

DOES SHAREHOLDERS' PARTICIPATORY POWER UNDERMINE THE BOARD AUTHORITY IN THE UK COMPANY LAW?

İngiliz Şirketler Hukukunda Pay Sahiplerinin Yönetime Katılma Yetkisi Yönetim Kurulunun Otoritesini Zayıflatır Mı?

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Abstract

The financial crisis of 2007-8 has focused increasing attention on the accountability of directors. Demands of greater accountability has given further impetus on shareholder empowerment. However, in particular, director primacy theory fiercely advocates limiting shareholder power because shareholder participation undermines the board authority to manage company freely and forces the board to act in the interests of shareholders rather than in the long-term interests of the company. The UK perspective has not enjoyed any sustained examination of the relationship between shareholder power and the board authority.

This paper examines the amendment of articles of association, shareholders' reserve power, the appointment and removal of directors, executive remuneration and takeover regulations in the UK and the board authority under UK case law, and argues that shareholder power does not undermine the authority of the board and these two concepts are compatible with each other.

Keywords: UK company law, director primacy theory, directors, shareholders, the allocation of power, the board authority

Özet

2007-8 Finansal Krizi şirket yönetim kurulu üyelerinin hesap verebilirliği kavramını gündeme getirmiştir. Şirket yönetim kurulu üyelerinin daha fazla hesap verebilirliğini sağlamak için pay sahiplerinin yetkilerinin artırılması gerektiği savunulmaktadır. Fakat, özellikle yönetim kurulu üyelerinin üstünlüğünü savunan görüşe göre pay sahiplerinin yönetime katılması yönetim kurulunu etkisiz hale getireceğinden ve yönetim kurulunu sadece pay sahiplerinin kısa dönemli menfaatlerine odaklanmasını sağlayacağından pay sahiplerinin gücünün kısıtlanması gerekmektedir. İngiliz şirketler hukukunda pay sahiplerinin yetkileri ile yönetim kurulunun otoritesi (yetkileri) arasındaki ilişki yeterince incelenmemiştir.

Bu çalışmada pay sahiplerinin ana sözleşme değişikliği, pay sahiplerinin saklı yetkisi, yönetim kurulu üyelerinin atanması ve görevden alınması, yöneticilerin ücret düzenlemesi, şirket devralma düzenlemesi ve yönetim kurulunun otoritesine ilişkin İngiliz Mahkeme Kararları incelenecektir. Bu makale, pay sahiplerinin yönetime katılma haklarının yönetim kurulunun otoritesini zayıflatmadığını ve bu iki kavramın birbiriyle uyumlu olduğunu ileri sürmektedir.

Anahtar Kelimeler: İngiliz Şirketler Hukuku, yönetim kurulunun üstünlüğü teorisi, yönetim kurulu üyeleri, pay sahipleri, yetki paylaşımı

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INTRODUCTION

The financial crisis of 2007-8 has led policymakers to focus on the excessive risk-takings of directors and managerial accountability problems in corporate governance.²In the UK, shareholders have been accused of being “asleep”.³The underlying rationale is that shareholders have not been critical about the business practices of companies in which they invest and should have monitored the board of directors.⁴To bridge the gap between shareholders and the management of companies, the UK Financial Reporting Council has issued the Stewardship Code,⁵ which considers shareholder activism a positive regulatory mechanism and aims to encourage shareholder activism. Some scholars also argue that shareholder empowerment is necessary for effective corporate governance and the maximisation of shareholder value.⁶ Therefore, shareholder power is considered a positive corporate governance attribute.

The literature has been, however, consistently conflicted about whether shareholders should play significant power over the structure and operation of companies.⁷The question of what roles shareholders and directors should play

² Jennifer Hill, ‘The Rising Tension between Shareholder and Director Power in the Common Law World’ (2010) 18(4) *Corporate Governance: An International Review* 344.

³ Jennifer Hughes, ‘FSA Chief Lambasts Uncritical Investors’, *Financial Times* (11 March 2009).

⁴ David Walker, A Review of Corporate Governance In Banks And Financial Institutions: Final Recommendations (Nov. 2009) (Hereinafter Walker Review) at 5.10-11, Available At http://www.Hm-Treasury.Gov.Uk/D/Walker_Review_261109.Pdf.

⁵ The Financial Reporting Council, UK Stewardship Code, available at <https://www.frc.org.uk/investors/uk-stewardship-code>.

⁶ Bernard Black, ‘Shareholder Passivity Reexamined’ 89(3) *Michigan Law Review* 520; Randall Thomas, ‘Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information’ (1990) 38 *Arizona Law Review* 331; Lucian Bebchuk, ‘The Case Against Board Veto in Corporate Takeovers’ (2002) 69 *The University of Chicago Law Review* 973; Lucian Bebchuk, ‘The Case for Increasing Shareholder Power’ (2005) 118 *Harvard Law Review* 833; Lucian Bebchuk, ‘Pay Without Performance’ (2006) 20(1) *Academy of Management Perspectives* 5; Lucian Bebchuk, ‘Letting Shareholders Set the Rules’ (2006) 119 *Harvard Law Review* 1784; Lucian Bebchuk, ‘The Myth of the Shareholder Franchise’ (2007) 93 *Virginia Law Review* 675; George Dent, ‘Academics In Wonderland: The Team Production and Director Primacy Models of Corporate Governance’ 44(5) *Houston Law Review* 1213; George Dent, ‘The Essential Unity of Shareholders and the Myth of Investor Short-Termism’ (2010) 35 *Delaware Journal of Corporate Law* 97; Lucian Bebchuk, ‘The Myth that Insulating Boards Serves Long-term Value’ (2013) 113 *Columbia Law Review* 1637; Ronald Gilson and Jeffrey Gordon, ‘The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights’ 113 *Columbia Law Review* 863; Paul Rose and Bernard Sharfman, ‘Shareholder Activism as a Corrective Mechanism in Corporate Governance’ (2014) 2014 *Brigham Young University Law Review* 1014.

⁷ *Infra* (n. 10 and 11)

in company law is a complex one and as old as companies themselves.⁸ Each jurisdiction has its own unique system for allocating legal powers between shareholders and directors.⁹ For example, while shareholders in the US have historically restricted power in terms of corporate governance rights,¹⁰ shareholders in the UK possess far more strong corporate governance powers.¹¹ Therefore, UK company law is highly shareholder-oriented in terms of corporate decision-making power.

Greater shareholder engagement or activism has not been always welcomed and has been met with apprehension and resistance in the literature¹² because it is argued that shareholder empowerment undermines the board authority and the board becomes vulnerable to shareholders and their interests.¹³ Therefore, they regard shareholder empowerment as value-reducing and an intervention to the board authority to manage company freely.

While the relationship between board authority and shareholder power has been examined by US company law scholars,¹⁴ it has not benefited a

⁸ Sofia Cools, 'The Dividing Line Between Shareholder Democracy and Board Autonomy: Inherent Conflicts of Interest as Normative Criterion' (2014) 2 *European Company and Financial Law Review* 258, p. 259.

⁹ See, Sofia Cools, 'The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers' (2005) 30 *Delaware Journal of Corporate Law* 697, 703.

