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Thesis submitted for the Degree of PhD in Law

THE EQUAL VALUE OF SHARES IN COMPANY LAW

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October 2005

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ABSTRACT OF THESIS

This thesis is about the value of shares. The focus is on analysing the norms of company law governing shares, shareholders' rights, and share value. A central point is that according to company law the value of shares is merely a matter of fact and opinion. In brief, shareholders decide about their shares; thus, share value is more a question of markets than of law. On the other hand, law has a role in setting the value for shares. The law determines which opinion should prevail if there is disagreement about valuation; furthermore, company law sets restrictions on shareholders' power.

The equality of shares is one of the general principles of company law. Overall, when shares in a company have similar rights, these shares rank equally. This study emphasizes equality; its aim is to clarify what the equality of shares means in company law. My conclusion is that English company law supports the equality of shares although that cannot be an absolute principle of law.

Several commentators regard *Short v Treasury Commissioners* as a ruling stating that majority shares are more valuable than minority shares. This study explains case law differently. I consider that fair share value is generally determined on a pro rata basis, which view is expressed, for example, in *O'Neill v Phillips.* In sum, I propose that the governing idea is the equal value of shares. Yet, as share value is mainly beyond the scope of company law, this equality prevails only when the value is determined by the power of law.

PREFACE

As Prof Lowry says in the preface of his book, *Core Text Series: Company Law*, company law is a difficult subject[1]. This friendly warning appeared in the book during my PhD studies under his supervision, but I have been told that the disclaimer is not especially for me. In any event, I consider that company law is a fascinating subject; furthermore, it has been a pleasure to study this area of law in England, where the concept of modern company was born.

I am very grateful to John Lowry for his excellent supervision during my studies in 2002 – 2005. I am pleased that this co-operation has been possible both at Queen Mary (2002 – 2004) and University College London (2004 – 2005). This thesis owes its being to his support.

I am indebted to my second supervisors Dr Loukas Mistelis (QM) and Dr Philip Rawlings (UCL). The comments of Prof Stephen Guest on my ideas and in particular on the concept of equality have been helpful. In addition, I sincerely thank Dr Simon Williams, who has supervised my English with great care. Responsibility for any mistakes is still mine alone.

In this study, 'CA 1985' refers to the Companies Act 1985. References to books and articles are set out in full on first mention in every chapter, and for second and subsequent mentions the short reference is used in notes. Full details of references can be found in the Bibliography. Moreover, when I use the word 'he' in a general context, it applies equally to male and female persons.

The law is stated as at 1 October 2005.

London, October 2005

Jyrki Knuutinen

[1] Lowry, John and Dignam, Alan, *Company Law* (3rd edn Oxford 2005) v.

SUMMARY OF CONTENTS

Abstract of Thesis		ii
Preface		iii
Table of Cases		xi
Table of Legislation		xix
Chapter 1	Introduction	1
Chapter 2	Shares and Shareholders' Rights	11
Chapter 3	Company Assets and Share Value	46
Chapter 4	Markets and Share Prices	75
Chapter 5	Equality of Shares	106
Chapter 6	Majority Power and Minority Protection	158
Chapter 7	Value of Shares in Law	205
Chapter 8	Conclusions	281
Bibliography		286

CONTENTS

Abstract of Thesis ii

Preface iii

Table of Cases xi

Table of Legislation xix

CHAPTER 1 INTRODUCTION 1

1.1 Company law and capital 1

1.2 Value of shares 2

1.2.1 Valuation in the markets and law 3

1.2.2 The value of shares in English company law 4

1.3 Research review 5

1.3.1 Law, rules, and principles 6

1.3.2 Law, economics, and society 6

1.3.3 Ownership, rights, and value 7

1.4 The agenda of research 8

CHAPTER 2 SHARES AND SHAREHOLDERS' RIGHTS 11

2.1 The importance of shareholders' rights 11

2.2 Shares in a company 12

2.2.1 Shareholders' interest in the company 12

2.2.2 Share capital and nominal value 17

2.3 Shareholders' rights 22

2.3.1 Shareholders' economic rights 24

2.3.2 Shareholders' control power 29

2.3.3 Shares as a bundle of rights 32

2.4 Transferability of shares 35

2.4.1 Transfer of shares under the Companies Act 37

2.4.2 Private companies 38

2.4.3 Public companies 40

2.4.4 The value of free transferability 42

2.5 Rights and value 44

CHAPTER 3 COMPANY ASSETS AND SHARE VALUE 46

3.1 Companies and shareholders 46

3.2 Company assets 47

3.2.1 Assets in a partnership 48

3.2.2 Assets in a company 48

3.3 The two-tier union 51

3.3.1 Company as a thing 52

3.3.2 Ownership of the company 56

3.3.3 Property and persons 62

3.4 Share value and fortune 68

3.4.1 The role of asset value in law 68

3.4.2 Value and fortunes 72

CHAPTER 4 MARKETS AND SHARE PRICES 75

4.1 Introduction to value and price 75

4.2 Investment and risk 76

4.3 The function of markets 79

4.4 Value and price of shares 81

4.4.1 Market price and value 81

4.4.2 Asset value 86

4.4.3 Intrinsic value 87

4.4.4 Market value 91

4.5 Liquidity of shares 97

4.5.1 Liquidity versus control 98

4.5.2 Value and price of liquidity 101

4.5.3 Liquidity and the value of a company 102

4.6 Value of shares in economics 104

CHAPTER 5 EQUALITY OF SHARES 106

5.1 The Notion of equality 106

5.2 Equality and freedom 107

5.2.1 Equality in law 107

5.2.2 Freedom in law 108

5.2.3 Synthesis of liberty and equality 110

5.3 Equality as a presumption in company law 110

5.4	Equal economic surplus	112
	5.4.1 Payment of shares and responsibility for losses	112
	5.4.2 Dividends	114
	5.4.3 Sharing of net assets	120
	5.4.4 Reduction of capital	131
5.5	Shareholders' pre-emption right	141
5.6	Right to transfer shares	148
	5.6.1 Free transferability of shares	148
	5.6.2 A company's power to purchase own shares	150
5.7	Equality of shareholders	153

CHAPTER 6 MAJORITY POWER AND MINORITY PROTECTION 158

6.1	Introduction	158
6.2	The company constitution	159
	6.2.1 Memorandum and articles of association	159
	6.2.2 Contractual nature of the company constitution	160
	6.2.3 Alteration of the company constitution	164
6.3	Company power and majority rule	168
	6.3.1 Ultimate power and company organs	169
	6.3.2 Majority rule	171
	6.3.3 Minority protection	174
	6.3.3.1 Exceptions of majority rule	174
	6.3.3.2 Minority shareholders' specific rights	180

6.4 Oppression of minority shareholders 182

6.4.1 Relationship in public and private companies 183

6.4.2 Unfair prejudice 187

6.4.3 Just end equitable winding up 193

6.5 Conclusions of majority and minority relationship 199

CHAPTER 7 VALUE OF SHARES IN LAW 205

7.1 Introduction 205

7.2 Property and liability rules 206

7.3 Objective value of shares 207

7.3.1 Market quotation as value 208

7.3.2 Fair value under the articles in private companies 210

7.3.2.1 Dividend basis 216

7.3.2.2 Asset basis 218

7.3.2.3 Earnings basis 225

7.3.2.4 Auditors' discretion 235

7.3.3 Hypothetical value of shares 237

7.4 The value of shares under CA 1985 s 459 247

7.5 The value of majority shares and *Short v Treasury Commissioners* 253

7.6 Share value in takeovers 259

7.6.1 The value of control power 261

7.6.2 Squeeze-out of minority shares 263

7.6.3 The Takeover Code 266

7.6.4 Takeover as collective action 270

7.6.5 The burden of proof in takeovers 274

7.6.6 Takeovers concluded 278

7.7 Share value in law 279

CHAPTER 8 CONCLUSIONS 281

8.1 The role of shareholders' rights 281

8.2 Value of shares as a fact 282

8.3 Value of shares in company law 283

Bibliography 286

TABLE OF CASES

Accrington Corporation Steam Tramways Co, Re [1909] 2 Ch 40 ... 111, 115

Agricultural Hotel Co, Re [1891] 1 Ch 396 ... 134

Alabama Farm Bureau Mutual Casualty Co Inc v American Fidelity Life Insurance Co (1979) 606 F 2d 602 (United States Court of Appeals Fifth Circuit) ... 99

Allen v Gold Reefs of West Africa Ltd [1900] 1 Ch 656 (CA) ... 108, 144, 161, 164-65, 200

Andrews v Gas Meter Co [1897] 1 Ch 361 (CA) ... 116

Anglo-Continental Produce Co Ltd, Re [1939] 1 All ER 99 ... 196

Anglo-Greek Steam Co, Re (1866) LR 2 Eq 1 ... 195

Arenson v Arenson [1973] Ch 346 (CA) ... 212, 215

Arenson v Casson Beckman Rutley & Co [1977] AC 405 (HL) ... 215, 232

Astec (BSR) plc, Re [1998] 2 BCLC 556 ... 30, 186

Attorney General v Davy (1741) 2 Atk 212; 26 LR 531 ... 172

Attorney-General v Jameson [1905] 2 IR 218 ... 34, 211, 245

Attorney-General of Ceylon v Mackie [1952] 2 All ER 775 (PC) ... 216, 219

Attorney General's Reference (No 2 of 1983) (1984) 78 Cr App R 131 ... 50

Atwool v Merryweather (1867) LR 5 Eq 464n ... 179

Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame [1906] 2 Ch 34 (CA) ... 171

Baber v Kenwood Manufacturing Co Ltd [1978] 1 Lloyd's Rep 175 (CA) ... 215

Bahia and San Francisco Railway Co Ltd, Re (1868) LR 3 QB 584 ... 37

Baillie v Oriental Telephone and Electric Co Ltd [1915] 1 Ch 503 (CA) ... 176

Baltic Real Estate Ltd (No 2), Re [1993] BCLC 503 ... 108, 183

Barclays Bank Ltd v Inland Revenue Commissioners [1961] AC 509 (HL) ... 243

Barrow Haematite Steel Co, Re (1888) LR 39 Ch D 582 ... 133-34

Battle v Inland Revenue Commissioners [1980] STC 86 ... 237, 241-43

Beattie v E & F Beattie Ltd [1938] Ch 708 (CA) ... 162, 172

Benfield Greig Group plc, Re [2000] 2 BCLC 488; [2002] 1 BCLC 65 (CA) ... 224, 234, 236, 244

Berg Sons & Co Ltd v Mervyn Hampton Adams [1993] BCLC 1045 ... 15

Birch v Cropper in Re Bridgewater Navigation Co Ltd (1889) LR 14 App Cas 525 (HL) ... 16, 50, 62, 63, 68, 114, 117-18, 120-25, 128, 130, 155, 225

Bird Precision Bellows Ltd, Re [1984] BCLC 195; [1985] BCLC 493 (CA) ... 217-18, 236, 242, 244, 248-52

Bisgood v Henderson's Transvaal Estates Ltd [1908] 1 Ch 743 (CA) ... 27, 162

Blériot Manufacturing Aircraft Co Ltd, Re (1916) 32 TLR 253 ... 194

Bligh v Brent (1837) 2 Y & C Ex 268; 160 ER 397 ... 12, 63

Blue Arrow plc, Re [1987] BCLC 585 ... 162, 186

Bolam v Friern Hospital Management Committee [1957] 1 WLR 582 ... 216

Bolton (H L) (Engineering) Co Ltd v T J Graham & Sons Ltd [1957] 1 QB 159 (CA) ... 170

Borland's Trustee v Steel Brothers & Co Ltd [1901] 1 Ch 279 ... 15-6, 21, 23, 32, 64, 168, 210-13, 245

Bovey Hotel Ventures Ltd, Re (31 July 1981 unreported) ... 189, 193

Bradford Investments plc (No 2), Re [1991] BCC 379 ... 19-20

Brady v Brady [1988] BCLC 20 (CA) ... 13, 14, 62, 65, 167

Bratton Seymour Service Co Ltd v Oxborough [1992] BCC 471 (CA) ... 162

Bridgewater Navigation Co, Re (1888) LR 39 Ch D 1 (CA); reversed by *Birch v Cropper* (1889) LR 14 App Cas 525 (HL) ... 115, 120-22

Bridgewater Navigation Co, Re [1891] 1 Ch 155; [1891] 2 Ch 317 (CA) ... 120, 125-26

British and American Trustee and Finance Co Ltd v Couper [1894] AC 399 (HL) ... 116, 134-37, 140, 146, 154, 156, 281

Broderip v Salomon [1895] 2 Ch 323 (CA); reversed by *Salomon v A Salomon and Co Ltd* [1897] AC 22 (HL) ... 49, 54

Brown v British Abrasive Wheel Co Ltd [1919] 1 Ch 290 ... 167, 179, 263

Buccleuch, Duke of v Inland Revenue Commissioners [1966] 1 QB 851 (CA) ... 242

Buckingham v Francis [1986] BCLC 353 ... 219, 225, 229-30

Bugle Press Ltd, Re [1961] Ch 270 (CA) ... 209, 273, 275

Burgess v Purchase & Sons (Farms) Ltd [1983] Ch 216 ... 214

Burland v Earle [1902] AC 83 (PC) ... 25, 73, 167, 173, 175, 177

Bushell v Faith [1970] 1 All ER 53 (HL) ... 173

Cade (J E) & Son Ltd, Re [1992] BCLC 213 ... 190

Campbell v Edwards [1976] 1 WLR 403 (CA) ... 214

Caparo Industries plc v Dickman [1989] QB 653 (CA); [1990] 2 AC 605 (HL) ... 13, 15, 29, 50, 57, 169

Carlen v Drury (1812) 1 V & B 154; 35 ER 61 ... 73, 137, 169, 173

Carlton Holdings Ltd, Re [1971] 1 WLR 918 ... 265, 277

Castleburn, Re (1989) 5 BCC 652 ... 216, 231, 236

Castner-Kellner Alkali Co Ltd, Re [1930] 2 Ch 349 ... 265

Catalinas Warehouses and Mole Co Ltd, Re [1947] 1 All ER 51 ...126

Chatterley-Whitfield Collieries Ltd, Re [1948] 1 All ER 911; [1948] 2 All ER 593 ... 137-39

Chez Nico (Restaurants) Ltd, Re [1992] BCLC 192 ... 268, 269, 273, 275-76

Claridge Holt & Co Ltd, Re, Times November 23, 1966 ... 213

Clemens v Clemens Bros Ltd [1976] 2 All ER 268 ... 144, 167

Collier v Mason (1858) 25 Beav 200; 53 ER 613 ... 214

Colonial Bank v Whinney (1886) LR 11 App Cas 426 (HL) ... 53

Commissioners of Inland Revenue v Crossman [1937] AC 26 (HL) ... 32, 34, 50, 163, 238, 241, 245-46, 253

Company (No 004475 of 1982), Re a [1983] Ch 178 ... 69, 192, 243

Company (No 002612 of 1984), Re a (1986) 2 BCC 99,453 ... 190, 218, 219, 226, 227, 229, 233, 247-48

Company, Re a [1985] BCLC 80; affirmed sub nom *Re Cumana Ltd* [1986] BCLC 430 (CA) ... 192

Company, Re a [1986] BCLC 362 ... 192, 199, 215, 216, 229, 239, 240, 247

Company, Re a [1986] BCLC 376 ... 23, 185-86, 190

Company (No 00370 of 1987), Re a, ex p Glossop [1988] BCLC 570 ... 13, 14, 25, 57-9, 195

Company (No 005685 of 1988), Re a, ex p Schwarcz (No 2), Re a [1989] BCLC 427 ... 190

Company (No 006834 of 1988), Re a, ex p Kremer [1989] BCLC 365 ... 214, 226, 229, 231

Company (No 005134 of 1986), Re a, ex p Harris [1989] BCLC 383 ... 247

Company (No 00789 of 1987), Re a, ex p Shooter [1990] BCLC 384 ... 189

Company (No 00314 of 1989), Re a, ex p Estate Acquisition and Development Ltd [1991] BCLC 154 ... 185, 194, 198-99

