takeover Code’), which has been endorsed by the FSA. The enforcement of the law on insider dealing, market manipulation, market abuse and other violations under the City Code including stricter rules on dealing, disclosure, and specific dealing such as Substantial Acquisition Rules will come under the FSA’s powers of investigation.

2. Power to Investigate, Sanctions and Criminal Prosecution

The FSA has the power to impose sanctions,\textsuperscript{34} to make public reprimand,\textsuperscript{35} to bring a prosecution, or to refer the matter to the relevant prosecuting authorities such as the Crown Prosecution Service or the Serious Fraud Office.

3. Injunction

The FSA can apply to the court for interim remedies. These remedies include prohibitory injunctions, mandatory injunctions, and freezing orders.\textsuperscript{36} Under section

\textsuperscript{33} B Cheffins ‘Minority shareholders and corporate governance’ [2000] Company Lawyer 41.
\textsuperscript{35} FSMA 2000 s 123(3).
\textsuperscript{36} FSMA 2000 s 381.
381(1) of the FSMA 2000, the FSA must satisfy the court that there is a reasonable likelihood that the market abuse will continue or be repeated in order to obtain a prohibitory injunction. However, re-offending will be found to have occurred when the Takeover Panel has already required a person to cease a particular conduct and that person has not done so. In order to obtain a mandatory injunction, the FSA must satisfy the court that any person is or has engaged in market abuse and there are steps which could be taken for remedying the market abuse. This includes mitigating the effect of market abuse. In order to obtain a freezing order, the FSA must satisfy the court that any person may be engaged in market abuse or may have been engaged in market abuse. The FSA has indicated that it may apply to the court to grant a freezing order under its inherent jurisdiction, as the FSA already has the power to freeze funds from which a restitution order may be made.

4. Restitution Order

The FSA can apply to the court for a restitution order. Two requirements will need to be satisfied: first, that a person has either been engaged in market abuse or, by taking or refraining from taking any action, required or encouraged another person or persons to engage in behaviour which, if engaged in by the person concerned, would amount to market abuse; and secondly, that profits have accrued to such a person and as a result one or more persons have suffered loss or been otherwise adversely affected. In determining whether to apply for such an order, the FSA will consider the following factors: 1) whether there are identifiable victims of the market abuse, the number of persons who have suffered loss and the extent of those losses; 2) the costs that would be

37 ENF 6.6.2; SEC v Time 833 F 2d 1086 (2nd Cir 1987) which laid down the guidance.
38 FSMA 2000 s 381(2).
39 FSMA 2000 s 381 (3) and (4).
incurred by the FSA in securing redress; 3) whether these costs are justified by the benefit to the victims of market abuse that would result from such action; 4) whether persons who have suffered losses are in a position to bring civil proceedings on their own behalf; 5) whether those who have suffered adverse effects are able to protect their own interests. However, whether the shareholders are entitled to the distribution of the fund obtained through the restitution order or not will depend on whether they are ‘qualifying persons’ or not under the Act.\textsuperscript{41}

\textbf{5. Consequences on the Bid}

Although the threat of criminal and civil sanctions by the FSA will have an effect on the trading of the shares of the company, a bid would still proceed with its terms. This is because the imposition of criminal and civil sanctions usually takes place long after the bid has been accepted or rejected. Exceptionally, and in rather unusual circumstances, the FSA or other public authority can apply for a prohibitory injunction to delay the transaction. This will have a huge impact on the bidding process. Adverse publicity to the board or the controlling shareholders may cause the minority shareholders to sell out their shares rather than hold on to them until the further developments of the investigation. This prompts the reasoning that shareholders are said to be ‘coerced’ to sell out their shares by market forces. Except for the case where an injunction is sought, the initiation of the investigation has a limited impact on the bid. As regards DTI investigations, the Takeover Panel has held that the appointment of inspectors does not require the bid to lapse, because the law does not give the Secretary of State express statutory power to prevent the bid.

\textsuperscript{40} FSAMA 2000 ss 383 (3) and 384(4).
\textsuperscript{41} FSMA 2000 s 383 (4) and (5).
E. DTI INVESTIGATIONS

1. Grounds for Conducting an Investigation

The Secretary of State for Trade and Industry has the power to appoint an inspector to conduct an investigation into a company’s affairs. The subject matter of the investigation may cover the following situations: first, whether the company’s affairs are being conducted or have been conducted with intent to defraud creditors or the creditors of any other person or otherwise for a fraudulent or unlawful purpose or in a manner which is unfairly prejudicial to some part of its members; secondly, whether any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial; thirdly, whether the company was formed for any fraudulent or unlawful purpose. Therefore, the offences discussed in the previous sections such as insider dealing, illegal loans to the directors, unlawful financial assistance, and market manipulation constitute grounds for the initiation of the investigation. Furthermore, civil wrongs, such as conduct causing unfair prejudice or a breach of director’s duty, can also be the trigger of an investigation. The Companies Act 1985 also provides that an inspection may be carried out if the persons concerned with the company’s formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance, or other misconduct towards it or towards its members, or the company’s members have not been given all the information with

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42 About three quarters of the investigations are promoted by allegations of fraudulent trading, theft, or acting as a director whilst disqualified or a bankrupt: Companies in 1995-97.
respect to its affairs, which they might reasonably expect. For the appointment of an inspector, the requirement is that it appears to the Secretary of State that there are circumstances suggesting that one of the situations warranting an investigation, as described above, has occurred.

2. Conduct of the Investigation

The power of investigation includes the power to compel production of documents, to conduct an examination of past and present officers or agents of the company, who will give answers under oath. The process will be assisted by threat of fines or contempt of court. The inspectors can make an interim report and, on conclusion of the investigation, a final report. If a criminal matter becomes known, the investigation must be discontinued or the scope of the investigation must be curtailed. Under these circumstances, the final report may only be made if the court, or the Secretary of State, so orders. This is clearly to preserve the secrecy of the investigation in order to carry out further prosecution.

3. Shareholder’s Liability

Under Section 439 of the Companies Act 1985, the DTI will be able to recover the costs of the investigation from the persons specified in the statutes. These include: first, anyone who is successfully prosecuted as a result of the investigation; secondly, any body corporate in whose name proceedings are brought under section 438 to the extent of the amount or value reasonable; thirdly, any body corporate dealt with in an inspector’s report when the inspectors were not appointed on the Secretary of State’s own motion unless the body corporate was the applicant or except so far as the
Secretary of State otherwise directs. When the shareholder makes a request to the DTI to carry out the investigation, the Secretary of State may require security not exceeding £5,000 for payment of the costs of the investigation. In addition to the security for costs, the shareholders also need to show evidence that there is good reason for such an application.\textsuperscript{43}

The fact that the shareholders may make an application, bear an evidential burden of proof, and may be liable for the costs of the investigation, demonstrates that the law relies on them to hold the controllers accountable. Therefore, further incentives should be provided to encourage shareholders to come forward. One such incentive is the subsequent use of information obtained during the DTI investigation in civil proceedings brought by the shareholders, which is discussed in the following section.

4. Consequences

The report, the evidence and the sources of knowledge obtained in the process of the investigation by the inspector can be of particular use for the shareholders in a subsequent civil trial.

It is at the DTI's discretion to publish the report and, if appropriate, to forward a copy of any report to the company's registered office and, on request and payment of a prescribed fee, to any member of the company or other body corporate which is the subject of the report, to any person whose conduct is referred to in the report, to the auditors, to the applicants in the investigation, and to any other person whose financial interests appear to be affected by matters dealt with in the report. Minority shareholders

\textsuperscript{43} Companies Act 1985 s 431(3).
as members of the company should be entitled to the report. The report will be admissible in the subsequent legal proceedings ‘as evidence of the opinion of the inspectors in relation to any matter contained in the report and, in proceedings on an application under section 8 of the Company Directors Disqualification Act 1986, as evidence of any fact stated therein’. The report will not be viewed as a fact, but only as opinion evidence in court. The shareholders would still need to produce the original evidence on which the opinion was based. The position is similar as regards a report of an inspection carried out under Part XIV of the Insolvency Act 1986. Under section 441 of the Insolvency Act 1986, a copy of any report of inspectors appointed under Part XIV, certified by the Secretary of State, is regarded as an authentic copy, is admissible in any legal proceedings ‘as evidence of the opinion of the inspectors in relation to any matter contained in the report.’ There is no ruling on whether the evidence in the report can be used in the subsequent proceedings. However, once the shareholders have obtained the report, it may enable them to identify the sources of the evidence on which the inspectors reached their conclusion, which may enable the shareholders to obtain, from those sources, the evidence they need. It appears that the law on public interest immunity does not apply to information obtained by the DTI in the exercise of its administrative function under the Companies Act 1985 or under the Insolvency Act 1986. Any such information is admissible in civil proceedings. The only limitation applies to criminal, not to civil proceedings. In criminal proceedings, the privilege against self-incrimination is a fundamental right protected by article 6 of the European convention on Human Rights. Compelled answers may not be used to incriminate the defendants in criminal proceedings.45

F. INDEPENDENT INQUIRY

An independent inquiry is a private enquiry into the affairs of a company. It does not have the statutory powers of investigation such as those of the FSA and the DTI. Therefore, there is no power to compel the production of documents, to interview witnesses under oath, or to conduct interrogations and cross-examination. The function of the enquiry is a fact-finding exercise to draw conclusions on the evidence received in the investigation. The co-operation of the investigated persons will be on a voluntary basis. The issue here is whether the report of such independent enquiries can be used in subsequent proceedings. For example, can shareholders use the report as material to initiate a civil suit against the company, directors, or other related defendants?

The leading House of Lords case on these issues is *Three Rivers District Council v Governor and Company of the Bank of England*, which allowed an appeal by a majority of three to two. The case concerns a civil suit by the depositors for public misfeasance against the Bank of England over the collapse of the BCCI, an international investment bank. After the collapse of the BCCI, Bingham LJ was appointed to carry out an inquiry into the supervision of BCCI under the Banking Acts, to consider whether the action taken by all the UK authorities had been timely, and to make recommendations. Bingham LJ did so and produced a report known as the Bingham Report. The claimants relied on the Report to issue a civil suit against the Bank of England. The defendant applied for summary judgment against the claimants under CPR, rule 24(2), which provides that the court may give summary judgment against a claimant or defendant on the whole of a claim or on a particular issue if it
considers that the claimant has no real prospect of succeeding on the claim or issue; and there is no other reason why the case or issue should be disposed of at a trial.\textsuperscript{47}

The defendants argued that the Bingham Report concluded that there was no evidence showing that the Bank, the defendant, was in breach of duty and the claimants were unlikely to have any more evidence to support their case. Lord Hope of Craighead, giving the leading judgment, said:

\begin{quote}
[T]he Bingham report is the result of an investigation that lacked the benefit of statutory powers and was conducted behind closed doors. The claimants were not present nor were they represented. In the conduct of his fact-finding exercise Bingham LJ was, as he said in his covering letter, greatly assisted by the co-operation which he received especially from the Bank and Price Waterhouse. But he had no power to compel the attendances of witnesses or to require the production of documents, and there was no counsel to the inquiry. As the appendices have not been published, the claimants have not had access to all the material which Bingham LJ had before him. .....it is plain that it cannot be suggested that Bingham LJ was in a position to conduct a fair trial of the issues relating to the tort of misfeasance in public office which the claimants are seeking to raise against the Bank in this case.\textsuperscript{48}
\end{quote}

Lord Hope of Craighead draws the distinction between the narrative of the evidence and the findings and conclusion in the light of the evidence. The narrative of the evidence ‘is a legitimate source to which reference can be made for the purposes of the motion to strike out, and his findings and conclusions in the light of that evidence’.

\textsuperscript{47} CPR r 24.2.
However, ‘trial judge was influenced by the findings and conclusions of Bingham, which is impermissible in considering strike out as the report is irrelevant’ 49 Lord Hutton also echoed this in saying that:

[I]t is clear that under well established principles the findings and conclusions of Bingham LJ as to the actions and motives of the Bank would be inadmissible on the hearing of the action: it would be the duty and responsibility of the trial judge to decide for himself, on the evidence which he heard, what were the actions and motives of the Bank. ....it is impermissible for the judge (Clarke J) and the majority of the Court of Appeal in deciding whether at this interlocutory stage whether there was no real prospect of the action succeeding to be influenced by the findings and conclusions of Bingham LJ. 50

Lord Hobhouse of Woodborough disagreed and stated that:

My noble and learned friend and those who agree with him [Lord Hope] are however critical of the actual use made by Clarke J and the majority of the Court of Appeal of the Report. I consider that with minor exceptions these criticisms are not fair to Clarke J nor to Hirst and Robert Walker LJJ. The relevant exercise was as I have said earlier not one of making findings of fact or comparable to a trial on admissible evidence. It was to make a predicative assessment. To use the Report as an aid was clearly appropriate and proper. Further, as the plaintiffs themselves said, their pleading and its particularisation were substantially taken from the facts set out in the Report. They were using the Report to plead their case. It was therefore not only permissible but also pertinent to compare their selection from the history

recounted in the Report with the whole and the conclusions drawn in the Report.51

Lord Hope of Craighead also considered the point of fairness and said that '[I]t is not just that those findings and conclusions would not be admissible at trial. Fairness to the claimants requires that proper weight is given to the nature of Bingham LJ’s inquiry and its limitations. He was not asked to determine the issues relating to the tort of misfeasance in public office which the claimants now seek to raise.'52 He continued to say that '[I]t would be contrary to the overriding requirement of fairness for them to be taken into account in reaching a decision as to whether this case can be decided without hearing oral evidence.'53

Another consideration is whether there is any possibility of more evidence becoming available. Because if it is not, the claimant will fail as there was no reasonable possibility that the claimants would obtain evidence in the future which might enable them to succeed. Lord Hutton, approving the judgment of Auld LJ in the Court of Appeal, stated that given the very different process that applies to court litigation as opposed to a non-statutory inquiry there was a reasonable possibility that not all the available evidence had been gathered by the enquiry and relevant issues of fact could be further tested in civil litigation.54

The claimant can use the material in the report to plead the case as the material was distinguished from the findings and conclusion of the report. The source of the evidence can be utilised by the claimant in a case such as Three Rivers.

G. CONCURRENT PROCEEDINGS

1. The First Takeover Case

The first takeover case which gives rise to the issue of concurrent proceedings is *R v Panel on Take-overs and Mergers, ex p Al-Fayed*.55 In this case, Mr Al-Fayed was subject to disciplinary proceedings by the Panel following irregularities in the takeover of Harrods, a department store, in 1985. Al-Fayed was already the subject of litigation by Lonrho, the competitor in the takeover, who alleged false and fraudulent representations by Al-Fayed in relation to his background and finance. The Panel, following the critical report of the DTI investigation into the takeover, brought disciplinary proceedings against Mr Al-Fayed for breaches of General Principle 12 of the City Code. Al-Fayed sought to defer the action until the litigation had been resolved claiming that otherwise the Panel’s decision could prejudice Al-Fayed’s case. The application for judicial review to stay the Panel’s disciplinary proceedings failed. The Court of Appeal said that the court could only intervene to prevent injustice and in the present case, there was no real risk that the proceedings would be prejudicial to the litigation.