¹⁰ Christopher Bruner, 'Power and Purpose in the Anglo-American Corporation' (2010) 50(3) *Virginia Journal of International Law* 580, p. 581.

¹¹ Christopher Bruner, *Corporate Governance in the Common-Law World* (Cambridge University Press, 2014) p. 28.

¹² See, Martin Lipton & Steven A. Rosenblum, 'Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come' (2003) 59 *Business Lawyer* 67; Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247; Stephen Bainbridge, 'Director Primacy The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547; Martin Lipton and Steven Rosenblum, 'Election Contests in the Company's Proxy An Idea Whose Time Has not Come' (2003) 59 *The Business Lawyer* 67; Lynn Stout, 'The Mythical Benefits of Shareholder Control' (2007) 93(3) *Virginia Law Review* 789; Theodore Mirvis, Paul Rowe, and William Savitt, 'Bebchuk's "Case for Increasing Shareholder Power": an Opposition' (2007) 120 *Harvard Law Review Forum* 43; Lynn Stout, *The Shareholder Value Myth* (Kindle Ed., Berrett-Koehler Publishers 2012); Stephen Bainbridge, 'The Case for Limited Voting Rights' (2006) 53 *UCLA Law Review* 601; Stephen Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) *Harvard Law Review* pp. 1735-1758; Stephen Bainbridge, *The New Corporate Governance in Theory and Practice* (OUP, 2008); William Bratton and Michael Wachter, 'The Case against Shareholder Empowerment' (2010) 158 *University of Pennsylvania Law Review* 653; Alan Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 36 *Seattle University Law Review* 639.

¹³ See, Dignam, (n 11), Part III.

¹⁴ See n. 11.

sustained examination from the UK perspective. This paper examines whether shareholders in the are able to undermine the board authority through the amendment of articles of association, the right to direct management, the appointment and removal of directors, say on pay, takeover regulation, and the board authority under UK case law. Such an examination will also wider implications on shareholder primacy and director primacy debates.

This article argues that shareholder power does not undermine the board authority and rejects the idea that the board cannot manage companies freely where shareholders do have strong participatory power. This article proceeds to set out and defend this proposition in four parts. The first part of this introduction, after which, Part II explains the key features of UK Corporate Governance. Part III first examines whether participatory shareholder rights, which enable shareholders to incorporate their perspectives into the decision-making process undermine the authority of directors. It then analyses the extent to which the board has authority and can resist the wishes of shareholders. Part IV concludes that the authority of the board is not undermined by shareholder power and that board authority is compatible with strong shareholder power.

I. KEY FEATURES OF UK CORPORATE GOVERNANCE

Corporate Governance in the UK is generally characterised by dispersed ownership, which means that it is extremely uncommon for a UK company to have a dominant shareholder.¹⁵ Share ownership is not concentrated in the hands of families, banks, or other institutions. Therefore, the UK corporate governance model is aptly described as an outsider system.¹⁶ The term 'outsider' is appropriate because shareholders rarely hold enough shares to have inside influence on public companies. However, in continental Europe, large companies tend to have dominant shareholders, who are well-situated to exercise internal influence.¹⁷

Share ownership of UK public companies is not static. It evolved from individual ownership to institutional ownership. Institutional shareholders first began to amass sizeable stakes in UK companies in the mid-1950s.¹⁸ In the

¹⁵ Ruth Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28(3) *Academy of Management Review* 447, p 448; Brian Cheffins 'Putting Britain on the Roe map: the emergence of the Berle-Means corporation in the United Kingdom'. in J. McCahery and L. Renneboog (eds), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets* (Oxford University Press, 2002) 147–70.

¹⁶ Christine Mallin, *Corporate Governance* (4th edition, OUP, 2013) Chapter 10.

¹⁷ Aguilera and Jackson (n. 14) p. 448-450.

¹⁸ John Armour and David Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727, p. 1770.

1960s, institutional shareholders held approximately 45 % of the shares of quoted companies, while individual investors held approximately 55%.¹⁹ Over time, these numbers have changed dramatically at the expense of individual investors. In 2016, the proportion of UK individual shareholders had decreased to 12.3% of shares of UK quoted companies, while the proportion of institutional shareholders had increased to 86.7 %.²⁰ Therefore, according to Davies, “it would be wrong to equate the UK pattern of shareholding with a fully atomised dispersal in which, for example, the largest shareholder typically holds no more than 1% of the voting rights”.²¹ It shows that single shareholders still do not hold large blocks of shares in UK corporations; therefore, ownership is still separated from control.

In a system of dispersed ownership, shareholders are assumed to be rationally apathetic.²² Where a shareholder holds a small portion of shares in a company, the shareholder has very little incentive to obtain information regarding the management of the company or to exercise control over management.²³ Shareholder control and monitoring would require the expenditure of time, effort, and capital, and communication with other shareholders.²⁴ Accordingly, it is not always rational for shareholders to seek control because of the cost of shareholder control and the fact that the benefits of improving the performance of the company would be shared by the shareholders according to the amount of shares they hold, not according to who incurred the cost of shareholder monitoring.²⁵ This free-rider problem discourages shareholders from expending resources to exercise control over the company.²⁶ Therefore, the rational strategy for dissatisfied shareholders is to sell their shares rather than seek more control.²⁷ A rational shareholder engages in monitoring only if the expected benefits of shareholder monitoring exceeds its costs. Additionally, since shareholders hold a small number of

¹⁹ Office of National Statistics, ‘Share Ownership Survey 2012’ (25 September 2013) http://www.ons.gov.uk/ons/dcp171778_327674.pdf (last visited 10 March 2018).

²⁰ Office of National Statistics, ‘Share Ownership Survey 2016’ (29 November 2017) <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2016#main-points> (last visited 30 December 2018).

²¹ Paul Davies, ‘Shareholders in the United Kingdom’ in Jennifer Hill and Randall Thomas (eds) *Research Handbook on Shareholder Power* (Edward Elgar 2015) p. 371.

²² Black (n 10) p. 527.

²³ Daniel Fischel, ‘The Corporate Governance Movement’ (1982) 35(6) *Vanderbilt Law Review* 1259, p. 1275.

²⁴ Fischel, (n 22) p. 1277.

²⁵ Fischel, (n 22) p. 1277.

²⁶ Bainbridge, *The New Corporate Governance in Theory and Practice* (n. 11) p. 202.

²⁷ Fischel, (n 22) p. 1277; Bainbridge (n 25) 202; Frank Easterbrook and Daniel Fischel, ‘Voting in Corporate Law’ (1983) 26(2) *The Journal of Law and Economics* 353, p. 420; see also, Albert Hirschman, *Exit, Voice and Loyalty* (Harvard, 1970).

shares, no shareholder would be likely to influence the outcome of voting in the company; therefore, they would hesitate to engage in monitoring actions.²⁸ Thus, shareholders are assumed to be inevitably passive, and the ownership and control is separated.