Company (No 00330 of 1991), Re a, ex p Holden [1991] BCLC 597 ... 212, 214, 237

Company (No 004415 of 1996), Re a [1997] 1 BCLC 479 ... 66, 189, 192, 197, 198, 217, 225

Cook v Deeks [1916] 1 AC 554 (PC) ... 177

Cotter v National Union of Seamen [1929] 2 Ch 58 (CA) ... 176

Crichton's Oil Company, Re [1902] 2 Ch 86 (CA) ... 121

Cumana Ltd, Re [1986] BCLC 430 (CA) ... 190, 192, 249

CVC/Opportunity Equity Partners Ltd v Demarco Almeida [2002] 2 BCLC 108 (PC) ... 185, 213, 215, 218-19, 223, 230, 240, 242, 250, 252

Dafen Tinplate Co Ltd v Llanelly Steel Co (1907) Ltd [1920] 2 Ch 124 ... 167, 263

Dean v Prince [1953] Ch 590; [1954] Ch 409 (CA) ... 4, 5, 75, 213-14, 220, 222-23, 235, 241, 243

Denver Hotel Co, Re [1893] 1 Ch 495 (CA) ... 151

Dimbula Valley (Ceylon) Tea Co Ltd v Laurie [1961] Ch 353 ... 126

Dronfield Silkstone Coal Co, Re (1880) LR 17 Ch D 76 (CA) ... 150

Duffy, Re [1949] Ch 28 (CA) ... 221, 243

Ebrahimi v Westbourne Galleries Ltd [1973] AC 360 (HL) ... 23, 40, 42, 49, 161, 167, 183-85, 194, 196, 201-2, 285-85

Edwards v Halliwell [1950] 2 All ER 1064 (CA) ... 175, 181

Elgindata Ltd, Re [1991] BCLC 959 ... 73, 77, 191, 193, 249, 251-52

Epsuela Land and Cattle Co, Re [1909] 2 Ch 187 ... 125

Equitable Life Assurance Society v Ernst & Young (a firm) [2003] 2 BCLC 603 (CA) ... 26, 49

Estate Acquisition & Development Ltd, Re [1995] BCC 338 ... 190

Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2 ... 172, 176, 179

Ferguson v Wilson (1866) LR 2 Ch App 77 ... 170

Fildes Bros Ltd, Re [1970] 1 All ER 923 ... 185

Fiske Nominees Ltd v Dwyka Diamond Ltd [2002] 2 BCLC 123 ... 267, 276, 278

Flitcroft's Case (1882) LR 21 Ch D 519 (CA) ... 62, 64

Foss v Harbottle (1843) 2 Hare 461; 67 ER 189 ... 169, 172ff, 180, 200-1

Foster (John) & Sons Ltd v Commissioners of Inland Revenue [1894] 1 QB 516 (CA) ... 50, 55, 62, 69, 71

Fraser v Whalley (1864) 2 H & M 10; 71 ER 361 ... 141, 143

Fraser and Chalmers Ltd, Re [1919] 2 Ch 114 ... 125

Ghyll Beck Driving Range Ltd, Re [1993] BCLC 1126 ... 226, 241, 250

Gillatt v Sky Television Ltd [2000] 2 BCLC 103 (CA) ... 213, 218

Godfrey Phillips Ltd v Investment Trust Co Ltd [1953] Ch 449 ... 16

Gold Coast Selection Trust Ltd v Humphrey (Inspector of Taxes) [1948] AC 459 (HL) ... 213, 242

Goldstein v Levy Gee (a firm) [2003] All ER (D) 12 ... 216, 220, 224-25, 236

Government of Mauritius v Union Flacq Sugar Estates Co Ltd [1992] 1 WLR 903 (PC) ... 33

Gramophone and Typewriter Ltd v Stanley [1908] 2 KB 89 (CA) ... 55

Great Eastern Railway Co v Turner (1872) LR 8 Ch App 149 ... 52

Greenhalgh v Arderne Cinemas Ltd [1951] Ch 286 (CA) ... 13, 144, 149, 152, 166-67, 178, 233

Greenhalgh v Mallard [1943] 2 All ER 234 (CA) ... 37-8

Grierson, Oldham & Adams Ltd, Re [1968] Ch 17 ... 4, 71, 91, 208, 213, 275, 278

Griffith v Paget (1877) LR 5 Ch D 894 ... 181, 271

Griffith v Paget (1877) LR 6 Ch D 511 ... 26, 30, 123

Guinness Peat Group plc v British Land Co plc [1999] 2 BCLC 243 (CA) ... 218, 221-23, 234, 242, 257

Harmer (H R) Ltd, Re [1958] 3 All ER 689 (CA) ... 187

Harrison v Mexican Railway Co (1875) LR 19 Eq 358 ... 115

Harrison (Saul D) & Sons plc, Re [1995] 1 BCLC 14 (CA) ... 35, 168, 186, 190

Hawkings-Byass v Sassen (Inspector of Taxes) [1996] STC (SCD) 319 ... 243

Hickman v Kent or Romney Marsh Sheepbreeders' Association [1915] 1 Ch 881 ... 161, 162

Hilder v Dexter [1902] AC 474 (HL) ... 113

Hoare and Co Ltd, Re (1933) 150 LT 374 ... 273, 274

Hodges' Distillery Co, Re, ex p Maude (1870) LR 6 Ch App 51 ... 113-14, 122

Hogg v Cramphorn Ltd [1967] Ch 254 ... 143

Holmes v Keyes [1959] Ch 199 (CA) ... 162

Holt, Re [1953] 1 WLR 1488 ... 213, 238-39

Howie, Re and Crawford's arbitration [1990] BCLC 686 ... 219, 221, 238, 244

Hutton v Scarborough Cliff Hotel Co Ltd (1865) 4 DJ & S 672; 46 ER 1079 ... 111, 116

Inland Revenue Commissioners v Gray (surviving executor of Lady Fox deceased) [1994] STC 360 (CA) ... 241

Inland Revenue Commissioners v Joiner [1975] 3 All ER 1050 (HL) ... 24

Inland Revenue Commissioners v Laird Group plc [2003] 4 All ER 669 (HL) ... 16, 24, 26, 32, 33, 50, 53, 58-9, 71, 163

Inland Revenue Commissioners v Rolls-Royce Ltd [1944] 2 All ER 340 ... 76

Isle of Thanet Electricity Supply Co Ltd, Re [1950] 1 Ch 161 (CA) ... 128, 130, 131

Jermyn Street Turkish Baths Ltd, Re [1971] 1 WLR 1042 (CA) ... 190

Johnson v Gore Wood & Co (a firm) [2002] 2 AC 1 (HL) ... 3, 50, 55, 69-71, 220

Joiner v George [2003] BCC 298 (CA) ... 213

Jones v Jones [1971] 2 All ER 676 ... 219, 236

Jones v Sherwood Computer Services plc [1992] 1 WLR 277 (CA) ... 214-15

Jupiter House Investments (Cambridge) Ltd, Re [1985] 1 WLR 975 ... 132

Katzowitz v Sidler (1969) 301 NYS 2d 470 (CA of New York) ... 143

Kenyon Swansea Ltd, Re [1987] BCLC 514 ... 191

Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722 (CA of the New South Wales) ... 14

Kohler v Kohler Co (1963) 319 F 2d 634 (United States Court of Appeals Seventh Circuit) ... 74
Langham Skating Rink Co, Re (1877) LR 5 Ch D 669 (CA) ... 169, 196
Lee v Neuchatel Asphalte Co (1889) LR 41 Ch D 1 (CA) ... 16
Legal Costs Negotiators Ltd, Re [1999] 2 BCLC 171 (Ch and CA) ... 191, 204, 285
Levy v American Beverage Co (1942) 38 NYS 2d 517 (Supreme Court, First Department of New York) ... 261
Levy v Feinberg (1941) 29 NYS 2d 550 (Supreme Court of New York) ... 267
Lifecare International plc, Re [1990] BCLC 222 ... 274
List v Fashion Park Inc (1965) 340 F 2d 457 (United States Court of Appeals Second Circuit) ... 74
Lloyds Bank plc v Duker [1987] 3 All ER 193 ... 221, 242
Loch v John Blackwood Ltd [1924] AC 783 (PC) ... 195
London School of Electronics Ltd, Re [1985] BCLC 273 ... 250
Lynall, Re [1969] 1 Ch 421 ... 217, 237
Lynall v Inland Revenue Commissioners [1972] AC 680 (HL) ... 238, 245
Macaura v Northern Assurance Co Ltd [1925] AC 619 (HL) ... 2, 13, 15, 24, 27, 49, 50, 54-5, 219
M'Connel's Trustees v Commissioners of Inland Revenue [1927] SLT 14 ... 218
MacDougall v Gardiner (1875) LR 1 Ch D 13 (CA) ... 169, 172, 176, 178, 179
McIlquham v Taylor [1895] 1 Ch 53 (CA) ... 237
Macro (Ipswich) Ltd, Re [1994] 2 BCLC 354 ... 191, 217, 220-22, 233, 242
Macro v Thompson (No 2) [1997] 1 BCLC 626 (CA) ... 215
Macro v Thompson (No 3) [1997] 2 BCLC 36 ... 217, 230, 235
Manley v Sartori [1927] 1 Ch 157 ... 48
Marks v Sherred (Inspector of Taxes) [2004] STC (SCD) 362 ... 230
Matlaszek v Bloom Camillin (a firm) [2003] EWHC 2728 ... 226-30
Mayville (La Cie de) v Whitley [1896] 1 Ch 788 (CA) ... 172-73
Menier v Hooper's Telegraph Works (1874) LR 9 Ch App 350 ... 176
Merivale Moore plc v Strutt & Parker [1999] 2 EGLR 171 (CA) ... 224
Metcalfe (William) and Sons Ltd, Re [1933] 1 Ch 142 (CA) ... 125
Midland Bank plc v Cooke [1995] 4 All ER 562 (CA) ... 111
Mutual Life Insurance Co of New York v Rank Organisation Ltd [1985] BCLC 11 ... 145-48
New Brunswick & C Co v Muggeridge (1859) 4 Drew 686; 62 ER 263 ... 49, 63, 69
Newman (George) & Co, Re [1895] 1 Ch 674 (CA) ... 49
Noble (R A) & Sons (Clothing) Ltd, Re [1983] BCLC 273 ... 189, 193
North Holdings Ltd v Southern Tropics Ltd [1999] 2 BCLC 625 (CA) ... 234, 246
Northern Counties Securities Ltd v Jackson & Steeple Ltd [1974] 1 WLR 1133 ... 30
North-West Transportation Co Ltd v Beatty (1887) LR 12 App Cas 589 (PC) ... 30, 152, 167, 177-79
Oakbank Oil Co v Crum (1882) LR 8 App Cas 65 (HL) (Sc) ... 117-18, 121-22
Ocean Coal Co Ltd v Powell Duffryn Steam Coal Co Ltd [1932] 1 Ch 654 ... 232
O'Neill v Phillips [1999] 1 WLR 1092 (HL) ... 5, 26, 48, 190, 192-93, 198, 233, 250-51, 284
Ooregum Gold Mining Co of India Ltd v Roper [1892] AC 125 (HL) ... 18, 19, 21, 27, 113

Parkinson v Eurofinance Group Ltd [2001] 1 BCLC 720 ... 219, 226, 230

Paulin (Sir William Thomas), Re [1935] 1 KB 26 (CA); reversed by *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) ... 32, 50, 217-19, 240, 241, 245, 253

Pavlides v Jensen [1956] Ch 565 ... 199

Pender v Lushington (1877) LR 6 Ch D 70 ... 30, 176

Percival v Wright [1902] 2 Ch 421 ... 66, 143

Perfectair Holdings Ltd, Re [1990] BCLC 423 ... 196

Peters' American Delicacy Co Ltd v Heath (1939) 61 CLR 457 (High Court of Australia) ... 24, 33, 179

Peveril Gold Mines Ltd, Re [1898] 1 Ch 122 (CA) ... 163

Phillips v Manufacturers' Securities Ltd (1917) 86 LJ Ch 305 (CA) ... 211

Phoenix Office Supplies Ltd, Re [2002] 2 BCLC 556; [2003] 1 BCLC 76 (CA) ... 192, 220, 226, 228-30, 231, 233, 250

Piercy v S Mills & Co Ltd [1920] 1 Ch 77 ... 143

Planet Organic Ltd, Re [2000] 1 BCLC 366 ... 227-28, 230, 252

Plat v Plat [1999] 2 BCLC 745 ... 220

Poole v National Bank of China Ltd [1907] AC 229 (HL) ... 132, 137

Posgate & Denby (Agencies) Ltd, Re [1987] BCLC 8 ... 73, 185, 190

Powell-Cotton's Resettlement, Re [1957] 1 Ch 159 ... 131

Press Caps Ltd, Re [1949] Ch 434 (CA) ... 4, 86, 208-9, 212-13, 232, 238, 273, 275

Profinance Trust SA v Gladstone [2000] 2 BCLC 516; [2002] 1 BCLC 141 (CA) ... 249, 252

Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd [1949] AC 512 (HL) ... 139

Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204 (CA) ... 2, 23, 62, 69, 70, 72, 176, 178, 180, 187, 218, 269

Punt v Symons & Co Ltd [1903] 2 Ch 506 ... 141, 165

R v Panel on Take-overs and Mergers, ex p Datafin plc [1987] QB 815 (CA) ... 269

R v Philippou (1989) 89 Cr App R 290 (CA) ... 50

R v Registrar of Joint Stock Companies, ex p Johnston [1891] 2 QB 598 (CA) ... 36

R v Spens [1991] 1 WLR 624 (CA) ... 269

Raja v van Hoogstraten [2004] 4 All ER 793 (CA) ... 15, 50

Ratners Group plc, Re (1988) 4 BCC 293 ... 132

Rayfield v Hands [1958] 2 All ER 194; [1960] Ch 1 ... 23, 65, 211

Reid (John) & Sons (Strucsteel) Ltd, Re [2003] 2 BCLC 319 ... 226, 228-30, 260

Ricardo Group plc, Re [1989] BCLC 566 ... 15

Richards v Lundy [2000] 1 BCLC 376 ... 218, 230, 250, 251

Ringtower Holdings plc, Re (1989) 5 BCC 82 ... 167

Rock Nominees Ltd v RCO (Holdings) plc (in liquidation) [2003] 2 BCLC 493; [2004] 1 BCLC 439 (CA) ... 239-40, 272, 274

Russel v Northern Bank Development Co Ltd [1992] 1 WLR 588 (HL) ... 163

Russell v Wakefield Waterworks Co (1875) LR 20 Eq 474 ... 176

Sadler v Whiteman (1910) 79 LJ KB 786 (CA) ...48

Salmon v Quin & Axtens Ltd [1909] 1 Ch 311 (CA); [1909] AC 442 (HL) ... 161, 176

Salomon v A Salomon and Co Ltd [1897] AC 22 (HL) ... 12, 49, 52, 54-5, 64, 66

Saltdean Estate Co Ltd, Re [1968] 1 WLR 1844 ... 32, 126

Salvesen's Trustees v Commissioners of Inland Revenue [1930] SLT 387; (1930) 9 ATC 43 ... 208, 217, 237, 245

Scott v Frank F Scott (London) Ltd [1940] Ch 794 (CA) ... 162

Scott v Scott [1943] 1 All ER 582 ... 25, 170

Scottish Co-operative Wholesale Society Ltd v Meyer [1959] AC 324 (HL) (Sc) ... 72, 189, 197

Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd [1949] AC 462 (HL) (Sc) ... 126, 128-31, 139

Securities and Exchange Commission v Texas Gulf Sulphur Co (1968) 401 F 2d 833 (United States Court of Appeals Second Circuit) ... 73-4

Segenhoe Ltd v Akins [2002] Lloyd's Rep PN 435 (Supreme Court of New South Wales) ... 49

Shaw (John) and Sons (Salford) Ltd v Shaw [1935] 2 KB 113 (CA) ... 170

Sheffield and South Yorkshire Permanent Building Society, Re (1889) 22 LR QB 470 ... 52

Short v Treasury Commissioners [1948] 1 KB 116 (CA); [1948] AC 534 (HL) ... 2, 4, 27, 49, 50, 54, 55, 56-7, 59, 69, 71, 105, 161, 208, 219, 221, 233, 253-259, 262, 279, 283

Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd [1927] 2 KB 9 (CA) ... 137, 144, 165, 173

Silsbury v McCoon (1850) 3 NY 379 (CA of New York) ... 206

Smith v Anderson (1880) LR 15 Ch D 247 (CA) ... 159

Smith v Croft (No 2) [1988] Ch 114 ... 176, 178, 179

Smith and Fawcett Ltd, Re [1942] Ch 304 (CA) ... 37, 39, 143, 148-49, 166, 183

Smith (Howard) Ltd v Ampol Petroleum Ltd [1974] AC 821 (PC) ... 143, 166

Smith, Knight & Co, Re, Weston's Case (1868) LR 4 Ch App 20 ... 37

South Australia Asset Management Co v York Montague Ltd [1997] AC 191 (HL) ... 224

Stanley, Re [1906] 1 Ch 131 ... 41, 51

Suburban Hotel Co, Re (1867) LR 2 Ch App 737 ... 196

Sudbrook Trading Estate Ltd v Eggleton [1983] 1 AC 444 (HL) ... 216

Stockton Malleable Iron Co, Re (1875) LR 2 Ch D 101 ... 37-8, 39, 40

Stothers v William Steward (Holdings) Ltd [1994] 2 BCLC 266 (CA) ... 39

Sussex Brick Co Ltd, Re [1961] Ch 289 ... 275

Sutcliffe v Thackrah [1974] AC 727 (HL) ... 205, 215

Sutton's Hospital, case of (1612) 10 Co Rep 23a; 77 ER 960 ... 47

Taylor v National Union of Mineworkers (Derbyshire Area) [1985] BCLC 237 ... 176, 178

Tett v Phoenix Property and Investment Co Ltd [1986] BCLC 149 (CA) ... 212

Thorn EMI plc, Re (1988) 4 BCC 698 ... 132, 281

Tottenham Hotspur plc, Re [1994] 1 BCLC 655 ... 186

Tottenham Hotspur plc v Edennote plc [1995] 1 BCLC 65 ... 15

Trevor v Whitworth (1887) LR 12 App Cas 409 (HL) ... 150-51

VGM Holdings Ltd, Re [1942] 1 All ER 224 (CA); [1942] Ch 235 (CA) ... 53

Virdi v Abbey Leisure Ltd [1990] BCLC 342 (CA) ... 195, 196-97, 212, 231, 236, 249

Walker v London Tramways Co (1879) LR 12 Ch D 705 ... 164

Weller (Sam) & Sons Ltd, Re [1990] Ch 682 ... 184, 189, 191-92

Welton v Saffery [1897] AC 299 (HL) ... 18, 23, 65, 161, 163-65, 210

West Mercia Safetywear Ltd (in liq) v Dodd [1988] BCLC 250 (CA) ... 14

Whiteoak v Walker [1988] BCC 122 ... 215, 220, 226

Will v United Lankat Plantations Co Ltd [1914] AC 11 (HL) ... 126-128, 161

Wise v Lansdell [1921] 1 Ch 420 ... 34

Wood v Odessa Waterworks Co (1889) LR 42 Ch D 636 ... 16, 25, 161, 176

XYZ Ltd, Re (1986) 2 BCC 99,520 ... 212

Yenidje Tobacco Co Ltd, Re [1916] 2 Ch 426 (CA) ... 183, 193-94

Zubaida v Hargreaves [1995] 1 EGLR 127 (CA) ... 213-14, 216

TABLE OF LEGISLATION

Table of Statutes

Joint Stock Companies
Winding-Up Act 1848 (c 45)
s 5 193

Companies Act 1862 (c 89)
s 133 121
Table A art 27 141-42
Table A art 72 117

Partnership Act 1890 (c 39)
s 1(1) 36, 48
s 1(2) 48
s 20(1) 48
s 24(1) 48, 111
s 24(7) 36
s 31(1) 36

Finance Act 1894 (c 30)
s 7(5) 238

Companies Act 1928 (c 45)
s 50 264
s 50(1) 264

Companies Act 1929 (c 23)
s 155 264

Companies Act 1948 (c 38)
s 28 39
s 210 188-89, 203

Companies Act 1980 (c 22)
s 75 189
s 88(2) and Sch 4 39

Companies Act 1985 (c 6) ('CA 1985')
s 1(1) 160
s 1(2)(a) 27, 113
s 2(2) 164
s 2(5) 17, 161
s 2(7) 164, 170
s 4 164
s 5 181
s 8 161
s 9 144, 164, 170, 173-74
s 10 159
s 13(3) 12, 159
s 13(4) 160
s 14(1) 160-62
s 16 165
s 17 164
s 24 18
s 28 164
s 53ff 182
s 54(2) 182
s 80 142, 170
s 81(1) 38
ss 89-96 141-44
s 89(1)(a) 142
s 95 142, 144
s 95(1) 143
s 99 19
s 100 18, 113
s 101 21
s 103 19
s 104 19
s 105 19
s 108 19
s 112 19
ss 117-18 18
s 117(1) 160
s 119 119
s 121 17, 141, 164, 170
s 135 131-32, 164, 170
s 135(1)(c) 132
ss 136-37 132
s 143(1) 151

Companies Act 1985 - cont
s 143(3) 151
ss 151-81 151
s 159 28
s 160(1)(a) 151
s 160(4) 151
s 162(1) 151
s 162(2) 151
s 163 152
s 164 152
s 165 152
s 166 152
s 169 152
s 171ff 151
s 182(1) 37, 64
s 263ff 22, 114
s 263(3) 25
s 292 172
s 301(1) 170
s 303 65
s 303(1) 172
s 319 65
s 368 181
s 373 172
s 376 181
s 378 164, 174
s 428-30F 28, 167, 267, 273, 278, 280
s 428 273
s 429 276-77
s 428(1) 268
s 430(2) 265, 276
s 430A 276-77
s 430B(2) 277
s 430C 265
s 430C(1) 277
s 430C(3) 277
s 459 108, 188-193, 198-99, 203, 207, 231, 236-37, 244, 247-52, 258, 280, 284
s 459(1) 188
s 461 189, 199
s 461(1) 188
s 461(2) 188
s 716(1) 38
s 744 22

Insolvency Act 1986 (c 45)
s 84 120, 170
s 84(1)(b) 26
s 122 120
s 122(1)(g) 194, 198
s 125(2) 198
s 143 26

Criminal Justice Act 1993 (c 36)
s 56(1)(d) 74

Financial Services and Markets Act 2000 (c 8)
s 143 269

Table of Statutory Instruments

Companies (Tables A to F) Regulations 1985 (SI 1985/805)
Table A 161
art 2 111
art 32 141
art 34 131
art 35 151
art 46
art 54 29, 171
art 70 170
art 73ff 170
art 76(b) 182
art 78 172
art 102 25, 115
art 104 119

Regulatory Reform (Removal of 20 Member Limit in Partnerships) Order (SI 2002/3203)
art 2 38

Table of EU legislation

Second Council Directive 77/91/EEC
[1977] OJ L 26/1
18, 112
Art 6 18
Art 29 141

Directive 2004/25/EC of the European
Parliament and of the Council of 21 April 2004
on takeover bids [2004] OJ L 142/12
270, 273, 278, 280, 284
Recitals (1), (2), (9) 270
Articles 3(a) and 5 270

CHAPTER 1

INTRODUCTION

If there were only one man in the world, he would have a lot of problems, but none of them would be legal ones.
David D. Friedman, *Law's Order* (2000) 3.

1.1 Company law and capital

The focus of my research is on companies, shareholders, and in particular on the value of shares. My main aim is to examine legal rules and principles governing shareholders' rights and share value. As stock markets fall within its realms, the study has both legal and economic dimensions.

The principal question of the research is whether the value of ordinary shares is equal in company law, although companies are governed by majority rule and shares are freely transferable. I consider that from the legal perspective share value should be related to shareholders' rights: value is fundamentally a matter of rights.

Companies are pooling vehicles that aggregate capital; they gather in and pump out money. Capital in general means wealth, but in company law it has a more restricted meaning: a company receives capital from shareholders in exchange for the shares issued. Companies and shares belong to the heart of capitalism, and company law provides an important legal structure for the operation of the whole system. My special interest is the relationship between company law and capital; the fundamental point in this analysis is how company law governs the value and price of shares.

Capital for companies is channelled through stock markets; further, in a wider meaning company law regulates both companies and capital markets. I accept that

company law includes securities regulation, which is also called capital markets law. The main task of this regulation is to control marketing of shares and financial products. Thus, securities regulation offers investor protection, and this study is about shareholders' protection too. Nonetheless, my main focus is on traditional company law, not on the regulation of stock markets, in general.

The prime interest is public companies, which are understood to be companies whose shares are quoted on the stock market. Significantly, public companies have a tighter regime under company law; in addition, companies with listed shares should follow the market regulation. But as equality is not a matter concerning public companies only, I review in this study both public and private companies.

1.2 Value of shares

Shareholders do not own the company or its assets[1], but the value of shares depends strongly on a company's business and its assets. It is said that the value of shares follows the fortunes of the company[2]. Moreover, shares in a way represent a proportionate part of an enterprise's net assets; as a result, there is a strong correspondence between company assets and share value[3].

As mentioned above, my intention is to emphasize that shareholders' rights are the starting point in share valuation. Even so, the value of shares is not simply a question of rights since there is no natural or right value for shares; therefore, even if the rights are known, the value of shares may still remain unknown. I stress that the valuation of shares is not just complicated, but it is predominantly a point of fact and opinion.

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[1] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA); *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL).

[2] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA) 224.

1.2.1 Valuation in the markets and law

Roscoe Pound states: "Wealth, in a commercial age, is made up largely of promises"[4]. Indeed, this is very true with shares whose value follows expectations on the markets. Still, the future success of a company's business is unknown. Economic decisions are always made under uncertainty; hence, market price for shares is an estimation of future profits and incomes. Furthermore, share value is related to a wide range of macroeconomic factors, and so the value of particular shares does not depend only on a company's own economic condition. In any event, share valuation is a task of markets. It is a fundamental principle of the market economy that values are reached via function of markets, which operate through demand and supply curves. Put simply, markets determine the price of shares in the same way in which the prices of apples and oranges are set. If a more academic and general formulation is used, I may state that: "once the original entitlement is decided upon, the state does not try to decide [the] value"[5]. This study underlines that it is impossible to say whether a share price is right or wrong according to law because that is a point decided by the buyer and the seller, and more generally, by the operation of markets.

Share value is more a question of markets than law, but what the law and the courts can do is to follow the markets and to accept the value reached in the market as the right value. In consequence, the valuation of shares in quoted companies is often a straightforward exercise since reference can be made to their market price.

Yet, the value of shares is also a matter of law. First, the law gives shareholders the right to determine the value of their property. In addition, share value depends on shareholders' rights and the level of shareholder protection. Therefore, when laws are protective, people are generally more willing to invest in stocks. The markets with these

[3] *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1 (HL) 62.
[4] Pound, Roscoe, *An Introduction to the Philosophy of Law* (New Haven 1922) 236.

features are then broader, and financial assets have a higher value. In this sense, the support of law is very important for share valuation.

1.2.2 The value of shares in English company law

The value of shares is regarded as a question of fact and opinion in company law. For example, in *Re Press Caps Ltd*[6], Wynn-Parry J formulated that: "A valuation is only an expression of opinion." Naturally, "the question of value is obviously one about which opinions may differ"[7]. The general position of the law is that the courts do not interfere in matters of opinion[8].

Since share value is a matter of fact, the courts should not value them. Can there then be a legal view about the value of shares? Significantly, leading English authors seem to have a clear idea about the value of shares. Davies[9] refers to *Short v Treasury Commissioners*[10] and notes that the law accepts that in principle controlling shares are more valuable than non-controlling ones. Sealy[11] agrees and says that the dicta in the case support the view that when a majority shareholding is sold by a single seller to a single buyer, it is proper to value the holding more highly. Further, Pettet[12], more generally, points out that the reasons for the discounted valuation of minority shares are obvious since a minority holding carries no control, can vote no director onto the board, can remove no director, and is dependent on the majority for any dividends. There seems to be a wide consensus among distinguished academics that majority shares are more valuable due to their power to control the company.

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[5] Calabresi, Guido and Melamed, A. Douglas, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 Harvard Law Review 1089, 1092.
[6] [1949] Ch 434 (CA) 447.
[7] *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 38 (Plowman J).
[8] See especially *Dean v Prince* [1954] Ch 409 (CA).
[9] Davies, Paul L., 'The Notion of Equality in European Takeover Regulation' in Payne, Jennifer (ed), *Takeovers in English and German Law* (Oxford 2002) 9, 13.
[10] [1948] AC 534 (HL).
[11] Sealy, L. S., *Cases and Materials in Company Law* (7th edn London 2001) 474.
[12] Pettet, Ben, *Company Law* (Harlow 2001) 253.

Back to case law: in *Dean v Prince*[13], Harman J held that the value of a block of shares which conferred control should include something above their break-up value. But the Court Appeal[14] reversed his decision with a statement that the court should not interfere on matters of opinion. The auditor was right in *not* attributing a special value to these shares on account of their carrying control, and from this perspective it is difficult to consider that there would be a rule that a majority block should include something above their pro rata value. Even more importantly, as Lord Hoffmann considered in *O'Neill v Phillips*[15], the fair value of minority shares is ordinarily a pro rata value, and he said that valuation on this basis reflects the existing practice. These cases raise doubts against commentators' ideas of how English company law sees share valuation. The pivotal question in this study is what the law rules about the value of majority and minority shares.

The valuation of shares may be a puzzling issue. However, this study suggests that the value of ordinary shares, which are homogeneous commodities, should be considered equal in *law*. I do not thus share the view that the law would regard majority shares as more valuable than minority shares.

1.3 Research review

In this study, I review shareholders' rights, the notion of equality, and the value of shares in company law. The central attempt is to emphasize that there is no mystery in English law about share value, but the current position of law is not accurately explained. In sum, my aim of research is to analyse, to explain, and partly to demystify the law.

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[13] [1953] Ch 590.
[14] [1954] Ch 409 (CA).
[15] [1999] 1 WLR 1092 (HL) 1107.

1.3.1 Law, rules, and principles

Sir Francis Palmer's view about company law is still relevant: "The Acts alone afford a very inadequate view of the law regulating companies"[16]. English company law rests strongly on the common law, and this applies to the value of shares too. Even so, as Palmer notes, "the Acts plus the decisions [of courts] constitute a great and, for the most part, admirable system of company law"[17]. The emphasis of this research is on judge-made law: my intention is to discover the current status of law from court decisions.

Company law is a system of rules, but it is also standards and principles. As the title of a leading company law book, *Gower and Davies' Principles of Modern Company Law*[18], implies, principles are important. Company law is based on the principles of common law and equity[19]. I am particularly interested in the notion of equality as a principle of company law. In company law, as in law generally, principles are able to justify and explain more specific rules.

Rules and principles are together called legal norms, and this is norms-oriented research. The agenda of this study is prescriptive: I describe and analyse company law norms concerning shareholders' rights and the value of shares.

1.3.2 Law, economics, and society

The company can be regarded as a social contract and a set of rules rationally adapted to the economic environment. It is an economic institution with social features. Company law organizes economic and social relationships. I support the view that the main function of company law is to govern the relationship between shareholders and to serve

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[16] Palmer, Francis Beaufort, *Company Law: A Practical Handbook for Lawyers & Business Men* (4th edn London 1902) v; on the other hand, it is fair to say that UK company law is nowadays "predominantly a creature of statute", as eg Griffin, Stephen, *Company Law: Fundamental Principles* (3rd edn Harlow 2000) xi says it.
[17] Palmer (1902) v.
[18] Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003).
[19] Eg Gower, L. C. B., *Gower's Principles of Modern Company Law* (4th edn London 1979) ix, where the preface to the first edition of the book exists.

their needs. Company law is an instrument and a tool to achieve economic and social purposes.

Companies and shareholders have an economic goal. The aim of companies is to generate profit for shareholders. As a part of the study, I seek to explain how company law serves shareholders' economic needs.

