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THE MEANING OF SHARE OWNERSHIP AND THE GOVERNANCE ROLE OF SHAREHOLDER ACTIVISM IN THE UNITED KINGDOM

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I. INTRODUCTION

Shareholder activism has been the key to effecting important corporate changes in recent years,¹ and may even be described as a rejuvenated exercise of ownership rights held by shareholders.² The concept of ownership allows corporate governance to be defined partly in terms of instituting accountability mechanisms to shareholders.³

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¹ For example, shareholder activists who opposed the re-election of Michael Eisner as Disney's Chairman in 2004 ultimately ousted him as Chief Executive a year later as well. UK's ITV also ousted Michael Green as Chairman in 2003. More empirical evidence of shareholder activism will be discussed in Part 3.

² The U.K. Government even considered shareholders as possibly owing a fiduciary duty to engage in appropriate activism in their investee companies. See DEP'T OF WORK AND PENSIONS, ENCOURAGING SHAREHOLDER ACTIVISM (Consultation Paper, 2002), available at <http://www.dwp.gov.uk/consultations/consult/2002/myners/shareact.pdf>. This is due largely to the tendency of institutional shareholders to be passive and insufficiently attentive to their investee companies' internal governance. See Helen Short & Kevin Keasey, *Institutional Shareholders and Corporate Governance*, in CORPORATE GOVERNANCE: RESPONSIBILITIES, RISKS, AND REMUNERATION 61-92, (Kevin Keasey et al. eds., John Wiley & Sons 1997); Rebecca Stratling, *General Meetings: A Dispensable Tool for Corporate Governance of Listed Companies?*, 11 CORP. GOVERNANCE 74 (2003).

³ No doubt this view of corporate governance is based on the importance of the finance perspective, principally espoused as the agency problem, where owners are regarded as bearing the residual risk of corporate failure and hence having the best incentives to ensure accountability of management to them. Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). This theory is often seen as being too narrow by stakeholder theorists, but Jensen and others have argued that the ultimate accountability of the managers to owners entails managerial goals to maximize the value of the corporation and that would also to a certain extent create social welfare. See Michael C. Jensen, *Value Maximization, Stakeholder Theory and the Corporate Objective Function*, reprinted in CORPORATE GOVERNANCE AT THE CROSSROADS (Donald H. Chew & Stuart Gillan eds., McGraw-Hill 2005); FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF*

The concept of ownership may also appear to legitimate more active forms of engagement by shareholders in order to protect their residual interests.⁴ This article first presents a brief but critical examination of the theoretical underpinnings of shareholder activism as an incident of “ownership.” Part 3 then looks at the practice, trends and developments in shareholder activism in order to critically examine how shareholder activism may be accounted for and accommodated within the theoretical framework of the company and the legal framework’s providing for shareholder involvement. Part 4 then discusses the governance of shareholder activism and critically questions whether shareholder activism actually plays such a role, and additionally, the benefits and costs that arise from activism. The main thesis of this article is that certain aspects of shareholder activism may not be well-founded in theory and also gives rise to practical concerns. There is a need to understand these implications in order to consider appropriate steps forward in our perception of shareholder activism.

II. THE FABRICATION OF SHARE OWNERSHIP IN THE UNITED KINGDOM

A. *The Legal Nature of Share Ownership*

A classic starting point to describe the nature of share ownership in a company is as follows:

A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se⁵

The above quotation does not actually describe the share as being an ownership interest, but a more limited interest entailing certain rights and liabilities. In fact, “of interest in the second” is vague, as no mention is made of the nature of the interest, and where the interest spe-

CORPORATE LAW (Harvard University Press 1991). *But see* MARGARET BLAIR, OWNERSHIP AND CONTROL (Brookings Institution Press 1995) (arguing that stakeholders such as employees are also residual risk bearers); JOHN PARKINSON, CORPORATE POWER AND RESPONSIBILITY 262–71 (Oxford University Press 1994) (supporting his prolific arguments in theory and ideology against adopting shareholder primacy as the dominant model of corporate accountability).

⁴ See, e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); ROBERT A. G. MONKS, *THE NEW GLOBAL INVESTORS* (Capstone Publishing 2001) (positing the importance of investors as being crucial to the sustainability of corporations and their practices).

⁵ *Borland’s Trustee v. Steel Bros. & Co.*, [1901] 1 Ch. 279.

cifically lies. Many commentators⁶ agree that the ownership label placed on shares is not quite accurate, as shares represent a bundle of interests and liabilities⁷ that differ somewhat from a conventional understanding of ownership.⁸ Property theorists have often pointed out that a key feature of an ownership interest is the ability to exclude others from any use or enjoyment of the subject matter over which the ownership right is exercised.⁹ One of the key characteristics that flow from the private exclusivity analysis is that property subject to an ownership right is indefeasible.¹⁰ Shares, however, are not indefeasible, and the private “ownership” right to a share can be eclipsed by the occurrence of squeeze-outs,¹¹ either under the Companies Act¹² or by provisions in the company’s Articles of Association.¹³

Further, it has been argued that it is perhaps inaccurate to describe proprietary rights over fungible items, such as shares as “ownership,” as no distinction can be made between fungible assets to identify which asset is owned by a particular owner. When such assets are transferred, it is more accurate to refer to such transactions as an extinguishment of certain rights and liabilities held hitherto by a particular person, and the giving rise of a bundle of rights and liabilities to another, rather than to refer to such transactions as “property transfer.”¹⁴ A commentator has opined that proprietary rights (or

⁶ Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39 (2000); Helen Bird, *A Critique of the Proprietary Nature of Share Rights in Australian Publicly Listed Corporations*, 22 MELB. U. L. REV. 131 (1988); Sarah Worthington, *Shareholders: Property, Power and Entitlement*, 22 COMPANY L. 258, 307 (2001).

⁷ Some of the notions will be teased out shortly.

⁸ See R.M. GOODE, *COMMERCIAL LAW* 31–35 (Penguin Books 2004) (defining ownership as an absolute interest in the residual rights in property, and such interest is indefeasible).

⁹ Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719 (2004); O. Lee Reed, *What is “Property”?*, 41 AM. BUS. L.J. 459 (2004). Both authors argue that private exclusivity is the hallmark of a proprietary right, and not a positive bundle of rights.

¹⁰ Bird, *supra* note 6. See, e.g., *Kwei Tek Chao v. British Traders and Shippers, Ltd.*, [1954] 2 Q.B. 459 (such indefeasibility may however be subject to certain passing of property rules in sales of goods transactions or by governmental acquisition and compensation legislation).

¹¹ Referring to majority buy-outs of minority shares under certain circumstances.

¹² See 2006, c. 46 § 979 (discussing squeeze-outs in a takeover situation).

¹³ Such Companies Act provisions in the company’s Articles of Incorporation, if secured by amendment, may also be reviewed by the court, especially in Australia. See, e.g., *Gambotto & Anor v. WCP Ltd. & Anor*, [1995] 182 C.L.R. 432 (Austl.) (requiring majority shareholders to act in the best interest of their company).

¹⁴ James Steven Rogers, *Negotiability, Property, and Identity*, 12 CARDOZO L. REV. 471 (1990).

rights *in rem*) are no different in substance from other personal rights, such as contractual rights, as all rights in relation to things also define parameters of rights and correlative duties, just like rights in relation to persons. The distinction is hence not substantively meaningful.¹⁵

Therefore, we are left with the perspective that share ownership gives rise to a bundle of rights and liabilities, but such a bundle sits between the realm of personal and proprietary rights. This is because a share can be regarded as a subject of proprietary transfer, although it does not relate precisely to a share in corporate assets. It is arguable that the fabrication of share ownership as a proprietary notion has been important for the following reasons: (a) shares need to be regarded as tradeable and negotiable assets; (b) private property notions such as ownership rights attached to primary investments in companies are important to the development of investment capitalism.

The growth of the modern corporation very much depended on investment capitalism. In an earlier research paper, this author argued that business growth requires investment in the form of equity and that there is a limit to the roles of debt and retained earnings as sources of corporate finance.¹⁶ Equity investment is arguably only attractive if investment securities are able to pass good title to the holder, and are negotiable so that the holder can then freely transfer such securities, and also trade them regularly if supported by liquid stock markets.¹⁷ Hence, the aspect of a share as an investment asset that could be held or transferred is fundamentally important to both the issuing corporation and the shareholder. This is the *external* dimension of the share, or in other words, the proprietary nature of the share as an asset recognized by the issuing corporation, and the market including the holder, as well as the third parties who could acquire such an asset. The proprietary notion attached to a share is fundamental in ensuring that the *external* dimension of the share entails no doubt as to its asset quality. The maintenance of such asset quality is arguably crucial to the development of an investment economy, as defining investment instruments, such as shares, as proprietary assets allows them to be fabricated in terms of economic resources that may be allocated and protected from arbitrary expropriation.¹⁸ That is to say that, “[P]rotecting private property rights [in share ownership] is

¹⁵ Pavlos Eleftheriadis, *The Analysis of Property Rights*, 16 OXFORD J. LEGAL STUD. 31 (1996).

¹⁶ Hse-Yu Chiu, *Can UK Small Businesses Obtain Growth Capital in the Public Equity Markets? An Overview of the Shortcomings in the UK and European Securities Regulation and Considerations for Reform*, 28 DEL. J. CORP. L., 933 (2003).

¹⁷ GOODE, *supra* note 8, at 570.

¹⁸ Harold Demsetz, *Toward A Theory of Property Rights II: The Competition between Private and Collective Ownership*, 31 J. LEGAL STUD. 653 (2002); Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

vital for preventing coercion, securing liberty and enhancing personal welfare. More recently, a growing body of empirical work demonstrates a strong positive association between the degree to which countries protect private property and economic development.”¹⁹

The legal protection of the share asset as private property is key to stimulating economic activity in relation to the investment market, arguably towards maximum efficiency.²⁰ In sum, the economic development of investment capitalism requires the expansion of private rights to stimulate market activity and such expansion includes establishing property rights over a range of private assets including investment assets.²¹

On the other hand, the *internal* dimension of the share is not completely or clearly defined. In other words, the share is clearly identified as an asset in its *external* proprietary terms and this is how it is fabricated for the market. Buyers, sellers and issuers have no doubt as to what is being traded, but what other enjoyment can be derived from the share as an incident of property from the prospective of the holder of the share? Does the holder of a share own any part of the issuing corporation? This refers to the *internal* dimension of the share and it is the *internal* dimension that the article focuses on to determine if and to what extent the enjoyment of ownership (other than in transferability) in a share may form the basis to support many modern forms of shareholder activism today. The *external* dimension of a share, which is supported by proprietary notions of ownership in order to facilitate the acceptance of a share as asset, and the free transferability of shares, should not arguably be borrowed to fabricate the paradigm of the *internal* dimension of a share.

The bundle of rights in the *internal dimension* of a share may still be argued to be “proprietary” in nature, as these rights allocate control over certain corporate assets and corporate decisions to shareholders.²² In *Her Majesty’s Commissioners of Inland Revenue v. Laird Group PLC*, Lord Millett stated:

¹⁹ Ross Levine, *Law, Endowments and Property Rights*, 19 J. ECON. PERSP. 61 (2005).

²⁰ See Randall Collins, *Weber’s Last Theory of Capitalism*, 45 AM. SOC. REV. 925 (1980) (explaining Weber’s exposition on how private property rights in general are indispensable to the economic use of assets towards maximum efficiency).

²¹ SAMUEL BOWLES & HERBERT GINTIS, *DEMOCRACY AND CAPITALISM: PROPERTY, COMMUNITY, AND THE CONTRADICTIONS OF MODERN SOCIAL THOUGHT* (Basic Books 1998); Wesley C. Mitchell, *Commons on the Legal Foundations of Capitalism*, 14 AM. ECON. REV. 240 (1924).

²² Sven-Olof Collin, *Governance Strategy: A Property Right Approach Turning Governance into Action*, 11 J. MANAGERIAL GOVERNANCE 215 (2007); Michael Whincop & John A. Armour, *The Proprietary Foundations of Corporate Law*, 27

It is customary to describe [a share] as “a bundle of rights and liabilities,” and this is probably the nearest that one can get to its character, provided that it is appreciated that it is more than a bundle of contractual rights. . . . These rights, however, are not purely personal rights. They confer proprietary rights in the company though not in its property.²³

In Henry Smith’s conceptualization of ownership property rights,²⁴ which is distinguished from what he terms as “governance rights,” Smith describes governance rights as existing in the rules of liability permitting defined actions and regarding certain other actions as forms of encroachment. As rules of liability define each permitted action *vis a vis* the property concerned, they are different from ownership rights. Ownership rights are defined in the ability to exclude others and there is, therefore, no need to define a bundle of rights, such as governance rights over the property. In Smith’s conceptualization, a bundle of rights representing certain extents of control would merely be a form of governance and is not to be regarded as ownership.