In a takeover situation, the protection of minority shareholders may be fulfilled indirectly through administrative investigations and criminal sanctions and, directly, through private law remedies. Administrative investigations are conducted by bodies exercising a public function. The criminal courts have jurisdiction to try persons accused of a criminal offence. Prosecuting authorities, mainly the Crown Prosecution Service and the Serious Fraud Office, have the power to investigate and prosecute criminal offences. Private law remedies, in the form of damages, injunctions, or declarations, may be sought by minority shareholders. This may give rise to concurrent proceedings. The main problem is that, when more than one set of proceedings arises out of the same factual matrix, parties may apply for one, or more, set of proceedings to be stayed to await the outcome of the other sets of proceedings. For instance, the defendants in the civil proceedings may apply for a stay pending the outcome of the criminal proceedings. If administrative proceedings are also under way, the defendants in the criminal proceedings may argue that the administrative investigation must be stayed. If administrative and civil proceedings are pending, the defendants in the civil proceedings may argue that the proceedings should be stayed to await the findings of an administrative body, such as, for instance, the FSA. In the alternative, it would also be possible to argue that the administrative proceedings should be stayed to avoid any interference with the civil proceedings. The following two sections examine the two interactions that are more likely to have a significant impact on minority shareholders' civil actions, namely the interaction between criminal and civil proceedings and the interaction between administrative and civil proceedings.

2. Criminal and Civil Proceedings

If a criminal investigation or prosecution is under way at the same time as a lawsuit brought by the minority shareholders relating to the same facts giving rise to the criminal offence, the claimants in the civil proceedings will almost certainly have to defend an application for stay by the defendants. If such an application is successful, then the remedy sought by the minority shareholders may be delayed by months or even years. This leads to the somehow paradoxical situation that the more serious the behaviour of the controllers of the company, the longer it takes for minority shareholders to obtain a remedy from the courts. This outcome is highly undesirable as a matter of policy and, it appears, is not justified by the authorities. In Jefferson Ltd v Bhetcha, the Court of Appeal rejected the idea that ‘there is an established principle of law that, if criminal proceedings are pending against a defendant in respect of the same subject matter, he, the defendant, is entitled to be excused from taking in the civil action any procedural step, which step would, in the ordinary way, be necessary or desirable for him to take in furtherance of his defence, if that step would, or might, have the result of disclosing, in whole or in part, what his defence is, or is likely to be, in the criminal proceedings.’ The Court went on to say that the burden is always on the defendant in the civil action to show that it is ‘just and convenient’ that the claimant’s ordinary rights of having his claim processed and heard and decided should be interfered with. The test applied by the Court was whether it would be just and convenient that the civil action should be stayed. This test requires the court to carry out a balancing exercise. Factors to be taken into account are whether there would be a real, as opposed to notional,
danger of the causing injustice in the criminal proceedings.\textsuperscript{59}

More recent cases also suggest that a stay of civil proceedings because of concurrent criminal proceedings will not be granted as a matter of course. In \textit{Surrey Oaklands NHS Trust v Hurley},\textsuperscript{60} Sullivan J allowed an application for summary judgment to proceed notwithstanding charges had been preferred against the first defendant. The judge emphasized the claimant’s right to have the claim determined expeditiously under the CPR.\textsuperscript{61} The cases of \textit{Jefferson} and \textit{Surrey Oaklands NHS Trust} are both concerned with applications for summary judgment. Indeed, in the latter case counsel for the claimant accepted that if the proceedings were to go to a full trial, a stay would have been appropriate. The argument could, therefore, be advanced that English authorities show a reluctance to stay applications for summary judgment because of the concurrent criminal proceedings. If the civil case proceeds to a full trial, there is no binding authority to the effect that the fairness of the criminal trial is not put at risk by the mere fact that civil proceedings are pending involving the same or related facts. In \textit{Secretary of State for Health v Norton Healthcare Ltd}, however, Lloyd J dismissed an application to stay civil proceedings at the case management stage in a case which was clearly proceeding to a full trial.\textsuperscript{62} The judge correctly pointed out that the unavailability of key witnesses is no grounds for staying civil proceedings.\textsuperscript{63} In \textit{Secretary of State for Trade and Industry v Crane},\textsuperscript{64} Ferris J allowed disqualification proceedings to go to trial notwithstanding criminal charges were being seriously contemplated against the defendants. He rightly pointed out that the \textit{dicta} by Millet J in \textit{Re DPR Futures Ltd}\textsuperscript{65}

\textsuperscript{60} \textit{Surrey Oaklands NHS Trust v Hurley} (QB, 20 May 1999).
\textsuperscript{61} CPR, r 1.1
\textsuperscript{62} \textit{Secretary of State for Health v Norton Healthcare Ltd} [2003] EWHC 1905 (Ch).
\textsuperscript{63} ibid, para 40.
\textsuperscript{64} \textit{Secretary of State for Trade and Industry v Crane} [2001] Butterworths Company Law Cases 222.
\textsuperscript{65} \textit{Re DPR Futures Ltd} [1989] 1 WLR 778.
and by Timothy Lloyd QC, sitting as a deputy High Court judge, in *Re Landhurst Leasing plc, ex p Ashworth*,66 to the effect that a trial may lead to greater injustice than an interlocutory application are ‘not a principle to be slavishly applied’.67 The judge went on to say that the disposal of the civil case by full trial is simply one of the factors to take into account in order to assess ‘what the practical risk is in the particular case.’68 This approach is correct. The different approach taken by Millet J in *Re DPR Futures Ltd* to the application for summary judgment, for which he saw no reason why it should have to await the outcome of the criminal proceedings, and the civil trial, which he thought should not precede the criminal trial, is founded on the adverse publicity that a trial, but not an application for summary judgment, brings about. However, the judge was concerned with the facts of the particular case and the adverse publicity that in the circumstances would flow from a civil trial. He did not lay out a general principle nor did he find this principle to have been stated by the authorities.

In conclusion, shareholders’ actions need not suffer any delay because of pending criminal investigations or prosecutions relating to the same facts. In normal circumstances, criminal and civil proceedings can, and should, be allowed to proceed in parallel.

### 3. Administrative and Civil Proceedings

If administrative investigations are under way at the same time as civil proceedings are pending, it is unclear whether the law requires either set of proceedings to be stayed. There appear to be two models. Under the first model, the court exercises discretion

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67 *Secretary of State for Trade and Industry v Crane* (above n 29) 230.
under its inherent jurisdiction\textsuperscript{69} to stay the administrative proceedings if the continuation of the proceedings gives rise to a real risk of serious prejudice which may lead to injustice.\textsuperscript{70} The broad application of this test by the Court of Appeal in \textit{Ex p Brindle}\textsuperscript{71} has been then limited to its facts in subsequent cases\textsuperscript{72} but the test still focuses on the impact of administrative proceedings on the civil proceedings. Under the second model, which developed in the area of EC and UK competition law, there is a trend in favour of staying the civil proceedings to await the outcome of the administrative proceedings.\textsuperscript{73} Which model should apply to minority shareholders' actions? It appears that the court when deciding applications for stay under both models exercises discretion under its inherent jurisdiction and its CPR case management powers. There is never a presumption in favour of staying administrative or civil proceedings. Under the competition law model, the likely outcome is the stay of the civil proceedings because the administrative decision is binding on the courts.\textsuperscript{74} Under the financial regulation model, the courts do not follow any established principle but determine any application on its own facts. It appears, therefore, that if administrative and civil proceedings relating to the same takeover situation are pending, the court will not order a stay of either set of proceedings unless there are circumstances that warrant a different conclusion. In the area of minority shareholders' actions, it seems that administrative

\textsuperscript{68} ibid.

\textsuperscript{69} Two theories have been proposed to explain the meaning of the term 'inherent jurisdiction': a) The inherent jurisdiction comprises the powers that are the immanent attribute of a superior court: see the seminal article by Sir Jack Jacob, 'The Inherent Jurisdiction of the Court' [1970] CLP 23; b) the inherent jurisdiction describes a set of powers arising at common law as incidental to the effective exercise of the judicial function: this theory is espoused by M Dockray, 'The Inherent Jurisdiction to Regulate Civil Proceedings' [1997] LQR 120.

\textsuperscript{70} \textit{R v Panel on Takeovers and Mergers, ex p Fayed} [1992] BCC 524, CA.

\textsuperscript{71} \textit{R v Institute of Chartered Accountants in England and Wales, ex p Brindle} [1994] BCC 297, CA


\textsuperscript{73} \textit{Case C-234/89 Stergios Delimitis v Henninger Bräu AG} [1991] ECR 1-935; \textit{MTV Europe v BMG Record (UK) Ltd} [1997] 1 CMLR 867, 878, CA.

\textsuperscript{74} Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty [2003] OJ L 1/1, Art 16(1); Competition Act 1998, ss 58 and 58A.
investigations are not likely to give rise to a real risk of serious prejudice that may lead to injustice in the civil proceedings. Therefore, unless the outcome of the administrative proceedings is binding on the courts and a stay of the civil proceedings is appropriate to save time and costs, civil and administrative proceedings are allowed to run in parallel.

4. Subsequent Use of Information

When administrative and civil proceedings relate to the same set of facts, the question arises as to whether information that has been disclosed or obtained by the public authority may be used in evidence in the civil action. The FSA’s approach is generally to negotiate with the person violating the provision and to impose the appropriate remedies before making the case public. The question is whether the information voluntarily disclosed to the FSA, in the process of negotiation would be available to the minority shareholders who wish to use the material, either as a source to obtain further evidence or as evidence itself in subsequent civil proceedings. The governing rule in such cases is the concept of ‘public interest immunity.’ In essence, ‘public interest immunity’ could prevent information disclosed to a public authority from being used in subsequent proceedings against the person for the purpose of encouraging the person under investigation to give evidence to the public authority in order to facilitate the exercise of the public function by the public authority. However, such a broad claim to public interest immunity was rejected by Arden J in Kaufmann v Credit Lyonnais.\(^75\) In the Kaufmann case, the claimants applied for specific disclosure of documents and correspondence between the Securities and Futures Authority (the SFA) and a regulated bank and its solicitors and auditors. The application arose out of an action for breach of

\(^{75}\) _Kaufmann v Credit Lyonnais Bank_ (1995) 7 Admin LR 669.
the rules of the securities association, negligence and breach of fiduciary duty, brought by Mr Kaufmann and other claimants against their investment manager for damages under section 52 of the Financial Services Act 1986. The application for production of documents was resisted on the ground of public interest immunity. Arden J said that a heavy onus lies on a person who seeks to establish a new class claim to public interest immunity. She saw no reason to uphold the public interest immunity claim and added that if the claim were to be upheld, a firm may even provide false information or 'put all the material likely to be sensitive in civil litigation into a report to the SFA.' The claim to public interest immunity was, therefore, dismissed.\textsuperscript{76} Based on this case, minority shareholders will, therefore, benefit from disclosure of documents produced to the FSA or other public authorities in the process of investigation in subsequent civil proceedings.

H. CONCLUSION

This chapter has analyzed the regulatory control model and its implications. Because of the impact on criminal and regulatory enforcement on the trading of the shares, the combination of the regulatory control model with the market control is fatal to minority shareholders. In most cases, they will have to sell their shares at a loss or will see the share price go down without any workable redress. Furthermore, criminal and regulatory enforcement do not serve the purpose of compensating minority shareholders for their losses. The only mechanisms that goes some way in this direction

\textsuperscript{76} Kaufmann v Credit Lyonnais Bank was referred to with approval by the Court of Appeal in Wallace Smith Trust Co Ltd v Deloitte Haskins & Sells [1996] All ER 403.
is the restitution order that can be obtained by the FSA under FSMA 2000. However, even in the case of restitution orders, minority shareholders have too little control over the procedure.

The regulatory control model must be complemented by the private actions model. The two models do not clash but complement each other. This chapter examined the procedural interactions between administrative and civil proceedings and has shown that shareholders may benefit from enforcement action by public authorities in that they may rely on the findings of the administrative investigation or make use of the evidence and sources of information obtained by the regulators. Furthermore, criminal and administrative proceedings do not have a delaying effect on the civil action. Private actions will not have to be stayed only because criminal or administrative proceedings relating to the same facts are under way.
CHAPTER IX

PROTECTION IN THE UNITED STATES

A. INTRODUCTION

This chapter analyses minority shareholders rights and remedies in the US. Federal and state laws in the US provide an interesting comparator to the law in England. In the US, the private actions model is well developed. First, courts have recognized in a number of circumstances that when change of corporate control is in question, controlling shareholders and directors owe a fiduciary duty directly to the minority shareholders. Secondly, state courts have been willing to examine the fairness of the merger, from both a procedural and a substantive perspective. Thirdly, shareholders have benefited from a broad range of remedies, including interim injunctions, statutory appraisal rights, and 'quasi-appraisal' rights.

This chapter examines first minority shareholders’ protection in federal law. Secondly, it focuses on the law of Delaware. Thirdly, it examines both corporate law statutes and the common law of the State of New York. Then, it goes on to analyse some seminal cases from other state jurisdictions. Finally, it draws some conclusions.
B. PROTECTION UNDER FEDERAL LAW

1. Introduction

In principle, US company law is a matter for the state legislature. Therefore, the protection of minority shareholders' rights is mainly based on common law developments and legislation at the state level. Federal law has only limited application in protecting the rights of minority shareholders. The principal statute at the federal level that applies to securities transactions is the Securities Exchange Act 1934, which aims to protect the investors in takeovers.

2. The Santa Fe Rule

In the Santa Fe case, a firm had appraised the value of the stock for the purposes of permitting the company in question to undergo a Delaware short-term merger. The case came before the federal court of the United States. The contention was whether the majority shareholders had violated their duties to the minority shareholders, under the provisions of the Securities Exchange Act 1934, and in particular, rule 10b-5 promulgated under the Act, when a merger transaction was used by the majority shareholders to eliminate the minority shareholders' interests. There were two significant issues leading the discussion: first, the defendant did not disclose the merger plan to the plaintiffs when offering them the stocks; secondly, the price

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1 The Commerce Clause of the US Constitution (Art I, Sec 8, cl 3, of the Constitution); Also see Edgar v MITE Corp 457 US 624 (1982); CTS Corp v Dynamics Corp 481 US 69 (1987).
offered to the plaintiff, the minority shareholders, was a gross under-valuation.