In a system of the dispersed ownership, the dominant paradigm is the separation of ownership and control.²⁹ Rational shareholder apathy leads to concerns that managers and directors could potentially act in an ill-advised or self-serving manner.³⁰ In economic parlance, managers could impose agency costs on shareholders.³¹ Agency costs are based on the premise that individuals are rational and seeking to maximise their own private interests and managers are no exception to this premise. Agency costs arise from the costs of the opportunistic behaviour of managers, the costs of monitoring, and the costs of mechanisms which align the interests of shareholders and managers.³² Hence, in a system of dispersed ownership, one of the primary targets of company law is to control and address agency cost problems and managerial accountability concerns.³³

Since the Cadbury Report in 1992, and through a succession of other reports culminating in the Walker Review of 2009, UK policymakers have consistently supported encouraged shareholder activism in order to address concerns about managerial accountability and agency problems in public companies.³⁴ Sir Adrian Cadbury was asked to lead a committee to investigate the BCCI and Polly Peck failures caused from management fraud in 1991.³⁵ The Cadbury Report envisaged shareholders to play a monitoring role, that is to ensure that the board is behaving as stewards. In 1995, excessive executive remuneration in privatised companies caused a public outcry and

²⁸ Bainbridge, *The New Corporate Governance in Theory and Practice* (n. 11) p. 202.

²⁹ John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' 41(3) *British Journal of Industrial Relations* pp. 531-555, p. 533.

³⁰ See generally, Adolf Berle and Gardiner Means *The Modern Corporation and Private Property* (Transaction Publishers 2009).

³¹ Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

³² Jensen and Mecklin (n. 30) p. 308.

³³ Klaus Hopt, 'Comparative Company Law' in Mathias Reimann and Reinhard Zimmermann (eds) *The Oxford Handbook of Comparative Law* (Oxford University Press 2006) at 1180-86.

³⁴ Adrian Cadbury 'Report of the Committee on the Financial Aspects of Corporate Governance' (December 1992); Richard Greenbury, *Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury* (17 July 1995); Paul Myners, *Institutional Investment in the UK: A Review* (2001); David Walker, *Review of Corporate Governance in Banks and Financial Institutions* (2009); John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (2012).

³⁵ Iris H-Y Chiu, *The Foundations and the Anatomy of Shareholder Activism*

led to the creation of Greenbury Committee. The Report recommended greater shareholder engagement on remuneration matters. The Myners Report focused on the institutional investment and encouraged managers of the institutional shareholders to have private meetings with the management of companies. In the wake of the Financial Crisis, Sir David Walker has been asked to look into what role corporate governance issues played in the banks' crises. The Walker Report recommended shareholders to be more active as stewards of companies and suggested the publication of the Stewardship Code. In 2010, the UK Financial Reporting Council adopted the UK Stewardship Code.³⁶ The Stewardship Code operates on a comply-or-explain principle, and encourages institutional shareholders to engage in corporate matters. This is not limited to voting in corporate decision-making processes but also includes engaging with companies on governance, performance, capital, and environmental and social matters through both formal and informal means.³⁷ In the eyes of regulators, the private goals of shareholders overlap with public policy, which is to ensure the sustainability of companies and, indirectly, the economy in general by preventing managerial failures.³⁸ Therefore, shareholder engagement has been one of the key aspects of UK Corporate Governance.

II. THE RELATIONSHIP BETWEEN SHAREHOLDER ENGAGEMENT AND THE AUTHORITY OF THE BOARD OF DIRECTORS

While policymakers in the UK have long supported shareholder engagement with the board of directors, shareholder engagement is not always welcomed and is often found uncondusive to the effective functioning of companies.³⁹ Director primacy theory provides the most theoretical of separation of ownership and control is efficient and shareholder is destructive for corporate governance.⁴⁰ According to this theory, it is vital from economic perspective that a central body collects all the information and exercises the power of fiat to tell the team members what to do. This theory rejects the direct or indirect shareholder control in the name of accountability into the corporate decision-

³⁶ Financial Reporting Council (FRC), *The UK Stewardship Code 2012* < <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf> >.

³⁷ See also, Iris H-Y Chiu, 'International Shareholders as Stewards: toward a New Conception of Corporate Governance' (2012) 6 *Brooklyn Journal of Corporate Finance and Commercial Law* 387; Lee Roach, 'The UK Stewardship Code' (2011) 11 *Journal of Corporate Law Studies* 463; Brian Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 *MLR* 1004.

³⁸ Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart, 2010) 33-63;

³⁹ Seesupra n 11.

⁴⁰ See generally, Bainbridge, *The New Corporate Governance in Theory and Practice* (n. 11).

making.⁴¹ In a system where shareholders routinely control and interfere with corporate decisions, the board's power of fiat becomes diluted and advisory rather than authoritative. Hence the theory argues that accountability and authority are antithetical.⁴² Any attempt to address managerial accountability concerns through shareholder empowerment would undermine the board authority, which would in turn be value-reducing for the functioning of corporate governance.

Under this theory, shareholder engagement could have the detrimental impacts on the long-term interests of companies because shareholders may have short-term preferences and prefer to hold shares for such a short duration.⁴³ The influence of short-term shareholders arguably leads the boards to focus on the short-term gains and to overlook the long-term value creation.⁴⁴ It plays a role in the boards' propensity to underinvest in long-term business strategies.⁴⁵ Likewise, Dignam argued that the UK learned wrong lessons from the recent financial crisis because activity of shareholders rather than passivity of shareholders is the major problem.⁴⁶ It is also claimed that short-term preferences of shareholders are transmitted to the board and affect the board discretion.⁴⁷ Accordingly, shareholder participation affects corporate decision-making and corporate time horizons, and the boards are not completely free to decide on corporate investments and time horizons.

It must be, however, assessed whether UK company law allows shareholders to undermine the board authority to manage company. By examining the shareholder rights and case law related to the board authority, it will be clearer whether UK company law allows shareholders to undermine the authority of the board of directors.

1. The Role of Shareholders in UK Corporate Governance

UK company law considers the division of power between the board of directors and shareholders a contractual matter which should be laid down in the articles of association.⁴⁸ As far as most of the substantive matters required for the general conduct of a company are concerned, they are to be regulated

⁴¹ Bainbridge, 'The Means and Ends of Corporate Governance' (n 11) p. 563.

⁴² Bainbridge, 'The Means and Ends of Corporate Governance' (n 11) p. 573.

⁴³ See for the short-termism argument, Mark Roe, 'Corporate Short-Termism - In the Boardroom and in the Courtroom' (2013) 68 *The Business Lawyer* 978, p. 985.

⁴⁴ Dignam (n. 11).

⁴⁵ John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making' Final Report (BIS 2012) p. 10.

⁴⁶ See also, Dignam (n. 11).

⁴⁷ Andrea Bowdren, 'Contextualising Short-Termism: Does the Corporate Legal Landscape Facilitate Managerial Myopia' (2016) 5(2) *UCL Journal Of Law And Jurisprudence* 285.

⁴⁸ 385; Alan Dignam and John Lowry *Company Law* (8th Edition, Oxford University Press 2012), 287.

through the articles of association rather than the CA 2006, as opposed to many jurisdictions.⁴⁹ This also highlights the enabling and flexible approach of UK company law.⁵⁰

It is, therefore, essential for companies to have articles of association.⁵¹ Section 19 of the Companies Act 2006 (CA 2006) authorises the Secretary of State to promulgate the model articles of association for different types of companies. Unless companies choose otherwise, the model articles apply to companies.⁵² Most people tend to use model articles⁵³ (default articles of association) given by the Companies Act (CA) 2006.⁵⁴ In this regard, the Companies Act 2006, the model articles and case law will be used in examining shareholder power and the board authority for decision-making in the UK. However, it should be noted that it is impossible to analyse every shareholder right in a short article; therefore, the focus will be merely on shareholder power to intervene directly in corporate governance. In this regard, this article will examine the amendment of articles of association, the reserve power of shareholders, the appointment and removal of directors, say on pay regulation, and takeover regulation.⁵⁵

⁴⁹ Sec. 17 of the Companies Act 2006; Paul Davies and Sarah Worthington, *Principles of Modern Company Law* (10th Edition, Sweet&Maxwell, 2016), p. 58-61.