Many would acknowledge that a stronger case may be made for saying that proprietary rights in the firm actually lie with management, as management has the power to make decisions regarding the use and allocation of corporate assets—although subject also to mandatory duties in law—and hence, although the legal fiction of the corporation actually owns any asset, the proprietary rights over the assets are more significantly exercised by management.²⁵ The right of the Board to manage is defined as “general authority” and a right to exercise “all the powers of the company.”²⁶ This is consistent with Smith’s conceptualization of ownership as having an unspecified bundle of powers. It may be argued that the Board is but an agent of the shareholders, as finance economists suggest. “Agency,” however, as understood in finance economics is rather different from the understanding under the law. An agent in law derives the remit of powers from the principal—and even in apparent authority, such authority is

OXFORD J. LEGAL STUD. 429 (2007); Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998).

²³ [2003] UKHL 54 at para 35.

²⁴ Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719 (2004); Henry E. Smith, *Exclusion and Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. 453 (2002).

²⁵ JOHN McDERMOTT, *CORPORATE SOCIETY: CLASS, PROPERTY AND CONTEMPORARY CAPITALISM* 80–91 (West View Press 1991).

²⁶ Model Articles for Private Companies Limited by Shares, and Model Articles for Public Companies, art. 2 (similar to the position to the predecessor to the Model Articles, Art 70, Table A of the Companies Act 1985).

derived from the principal's representation²⁷ to begin with. The powers of the Board and shareholders are however seen in a paradigm of "division" of roles and the proper principal of the Board is the real entity, the company. This may be explained by a series of cases testing the nature of the directors' employment contracts. Often the terms of directors' employment with the company are spelt out in the Articles of the company. As the Articles are a contractual document representing the relationship between members *inter se*,²⁸ only members acting in the capacity of members are able to enforce the Articles in court.²⁹ Terms benefitting or relating to directors are often not enforceable as directors are regarded not to have a contract with members of the company as such.³⁰ If the law upholds the agency model of corporate governance and directors are treated as agents of shareholders, then surely shareholders can embody in a document that represents their collective agreement, the terms of the agency. The law has recognized directors' employment contracts with the company, the real entity. The provisions of the Articles dealing with directors may to some extent be implied into the employment contract,³¹ but in the absence of an independent employment contract with the company, directors are unable to enforce employment terms in the Articles *in vacuo*. The "division of powers" paradigm is arguably the dominant legal paradigm that defines the relationship between directors and shareholders and the law does not seem to subscribe to a pure conception of "agency." This is affirmed in the key case of *Breckland Group Holdings Ltd. v. London & Suffolk Properties Ltd.*,³² where a majority shareholder's usurpation of the power to decide to institute proceedings against a minority shareholder was set aside as the decision had to be taken by the Board. Where the Board is to have general management authority, English law has quite firmly held that shareholders do not have the arbitrary power to intervene.

Why do many commentators and the judiciary accept that shareholders' powers have a "proprietary character?" This may be partly attributed to the legal position that shareholders have a reserve power³³ to direct management if shareholders procure a special resolution to do so. Hence, the enabling framework in company law may allow shareholders to be more involved in management decisions and

²⁷ *Freeman and Lockyer v. Buckhurst Park Properties*, [1964] 2 Q.B. 480.

²⁸ *Hickman v. Kent or Romney Marsh Sheepbreeders Ass'n*, [1915] 1 Ch. 881.

²⁹ *Eley v. Positive Gov't Sec. Life Assurance Co.*, (1876) 1 Exch. Div. 88.

³⁰ *See Read v. Astoria Garage (Streatham) Ltd.*, [1952] Ch. 637; *S. Foundries v. Shirlaw*, [1940] A.C. 743.

³¹ *See Read v. Astoria*, Ch. 637.

³² [1988] 4 BCC 542.

³³ *Id.* at art. 3 (codifying the position in *Quin & Axtens v. Salmon*, [1909] A.C. 442).

having proprietary control over the company's assets if the Articles so provide or if the reserve power of shareholders is exercised. English law has always accorded a special provision to the equity capital suppliers of the firm. This may be due to the fact that companies evolved out of partnership law and until 1855, members of a company did not have limited liability.³⁴ Equity providers were not seen as a collective mass of anonymous persons but often as participants in the company.

The recognition of the reserve power dates back to 1909 in the seminal case of *Quin & Axtens v. Salmon*.³⁵ In that case, a company with two directors was obligated to comply with an Article providing that all decisions with respect to acquiring or letting of property, required the consent of both directors. One director dissented and the other procured a general meeting where the resolution of securing a lease was passed by simple majority. The court held that only if the resolution was passed by a special majority would the resolution be binding on the company. Hence, the case set the rule for reserving residual management to the general meeting only if the general meeting exercised such power with a three-fourths majority. This position has now been adopted in the Model Articles under the Companies Act, which form the default constitution for companies. The U.K. legal regime has provided for a generous regime of governance for shareholders through the reserve power, which is not available in the United States. The "reversion" of power may be regarded as an acceptance of some proprietary notions of the concept of share ownership. It could also be argued that the "reversion" is based on a "division of powers" paradigm as shareholder power is only summoned if the Board is deadlocked or unable to act.³⁶ Today, it is arguable that the regime of the reserve power may be supported by reference to the development of the "residual claimant" theory in institutional economics.

Mandatory law also confers on shareholders certain specific governance rights to which we shall turn shortly and these arguably reinforce the perception that shareholders are "residual owners." There are, however, other aspects of the legal regime that do not un-

³⁴ Ross Grantham, *The Doctrinal Basis of the Rights of Company Shareholders*, 57 CAMBRIDGE L.J. 554 (1998).

³⁵ *Quin & Axtens v. Salmon*, [1909] A.C. 442.

³⁶ See, e.g., *Re Opera Photographic*, [1989] 5 BCC 601; *Union Music Ltd. v. Watson Arias Ltd. V. Blacknight Ltd.*, [2004] BCC 37. These cases concerned whether a shareholder could ask the court to order the convening of a general meeting in order to resolve any deadlock in management, but the court has used such power carefully so that reversion is granted only when it is necessary for the general meeting to make a management decision that otherwise would not be made. The court has refrained from aiding the calling of general meeting with an often amended quorum if doing so will override minority and class rights that were sought to be protected. See *Ross v. Telford*, [1997] BCC 945.

equivocally support shareholder primacy. The article now turns to examine the contesting aspects of the legal regime in framing shareholders' governance and rights in a company.

B. Governance and Control Rights: The Legal Principles

1. Nature of the Right To Vote

The key governance right derived from share ownership is the right to vote. Shareholders are entitled to vote on their shares as an incident of property,³⁷ and so the legal framework recognizes voting as the main control mechanism for shareholders to participate in the governance of a corporation. A vote allows an expression of preference between given options, but the nature of the vote is such that only the collective aggregation of votes into a majority matters for the outcome.³⁸ Hence, the allocation of an individual right to vote does not *per se* entail the exercise of strong powers, such as those inherent in the exclusionary nature of ownership rights.

However, the right to vote may translate into stronger forms of control and exercise of ownership rights under certain situations. This seems to be the case in companies with a concentrated large blockholding where shareholders are in the position to vote themselves or trusted persons onto the Board, and the right to vote becomes a strong control right that can ultimately take decisions directly affecting corporate assets and the existence of the corporation itself. Commentators have observed how concentrated large blockholding, particularly by families, affects the management expertise and decisions of the company,³⁹ as well as the use, acquisition, or disposal of corporate assets.⁴⁰ This is also the case where the right to vote may be weighted, and the extent of control that such a right entails becomes sufficiently

³⁷ *N. Counties v. Jackson & Steeple*, [1974] 1 W.L.R. 1133; *North-West Transp. Co. Ltd. v. Beatty*, [1887] 12 App. Cas. 589.

³⁸ See KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1970) (arguing that the social choice aggregated from the voting decisions need not provide the most optimal outcome for all participants).

³⁹ See Sven-Olof Collin, *Governance Strategy: A Property Right Approach Turning Governance into Action*, 11 J. MANAGERIAL GOVERNANCE 215 (2007); ROLF H. CARLSSON, *OWNERSHIP AND VALUE CREATION* (2001) (describing how Swedish owners who are also in management bring various forms of input and motivational impetus to the corporation).

⁴⁰ David L. Kang & Aage B. Sorensen, *Ownership, Organization and Firm Performance*, 25 ANN. REV. SOC. 121 (1999); R. Gilson, *Controlling Shareholders and Corporate Governance* (ECGI Working Paper 49/2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=784744 (reporting of tunnelling and extraction of corporate value for private interest are also rife); M. ARARAT, B. SENER & E. TABOGLU, *INTERNATIONAL CORPORATE GOVERNANCE: A CASE STUDY APPROACH* 269, 283 (C. Mallin ed., 2006).

significant.⁴¹ Further, the majority vote at a general meeting may indicate the general meeting's advice to management, and where the majority vote is a super-majority, the special resolution could direct management to be bound to take certain courses of action,⁴² which is earlier described as the shareholders' reserve power. Where the right to vote is concentrated, sufficiently collective, or sufficiently weighted, it can be used to further the exercise of exclusionary rights over corporate assets and decisions, and hence, the ownership of shares could practically translate into ownership rights over the firm itself.

The mandatory framework in company law has arguably played a stronger role in reinforcing the ownership notion underlying shareholdership. This is because the mandatory framework in company law has co-opted shareholders into a governing role *vis a vis* management, especially in situations of conflicts of interest. Such a co-option seems to be based on the perspective that sees shareholders as the ultimate residual claimants of a company, and hence residual owners.

The mandatory framework in company law reserves certain decisions to shareholder meetings, or prohibits certain executive decisions to be made unless shareholders approve. Provisions dealing with the appointment and removal of directors are examples of the former.⁴³ Such powers may translate into the direct or indirect exercise of ownership rights in the firm, as may often be the case in concentrated blockheld companies. Further, directors, or their connected persons, are not allowed to enter into substantial property transactions with the company,⁴⁴ or to benefit from a company loan or quasi-loan⁴⁵ or other credit transaction,⁴⁶ without the approval of shareholders by an ordinary resolution. These provisions co-opt shareholders into monitoring the prospects of self-dealing by management, and in turn translate into a form of proprietary control for shareholders. Mandatory law has also provided for shareholders to have the right of ratification or otherwise of breaches, negligence, or omissions commit-

⁴¹ *Bushell v. Faith*, [1970] A.C. 1099. Also the weighted voting structures frequently used in family-founded firms even where the founding family shareholders are no longer in the majority. See J. AGNBLAD, E. BERGLOF, P. HOGFELDT & H. SVANCAR, OWNERSHIP AND CONTROL IN SWEDEN: STRONG OWNERS, WEAK MINORITIES AND SOCIAL CONTROL, *THE CONTROL OF CORPORATE EUROPE* 250, 255 (Barca & Becht eds., 2002).

⁴² *Quin & Axtens v. Salmon*, [1909] A.C. 44 (now codified in Art. 3, Model Articles).

⁴³ Companies Act, 2006, c. 45, §§ 160, 168–69, 188 (with respect to long-service contracts exceeding two years with the company).

⁴⁴ *Id.* at §§ 190–196.

⁴⁵ *Id.* at §§ 197–200, 213–14.

⁴⁶ *Id.* at §§ 201–14.

ted by directors.⁴⁷ The right of shareholder ratification seems particularly based on the perspective of shareholders as residual risk bearers and hence the appropriate assessors of whether or not to accept irregularities committed by management and how such irregularities may affect their investment.

2. *Are Shareholders Residual Claimants or Owners?*

The residual claimant theory was developed from an economic theory about the organization of a firm. Coase's famous theorem⁴⁸ argued that firms were organized in order to internalize certain contractual arrangements on a revolving basis, such arrangements would otherwise have to be sourced on the market. Williamson took Coase's theorem one step further by showing how internalization minimized opportunity costs (or transaction costs) that took place with repeated on-market arrangements and hence the organization of a firm was based on efficiency of economic arrangements minimizing transaction costs that would otherwise have been incurred on the market.⁴⁹

The internalization, however, of a firm as a nexus of contracts would feature some long term open-ended contracts, as specific rights are unlikely to be completely spelt out in an ongoing relationship where myriad possibilities exist, such as a shareholder's investment in a company or long-term employees with firm specific expertise.⁵⁰ Such open-ended contracts would result in renewed negotiations and arrangements over time, and hence it is argued that "[the] Board of directors thus arises endogenously, as a means by which to safeguard the investments of those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined and cannot be protected in a well-focused, transaction-specific way."⁵¹ Who are these residual risk bearers whose investments are long term and ill-defined? Alchian and Demsetz argue that internalization of a nexus of contracts within a firm must be subject to a centralized contractual agent, that organizes the input into the team production process of the firm.⁵² Such a centralized contractual agent must then have the incentives to monitor the rest of the team in overseeing their inputs. In order for the monitor to be incentivized to monitor, he or she could be designated a residual owner of the net earnings

⁴⁷ *Foss v. Harbottle*, (1843) 2 Hare 461 (codified with modification in § 239 of the Companies Act 2006).