The company is a co-operative activity with many similarities with society[20]. Therefore, the corporation also faces the problems that typically exist in every democracy[21]. But the relationship between members of society is political and predominantly social in nature. In contrast, members' relationship, especially in a public company, is fully economic and impersonal. Different kinds of societies should be governed by their own rules; further, equality as a principle cannot have the same meaning in politics and company law. Therefore, I do not try to draw any direct analogies between societies and companies. However, I propose that the co-operative notion of companies is an important point since the company as a concept is a collective action[22].

Companies can operate successfully only under the rule of law. This is dominantly a study of law. On the other hand, I see that understanding of economics and sociology advances understanding of law. In effect, in this research company law is analysed in its functional context, and also some economic and social argumentation is used to explain shareholders' rights and share value.

1.3.3 Ownership, rights, and value

Shareholders own their shares; I stress the point. In addition, they, like owners in general, can be called residual claimants. Due to shareholders' residual right, a

[20] For example, analogies can be drawn between the constitution of a company and a nation-state.
[21] See eg Epstein, Richard A., *Simple Rules for a Complex World* (Cambridge, Massachusetts 1995) 248.

company's profit 'belongs' to them. Overall, the company is a complex set of relationships between persons. My focus is on shareholders and the relationship among them inter se.

Shares are shareholders' property; furthermore, they are a bundle of rights. The value of shares is a consequence of these rights, and my emphasis is on shareholders' rights. I think that it is an important point to note that shareholders have those rights that company law and the company constitution give them. In practice, this mean that shareholders participate in company through their shares and their rights are attached to the shares.

My intention is not to explain what the value of shares should be on stock markets. The perspective is legal: the emphasis is on determination of value in accordance with law. In essence, I stress that there exist property and liability rules; therefore, share valuation does not follow similar principles under different rules. The conclusion is that there cannot be a single 'right' value for shares in law.

Finally, the aim is to show that, since the value of shares has features of fact, the law should not decide their value; instead, law often only accepts it. Share value from the perspective of law is typically a question of opinion. Yet, it is the law that determines whose and what opinion prevails if opinions differ. The valuation of shares might seem to be complicated and confusing. But the equal value of shares as a principle makes valuation clearer and more predictable. In sum, equality can be the most straightforward organizing principle in company law and share valuation.

1.4 The agenda of research

I start the discussion, in chapter two, with the analysis of shares and rights attached to them. Yet, my focus is more on the rights of shareholders than the nature of shares.

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[22] Eg Cooke, C. A., *Corporation, Trust and Company* (Manchester 1950) 7: the company "creates a

Shareholders' rights are a very important part of the study since the value of shares is a consequence of the rights.

The relationship between company assets and share value is discussed in chapter three. Company law does not rule that the value of shares is their proportionate part of a company's assets. However, the value of shares is strongly related to the company's business and assets as their value follows its fortunes. Therefore, I do not declare that the asset value is not the share value, but the point is analysed more deeply.

The function of stock markets is of special interest in this study. In chapter four, I review markets and their pricing mechanism. That is done particularly to show that market prices are decided under uncertainty. In consequence, these prices cannot be right or wrong but they are the best available real prices. I emphasize that markets cannot really know right prices and values. Moreover, the value of majority shares is a special question in this study, so the aim of this discussion is to demonstrate that there is no general market rule directly supporting the idea that majority shares generally have a higher per share value.

Chapter five is about equality of shares. I stress that when shares in a company have similar rights these shares should be regarded as equal. But it is not enough only to argue that shares are equal, and this study goes further and seeks to clarify what this equality of shares means in company law. My conclusion is that English company law supports equality of shares, although it is not an absolute principle in company law.

Companies are governed by majority power, and thus it should be asked whether there can be any equality in a company between majority and minority shareholders. In chapter six, I demonstrate that company law balances the interests of a majority and minority. On the one hand, the company is governed by majority rule; on the other hand, law offers shareholder protection. I consider that interests of minority

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common action where no common action is possible."

shareholders are protected in the most efficient way when company law supports equality.

In chapter seven, the value of shares is reviewed from the legal perspective: the focus is on their objective value. Significantly, my analysis of case law does not support the view that majority shares are generally regarded as more valuable than minority shares. In essence, the value of shares is a mixed point of fact and law. Moreover, there is no single rule that is fully capable to set their value. Yet, I propose that the current law mainly supports the idea that every share has the same value.

Chapter eight includes the main conclusions. I emphasize the importance of shareholders' rights in share valuation. Nevertheless, as the hypothetical value of shares is a matter of fact and opinion, their value is normally determined by the support of expert evidence. Even so, the law has a pivotal role in share valuation. The idea in the law is not that the courts should fix the value of shares solely with reference to their hypothetical value. Company law really sets guidelines for share valuation. My prime conclusion is that the law and the courts favour the principle of equal share value. I consider that this idea is a proper and fair legal mode.

CHAPTER 2

SHARES AND SHAREHOLDERS' RIGHTS

The institution of rights is therefore crucial, because it represents the majority's promise to the minorities that their dignity and equality will be respected.
Ronald Dworkin, *Taking Rights Seriously* (1977) 205.

2.1 The importance of shareholders' rights

I start analysing shares and the rights attached to them. These rights are an important part of my study since the value of shares derives from them. Put simply, shares are valuable because of the rights.

Shareholders own their shares, which are private property. By contrast, shareholders do not own the company. Thus, it is accurate to say that shareholders own their shares and have shareholders' rights[1]. In any case, they together have ultimate control over the company; therefore, share ownership has some distinctive collective features. In this chapter, I concentrate on shareholders' individual rights.

The word 'share' may imply that shareowners share the company. Yet, that is not true. The word share might be even like a misnomer for shares[2]. Nevertheless, I argue that shares are real 'shares', especially in the relationship between shareholders. At bottom, shares are shares *in* a company but not shares *of* a company.

Shareholders have both economic and control rights. Because companies are in essence economic societies, I thus stress that the value of shares ultimately depends on shareholders' economic rights.

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[1] Eg Davies, Paul L., *Introduction to Company Law* (Oxford 2002) 257; further chapter three 3.3.2.
[2] For example, Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003) 615.

Companies acquire share capital by issuing shares. For shareholders, shares are their assets and transferable investments. The transferability of shares is a central point in my analysis.

2.2 Shares in a company

In general, a share is "a part of a larger amount which is divided among or contributed by a number of people"[3]. In a commercial context, the idea of dividing a business into shares derives from the Middle Ages. Shares permit the accumulation of large capital; by co-operation and contribution of capital, many men can undertake enterprises that a single man finds impossible. However, the company or its assets are not divided among shareholders, who share only rights in a company. I first analyse the nature of shareholders' interest and the role of share capital.

2.2.1 Shareholders' interest in the company

As the CA 1985 s 13(3) states, shareholders are a body corporate by the name contained in the memorandum. In general, the company used to be in English 'they' and not 'it'[4]. But according to law, shareholders are not the company, and therefore a company cannot be them. A company is a legal entity distinct from its members: it has an own legal identity and personality. As a result, a company is "at law a different person altogether"[5] from its shareholders. A shareholder is not the company, although he holds all the shares in a company[6].

Still, shareholders' interests are paramount in company law. The company itself is an artificial person, whose interests cannot be distinguished from the interests of

[3] *The Oxford Compact English Dictionary* (2nd revised edn Oxford 2003) 1052.
[4] See Sealy, Len, 'Perception and Policy in Company Law Reform' in Feldman, David and Meisel, Frank (eds), *Corporate and Commercial Law: Modern Developments* (London 1996) 11, 25.
[5] *Salomon v A Salomon and Co Ltd* [1897] AC 22 (HL) 51 (Lord Macnaghten); *Bligh v Brent* (1837) 2 Y & C Ex 268, 295 (Alderson B): "the individual members of a corporation are quite as distinct from the metaphysical body called 'the corporation' as any others of his Majesty's subjects are."

shareholders[7]. So, the interest of the company as a whole must equate with the interest of shareholders as a group[8]. A company is a vehicle for carrying on a business for the benefit of all shareholders[9].

Company law considers that there exists indoor management rule: a company's organs decide upon its business. Further, the main principle is that companies are governed by majority rule. However, my interest in this chapter is not how companies are governed but how their success is divided among shareholders.

Shareholders are investors, whose interest is to get a return on their capital. But they do not only require return as yield since their desire is also to make profit with their shares. Naturally, gains can be made when share value rises. The main interest of a rational shareholder is ordinarily the value of shares: the right to get dividends or to have the capital returned have less importance in practice[10].

Yet, the rising share value is not a legal expectation and shareholders' right. Obviously, the aim of company law cannot be to secure shareholders a gaining share value. In addition, company law does not guarantee that dividends are paid or shareholders' investment is returned. Company law gives rights to shareholders; thus, share value rests on these rights.

The nature of an owner's interest is generally residual: this idea applies to shareholders too. They have both residual income and control interest in the company. Shareholders' residual economic interest means that they have a right to the company's profit after other payments like wages for employees, charges for suppliers of materials,

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[6] *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL) 633 (Lord Wrenbury).
[7] *Brady v Brady* [1988] BCLC 20 (CA) 40 (Nourse LJ); see also *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL) 626 (Lord Bridge).
[8] *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA) 291 (Evershed MR).
[9] Eg *Re a company (No 00370 of 1987), ex p Glossop* [1988] BCLC 570, 576 (Harman J).
[10] More below, chapter four.

and interest to lenders of capital have been made. After these payments, all the profit belongs to them[11].

In this way, shareholders are like owners in the corporate structure as the profit of a company is 'their profit'. Therefore, it has been considered that, in a practical sense, the assets of a solvent company are their assets through the medium of the company[12]. However, in the legal sense, that is not true because a company's profits and assets are always its assets and money. Shareholders do not have property rights in the company assets.

Furthermore, shareholders' interest in the company is residual in another way: they can get their capital back in winding up only when all the other liabilities have been met. In an insolvent company, the assets of the company are in a practical sense its creditors', whose interests should prevail[13]. Shareholders lose their residual interest and controlling votes when the company is in serious economic difficulties.

In sum, shareholders stand first as far as there are losses; on the other hand, they are last in line in the case of surplus. They share in the company both profits and risk. Naturally, shareholders' residual interest makes their status very distinctive.

In general, ownership is a source of power, ie owners have residual powers. Ultimate power in companies rests on shareholders. But their ultimate control power does not make them owners of the company[14]. They have power in the company because they are residual claimants, and they need the power to protect their economic interests.

Although shareholders do not own the company, due to the nature of their interest, they are often recognized as beneficial owners. If a company has a single

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[11] *Re a company (No 00370 of 1987), ex p Glossop* [1988] BCLC 570, 577.

[12] *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (CA of the New South Wales) 730; quoted in *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250 (CA).

[13] Ibid; *Brady v Brady* [1988] BCLC 20 (CA) 40 (Nourse LJ).

shareholder, that person may then be regarded as "the beneficial owner of the company"[15]. Indeed, the aim of companies is to operate in the interest of shareholders: in this sense, they are the beneficiaries of the company. However, shareholders own only their shares, not the company. Furthermore, there is no need to call them 'beneficial owners' of their shares[16] since a shareholder is the legal owner of his shares. A beneficial owner can exist only when the legal and equitable interests are separated; for example, shares are registered in the name of a nominee shareholder, or there is a binding agreement to acquire shares[17].

Shareholders have special interest in the company, and therefore the courts might hold that they have a 'proprietary interest'[18]. Indeed, it is considered that it is "some sort of proprietary interest in the company though not in its property"[19]. Yet, the company is a legal entity separate from its shareholders; thus, the relationship between a shareholder and a company is not a relation between an owner and property. Shareholders do not have a legal or equitable proprietary interest in the company's assets[20]. Therefore, their proprietary interest in the company is their shareholding.

In *Borland's Trustee v Steel Brothers & Co Ltd*, Farwell J considered the nature of shares in this way:

> 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

[14] Although historically their status as owners has been the central explanation for shareholders' control in the company; see eg Grantham, Ross, 'The Doctrinal Basis of the Rights of Company Shareholders' (1998) 57 CLJ 554.
[15] See *Raja v Van Hoogstraten* [2004] 4 All ER 793 (CA) 824 (Chadwick LJ).
[16] Contrast *Tottenham Hotspur plc v Edennote plc* [1995] 1 BCLC 65, 66 (Rattee J), where Mr Venables was called the "indirect beneficial owner of all the shares".
[17] Eg *Re Ricardo Group plc* [1989] BCLC 566; about the terms, see Stapledon, Geof, 'Analysis and data of share ownership and control in UK' (undated); available www.dti.gov.uk/cld/other_information.htm#e (16.10.2005).
[18] *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL) 631 (Lord Oliver); *Berg Sons & Co Ltd v Mervyn Hampton Adams* [1993] BCLC 1045, 1064 (Hobhouse J).
[19] Davies (2003) 616.
[20] See especially *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL).

second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se.[21]

First, shares are not a sum of money: they are just measured by a sum of money to show a shareholder's liability for the payment of shares and his proportional interest. Shares are the measure of the proportion of the total interest in the company[22]. Moreover, the capital paid for shares is the property of the company. A shareholder is not like the creditor of a company[23]; for example, the dividend from a company is a debt to shareholders only when it has been declared[24]. Second, shares consist of mutual covenants entered into by shareholders. There exists a statutory contract between members inter se and between each member and the company. The corporate contract contained in the articles of association is one of the original incidents of the share. Shareholders' rights depend particularly on the articles because these rights "spring from" the statutory contract[25]. In sum, the argumentation in *Borland's Trustee* recognizes clearly the contractual nature of the company.

To conclude, shareholders' interests are paramount in company law: the interest of a company must equate with their interest. A company's profits fundamentally belong to its shareholders, who have control over it. However, shareholders, who have financial interest and legal rights in the company, do not own it or its assets. They participate in a company indirectly "through their shares alone"[26].

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[21] [1901] 1 Ch 279, 288.
[22] *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 679 (Lord Millett).
[23] See *Lee v Neuchatel Asphalte* Co (1889) LR 41 Ch D 1 (CA) 23 (Lindley LJ).
[24] *Wood v Odessa Waterworks Co* (1889) LR 42 Ch D 636; *Godfrey Phillips Ltd v Investment Trust Co Ltd* [1953] Ch 449.
[25] Wedderburn, K. W., 'Shareholders' Rights and the Rule in *Foss v. Harbottle*' [1957] CLJ 194, 209.
[26] *Birch v Cropper* (1889) LR 14 App Cas 525 (HL) 546 (Lord Macnaghten).

2.2.2 Share capital and nominal value

Share capital is one of the essential features of the company. Every company limited by shares has a share capital; furthermore, shares have a nominal value. But as the term nominal implies, it is no real value for shares. Their nominal value is actually a matter of company law tradition and accounting. It gives very little useful information about shares. Still, share capital has a special role: it is one of the fundamental concepts that lie at the heart of company law. Therefore, it is difficult to understand the value of shares without knowing the roles of share capital and nominal value.

Share capital can be seen as a financial fund that the company has in order to operate. According to CA 1985 s 2(5), the memorandum of association must state the amount of share capital. This nominal or authorised share capital is the total amount of share capital that could be issued. The nominal share capital shows the maximum amount of share capital, but not the existing share capital of a company.

The CA 1985 s 2(5) also states that the share capital must be divided into shares of a fixed amount. The nominal share capital divided by the number of shares is the nominal value of a share, or the other way, the nominal value of shares multiplied by the number of all the shares is the nominal share capital. The relationship is mathematical, but it is not very informative since these two figures can together only tell how many shares there could be in the company if all the shares were issued. Furthermore, as the memorandum is alterable[27], the nominal share capital is purely the current maximum amount for share capital.

There is no minimum amount for a private company's share capital: it can be £1 or even less. English company law has let companies determine their share capital without setting any minimum requirement. But in the case of a public company, the

[27] See CA 1985 s 121.

statutory minimum of share capital is £50,000[28], which requirement comes from European Company Directives[29]. Nonetheless, for public quoted companies, taking into account the general size of their business, this amount of share capital is very low. Therefore, the amount of share capital is clearly a matter that is decided by companies, by their shareholders, and often by the requirements of their creditors. Company law mainly rules that companies should have a share capital.