⁵⁰ Dan Prantice, 'The Role of Shareholders in the UK' in Sabrina Bruno and Eugenio Ruggiero (eds) *Public Companies and the Role of Shareholder* (Kluwer 2011) p. 196.

⁵¹ Sec. 18 of the CA 2006.

⁵² Sec. 20 of the CA 2006.

⁵³ The model articles which apply unless excluded by shareholders might be helpful to understand the distribution of decision-making power in UK company law. For public and private companies, two different types of model articles have been issued.

⁵⁴ Alan Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 36 *Seattle Law Review* 636, p. 660. in the form of "stewardship" and shareholder engagement, is an error built on a misunderstanding of the key active role shareholders played in the enormous corporate governance failure represented by the banking crisis. Shareholders' passivity, rather than activity, has characterized the reform perception of the shareholder role in corporate governance. This characterization led to the conclusion that if only they were more active they would be more responsible "stewards" of the corporation. If, as this Article argues, shareholder activity was part of the problem in the banks, then encouraging increased shareholder action and exporting it outside of banks, as we have subsequently done in the United Kingdom, risks a wider systemic corporate governance failure. In short, we have learned the wrong lesson about shareholders from the bankin", "author": [{ "dropping-particle": "", "family": "Dignam", "given": "Alan", "non-dropping-particle": "", "parse-names": false, "suffix": "" }], "container-title": "Seattle Law Review", "id": "ITEM-1", "issue": "138", "issued": { "date-parts": [["2013"]] }, "title": "The Future of Shareholder Democracy in the Shadow of the Financial Crisis", "type": "article-journal", "volume": "639" }, "uris": ["http://www.mendeley.com/documents/?uuid=bf028087-ffbf-4817-ac65-a8828c0bff8d"] }, "mendeley": { "formattedCitation": "Alan Dignam, \u2018The Future of Shareholder Democracy in the Shadow of the Financial Crisis\u2019 (2013)"

⁵⁵ In the context of shareholder power to intervene in the management of companies,

a. Amendment of Articles of Association

Articles of association play a remarkable role in UK corporate governance because the regulation of internal affairs of a company is left to be regulated through them. Therefore, the division of power between shareholders and the board is regulated through articles of association.

The articles can be altered by a special resolution in a general meeting, since any changes in the articles of association affect the balance between the shareholders and directors, and between shareholders and shareholders.⁵⁶ As the Act requires a special resolution in order to alter the articles, at least 75% of the total voting rights of the members who (being entitled to do so) vote in person, by proxy or in advance on the resolution.⁵⁷

Accordingly, shareholders can amend the articles without the involvement of the board and are not inferior and powerless. Such an ability gives rise to the concern that shareholders could collect all corporate decision-making power through a change in articles of association at the expense of the board authority. However, as noted above, high majority of public companies apply model articles of association for public companies, which lays down that 'Subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company'.⁵⁸ As seen, shareholders understand and recognise the value of the board authority. In addition, given the collective action problems mentioned above, it is extremely difficult for a shareholder proposal to satisfy the high threshold required for the amendment of articles of association, which does not benefit to all shareholders. Hence, the high threshold and the behavioural limitation arising from the coordination difficulties serve a filtering role and prevents the ill-considered shareholder proposals.

academics tend to examine the amendment of articles of association, shareholders' reserve power, the appointment and removal of directors, takeover regulation in order to highlight how shareholder-centric UK corporate governance is. Bruner, for instance, analyses the right to call special meetings, remove directors without cause, initiate charter amendments, approve takeover rights to show that UK shareholders possess substantial power to intervene directly in corporate governance, see Christopher Bruner "Power and Purpose in the Anglo-American Corporation" 50(3) *Virginia Journal of International Law* 580, p. 603; Bebchuk, for example, places focus on the amendment of articles of association, the replacement of directors, the reserve power of shareholders, and takeover regulation to highlight the extent to which shareholders could intervene in corporate governance, see Lucian Bebchuk, "The Case for Increasing Shareholder Power" 118(3) *Harvard Law Review* 833, p. 847.

⁵⁶ Sec. 21 of the CA 2006.

⁵⁷ Section 283(5) of the CA 2006.

⁵⁸ Article 3 of Model Articles for Public Companies.

b. The Reserve Power of Shareholders

Until the end of nineteenth century, it was broadly accepted that the general meeting was the supreme decision-making body of the company and the board of directors was subject to the control of the general meeting.⁵⁹ However, the Court of Appeal in *Automatic Self-Cleansing Filter Syndicate v. Cuninghame*⁶⁰ held that the division of power between shareholders and directors depended on the articles of association and that, where articles of association provided the board with the power, general meeting cannot interfere in how the board exercise its power. Since *Quin & Axtens v Salmon*,⁶¹ it has been acknowledged that shareholders cannot interfere with a decision of the board where the power is vested in the board of directors. The modern doctrine was stated in *Shaw & Sons (Salford) Ltd v Shaw*⁶² as follows:

“A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors; certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to reelect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders”.

The model articles of association contains specific articles now make clear that the authority of the board of directors is subject to the articles, and that shareholders have reserve power.⁶³ Article 4 of the Model Articles of Association lays down that shareholders by a special resolution, can direct the directors to take or refrain from taking a specified action.⁶⁴ This is an instruction right by which shareholders can tell the board and management what to do. It should be noted that special resolution giving instruction to directors does not have any effect on the validity of the decision taken by the directors before the passing of the resolution. UK company law provides shareholders an unique right, which is almost a reminder that shareholders are at the heart of UK corporate governance. As a result, UK company law is more generous than many other

⁵⁹ Paul Davies and Sarah Worthington, *Principles of Modern Company Law* (10th Edition, Sweet & Maxwell, 2016) p. 358.

⁶⁰ *Automatic Self-Cleansing Filter Syndicate v. Cuninghame* [1906] 2 Ch. 34 CA.

⁶¹ *Quin & Axtens v Salmon* [1909] 1 Ch. 311; [1909] AC 442.

⁶² *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 K.B. 113 CA.

⁶³ Article 4 of the Model Articles of Association.

⁶⁴ Article 4 of the Model Articles.

jurisdictions in this regard. However, as a practical matter, it may not be worrying in terms of the board authority because of the collective action and free-rider problems mentioned above.

c. Appointment and Removal of Directors

aa. The Nomination and Appointment of Directors

The appointment of directors is an important mechanism that incentivises the board to perform better and to reduce agency cost and accountability problems in corporate governance.⁶⁵ The right to nominate and appoint directors, i.e. a competitive board election, is a means of providing discipline on the board of directors⁶⁶ and management.