Mr Justice White, in that case, held that breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, did not violate the Securities Exchange Act 1934 or the related SEC rule proscribing use of manipulative and deceptive devices. The court went on to say that the words ‘manipulative and deceptive’ under the rule must be read according to their literal meaning and should not be stretched too far to cover corporate matters, which traditionally fall within the jurisdiction of the State. It was not the intention of Congress to create a uniform federal fiduciary duty, although this might have been desirable. The court considered that an extension of rule 10b-5 could impose stricter standards of fiduciary duty than those required by the law of some States. In the end, the court held that there was no violation of the federal rules based on the facts of the case.

It would appear that Delaware law influenced the perception of the court in the application of rule 10b-5, particularly in relation to the main two issues of nondisclosure and under-valuation. Delaware law did not require the respondents to give notice of the merger plan to the plaintiff, and the short-term merger statute allows majority shareholders to eliminate the minority interest without any company purpose. The merger plan is subject only to an appraisal remedy. It is debatable whether the court would have held otherwise had the State law required notice of the merger to the plaintiff before the implementation of the merger plan. The court rightly held that ‘manipulation’ is ‘virtually a term of art when used in connection with securities

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2 430 U.S. 462, 97 SCt 1292.
markets. The term refers generally to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity. There were no facts indicating such patterns in the case. However, the fact that it was a short-term merger, i.e., a merger of a 90 per cent parent company taking over the subsidiary company, must not be overlooked. The short-term merger is a statutory merger and all the requirements under the statute were fulfilled. If the merger statutes stipulated other requirements, such as a reasonableness test, and the defendant manifestly violated the test of reasonableness, the court would hold that the rule had been violated. The court looks at the procedural requirements of the state law as a question of fact in determining whether the conduct amounts to 'manipulation and deception' that violates the rule under Federal law.

In the case of *Tracinda Corporation v DaimlerChrysler*, the plaintiff alleged that there was a breach of Rule 10b-(5) as the director of the merged company did not inform the plaintiff that the plan was intended to be a takeover rather than a 'merger of equals' as stated in the merger agreement. The Federal Court of Delaware had the opportunity to undertake the challenging task of defining the term of 'merger of equals'.

3. The Williams Act 1934

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3 *Ernst & Ernst* 425 US, 199, 96 SCt, 1384.
4 The shareholders will have to decide in which court to commence the lawsuit, either the state court, the federal court, or both. The shareholders may choose the federal court under rule 10(b)-5. As a consequence, the state court may not then hear the case. However, since the case does involve state law issues, the federal court will be called upon to look at the requirements of the state law to assess the terms of 'manipulation and deception', and it is likely that the court may refer the case back to the state court in determining whether or not the specific state provision has been violated.
5 *Tracinda Corporation v Daimlerchrysler*, In the United States District Court For the District of Delaware.

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The Securities Exchange Act 1934, the Williams Act, is the principal governing statute that applies to tender offers. It is enforced by the Securities and Exchange Commission (the SEC). The basic principle of the Act is the concept of ‘fairness’, expounded by the requirements of equal treatment and full disclosure. The minority shareholders have the same rights as the rest of the shareholders. There is no extra protection offered to the minority shareholders.

The *pro rata* rule is a distinct feature of the Act. The rule promotes the concept of ‘equal treatment’, which means that in a takeover the shares must be offered to all the shareholders in the company and the offer will be tendered by the tendering shareholders in proportion to the shareholding of each individual shareholder. The *pro rata* rule, together with mandatory disclosure requirements, has the effect of eliminating the problem of ‘coercion’, which is a variant on the theme of looting in which the looters offer an implicit two-tier price: something over market price to those who sell, and something less (maybe much less) to those who hold out.⁷

This statutory design does not eliminate the problem of the ‘prisoners dilemma’, in which shareholders will hesitate to tender the shares in the hope that the bidder will

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⁶ The Williams Act 1935 15 USC ss78m (d), (e), 78n (d)-(f).
increase the price as the bidder fears that the bid may fail because he is unable to obtain the controlling shareholding, which is the condition for the acceptance. Minority shareholders who find themselves in this situation may act in two ways. First, they could liaise with the majority shareholders to act jointly and to share the consequences of becoming minority shareholders altogether, where the former majority shareholders will be the majority of the minority shareholders in the company which has been taken over. Secondly, they may tender their shares regardless of how the majority shareholders will react, and if the majority shareholders do not tender the shares, the majority shareholders may be minority shareholders of the new company, although normally the bidder will specify the condition of the acceptance of the offer by the majority shareholders. In the first situation, shareholders are unlikely to receive the maximum benefits for the control because of the pro rata rule. In the second situation, they are to benefit more. However, this situation rarely occurs unless the majority liaised with the bidder to squeeze out the minority.

Whether the protection of minority shareholders is adequate or not can be looked at in three phases: before the takeover, post-merger (post takeover), and upon leaving the company. Unless the shareholders act collectively, the protection in the first phase is only to ensure that they will receive some benefits out of the change of control, ie a control premium, as they can not be offered less than the market price. In the taken over company, the problems faced by minority shareholders will depend on the post-merger integration led by the new management, which is governed primarily by state company law. Federal law only provides a minimum level of protection to minority shareholders. If the minority shareholders decide to leave the company, the federal rules do not provide any protection since the statutory requirements only apply to a
tender offer, and federal law does specify a right to sell. Without the safeguard of the mandatory bid or state law specifically giving rights to minority shareholders, the control of the company can be obtained cheaply by the bidder through the method of the two-tier bid whereby the bidder first takes only 51 per cent of the shares and then offers a price significantly below the offer price or the intrinsic value of the shares to the remaining shareholders. Such a method amounts to expropriation of minority shareholders’ wealth. However, some academic authors do not think that an offer below the intrinsic value should be regarded as a problem as long as the offer yields gains as great as doubling the market value of the firm.9

C. PROTECTION UNDER DELWARE LAW

1. Introduction

Delaware is the most important state jurisdiction for corporate law,10 as nearly 50 per cent of the companies listed on the New York Stock Exchange and roughly half of the Fortune 500 companies are incorporated in Delaware, and approximately 80 per cent of the firms that change their state of incorporation move to Delaware.11

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10 JR Macey ‘Displacing Delaware: Can The Feds Do A Better Job Than States In Regulating Takeovers?’ 57 BusLaw 1025 (2002); DJ Block ‘The Business Judgement Rule: Fiduciary Duties of Corporate Directors’ 3 (5th ed 1998) (‘[T]he Delaware court system often is viewed as ‘the Mother Court of corporate law’”).
There are four important principles developed by case law with regard to minority shareholders' protection in takeovers under Delaware state law. They are the business judgment rule, the entire fairness test, the *Unocal* proportionality test,\(^{12}\) and the *Revlon* duty to maximise share value in the short term\(^ {13}\). Additional protection is provided by the provisions of the Delaware Corporation Law (the 'Code') and equitable remedies designed to supplement the Code. Before analysing these principles and protections, it is necessary to describe the main features of Delaware law that are relevant to the various takeover techniques resulting in the squeeze-out of minority shareholders.

### 2. Long-form and Short-form Mergers

The ultimate objective of any squeeze-out transaction is the elimination of continuing equity ownership by minority shareholders resulting in 100 per cent equity ownership by the majority. The more common methods employed include 'long-form' mergers, 'short-form' mergers, tender offers followed by 'short-form' mergers, and reverse share splits or share reclassifications.

Sections 251 and 252 of the General Corporation Law of Delaware (GCL) permit two or more Delaware corporations, or one or more Delaware and one or more non-Delaware corporations, respectively, to merger into a single corporation.\(^ {14}\) The merger

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\(^{12}\) *Unocal Corp v Mesa Petroleum Co* 493 A2d 946 (Del 1985).

\(^{13}\) *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*, 506 A2d 173 (Del 1986).

\(^{14}\) 8 Del C s 251, 252.
must be approved by the shareholders of each merging party by the vote of a majority of the outstanding shares entitled to vote thereon, or such other percentage as may be required by law in the case of non-Delaware entities.15

In a short-form merger, section 253 of the GCL permits a parent corporation, in limited circumstances, to bypass the necessity of any action by the directors or shareholders of the subsidiary and to effect directly a merger of the subsidiary into the parent (or of the parent into the subsidiary). If a parent company holds at least 90 per cent of each class of shares otherwise entitled to vote on a merger, the parent company may, by action of its own board of directors, resolve to merge the subsidiary into the parent. Under this procedure, the parent board may, without any action on the part of the subsidiary’s board or the subsidiary’s other shareholders, unilaterally fix the consideration to be received by any minority shareholders of the subsidiary in exchange for their shares. In this situation, as will be discussed below in more detail, the parent company deprives the subsidiary’s board of any decision-making power. Therefore, the directors of the subsidiary company, who are fiduciaries for the minority shareholders of that company, have no say on the merger. Section 253 effectively eliminates any requirement of ‘procedural fairness’ in squeezing out the minority shareholders.16 The substitute for this protection is a guaranteed statutory appraisal right.

In the situation of tender offer followed by a long-term or a short-term merger, only a back-end merger structured as a long-term merger will give rise to fiduciary obligations by the offeror to the shareholders whose shares are sought. Statutory

15 8 Del.C. s 251(c).
16 Glassman v Unocal Exploration Corp. 777 A2d 242 (Del 2001).
appraisal rights will not be available for shares tendered as the front-end offer. Such rights may be available for shares converted in the back-end merger if structured as a long-form merger, and will be available for shares converted in the back end if structured as a short-form merger.

In a reverse share split, the certificate of incorporation of the corporation is amended to reclassify each existing issued share into a fraction of a share. Under the GCL, a corporation is permitted but not required to issue fractional shares. In order to eliminate the minority shareholders, the conversion ratio needs only be set at a fraction sufficient to cause each minority holding to be converted into less than one full share. In a share reclassification the shares of the minority shareholders are reclassified by means of an amendment of the certificate of incorporation into cash while the interest of the majority is reclassified into new shares constituting all of the outstanding equity. The use of the reverse-split or share reclassification mechanism does not give rise to statutory appraisal rights, but does implicate fiduciary responsibilities of the board to the minority shareholders.

3. Business Judgment Rule, Unocal and Revlon Rules

Under the business judgment rule, if the directors under their duties have made an informed business decision which is not grossly negligent and have acted in
good faith, the court will not second-guess the directors' decision, because the presumption is that the directors have met the burden imposed on them by the duties of care and loyalty. This rule emerges naturally from Section 141(a) of the Delaware Code, which assigns management of the day-to-day business and affairs of the corporation exclusively to the board of directors.23

Under the proportionality test of the *Unocal* case, the directors' action in the situation of a tender offer will need to be proportionate to the risks involved for the company as a business entity. It was held by the court that '[w]hen a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decision should be accorded in the realm of business judgment.'24 This rule heightened the threshold of the business judgment rule, because the measures taken must be 'reasonable in relation to the threat posed.'25 In the *Unocal* case, the court appeared to distinguish long-term value from short-term interests in determining the reasonableness of the director's measures. In *Paramount Communications Inc v Time Inc*26 the court moved away from this approach where it noted that 'the question of “long-term” versus “short-term” values is largely irrelevant because directors generally are obliged to charter a course for a

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22 *Van Gorkom* 488 A2d, 872. The gross negligence threshold established by von Gorkom as necessary to overcome the business judgement rule in Delaware is more favourable to directors than other formulations of the rule; See *Meyers v Moody*, 639 F2d 1196, 1211 (5th Cir 1982); *McDonnell v American Leduc Petroleum, Ltd*, 491 F2d 380, 384 (2d Cir 1974); See also Ali *Principles of Corporate Governance* S4.01(c) (3) (requiring that a director 'rationally believes that the business judgment is in the best interests of the corporation. '); *Partner v Marshall Field & Co*, 646 F2d 271, 293 (7th Cir 1981); *Sinclair Oil Group v Levien*, 280 A2d 717 (Del 1971); *Smith v Van Gorkom*, 488 A2d 858 (Del 1985).

23 *Unocal Corp v Mesa Petroleum*, 493 A2d 946, 954 (Del 1985); See also *Pogostin v Rice*, 480 A2d, 627.

24 *Unocal*, 493 A2d, 955.

25 *Paramount Communications, Inc v Time, Inc*, 571 A2d 1140 (Del 1989).
corporation which is in its best interests without regard to a fixed investment horizon.\textsuperscript{27}

Under the \textit{Unocal} rule, the directors can bargain collectively, as agents, for the shareholders, and in order to avoid the problem of the two-tiered bid which is inherently coercive, limiting shareholders' choice. However, a collective resolution may not be rational to individual shareholders, or vice-versa. It was held in \textit{Mills Acquisition Corp v MacMillan}\textsuperscript{28} and \textit{AC Acquisitions Corp v Anderson, Clayton Co}\textsuperscript{29} that, even in the face of a valid threat, such as a two-tiered bid, management may fail the proportionality test if it acts coercively or forces shareholders to accept a management-sponsored alternative to a hostile bid.\textsuperscript{30} The courts have held in later cases that the directors may raise defensive measures in hostile takeovers to fulfil the duty to the shareholders facing the threat of coercive bids. Arguably, the minority shareholders in such a situation can raise the issue of 'coercive bid' which is for the directors to address under the \textit{Unocal} rule.

As regards defensive measures, the Delaware Supreme Court held in \textit{Paramount Communications Inc v QVC Network Inc}\textsuperscript{31} that defensive measures introduced before a takeover offer will be reviewed with greater leniency than measures introduced post-offer. It was said that such a rule, created for the collective benefit of all shareholders at the expenses of \textit{pro rata} distribution of rights among shares, has positive discrimination effects which weaken shareholders' rights. In \textit{Nixon v

\textsuperscript{27} \textit{Paramount Communications, Inc v Time, Inc}, 571 A2d 1140, 1150 (Del 1989).
\textsuperscript{28} \textit{Mills Acquisition Corp v Macmillan} 559 A2d 1261 (Del 1988).
\textsuperscript{29} \textit{AC Acquisitions Corp v Anderson, Clayton Co} 519 A2d 103 (Del Ch 1986).
\textsuperscript{30} \textit{Paramount Communications, Inc v Time, Inc}, 571 A2d 1140, 1150 (Del 1989).
\textsuperscript{31} \textit{Paramount Communications, Inc v QVC Network, Inc} 637 A2d 34 (Del 1994).
Blackwell, a case decided under the entire fairness standard, the court held that an employee stock ownership plan (ESOP) and board policies which gave corporate officers beneficial treatment were acceptable even though they discriminated against minority shareholders. Hence, it is suggested that the predictable expansion of the principle of positive discrimination to non-takeover contexts augments board powers unnecessarily at the expense of minority shareholders since the automatic check of the proportionality test does not exist in contexts other than takeover scenarios and the power was designed exclusively for the takeover context.