⁴⁸ Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

⁴⁹ OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 15 (1985).

⁵⁰ *Id.* at 306.

⁵¹ *Id.*

⁵² Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organisation*, 62 *AM. ECON. REV.* 777 (1972).

of the firm so that he or she would not be incentivized to shirk the monitoring responsibility. By this argument, it is not yet necessary to designate the shareholder as the residual owner, and constituents who fall within this category arguably include management itself, shareholders, long term creditors and employees.

Another group of economists, however, took the contractual relationships in constituting the firm to another level, the level of property rights. Grossman and Hart argued that in order for the contractual relationships in the firm to be sustained, contractual relationships must spell out either specific rights or residual rights.⁵³ Where specific rights cannot be spelt out and the rights are long-term, unspecific and residual, the holder of residual rights in effect holds proprietary rights over the net assets of firm, as such proprietary rights are the platform upon which the residual rights are based. Hart⁵⁴ argues that as the organization of the firm is centered around the use of the firm's non-human assets, the residual rights should then be structured as residual ownership rights over those assets.⁵⁵ In economic theory, little distinction is made between capital providers and managers of the firm, and the usual assumption is the fusion of the two. However, where there is separation of ownership from control, who then is the residual claimant in the firm?

The "finance perspective" of the firm, introduced by Jensen and Meckling, is crucial to our recognition of shareholders as the residual claimants in the firm with property rights. The "finance" perspective placed emphasis on the role of the capital providers to the firm (such as shareholders and creditors). Jensen and Meckling worked on a

⁵³ Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986).

⁵⁴ Oliver D. Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757 (1989).

⁵⁵ *Id.* But see Charles F. Sabel & Jane E. Prokop, *Stabilization through Reorganization*, in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA 151 (R. Frydman et al. eds., 1996) (arguing that new economies need not be built upon capitalistic notions of residual ownership of corporate assets and decisions made by the pricing mechanism of the free market, thus revealing that Hart's view may be outdated). This is because production is getting harder and more product runs are short, making work organization less based on product-specific property but on more flexible forms of property that can be used for all sorts of production. This means that suppliers, firms and customers should combine with each other at different points to produce a collaborative network that may always be changing. In this context, to make residual owners who also have diversified portfolios as economic owners and deciders of firm decisions may not be optimal. Alternative forms of defining ownership of residual assets that are decoupled from control is necessary, and that will allow more collaborative frameworks to arise so that governance may be provided by different actors who have different incentives to drive production as may be necessary.

model of separation of capital provision from managerial control, and opined that the capital providers would be interested in maximizing the cash flow rights and residual value of the firm while managers may be interested in maximizing their private utility and job satisfaction. The relationship between owners, managers, and creditors would hence manifest in agency costs.⁵⁶ The structure of the firm would then depend on the monitoring and bonding activities undertaken by creditors and shareholders to reduce management expropriation of private benefit in their position of control.⁵⁷ They also opined that although capital will always be a mixture of debt and equity, debt produces enormous agency costs for creditors and costs for both the manager and the firm itself in being constrained by various covenants. Hence, debt is not a preferred source of finance. From a finance perspective, the separation of ownership from control creates conflicts of objectives between shareholders and management, and management may direct the firm into transactions that need not necessarily maximize the net cash flow for shareholders. This represents agency costs for shareholders, and hence they bear the residual risk of the value outcome of the firm.⁵⁸ The finance perspective is arguably responsible for identifying the shareholder as the residual claimant/owner developed in organizational economic theory. Agency costs are therefore seen as the dominant factor affecting the risk borne by shareholders, but is a necessary evil, as Fama and Jensen argue that from an organizational perspective, the separation of professional managers from diverse shareholders is still most likely to be efficient, and managers may be controlled by internal monitoring and ratification, and external forces such as the market for corporate control and monitoring from the stock market that is pricing the stocks.⁵⁹

The development of shareholder primacy is founded both on the perspectives of shareholders as “principals” controlling agents, and as residual claimants/owners in the firm. These perspectives firmly entrench shareholders in a position where it is accepted that shareholders would naturally bargain for maximization of cash flow rights and hence firm value, and that would be what managers as agents are

⁵⁶ *But see* A.A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (describing directors as trustees of power in managing the corporation). Subsequent finance literature has brought the negative self-dealing incentives of the “trustees” to the forefront.

⁵⁷ *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

⁵⁸ Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983).

⁵⁹ *See generally id.*

hired for.⁶⁰ These theoretical perspectives lend support to the fabrication of “ownership” of the firm by shareholders. It is even arguable that legal developments manifested in the United Kingdom Companies Act of 1985 on shareholder controls on director expropriation (which, as discussed earlier, are imposed under mandatory law), are derived from this perspective of shareholders as “owners.”⁶¹ The legal framework, however, on the whole is arguably ambivalent in recognizing shareholders as the only residual owners, as will be discussed below.

The finance perspective, supporting shareholders as residual owners and shareholder primacy, has been criticized by a number of leading proponents. Margaret Blair has criticized the shareholder primacy model as based on an erroneous assumption that only shareholders are residual risk bearers.⁶² Blair argues that employees are also a class of residual risk bearers as they acquire firm specific expertise and the longer they work for the firm, the less likely they will be able to move freely to another job.⁶³ Long service employees hence make a firm-specific investment and are residual risk bearers of a firm’s insolvency.⁶⁴ Blair, together with Lynn Stout, developed a director primacy theory arguing that directors must maintain their primary roles in managing the different inputs into a firm, including those of shareholders, employees, and creditors, and allowing shareholder primacy to dictate the objectives of the firm, or the actions shareholders can take in monitoring and controlling, is misplaced.⁶⁵

⁶⁰ See generally FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (Harvard Univ. Press) (1991).

⁶¹ The Companies Act 1948 contains significantly fewer and less detailed provisions controlling director expropriation than later Companies Acts. The provisions controlling directors’ transactions with the company were first introduced in Part IV of the Companies Act 1980, thereafter consolidated as Part X of the Companies Act 1985, and now retained in the 2006 Act. The 1980 Act’s provisions may be attributable to the explosion of awareness of the agency problem developed in finance literature in the 1970s and 80s.

⁶² MARGARET M. BLAIR, *OWNERSHIP AND CONTROL* 223–45 (Brookings Inst. Press 1995).

⁶³ See *id.* at 230–31, 238–39.

⁶⁴ See *id.* at 238–39.

⁶⁵ See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719 (2006); accord Armen A. Alchian & Susan Woodward, *The Firm Is Dead; Long Live The Firm*, 26 J. ECON. LITERATURE 65 (1988) (reviewing OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985)) (viewing labor as another form of capital and hence refusing to accord primacy only to cash capital suppliers); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789 (2007); Sarah Worthington, *Shares and Shareholders: Property, Power and Entitlement*,

Blair's director primacy theory augments Dodd's early model that managers are trustees for the corporation as an entity in itself.⁶⁶ This school of thought endorsing director primacy is arguably in line with the Model Articles and *Breckland Holdings*, and is wary of shareholders taking advantage of their positions in interfering with management to satisfy their private interests which may not have anything to do with maximizing cash flow rights for all.⁶⁷

Economists Alchian and Woodward also argue that the view treating shareholders as residual claimants over non-specific firm value and hence superior to the other constituents in the firm is erroneous. They argue that managers invest firm-specific input not only in terms of expertise, but frequently in terms of investment of capital in the firm itself too, and similarly for employees of the firm. That is why many professional firms are labor-owned and not capital-owned, as the input by labor is regarded as specific and non-time limited to the firm, and there is no reason why labor should not be responsible for administering the proprietary decisions over the firm and sharing in the residual claims.⁶⁸

In their words:

First, the leader of a team (management) is the member with the comparative advantage in deciding what the team and its members should do, and this manager need not be an owner or even part-owner in the firm; second, ownership of the team is the residual claimancy on the most team-specific resources, which may be labor or capi-

22 COMPANY LAW. 258, 307 (2001) (rejecting "ownership" fabrication of shareholdership, and arguing that there is no entitlement on the part of shareholders to require firms to be run for their primary interests).

⁶⁶ E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932).

⁶⁷ See generally Martin Lipton & Paul K. Rowe, *The Inconvenient Truth about Corporate Governance: Some Thoughts on Vice-Chancellor Strine's Essa*, 33 J. CORP. L. 63 (2007) (voicing similar concerns); Jeffrey N. Gordon, *Shareholder Initiative and Delegation: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991); Lynn A. Stout, *Shareholders Unplugged*, LEGAL AFFAIRS, Mar.-Apr. 2006, at 21, available at http://www.legalaffairs.org/issues/March-April-2006/argument_Stout_marapr06.msp; Theodore N. Mirvis, Paul K. Rowe, & William Savitt, *Bebchuk's "Case for Increasing Shareholder Power": An Opposition* Harvard Discussion Paper No. 586 (2007), available at <http://ssrn.com/abstract=990057> (responding to Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005)); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006).

⁶⁸ Alchian & Woodward, *supra* note 65.

tal. To start an analysis of firms by assuming the presence of “capital” or that capital hires labor is to beg the question of the basis for the existence of a firm.⁶⁹

Further, modern perspectives of the firm see the firm as not an organization around assets that are used towards a production of the same outputs, but as networks of resources that can be combined, collapsed, and re-combined to produce a variety of outputs for the competitive markets. Such a view allows a network of interacting and flexible relationships in an organization less based on pools of stable property, hence even diminishing the stature of the “residual claimant,” as resource providers can move freely and flexibly with less committal to particular economic arrangements in order to meet changing production objectives.⁷⁰

Another school of thought disagreeing with shareholder primacy approaches from the social welfare stance. Parkinson argues that the emphasis on wealth maximization may be misplaced when looked at in the context of social or moral welfare.⁷¹ In considering these other priorities, he advocates a model that includes other stakeholders such as employees in management, based on arguments that employees need to have a right to democratic self-government in an organization, and such rights should not be sidelined by conventional efficiency and “capital as property” perspectives.⁷² This school of thought is echoed in many other “stakeholder” theories⁷³ that reject the fundamental analysis of shareholder primacy from the finance perspective.

Modern developments may also undermine the finance perspective. The finance perspective is based on recognizing that shareholders bear the greatest amount of residual risk in the firm due to agency costs. The assumption made by all institutional economists is that the residual claimant is subject to a long term, undefined, and open-ended risk of expropriation of the firm’s assets, as if the risk

⁶⁹ *Id.* at 72.

⁷⁰ Charles F. Sabel & Jane E. Prokop, *Stabilisation through Reorganisation*, in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA 151 (R. Frydman et al. eds., 1996).

⁷¹ See J.E. PARKINSON, *CORPORATE POWER AND RESPONSIBILITY* (Oxford Univ. Press 1993).

⁷² See *id.*

⁷³ See generally Shann Turnbull, *Stakeholder Governance: A Cybernetic and Property Rights Analysis*, 5 SCHOLARLY RES. & THEORY PAPERS 11 (1997); Tony Ike Nwanji & Kerry Howell, *The Stakeholder Theory in the Modern Global Business Environment*, 1 INT’L J. APPLIED INSTITUTIONAL GOVERNANCE (2008), available at <http://www.managementjournals.com/journals/ig/article148.htm>; Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705 (2002).

borne residual claimant is wholly defined by his relationship to the firm. If shareholders' risks are gradually being mitigated or dissipated by other means outside of the firm's boundaries, then they may be less affected by agency costs within the firm, and according them primacy for being the most vulnerable residual risk bearers may then become misplaced. For example, many modern shareholders of firms are institutions such as pension funds, mutual funds, and hedge funds. These funds, being professionally managed, are diversified, or are able to hedge their investments in order to mitigate risk. Next, some shareholders are able to enter into arrangements where they do not have to bear the risk of cash flow rights but only holding on to voting rights. In situations where the cash flow rights have been decoupled from voting rights, can we really say that the holder of the voting rights bear a residual risk in the changing values of the firm?⁷⁴ Partnoy and Martin discuss how the decoupling of rights in shares affects the propensity to vote, and the perversity of allowing certain technical "holders" of shares to vote who may have economic interests adverse to the firm.⁷⁵ Further, it is documented that many joint venture shareholders have complex arrangements where cash flow rights, voting rights, liquidation rights, and Board representation rights may all be separated, and hence, it may be too simplistic to hold on to a perception of the "residual owner" as a residual risk bearer in the firm.⁷⁶

Further, it is arguable that the co-option of shareholders to exercise strong governance rights over potentially conflicting transactions involving directors need not be based on shareholders' proprietary claim to the company or a fabrication of "ownership" in the company. Regulatory theory argues that the complexities of modern regulation often make it difficult for regulators to have comprehensive oversight or control, or to design comprehensive incentives to direct or facilitate the working of the market in a particular way.⁷⁷ Regulators therefore co-opt other actors in the market as these have their own

⁷⁴ See generally Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

⁷⁵ Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, Legal Stud. Res. Paper Series No. 05-23, at 14–19 (2004), available at <http://ssrn.com/abstract=621323>.