Despite its importance, the Companies Act 2006 is almost silent about the appointment of directors⁶⁷ and only requires that the appointment of each director must be voted for separately.⁶⁸ In the absence of any specific regulation, according to Article 20 of the Model Articles, the general meeting has the power to appoint a director by an ordinary resolution which is adopted by a simple majority.⁶⁹ There is no restriction on the ability of shareholders to nominate a director. However, contested elections are rare rather than being a norm in the UK.⁷⁰ Davies argues that due to the provisions in the articles of association, it may be difficult for shareholders to nominate a director instead of the board's candidates.⁷¹ In practice, the board usually prepares a list of proposed candidates for the board for the shareholders to appoint; therefore, shareholder appointment can be a formality.⁷² Therefore, shareholders rarely interfere in the election of directors.

bb. The Removal of Directors

As seen above, company law does not interfere heavily in the appointment process, which is regulated predominantly by the articles of association. By contrast, section 168 of the CA stipulates that a director could be removed by a simple majority of shareholders at any time without any reason for so doing.

⁶⁵ Lucian A Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675, p. 679.

⁶⁶ See Lucian Bebchuk, 'The Case for Shareholder Access to the Ballot' (2003) 59(1) *The Business Lawyer* 43.

⁶⁷ Len Sealy and Sarah Worthington, *Sealy's Cases and Materials in Company Law* (9th edition, Oxford, 2010), p. 265.

⁶⁸ Section 160 of the CA 2006.

⁶⁹ Section 282 of CA 2006.

⁷⁰ Bebchuk (n 63) at 725.

⁷¹ Davies and Worthington (n 52) p. 367.

⁷² Paul Davies, 'Corporate Boards in the UK' in Paul Davies et al (eds) *Corporate Boards in Law and Practice* (OUP 2013) p. 744.

This section could be enforced even if there is, 'anything in any agreement between it and him'.⁷³

It can easily be argued that the right to remove a director by an ordinary resolution significantly restrains the discretionary power of the board and provides a strong bargaining power to shareholders,⁷⁴ because directors are aware that they could easily be removed by shareholders in the case of disobedience of shareholders' instructions. This can undermine the value of the board's authority and management, and put shareholders in a position where they can impose their selfish demands on management.

There is, however, one formal and one behavioural limitation that restrict the ability of shareholders to remove directors, and it will be shown that shareholders can remove directors in the case of serious misconduct rather than for arbitrary reasons.

First, under section 168(5) a director cannot be deprived of any claim for compensation in the event of termination. The resolution removing a director may oblige the company to pay a substantial amount of compensation, which can be around several million pounds, if section 168 is triggered without any reasons – other than for serious misconduct. This can be prohibitive for shareholders unless there are solid reasons to remove directors.

The second limitation comes from coordination problems and the market culture of the UK. Shareholders need to form a coalition to remove the board of directors or management. Such coalitions are indeed formed in practice, but rarely, and on an ad hoc basis.⁷⁵ Historically, British institutional investors tend to oust management in poor performances.⁷⁶ The removal of management takes place when the lack of ability of management became evident or there is no doubt that the company's management is wrong. Until this point, institutional investors are in contact with the existing management.⁷⁷ Once a large institution has strong suspicion about the financial situation of the company, this proactive institution raises voices against the impugned management through 'behind-the-scenes negotiation'⁷⁸ and starts seeking support from other investors.

As a result, shareholders have a very strong right to remove a director by an

⁷³ Section 168(1) of the CA 2006.

⁷⁴ See Dignam (n 11) p. 660.

⁷⁵ Bernard Black and John Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92(7) *Michigan Law Review* 1997, p. 2044-6.

⁷⁶ Rafel Crespi and Luc Renneboog, 'Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coalitions in the Pre-Cadbury Era' (2010) 18(4) *Corporate Governance: An International Review* 274.

⁷⁷ Geof Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 123.

⁷⁸ Stapledon (n 91) 125.

ordinary resolution at any time. Such a right could be possibly used to influence the way in which the board manages the company because a director will be aware that disobedience may result in the removal from office. However, the formal and the behavioural limitations prevents shareholders from using the right to remove only for their own interests; therefore, shareholders are less likely to undermine the discretion of the board.

d. Say on Pay Regulation

The remuneration of directors and managers comes from fees paid to them and other monetary benefits under service contract entered into by them and company itself. This has been and continue a huge source of concerns and controversy. The UK has preferred to address this controversy by making the executive remuneration contracts subject to shareholder approval.⁷⁹

The first steps to implement an executive remuneration regulation were taken by the UK Department of Trade and Industry (DTI) in the 2000s. The DTI suggested that shareholder engagement would be more efficient if a legal framework requiring a shareholder vote on executive pay were to be provided.⁸⁰ The DTI reasonably believed that, under appropriate circumstances, shareholders might exert better controls over the pay-setting process. The UK introduced a non-binding 'say on pay' reform in 2002, through the Directors' Remuneration Report (DRR) regulations, and remuneration decisions were not based on the approval of shareholders. Under section 420 of the Companies Act 2006, the directors of a listed company are required to prepare a DRR for each financial year of the company. This approach also demonstrates the traditional British approach of negotiated regulation, which imposes a balanced bottom-up approach to solve problems without heavy regulatory involvement.⁸¹

Shareholder dissent has been observed in a number of high profile cases. For instance, in 2003, the golden parachute for the CEO of GlaxoSmithKline, which amounted to \$35 million was not approved by shareholders and their dissenting view led to the rejection of the remuneration committee's report.⁸² Since the enactment of 'say on pay' regulation, it has attracted attention from the academic literature. The impact of the regulation is controversial. Some empirical evidence suggests that the regulation had no substantial impact on

⁷⁹ Jeffrey Gordon 'Executive Compensation: If There's A Problem, What's the Remedy? The Case for 'Compensation Discussion and Analysis'' (2005) *The Journal of Corporation Law* 675, p. 698.

⁸⁰ Department of Trade and Industry (DTI), 'Rewards for Failure' Directors' Remuneration - Contracts, Performance and Severance' (2003) p. 8.

⁸¹ Iris HY Chiu, 'Learning from the UK in the Proposed Shareholders' Rights Directive 2014? European Corporate Governance Regulation from a UK Perspective' (2015) SSRN Paper 2589173.

⁸² Gordon (n 111) 700.

executive pay growth.⁸³ Nevertheless, it might have 'a moderating effect on the level of CEO compensation only *conditional upon poor performance*'.⁸⁴ Shareholders express their dissatisfaction more where executive remuneration is higher than average and not related with the performance.⁸⁵ Ferri and Maber argue that shareholders 'regard say on pay as a value-creating governance mechanism'.⁸⁶

After the financial crisis, the growing public opinion against high executive remuneration prompted debates on the potential introduction of binding shareholder votes on the remuneration policy of a company. In 2013, the UK adopted a binding shareholder vote on the directors' remuneration policy, to take place at least every three years.⁸⁷ It has to be highlighted that the UK Listing Authority will continue to require the approval of shareholders for *employees' share schemes and long-term incentive schemes*.⁸⁸

With regard to the directors' remuneration reports, shareholders basically vote on two reports: a backward-looking annual report (advisory) and a forward looking remuneration policy (binding at least every three years). The first report is related to the implementation of remuneration policy reports and is subject to an advisory vote of the shareholders every year. The major decisions as to remuneration, the major changes during the year, and the reasons for changes must be stated by the chair of the remuneration committee.⁸⁹ The annual report on remuneration must contain information with regard to how much directors have been paid, and how the remuneration policy will be enforced. Furthermore, the report must include a single total figure for each director, and in particular, a table setting out the details of their remuneration.⁹⁰ The report enables investors to analyse the remuneration in the context of corporate performance, cash flow, and remuneration of the wider workforce. Shareholders will deliver their opinion through the annual advisory vote under section 439 of the CA 2006.