The nominal value of shares is a question of the company constitution. A company can have one share, a hundred, a million, or as many shares as is determined by its constitution, and even though the share capital would be only £1. Public limited companies have a minimum requirement of two shareholders[30]; naturally, there should then be at minimum two shares. The practice in public companies is that shares are issued in small denominations. So, when a company has a large amount of shares, it can also have a large number of shareholders.

Shares should have a nominal value. The nominal value, or par value, is the value that the shares are nominally declared to have: it is given to them in a quite technical sense. But the nominal value has some role since according to company law shares may not be issued at a discount to their nominal value[31]. This is a very clear rule although, if the value of shares is below their nominal value, it is dubious whether the rule really protects anybody[32]. The par value seems to be "a doubtfully useful concept"[33], and "it is questionable whether at present the requirement to have par value

[28] CA 1985 ss 117-18.
[29] Second Council Directive 77/91/EEC [1977] OJ L 26/1; UK has set a lightly higher minimum for public companies as the minimum requirement according to the Directive is 25,000€; see Article 6.
[30] CA 1985 s 24.
[31] *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 (HL); *Welton v Saffery* [1897] AC 299 (HL); CA 1985 s 100.
[32] The nominal value cannot protect the value of shares already issued because if the real value of shares is less than the nominal value, it is good for the company and shareholders that somebody is able to subscribe shares at their real value, and when the real value of shares is more than their nominal value, the subscribers do not pay enough for shares if their issue price is only the nominal value.
[33] Davies (2003) 231.

for shares serves any useful purpose"[34]. In the Company Law Review, it was seen that the nominal value has become "an anachronism"[35]. However, the nominal value of shares is a rule of English company law, and in the case of public companies this requirement comes from the European Company Directive. Even so, nominal value might be more a source of confusion than any source of information, especially as far as it concerns real share value.

Further, the authorised share capital and the nominal value do not show the amount paid for shares. A company's issued or allotted share capital is only the total nominal value of the issued shares. Yet, the interesting point is not this nominal value, but the amount paid for shares since, of course, it is the real capital that matters most. As stated in *Ooregum Gold Mining Co of India Ltd v Roper*[36], nominal value is the minimum price that shareholders have to pay for shares. They and the company can decide that the issue price of shares is their nominal value or anything above it. It is not a task of company law to limit the subscription price per share. The real issue price for shares is merely a matter of bargain and markets.

Company law requires that shares should be paid up in money or money's worth[37]. Under CA 1985 s 103, a public company may not allot shares paid up otherwise than in cash unless the consideration for the allotment has been independently valued[38]. The no-cash consideration should have the value it is said to have. For example, in *Re Bradford Investments plc (No 2)*[39], shareholders failed to show that the company had received assets equal to the nominal value of issued shares, and therefore they were required to pay their shares to the company because the consideration was not independently valued.

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[34] McGee, Andrew, *Share Capital* (London 1999) 7.
[35] *Company Law Reform: Modern Company Law For a Competitive Economy – The Strategic Framework* (London 1999) 5.4.27.
[36] [1892] AC 125 (HL).
[37] CA 1985 s 99.
[38] See also CA 1985 ss 104 and 108, and about the consequences, ss 105 and 112.

Shares are issued at a premium when the issue price is more than their nominal value. The issue price has two elements: first, there is the nominal value, and second, there may be this premium attached to it. The subscriber of shares has to pay the issue price that can be anything above the nominal value. If there is no premium, the issue price is the nominal value.

In essence, the subscription price is a matter of contract: it is the price at which the company is willing to issue new shares and the subscribers are prepared to have them. A subscription of shares is a financial decision: the pricing mechanism in share issues is economic in its nature. Shares are typically issued at the market price. But according to company law, shareholders have a pre-emption right to subscribe the new shares issued by the company, and when shares are offered to shareholders in proportion to their existing shares, the issue price is of less importance[40]. The issue price of shares is decided in accordance with company law and the company constitution. However, the issue price is more a question of contract than law, although shareholders' rights and protection have a role in share issues too.

Companies receive capital from shareholders in exchange for issued shares. In the company's book-keeping, the received capital is share capital only to the amount of the nominal value of shares; the premium is credited to a share premium account. The share premium is not strictly share capital but it is a special statutory reserve and subject to rules that treat it as share capital. Therefore, in practice, the share premium is a part of the share capital in its wider sense. There is no real distinction between the share capital and the share premium account[41].

The paid share capital includes the share premium account; these two elements show together how much subscribers have paid for shares and how much capital the

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[39] [1991] BCC 379.
[40] About shareholders' pre-emption right, see below, chapter five 5.5.
[41] *Company Law Reform - The Strategic Framework* (1999) 5.4.27.

company has received. The issue price of shares has much greater importance both economically and legally than their nominal value. Their issue price is more a real price, and the nominal value is mainly a book-keeping unit. However, the subscription price can only be a historical value: the price that has been paid for them. Furthermore, we do not know whether their price was a real market price, or just a price that was used when the shares were issued. Therefore, it is quite impossible to get any real information from share capital about share value.

The prime interest of company law is that shareholders pay issued shares. As Farwell J explained in *Borland's Trustee v Steel Brothers & Co Ltd*[42], a share is the shareholder's interest in the company measured by a sum of money to show his liability and interest. The limited liability in companies means that shareholders have an obligation to pay the issue price of subscribed shares, but nothing more. When issued shares are fully paid, a shareholder has no further liability to contribute capital to the company[43]. Moreover, in modern market practice, issued shares are also fully paid shares[44]. Shareholders typically pay shares when they are issued, and no further contributions are required.

The doctrine of capital maintenance is essential in company law; it ensures that the capital of the company constitutes a fund available for its creditors. As a part of this doctrine, shareholders are obliged to pay their shares fully, and the issue price may not be less than the nominal value. Still, the central parts of the doctrine are the rules concerning the maintenance of share capital, and therefore capital may be returned to shareholders only under the special requirements of company law[45]. For instance, to pay

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[42] [1901] 1 Ch 279, 288.

[43] See *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125 (HL) 136 (Lord Watson).

[44] Although company law recognizes partly paid shares and the calls of payment; about partly paid-up shares in public companies, see especially CA 1985 s 101.

[45] The central parts of this doctrine are: 1) the capital may not be reduced except with the sanction of court; 2) a company may not redeem its own shares; 3) a company may not purchase its own shares; 4) a company may not provide financial assistance for the purchase of its own shares; and 5) dividends may be paid out of the profits of the company only.

a dividend, a company should have distributable profits[46]. Consequently, a company's creditors can trust that share capital is maintained in the company in the legal sense. Of course, it is very natural that in companies where shareholders have a limited liability there should be special rules governing the maintenance of share capital. In sum, this doctrine of capital maintenance belongs to the heart of company law in the same way as share capital itself.

As explained, the nominal value of shares does not show their real value. Moreover, nominal value does not serve any useful purpose in company law. However, it is still part of company law[47]. Furthermore, every shareholder is responsible for contributing his share of the capital. The paid share capital shows the invested equity and the amount paid for shares, but it does not mean that the issue price is the real value of shares.

In conclusion, shares are shares in the company, but not shares of the company. As CA 1985 s 744 states: a share is "share in the share capital of a company". Yet, the main interest of company law and this research is in shareholders' rights, not in the nature of shares.

2.3 Shareholders' rights

Company law provides the formal structure and framework for the operation of companies. Companies and shares are creatures of company law. In a way, the company is split up into shares, to which shareholders' rights are attached.

The company is a separate legal entity; therefore, the rights of shareholders should be limited. The courts have partly sacrificed shareholders' private rights to serve

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[46] CA 1985 s 263ff.

[47] *Company Law Reform* ('*White Paper*') (Cm 6456) (London 2005) 43 proposes that the requirement of authorised share capital is removed.

the greater good available through the corporate personality[48]. As explained in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[49], when a shareholder acquires a share, he should accept the fact that the value of his investment follows the fortunes of the company. In addition, a shareholder can only exercise his voting rights in general meeting. In brief, the law confers on him the right to ensure that the company observes the limitations of its memorandum and the right to ensure that other shareholders observe the rules imposed by the articles. The relationship in a company is contractual as shareholders' rights are set by the company constitution. As a result, shares are rights of participation in the company on the terms of the articles[50].

The articles of association regulate shareholders' rights in the company and inter se[51]. The memorandum and the articles determine shareholders' rights: their rights under the articles of association and the Companies Act are "an exhaustive statement"[52] of their interests as members. Furthermore, a company is entitled to issue shares conferring any rights. However, I do not further explore how shareholders' rights are set: the focus in this chapter is on shareholders' rights in general.

The object of a company is to make profit for its shareholders, who are residual claimants in the company. The ultimate power in companies rests on them. Normally, shareholders have rights to receive dividends, if declared, rights in liquidation to receive a share of surplus, and rights to vote[53]. Due to the nature of their interest, shareholders' rights are more *in* the company, not so much *against* the company.

Shareholders' rights cannot be very exact because they are residual. Put simply, equities are shares that carry no fixed economic right. Shareholders' rights cannot be

[48] Dignam, Alan J. and Allen, David, *Company Law and the Human Rights Act 1998* (London 2000) 219.
[49] [1982] Ch 204 (CA) 224.
[50] Ibid 223.
[51] *Welton v Saffery* [1897] AC 299 (HL); *Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279; *Rayfield v Hands* [1958] 2 All ER 194.
[52] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 379 (Lord Wilberforce); *Re a company* [1986] BCLC 376, 379 (Hoffmann J).

very clear since their economic claim in the company has an "open-ended nature"[54]. Their economic interest is not a "legally enforceable promise"[55]. These rights may be "the most ill-defined"[56] in the company in purely contractual terms. Actually, in a way, shareholders expect and hope to earn a return, but do not have a specific right to one. So, they need control rights to protect their economic interest. I next review separately shareholders' economic rights and their control power.

2.3.1 Shareholders' economic rights

In the company, shareholders participate in a venture, where each shareholder may claim his share in the wealth generated by the joint enterprise. Shareholders have a residual interest in the company, so the return of their investment is strongly related to the economic success of the company. Shareholders participate in the profits of the company; their lot is the gains and losses from its good or bad performance.

A share is primarily a piece of property conferring rights in relation to distributions of income and of capital[57]. Shareholders are entitled to share in the profits as dividends when the company is operating and a share in the distribution of the surplus assets when it is wound up[58]. But as mentioned, shareholders' economic rights are not very exact. Shares do not pay any fixed return, and do not have a fixed maturity date. In addition, the Companies Act does not explicitly describe shareholders' rights to dividends and participation as these matters are left to the internal regulations of the company.

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[53] *Inland Revenue Commissioners v Joiner* [1975] 3 All ER 1050 (HL) 1056 (Lord Wilberforce); *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 678 (Lord Millett).
[54] Cheffins, Brian R., 'Corporations' in Cane, Peter and Tushnet, Mark (eds), *The Oxford Handbook of Legal Studies* (Oxford 2003) 485, 493.
[55] Davies (2002) 262.
[56] Worthington, Sarah, 'Shares and shareholders: property, power and entitlement' (2001) 22 Company Lawyer 307, 311.
[57] *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 (High Court of Australia) 503-4 (Dixon J).
[58] *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL) 626-27 (Lord Buckmaster).

A company's profit is divided among its members in proportion to their shares; the payment of dividends is one of the major benefits to shareholders[59]. The basic idea of the joint stock company is to be a sort of machine into which shareholders put money and out of which they draw dividends[60]. A surplus[61] in a company is for shareholders, but they do not have any legal right to demand it or any part of it to be paid out as a dividend. The paying a dividend depends on the recommendation of the board and the resolution of general meeting following it[62]. Lord Davey stated the law in *Burland v Earle* in this way:

> Their Lordships are not aware of any principle which compels a joint stock company while a going concern to divide the whole of its profits amongst its shareholders. Whether the whole or any part should be divided, or what portion should be divided and what portion retained, are entirely questions of internal management which the shareholders must decide for themselves, and the Court has no jurisdiction to control or review their decision, or to say what is a 'fair' or 'reasonable' sum to retain undivided, or what reserve fund may 'properly' required.[63]

If the board does not recommend the payment of a dividend, it cannot be declared before the company has a board willing to recommend it. A shareholder has the right to get the dividend paid only in accordance with the articles[64]; it is so a discretionary

[59] See eg *Re a company (No 00370 of 1987), ex p Glossop* [1988] BCLC 570, 576 (Harman J).
[60] Maitland, Frederic William, *The Collected Papers*, vol III (Fisher, H. A. L., ed) (Cambridge 1911) 383.
[61] CA 1985 s 263(3) rules that dividends are payable from a company's accumulated realised profits only.
[62] Companies (Tables A to F) Regulations 1985 ('Table A') art 102; see also *Scott v Scott* [1943] 1 All ER 582.
[63] [1902] AC 83 (PC) 95.
[64] See *Wood v Odessa Waterworks Co* (1889) LR 42 Ch D 636.

payment from a company to its shareholders. Until a dividend is declared, shareholders have no right to it[65].

To summarise, shareholders have a right to dividends that a company has declared to pay. Company law does not require that the profits of a company should be distributed either at all or at any particular date or rate[66]. From the perspective of an individual shareholder, company law rules that if a company makes profit and pays dividends these should be paid to shareholders in proportion to their shares.

Shareholders share both distribution and capital in a company. But as shares are perpetual securities, company law does not offer shareholders a withdrawal right. They are not allowed to exit the company at will: they cannot simply 'divorce' from it[67]. An individual shareholder does not have the right to demand that capital should be returned nor that the company should be wound up. Naturally, as the shareholders have ultimate control over the company, they can decide the winding up by special resolution[68]. In addition, as shareholders' claim is residual, they have a right to the return of the capital only after the company has first paid its creditors[69]. In any case, public companies are rarely wound up voluntarily. Companies are generally immortal: it is not normal for them to return the capital. Yet, if a company and shareholders decide to do so, the net capital should then be returned to shareholders. In brief, shareholders do not have the right to get the capital paid but they have a right to share net assets if capital is returned.

As mentioned above, the company owns its assets, and shareholders own their shares. Furthermore, shareholders are not part owners of a company. Shareholders have no right to any item of the company's property as they have no legal or equitable

[65] *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 679 (Lord Millett).
[66] *Equitable Life Assurance Society v Ernst & Young (a firm)* [2003] 2 BCLC 603 (CA) 666.
[67] See especially *O'Neill v Phillips* [1999] 1 WLR 1092 (HL).
[68] Insolvency Act 1986 s 84(1)(b).
[69] See *Griffith v Paget* (1877) LR 6 Ch D 511; Insolvency Act 1986 s 143 states that in liquidation the assets of the company should be "realised and distributed to the company's creditors and, if there is a surplus, to the persons entitled to it."

interest therein[70]. In this sense, shares are not shares of the company because a shareholder has no direct share in its assets[71]. However, there is a relation between the assets of the company and the value of its shares, and this question is under discussion in the next chapter. But for now, it is enough to state that the relationship is economic, not legal in its nature.

The right to transfer shares is shareholders' economic right that offers them a way to join and leave the company. Shareholders have an affiliation right that make it easy for them to enter or exit a company. However, it should be remembered that although shareholders have a right to transfer their shares, nobody has a duty to buy them. Therefore, the free transferability of shares is more an economic possibility than a legal right, and this point is discussed further later[72].

Shareholders have duties too. Their main one is to pay the issue price of shares, which liability continues as long as anything is unpaid on a share[73]. But it is the fundamental principle of companies limited by shares that the liability of the members is indeed limited to the amount unpaid on the shares held by them[74]. From the perspective of a shareholder, limited liability is a privilege: a right to invest in shares while his liability is restricted. Limited liability, which promotes the transferability of shares and encourages share investments, is often regarded as the main advantage of incorporation.

Shareholders have no duty to subscribe more shares, even if the company urgently needs further capital. Naturally, this is a consequence of the principle of limited liability. Still, share offerings can be made to shareholders on a pre-emptive

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[70] *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL) 626 (Lord Buckmaster).
[71] *Short v Treasury Commissioners* [1948] AC 534 (HL) 545 (Lord Porter).
[72] Below 2.4.
[73] *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125 (HL).
[74] CA s 1(2)(a); the constitution cannot require shareholders to make further contributions after shares are fully paid; *Bisgood v Henderson's Transvaal Estates Ltd* [1908] 1 Ch 743 (CA).

basis. However, shareholders then have only a pre-emption right to new shares, but no duty to subscribe them.