⁷⁶ Hirokazu Takizowa, *New Institutional Arrangements for Product Innovation in Silicon Valley*, in OWNERSHIP AND GOVERNANCE OF ENTERPRISES: RECENT INNOVATIVE DEVELOPMENTS 69 (Palgrave MacMillan 2003).

⁷⁷ Julia Black, *Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation* (London School of Economics Public Law Working Paper Group, Paper No. 63, 2003); Julia Black, *Decentring Regulation* (London School of Economics Current Legal Problems Working Paper Group, Paper No. 103, 2001); Colin Scott, *Analysing Regulatory Space: Fragmented Resources And Institutional*

resources and leverage upon the natural incentives of these actors to perform certain roles that would achieve a regulatory effect. Hence, the role that mandatory law has given to shareholders may be read no more than in that light, and it may arguably not represent the law's endorsement of a fabrication of "ownership."

Turning to the legal framework in the United Kingdom, it is arguable that the law is ambivalent about shareholder primacy. Although shareholders have "reserve powers" that can intervene specifically in a management decision, and can contract for powers of control in a company other than in accordance with the Model Articles, there are aspects in company law that do not accord shareholders with primacy. Worthington has argued that whether we view the company as a "nexus of contracts" or as a "real entity," the legal framework does not support any assertion that shareholders are entitled to have directors run the company for the purposes of shareholder wealth maximization. The "nexus" perspective allows companies to be seen as a web of interactions among constituents, but the theory itself does not give primacy to shareholders. It is only if we accept the finance economists' attribution of importance to the residual risk bearer (at least in terms of financial capital) that a primary position can be accorded to shareholders. The law recognizes that shareholders risk their capital in the company for the long term without easy prospects of withdrawing the capital.⁷⁸ Shareholders, on the other hand, are ameliorated by the rule on limited liability, and the prospect that their shares can ordinarily (subject to contractual restrictions in the Articles) be sold in a liquid market or otherwise. Looking at rules on transaction avoidance,⁷⁹ directors' duty to creditors during the twilight of a company⁸⁰ and provisions protecting creditors at a voluntary liquidation,⁸¹ company law clearly allows others' concerns to be given priority over shareholders under certain circumstances. The mandate to consider a wide range of stakeholders' interests in the discharge of directors' duties⁸² and the need for shareholders to consider stakeholders' interests in pursuing a derivative action⁸³ are examples of when shareholder primacy does not rule. Further, the legal framework is also heavily based on the "real entity" theory as the company's interest is regarded

Design (London School of Economic Public Law Working Paper Group, Paper No. 32, 2001).

⁷⁸ *Trevor v. Whitworth*, (1887) 12 App. Cas. 409 (demonstrating modern day limitations in the rules on maintenance of capital).

⁷⁹ Insolvency Act, 1986, c. 45, §§ 238, 239, 245.

⁸⁰ *The Liquidator of West Mercia Safetyware Ltd v. Dodd*, [1988] 4 B.C.C. 30.

⁸¹ *See, e.g.*, Insolvency Act, 1986, c. 46, §§ 84, 89.

⁸² Companies Act, 2006, c. 45, § 172.

⁸³ Companies Act, 2006, c. 45, § 263(2) and (3).

as distinguishable from shareholders' interests and directors' duties are defined as duties to the company.⁸⁴

Case law has repeatedly affirmed that a shareholder's nominee director on the Board should serve the company's interests first and foremost, and it would be a breach of duty if such director did not consider the company's interests as such, only considered the appointing shareholder's interests.⁸⁵ Even where shareholders engage in the activity of voting to amend the Articles, the "real entity" theory is arguably at work as the vote must be exercised *bona fides* for the benefit of the company as a whole.⁸⁶ Finally, the case of *Short v. Treasury Commissioners*, it is stated that "shareholders are not, in the eye of the law, part owners of the undertaking."⁸⁷ Shareholders do not have a proprietary stake in the assets of the company, the "real entity," as was affirmed in the much more recent case of *Her Majesty's Commissioners of Inland Revenue v Laird Group PLC*.⁸⁸

The legal framework in the United Kingdom has the following features:

- (a) Unless otherwise modified, the enabling legal framework provides for director primacy;
- (b) Shareholders have a reserve power to direct management in a specific resolution passed by special majority, but not a general power of interference;
- (c) Shareholders are empowered under general mandatory law to have exclusive governance over various areas such as appointment and removal of directors, approval of certain transactions and in general ratification;
- (d) But directors are allowed to consider other constituents' interests and above all, the interests of the "real entity," the company, above shareholders;
- (e) The law regards the value of the company as separate and distinct from shareholders' share values in aggregate,

⁸⁴ Companies Act, 2006, c. 45, § 170(1).

⁸⁵ *Scottish Coop. Wholesale Soc'y Ltd. v. Meyer*, [1959] A.C. 324; *Kuwait Asia Bank E.C. v. Nat'l. Mut. Life*, [1990] 1 A.C. 187.

⁸⁶ *Allen v. Gold Reefs of West Africa, Ltd.*, [1900] 1 Ch. 656. This position has been somewhat changed by the interpretation given in the later case of *Greenhalgh v. Ardenne Cinemas Ltd.*, [1951] Ch. 286, where the benefit for the company as a whole is to be determined by the "reasonable corporator". This arguably links shareholders' interest to be the same as what benefits the company, and such a presupposition may be questioned. However, the "reasonable corporator" is itself a fiction and hence it could be argued that there is no difference between the two expositions.

⁸⁷ *Short v. Treasury Comm'rs*, [1948] 1 K.B. 116.

⁸⁸ [2003] UKHL 54.

hence affirming the “real entity” as separate from shareholders.

The above analyses show that the fabrication of shareholders as “owners” has come largely from a finance perspective whose dominance may not be completely warranted. The law acknowledges the special nature of shareholders’ bundle of interests, and the reserve power goes fairly close to a fabrication of ownership. Shareholders are also endowed with a general power of ratification in such a way that shareholders are treated as the only residual claimant or owner of the firm that can decide whether to forgive or enforce against irregularities committed against the firm—for example, that other constituents do not have a say in this. It is also to be noted that shareholders’ power of ratification is subject to their freedom to vote,⁸⁹ and the *Allen v. Gold Reefs* limitation arguably does not apply.⁹⁰ On one hand, the enabling framework of company law can allow shareholders to contract for substantial control over corporate decisions and assets, making their power more “proprietary” in nature. However, on the other hand, this is rarely the approach taken in public and listed companies that uphold the division of powers in the default Model Articles. Many provisions in mandatory law reinforce the conception of the shareholder as residual owner and not just as a participant in certain aspects of governance. However, the other aspects of mandatory company law do not quite support that fabrication unequivocally. Mandatory law co-opting shareholders into a specific form of governance over directors may be explained as regulatory techniques in the public interest instead necessarily of an endorsement of the fabrication of ownership.

Against this backdrop, this article examines the practice of shareholder activism in the name of “ownership.” Notably, shareholder activism is generally carried out by minority shareholders—many in widely held public and listed firms. Where there is a dominant or majority owner and there is fusion with management, proprietary control over the firm may take place without the need for activism.⁹¹ This article does not address the many unique arrangements that may be made in the context of private companies, but instead focuses on public and widely held companies as activism occurs under circumstances where the shareholders do not have better control rights than the conventional governance rights found in the Model Articles.

⁸⁹ *N. Counties Sec. Ltd. v. Jackson & Steeple Ltd.*, [1974] 1 W.L.R. 1133.

⁹⁰ *Allen*, 1 Ch. at 656.

⁹¹ Majority—or even just large shareholders with a significant block, for example, 25%—can make a direct impact on key issues such as R&D policy, executive compensation and dividends. See Henrik Cronqvist and Rudiger Fahlenbach, *Large Shareholders and Corporate Policies* (2008), available at <http://www.ssrn.com/abstract=891188>.

3. *Shareholder Activism*

In Dalia Tsuk Mitchell's insightful article,⁹² U.S. shareholders are conceptualized as "investors" whose primary right is to sell as they choose, rather than as participants in the internal reform of companies. This conceptualization is supported by the U.S. law's emphasis on securities market regulation and transparency, which underlies the political antagonism against concentrated power, favoring dispersal of corporate ownership amongst a mass of investors.⁹³ Although the same political culture is absent in the United Kingdom, the United Kingdom and the United States converged in the ownership structure of firms since pension funds and institutional investors—such as mutual funds and insurance companies—own the majority of publicly traded equity.⁹⁴ In the United Kingdom, empirical evidence indicates that institutional investors behave first and foremost as "investors" with respect to their shareholdership.⁹⁵ Thus, this pre-occupation influences their engagement with their investee companies.

Alternative funds such as hedge funds and some sovereign wealth funds are starting to acquire more significant stakes in Anglo-American jurisdictions companies. Hedge funds especially engage in activism to influence various corporate governance and management decisions in a company. Although there is no deliberate ideological movement towards dispersal of shareholding, the evolution of investment capitalism and pension saving in the United Kingdom has led to a similar shareholding structure in the most significant public companies.

Shareholder activism may be defined along a spectrum of actions—from gaining corporate control (corporate raiding in 80s America) to instituting shareholder litigation to other forms of influence changing corporate directions without changing the stake of control (such as accessing the proxy system, making proposals and

⁹² Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 65 WASH. & LEE L. REV. 1503 (2006).

⁹³ Mark Roe, *Strong Managers, Weak Owners* (NJ: Princeton University Press 1996).

⁹⁴ Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 468 (2001).

⁹⁵ Kathleen Rehbein, Sandra Waddock & Samuel B. Graves, *Understanding Shareholder Activism: Which Corporations are Targeted?*, 43 BUS. & SOC'Y 239 (2004); John Hendry, Paul Sanderson, Richard Barker & John Roberts, *Responsible Ownership, Shareholder Value and New Shareholder Activism*, (ESRC Centre for Business Research, Working Paper No. 297, 2004); Andrew Jackson, *Towards A Mutual Understanding of Objectives? Attitudes of Institutional Investors and Listed Companies to Corporate Governance Reforms* 9(3) CORP. GOVERNANCE 196 (2001).

initiating dialogue, or relationship investing).⁹⁶ The current, rising form of shareholder activism is that which systematically influences corporate direction and decisions with a minority stake without resorting to the legal framework supporting shareholder litigation. This form of activism was led in the United States in the mid 1980s by public pension funds, such as CALPers, and influenced other private investment funds, such as LENS and the U.K. Hermes funds.⁹⁷

Relationship investing of contemporary shareholder activism can be undertaken through a range of actions. Shareholders could make proposals to be voted on at general meetings. In the United States, Rule 14a-8 of the Securities Exchange Act 1933 allows a holder of \$2000 in market value or 1% in equity to submit a single proposal to be voted on the general meeting.⁹⁸ In the United Kingdom, a member in a public company can ask for circulation of a proposal if he holds at least 5% of the company's equity or the proposal is supported by at least 100 members each having an equity value of not less than £100.⁹⁹ Further, members' proposals for resolutions must be received by the company at least six weeks¹⁰⁰ before the general meeting, but as companies are entitled to give a minimum of twenty-one days' notice¹⁰¹ for the general meeting (or twenty-eight days if the removal of a director is proposed¹⁰²), members may be unable to send proposals to a company in time—including for the removal of directors. This may, however, be made up for by the power of members to call an extraordinary general meeting. Hence, members are not limited by the directors' power to call a general meeting. The law also allows voting to be carried out by appointed proxies.¹⁰³ Empirical evidence shows that members' proposals for resolutions in the United States are increasingly successful as they attract fellow shareholders' support and although not binding in nature, could practically change the direction that the company was originally taking.¹⁰⁴ The proposal process is

⁹⁶ See Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence* (1998), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=663523&rec=1&srcabs=796227.