Under the Revlon rule, if the corporation is to be dissolved as a result of a merger that potentially eliminates the continued existence of the corporate strategy, directors have a fiduciary duty to maximise shareholder value in the short term because their actions involve a sale of control and shareholders automatically enjoy a right to share in the control premium. Once corporate control is put up for sale, the 'whole question of defensive measures [becomes] moot. The directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.' The time of 'up for sale' was said to be when there is a change in the control structure of the corporation. In Paramount Communications, Inc v QVC Network Inc, both Paramount and Viacom claimed that

34 Paramount Communications, Inc v Time, Inc, 571 A2d 1140, 1150 (Del 1989).
38 In re Holly Farms Corp Shareholders Litig, Civ ANo10350, 1988 WL 143010 (Del Ch 1988).
their friendly merger acted as a strategic alliance that would preserve the business strategy of Paramount. Vice Chancellor Jacobs rejected this argument, holding that, given the lack of any ‘structural protections that would ensure the continuity of [the] merged enterprise,’ the deal must be evaluated under Revlon and Unocal so as to protect the shareholders. Therefore, in a friendly merger, if a structural protection for the minority shareholders is in place in the post-merger company, such as exit provisions or cumulative voting right guaranteeing minority-elected directors on the board, the court will allow the directors to look at the broader interests of the company, rather than a short-term interest for the shareholders.

Revlon supplements the entire fairness test by protecting constructive minorities: the shareholders of a target company who will form an actual minority if the merger is consummated. On the other hand, the entire fairness standard under the Weinberger rule protects existing minority shareholders from the actions of a controlling shareholder.

4. Fairness Rule

In Solomon v Pathe Communications Corp, the Delaware Supreme Court confirmed that, as a general principle, a controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation to offer any particular price for the minority-held share, so long as material information about the offer has not been withheld or misrepresented, and the offer is not coercive in some significant

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39 QVC Network, Inc v Paramount Communications Inc 635 A2d 1245, 1267 (Del 1993).
This is because the majority shareholder is not exercising control over the property of the minority shareholders and should not be required to bear the burden of demonstrating that the offer is 'entirely fair'. However, this rule is not followed by the courts in other jurisdictions.

Delaware enacted legislation to give appraisal rights to the minority shareholders who dissent from the proposed merger. These statutes have been seen by some commentators as a means to replace the protections dissenting shareholders traditionally possessed through their veto power but had since lost due to the changing legal structure of corporations. The appraisal rights statutes require each shareholder electing an appraisal to submit a written demand to the merging corporation prior to a shareholder vote on the merger. The written demand must notify the corporation of the shareholder's intent to seek appraisal. Normally, the availability of an appraisal remedy prohibits dissenting shareholders from seeking relief in other forms. However, the following discussion will show that appraisal rights are not the only remedy for minority shareholders. Appraisal rights are limited to a closely-held company.

In *Sterling v Mayflower Hotel Corp*[^46], the court examined whether the terms of a

[^41]: Soloman v Pathe Communications Corp 672 A2d 35, 39 (Del 1996).
[^42]: Re Siliconix Inc Shareholders Litigation, CA No 18700 (Del Ch June 21, 2001); In re Pure Resources, Inc., Shareholders Litigation. 808 A2d 421 (Del Ch 2002) (imposing various conditions and requirements on structure of offer as necessary to avoid injunction).
[^43]: See the later discussion on majority shareholder's duty towards the minority shareholders in other jurisdictions.
[^45]: DEL.CODE ANN. Tit. 8, S262 (d) (1991). In cases where a shareholder vote is unnecessary but where the appraisal remedy is still available, shareholders may perfect appraisal right by making a written demand on the company within 20 days after the company mails out notice of the availability of the appraisal right to shareholders.
[^46]: Sterling v Mayflower Hotel Corp 93 A2d 107 (Del 1952).
The court did not spell out the definition of fairness, but left the fiduciary, the Hilton Hotel, to prove that the transaction was fair. In particular, it relied on a stock’s market value as the primary factor in determining if a merger transaction was fair, and was apparently oblivious of the fact that a controlled merger could offer a premium over market price and still be unfair. In Singer v Magnavox Co, the duty extended to permitting the minority to retain its interest in an enterprise unless its elimination could be justified by a proper business purpose. It is probably not until the Weinberger case that some light was shed on the problem of ‘fairness’ by focusing on the appraisal valuations.

5. The Weinberger Rule

The Weinberger case relates to the issue of eliminating minority shareholders through back-end ‘freeze-out’ merger. In Weinberger v UOP, UOP, a company which was the majority shareholder of a subsidiary company, had sought, and acquired, the remaining shares of its subsidiary by merger transaction in the form of share-for-share with payment of cash to the minority shareholders of the subsidiary for their minority shareholdings. Weinberger, a minority shareholder, on behalf of the class of all

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47 Sterling v Mayflower Hotel Corp 93 A2d 107 (Del 1952) 109-10.
48 Sterling v Mayflower Hotel Corp 93 A2d 107 (Del 1952) 111.
49 Singer v Magnavox Co 380 A.2d 969 (Del 1977), overruled by, Weinberger v UOP, Inc, 457 A2d 701 (Del 1983). The case involved a long-form cash merger of Magnavox into T.M.C. Development Corporation, which was an indirect, wholly owned subsidiary of the company, which in turn owned 84.1% of Magnavox.
50 Singer v Magnavox Co 380 A2d 969 (Del 1977).
51 Weinberger v UOP, Inc 457 A2D 701, 715 (Del 1983).
52 Weinberger v UOP, Inc 457 A2D 701, 715 (Del 1983).
53 Schreiber v Burlington Northern Inc, 472 US 1, 1 n.1(1985), the case defined a ‘squeeze-out’ merger as occurring when Corporation A, which holds a controlling interest in Corporation B, uses its control to merge B into itself or into a wholly owned subsidiary. The minority shareholders in Corporation B are, in effect, forced to sell their stock.
subsidiary shareholders who had not exchanged their shares at the merger price, attacked the validity of the merger transaction and sought to set the merger aside, or, alternatively, an award of monetary damages against the subsidiary, the majority shareholder UOP, and the investment banking firm which provided fairness opinion prior to the merger. The Supreme Court of Delaware held that the merger did not meet the test of fairness because the directors failed to disclose the information to the subsidiary’s outside directors, and on remand, the minority shareholders would be entitled to damages based on the fair value of their shares as determined by taking into account all relevant factors, including the elements of rescissory damages if susceptible of proof and appropriate to the issue of fairness. The Court, however, also eliminated the doctrine of ‘proper business purpose’ as a requirement for a freeze-out merger. That is to say the majority shareholders or the board of directors will not need to justify such a ‘freeze-out’ merger based on any proper business purposes.54

There are several significant issues arising in the *Weinberger* case. The first is that the decision formally recognised a shareholder’s right to equal sharing of the enterprises’ value on a ‘going concern’ basis.55 In the old cases, the court used the Delaware block method for appraisal right, in which the appraiser computes separate values for market value, earnings, and the net assets, gives a weight to each, and then adds them together. This method had been criticised because a separate inquiry into earnings or net assets values is redundant.56

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55 *Weinberger v UOP, Inc* 457 A2D 701, 713 (Del 1983); However, ‘going concern’ value does not equate to the highest value a firm could obtain through an auction. A majority shareholder has no affirmative duty to auction the corporation when it seeks to cash-out the minority. Its fiduciary duty of fairness does not require it ‘to sell its holdings...merely because the sale would profit the minority’. *Bershad v Curtiss-Wright Corp*, 535A2d 840, 844-45 (Del 1987).
56 F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (1st edn Harvard University
The second fundamental issue in *Weinberger* is that the court attempted to articulate an 'entire fairness' standard in a cash-out merger, which would be applied to other situations where a minority is eliminated.57 'Fairness' includes fair dealing as its procedural dimension, and fair price as its substantive dimension.58 Procedural fairness, or fair dealing, embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, and disclosed. Substantive fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors such as assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.59

The third point to be noted is that the court suggested that if the transaction is fair dealing, the product is likely to be the product of a fair process. Such a process includes full disclosure of all pertinent information, review, and approval by an independent and informed committee, and a provision for a minority veto.60

Fourth, *Weinberger* denies to plaintiff-shareholders the use of an equity forum to litigate inadequacy of price unless there are specific allegations of fraud, misrepresentation, self-dealing, deliberate corporate waste, or gross overreaching.61

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57 Pinson v Campell-Taggart, Inc, CA. No 7499 (Del Ch Feb 28, 1989); Gottlieb v Heyden Chem Corp, 91 A2d 57, 58 (Del 1952); Sealy Mattress Co of NJ v Sealy, Inc, CA No 8853 (Del Ch Jul 20 1978); In re Trans World Airlines, Inc Shareholders L., CA No 9844 (Del Ch Oct 21, 1988).
58 Weinberger v UOP, Inc 457 A2d 701, 711 (Del 1983); Moore 'The Interested' Director or Officer Transaction' (1979) 4 Del J Corp L 674, 676; Nathan and Shapiro 'Legal Standards of Fairness of Merger Terms Under Delaware Law' 2 Del J Corp L 44, 46-47 (1977).
59 Weinberger v UOP, Inc 457 A2d 701, 711 (Del 1983).
61 Weinberger v UOP, Inc 457 A2d 701, 715 (Del 1983). This correlates the Federal rule protection under *Santa Fe*. 
Finally, for cases and mergers that come under this rule, any affected shareholders who had renounced their appraisal rights would retain their right to challenge the fairness of price in the equity court. A review of post-
*Weinberger* decisions reveals that where there has been a gross failure of process, the court is likely to conclude that the price offered could not have been fair. Similarly, where there is direct evidence showing that the price from arm’s length negotiations differs significantly from the offer price, the court will be likely to conclude that the price was not fairly offered.

(a) Quasi-Appraisal Right vs Statutory Appraisal Right

The *Weinberger* case raises three questions: first, whether the judgment precludes future challenges based on the ‘fairness’ of the procedure by asserting that statutory appraisal is the exclusive remedy to minority shareholders in a freeze-out; secondly, whether shareholders can obtain what is essentially a ‘quasi-appraisal’ remedy in statutory appraisal proceedings; thirdly, whether shareholders who had not voted in favour of a merger, but nevertheless tendered their shares, are eligible to obtain a remedy under *Weinberger*.

As regards the first and second questions, it was held that appraisal and ‘quasi-appraisal’ proceedings serve different purposes and provide different, not interchangeable remedies. In an appraisal action, the sole issue is the adequacy of

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65 Cede & Co v Technicolor Inc 542 A2d 1182 (Del 1988).
the offer price. The only available relief is a judgment against the surviving corporation for the fair value of the dissenter’s shares. By contrast, an action in equity pleaded on ‘fair dealing’ arguments is an action brought against the alleged wrongdoers. The court has wide discretion in fashioning remedies in such cases and will do so according to the facts of each case. Relief in an action in equity is broader in ‘quasi-appraisal’ proceedings, as it will include rescissory damages if found appropriate. The similarity which statutory appraisal right and quasi-appraisal right have is the method of valuation in which the court should consider all relevant factors, including the future prospects of the company and any damages to the shareholders from forcible taking, and should exclude only speculative estimates and those gains related directly to the merger.

As regards standing to commence the action, it was held in Bershad v Curtiss-Wright Corp, that those who had voted in favour of the merger or had tendered their shares had acquiesced in the transaction, and, therefore, could not later attack it unless there was proven misconduct on the part of the majority. The appraisal standard continues to exclude elements of value attributable to the transaction that provokes the dissent. Furthermore, managers may exercise ordinary business judgment in structuring control transactions.

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66 Cede & Co v Technicolor, Inc 1187.
68 Examples outside Delaware include Yanow v Teal Indus, 178 Conn. 262, 422 A2d 311 (1979) (rejecting Singer); Deutsch v Blue Chip Stamps, 116 CalApp 3d 97, 172 Cal Rptr21 (2d Dist 1981) (apparently rejecting Singer); Gabhart v Gabhart, 370 NE2d 345 9 Ind (1977) (adopting modified version of Shareholding that courts must inquire into business purpose but may not inquire into entire fairness). Within Delaware see Weinberger v UOP, Inc, 457 A2d 701 (Del 1983) (discarding Singer). Tanzer v International Gen Indus, 379 A2d 1121 (Del 1977) (one firm may keep all of the gain).Bell v Kirby Lumber Group 413 A2d 137 (Del 1980) pure going-private transaction lawful and dissenting investors are not entitled to any gain produced by the transaction from which they dissent). See also Coleman v Taub, 638 F2d 628 93d Cir 1981(applying Delaware law); Dower v Mosser Industries, 648 F2d 183, 189 (3d Cir 1981)(applying Pennsylvania law but decided on assumption that Delaware law was a useful guide).
(b) Quasi-Appraisal Right vs Preliminary Injunction

It was conceded that appraisal was the exclusive remedy of dissenting shareholders except in cases of fraud or illegality. In *Singer v Magnavox* a Delaware court held that a minority shareholder could have a merger enjoined if he could show that it lacked a 'proper business purpose' or was not 'entirely fair'. In *Lynch v Vickers Energy*, the court held that a minority shareholder could obtain rescissory damages against the acquiring firm for misrepresentations or other breach of fiduciary duty in connection with a tender offer. *Weinberger* discarded the business purpose requirement of *Singer* and made appraisal exclusive except in the event of fraud or misrepresentation. Even in the case of fraud or misrepresentation, the court said that rescissory damages are to be awarded in the appraisal proceedings. However, in *Rabkin v Phillip A Hunt Chemical Corp*, the court held that it may enjoin a merger to prevent the firm from forcing appraisal to get around a contractual obligation. *Cede & Co v Technicolor* held that the court may enjoin a merger if fraud led the investor into demanding an appraisal. Therefore, it can be said that the appraisal right is not really 'exclusive'.

There are other procedural uncertainties in relation to pleadings which could result in

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69 Which is what the statutes, including Delaware's, say? *Stauffer v Standard Brands* 187 A2d 78 (Del 1962); *David J Greene & Co v Schenley Industries*, 281 A2d 30 (Del Ch 1971).
70 *Singer v Magnavox* 380 A2d 969 (Del 1977).
72 *Rabkin v Phillip A Hunt Chemical Corp* 498 A2d 1099 (Del 1985).
73 *Cede & Co v Technicolor* 542 F2d 1182 (Del 1988).
more litigation. In Steiner v Sizzler Restaurants International Inc,75 and Ocean Drilling & Exploration Co Shareholders Litigation,76 the Court of Chancery denied requests to issue a preliminary injunction because of the availability of the ‘quasi-appraisal’ remedy, and a corresponding failure to show irreparable harm. The court reiterated that ‘quasi-appraisal’ remedy is available to any shareholder who decides to accept the offer and to forego the prospect of statutory appraisal based on disclosure proven to be misleading or incomplete. The uncertainty is about the legal and factual burden of proof required of the parties to proceed with the case. Should the plaintiff prove the facts substantiating the allegation of ‘procedural unfairness’ or should this burden lay with the fiduciary? If the offer was below the intrinsic value, is that to say that the plaintiff was only required to prove that the offer was undervalued and let the court infer ‘unfairness’?