Shareholders do not have the right to sell their shares to somebody who has an obligation to buy them. Similarly, they do not have a duty[75] to sell their shares. But there is an exception to this principle in takeover situations, where the still-existing minority shareholders are obliged to sell their shares at the same price as the offeror has acquired nine-tenths of the shares to which the offer relates[76]. The idea is to limit minority shareholders' lock-up power in takeovers. Furthermore, it is possible to consider that these rules give for the special majority of shareholders in a way a possibility to wind up the whole company through a sale of all the shares. Therefore, this right might be more a governance than economic right. By accepting the offer, the special majority decides on behalf of all the shareholders, and after that decision, the offeror has the right to buy out the shares of the still-existing minority[77].

In conclusion, shareholders have economic rights, which are to have a dividend if that is declared and to have a share of company net assets if the company is wound up. In the legal sense, these are more like promises than any exact rights. On the other hand, the economic point is that shareholders know that they will have their proportionate share of dividends if they are declared and of company assets if the company is wound up. Obviously, these rights assure that shareholders really have a residual right to the company's profits. So, shareholders have these legal promises, and shares are rights of participation in a company. These rights make shares valuable; in addition, they are fundamentally future rights: something that is promised to every shareholder in future under certain circumstances. Thus, the value of shares is very much a question of the future, and of course the value of economic expectations is

[75] Companies can have redeemable shares, which are not typical in public companies; see CA 1985 s 159.
[76] See CA 1985 s 428ff; and in takeover situations minority shareholders have a right to be bought out by the offeror; see s 430A.

decided on markets. But as shareholders' economic rights cannot be exact, they need control rights in the company.

2.3.2 Shareholders' control power

In the company, votes are attached to common stocks. Shareholders' right to vote follows their residual claim in the company. In a way, shareholders contract for votes, no rational shareholder would subscribe ordinary shares if control rights were not attached[78]. The voting power is a substitute since shareholders' economic rights cannot be exact: shareholders need that to protect themselves in the company.

Shareholders use their control power by voting, where the basic rule is that there is one vote for every share[79]. Shareholders voting rights, like their economic rights, are in proportion to their shares. In any case, they act in the company collectively and only through the medium of general meeting[80].

The most important feature concerning control right is that companies are governed by majority rule. This means that the majority of shareholders is able to decide on behalf of the company, and the quorum is normally half of the votes. It is fundamental part of corporate governance that decisions made with the support of the majority bind every shareholder.

There are three main areas where shareholders control the company: first, they control its constitution; second, they have control over the management; and third, they control its economic surplus. Still, it should be noted that by their control power, shareholders are able to decide how companies are governed, but this power does not mean that the majority is able to decide how the success of business is divided among

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[77] More below, chapter seven 7.6.
[78] Davies (2002) 262.
[79] Table A art 54.
[80] *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL) 630 (Lord Oliver).

shareholders[81]. That division is a matter of shareholders' economic rights, the company constitution, and company law.

The presumption of company law is that shareholders together make resolutions that follow their shared interest as the suppliers of share capital. This proposes that shareholders also make efficient decisions. When resolutions are made by majority rule, they are beneficial to the majority and are supposed to be for the benefit of the company as a whole. The decisions made by majority power should represent the interests of all the shareholders. However, their interests can be conflicting too.

Shareholders are entitled to use their votes for their personal interest[82]. They do not have fiduciary duties towards each other[83], and they have a right to vote in the company as they please. But company law governs how the majority may use their power: the law offers protection to minority shareholders. I review minority protection later together with majority power[84].

The term separation of management and ownership implies that it is undesirable if shareholders participate in the governance of a company. From the traditional perspective, companies should have strong managers and dispersed shareholders[85]. Shareholders' powerlessness is a necessary result of the diffusion of "the old property relationships"[86]. Shareholders are distant, and they should not even be interested in using the power they might have in a company. An important reason for this attitude is that the investment portfolios of modern investors are diversified into many companies: holdings in single companies are relatively small. Shareholders may just be rational

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[81] Eg *Griffith v Paget* (1877) LR 6 Ch D 511.
[82] *Pender v Lushington* (1877) LR 6 Ch D 70; *North-West Transportation Co Ltd v Beatty* (1887) LR 12 App Cas 589 (PC).
[83] Eg *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133, 1144; *Re Astec (BSR) plc* [1998] 2 BCLC 556, 584.
[84] Below chapter six.
[85] Berle, Adolf A., Jr and Means, Gardiner C., *The Modern Corporation and Private Property* (New York 1932); see also Roe, Mark J., *Strong Managers, Weak Owners – The Political Roots of American Corporate Finance* (Princeton 1994).
[86] Berle and Means (1932) 2.

when they are more or less apathetic concerning a single company. Shareholders can be seen as bystanders in the company structure when their interest is more on the market than in individual companies[87]. Shareholders are expected to express their views by buying and selling shares rather than by trying to govern companies.

On the other hand, these opinions are no longer current because the corporate governance movement means that shareholders have taken a more active role in companies. The way in which companies are governed is evolving. Maybe we should talk nowadays about the post-modern Anglo-American company where shareholders have a greater role to play. Nevertheless, this is a legal study, and my conclusion is clearly that shareholders have control power in companies. Company law places shareholders in the driving seat of the company[88]: ultimate power and legal authority in the company rest on shareholders. Further, they have the right to decide not to use this power and to be passive. Company law does not set shareholders a duty to use their votes[89]. Naturally, if shareholders are passive, other shareholders, or even the management by proxies, are then able to use the power they would have.

To conclude, shareholders have their control power: only they have votes in the company. Shareholders use the votes to govern the company and to protect their economic interests. Shareholders have a right to vote in a company, but no duty to do so.

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[87] See Buxbaum, Richard M., 'Corporate Legitimacy, Economic Theory, and Legal Doctrine' (1984) 45 Ohio State Law Journal 515, 526, where he describes the transformation of the shareholder from "king of the corporation to king of the market."

[88] Davies (2002) 255.

[89] Although some academics see that shareholders should regard the use of votes as a duty as well; see eg Dine, Janet, 'The Role of the Non-Executive Director' in Sheikh, Saleem and Rees, William (eds), *Corporate Governance & Corporate Control* (London 1995) 199, 208.

2.3.3 Shares as a bundle of rights

As Bentham says, property is "entirely the work of law", ie there is no such thing as natural property[90]. Rules, principles, rights, and duties make together the law, and in a very similar way shares are a bundle of rights and duties[91]. But this is no special feature concerning shares only since ownership can in general be understood as a bundle of rights[92].

In *Borland's Trustee v Steel Brothers & Co Ltd*[93], Farwell J explained that a share consists of mutual covenants entered into by shareholders. Shares can be regarded as a bundle of contractual rights. A share is an interest consisting various rights contained in the corporate contract. This bundle of rights makes up a share[94]. However, this definition is not enough. In *Inland Revenue Commissioners v Laid Group plc*, Lord Millett formulated the point in this way:

> 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.[95]

A share is more than a contractual bundle of rights. The memorandum and articles of association together with the law define shareholders' interest in the company[96]. So,

[90] Bentham, Jeremy, *The Theory of Legislation* (Ogden C. K., ed) (London 1931) 111; see also Penner, J. E., *The Idea of Property in Law* (Oxford 1997) 3: property is always a creature of the legal system.
[91] *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 57 (Romer LJ): a share is "the totality of his rights and liabilities as they exist under the provisions of the Companies Act and the constitution of the particular company."
[92] For example, like the ownership of land; eg Hohfeld, Wesley Newcomb, *Fundamental Legal Conceptions* (New Haven 1919) 96; see the definition of ownership in Walker, David M., *The Oxford Companion to Law* (Oxford 1980) 910.
[93] [1901] 1 Ch 279, 288.
[94] Eg *Re Saltdean Estate Co Ltd* [1968] 1 WLR 1844, 1850 (Buckley J).
[95] [2003] 4 All ER 669 (HL) 678.
[96] *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) 66 (Lord Russell).

shares as a bundle of rights are acquired by contract, but they are in crucial respects "constituted, conferred and defined" by the law[97].

Shares are property. Further, shareholders' rights are their rights of property; therefore, shareholders are entitled to exercise their rights to protect their individual interest. As a result, they may vote as they please. Does this mean that shareholders actually own their rights?

Although the juridical nature of shares is not easy to describe[98], the answer is clear: shareholders do not own their rights but the shares only. Shareholders have their rights since they are members of the company and owners of their shares. However, that does not work vice versa, ie nobody becomes a member of the company because he has rights there. For example, as stated in Table A art 54, the members have votes in the company, and they have this right because they own shares.

There exist some Commonwealth cases that explain the distinction between shares and shareholders' rights. In *Government of Mauritius v Union Flacq Sugar Estates Co Ltd*[99], it was held that the property owned by a shareholder is his share, and his right to vote in general meetings is "not property in its own right" but merely "an incident of the ownership of a share". In addition, an explanation of the nature of shares as property can be found in the judgment of the High Court of Australia in *Peters' American Delicacy Co Ltd v Heath*[100]. There was also considered that shares "are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage"[101]. These two rulings are very understandable. Shareholders rights are components of shares and no distinct items of property. Shares are items of property, and the rights that together make up them are

[97] Ireland, Paddy, 'Property and contract in contemporary corporate theory' (2003) 23 LS 453, 471.
[98] [2003] 4 All ER 669 (HL) 678 (Lord Millett); Pennington, Robert, 'Can shares in companies be defined?' (1989) 10 Company Lawyer 140.
[99] [1992] 1 WLR 903 (PC) 909-10 (Lord Templeman).
[100] (1939) 61 CLR 457.
[101] Ibid 504 (Dixon J).

not[102]. Shareholders own their shares but not their rights, which they have as the members of the company.

It is not possible to separate the voting rights from shares, which are "one indivisible piece of property"[103]. Someone who wants to buy a vote must buy a share. Although shareholders may transfer their votes by selling the shares, where votes are attached, they may not sell the votes independently of the shares. In the USA, some states explicitly ban the sale of votes by statute, and other states by judicial decisions[104]. This kind of rule may sound to be a curious limit on shareholders' ability to make their own arrangements. However, the separation of shares from votes introduces a disproportion between the expenditure and reward. Thus, legal rules tying the votes to shares increase the efficiency of a corporate organization[105]. In contrast, the companies' legislation in England does not include any explicit rule that would ban the sale of votes; in addition, there does not seem to be any direct court ruling concerning the point. On the other hand, the rule is that only the registered shareholders are entitled to vote in a company[106]. According to Table A art 59, on a poll votes may be given personally or by proxy: a possible buyer of votes is actually neither of them. Consequently, there may be reasons to note that a possible buyer of votes is not entitled to vote in general meeting. The agreement is efficient between the shareholder and the buyer, but the agreement does not bind the company. This idea applies to shareholders' agreements, which cannot have a binding force in the company.

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[102] Pennington (1989) 144.
[103] See *Attorney-General v Jameson* [1905] 2 IR 218, 228 (FitzGibbon LJ); quoted in *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL).
[104] See Easterbrook, Frank H. and Fischel, Daniel R., *The Economic Structure of Corporate Law* (Cambridge, Massachusetts 1991) 63ff; Easterbrook, Frank H. and Fischel, Daniel R. 'Voting in Corporate Law' (1983) 26 Journal of Law and Economics 395, 410ff; further, it is interesting to notice that Manne, Henry G., 'Our Two Corporation Systems: Law and Economics' (1967) 53 Virginia Law Review 259, 276 sees that the rulings holding a sale of votes illegal are errors made by the courts.
[105] Easterbrook and Fischel (1983) and (1991); see also Berle, Adolf A., 'The Price of Power: Sale of Corporate Control' (1965) 50 Cornell Law Quarterly 628, 631: " because the stockholder's vote exists for [the interests of the corporation as a whole], he is not allowed to sell it."
[106] *Wise v Lansdell* [1921] 1 Ch 420.

Yet, English company law accepts that a company may have different series of shares, when one series can even have all the economic rights and another series all the voting rights in the company[107]. Economic rights and control power do not have to be bundled together on a one-to-one basis. Thus, if shareholders want to separate votes from the equity interest in the company, they can do it collectively through the company constitution. However, from the perspective of an individual shareholder the separation of votes from the economic interest is not a right that company law supports.

In conclusion, I quote Maitland, who says: "Like the man, the corporation is a right-and-duty-bearing unit"[108]. Still, this term describes more shares rather than men or companies. Shares are right-and-duty-bearing units since the very fundamental point with shares is the rights attached to them.

The company signifies what law makes it signify. To explain the company, we must refer to the relevant legal rules[109]; in addition, company law is a set of working rules[110]. In a similar way, shareholders have the rights that company law and the company constitution provide to them: shareholders do not have any natural rights. They share rights in respect of dividends, return of capital, and voting. It is possible to call shares a bundle of these rights.

2.4 Transferability of shares

Shares are transferable personal property that can be traded between buyers and sellers. The company is a distinct legal entity having its own independent and continuous existence. From the perspective of the company, the personality of shareholders is not generally an important point. A company is legally the same even if all the shares have

[107] This kind of a special company with three series of shares can be found in *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14 (CA).
[108] Maitland (1911) 307.
[109] Hart, H. L. A., 'Definition and Theory in Jurisprudence' (first published 1953) in *Essays in Jurisprudence and Philosophy* (Oxford 1983) 39.
[110] See generally eg Commons, John R., *Legal Foundations of Capitalism* (New York 1924) 134ff.

been sold to new shareholders. It is this separate corporate personality that makes the free transferability of shares possible.

Due to the incorporation, shareholders' freedom to transfer their shares is both legally and practically attainable. A company is an association in which shares are transferable[111]. The transferability of shares is a feature in which companies clearly differ from partnerships which are not incorporated and where the relationship between partners is personal.

The Partnership Act 1890 s 1(1) states: " Partnership is the relation which subsists between persons carrying on a business in common." Partnerships are based on mutual trust in order to engage in a business for partners' joint benefit; thus, having a new a partner or a change of a partner is a sensitive issue. Shares in partnerships cannot be freely assigned: a new partner may be introduced only by the consent of all existing partners[112]. An assignment of shares in a partnership is not efficient against other partners; therefore, the assignee is only entitled to receive the share of profits to which the assigning partner would otherwise be entitled[113]. Shares in partnerships are not freely transferable because that would be against the basic nature of partnerships.

However, the free transferability of shares is not a common feature in all companies either. Shares of private companies are rarely freely transferable due to the pre-emption clauses in their articles. As in partnerships, the relationship in these close companies among shareholders is personal in nature: transfers of shares are not typically allowed. In public companies, shareholders are investors, whose shares are freely transferable. I next analyse transfer of shares generally under the Companies Act, and then separately in private and public companies. Furthermore, I ask whether the transferability of shares can make them more valuable.

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[111] *R v Registrar of Joint Stock Companies, ex p Johnston* [1891] 2 QB 598 (CA) 610 (Lindley LJ).
[112] Partnership Act 1890 s 24(7).
[113] Ibid s 31(1).

2.4.1 Transfer of shares under the Companies Act

As the CA 1985 s 182(1) declares, shares are items of personal property that are transferable in the manner provided by the company's articles. However, company law does not explicitly guarantee the transferability of shares. But as Blackburn J said in *Re Bahia and San Francisco Railway Co Ltd*[114]: "When joint stock companies were established, the great object was that the shares should be capable of being easily transferred." Indeed, company law has a presumption that shares are freely transferable, and shareholders may deal freely with their shares and to transfer them to whomever they please[115]. It is a normal right of a shareholder that shares are freely transferable[116]. In *Greenhalgh v Mallard*, Lord Greene MR stated:

> a share, being personal property, is prima facie transferable, although the conditions of the transfer are to be found in the terms laid down in the articles. If the right of transfer, which is inherent in property of this kind, is to be taken away or cut down, it seems to me that it should be done by language of sufficient clarity to make it apparent that that was the intention.[117]

Company law supports transferability of shares. The basic attitude in company law is very much opposite than in partnership law, where transferability is restricted.