⁹⁷ *Id.*; See Sanford M. Jacoby, *Convergence by Design: The Case of CalPERS in Japan* (2006), available at <http://ssrn.com/abstract=920883> (explaining how CALPers influenced other funds).

⁹⁸ 17 C.F.R. § 240.14a-8 (2008).

⁹⁹ Companies Act, 2006, ch. 46 § 338.

¹⁰⁰ *Id.*

¹⁰¹ Companies Act, 2006, ch. 46 § 307(2)(a).

¹⁰² Companies Act, 2006, ch. 46 §168, 312.

¹⁰³ Companies Act, 2006 ch. 46 §324.

¹⁰⁴ Randall Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction* (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=868652; Stuart L. Gillan

also helped by rules allowing for solicitation of proxies.¹⁰⁵ However, the proxy process may sometimes be fraught with difficulties in terms of communication, coordination and cost.¹⁰⁶ That said, the threat of putting up a proposal for a resolution may itself be an influence for management to be reckoned with, whether or not the proposal is in fact put through and the proxy solicitation efforts are undertaken.¹⁰⁷ Other indirect forms of activism that leverage on the power to vote are in the form of “just vote no” to appointments and re-elections of directors, as a form of protest in order for management to register other specific shareholder demands.¹⁰⁸ Empirical evidence shows that such campaigns are being noticed by management and could lead to a change in corporate policy and even CEO turnover.¹⁰⁹

However, the proposal and solicitation process are less likely to be relied on in the United Kingdom as means of activism, and private

& Laura T. Sparks, *The Evolution of Shareholder Activism in the US* (2007), available at <http://ssrn.com/abstract=959670>; Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, & Chester S. Spatt, *The Role of Advisory Services in Proxy Voting* (Jan. 2008) (unpublished manuscript, on file with University of Maryland); Ernst G. Maug & Kristian Rydqvist, *Do Shareholders Vote Strategically?* (ECGI, Finance Working Paper No. 31/2003, 2006).

¹⁰⁵ See 17 C.F.R. § 240.14a-1 (2008).

¹⁰⁶ Shareholders may be passive due to the collective action free rider problem, or their behavior may largely depend on private motivations and whether they face conflicts of interest managing the funds of their investee companies. See Bernard S. Black, *Shareholder Passivity Re-examined*, 89 MICH. L. REV 520 (1990); Gerald F. Davis & E. Han Kim, *Would Mutual Funds Bite the Hand that Feeds Them? Business Ties and Proxy Voting* (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=667625; Pengfei Ye, *On Investors' Ownership and Voting Decisions: Evidence from Mutual Funds* (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1100362; Rasha Ashraf & Narayanan Jayaraman, *Determinants and Consequences of Proxy Voting by Mutual Funds on Shareholder Proposals*, available at <http://ssrn.com/abstract=962126>. Shareholders may also face communication costs problems. See Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy* (ECGI, Working Paper No. 92/2008, 2008), Jennifer E. Bethel & Stuart L. Gillan, *Corporate Voting and the Proxy Process: Managerial Control Versus Shareholder Oversight* (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236099 (describing how shareholders can be subject to distortions and manipulations introduced by management).

¹⁰⁷ N. K. Chidambaran & Tracie Woidtke, *The Role of Negotiations in Corporate Governance: Evidence From Withdrawn Shareholder-Initiated Proposals* (1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=209808.

¹⁰⁸ *Id.*

¹⁰⁹ Diane Del Guercio, Laura Seery & Tracy Woidtke, *Do Boards Pay Attention when Institutional Investor Activists Just Vote NO?* (2008), available at <http://ssrn.com/abstract=575242>.

forms of engagement are regarded as more effective.¹¹⁰ Shareholder activism carried out by a minority shareholder in the United Kingdom is most likely in the form of private dialogues and negotiations.¹¹¹ Empirical research from a number of jurisdictions, including the United States, has generally opined that such engagement successfully leads to changes implemented by the Board.¹¹²

III. TWO PARADIGMS OF SHAREHOLDER ACTIVISM

A. *Open-ended Contracting*

Early shareholder activism—such as that undertaken by CALPers in the United States in the 1980s and onwards, or other public pension funds such as TIAA-CREF, and the U.K. Hermes—targeted underperforming companies. These campaigns are phrased in terms of “unlocking shareholder value,” where shareholders are perceived to have been short-changed on what could be the potential price growth for their shares. These campaigns surrounded issues such as making executive compensation linked to performance,¹¹³ removal of anti-takeover defenses,¹¹⁴ changing Board composition to include independent directors, and other stakeholder concerns such as employment and environmental issues,¹¹⁵ all seen as measures that could be linked to improvement in share values.

The “unlocking of shareholder value” movement is arguably shareholder-centric, as its label itself suggests, and emphasizes the

¹¹⁰ Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 10 REV. OF FIN. STUD. 1093 (2008).

¹¹¹ *Id.*

¹¹² Roberta Romano, *Less is More: Making Shareholder Activism a Valued Mechanism in Corporate Governance* (2000), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=218650; Jonathan M. Karpoff, Abstract, *The Impact of Shareholder Activism in Target Companies: A Survey of Empirical Findings* (Sep. 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885365 (surveying of a range of other studies showing that private negotiations are more effective in inducing change than shareholder proposals); William T. Carleton, *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335; Becht et al., *supra* note 110.

¹¹³ Kenneth J. Martin & Randall S. Thomas, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1021 (1999) (discussing shareholder activism against excessive remuneration for CEOs of underperforming companies).

¹¹⁴ Particularly in the United States, as the United Kingdom has always had a friendly regime supporting takeovers and discourages the use of anti-takeover defenses such as the poison pill.

¹¹⁵ Kathleen Rehbein, Sandra Waddock & Samuel B. Graves, *Understanding Shareholder Activism: Which Corporations are Targeted?* 43 BUS. & SOC. 239 (2004).

share price value of the shareholder's investment, not the operating performance of the companies or its long-term profitability and survival.¹¹⁶ However, calls for reforming excessive executive compensation may entail a social benefit in lessening the gap between top managers and employees, and not concentrating corporate gains at the top. But unlocking shareholder value is chiefly concerned about distributing the gains from management to shareholders, and the social benefit if any, is incidental.¹¹⁷ Calls for changing Board composition, arguably, also have a social benefit dimension in that independent directors may be able to check abuses and excesses on the Board. This may increase the firm's risk management against management

¹¹⁶ This is also consistent with empirical findings on the financial impact of shareholder activism. Most literature argue that the financial impact on share prices may be mildly significant in the short run, but long term impact on operating performance is almost non-existent. See Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, (1996), http://www.pensionsatwork.ca/english/pdfs/scholarly_works/sw_edition3/Smith.pdf; Karpoff, *supra* note 112; Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. & QUANTITATIVE ANALYSIS 1 (1996); Becht et al., *supra* note 110 (discussing returns to shareholders in the form of increased share prices after activism). Where hedge funds are concerned, similar findings of short term share price abnormal returns are recorded after activism, see Nicole M. Boyson & Robert M. Mooradian, Abstract, *Hedge Funds as Shareholder Activists from 1994–2005*, (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992739; Chris Clifford, Abstract, *Value Creation or Destruction? Hedge Funds as Shareholder Activists* (2007), <http://ssrn.com/abstract=971018>; Alon Brav, Abstract, *Hedge Fund Activism, Corporate Governance and Firm Performance* (2007), <http://ssrn.com/abstract=948907>. But see Yvan Allaire, Abstract, *Hedge Funds as "Activist Shareholders": Passing Phenomenon or Grave-Diggers of Public Corporations?* (2007), <http://ssrn.com/abstract=961828>.

¹¹⁷ Although some commentators insist that shareholder value maximization will also result in the maximization of utility of stakeholders, see generally Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, available at <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>; Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235 (2002); HENRY G. MANNE & HENRY C. WALLICH, *THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY* (1972); Bernard S. Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Philip Goldenberg, *Shareholders v. Stakeholders: The Bogus Argument*, 19(2) COMPANY LAW. 34 (1998).

fraud,¹¹⁸ and mitigate the possibility of severe consequences such as insolvency that would affect a range of constituents.¹¹⁹

Shareholder activism is a self-help measure that shareholders undertake in order to protect their investment. This may be theoretically framed as part of the open-ended contracting process among the nexus of contracts, of which shareholders are a part. As such, shareholder campaigns in terms of anti-takeover defenses in the United States or against excessive executive remuneration in the United Kingdom are examples of contractual responses from shareholders in navigating the balance of interests in the nexus. This type of activism contracts for terms that are hitherto unregulated, hence falling within the enabling framework of company law. Shareholders are giving input, via the contractual process, on issues that have been left open, such as what executive remuneration should be related to or how it should be computed, the composition of the Board and whether a particular Chief Executive should continue to hold office. Such self-help measures may be accommodated within the understanding of the firm in institutional economics and within the enabling framework in company law. Perceived as such, shareholder activism may be regarded as part of the natural contractual outworking of the nexus of contracts, and this type of shareholder activism is termed as “open-ended contracting” in this article. It is suggested that shareholder activism of the “open-ended contracting” type is a natural manifestation of the bargaining process in the nexus, and can be theoretically supported. However, it must be questioned whether such activism is form of improper pressure in contracting, and whether such activism is unfair to other constituents in the nexus of contracts within the firm.

It may be argued that activism is not an improper form of pressure because shareholders as “residual owners” have the right¹²⁰ to bargain over an open-ended range of matters. But this argument depends on acceptance of the finance perspective of shareholder primacy, to which the legal framework does not completely subscribe.

In the enabling framework of company law, it may be possible that an activist is pushing for an agenda that may not be accepted by other shareholders. If the Board succumbs to that pressure, without

¹¹⁸ Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the UK- Non-executive Directors following the Higgs Report*, 6 THEORETICAL INQUIRIES L. 413 (2005).

¹¹⁹ See Iris H-Y Chiu, *The Role of Securities Disclosure Regulation in Investor Protection Relating to Corporate Insolvency? Some Observations of the US, EU and UK Regulatory Frameworks*, 29(2) COMPANY LAW. 35 (2008).

¹²⁰ What one has a right to carry out may not be regarded as a form of improper pressure or coercion upon another, see Tony Honore, *A Theory of Coercion*, 10(1) OXFORD J. LEGAL STUD. 94 (1990) (commenting on ALAN WERTHEIMER, COERCION (1987)).

the matter going to a vote, the activist would arguably have excluded other shareholders from the bargaining process in the nexus of contracts. The law has attempted to strike a balance between allowing an individual shareholder to pursue his grievances,¹²¹ and not allowing certain individual grievances to undermine the collective resolution of the interests of all shareholders in a company.¹²² Hence, it is imperative that shareholder activism in the extra-legal realm be examined carefully to discern to what extent the legal framework that protects other shareholders' interests is undermined. If we accept an "ownership" and proprietary fabrication of shareholders' rights in a company, the danger, when combined with shareholder activism, is that proprietary notions often give rise to and justify self-interested behavior to the exclusion of others (the essence of property rights).¹²³ This may form the foundation for justifying activists' extraction of private benefits through activism, leading to abnormal returns on share price at the announcement and at the end of the activism campaign. One has to recall that proprietary notions underlie the phenomenon of allowing concentrated shareholders of a company, who are also in management, to expropriate private benefits through their position in the company, often at the expense of minority shareholders.¹²⁴ Since there is broad consensus that majority extraction of private benefit needs to be controlled and regulated,¹²⁵ would there not be a case for examining the extent of private benefit extraction by minority activists which did not go to a vote?

If activists could influence direct implementation of changes they propose without going to a vote, and extract private benefit for themselves in the process, then the minority shareholding of an activist shareholder is disproportionate to its power. The exercise of such power, in the extraction of private benefit must be considered carefully to ascertain if legal controls are necessary.¹²⁶ Even if it could

¹²¹ Companies Act, 2006, S994, available at http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_1.

¹²² For example, enforcement of personal rights in the Articles may be trumped by collective ratification, see *MacDougall v. Gardiner*, [1875] 1 Ch. D. 13, or that a shareholder's campaign to amend the company's constitution has to be subject to the collective benefit of the company, see *Allen v. Gold Reefs of West Africa, Ltd.*, [1900] 1 Ch. 656.

¹²³ Reed, *supra* note 9.

¹²⁴ Ronald J. Gilsson, Abstract, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy* (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=784744.

¹²⁵ See generally World Bank, *Minority Shareholders* (Aug 2003), <http://rru.worldbank.org/PapersLinks/Open.aspx?id=2397>.