The second report is concerned with the remuneration policy of the company, which contains information about, 'the making of remuneration payments and

⁸³ Fabrizio Ferri and David A. Maber 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 *Review of Finance* 527 528 (emphasis added).

⁸⁴ Ferri and Maber (n 115) 530.

⁸⁵ See Randall Thomas and Christoph Van Der Elst, 'Say on Pay Around the World' (2015) 92 *Washington University Law Review* 653 666.

⁸⁶ See Ferri and Maber (n 115) 534.

⁸⁷ Section 439A of CA 2006; see also BIS, *Directors' Remuneration Reform: Frequently Asked Questions* (2013) p. 4.

⁸⁸ Listing Rules 9.4.

⁸⁹ The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (SI 2013/1981), Part 2 of Schedule 8.

⁹⁰ SI 2013/1981 (n 80) part 3 of Schedule 8.

payments for loss of office⁹¹ and is subject to a binding vote by shareholders.⁹² Section 439A of CA 2006 introduced a new part to the directors' remuneration policy. The remuneration policy must account for how the pay arrangements affect the short and long-term strategies of the company.⁹³ In short, this policy report ensures that investors are able to understand the general remuneration policy, and how the pay arrangements are related to performance.

Consequently, shareholders have an advisory vote on a backward-looking report and a binding vote on a forward-looking remuneration policy report.

e. Takeover Regulation

The UK takeover regulation is often used to elucidate how shareholder-centric UK corporate governance is⁹⁴; however, it will be also shown here that the board still plays a role in a shareholder-oriented model.

The market for corporate control regards takeovers as an important mechanism for aligning the interests of directors and managers with the interests of shareholders.⁹⁵ This approach assumes that there is correlation between corporate managerial efficiency and the share price of companies.⁹⁶ If the existing management of the company underperforms, share prices will drop and other market participants may consider it an opportunity to take over the company.⁹⁷ However, the theory may not function as a disciplinary mechanism in the market. It is also argued that the threat of takeover may force the board to satisfy the share price expectation of shareholders in order to prevent them from selling their shares to a predator.⁹⁸ Accordingly, the focus will be on increasing share prices at the expense of the long-term investment and research and development (R&D) and job growth due to the threat of takeovers. Therefore, Martin Lipton, for instance, advocated to stop hostile takeovers to deal with short-termism problem.⁹⁹

The extent to which the market for corporate control may align the interests of shareholders and managers depends on the legal and regulatory landscape.

⁹¹ Section 421(2A) of the CA 2006.

⁹² Section 439A of the CA 2006; see also Statutory Instrument, *The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations*, (2013) No. 1981, Part 4.

⁹³ SI 2013/1981 (n 80) part 4 of Schedule 8.

⁹⁴ Bruner (n. 9) p. 32.

⁹⁵ Henry Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110.

⁹⁶ Manne (n. 84) p. 112.

⁹⁷ Manne (n. 84) p. 113.

⁹⁸ Bowdren (n. 46) p. 296.

⁹⁹ Martin Lipton, 'Takeover Bids in the Target's Boardroom' (1979) 35 *Business Lawyer* 101, p. 104.

In the UK, a quasi self-regulatory approach has been adopted, regulating takeovers through The City Code on Takeovers and Mergers (the Takeover Code), and establishing a Panel on Takeovers and Mergers (the Takeover Panel) to administer the Takeover Code and to enforce it.¹⁰⁰ The Takeover Panel was formed by primarily institutional shareholders and investment bankers operating in the City of London, where the business community is based. While these groups were powerful in the UK, corporate managers were not in a position to influence the formulation of the Takeover Code, unlike their counterparts in the US.¹⁰¹ Institutional investors were key players in the formation of takeover regulation in the 1960s. This also coincides with the time when they became the key players in the market in the UK.¹⁰² It is reasonable to conclude that institutional shareholders have been key players in the establishment of governance rules in the UK since they emerged in the 1950s.

The UK legal framework is very prohibitive of employing anti-takeover tactics without the consent of shareholders and is strikingly shareholder oriented.¹⁰³ Regulation in the UK has been based on the 'no frustration' rule. It considers the takeover to be a transaction between the bidder and the shareholders of the target company; therefore, the board of directors, in principle, does not have legitimate grounds to take action.¹⁰⁴ The core tenet of the UK takeover regulations is that the future of the target corporation rests only with its shareholders.

In the UK, Rule 21 of the Takeover Code does not allow managers to take any frustrating actions without the approval of shareholders, 'during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent'.¹⁰⁵ This 'no frustration' rule is only applicable when a bid is imminent. The rules attribute the directors an advisory role and leave the final decision to the shareholders. It was similarly decided in *Dawson International Plc v Coats Paton Plc* that the board is under a duty to provide their honest view about the effects of the takeover on the company to shareholders.¹⁰⁶

¹⁰⁰ In the UK, in particular institutional shareholders played a pivotal role in the development of takeover code in order to avoid *ex-post* litigation. See John Armour and David A. Skeel 'Who Writes the Rules for Hostile Takeovers, and Why?— The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727, p. 1731.

¹⁰¹ See for the history of the formation of the Takeover Panel, Armour and Skeel (n 86) at 1730.

¹⁰² Armour and Skeel (n 86) p. 1767.

¹⁰³ John Armour et al., 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531, p. 534.

¹⁰⁴ Davies (n 52) 1010.

¹⁰⁵ Rule 21 of Takeover Code; See also general principle 3 of the Takeover Code.

¹⁰⁶ *Dawson International plc v Coats Paton plc and others* (1989) BCLC 233.

Defensive mechanisms such as the issue of new shares attached more voting rights, the use of golden shares, or setting very high compensation for managers are, however, still possible if they are imposed well before any bid. However, this so-called 'embedded mechanisms' are less likely to be successful because the issue of new shares is subject to shareholder approval; while dual class voting rights are not specifically prohibited,¹⁰⁷ they are not welcomed by institutional shareholders. Furthermore, as seen below, the issue of share for purposes other than commercial purposes might be considered a breach of fiduciary duties due to the improper use of authority to retain their positions rather than seeking the interest of company.

The takeover regulation in the UK has been criticised on the grounds that it increases the vulnerability of UK companies to takeovers, and that it leaves the company's fate in the hands of the shareholders.¹⁰⁸ The acquisition of the Cadbury by Kraft¹⁰⁹ heated the debate about short-term investors and this takeover is attributed to the increasing ownership of the short-term investors, hedge funds, instead of the long-term shareholders in the company. Hedge funds were blamed for this takeover and argument against hedge funds such as short-termism at the expense of long-term profitability of company played a role in calls for the reforms of the UK takeover regulation.¹¹⁰ Although the bid was accepted by shareholders, some mainstream shareholders such as Legal & General and Frankling Mutual Advisers disapproved the transaction on the basis that the bid does not reflect the fundamental value of Cadbury; yet, some institutional investors argued that Cadbury is sold because of the underperformance over years, the less skilled management for company's operations, and mistrust to management.¹¹¹

The boards in the UK holds indirect power to prevent a hostile takeover by advising the target shareholders.¹¹² The view of the board's influence does not only find ground in theory but also is supported in some empirical research.¹¹³

¹⁰⁷ Stapledon (n 91) at 58-60.