It has been maintained that the less accurate the appraisal price, the more useful the other remedies are.77 This is because an injunction will enable the investors to negotiate with the other shareholders, in so doing, improving the operation of the market in corporate control.78 The drawback is that if there are many shareholders, it will be difficult for the defendants to negotiate with each of them to purchase the right to seek an injunction. In this respect, it has been suggested that injunctions be made available only when the appraisal remedy is plainly deficient or the fraud is quite clear.79

79 FH Easterbrook & DR Fischel The Economic Structure of Corporate Law (Harvard University Press
Some problems arise here. What constitute a ‘deficient’ remedy? And what is the legal definition of ‘fraud’ in this respect? Weinberger upheld the traditional rule that injunctive relief is available only in cases involving fraud.\textsuperscript{80} Weinberger implied that courts could find fraud whenever persuaded that the price offered was grossly inadequate. However, the courts then adopted the approach, which was discussed above, that a price properly derived is not ‘fraudulent’ even though relatively low to investors’ expectations, and that the persons proposing control transactions need not reveal their best price.\textsuperscript{81} Although the court can infer unfairness if the price offered is inadequate, in practice it will be exceptionally difficult for a court to identify fraud coupled with inadequacy of the appraisal process.\textsuperscript{82} Any search for fraud would increase the risk of mistakenly enjoining value-increasing transactions.\textsuperscript{83}

6. Impact on Shareholders

When shares have been offered to be bought in a share-for-share takeover, shareholders must decide whether to perfect their appraisal rights, or to accept the offer based on bare bones disclosure on the exchange offer. They have the ‘quasi-appraisal’ remedy even though they have accepted the offer if they later succeed on the merits in a ‘fairness hearing.’ However, the reliance on \textit{ex post facto} proceedings

\textsuperscript{80} Weinberger \textit{v} UOP, Inc, 457 A2d 701 (Del 1983); See, for example, Model Business Corporation Act, s 13.02 (b) (appraisal remedy exclusive unless the action taken is ‘unlawful or fraudulent with respect to the shareholder or the corporation’); NY Bus Corp Law, s 623 (b) (appraisal remedy not exclusive where corporate action is unlawful or fraudulent as to complaining shareholder.

\textsuperscript{81} Bershad \textit{v} Curtiss-Wright Corp 535 A2d 840 (Del 1987); Rosenblatt \textit{v} Getty Oil Co 493 A2d 929, 944-945 (Del 1985); See also 3 Model Business Corporation Act Annotated 1430-35 (citing cases from other states).

\textsuperscript{82} FH Easterbrook \& DR Fischel \textit{The Economic Structure of Corporate Law} (Harvard University Press Cambridge MA 1991) 160.

\textsuperscript{83} FH Easterbrook \& DR Fischel \textit{The Economic Structure of Corporate Law} (Harvard University Press Cambridge MA 1991) 160.
places tendering shareholders at an evidentiary disadvantage. Furthermore, if their challenge of ‘fairness’ fails to meet the threshold required to sustain a claim for breach of fiduciary duty by the controlling shareholders, shareholders will have foregone their appraisal right and will have been left with the proffered consideration only, without the benefit of adequate disclosure at the time of the transaction. Tendering shareholders will be forced to make a decision among available alternatives (whether to accept the offer terms, or elect an appraisal or other judicial remedy) in an ‘information vacuum’.84

7. Fair Dealing, Reasonable Expectations, and Arm’s Length

Whether shareholders have been fairly dealt with will be decided on the following tests. The first is whether shareholders’ reasonable expectations have been frustrated.85 The second is the court’s view of equal sharing of the company as a going concern, in value terms, as the underlying norm in determining the expectation of equal sharing in the intrinsic value of an enterprise. In a freeze-out merger, judges feel reasonably assured that the minority will receive their pro rata share of the enterprise’s going concern value, if the negotiating framework employed in the transaction approximates that of parties dealing at arm’s length. The rationale for this approach appears to be that if one could be confident that the bargain reached will resemble the result of vigorous negotiations between parties dealing at arm’s length, one would be assured that there had been no gross overreaching.86 The arm’s length approach is said to have both conceptual and pragmatic merits. If the courts were

86 Weinberger v UOP, Inc, 457 A2d 701, 710 n 7 (Del 1983).
involved in assessing the substantive fairness of every merger, the majority shareholders would eventually find the value offered to be substantively fair, which would result in uncertainty in business transactions. The courts are better equipped to assess the fairness of the procedure rather than to assess the fairness in substantive terms.

However, if there is evidence showing that the offered price is substantially different from the intrinsic value, the court may conclude that the sale is not at arm’s length. In *Rabkin v Phillip A Hunt Chemical Corp*, where there was a cash-out merger of Hunt Chemical Corporation’s minority shareholders by its controlling shareholder, Olin Corporation (‘Olin’), at $20 per share, Olin had purposely timed the merger to occur after the expiration of a commitment period in order to avoid paying the minority shareholders the committed price of $25 per share. It was held that the committed price of $25 per share was cogent evidence of what the offer price would have been if the transaction had been negotiated between two truly independent parties. Despite the fact that there was no gross failure of process, and the offer had been approved by Hunt’s independent committee as being fair, though not generous, the court recognised that there was unequal bargaining power, which was shown by the difference between the pre-committed price and the offer price, between the minority and the majority.

In *Kumar v Racing Corp of America Inc*, minority shareholders intended to exercise

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87 EJ Weiss ‘Balancing Interests in Cash-Out Mergers: The promise of *Weinberger v UOP, Inc*’ (1983) 8 DelCorpL 1, 47 n300.
89 *Rabkin v Phillip A. Hunt Chemical Corp* 498 A2d 1099 (Del 1985).
90 *Rabkin v Phillip A. Hunt Chemical Corp* 498 A2d 1099, 1101 (Del 1985).
91 G Fung ‘A Common Goal From Two Different Paths: Protection of Minority Shareholders In
the conversion and option rights in an approved merger by the interested board. The court held that the original arrangement was evidence of the true bargain reached between the parties, although at the time there was no market to assess the intrinsic value of the shares.

8. Tender Offer

In Re Ocean Drilling & Exploration Co Shareholders Litig, the minority shareholders applied for a preliminary injunction in respect of an exchange offer by a 64 per cent majority shareholder, Murphy Oil Company. The proposed exchange offer appeared coercive on the face of it, and the related disclosure was lacking in clarity. The court found that the offer was not ‘actionably coercive’, nor was the non-disclosure fatal. The court thought that any deficiencies could be addressed by the new ‘quasi-appraisal’ remedy. However, it was said that class action may not necessarily follow through the discovery of the evidence of unfairness.

Although Weinberger was a case concerning a cash-out merger, its principles also apply to the situation of tender offer. In Joseph v Shell Oil Co, the court found a gross failure of process, owing to materially deficient disclosure. It granted a preliminary injunction together with an order to cure the defects in the disclosure. It has been maintained that the decision shows that the court recognised the fact that

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minority shareholders are not totally free from coercion, due mostly to their lack of bargaining power and their lack of full information. However, the problem arose when the transaction was complete and it was unlikely that the whole transaction would be rewound notwithstanding the omission and error in the process of disclosure. It was held that this situation falls within the *Weinberger* window rule in which the plaintiff could seek the remedy of 'quasi-appraisal'.

In *Smith v Shell Petroleum Inc*, the court granted the remedy of quasi appraisal to shareholders who had accepted the cash-out consideration and consequently did not exercise their statutory appraisal right. The relief, as discussed above, ought to include rescissory damages. It is unclear from the *Smith*’s opinion if the determination of fair value was made before or after the discovery of the error.

9. Statutory Protection

Delaware law provides that two or more Delaware corporations may merge into one corporation if they meet the requirements of Section 251, which requires that the board of directors of each corporation adopts a plan of merger and submits this plan for shareholder approval. A majority of both outstanding voting and non-voting stock must then approve the merger.

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96 *Joseph v Shell Oil Co* 482 A2d 335 (Del Ch1984).
98 *Technicolor Inc*, 542 A 2d 1182 (Del 1988).
100 DEL.CODE ANN tit 8, S251(a)(1991).
102 DEL.CODE ANN tit.8, S251(c)(1991) requires the plan of merger to be submitted to shareholders of each corporation engaging in the merger at least twenty days prior to the meeting at which a shareholder vote will be held.
103 Prior to 1969, two-thirds of shareholders were required to approve the merger. The 1969
The right to vote is not absolute and the right may be denied if three conditions are met. First, the plan of merger must not require the amendment of the corporation’s certificate of incorporation. Second, each share of the corporation before the merger must be ‘identical’ to a share after the merger. Thus, the board cannot circumvent the requirement in section 242 that any change in the number of authorised shares be made by amendment of the articles of incorporation by making this change in the merger agreement without requiring a shareholder vote. The third requirement limits share issuance as part of a merger, including authorised but unissued shares, to a 20 per cent increase in the number of outstanding shares of the common stock of the corporation before the merger. It appears that this section reflects the Code’s recognition that mergers present special risks to minority shareholders because mergers arise outside the normal course of the corporation’s business and, as a result, board members’ own interests may conflict with the interests of minority shareholders.

C. PROTECTION UNDER NEW YORK STATE LAW

1. Introduction

The approach in the State of New York, primarily through legislation, focuses on control in the management and shareholders meetings. This section is intended to examine how the legislation strengthens and weakens the minority shareholders’

Amendments of the Delaware Code reduced the approval threshold to 50%; See E Folk, R Ward & E Welch, Folk on the Delaware General Corporation Law S251 2.1.2 (1982).
position through direct statutory intervention while the development of the common
law in the state is clearly in the direction of protecting the minority shareholders.

2. Voting on Directorship

Cumulative voting rights give the minority shareholders a greater say in the
management of the corporation because it enables the minority to elect directors to
the board more easily. This enhances the position of minority shareholders especially
if one considers that the director representative of the minority shareholders, once
elected, cannot be removed without cause by other shareholders. Absent cumulative
voting, each director is elected at the general meeting where each shareholder is
entitled to cast only one vote for each share possessed, in principle, as many votes for
each directorship as he or she has shares. In cumulative voting, each share is entitled
to as many votes as there are directors being elected, and the shareholders may cast
all their votes for a single candidate or divide the votes as they see fit. The set back is
that cumulative voting is permitted only if provided for in the certificate of
incorporation.\textsuperscript{104} Where cumulative voting is permitted, the Business Corporation
Law (BCL) limits shareholders’ power to remove directors.\textsuperscript{105}

If the shares are divided into classes, the certificate of incorporation may require that
specified classes or series of shares shall vote as a class, either generally or as to
specified matters. Such a required vote is in addition to any other required vote.\textsuperscript{106} If
any class or series of shares or bonds is entitled to elect directors as a class, removal

\textsuperscript{104} BCL s 618.
\textsuperscript{105} BCL s 706(c)(1).
\textsuperscript{106} BCL s 617.
may be effected only by the electing shares. Minority shareholders with 10 per cent of the shares, both voting or non-voting, may sue for judgment removing a director for cause. The court may also bar re-election of the directors so removed.

Cumulative voting was designed to remedy the problem arising out of the separation of ownership and control; it strengthens the minority shareholders’ position by giving more leverage to bargain at board meetings and at general meetings.

3. Shareholder’s Fiduciary Duties

In principle, shareholders not occupying a control position in the corporation may act in their own personal interest and they have no fiduciary duty to the corporation or to their fellow shareholders. However, shareholders who do occupy a control position, either de facto or de jure, owe a duty to the minority shareholders to exercise the utmost good faith.

Under New York State law, controlling shareholders may not use their management power to their individual advantage at the expense of the corporation. The controlling shareholders do not violate the duty to the corporation or their fellow shareholders when the sale of control shares is at a premium. Thus, in the absence of looting of corporate assets, converting corporate opportunities, fraud, or other instances of bad faith, a controlling shareholder is free to sell his controlling interests at a premium, and the minority shareholders are not entitled to share in the premium

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107 BCL s 706 (a).
108 The attorney general also has the same right.
110 Kavanaugh v Kavanaugh Knitting Co 226 NY 185 (1919).
111 Leibert v Clapp, 13 NY 2d 313 (1963) ie looting, freeze-out, waste.
at common law. In a freeze-out, the minority shareholder will be able to bring an action in equity to review a freeze-out and the court will review the transaction as a whole to determine the following: first, whether the transaction was tainted with fraud, illegality, or self-dealing; second, whether the minority shareholders were dealt with fairly; and third, whether there was any independent corporate purpose for the merger. However, illegality and unfairness are two different concepts at common law. As a consequence, it seems that the court will enjoin the freeze-out merger as long as there is any unfairness to the minority shareholders even if there is no illegality. The conclusion is that controlling shareholders owe a duty to the minority to act fairly to them even without proven illegality.

In *Celia Barbour v Gabriele Knecht*, on a motion for summary judgment, a minority shareholder in a cooperative corporation brought individual and derivative claims against the corporation and its directors. The plaintiff alleged that the respondents after having acquired the control of the corporation altered its by-laws, which had the effect of depriving the minority shareholders of the right of management which they had under the by-laws in their original form. The court held that 'the majority shareholders and directors of a closely-held company stand in a fiduciary relationship with the corporation and minority stockholders and are required to exercise the utmost good faith.' The court dismissed the action, allowing it to be repleaded within 30 days, because of the mingling of derivative claims and individual claims,
which requires dismissal on procedural grounds.\(^{117}\)

4. Director's Duties

Directors' duties to the company include the duty of care and duty of loyalty. Directors and officers must discharge their duties in good faith and with that degree of diligence care and skill that an ordinary prudent person would exercise under similar circumstances in like positions.\(^{118}\) A director must keep himself reasonably informed of the corporation's affairs,\(^{119}\) and courts will not second-guess the business judgment of directors if exercised in good faith on available information.\(^{120}\) Duty of loyalty means that the directors must act in 'good faith', whereby they are bound by all those rules of conscientiousness, fairness, morality, and honesty in purpose that the law imposes as guides for those who are under fiduciary obligations and responsibilities.\(^{121}\) This common law rule is similar to the position in England. However, in England there is no rule stating that the directors must act fairly to the minority shareholders for the fulfilment of the obligation.

In *Barbour v Knecht*, in determining whether the board, in approving the sale of shares to the would-be majority shareholders and disapproving the transfer to plaintiff, unreasonably withheld its consent in the latter instance, the court held that it is the business judgment rule, not the court's independent assessment of the reasonableness of the decision, that provides the proper standard of review.\(^{122}\) But the business

\(^{117}\) *Celia Barbour v Gabriele Knecht* 743 NYS 2d 483; Also see *Abrams v Donati* 66 NY 2d 951, 953, 498 NYS 2d 782, 489 NE 2d 751; *Baliotti v Walkes* 134 AD 2d 554, 555, 521 NYS 2d 453

\(^{118}\) BCL s 717, 717(a).