¹²⁶ Ronald J. Gilsson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=417181; Iman Anabtawi &

be argued that a Board bowing to an activist may be in breach of directors' duty by failing to take the course of action that best benefits the real entity, the company itself,¹²⁷ such a course of action does not address the real concern. Penalizing the Board for taking on board certain activists' demands may affect the value of the company for the other shareholders, after the activists have already extracted their private benefits. The activist could also be regarded as a shadow director under U.K. law if the Board is accustomed to listening to and acting on his wishes.¹²⁸ However, such a threshold is difficult to mount if an activist merely engages in an intensive short term campaign and the pattern of Board obeisance over the long term, as required under the law, cannot be established. Hence, even if an activist is acting consistent with the concept that s/he is influencing the open-ended contractual process within the nexus of contracts, the appropriation of private power through activism and its impact on shareholders must be considered carefully as to its desirability. The legal framework at present does not address this issue, since minority shareholder remedies in the United Kingdom¹²⁹ may not be applicable against a minority activist shareholder, and legal controls over directors' duties or shadow directors may not sufficiently address the concern.

The abovementioned issue is likely to remain a moot point as the present climate is not antagonistic to minority shareholder activists. If activism achieves abnormal returns in share price that can be enjoyed by all shareholders in the market, then other shareholders are unlikely to complain or be antagonistic towards that activism although the collective interests of shareholders may not be the same.¹³⁰ Further, other shareholders are generally supportive of activism, as activist shareholders help in overcoming the free-riding problem faced in the collective action dilemma amongst shareholders,¹³¹ and there is no reported evidence of counter-activism or anti-activism. The issue of improper influence exercised by activists is unlikely to be mounted by other shareholders for now.

In the United States, as there is no regime of "reserve power" for a special majority of shareholders, it is arguable whether share-

Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1256 (2008).

¹²⁷ Companies Act, 2006, S172, available at http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_1; In *Re Smith v. Fawcett Ltd.*, [1942] A.C. 304. (appeal taken from Ch.).

¹²⁸ *Secretary of State v. Deverell* [2001] ch. 340.

¹²⁹ Companies Act 2006, c.46, § 994.

¹³⁰ Ian B. Lee, *Corporate Law, Profit-Maximisation and the Responsible Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 37 (2005).

¹³¹ Michael Smith, *Shareholder Activism By Institutional Investors: Evidence From CalPERS*, 51 J. FIN. 227, 229 (1996).

holder activists should be regarded less unfavorably in tilting the balance of power which has overly favored directors. As argued, shareholder activism pursuant to “open-ended contracting” is theoretically supportable subject to the concern raised above on whether an activist’s action results in any externalities to other constituents in the nexus.

B. Property Rights Activism

When a shareholder activist is acting on his own, outside of the mandatory framework for shareholder governance, and where the reserve power of the general meeting is not summoned, the legal framework allows management to ignore such a shareholder unless his personal right under the Articles has been undermined,¹³² or a case of unfair prejudice can be sustained.¹³³ Such a shareholder is not acting within the empowerment of mandatory law and is also not entitled to call upon the reserve power of shareholders under the enabling framework of company law. Increasingly, management frequently listens to and gives in to certain aggressive shareholder’s demands. This explains how, for example, Nelson Peltz could influence Cadbury Schweppes in selling off its non-core beverage business with only a 3% minority stake in the company. Many issues campaigned in contemporary shareholder activism relate to how a company’s property may be used or allocated. For example, shareholders have campaigned for dividends,¹³⁴ share buybacks where they believe that companies were “sitting on a cash pile,”¹³⁵ for companies to sell off non-core businesses or assets¹³⁶ or to expand into certain areas believed to generate more shareholder value.¹³⁷ These directly relate to the areas that management has control over—the corporate property and corporate decisions.

¹³² *Pender v. Lushington* (1877) 6 Ch. D. 70, 81.

¹³³ *O’Neill v. Phillips* [1999] 1 WLR 1092, 1098 (interpreting § 994 of Companies Act 2006).

¹³⁴ *E.g.*, *TCI Embarks on Proxy Fight to Change J-Power*, NIKKEI WEEKLY, May 26, 2008 (discussing the Children’s Investment Fund’s campaign against J-Power in June 2007).

¹³⁵ For example, CALPers’ campaigns against their Japanese investee companies in the 1980s. *See Jacoby, supra* note 97.

¹³⁶ Jane Wardell, Associated Press, *Cadbury Spins Off Beverage Partner: Schwepp Jettisoned Investor Pressure Eased*, J. GAZETTE, March 16, 2007, at 3E (discussing Nelson Peltz’s campaign against Cadbury Schweppes to separate its drinks and candy businesses, 2007).

¹³⁷ *E.g.*, David Litterick, *Cadbury Activist Pursues Kraft*, DAILY TELEGRAPH, June 22, 2007, at 4 (describing Peltz’s campaign for Kraft to expand into frozen foods and pizzas).

The type of activism mentioned above, if successful and causing management to take the action recommended by the activists, would have had a direct effect upon the allocation of corporate property and resources. Although the chain of causation that leads up to final management decision may be indirect and tortuous to determine,¹³⁸ the influence of such aggressive shareholder activism would arguably be tantamount to an appropriation of a share of management powers over corporate property by the activist shareholders. This form of activism is tantamount to form of co-governance with management and seems to be founded upon a fabrication of shareholdership as ownership. This shareholdership as ownership, as argued earlier, is somewhat flawed, as it fails to take into account the complete picture of both institutional theory and company law. The article terms this type of shareholder activism "property rights activism," as co-governance may apparently be justified on ownership claims. This article is concerned that shareholder activism in issues such as campaigns in relation to pressuring companies to sell off non-core assets, making certain investment decisions such as R&D, carrying out share buybacks or handing out dividends, relate to an interference with the managerial discretion traditionally upheld in the separation of ownership from control model affirmed in the Model Articles.

Activists are not exercising the managerial power, but are only making demands to management to exercise their powers in a certain way. Hence there is no subversion of the principles upheld in *Breckland Holdings*. However, if activist shareholders could get a company to reallocate its corporate assets after a series of campaigns, then such activists would have been able to surpass the limitations of their non-majority stake, to circumvent the need to summon the reserve power of the general meeting, the limitations of the mere majority advisory vote in the general meeting, the perhaps opposing views of other shareholders, and the legal framework that takes into account the collectivity of the general meeting¹³⁹ in any enforcement of shareholder rights. Such forms of activism that directly affect how the legal framework has allocated control and governance rights over a company's property may undermine the values supported by the legal framework itself. Where the Model Articles and *Breckland Holdings* regarding division of powers in a company apply, the nexus has made a fundamental bargain that vests management powers in directors with reserve power to the general meeting in special majority. Although the division of powers is not immutable, the issue being situated in the enabling framework of company law, changes to the division would

¹³⁸ Anabtawi & Stout, *supra* note 126, at 1297.

¹³⁹ MacDougall v. Gardiner (1875) L.R. 20 Eq. at 396; Allen v. Gold Reefs of West Africa, Ltd. (1900) 1 Ch. at 667.

possibly have to be negotiated through the nexus and not imposed arbitrarily by any one constituent within the nexus.

Shareholder activists who are in a position to push through their agendas would effectively be co-governors with management without having the legal safeguards of director liability imposed on them. Shareholder activism is arguably an investment strategy carried out by investors, a move away from more market-based strategies such as buy-and-hold, or hedging using derivatives such as options, warrants or swaps, or short-selling. Where shareholders combine their own investment objectives with co-governance, there is a conflict of interest that may not be addressed by established regimes of director liability unless the activist may be regarded as a shadow director, which is rare because the threshold for establishing shadow directorship is rather high. Shareholder activists and management that engage in co-governance have arguably bypassed the other constituents of the nexus, in rewriting the fundamental governance arrangement in the division of power. This is a breach of the understanding among the nexus and should not be regarded as legitimate unless the nexus has consented to such co-governance. Under current law, if shareholder activism in the property rights type can be argued to be a contractual breach, then the law only extends recognition to the contractual relationship between members under section 33 of the Companies Act, and not broadly to the wider nexus that theoretical frameworks accept. Jurisprudence on section 33 has dealt with specific breaches of Articles,¹⁴⁰ and it remains questionable as to whether shareholders can sue an activist minority for breach of an Article relating to the division of power that confers management powers upon the Board.

From a theoretical point of view, this article argues that shareholder activism amounting to co-governance is incompatible with the nexus, unless the nexus is co-opted into information and dialogue on the change in the foundational understanding on division of powers and accommodates such co-governance. If one argues from the property thesis that “property rights activists” are entitled to exercise “ownership” rights in activism as an incident of property, then we are allowing the property thesis to undermine the nexus, when such property thesis has never been unequivocally accepted in the scholarship of institutional economics or the legal framework.¹⁴¹ Although institutional economists such as Alchian and Demsetz¹⁴² opined that the “residual claimants” in the nexus would be of greater importance in the nexus, residual claimants were defined according to the nature of

¹⁴⁰ *E.g.* *Pender v. Lushington* (1877) L.R. 6 Ch.D. at 75–76; *Hickman v. Kent or Romney Marsh Sheepbreeders Association* [1915] 1 Ch. 881, 888.

¹⁴¹ *See supra* Part 2.

¹⁴² Alchian & Demsetz, *supra* note 52.

their contractual rights and not according to the kind of input they supplied to the firm. Capital providers did not necessarily have supremacy in the nexus in institutional economics. Further, the constituents in the nexus all arguably have some “proprietary” power¹⁴³ that allows them to participate in certain aspects of governance or allocation decisions in the firm, because they are part of a team supplying input into a company,¹⁴⁴ and provisions in mandatory law, as discussed earlier, may protect their interests. Hence it is not correct to view the shareholders as being the only “owners” of certain superior property rights. The property rights thesis is simplistic and does not represent the theoretical or legal position of shareholders in the nexus of contracts constituting the company. “Property rights activism” pursued in the name of ownership should arguably be viewed with skepticism in the light of actually weak theoretical support. This form of shareholder activism also has the tendency to mislead the wider community into supporting the flawed property rights thesis upon which it is based, and a resort to property justifications often leads to a justified exclusion of others’ interests, the essence of a proprietary right. This exclusion is likely to lock other shareholders’ or stakeholders’ interests out of dialogue as exclusion is characteristic of “property rights.”

Further, such activism also raises an issue similar to the one raised earlier in respect of “open-ended contracting” activism, because such activism outside the legal framework has the potential to subvert the principles of democratic governance by voting, and the equal treatment of shareholders.¹⁴⁵ However, real evidence of practical benefit and actual support by other passive shareholders would mitigate such risk. Proponents of the “director primacy” model of corporate governance would likely be ready to accept the argument that some forms of minority shareholder activism in the name of ownership actually undermine the collective interests of shareholders and other constituents who make inputs into a firm, and disrupts the balancing and mediat-

¹⁴³ Eirik G. Furubotn & Svetozar Pejovich, *Property Rights and Economic Theory*, 10 J. ECON. LITERATURE 1137, 1148 (1972); Milhaupt, *supra* note 22, at 1151–52.

¹⁴⁴ Most firms, of course, adopt a conventional division of powers model as found in the Model Articles.

¹⁴⁵ This principle may arguably be manifested in cases such as *Brown v. British Abrasive Wheel Co.* [1919] 1 Ch. 290, 294; *Dafen Tinplate Co. v. Llanely Steel Co.* [1920] 2 Ch 124, 133, the redress against minority expropriation that may now be found in § 994, although *O’Neill v. Phillips* (1999) 1 WLR 1092, 1102 has limited its application somewhat. See also Principle 1 of the General Principles of the Takeover Code, available at <http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf>.

ing role that directors carry out as managers of the nexus of contracts.¹⁴⁶

The legal framework at present does not support treating shareholders as direct interveners in issues that are reserved for management,¹⁴⁷ and even the power of ratification does not extend to that. The power to ratify is called upon after management has acted, and not to preempt or direct management before management has acted. Hence, shareholder activism in issues such as calling for share buybacks, and asking for firms to restructure their businesses or assets, is tantamount to a form of illegitimate co-governance with management in the management of the firm.¹⁴⁸ However, even though “property rights activism” is not arguably supported in theory and principle, it is unlikely to be regarded unfavorably in the present climate. Shareholders have been indifferent for far too long to their investee companies and hence activism is not regarded as a malaise.¹⁴⁹ Further, it is arguable that shareholder activism is not carried out on a large enough scale to threaten the unwinding of any institution.¹⁵⁰ Third, there may be regulator and industry support for such activism as an accompanying social benefit may be derived from activists’ actions.