In company law, there is a clear distinction between the company and shareholders. There are typically no negative consequences of a transfer of shares; it is generally no problem to the company and shareholders. Shares should then be bought, sold, and transferred freely. In *Re Stockton Malleable Iron Co*, Jessel MR declared:

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[114] (1868) LR 3 QB 584, 595.
[115] *Re Smith, Knight & Co, Weston's Case* (1868) LR 4 Ch App 20.
[116] *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA) 306 (Lord Greene).

> It is against the interest of companies to fetter transfers. The more free the companies make the transfers the better for them, and the better for their shareholders.[118]

Company law generally understands the transferability of shares in this way.

2.4.2 Private companies

Private companies provide their share capital from a limited number of people. Shareholders in these companies are normally personally related with each other. In private companies, shareholders are typically the entrepreneurs of the company's business. In a partnership, the maximum number of members by the law used to be 20 persons[119], but there have been no legal restriction for the maximum number of shareholders in a private company. However, the nature of the company sets a restriction to the number of shareholders: there is no room for too many shareholders to keep the relationship in a private company personal. In practice, the normal number of shareholders in a private company is much less than 20 persons. This feature clearly distinguishes private companies from public companies.

Shares of private companies may not be offered to the general public[120]. The presumption of company law is that these companies should provide their capital from their founding members, and in no case from the general public. Company law clearly signals that private companies are not intended to raise equity capital from a large group of investors. As their name implies, these companies should be private.

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[117] [1943] 2 All ER 234 (CA) 237.
[118] (1875) LR 2 Ch D 101, 103.
[119] CA 1985 s 716(1); repealed by Regulatory Reform (Removal of 20 Member Limit in Partnerships) Order art 2.
[120] CA 1985 s 81(1).

Company law contained a requirement[121] that every private company should place some restriction on transfer of shares in its articles. But since the Companies Act 1980, this has no longer been necessary. Nevertheless, it remains common for private companies to place some restriction on the free transferability of shares. Some companies require in their articles that the directors should approve new members, and some have a pre-emption clause in favour of existing members. A company's articles may impose any kind of a restriction on transferability of shares, but these clauses cannot prohibit transfers completely. Shares must be transferable to some extent. Further, the courts interpret the restrictions on transferability strictly: if there is an ambiguity or uncertainty, shareholders right to transfer shares freely is supported[122]. Lord Greene MR formulated this principle in *Re Smith and Fawcett Ltd* by these words:

> the shareholder has such a prima facie right, and that right is not to be cut down by uncertain language or doubtful implications. The right, if it is to be cut down, must be cut down with satisfactory clarity. It certainly does not mean that articles, if appropriately framed, cannot be allowed to cut down the right of transfer to any extent which the articles on their true construction permit.[123]

The fundamental view of the law is also in the case of private companies that shares are freely transferable unless the articles or the terms of issue explicitly and clearly restrict it[124].

Private companies have many similarities with partnerships; therefore, they are often called quasi-partnerships. Private companies are from the business and personal

[121] Companies Act 1948 s 28; repealed by Companies Act 1980 s 88(2) and Sch 4.
[122] See *Re Stockton Malleable Iron Co* (1875) LR 2 Ch D 101.
[123] [1942] Ch 304 (CA) 306.
[124] See also *Stothers v William Steward (Holdings) Ltd* [1994] 2 BCLC 266 (CA).

point of view much more analogous to partnerships than to public companies[125]. However, in law all companies are governed under the Companies Acts[126]. Shares of private companies are freely transferable if the articles do not explicitly restrict their transfer. The essential difference between a partnership and a company is that the proprietary interest in a company is fundamentally transferable. But law does not encourage the general public to invest in the shares of private companies. Law actually forbids the offerings of these shares to the general public. However, nobody is forbidden to invest in and to have these shares; moreover, the law is unable to say what the right number of shareholders is in a close company. In sum, the nature of private companies is different, which point should be emphasized also in this context. While the main focus of this research is on public companies, we move on to analyse transferability of these shares.

2.4.3 Public companies

Public companies are capital-raising vehicles that may offer their shares to the general public. They are capable to facilitate investments from a large number of people in one institution. The share capital of a public company is typically subdivided into a very large number of shares with a low denomination to allow investors widely to become its members. These modern Anglo-American companies have a 'wide dispersed ownership'. The theory of modern company tells that ownership and management of these companies are separated, which process has been essential to create stock markets[127]. In public companies, shareholders have the role of investors, whose relationship with the company and other shareholders is not personal or close. The

[125] Lord Greene [1942] Ch 304 (CA) 306.
[126] See generally eg *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 380.
[127] Berle and Means (1932) 285; further below, chapter three and four.

shares of public companies are commodities that can be sold, acquired, and transferred freely.

It is an essential part of public companies' nature that they have a large number of shareholders and their shares are transferable. Such as it was explained in *Re Stanley*[128], the company involves two main ideas: members are so numerous that it cannot be described as a partnership, and they may transfer their interest freely. These two features have a strong connection with each other. In the case of a public company, shares have to be freely transferable to get a large number of shareholders; on the other hand, if shares were not freely transferable, then investors could not widely have them, and actually they would not even be willing to have them. Free transferability of shares makes them marketable; in addition, to be listed shares must be freely transferable[129].

Shares of public companies are marketable and liquid. Shareholders are free to leave the company when they please. The transferability of shares makes possible to sell shares to anybody who is willing to buy them. So, there are transactions and transfers of shares as the sellers and the buyers decide so: it is not up the directors to approve new members, and there is no a pre-emption clause with an obligation to offer the shares to the other members. Thus, the market determines the existence of transactions and the price of shares. Consequently, the price and value of shares are not questions decided by the company, its management, or company law generally; the sellers and buyers set the price of shares in their transactions. Shareholders are free to decide whether they sell shares: they have an exit right out of the company. It is part of Anglo-American stock market tradition that unsatisfied shareholders are supposed to sell their shares and leave the company.

Company law cannot guarantee that there are willing buyers for shares and the market is operating well. Company law gives a shareholder the right to transfer his

[128] [1906] 1 Ch 131, 134 (Buckley J).

shares, but it does not impose upon anybody a duty to buy them. Naturally, company law cannot rule the price in these transactions. In a legal sense, company law does "rather little"[130] to secure that shareholders have a real right to transfer their shares at a right price. Shareholders' ability to sell their shares and quit the investment may be "a useful self-help remedy"; on the other hand, the importance of the option should not be overstated[131]. Law makes the function of stock markets possible, yet it is up to the market whether it operates well and whether share prices are fair. In addition, the regulation of stock markets is clearly a question of law too, but my intention is not to review deeply capital markets law in this research. However, it should be mentioned that in many cases the operation of markets and the market price for shares can offer shareholders more protection than company law and the courts are able to provide. Altogether, both company law and markets have their own roles, but from the strict market perspective, the task of company law is to make shares freely transferable and the function of markets possible.

The company is a distinct entity from its shareholders; therefore, shares are freely transferable. Indeed, freedom is a very fundamental value in company law. I next propose that it makes shares more valuable.

2.4.4 The value of free transferability

In a private company, whose shares are not freely transferable, a shareholder may find himself in an "unfortunate position, unable to exit the company or to do so only at an unrealistically low price"[132]. A shareholder can be "at the mercy" of the majority shareholders[133]. This kind of a shareholder is in practice very much locked into the

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[129] UKLA Listing Rules 2.2.4 (1).
[130] Davies (2002) 23.
[131] Blanchard, Julian, 'Who Are Shareholders? –Search for Identity and Role' (1999) 11 Corporate and Business Law Journal 165, 171.
[132] Davies (2002) 23.
[133] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 381 (Lord Wilberforce).

company. The situation can be the same even if shares were under the articles freely transferable since the shares of private companies have no well-operating markets. For example, a minority shareholder might be willing to leave a private company because he is not happy with the company's policy governed by majority shareholders. Still, as the relationship in private companies is personal, the question is not only whether somebody is willing to buy his shares: it is more about whether somebody is willing to step into his shoes and take his place in the company. The relationship between shareholders is more like in a family, not only a relationship between investors. This point makes selling and buying of these shares more complicated. In addition, if the existing minority shareholder is really disappointed with the company and its majority shareholders, the new possible shareholder may share this view too. The natural buyer is often the majority shareholder or somebody close to him, and if there is only one possible buyer, the seller cannot expect to reach the best price in the transaction. To sum up, it is very difficult to sell a private company's shares in a fair price although these shares would be legally freely transferable. These shares do not have real markets; they are never freely transferable in practice.

It is different in quoted companies. Shares are not only legally freely transferable, but due to the stock market, they can be bought and sold every day and all time. There are always some investors willing to buy shares: companies get new members and existing shareholders buy more shares and vice versa. Market transactions are normal in these companies, and nothing exceptional as the case is in private companies. Moreover, the market is said to be functioning well when there are many transactions and shares are widely sold. The free transferability of shares together with operation of stock markets gives shareholders a real way to join and leave the company as they please.

On stock markets, there is a great number of possible buyers for shares since every investor can become a member of the company. As there are many buyers and sellers, these markets are liquid. Shares are sold at a public auction that secures the best possible price for the seller: stock markets offer a very efficient way to carry out transactions. The transferability of shares and a functioning stock market together mean that there exists "easy come, easy go situation" for investors[134]. Overall, the market price is the best price for shares. So, the free transferability with the market mechanism makes shares, in fact, more valuable. The market has a wealth-creation function, and I analyse the relationship between markets and share prices more below in chapter four.

Due to free transferability of shares, shareholders may legally and economically be free to leave a company. But naturally, free transferability has no value for shareholders if there is a very limited number of possible buyers and no market for shares. Company law itself is unable to provide any value for shares: the price of shares is generally available only from markets. The value of shares is their market price, and when the market operates well, the higher is their value.

2.5 Rights and value

Proprietary interest in a corporate structure is split to investors, but shareholders participate in the company through their shares only. Shareholders' rights are in proportion to their shares, which have economic value due to the rights. Free transferability makes shares marketable; moreover, shares are most valuable when stock markets operate well. Shareholders can expect to have periodic income from their shares as dividends are paid. In addition, they are able to get capital gains if the company's capital is returned or when they sell their shares. But company law does not guarantee that dividends are paid, capital is returned, or there are buyers for shares.

[134] Buxbaum (1984) 526.

Shares are property, and as Bentham notes, property is "nothing but a basis of expectation"[135]. Shares are a bundle of rights which is transferable and valuable. The value of shares rests on shareholders' rights, but their value itself is decided in the markets. As Worthington states: "The law is concerned with entitlements; the market with expectations"[136]. I conclude this chapter by noting that the law is about rights and the market about values. Therefore, although I have analysed shareholders' rights, I am still unable to say anything firm about the value of shares.

135 Bentham (1931) 111.
136 Worthington (2001) 258.

CHAPTER 3

COMPANY ASSETS AND SHARE VALUE

The meaning of a corporation, like the meaning of property and liberty, has been changing during decades and centuries, and when a corporation appears in court it takes on a variety of shapes derived from different parts of its history.
John R. Commons, *Legal Foundations of Capitalism* (1924) 291.

3.1 Companies and shareholders

The important starting point is that companies are legal entities, which own their assets. Shareholders own their shares, but they do not own the assets of a company. Still, there is a connection between a company's assets and the value of its shares because share value is related to the success of the company's business and the value of its assets.

In this chapter, I analyse the relationship between the company and share value. The value of a company's assets really has importance when shares are valued. Yet, my aim is to demonstrate that this relationship is more economic than legal in its nature. As a result, the law does not rule that the value of shares is their proportionate part of a company's asset value.

In addition, I review the notion of ownership in company law. This study accepts that companies have features of two-tier ownership since shareholders are, in a way, the ultimate owners of a company but the company itself owns its assets. Overall, I stress that shareholders own the company only metaphorically but not legally.

3.2 Company assets

The concept of a corporation is from Roman law. As a leading Roman jurist, Ulpian, explained, the property of a corporate body is not the property of its members. Ulpian underlined this point by saying that, even if a corporation consists of a single member, it is still a distinct and separate entity from this member. However, these Roman corporations were created by the state to serve special ends, so they were no commercial entities.[1] Legal institutions of capitalism are not derived from Roman law[2].

In England, the history of corporations is a millennium long. The first English corporations had a non-profit character: they were very much like their Roman ancestors. These corporations were monasteries, universities, hospitals, and other institutions having public nature. They were creatures of law, whose existence was confirmed by the sovereign power[3]. Due to their special nature, they enjoyed certain privileges, but these public corporations are beyond the interest of this study. While companies share the history of corporations that are their predecessors, the modern commercial company is mainly a creature of the past two centuries: it is a relatively recent development in Anglo-American law[4]. In fact, the first joint stock companies were large partnerships with a common transferable stock. Companies, indeed, have both corporation and partnership roots. I now review the role of assets in partnerships and companies.

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[1] About Roman law, see eg Tigar, Michael E., *Law and the Rise of Capitalism* (2nd edn New York 2000) 31-32.

[2] Stein, Peter, *Roman Law in European History* (Cambridge 1999) 121.

[3] *Case of Sutton's Hospital* (1612) 10 Co Rep 23a, 26b: "the incorporation cannot be created without the King."

[4] The first typical joint stock companies appeared in the 18th century; see eg Cooke, C. A., *Corporation, Trust and Company* (Manchester 1950) 50; Formoy, Ronald Ralph, *The Historical Foundations of Modern Company Law* (London 1923) 3, where he sees that towards the end of the 17th century "something very much like the modern organisation of companies" had developed but it had not yet obtained legal recognition or regulation.

3.2.1 Assets in a partnership

A partnership is "the relation which subsists between persons carrying on a business in common with a view of profit"[5]. Naturally, also companies carry out business with a view of profit. But companies are not partnerships: they are explicitly excluded from the Partnership Act 1890[6]. The main difference between companies and partnerships is that companies are legal entities while a partnership is not an organization in its own right with a separate legal personality. In *Sadler v Whiteman*, Farwell LJ stated:

> In English law a firm as such has no existence; partners carry on business both as principals and as agents for each other within the scope of the partnership business; the firm name is a mere expression, not a legal entity.[7]

Partners are collectively the firm. "If anything is owed to the partnership, it is owed to the individual members and the individual members owe what is owed by the partnership," as Lindley and Banks put it[8]. Partners own the assets of a firm, and they hold partnership property jointly as tenants in common[9]. They share the assets of a partnership: each partner has a proprietary interest in each and every asset in the firm[10].

3.2.2 Assets in a company

Companies are extensions of partnerships. Further, company law has developed "seamlessly from the law of partnership"[11]. Yet, it should be remembered that

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[5] Partnership Act 1890 s 1(1).
[6] s 1(2).
[7] (1910) 79 LJ KB 786 (CA) 799.
[8] I'Anson Banks, R. C., *Lindley & Banks on Partnership* (18th edn London 2002) 21.
[9] Partnership Act 1890 s 20(1).
[10] Partnership Act 1890 s 24(1); *Manley v Sartori* [1927] 1 Ch 157, 163 (Romer J): a partner "has an unascertained interest in every single asset of the partnership."
[11] *O'Neill v Phillips* [1999] 1 WLR 1092 (HL) 1098 (Lord Hoffmann).

companies are not partnerships, and company law is not partnership law[12]. The legal status of members in a company and in a partnership is not equivalent.

The House of Lords set the final seal on legal corporate existence in *Salomon v A Salomon and Co Ltd*[13], where Mr Salomon and 'his' company were not regarded as the same person[14]. As Lord Macnaghten declared: "The company is at law a different person altogether from the subscribers to the memorandum"[15]. Companies are legal entities that have their own personality.