\(^{120}\) *Auerbach v Bennett*, 47 NY 2d 619 (1979).

\(^{121}\) *Kavanaugh v Kavanaugh Knitting Co* 226 NY 185 (1919).

\(^{122}\) *Barbour v Knecht* 743 NYS 2d 483; Also see *Levandusky v One Fifth Ave Apt Corp*, 75 NY 2d
judgment rule is not an insuperable barrier and 'permits review of improper decisions, as when the challenger demonstrates that the board’s action… deliberately singles out individuals for harmful treatment.'\textsuperscript{123} The business judgment rule is subject to the individual’s interests to the extent that the burden of proof is on the plaintiff to show that he suffered harm and damages in order to establish the cause of action. The board must act in good faith, as the court said ‘…the courts must defer to a board’s determination if it was taken in furtherance of the corporation’s purposes, was within the scope of the board’s authority and was taken in good faith.’\textsuperscript{124}

The court went on to say that the plaintiff was not required to show that the board members were self-interested,\textsuperscript{125} and showing unequal treatment is sufficient,\textsuperscript{126} and, in any event, the concept of ‘self-interested’ is not limited to financial self-interest as self-interest can be shown if a director is controlled by an interested director.\textsuperscript{127} It is questionable whether the rule will extend to non-closely held corporation. In this respect, the trend in New York State law resembles the position in England in that minority shareholders are generally offered more limited remedies and protection in the listed company.

5. Insider Trading

As a general rule, any shareholder may acquire or dispose of his shares as his self-
interest dictates. However, where the shareholder is also a director or officer of the company, or, by analogy, a controlling shareholder, certain rules imposing special standards of conduct come into play, depending on the circumstances. Directors are held as fiduciaries of other shareholders with whom they deal in the corporation’s shares. They must not take advantage of their position by affirmative acts to injure the seller, such as by suppressing the truth or making deceptive statements. However, the mere fact that the price received from the buyer exceeds current market price, does not, in itself, constitute a breach of the fiduciary duty, in the absence of other proof of unfairness or undue advantage. As controlling shareholders and management have access to the information, the profit they made from marketing trading in the corporation’s securities through use of ‘inside’ information gained in their official positions, must be accounted for to the corporation. Federal law also forbids ‘short-swing’ profits made by directors, officers, or 10 per cent shareholders from purchases and sales, or sales and purchases, of the corporation’s shares made within six months of one another. Thus, minority shareholders are protected by Federal law and through enforcement by the SEC. In addition, they can bring a derivative action on behalf of the corporation provided the requirements for the derivative suit are met.

6. Derivative Actions

If the minority shareholders wish to bring a derivative action to enforce the rights of

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129 Von Au v Magenheimer 126 AD 257 (1908), 196 NY 510 (1909).
130 Borden v Guthrie 23 AD 313 (1965), 17 NY 2d 571 (1966).
132 Securities Exchange Act of 1934 s 16(b)
133 See discussion below.
the corporation either against directors or controlling shareholders, they must be shareholders when the action was brought; and they must have been shareholders at and from the time of the complained-of transaction or their shares must have 'devolved on them by operation of law'. The plaintiff shareholder must demonstrate that he would fairly and adequately represent the interests of the shareholders and the corporation, in that he was free of adverse personal interest or animus. The shareholder must be pursuing a corporate right, as distinguished from an individual right, to procure a judgment in the corporation's favour. An action to compel dividends or a claim for corporate waste must be brought derivatively. The complaint must set forth with particularity the plaintiff's efforts to secure initiation of action by the board or the reasons for not making such an effort. The majority of the board need not be active wrongdoers for the court to find that this requirement has been fulfilled and allow the derivative action to proceed if the board failed to exercise independent judgment as directors. Hence, even if the directors decided not to commence the suit by the influence of the majority shareholders or of their own at the board meeting, the minority shareholders will be able to bring a derivative suit.

To ensure that the corporation is not stuck with the expenses caused by the derivative action, the corporation is given the right, at any stage, to require the plaintiff to give security for the reasonable expenses that may be incurred by the corporation or by other defendants whom the corporation may be required to indemnify unless the plaintiff holds, on record or beneficially, 5 per cent or more of any class of shares (including holdings of voting trust certificates) or, the plaintiff's shares exceed $

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134 See the discussion under the English law.
135 *Steinberg v Steinberg* 434 NYS 2d 877 (1980).
137 *Lewis v SL & E, Inc*, 629 F 2d 764 (2d Cir 1980).
50,000 in fair value. The purpose of these provisions is to deter 'strike suits'.

7. Minority shareholder’s Rights in Major Corporate Changes

The procedures for major corporate changes are governed by the New York Business Corporation Law. These changes are amendments to certificate of incorporation, mergers, consolidations, sale of assets, and dissolution. The legal basis of the certificate of incorporation is a 'contract' within the meaning of the 'Impairment of Obligation of Contracts' clause of the US Constitution. However, the legislature and the shareholders so empowered by the legislature, and in some cases the directors, can amend the corporation's certificate of incorporation and make other major corporate changes. Although an amendment may not impair shareholders' constitutional rights, New York law does not adhere to the so-called vested rights doctrine, which prohibits amendments eliminating accrued but undeclared dividends. A shareholder has no constitutional right to remain an investor in the corporation. His only right is to have the value of his holding protected. This basic principle is also upheld in English law where a shareholder has the right to capital, ie the right to the value of his shares, but not the right to be a member of the company.

If a proposed amendment adversely affects any class, the authorisation will also require, in addition to other required votes, a majority of the votes of the outstanding shares of the affected class, whether or not the class comprises voting shares. The

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139 Mintz v Allen 254 FSupp 1012 (SDNY 1966).
140 Trustees of Dartmouth College v Woodward 17 US (4 Wheat) 518 (1819).
141 McNulty v W & J Sloane 54 NYS 2d 254 (1945).
142 Wilcox v Stern 18 NY 2d 195 (1966); Beloff v Consolidated Edison Co 300 NY 119 (1949) - cash exchanged for shares in merger.
certificate of incorporation may not restrict this class voting right. The minority shareholders ought to receive payment of the fair value of their shares in the same fashion as in the exercise of appraisal rights if the amendment they dissented from would adversely affect their interests.

8. Merger and Consolidation

For a merger to take place, where one of the constituent corporations survives and the other merges into it, or a consolidation, where none of the constituent corporations survives and a ‘new’ corporation is formed, a shareholders’ resolution of two-thirds, if the corporation was formed before February 1998, or of a simple majority, if the corporation was formed after February 1998, must be obtained. Minority shareholders are offered less protection and have less leverage if the corporation was formed after 1998. The minority shareholders may demand payment of the fair value of their shares in the exercise of their appraisal rights, if they are entitled to vote and do not consent to the merger or consolidation. However, the shareholders with respect to shares listed on a national securities exchange or NASDAQ will not be entitled to the appraisal rights. The rationale for it is that if there is a ready market, such a market is the most appropriate mechanism to determine the value of the shares and it would not be appropriate for the court to interfere directly in the market mechanism.

9. Remedy of Dissolution

The dissolution is similar to the winding up order in English law sought pursuant to

143 Business Corporation Law s 804.
144 This may be explained by the state’s policy to attract more business incorporating. This is so called
section 122 of the Insolvency Act 1986, whereby the court will grant the winding up order of a company, if it is ‘just and equitable’ for the court to do so, upon minority shareholders’ petition to the court. Under the state law of New York, holders of 20 per cent of voting shares of a corporation whose shares are not traded on a securities market may petition for dissolution if either the directors or those in control of the corporation have been guilty of illegal, fraudulent, or oppressive actions toward the complaining shareholders; or the assets of the company are being looted, wasted, or diverted by directors, officers, or those in control.\textsuperscript{145} ‘Oppressive’ conduct has been held to include conduct by majority shareholders that substantially defeats expectations of minority shareholders, which, viewed objectively, were both reasonable under the circumstances and were central to the petitioner’s decision to join the venture.\textsuperscript{146}

\section*{D. CASES IN OTHER STATES}

\subsection*{1. General}

Federal law has limited application to some company law issues, one of which is the protection of minority shareholder. Most of the States in the US have common law origin and, like the law in England, Delaware, and New York, company law is based on similar principles. One of the main differences lies in the degree and willingness

\footnote{the effect of ‘race to the top’, ‘race for the bottom’.}
\footnote{Business Corporation Law s 1104-a.}
\footnote{Re Kemp & Beatley Inc 64 NY 2d 63 (1984) - de facto dividends awarded to all except a class of minority shareholders.}
of the court in recognising any duty owed by the majority shareholders or the directors to the minority shareholders in a company. The following section discusses cases in different courts of different States. The analysis shows diversity of approaches at State level.

2. *Perlman v Feldmann*\(^{147}\)

*Perlman v Feldmann* is a federal appeal case concerning the law of Indiana. The action was brought by minority shareholders of Newport, an Indiana corporation, on the grounds that a former director of the company and a dominant stockholder, Feldman, had sold the shares to steel users, together with consequent rights to control distribution of steel, to Wilport, a group of syndicates. The court held that the director was accountable to the minority shareholders. There are three issues involved: first, whether the director, at the same time a dominant shareholder, owes a fiduciary duty to the minority shareholders; secondly, what is the nature of the minority shareholders’ right is, ie whether the action concerns a derivative right or a right personal to the minority shareholders; thirdly, how the damages should be quantified.

The court held that the defendant, the director and the dominant shareholder, stood in a fiduciary relationship to the company and to the minority shareholders as beneficiary thereof. Under Indiana law, there was no decided case directly addressing these issues. The Court relied on the equitable principles that the directors of a business or company are acting in a strictly fiduciary capacity and are entrusted with the company’s business by the company. The first principal duty arising from the official relation is to act in all trust wholly for the benefit of his company. The
responsibility of the fiduciary duty also includes the dedication of the director's uncorrupted business judgment for the sole benefit of the corporation, in any dealings, which may adversely affect it. The court further held that the defendant also owed fiduciary duties as majority shareholder, for in that capacity he could choose and control the directors. The plaintiff alleged that as a director, the defendant owed a duty of loyalty to the company, the fiduciary principal. In this case, the alleged breach is the diversion of corporate opportunity.

As a majority shareholder, the court did not forbid the defendant to dispose of the controlling block of stock to outsiders without having to account to his corporation for profits, nor did the court rule that it was a breach of duty to sell the shares to a buyer who was an interested customer, actual or potential, for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary that has caused the sacrifice, the fiduciary should account for his gains.

The second issue regards the nature of the suit. It was held that the directors and the co-defendants were accountable to the minority shareholders.¹⁴⁸ The plaintiff, the minority shareholder, was entitled to a recovery in his own right rather than that of corporation (as in derivative actions), because neither the purchaser nor the successors in interests should share in any judgment, which may be rendered.¹⁴⁹ Swan J dissented on this point and pointed out that this conclusion is inconsistent with the theory advanced at the outset of the opinion, namely, that the price of the stock 'included compensation for the sale of a corporate asset.' He further said that if a

¹⁴⁸ Restatement, Restitution SS 190,197 (1937); *Seagrave Corp v Mount*, above, 6 Cir, 212 F 2d 389.
corporate asset was sold, surely the corporation should recover the compensation received for it by the defendants. If the plaintiffs were suing in their own right, then the company was not a proper party.

Sales at a premium are lawful, and the controlling shareholder generally has no duty to spread the gains. However, the principle of equal treatment requires the sale of control to be shared compulsorily as control is a ‘corporate asset’. It is suggested that the court’s ruling, which held that Feldman could not accept the premium, was based on the belief, warranted by the facts of the case, that the shortage allowed Newport to finance needed expansion, and that the premium paid for the shares represented an attempt by the buyer to divert a corporate opportunity - to secure for itself the benefits resulting from the shortage. The court said on this point that ‘only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed.’

Unfortunately, this case has not been followed consistently by subsequent cases. It was not followed by *Ida Bokat v Getty Oil Company*, where the court held that a shareholder bringing a derivative action is not able to recover in his own right under

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149 *Southern Pacific Co v Bogert* 250 US 483, 39 SCt 533, 63 LEd 1099.
150 *Treadway Co v Care Corp* 638 F2d 357 (2d Cir 1981); *Zetlin v Hanson Holdings* 48 NY2d 684, 397 NE2d 387 (1979); *Tryon v Smith* 191 Ore 172, 229 P2d 251 (1951); See R W Hamilton ‘Private Sale of Control Transactions: Where We Stand Today’ (1985) 36 Case WResLRev 248; Firms may repurchase shares from particular investors at a premium or make a general offer but exclude one or more named investors. See *Unocal Corp v Nesa Petroleum Co* 493 A2d 946 (Del 1985); See generally J Macey & F McChesney ‘A Theoretical Analysis of Corporate Greenmail’ (1985) 95 Yale LJ 13; A Schleifer & RW Vishny ‘Greenmail, White Knights, and Shareholders’ Interest’ (1986) 17 Rand J Econ 293; *Getty Oil Co v Skelly Oil Co*, 267 A2d 883 (Del 1970), is among the many cases allowing firms to allocate corporate opportunities to privileged insiders; *El Du Pont de Nemours & Co v Collins* 432 US 46 (1977); *Weinberger v OUP Inc* 457 A2d 701 (Del 1983) allow unequal division of the gains from mergers; See also *Fins v Pearlman* 425 A2d 305 (Del 1980).
152 *Perlman v Feldmann* 219 F2d 173 (2d Cir 1955) 177.
the law of Delaware. The court explained this by saying that the cases which followed *Perlman v Feldmann* either have particular circumstances that justify permitting a shareholder plaintiff in a derivative action to continue the suit in his own right, or are simply in opposition to the law of Delaware. In Delaware, a member or an assignee of an interest in a limited liability company may bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favour if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed. Therefore, a personal right to bring a case to the court is a last resort for the shareholders.

3. *June K Jones v H F Ahmason & Company*

In *June K Jones v H F Ahmason & Co*, a minority shareholder brought an action in the superior court against a holding company formed by the defendant’s majority shareholders and officers of the association. The plaintiff sought damages and other relief for losses allegedly suffered by the minority shareholders as a result of breaches of fiduciary responsibility by the defendants in the creation and operation of the holding company. The owner of 85 per cent of the shares of United Savings and Loan Association, a closely held corporation, organised a Delaware holding company. In exchange for shares of the holding company, they transferred all their shares in the savings and loan association along with other business. The original controlling shareholders of the savings and loan association ended up with stock in a leveraged holding company; the position of the minority shareholders of United was unaffected.