One should be wary of extremes and not regard selective activism as a cure for shareholder indifference that was the norm in the 1990s. Shareholder indifference is a different problem from shareholder activism, and activism does not cure the problems of indifference and generates problems of its own. Further, it is doubtful that shareholder activism is few and far in between to warrant attention, and we can expect to see more “legitimate” shareholder activism filling the vacuum in “regulating” corporate governance pending regulatory action. It is unlikely that shareholder activism is merely a rare and peripheral issue. Finally, shareholder activism of both types is supported by the regulator and industry.¹⁵¹ Although regulators and the industry acknowledge that shareholder activists pursue their actions chiefly for private benefit, there is accompanying social benefit that

¹⁴⁶ Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* (UCLA School of Law, Law and Econ. Research Paper No. 05-20, 2005), available at <http://ssrn.com/abstract=796227>.

¹⁴⁷ See *Quin & Axtens v. Salmon*, [1909] A.C. 442.

¹⁴⁸ Lori Verstagen Ryan, *Shareholders and the Atom of Property: Fission or Fusion?*, 39 *Bus. & Soc’y* 49, 57 (2000), available at <http://bas.sagepub.com/cgi/content/abstract/39/1/49>.

¹⁴⁹ See Mitchell, *supra* note 92, at 1505.

¹⁵⁰ See Black, *supra* note 106, at 524–25.

¹⁵¹ See Department of Work and Pensions, Consultation Paper, *Encouraging Shareholder Activism*, p. 4, ¶ 10, (2002), <http://www.dwp.gov.uk/consultations/consult/2002/myners/shareact.pdf>.

flows from the activism, and that the existence of such social benefits allows us to co-opt shareholder activists into the landscape of corporate governance, being a force for better corporate governance and better run companies. Regulators see shareholder activists as resourceful actors that generate disciplining effects and hence contribute to “regulatory action.” However, in “property rights activism,” there are possibly substantial private benefits to be gained, and such private benefits would be argued below to be unjustified from a theoretical perspective. Even if the extraction of private benefit by shareholder activists also produce certain social benefits in the network effects of collective shareholder gains, it will be argued that these are likely to be illusory and transient, and unlikely to be sustainable in the long run.

In the next Part, the article addresses the two questions: First, what sort of private benefits does shareholder activism generate and can these be justified? Second, how does the extraction of private benefit through shareholder activism compare with the social benefits of shareholder activism, and are shareholder activists therefore legitimately enrolled into the regulatory landscape?¹⁵²

C. *The Costs and Benefits of Shareholder Activism*

This article has so far introduced a typology of shareholder activism, and argues that activism of the “open-ended contracting” type may be theoretically supported but may, from case to case, generate issues of unfairness and disproportionate appropriation of power by activist minority shareholders. However, shareholder activism of the “property rights activism” type is not theoretically supported, and also raises issues of concern. Is it that our theory and legal framework should be adapted and evolved in order to accommodate the private and social benefits generated by shareholder activism, or should we be skeptical of shareholder activism that is currently not well-supported in theory and principle? This Part delves into the private and social benefits generated by shareholder activism to ascertain whether there is a case that should be made to legitimize shareholder activism, especially of the “property rights” type, and that our theory and legal framework should be adapted in due course.

The motivations for private benefit extraction by activists who are institutional investors or hedge funds have been discussed by much existing academic literature. It has been argued that institutional investors who produce quarterly or half yearly results in investment management to their beneficiaries are often motivated to show

¹⁵² Julia Black, *Decentering Regulation*, CURRENT LEGAL PROBS. 103 (2001); Julia Black, *Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation*, PUB. L. 63 (2003); Colin Scott, *Analyzing Regulatory Space: Fragmented Resources And Institutional Design*, PUB. L. 32 (2001).

the share price earnings on their portfolios, and may engage in activism¹⁵³ or vote with management¹⁵⁴ towards that end. Although some of these institutional investors may hold long positions of equity and need not be considering an exit with abnormal returns, the gains on paper are necessary to meet the obligations of these institutional investors to their fund beneficiaries. Hotchkiss, et al., also argue that institutional investors display extremely sensitive responses in market selling or buying around the periods where company earnings are reported every quarter (in the United States), and show that their preponderant concern is for share price earnings.¹⁵⁵ Investors such as hedge funds may hold shorter positions in equity with a mind towards exit, and activism is generally carried out to maximize the earnings on share price upon such exit.¹⁵⁶ Institutional investors as well as other alternative investment vehicles such as hedge funds are primarily concerned with the generation of abnormal returns based on increased earnings on share price, although it is also documented that some public pension funds engage in activism for other political reasons such as augmenting its profile,¹⁵⁷ or that some shareholder activists may have certain social or political issues they wish to drive in the corporation.¹⁵⁸

This Part argues that the principal private benefit extracted by “property rights activists” is largely found in abnormal returns on share price, and this private benefit does not translate into a social benefit for the interest of the company, the real entity, and the other constituents in the nexus. The perception of social benefit ensuing from such activism is likely to be illusory, transient or unpredictable.

Commentators¹⁵⁹ suggested that shareholder value maximization in a company is tantamount to the maximization of utility for all concerned, a rather purist view of the aggregate good that individual capitalism will necessarily entail. The findings from empirical litera-

¹⁵³ Hendry, *supra* note 95.

¹⁵⁴ ROY C. SMITH & INGO WALTER, *GOVERNING THE MODERN CORPORATION* 146–47 (Oxford 2006).

¹⁵⁵ Edith S. Hotchkiss et al., *Does Shareholder Composition Matter? Evidence from the Market Reaction to Corporate Earnings Announcement*, 58 J. FIN. 1469 (2003).

¹⁵⁶ Allaire, *supra* note 116; Boyson & Mooradian, *supra* note 116; Clifford, *supra* note 116.

¹⁵⁷ See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (explaining that public pension funds face investment conflicts regarding that other investors do not which limits shareholder activism).

¹⁵⁸ See generally Lee, *supra* note 130 (discussing the relationship between shareholder responsibility and corporate social responsibility).

¹⁵⁹ Goldenberg, *supra* note 117, at 34; Friedman, *supra* note 117, at SM17.

ture seem to suggest that shareholder activism in general (not distinguishing between the two types) may result in some abnormal returns in share price at the announcement date of activism commencing¹⁶⁰ and when the activism objectives have been achieved.¹⁶¹ However, there is also empirical evidence showing that abnormal earnings on share price as a result of activism are not significant.¹⁶² A cursory meta-survey of empirical literature thus presents the result that shareholder activism often has some sort of effect on share price to generate abnormal earnings on share price, but these are not generally significant enough on a consistent basis and do not reflect in improved operating performance of companies. Indeed, empirical evidence shows that shareholder activism does not have a significant impact on the operating performance of the firm.¹⁶³ The firm's actual revenues, turnover, market share and profitability are possibly more important to the other constituents in the nexus, such as employees and management. The community in which the firm is operating, such as charities in the community may benefit more from the firm in a profitable year where donations may also be more generous, than from increases in shareholders' stock price earnings. Hence, the focus on abnormal share price increases in private benefit extraction by shareholder activists may obscure the fact that many firms do not fundamentally become more successful in the long run. If this is so, one should query whether the expense of activist resources and the costs incurred by targeted companies are socially wasteful, compared to the private gains made by activists on the share price earnings.

Fisch¹⁶⁴ also argues that it is narrow-minded for a firm to measure its value primarily in terms of shareholder gains, as stock price performance and gains in shareholder wealth do not show the actual operating performance or profitability of the firm itself. The value of the firm is not always reflected in its stock price,¹⁶⁵ and wealth trans-

¹⁶⁰ Could be a Schedule 13D filing for activist shareholders acquiring more than 5% of equity with the view to influencing control of the issuer.

¹⁶¹ Becht et al., *supra* note 110; Smith, *supra* note 131.

¹⁶² Wahal, *supra* note 116; Karpoff, *supra* note 112.

¹⁶³ Becht et al., *supra* note 110 (finding no statistically significant increase in operating revenues; on hedge funds); Carleton, *supra* note 112; Smith, *supra* note 131; see Allaire, *supra* note 116; April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* (2006) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362. *But see* Boyson & Mooradian, *supra* note 116 (finding that improved long term performance of companies is reportedly achieved through some forms of hedge fund activism).

¹⁶⁴ Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006).

¹⁶⁵ See Eugene F. Fama, *Efficient Markets: A Review of Theory and Practical Work*, 25 J. FIN. 383 (1970). Other models of share price behavior have since

fers of the firm to creditors and suppliers are completely ignored if one takes only stock price performance as an indication of firm value.¹⁶⁶ This raises the question of whether private benefit extraction by shareholder activists actually generate any wider social benefit for others if the success or sustainability of the company in the long run is not necessarily improved by the activism.

Further, it is also arguable whether, theoretically, the extraction of private benefits in the form of increased share price earnings subverts the nature of the open-ended relationship between the shareholder and the company in the nexus. As shareholders are a class of residual claimants in the firm under the theoretical models of institutional economics, if shareholders engage in activism in order to extract private benefits in the form of improved share price and then exit the company by selling the shares, such activism contributes to the shareholder's determination of its residual claimant status—since the shareholder is trying to realize the value of the shares in order to close the open-ended nature of his/her investment in the company.

This seems to give shareholders an unfair advantage in navigating the nexus of contracts that constitute the firm. Even where exit is not contemplated, and the activist shareholder is seeking to achieve a certain level of share price earnings in order to boost the value of its investment portfolio, it is also arguable that such behavior may go towards mitigating the residual claimant's risk in the long term by extracting short term benefits, again an unfair advantage over other residual claimants (although some managerial excesses may arguably also be similarly abusive in having a one-up against the rest of the nexus). Thus, it is imperative to study whether the extraction of private benefit in the short terms is effected at the expense of other residual claimants in an open-ended relationship within the nexus. Again, it is flawed to support the private benefit extraction by activist shareholders based on a property rights thesis giving shareholders supremacy over other constituents in the nexus. A property rights

arisen, including the random walk theory. See J. Tobin, *On the Efficiency of the Financial System*, LLOYD'S BANK REV. 1 (1984). However, the Martingale model still continues to uphold efficient capital markets. See Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. ECON. LIT. 1583 (1989); Eugene F. Fama, *Efficient Capital Markets II*, 66 J. FIN. 1575 (1991). Behavioral finance has most recently attacked the theory, and has many followers. See Stephen M. Bainbridge, *Mandatory Disclosure—A Behavioural Analysis*, (2000) 68 U. CIN. L REV. 1023; ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (Broadway 2001); Robert Prentice, *Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for Its Future*, 51 DUKE L. J. 1397 (2002).

¹⁶⁶ William W. Bratton Jr., *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

fabrication of “ownership” rights tends to exclude the other constituents in the nexus from asserting their countervailing interests.

Thus, the social benefit that accompanies private benefit extraction by property rights activists is illusory, as benefits based on improved share price earnings do not benefit many wider constituencies other than shareholders. Further, if we accept that activist private benefit extraction is a process that unfairly undermines the other residual claimants and constituents of the firm, then any perception of social benefit is also rather illusory. There are possibly some forms of wider social benefit generated in the “open-ended contracting” type of shareholder activism, for example, in asking for CEO turnover or for curbs on excessive executive pay. For this type of shareholder activism, empirical evidence reports mainly gains in share price earnings,¹⁶⁷ but some long term gains to the operating performance or long-term sustainability of the company as well.¹⁶⁸ Hence, there is some room to observe the social benefits of the “open-ended contracting” type of activism and perhaps allow such forms of activism to provide a form of self-regulation for long-term sustainability.

Hence, a better case may be made for “open-ended contracting” activism and its legitimacy as such activism may have resulted in institutional reforms in the governance of the company to include more non-executive directors and performance-related pay, that are more acceptable to the other constituents in the nexus and the wider public community, making the company “better-run” or “better-governed.”

¹⁶⁷ Becht et al., *supra* note 110; Smith, *supra* note 131, Carlos Alves & Victor Mendes, *Corporate Governance Policy and Company Performance: The Portuguese Case*, 2(3) CORP. GOVERNANCE 290 (2004) (relating to where activists call for companies to adhere to the best practices code of corporate governance).

¹⁶⁸ See Kenneth J. Martin & Randall S. Thomas, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021 (1999), Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Operating Performance* (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=814205 (arguing that certain corporate governance changes do result in longer term returns such as improved operating performance and returns on assets); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests, Shareholder Wealth and Operating Performance: An Analysis in the 1980s* (1999), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=5423 (arguing that removal of takeover defenses in the US and changes in management secured positive results for operating performance of sampled companies). *But see* Wei Ling Song et al., *Does Coordinated Institutional Investor Activism Reverse the Fortunes of Underperforming Firms?*, 38 J. FIN. Q. ANALYSIS 317 (1999); Sanjai Bhagat & Bernard S. Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (relating to where shareholder activism may pertain to changing the Board composition); Victor Dulewicz & Peter Herbert, *Does the Composition and Practice of Boards of Directors Bear Any Relationship to the Performance of their Companies?*, 12 CORP. GOVERNANCE 263 (2004).