¹⁰⁸ Bowdren (n. 46) p. 298.

¹⁰⁹ Tim Webb, 'Lord Mandelson Calls for Overhaul of Takeover Rules' *The Guardian* (1 March 2010).

¹¹⁰ Tsagas (n 136) at 269.

¹¹¹ Jenny Wiggins 'The inside story of Cadbury Takeover' *The Financial Times* (12 March 2010); Zoe Wood, 'Kraft Set for Higher Cadbury Bid as Deadline Looms' *The Guardian* (18 January 2010).

¹¹² Paul Davies and Klaus Hopt, 'Control Transactions' in Reiner Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, OUP 2009) at 235; see also, Georgina Tsagas, 'A Long-Term Vision for UK Firms? Revisiting the Target Director's Advisory Role since the Takeover of Cadbury's Plc' (2014) 14 *Journal of Corporate Law Studies* 241.

¹¹³ Blanaid Clarke 'Reinforcing the Market for Corporate Control' (2010) *UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper* No 39/2010 at 11.

Following the heated debates among British community the Panel added a new section to the notes explaining Rule 25.2, which sets out that the board could take into consideration financial merits of the offer as well as other relevant factors, and bid price is not the only factor in providing opinion to the board. In the context of section 172 of CA 2006, general duties of directors, the new interpretative notes to the Rule 25.2 and general principle 3 of the Takeover Code, the board of directors have broader discretion and can consider a range of issues from financial merits of the bid to sustainability of the company in the formation of their opinion as to the bid.

In the UK, therefore, the board of directors play an indirect role in the context of takeovers. Directors can issue their opinion in prioritising the sustainability of company or the interest of the future company. The board could ensure that shareholders make informed decision about the takeover bid. If shareholders finds the board's opinion that the bid does not reflect the long-term value of company, shareholders could overturn the offer, but this depends on the trust between the board and shareholders.

2. The Role of the Board of Directors in UK Corporate Governance

The section above demonstrated the favourable treatment of UK company law to shareholders. Shareholders have an arsenal of participatory power to shape the rules of corporate governance. However, the analysis above demonstrated that the market and coordination problems prevent shareholders from exercising their rights arbitrarily, and that the board plays an important role by ensuring that shareholders exercise informed voting. As noted above, article 3 of the model articles for public companies confers a broad range of powers on the board to manage company. Article 3 stipulates that "*subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company*". It is therefore necessary to analyses whether the board is able to exercise its power to manage the company. When there is a conflict between this broad managerial power of the board, and the participatory rights of shareholders, the court may have to interfere and determine the outcome. Striking a balance between the board's authority and accountability to shareholders was not a straightforward task for the court. The core question is here whether the board of directors is able to take decisions against the wishes of shareholders.

At the beginning of the twentieth century, the court stopped equating shareholders with the company and recognising directors as the shareholders' agent in *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunningham*.¹¹⁴ The court decided that the power given to the board could be exercised by them and that shareholders have no power to interfere with their discretion. In another

¹¹⁴ [1906] 2 Ch. 34, CA.

decision, the court denied that directors are agents of and bound to serve shareholders and accepted that the company can be the only principal of the directors.¹¹⁵

The modern doctrine on the legal effect of the articles of association as to the division of power among shareholders and directors is established in *Shaw & Sons (Salford) Ltd v Shaw*¹¹⁶ and reiterated in *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, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office.¹¹⁷

In a relatively recent case in 2001, the court applied the same line of reasoning.¹¹⁸ It seems clear that where the default regime is applied the common law protects and respects the authority of the board of directors. In principle, the board of directors is not obliged to follow the shareholders' demands at general meetings or through other means unless there is a special provision in the articles.¹¹⁹ It is difficult to deduce that the board is vulnerable to activist shareholders as a result of the allocation of power between shareholders and directors. However, it is still possible that the authority of the board could be restrained by a special resolution directing the directors what to do,¹²⁰ but in practice, it might be very difficult. Moreover, the removal of directors has, of course, influence on the bargaining power of shareholders, which will be examined in the following sections.

The way in which directors are allowed to exercise their power can also constitute a limitation to their discretion. The authority of the board of directors is subject to the general duties of directors in order to ensure that the delegated power is not misused. This is also related with the broader questions of what are the objectives and interests of the company? In the light of the approach explained above, the general formulation of directors' duties does not confer any obligation to focus on merely shareholder interests. Rather, section 170 clearly sets out that the duties are owed to the company. Section 172 mandates

¹¹⁵ *Gramophone and Typewriter v Stanley* [1908] 2 KB 89 at 106; Likewise, the decisions of a general meeting instructing the board to distribute interim dividend were found invalid by the court. *Scott v Scott* [1943] 1 All E.R. 582.

¹¹⁶ *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 K.B. 113, CA.

¹¹⁷ *Howard Smith Ltd. v. Ampol Petroleum* [1974] A.C. 821 (P.C.) at 837; see also *Quin & Axtens v Salmon* [1909] 1 Ch. 311, CA; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd & Ors* [1988] 4 BCC 542.

¹¹⁸ *Towncester Racecourse Co Ltd v Racecourse Association Ltd* [2002] EWHC 2141 (Ch).

¹¹⁹ Furthermore, article 70 of the Model Articles provides right to declare dividend to the board of directors.

¹²⁰ See Article 4(1) of the Model Articles.

a director to act 'in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard' the stakeholders' concerns. In this sense, it is very straightforward: the duties are owed to the company and directors are under a duty to act in the best interest of the company. However, when one delves into the question of what are the interests of the company, the picture becomes more complicated, because a company as an artificial entity is not in a position to identify its own interests.¹²¹ Therefore, it is a device for benefitting an identified group or groups depending on the interpretation of the interest of the company with reference to shareholders, primarily.¹²²

The scope of authority, therefore, is also based on the interpretation of the interest of the company. For instance, if the shareholders' interest is equated to the interests of the company the result may be an inconsistent situation, in which, on the one hand, the company is a separate legal entity from its shareholders and on the other hand, its substance is the interest of shareholders. Dignam argues that if directors are indirectly obliged to pursue the interest of shareholders, it is questionable to what extent they can take actions against the shareholders' demands and that they would violate their duties if they acted against the interests of shareholders.¹²³ In this case, he further legitimately asks, 'what exactly are the directors for if no real delegation of power takes place?'¹²⁴

The difficulty starts here, as the company is an artificial legal entity, and its interest is often identified with reference to its shareholders. In some cases, the judiciary has adopted a narrow approach in which it strictly acknowledged the shareholders as the substance of the company. In other cases, it has applied a broader approach where the board has delegated power and uses its power for the proper purposes.