153 *Taormina v Taormina* 32 Del Ch 18, 78 A2d 473.
In the next few years, the prices of the shares of the holding company went up. After the rise in the holding company’s share price, the minority shareholders demanded admission. The minority shareholders were offered $2,400 per share as opposed to the equivalent market value of $8,800. The court allowed minority shareholders to elect between the appraised value of their shares at the time of the exchange and the price of the holding company shares that they would have had at the time of the action.

The plaintiff claimed that the right is not derivative in nature, but is brought for injury to her and the other minority shareholders. The case relied on by the plaintiff was Shaw v Empire Savings & Loan Association, where it was held that the shareholder of a company has no personal or individual right of action against third persons, including the corporation’s officers and directors, for a wrong or injury to the corporation which results in the destruction or depreciation of the value of the stock, since the wrong thus suffered by the shareholder is merely incidental to the wrong suffered by the company and affects all shareholders alike.\textsuperscript{155} The exception to the rule is the case where the minority shareholder can show that the injury was different from that of the other minority shareholders. However, the court in June K Jones v H F Ahmason & Co held that the rule was erred, and to have a cause of action the plaintiff does not need to prove that the injury was unique to the plaintiff, rather that the injury may affect a substantial number of shareholders.

The decision in June K Jones v H F Ahmason & Co has been criticised as it would produce inefficiencies because participation by the minority’s shares in the holding company would decrease the incentive of the controlling shareholders to generate
gains by incurring the costs of consolidating the related businesses. Moreover, the
court did not grasp the significance of the minority shareholders’ delay in bringing
suit. The minority shareholders should not take a free-ride on the benefits that
represented the expected reward from the increased value of the transformed asset.
The court’s *ex post facto* view of fairness, giving the minority shareholder a right to
participate in the gains without taking the risk of loss, would go a long way toward
discouraging beneficial control transactions.\(^{156}\)

With regard to the majority shareholder’s duty to the minority shareholders, the
Courts of Appeal have often recognised that majority shareholders, either singly or
acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the
minority shareholders and to the company to use their ability to control the
corporation in a fair, just, and equitable manner. The majority shareholders may not
use their power only to their own benefit or in a manner detrimental to the minority.
The power of control of the corporation must benefit all shareholders proportionately
and must not conflict with the proper conduct of the corporation’s business.\(^{157}\) In
other words, the court focuses on the duties of majority shareholders as well as
directors towards the shareholders rather than towards the company. The court
affirmed in *Remillard Dandini Co*, that the fiduciary obligations, arising from trust, of
directors and shareholders are neither limited to specific statutory duties and
avoidance of fraudulent practices nor are they owed solely to the corporation to the
exclusion of other shareholders.

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\(^{155}\) *Shaw v Empire Savings & Loan Association* 186 CalApp2d 401, 407.

\(^{156}\) FH Easterbrook & DR Fischel *The Economic Structure of Corporate Law* (Harvard University

\(^{157}\) *Brown v Halbert* 271 Cal App2d 252; *Burt v Irvine Co* 237 CalApp2d 828; *Effort v Kalmanovitz*
The issue is a matter belonging to the individual State, and federal courts do not have jurisdiction over this matter. A federal court in *Christophides v Porco*\(^{158}\) held that the majority's act which caused a diminution in the value of minority shares did not violate the Securities and Exchange Act of 1935, section 10(b), although the charge might have significance 'in respect of some sort of a state-created claim for fiduciary breach' over which the court lacked jurisdiction.\(^{159}\) However, as has been discussed above, the court under the *Santa Fe* rule may, under certain circumstances, assume the jurisdictions under the Securities Exchange Act 1934.

In *Parfi Holding AB v Mirror Image Internet Inc*,\(^{160}\) where the minority shareholders alleged breaches of fiduciary duties in diluting minority shareholders ownership and brought an action on the grounds of illegality and fraud, the court refused to grand the relief because the minority shareholders knew all along that the transaction was unfair. The minority shareholders also claimed that there was an implied contract with the majority shareholders that future stock offerings would be made available to minority shareholders. The court held that the minority shareholders failed to plead facts evidencing a course of conduct supporting that there was an implied contract. The court did not rule out majority shareholders' duties owed to the minority shareholder. Rather, it was the fact that the minority shareholders had been aware of the unfairness of the deal before the agreement was entered into that led the court to rule in favour of the majority shareholders in that case.

\(^{158}\) *Christophides v Porco* (SDNY 1968) 289 FSupp 403.

\(^{159}\) *Christophides v Porco* (SDNY 1968) 289 F.Supp 403,407.
E. CONCLUSION

US federal and state case law provides an interesting comparator to the position in England and Wales. In the US, the courts have developed a private actions model alongside the models of regulatory control and market control.

Federal law does not provide a comprehensive protection of minority shareholders rights but only a limited protection that mainly concerns procedural fairness under the Santa Fe rule. Federal courts have shown unwillingness to extend the scope of the protection beyond procedural matters. They are not inclined to consider the substantive fairness of the outcome of the takeover bid, even if the minority shareholders have received a grossly undervalued bid for their shares. Under federal law, the minority shareholders will have no standing to assert their rights in the merged or taken over company, in case of squeeze-out. However, federal courts may be willing to re-formulate the Santa Fe rule by looking at the State law as a matter of fact in determining whether the conduct amounts to manipulation and deception. By doing so, they would give minority shareholders a more adequate form of protection, which would coexist with the existing protection provided by the mandatory disclosure rule and pro rata rule under the Securities Exchange Act 1934.

Under Delaware law, the remedies available to the minority shareholders include injunction, statutory appraisal rights, and quasi-appraisal right established by the Weinberger rule. Before the bid is consummated, if the minority shareholders assert manifest procedural unfairness in the process and can prove irreparable harm to them

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160 Parfi Holding AB v Mirror Image Internet Inc 2001 WL 16714411 (Del.Ch.)
once the bid is consummated or if the merger plan proceeded, an injunction will be
granted. Even if minority shareholders have tendered their shares or dissent from the
merger vote, they will be able to commence quasi-appraisal proceedings if there is
procedural or substantive unfairness. Even if there is no element of unfairness,
minority shareholders may commence action based on statutory appraisal right, which
only relates to the issue of price. Under Delaware law, directors and majority
shareholders owe duties directly to the minority shareholders where change of
corporate control is in question.

New York law enacted statutory provisions to govern the conduct of internal affairs
by giving the choice of cumulative voting rights to remove the problem of under­
representation of minority shareholders and requiring a business purpose for merger
and consolidation. However, for companies formed after 1998, minority shareholders’
protection was reduced by the lowering of the majority from 75 per cent to 50 per
cent required for the resolution necessary to approve substantial changes in the
company. As far as minority shareholders’ standing is concerned, New York state law
recognises duties owed by the majority shareholders and the directors of the company
directly to the minority shareholders. Alongside this remedy, New York law interprets
the requirement for the derivative action quite broadly.

Analysis of cases in other jurisdictions also suggests that minority shareholders have
a personal right to bring an action against the wrongdoers. However, the issue is still
open as to whether a duty is owed to the minority shareholders, rather than
shareholders as a whole.
CHAPTER X

GENERAL CONCLUSION

A. OVERVIEW

In this chapter, the main conclusions of this study will be drawn. The discussion relies on four models of control of takeover: the internal control model, the market control model, the regulatory control model, and the private actions model. The structure of the conclusions reflects the structure of the analysis carried out in the previous chapters. First, the theoretical bases for effective protection of minority shareholders are discussed, followed by the analysis of the internal control model, the market control model, and the principle of shareholders’ legitimate expectations. Secondly, the private actions model in the current English common law is analysed. Thirdly, the statutory protection is addressed. The conclusions on remedies will follow. Then, the impact of criminal and regulatory enforcement on minority shareholders is examined. Throughout this chapter, reference will be made to US federal and state laws as a comparator to the English position.

The conclusion of this study is that effective protection of minority shareholders must rely on the private action model. None of the other models, on its own or in combination
with the others, can provide effective protection of minority shareholders’ rights in takeovers without the complement of the private actions model. The private actions model is underdeveloped in England. This is because the law does not impose duties on the directors and the controlling shareholders to the minority shareholders where change of corporate control is in question. It appears, however, that in the traumatic scenario of change of control, those who exercise actual control on the company should owe a duty to the minority shareholders to act fairly so as not to harm their legitimate interests and expectations. The scope of interim and final remedies available to minority shareholders should be broader, funding arrangements should include contingency fees (currently illegal in England in contentious matters), and a pre-action protocol for shareholders disputes should be introduced.

B. MINORITY SHAREHOLDER PROTECTION

This study addressed the problem of minority shareholder protection in takeovers. While there has been a wealth of research and cases on minority shareholders’ protection in small private companies, there is little research on the legal basis of minority shareholders’ protection in public and listed companies. The general view appears to be that in a listed company the most appropriate remedy for minority shareholders should be to rely on the stock market, where they can sell out their shares at the current share value if they do not want to maintain their investment in the company. Courts in England have
not been reluctant to intervene in takeover transactions. However, the development of the common law in the US, and especially in Delaware, shows that courts can adopt a different approach to enhance accountability of company directors and majority shareholders to the minority.

In principle, control over a takeover can be exercised through four different models. Under the internal control model, control of takeover transactions is exercised through mechanisms internal to the company. Under the regulatory control model, public authorities or bodies exercising public functions have the duty and the power to supervise takeover transactions in the public interest. Public interest does include the interests of the stakeholders, including minority shareholders, but stakeholders themselves have little control over the enforcement process. Under the market control model, the market mechanism will 'regulate' the market for corporate control according to the forces of buy and sell. Finally, the private actions model relies on the affected parties to bring legal proceedings in the courts to protect their own interest and, indirectly, enforce principles of fairness and accountability within the company.

A number of considerations point towards the need for enhanced protections of minority shareholders in takeovers. Furthermore, these arguments suggest that shareholders should be empowered to protect their own interests by way of recourse to the process of litigation. These are the following. First, minority shareholders have a proprietary interest in the company. Article 1 of Protocol 1 to the European Convention of Human Rights recognizes a fundamental right to property. Secondly, shareholders may be deemed to
enter into contractual arrangements with the company and between themselves. However, not all terms of such contracts can be expressly negotiated without incurring inefficient transactional costs. Therefore, courts must intervene ‘to fill the gaps’ by imposing fiduciary duties on directors and shareholders. Thirdly, shareholders’ active participation in the management of the company stimulates total wealth creation. Fourthly, empowering minority shareholders is necessary to protect them from abuses of the majority rule. Finally, the theories of corporate social and ethical responsibility and distributive justice demand that stakeholders be more actively involved in managing the corporation but also be granted a ‘voice’ capable of being heard by the controllers and the supervisory authorities.

C. THE INTERNAL CONTROL MODEL

The internal control model is analyzed through examining the essential constituents of the internal structure of the company: control and constraint. Takeover is a way to obtain control by one company over another, and control is a term not yet clearly defined in law and in practice.¹ Traditionally, control is regarded as a proprietary right over something.² However, this theory is no longer sufficient to explain the nature of control in the modern capitalist societies where corporations are characterized by separation of ownership and

¹ See the analysis in chapter I. Herman Corporate Control, Corporate Power (University of Cambridge Press Cambridge MA1981).
control.

The analysis of the concepts of corporate control and corporate constraint in chapter II led to the following conclusions. Accountability is the primary duty of the corporate controller. To whom the duty of accountability is owed will be determined according to the legal basis of control. In English law, a director owes a fiduciary duty to the company, rather than a shareholder, whereas a bank, as finance controller, does not owe a duty to any member of the company. In fact, a bank does not owe a duty, but a contractual obligation to the company. A majority shareholder owns and controls the company, but he does not owe a duty to the rest of the shareholders, and, indeed, he does not owe a duty to the company. Therefore, a person, either legal or natural, could be a *de facto* controller without the duty of accountability to the company or the interested persons. However, accountability is of crucial importance in corporate transformations, especially in changes of corporate control where there is a deal only between the pre-controller and ex-controller. The principle of accountability, as well as other principles such as fairness and equality, must be upheld to ensure the protection of persons interested in the company. As shareholders have direct property interests in the company, these interests should not be ignored or sacrificed by the controllers of the company. Therefore, in every system for takeover governance, the controllers must be capable of being identified in order to be accountable to the controlled, defined according to their interests in the company. However, any form of protection of the shareholders in corporate control transactions should not sacrifice the utilities that takeovers will bring to the company, and the

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3 Chapter I. M Zeitlin 'Corporate Ownership and Control: The Larger Corporation and the Capitalist Class' (1973-74) 79 American Journal of Sociology 1073.
economy as a whole, without clear and convincing justification. To give more protection to the controlled will increase the accountability of the controllers. On the other hand, the role given to the controlled must be proportionate to the optimal accountability of the controllers.

D. THE MARKET CONTROL MODEL

Chapter III addressed the issue of a market for corporate control in which the interests of minority shareholders are left to be 'regulated' by the market mechanism alone. Minority shareholders of the target company may be affected in a takeover situation through dilution of their shareholdings. As a consequence of such a dilution, the constraint exercised by non-controlling shareholders over the controlled is diminished in the post-takeover scenario. It is also possible that shareholders tendering their shares are not paid a price which incorporates the appropriate control premium. On the other hand, the decisional powers of the minority shareholders in the takeover process may be very limited. Often, their only choice is whether or not to tender their shares and this decision is influenced by the information that the controllers of the offeror and the offeree make available to them. The analysis carried out in chapter III has shown that the market control model alone does not provide minority shareholders with adequate protection in takeovers. The internal model does provide an answer to some of the problems by requiring shareholders' approval for certain action to be taken by the directors or for
certain transactions to be carried out. However, in many situations minority shareholders do not have a real say on the takeover and, even if a resolution is required, the majority rule means that minority shareholders are likely to be outvoted.

E. THE PRINCIPLE OF LEGITIMATE EXPECTATIONS

Chapter IV examined minority shareholders' legitimate expectations from the perspective of a rights-based theory. There are several rights that the minority shareholders are entitled to, including the right to capital, the right to vote, the right to dividends, the right to management, the right to information, the right to a fair and equal treatment, and the right to bring a claim or standing. From an economics point of view, minority shareholders' rights serve the function of reducing the agency cost, because minority shareholders can increase the degree of the controller's accountability.

The analysis of shareholders' legitimate expectations in the context of corporate decision-making has shown that the majority rule principle cannot, ipso facto, legitimise the decision of the general meeting. The model of democracy must incorporate the concept of deliberative democracy in which the majority shareholders owe a duty to contemplate the minority shareholders' interests while casting their votes on issues affecting them. Shareholders' legitimate expectations also include the expectation that the deliberative process in the company will be fair and not biased against them.
Both the rights-based theory and the principle of deliberative corporate democracy receive support by scholarly thinking on company law and corporate governance based on the ideas of corporate ethics and company social responsibility. Although these theories may not always be easily translated into practice, and it may not always be desirable to do so, they do provide authoritative support to the thesis that minority shareholders' rights and the standing to enforce such rights are justified on grounds of legitimate expectations and serve the purpose of enhancing the standards of corporate governance and social responsibility of the company.