This may translate into quantifiable or qualitatively observable benefits to the company and the wider nexus and community, such as in improved operating performance, long term competitiveness, or a company's better image, reputation and appeal.¹⁶⁹

Regulators thus far seem to be encouraging of shareholder activism generally, without making the distinction between the *two* types of activism. This is understandable, given that a large part of the legal framework regulating companies is enabling, and regulators see shareholders as naturally co-opted to provide a form of regulatory governance for companies they invest in. Regulators may not be able to prescribe myriad minutiae for governing the nexus of contracts that constitute the firm, and would naturally leverage on the contracting process itself for parties to come to positions that protect their interests.¹⁷⁰ Hence, regulators' benign disposition towards shareholder activists is understandable, and the actions of shareholder activists are at the moment unregulated, subject (voluntarily) to best practices in disclosure under the Institutional Shareholders Committee¹⁷¹ or to the set of best practices developed by the Hedge Funds Standards Board, which are more concerned about preventing market abuse than the substance of the activism itself.¹⁷² However, regulators should be wary of supporting shareholder activism just because shareholders are in a position to be enrolled into the regulatory landscape.

The mandatory law in the United Kingdom, for example, supports forms of reversion of governance to shareholders, as discussed

¹⁶⁹ Salil Kumar Sen, *Societal, Environmental and Stakeholder Drivers of Competitive Advantage in International Firms* (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1009991; see G.A. STEINER & J.F. STEINER, *BUSINESS, GOVERNMENT, AND SOCIETY: A MANAGERIAL PERSPECTIVE, TEXT AND CASES* (McGraw Hill/Irwin 2006) (showing that businesses that take into account a wider context of concerns generally tend to gain a competitive advantage in its market as well); W. Lazonick, *Investment in Innovation, Corporate Governance and Employment: Is Prosperity Sustainable in the United States?* (1998), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=114268; D. N. Rao, K. Shankariah & Ali Al-Hakmani, *Developing Customer Loyalty: A Case-study of National Bank of Oman* (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438601 (opining that good corporate governance contributes to a company developing customer loyalty and retention).

¹⁷⁰ The idea that regulation is de-centered and enabling where there are various parties in the landscape of a regulatory regime that may contribute towards self-regulation, setting of standards and best practices and contractual resolutions. See Scott, *supra* note 152, at 32; Black, *supra* note 152, at 103; Black, *supra* note 152, at 63.

¹⁷¹ ISC, *The Responsibilities of Institutional Shareholders and Their Agent s-Statement of Principles* (June 2007), <http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf>.

¹⁷² Hedge Funds Standards Board, *The HFSB Standards*, http://www.hfsb.org/sites/10109/files/best_standards.pdf (last visited Feb. 24, 2009).

earlier. Such mandatory governance is possibly motivated by the perception of social benefit, as there is comparatively little cost in submitting transactions to general meeting approval to gain the greater benefit of preventing managerial abuse which could lead to corporate demise.¹⁷³ If management indulges in self-dealing, for example, by selling their assets to the firm at a high price, or by buying firm assets for their own use at a below-market price, value from the firm is extracted to benefit managers, and such a value reduction in the firm affects the share and residual value of the firm, hence affecting shareholders, but may also affect the profitability of the firm, hence affecting decisions with respect to employees and other stakeholders such as suppliers. Over the long term, unchecked managerial abuse can snowball into an irreparable hole in the company's finances and cause company demise. The prevention of management self-dealing is more effective than cure by shareholder or regulator litigation. Shareholder litigation may suffer from a free riding problem, since the value reduction in the firm affects many other constituents, and which shareholder would take the initiative to litigate amongst the lot? Regulator litigation would mean that public money is used to subsidize the value loss suffered by private parties in the nexus of contracts in the firm. Hence, crafting mandatory governance by co-opting a particular group of constituents to check and approve of management behavior in potential conflict of interest situations may accord with those constituents' interest, but may also achieve a wider social benefit for others not co-opted in the governance.¹⁷⁴

Regrettably, with management scandals from Enron in 2002 to the failure of several large investment banks such as Lehman Brothers in 2008, the tide has so revolted against the managerial class so that monitoring the manager is seen as absolutely necessary. Further, much trust is increasingly being reposed in shareholders, especially activist ones, to play that role,¹⁷⁵ extending beyond the mandate of mandatory law. However, this should not extend to an unconditional support for shareholder activism. Regulators should examine carefully the types of shareholder activism that are being mounted and to consider carefully if theoretical support is tenable for the type of shareholder activism carried out. Regulators then have to consider how the private benefits extracted by shareholder activists may be compared to any social benefit. The existence of some social benefit flowing from

¹⁷³ For example, in the case of Parmalat in 2003.

¹⁷⁴ See generally Becht et al., *supra* note 110 (demonstrating some general readings on "co-opting" private parties to participate in governance behavior that may have wider social benefits).

¹⁷⁵ Editorial, *FIN. TIMES*, Sept. 22, 2008 ("The first line of defence . . . remains the shareholders of financial companies. They have done too little so far, and they have suffered more than most as a result. Expect more diligence in future.")

the “open-ended contracting” type of activism should also not extend to a wholesale endorsement of the more questionable “property rights activism.” The costs incurred by companies in meeting activist demands will have to be balanced against the possibility that activists may be able to exit early and terminate in fact, their residual risk-bearing status. Companies targeted for short term disposal of non-core assets may entail constituency losses in terms of lost jobs or supply contracts, and such short term losses have to be weighed up against any longer term effects on the company and the community concerned. Although it is arguable that reform in the United Kingdom law on directors’ duties compels directors to take a long term view of the corporation and the impact of their decisions on stakeholders,¹⁷⁶ the new provision is subject to interpretation, and many commentators have warned¹⁷⁷ that the provision will still allow shareholders’ interests to trump any other concern. Besides, I have earlier argued that controls imposed upon directors or penalizing directors are not likely to be constructive in addressing aggressive shareholder activism of the “property rights” type. Ultimately, regulators should not automatically see shareholder activism as a complementary regulatory force or as a substitute for regulation,¹⁷⁸ but should discern what aspects of shareholder activism are desirable market characteristics that perpetuate self-regulatory behavior and what aspects may result in losses and externalities, and may warrant some form of regulatory control instead.¹⁷⁹

The article is aware of the merits of various proposals already suggested by academics to control certain shareholder behavior, although it is not ready to take a position on any of the suggestions. For instance, Anabtawi and Stout¹⁸⁰ argue that activist shareholders should be subject to fiduciary duties similar to those imposed on directors, as activist shareholders may also have self-serving tendencies in their activist behavior that conflicts with the company’s interests. Activist shareholders may hold investments in the company in the form

¹⁷⁶ See Companies Act, 2006.

¹⁷⁷ Daniel Attenborough, *The Company Law Reform Bill: an Analysis of Directors’ Duties and the Objective of the Company*, COMPANY LAW. 162 (2006); Mary Arden, *Reforming the Companies Acts—the Way Ahead*, J. BUS. L. 579 (2002); Andrew Keay, *Section 172(1) of the Companies Act 2006: an Interpretation and Assessment*, COMPANY LAW. 106 (2007).

¹⁷⁸ Neil Fligstein & Robert Feeland, *Theoretical and Comparative Perspectives on Corporate Governance*, 21 ANN. REV. OF SOC. 21 (1995) (noting regulatory intervention as a “leftover” response to patch up what may be missing from shareholder actions).

¹⁷⁹ There is existing literature discussing forms of control or restraint to be imposed on activist behavior, but recommending a particular measure of control or restraint is beyond the scope of this paper.

¹⁸⁰ Anabtawi & Stout, *supra* note 126, at 1255.

of equity, bonds, hybrid instruments, and derivatives of these investments, and certain actions affecting the company's assets may trigger gains in the particular instrument the investor holds. Further, hedge funds have engaged in empty voting, i.e. holding onto voting rights without a concern for economic rights that are being hedged away, and it is queried as to whether empty voting is done with motivations that may benefit the company and other stakeholders. Activist shareholders may also push for CEO removal if the CEO is not in favor of pursuing policies that may confer private benefits on certain shareholders—for example, pension fund shareholders may push for management friendly to unions. In light of such potentially self-serving behavior that may be allowed as shareholders are not regulated to owe “duties” to the corporation or fellow shareholders, Anabtawi and Stout suggest that it is apt to impose fiduciary duties on such shareholders. However, they acknowledge that some of the problems of this proposal are that shareholder activism is generally influential in nature and how it precipitates certain management action is uncertain. Hence, there is a “causation” issue in connecting up the activism to the ultimate corporate decision that is made that may be influenced or pursuant to the activism. The degree of “control” a shareholder activist has is not necessarily dependent on voting power, or percentage of stake, and difficulties may abound in showing the causation between the activism and the corporate outcome.¹⁸¹

Another possible instrument of control that may be imposed on activist shareholders is disclosure, such as a Schedule 13D filing in the United States, but may be expanded to declare intentions of activism, the structure of the shareholder stake including how voting rights, cash flow rights, and other rights such as liquidation or dividend rights are structured, so that other shareholders may have some scrutiny on how the activist shareholder is behaving. This form of control is less prescriptive and relies on other shareholders to resist activism that they consider adverse, but whether such resisting shareholder action may also be motivated by other self-serving concerns is another concern.

At the moment, this article argues that it is imperative to recognize that “property rights activism” is theoretically and legally disconcerting and we should address our minds to this, and not just when adverse consequences are actually seen.

IV. CONCLUSION

It is imperative that shareholder activism be analyzed in the typologies suggested in this article in order to discern the issues that

¹⁸¹ Deborah Demott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 246 (1993).

need to be addressed. This article has, however, refrained from any premature suggestion that one policy or another may resolve the concern. This article first examines the theoretical and legal conception of being a shareholder in a company. It argues that, by critically examining the internal and external dimension of proprietary ownership in a share, and the legal framework in the United Kingdom surrounding the aforementioned two dimensions, “shareholdership” does not, strictly speaking, amount to “ownership” of any part or the whole of a company. However, the unique position of the shareholder in the governance of a company under the law is shaped by three sets of sometimes competing theoretical frameworks: the real entity of the company, the recognition in the law for the competing interests in the nexus of contracts constituting the company, and mandatory law that seems to treat shareholders as the primary group of residual claimants in the company. These have given rise to an aggregate framework that significantly co-opts shareholders into the governance process of a company. Hence, although U.K. law does not unequivocally accept share ownership as “ownership” in relation to a company, there is a fairly generous regime of rights and powers for shareholders and a climate of rather benign perception of minority shareholder activism in widely-held public companies.

The above examination lays the foundation for our study into shareholder activists’ activities, and how these may be accommodated within the theoretical and legal frameworks fabricating “shareholdership” in the United Kingdom. The article examines the types of activism carried out and categorizes two main types of activism: first, activism in relation to modifying and defining open-ended terms in the contractual relationship between shareholders and the company as part of the nexus of contracts, and, second, activism that amounts to a form of co-governance with management, influencing the making of certain decisions over the allocation of company property. The first type of activism, termed as “open-ended contracting,” is largely supported by the theoretical conception of shareholders as part of the nexus of contracts and under the enabling legal framework of company law. However, the manner in which the activism may be carried out may have to be considered and examined further, if such activism is based on a fabrication of “ownership” rights that are not theoretically or legally supported. This article also examines the private and social benefits that ensue from this type of activism, and calls for a generally more comprehensive and long term assessment of cost-benefit in allowing or encouraging such activism.

As for the second type of activism termed as “property rights activism,” such activism is of a different nature, and is arguably tantamount to co-governance with management. Co-governance by shareholders in issues traditionally reserved for management, and that may

have allocational economic effects on corporate property, is unlikely to be theoretically supported. Further, such activism may bring about the permanent undermining of stakeholders' interests, and this article argues why those critics who are of the view that shareholder activism and maximization of shareholder interests would benefit stakeholders are mistaken. The extraction of private benefit by "property rights" activism may not be outweighed by any ensuing "social benefit," at worse, any social benefit may arguably be illusory or transient. An appeal to social benefit in supporting this type of activism is likely to be misplaced. The view taken in this article is that there should be more skepticism regarding "property rights" activism.

The theoretical approach taken in this article allows us to distinguish two different types of shareholder activism and discuss in detail whether these activities can be supported within the theoretical and legal frameworks. This is in order to discern not only the foundational soundness of such activities but also the costs and benefits that follow from such activities. This approach will hopefully become a platform for future discussions on shareholder activism, and the social and legal approaches taken towards it.