In general, the interest of the company has been traditionally defined with reference to the shareholders. The predominant example of this narrow interpretation of the interest of the company can be found in *Greenhalgh v Arderne Cinemas Ltd.*¹²⁵ The court held that, 'the phrase "the company as a whole" does not...mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body'.¹²⁶ Similarly, in another decision, the court stated that, 'so long as the company is solvent the

¹²¹ See, John Parkinson, *Corporate Power and Responsibility* (first published 1993, Clarendon Press, 2002) 76.

¹²² See Parkinson (n 110) 79.

¹²³ Dignam (n 11) p. 663.

¹²⁴ Dignam (n 11) p. 663.

¹²⁵ *Greenhalgh v. Arderne Cinemas Ltd.*, [1951] Ch. 286, 291.

¹²⁶ *Greenhalgh* (n 114) p. 291.

shareholders are in substance the company.¹²⁷ In *Brady v Brady*, the court stated that, 'the interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it.'¹²⁸ This exemplifies the narrow understanding of the interest of the company. However, the courts are also aware of the danger that strict adherence to the narrow approach could undermine the authority of the board. The courts solve this problem by adopting a broader approach when the board exercises power for the proper purposes.

First, the courts made a distinction between 'current shareholders' and 'future' shareholders.¹²⁹ The court acknowledged that the interest of the company cannot be determined without including the current and future shareholders within the concept of the company as a whole.¹³⁰ The emphasis on the future interest of shareholders within the interests of the company highlights that shareholders' interests are also related with the company's long-term performance, because the interest of future shareholders depends on investing in R&D projects, the reputation of the company as to the ESG issues, and training programmes for employees. The interest of shareholders therefore involves both immediate and long-term performance of companies according to judicial views. Indeed, this distinction is required because the shareholder base of a listed company consists of different types of shareholders and there is no one typical interest of shareholders. It also implies that there are a variety of interpretations of the interests of shareholders.

The courts have demonstrated sympathy by interpreting the interest of the company broadly to embrace some stakeholder concerns and this, in turn, expands the board's authority. The early and often-quoted example for this understanding is the *Hutton v West Cork Railway Co* case in which, while acknowledging the significance of shareholders' interests, there were early signs of stakeholder concerns that could be incorporated into the decision-making by directors. Lord Justice Bowen stated that:

The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company... liberal dealing with servants eases the friction between masters and servants, and is, in the end, a benefit to the company.¹³¹

This broad understanding of the interest of the company is even more evident in *Evans v Brunner Mond & Co*.¹³² The court held that a company

¹²⁷ *Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services.*, [1983] Ch. 258, 288.

¹²⁸ *Brady & Anor v Brady & Anor* [1988] BCLC 20 at 40.

¹²⁹ *Gaiman and Others v National Association for Mental Health* [1971] Ch. 317, 329.

¹³⁰ See *Gaiman and others* (n 118).

¹³¹ *Hutton v. West Cork Ry. Co.*, [1883] 23 Ch.D. 654, 672–73

¹³² *Evans v. Brunner Mond & Co.*, [1921] 1 Ch. 359.

can make donations to universities for educational purposes even if there is no expectation of immediate and direct return to the company. The *Fulham Football Club v Cabra Estates* case supports this understanding, 'the duties owed by the directors are to the company and the company is more than just the sum total of its members'.¹³³

This shows that the courts tend to broaden the scope of the 'company as a whole' and indirectly the authority of the board. This inclusive understanding is now found in section 172 which imposes a duty on directors to, 'promote the success of the company for the benefit of its members as a whole, and in doing so have regard' for the stakeholder concerns. For the first time, the directors are given statutory protection to balance stakeholder concerns in order to promote the long-term success of the company for the benefit of its members. It is open to discussion whether the law creates an obligation on directors to regard stakeholder concerns or if directors are entitled to further stakeholders' interests at the expense of shareholders' interests, or if directors have been given power to consider stakeholder interests as a means to advance the success of the company for the interest of shareholders. However, it is now clear that the board is given statutory discretion to incorporate stakeholder concerns into the decision-making process.

This interpretation by the courts is significant for the authority of directors because it expands the scope of the board's power, by allowing the board to justify their actions with reference to the success of the company, even if it is against the wishes of current shareholders. The courts acknowledge the fact that directors owe fiduciary duties to the company and that the interests of the company could be different from those of shareholders and should not be sacrificed for a group of shareholders.¹³⁴

When the board uses its delegated power outside the proper purposes, then their actions are subject to judicial scrutiny. The directors are not allowed to exercise their authority as they wish.¹³⁵ In the *Howard Smith v Ampol* decision (discussed above), after emphasising the importance of the independent discretion of the board, the court held that the issue of shares to thwart a takeover bid was not a proper use of the delegated power, because the power had been provided to raise capital. These decisions show that when the power is delegated for a specific purpose, it must be used for this purpose, rather than with the aim of protecting the board or management.¹³⁶

¹³³ *Fulham Football Club Ltd & Ors v Cabra Estates plc* [1992] B.C.C. 863 at 876.

¹³⁴ *Re a Company (No.004415 of 1996)* [1997] 1 B.C.L.C. 479 at 491; *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155, 251.

¹³⁵ *Hogg v Crampborn* [1967] Ch. 254.

¹³⁶ Wen Shuangge, 'The Magnitude of Shareholder Value as the Overriding Objective in the United Kingdom--The Post-Crisis Perspective' (2011) 26 *Journal of International Banking*

As a result, the broad managerial authority of the board conferred by article 3 of model articles for public companies has been protected and respected by case law. The authority of the board is further expanded by section 172 of CA 2006 and case law which incorporate the interests of future shareholders and stakeholders into the interests of companies. Hence, the board is able to act in the long-term interests of the company as long as the authority is used for the proper purposes. Therefore, the board has authority to take difficult decisions within its delegated power, and are not required to maximise the short-term profit of the company at the expense of its long-term success.

CONCLUSION

In the UK company law, the board of directors is given the managerial power through the articles of association of the company. UK corporate governance is highly shareholder-oriented and shareholders are empowered to contribute corporate governance matters such as amendment of articles of association, the appointment and removal of directors, executive pay and takeovers. In a conceptual sense, UK company law allows shareholders to exercise ultimate authority in a company, which is considered a limitation on the exercise of the authority of the board of directors.

However, this article argues that shareholder power does not necessarily undermine the board authority, and that the board has substantial power to make decisions against the wishes of shareholders. The practice in the UK has not been to constrain the authority of the board and the board of directors is conferred a broad range of authority to run the company. The board is the primary decision-making body in UK public companies. In the UK, shareholders are also subject to free-rider and collective action problems. While these problems constitute an impediment to shareholder activism, they serve a filtering role, which prevents self-interested shareholders. More importantly, The Companies Act 2006 and case law do not lend any support for the idea that shareholders are entitled to force the board to focus on only their interests. The board's discretion is further expanded and protected by the courts and statutory duties that incorporate the current and future shareholders' interests and various stakeholder interests into the interests of the company.

Law & Regulation 325 at 329. There are some dissent approaches to the strict application of proper purpose doctrine. The court did not eliminate the possibility that the proper use of authority may include the issue of shares to discourage takeover bid. See, *Criterion Properties Plc v Stratford UK Properties LLC* [2003] B.C.L.C 129 (CA).

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