It is the conclusion of the analysis of shareholders' legitimate expectations carried out in chapter IV that minority shareholders have the expectation that: 1) their interests as capital providers will not be unfairly or unjustly compromised; 2) the democratic deliberative process in the process will be fair. If these legitimate expectations are not upheld under the internal control model, then minority shareholders have a legitimate expectation that they will be able to obtain redress by bringing legal proceedings against the company, the directors, or the controlling shareholders as the case may be. The fundamental role of the private action model becomes evident.
The analysis of the English common law shows that there is a gap between the protection that should be afforded to minority shareholders as members of the company and the rights and remedies that they have at common law. In company law, all shareholders have certain indiscriminative rights such as the right to capital, the right to dividend, the right to information, the right to management, the right to vote. However, what distinguishes minority shareholders from majority shareholders is the right of the majority to initiate a proceeding against the controllers. This also has a discriminative effect on the indiscriminative rights of the shareholders, such as the right to capital and the right to vote.

At common law, minority shareholders do not have an automatic right to initiate court proceedings against the controllers. The company is said to be the appropriate institution to bring such proceedings. The exception to this rule is when the controllers commit an illegal act, arguably an *ultra vires* act, an act committed without the required special resolution, and an act falling within the scope of 'fraud on the minority'. It appears to be justified to say that in the situation of illegality and *ultra vires*, the proceedings brought by the minority shareholders aim to enforce derivative rights. However, in the situation of ‘fraud on the minority’, it is suggested that the right should be regarded as a personal

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5 See Chapter IV.
6 *Foss v Harbottle* (1843) 2 Hare 461; V Brudney 'Equal Treatment of Shareholders in Corporate Distributions and Reorganisations' (1983) 71 CalifLRev 1078, 1087.
7 *Foss v Harbottle* (1843) 2 Hare 461. For the discussion of this seminal case, see above Chapter V.
right as the act is directed against the interests of the minority shareholders. This calls for just compensation or other effective remedies to be awarded to the minority shareholder in his own right.

An overall assessment of the English common law shows that English courts have so far favoured the market control model and the internal control model. The private action model is undeveloped. This approach has been adopted to solve the floodgate problem. However, it appears that the courts are able to dismiss unwanted actions by applying the doctrine of abuse of process and using their powers under the CPR. There is no need to place limitations on the standing of minority shareholders especially where a personal right based on harm to the shareholder can be identified. If the harm to the minority shareholders is not insignificant and there is a clear evidence of differential treatment or unfair prejudice, there is no reason to deny standing to minority shareholders to bring actions against the controllers of the company, including directors and controlling shareholders. The harm must be caused by the wrongs of the wrongdoers, but it should not depend on whether the wrong was ratifiable or has been ratified. The next step is to identify the wrongdoers, be it the company itself, directors, majority shareholders, or even third parties. The relationship between the wrongdoers and the minority shareholders can be fiduciary, contractual, or of proximity in the tortuous sense. The wrongdoers will be able to raise the defence of ratification, in which they must prove that in the process of ratification there is no abuse of power that renders the process unfair.

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9 See the analysis in Chapter V.
The Human Rights Act 1998 does not bring about a 'sea change' in the protection of minority shareholders' protection. The European Court of Human Rights adopts a doctrine of legal personality and limitations on shareholders' standing that are in line with the English common law. The real significance of the Human Rights Act 1998 is that courts have a duty under the Act to construe and apply the law in a way which is, as far as practicable, consistent with Convention rights. This means construing and applying the common law and the statutes protecting minority shareholders so as to give effect to their proprietary rights. This may give rise to a more harm-based and rights-based jurisprudence on shareholders' actions than has been the case so far.

Alongside the derivative action, the English common law recognizes other legal bases for minority shareholders' actions. Minority shareholders may bring an action against the controller in contract if a contractual arrangement can be established.\(^\text{10}\) Alternatively, the wrong committed by the controllers towards the minority shareholders can be tortious or fiduciary in nature. The nature of the right that is being enforced in any given case may at times be rather confusing.

Some jurisdictions address the problem of minority shareholders' standing to sue by way of statutory provisions laying down clear requirements that must be fulfilled for minority shareholders to be able to bring an action against the controllers of the company.\(^\text{11}\) The law in both New York and Taiwan allows a representative suit to be brought by the minority shareholders against the wrongdoers subject to the requirement of making a

\(^{10}\) See Chapter IV; Companies Act 1985 s14.
\(^{11}\) Business Corporation Law, New York; Company Law, Taiwan.
request to a body within the company capable of initiating the proceedings.\textsuperscript{12} The representative suit, although proposed by the Law Commission, has not been incorporated into the Companies Act 1985. A way forward would be to adopt, in English law and on a statutory basis, a form of representative suit that enables minority shareholders holding a certain percentage of the shareholdings for a given period of time to initiate the proceedings against the controllers, with or without permission or approval of the general meeting. This would clarify the common law position under \textit{Foss v Harbottle} which, as currently stands, creates uncertainty and a lack of legal protection for the minority shareholders.\textsuperscript{13}

\textbf{G. STATUTORY PROTECTION}

Statutory provisions provide an additional basis for the protection of minority shareholders that the common law fails to protect under the current restrictive approach.\textsuperscript{14} It has been suggested in this thesis that under section 459 of the Companies Act 1985, minority shareholders should be protected from the exclusion of management, dilution of shareholding, exclusion from consultation and information, and damages incurred from the mismanagement of the company by the controllers. The minority shareholders should have the right to petition to the court for relief as long as they can show that there is unequal treatment. Unfairness should be inferred from the degree of damages and harm to

\textsuperscript{12} See Chapter IV.
\textsuperscript{13} \textit{Foss v Harbottle} (1843) 2 Hare 461.
\textsuperscript{14} See Chapter V.
the petitioning shareholders. Case law suggests that the court will grant the petition if there is a breach of minority shareholder’s ‘legitimate expectation’.\textsuperscript{15} How far the court is prepared to extend this rule to cover the situations described above is not clear. However, it is suggested that the court should bear the objective of ‘corporate governance’ and the model of ‘corporate governance’ in mind while ruling on the issue of the ‘informal understanding’ between the shareholders rather than narrowly focusing on equitable principles that do not incorporate the modern concept of ‘shareholders’ activism’.

A minority shareholder’s petition for a ‘just and equitable’ winding up order under section 122 of the Insolvency Act 1986 may not be granted if the harm or damages committed towards the minority shareholders are not of such magnitude that is proportionate to the winding up of the company.\textsuperscript{16} The consequence of this approach is that if only the interests of a small proportion of minority shareholders, rather than those of minority shareholders holding a large stake capable of influencing the decision-making process, are affected by the controller’s unfair conduct, a winding up order would be regarded by the court to be disproportionate. It is suggested that even if the winding up order sought on petition cannot be awarded by the court, if the court rules that there is an unfair conduct resulting in discriminative harm to the minority shareholders, the minority shareholders should be entitled to some other relief. However, unless it is accepted that the controllers of the company owe a fiduciary duty to the minority, it is difficult to envisage what such relief could be under the current English legal framework.

\textsuperscript{15} Re Saul D Harrison & Sons plc [1995] 1 BCLC 14, 19 per Hoffmann J.
\textsuperscript{16} Ebrahimi v Westbourne Galleries Ltd [1973] AC 360; Re Chesterfield Catering Co Ltd [1977] Ch 373.
In statutory rescue programmes, such as the voluntary arrangement under the Insolvency Act 1986, capital restructuring, and the schemes of arrangement under the Companies Act 1985, courts should play a more active role in safeguarding minority shareholders’ interests. The key concept in such voluntary schemes is that of ‘compromise’. The court may withhold the sanction of a scheme which requires the court’s approval if the scheme is not a ‘compromise’ involving some element of ‘give and take’. Under this approach, the court may assess the arrangement to make sure that the interests of all the parties involved have received a reasonable and fair treatment. This is because the arrangement requires a ‘compromise’, which implies a degree of reasonableness based on a process of bargain on equal footing.

The statutory protection of minority shareholders is complemented by the self-regulatory provisions of the Takeover Code. The Takeover Code protects the minority shareholders’ interests through provisions such as the Rules Governing Substantial Acquisitions, the disclosure rules, and the mandatory bid provisions. The Rules Governing Substantial Acquisitions require the acquirer of the shares to disclose the total percentage of the shareholdings and has the effect of preventing the ‘crept in’ practice that will result in the shareholders not being able to share the ‘control premium’. The mandatory offer rules enable the minority shareholders to share the ‘control premium’ with the other shareholders. In contrast, the US Securities Exchange Act 1934 does not make provisions for a mandatory bid. Therefore, it is permissible under federal law for a bidder to make an offer to purchase only the shares that are sufficient to obtain control. In such an

17 See Chapter V.
18 See Chapter V.
19 See Chapter VIII.
instance, the ‘control premium’ is not paid in full to the shareholders. By contrast, in the UK the remaining shareholders who did not accept the offer may exercise their rights to have their shares bought by the bidder at the same price as the offering price within the period of four months if the bidder holds more than 90 per cent of the shares. However, if the bidder holds less than 90 per cent of the shareholding, the remaining shareholders will not have the right to have their shares bought at the offering price. Even if the bidder holds more than 90 per cent of the share capital, the minority shareholders will not be able to exercise the right to sell at the same price as the offering price after the four months period. Even if there is ‘unfair prejudice’ or some other grounds justifying the remedy of ‘selling out’, it is unlikely that the court will order the controller, or the bidder, to purchase the share at such a premium as the offering price. This is because there is already a ‘ready market’ for the shares to be bought, and the court is unlikely to intervene in the market mechanism.

H. PROCEDURE AND REMEDIES

If the private action model is to develop, it is important to set up a pre-action protocol for disputes between shareholders, or shareholders and the company or the controllers of the company. A pre-action protocol should deal with issues of exchange of information and pre-action disclosure to ensure that cases will be conducted on an equal footing and

minority shareholders will not be prejudiced by lack of accessibility to corporate information. A pre-action protocol also serves the purpose of facilitating early settlement of the dispute and, if proceedings arise, exchange of information between the parties prior to the litigation will help the court in its case management.

Among interim remedies, interim injunctions are particularly important. Interim injunctions should be more easily obtainable in favour of minority shareholders. It may be difficult for shareholders to satisfy the three-limb test laid down by the *American Cyanamid* case. More often than not, the sought injunction amounts to disruption of the company’s business. Therefore, the balance of convenience would probably come down against the grant of an injunction. However, in takeovers or friendly mergers the preservation of the *status quo* may weigh in favour of enjoining the transaction. Furthermore, our analysis has come to the conclusion that courts should give proper weight to the role of minority shareholders’ actions as an element of corporate governance. To impose undue limitations on the development of the private actions model weakens the internal control model. For the internal control model to work well, directors and controlling shareholders should be accountable to the minority shareholders through, *inter alia*, private actions. This analysis counterbalances the arguments to the effect that the company’s business should be disrupted as little as possible. The role of minority shareholders and their legitimate expectations should be taken into account in the application of the test derived from equity, ie the balance of convenience.

As regards final remedies, the scope of the final orders should be broader, taking into
account the needs of the minority shareholders and the difficulties in the enforcement of orders such as mandatory injunctions or a court order to compel the management to behave in a certain way. If buy-out is the only realistic remedy, the method of valuation should take into account the interaction of the minority shareholders and the company. The more involved the minority shareholders are in the management of the company, the more favourable to the minority shareholders the valuation method should be. This will encourage and reward shareholders’ activism. The rationale for this is that shareholders’ activism is a fundamental tool of corporate governance.

The European Takeover Directive does not have any significant impact on shareholders’ remedies except in the area of State liability for breach of Community law. The liability of the State for failure adequately to implement the Directive would extend to any authority designated under Article 4(1) as competent to supervise the bid, including self-regulatory bodies. However, the Community law remedy of damages against the State and emanations of the State is a weapon of last resort for shareholders. It can be defined as a residual and exceptional remedy. The reality is that the Takeover Directive is based on the regulatory model. It does not affect the private actions model, the regulation of which is left to the Member States.

The issue of the funding of the proceedings is crucial to the development of the private actions model. Fee arrangements such as contingency fee arrangements, currently illegal in contentious matters in England and Wales but widely used in the US, should be made

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available to minority shareholders as a means to fund their proceedings. It also appears that contribution to the costs incurred by minority shareholders should be more readily available not only when they bring a derivative action, but also when they bring a personal action or a petition under section 459 of the Companies Act 1985. For instance, even if the proceedings under section 459 are strictly not an action on behalf of the company, the court should be more willing to allow the minority shareholder’s request for contribution to the costs by the company.

I. CRIMINAL AND REGULATORY ENFORCEMENT

Chapter VIII analyzed the regulatory control model and its implications. Because of the impact on criminal and regulatory enforcement on the trading of the shares, the combination of the regulatory control model with the market control is fatal to minority shareholders. In most cases, they will have to sell their shares at a loss or will see the share price go down without redress. Furthermore, criminal and regulatory enforcement do not serve the purpose of compensating minority shareholders for their losses. The only mechanisms that goes some way in this direction is the restitution order that can be obtained by the FSA under FSMA 2000. However, even in the case of restitution orders, minority shareholders have too little control over the procedure.

The regulatory control model must be complemented by the private actions model. The
two models do not clash but complement each other. Chapter VIII examined the procedural interactions between administrative and civil proceedings and showed that shareholders may benefit from enforcement action by public authorities in that they may rely on the findings of the administrative investigation or make use of the evidence and sources of information obtained by the regulators. Furthermore, criminal and administrative proceedings do not have a delaying effect on the civil action. Private actions will not have to be stayed only because criminal or administrative proceedings relating to the same facts are under way.

J. GENERAL CONCLUSION

This thesis has shown that protection of minority shareholders under current English law is too limited. The analysis included an integrated approach that assessed different forms of protection available at common law and under statute. Further issues of remedies and funding were also analysed. Finally, lessons were drawn from US law. The main conclusion of this study is that there are sound justifications in legal theory and comparative analysis for developing private actions model as a model of control of takeover transactions. This could be achieved by relaxing the strict requirements of the derivative action, and recognising that in cases of fraud on the minority, where there is an identifiable harm to minority shareholders, they should have a personal as opposed to a derivative right to bring an action. Furthermore, the area of fiduciary duties owed by the
controllers to minority shareholders can be expanded. In a takeover situation, where change of control is in question, those who exercise actual control over the company should owe a duty to the minority shareholders to act fairly so as not to harm their legitimate interests and expectations. US state law has moved in this direction although there is still some uncertainty in the US cases as to the exact scope of the fiduciary duty and the persons to whom the duty is owed.
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