Since companies have their legal personality, shareholders lack any proprietary interest in the company's assets[16]. An incorporated company's assets are its property, not the property of shareholders[17]. Simply, a company itself owns its assets which do not belong to shareholders. In *Macaura v Northern Assurance Co Ltd*, Lord Buckmaster explained shareholders' status in this way:

> no shareholder has any right to any item of property owned by the company, for he has no legal or equitable interest therein. He is entitled to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus assets when the company is wound up.[18]

The company owns its property both legally and beneficially[19]. It has its own assets and liabilities and its own creditors[20]. As Lindley and Banks state: "If anything is owed to

[12] *New Brunswick & C Co v Muggeridge* (1859) 4 Drew 686, 700: it is a fallacy to call a joint stock company a partnership; see also *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 380.
[13] [1897] AC 22 (HL).
[14] Mr Salomon had 20,001 of 20,007 shares, and in the words of Lopes LJ in *Broderip v Salomon* [1895] 2 Ch 323 (CA) 341, the remaining six shares were held by "dummies" and "puppets", ie the members of his family.
[15] [1897] AC 22 (HL) 51.
[16] *Segenhoe Ltd v Akins* [2002] Lloyd's Rep PN 435 (Supreme Court of New South Wales); quoted in *Equitable Life Assurance Society v Ernst & Young (a firm)* [2003] 2 BCLC 603 (CA) 665.
[17] *Re George Newman & Co* [1895] 1 Ch 674 (CA) 685.
[18] [1925] AC 619 (HL) 626-27.
[19] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA).

an entire body, it is not owed to the individual members, nor do the individual members owe what is owed by the entire body"[21]. In essence, a shareholder has no direct share in the assets of the company[22]. Shares are not the same thing as the property that the company owns[23].

Yet, a company's property has importance to shareholders, who have a residual economic interest in the company. Shareholders' proprietary interest in the company is their shareholding: they have shares and shareholders' rights[24]. Further, shareholders have the rights defined by the company's constitution and the Companies Act[25]. These rights do not include a right to the assets of the company. In sum, shareholders have a proprietary interest in the company, but no right in the property of the company[26].

Sir Francis Palmer says: "A corporation, it must be remembered, is not, like a partnership or a family, a mere collection or aggregation of individual units"[27]. The company and its shareholders are distinct persons. A company is capable of enjoying rights and being a subject to duties that are not the same as those enjoyed or borne by shareholders. The property of a company is not shareholders' joint property. In addition, although a shareholder owns every share in a company, he does not own the assets of the company[28].

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[20] *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1 (HL) 61 (Lord Millett); *John Foster & Sons Ltd v Commissioners of Inland Revenue* [1894] 1 QB 516 (CA) 529 (Kay LJ): "property is vested in an entirely independent and separate body."
[21] I'Anson Banks (2002) 21.
[22] *Short v Treasury Commissioners* [1948] AC 534 (HL) 545 (Lord Porter); *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 678 (Lord Millett).
[23] [1894] 1 QB 516 (CA) 530; *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 57 (Romer LJ): it is not possible "to treat a share as being an interest in the company's assets."
[24] *Birch v Cropper in Re Bridgewater Navigation Co Ltd* (1889) LR 14 App Cas 525 (HL) 546: shareholders participate in the company "through their shares alone".
[25] *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) 66.
[26] [2003] 4 All ER 669 (HL) 678; *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL) 631.
[27] Palmer, Francis Beaufort, *Company Law: A Practical Handbook for Lawyers & Business Men* (4th edn London 1902) 45.
[28] *Raja v van Hoogstraten* [2004] All ER 793 (CA) 824 (Chadwick LJ); *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL) 633 (Lord Wrenbury); furthermore, the position in criminal law is no different as even the sole shareholders can be charged with theft of a company's property; see *Attorney General's Reference (No 2 of 1983)* (1984) 78 Cr App R 131; *R v Philippou* (1989) 89 Cr App R 290 (CA); Iwai, Katsuhito, 'Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance' (1999) 47 AJCL 583, 592: "If I take away a gadget from the factory

The law is clear: shareholders own their shares and have shareholders' rights, but they do not have rights in the property of the company. A company alone owns its assets. There is no direct legal relationship between shareholders and the company's assets.

3.3 The two-tier union

Companies are legal entities and persons that are distinct from their shareholders. On the other hand, the company is not only a person: it is also a union. This duality makes it complicated to explain and understand what the company actually is. Altogether, it may be a difficult and confusing concept both for legal theory and the courts[29].

In addition, the company is a legal entity having features of a contract. But companies are not contracts since the relationship in the company is not predominantly contractual[30]. Furthermore, some commentators claim that companies play a dual role in another way: the corporate is both a person and a thing[31]. I next ask whether the company can be described as a thing or whether there exists a different kind of duality in the company. As a part of these analyses, I review a fundamental question: do shareholders own the company?

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of the corporation I am shareholder of, I will be immediately subject to arrest as a thief. Why? Because a corporate shareholder is not the legal owner of the corporate assets."

[29] See eg Hart, H. L. A., 'Definition and Theory in Jurisprudence' (originally 1953) in *Essays in Jurisprudence and Philosophy* (Oxford 1983) 21ff; *Re Stanley* [1906] 1 Ch 131, 134 (Buckley J): "The word 'company' has no strictly technical meaning."

[30] More below, chapter six 6.2.2.

[31] Eg Iwai (1999) 583; see also Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003) 616.

3.3.1 Company as a thing

Companies are artificial persons that do not have any physical or real existence. They are products of law and creations of the jurist's mind[32]. In consequence, corporate personality may be a convenience[33]. However, these artificial legal persons are as natural *in law* as natural persons[34]. In law, all persons, if we quote Maitland, are "right-and-duty-bearing units"[35], although I propose that this term better describes shares that are bundles of rights[36]. In the legal sense, the company is not a myth or fiction; companies are as real as the law itself. It is "impossible to say at the same time that there is a company and there is not"[37]. When a company exists, it is a legal person and entity. In English law, companies are persons and subjects.

Persons may own property, and shareholders own their shares. From the perspective of shareholders, shares are the objects of their legal rights, ie shares are things owned by them[38]. One way to describe the basic relationship between persons and things in the market economy is the following:

> Persons are subjects of property right, and things are objects of property right. Persons own things, and things are owned by persons. There is an absolute divide between persons and things. If persons own persons, we are back to the slave economy of the ancient past. If things own persons, we are perhaps trapped in the world of a science-fiction story. Indeed, it is because persons and things

[32] *Great Eastern Railway Co v Turner* (1872) LR 8 Ch App 149, 152 (Lord Selborne LC): the company is "a mere abstraction of law".
[33] See Arnold, Thurman W., *The Folklore of Capitalism* (New Haven 1962) (originally 1937) 350; Pound, Roscoe, *Jurisprudence*, vol IV (St Paul 1959) 261.
[34] *Re Sheffield and South Yorkshire Permanent Building Society* (1889) 22 LR QB 470, 476: "A corporation is a legal *persona* just as much as an individual,"; see also Commons, John R., *Legal Foundations of Capitalism* (New York 1924) 143; Kelsen, Hans, *Introduction to the Problems of Legal Theory* (Oxford 1992) (originally 1934) 46ff.
[35] Maitland, Frederic William, *The Collected Papers,* vol III (Fisher, H. A. L., ed) (Cambridge 1911) 307.
[36] Above chapter two 2.3.3.
[37] *Salomon v A Salomon and Co Ltd* [1897] AC 22 (HL) 31 (Lord Halsbury).
[38] See the definition of things in Walker, David M., *The Oxford Companion to Law* (Oxford 1980) 1216; in addition, it should be noted that property does not only mean material things.

are strictly opposed as subjects and objects of property right that it is possible for two persons to exchange the things they own in a market.[39]

This is understandable, but the relationship between subjects and objects is more complex. Subjects are possessors of legal rights and duties. Men and companies are subjects, ie they are right-and-duty-bearing units. Yet, shares are also these kinds of units: they are bundles of rights. Shares are subjects of rights too. On the other hand, shares are things, and more precisely, choses in action[40]. Shares may be both objects and subjects of rights. However, a subject does not mean in law a person, and things are not only objects. A share is the object of shareholders' ownership, but beyond this, it is the subject of shareholders' rights since these rights are attached to them. Furthermore, shares are property, but shareholders' rights are not[41]. In essence, shares play a dual role in law by trespassing across the 'great divide' between subjects and objects. The conclusion is however that only shareholders and companies are persons: shares are things.

Naturally, persons can exchange objects in a market, and shares are commodities that are widely bought and sold. But it is not possible to buy or sell a company on the share market, where shares are quoted. Share transactions are indeed share transactions, although stocks are bought and sold as the shares of a company and because the company has some assets. Nonetheless, the 'things' transferred are shares.[42]

The company is not property in itself[43] since it is a person. Companies cannot be bought and sold because they are not property nor things. A company has its

[39] Iwai (1999) 587.
[40] *Re VGM Holdings Ltd* [1942] Ch 235 (CA) 241 (Lord Greene MR); *Colonial Bank v Whinney* (1886) LR 11 App Cas 426 (HL).
[41] See chapter two 2.3.3.
[42] About transactions in securities and relating to securities, see *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 677; however, see also ibid 678: "The company is at one and the same time a juridical person with rights and duties of its own, and a *res* owned by its shareholders."
[43] Eg Cooke (1950) 17.

independent legal existence; it remains the same, even if its every share is transferred to new shareowners. Furthermore, all the shares in a company are not the company[44]. The company is not divided among shareholders, who have their rights, but no property right in the company. As a result, a company is not shareholders' property, and it cannot be a thing[45]. The company does not cross the border between persons and things.

A person is able to buy all the shares of a company. So, it is argued that the majority or single shareholder is de facto the company, although the company is still the sole legal owner of its assets[46]. But ownership is a legal concept, and therefore company law rules the ownership of the company. It should be remembered that in *Broderip v Salomon* the Court of Appeal accepted that Mr Salomon was the company[47]. In contrast, the House of Lords held in *Salomon v A Salomon and Co Ltd* that Mr Salomon was not the company[48]. The position of law is that "once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself"[49]. Another well-known case is *Macaura v Northern Assurance Co Ltd*, where Mr Macaura believed that the timber of the company was his as he was the sole shareholder. Of course, it was not. Lord Wrenbury formulated: "the corporator even if he holds all the shares is not the corporation"[50]. The law determines that the company is a separate and distinct entity from its shareholders. No shareholder is de facto a company according to company law. They do not carry on the business of a

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[44] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA) 122.
[45] Worthington, Sarah, 'Shares and shareholders: property, power and entitlement' (2001) 22 Company Lawyer 258, 259 summarises the current legal view that a share "does not give the shareholder any interest in the company's assets or ownership of the company as a thing"; in addition, ibid 265: "if a company truly is a person at law, then it cannot also be a thing – there is a fundamental disjunction between the two."
[46] Iwai (1999) 594; in addition, Hart, Oliver, *Firms, Contracts, and Financial Structure* (Oxford 1995) 29 sees that company A, which acquires company B, becomes *in a legal sense* the owner of company B's assets.
[47] [1895] 2 Ch 323 (CA).
[48] [1897] AC 22 (HL); Palmer (1902) 45 sees that the ruling of the Court of Appeal was "a melancholy instance of the legal quagmire into which the neglect of [corporate personality] may conduct even the most learned judges."
[49] [1897] AC 22 (HL) 30 (Lord Halsbury).

company[51]. Shareholders can do so only "in a popular sense", but not legally[52]. A shareholder is not "in truth the company"[53], and anything else "is a fallacy from beginning to end"[54].

To repeat, shareholders are not the company, which remains a distinct person from them. There is a clear distinction between the company and shareholders. In law, it does not matter whether the shares of a company are in the hands of one or many[55]. The acquisition of shares in a company offers no way to become a company.

Company law can be confusing: it is artificial and unnatural to think that companies are persons. The notion of legal personality may even hinder the understanding of corporations[56]. Corporate entities cannot be analysed as human persons, and so some commentators prefer to use the term 'legal entity' to describe their juridical basis[57].

The company is not 'they', ie the shareholders, but the company is 'it', because the company has its own legal personality. That point has a "critical significance" in law[58]. Corporate personality has to be taken 'seriously' from the legal perspective[59].

Should the company then be called 'he', since it might be easier to accept that the company has its own personality? Absolutely not, there is no need to personify and mystify the company any further. That is not the direction in which legal theory or practice should move. It is more appropriate that everybody attempts to understand that

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[50] [1925] AC 619 (HL) 633; in addition, the holder of a block of shares in a company is in not the owner of an appropriate part of the undertaking; see *Short v Treasury Commissioners* [1948] 1 KB 116 (CA).
[51] *Gramophone and Typewriter Ltd v Stanley* [1908] 2 KB 89 (CA).
[52] [1897] AC 22 (HL) 43 (Lord Herschell).
[53] Ibid 35 (Lord Watson).
[54] *John Foster & Sons Ltd v Commissioners of Inland Revenue* [1894] 1 QB 516 (CA) 530 (Kay LJ).
[55] [1897] AC 22 (HL) 53 (Lord Macnaghten).
[56] Stoljar, S. J., *Groups and Entities* (Canberra 1973) 188; in addition, corporate personality raises difficult questions that "have been among the most controversial in law and legal theory"; see ibid v; Radin, Max, 'The Endless Problem of Corporate Personality' (1932) 32 Columbia Law Review 643.
[57] Eg Hansmann, Henry and Kraakman, Reinier, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387, 439.
[58] *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1 (HL) 60 (Lord Millett).
[59] Cheffins, Brian R., 'Corporations' in Cane, Peter and Tushnet, Mark (eds), *The Oxford Handbook of Legal Studies* (Oxford 2003) 485, 486.

companies are persons in law. This personality cannot be a piece of new information as the existence of corporations is an old story. Therefore, this study proposes that companies should be just companies, including the notion that companies are not things and property. Simply, a person is a person, not a thing, and this also applies to companies.

In summary, companies and shares may have features of property and contract. Still, companies, shares, and shareholders' rights are products of law. It is significant that company law makes companies persons; therefore, they cannot be contracts or things.

3.3.2 Ownership of the company

Since the company is a person, it cannot be owned. Those who argue that the company is a set of contracts might conclude that nobody can own companies and markets[60]. That is true, and the reason is clear: they are not property. Yet, companies are neither contracts nor markets. For example, Coase says that the company and the market are "alternative methods of organization"[61]. Companies emerge when contracts are unsatisfactory; in the company, some market transactions might be eliminated and substituted by "the entrepreneur-co-ordinator"[62].

An important statement concerning shareholders' position can be found in *Short v Treasury Commissioners* where Evershed LJ declared:

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[60] Fama, Eugene F., 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288; see also Deakin, Simon and Slinger, Giles, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1997) 24 JLS 124, 126.

[61] Coase, R. H., 'The Nature of the Firm' in *The Firm, the Market, and the Law* (Chicago 1988) (originally 1937) 33, 41; on the other hand, a company also resembles the market since it is a medium where buyers and sellers engage in free and willing exchange; see Cheffins, Brian R., 'Using Theory to Study Law: A Company Law Perspective' (1999) 58 CLJ 197, 209.

[62] Coase (1988) 35.

> Shareholders are not, in the eye of the law, part owners of the undertaking. The undertaking is something different from the totality of share-holdings.[63]

Indeed, the position in law is that: 1) shareholders do not own the assets of the company; and 2) neither they own the company. Instead, shareholders own their shares[64].

Could there then be any room for confusion about the ownership of the company? Unfortunately, there have been different views as long as there have been companies. It is part of modern corporation theory that there exists separation of ownership and control in a company[65]. Directors control the company, and shareholders only 'own' it. But actually, shareholders do not own the company, and directors do not have ultimate control over it. The term 'separation of risk bearing and management' is more appropriate[66]. In sum, shareholders own the company neither in theory nor in practice.

Surprisingly, there exists case law that directly supports the notion that shareholders own the company[67]. I analyse two rulings where shareholders were explicitly regarded as the owners of the company.

Re a company (No 00370 of 1987), ex p Glossop

In *Re a company (No 00370 of 1987), ex p Glossop*, Harman J declared that:

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[63] [1948] 1 KB 116 (CA) 122.
[64] Eg Dias, R. W. M., *Jurisprudence* (5th edn London 1985) 255; Demsetz, Harold, 'Toward a Theory of Property Rights' (1967) 57 American Economic Review, Supplement 347, 359: "What shareholders really own are their shares and not the corporation."
[65] Berle, Adolf A., Jr and Means, Gardiner C., *The Modern Corporation and Private Property* (New York 1932).
[66] See eg Boros, Elizabeth J., *Minority Shareholders' Remedies* (Oxford 1995) 5; Roe, Mark J., *Strong Managers, Weak Owners – The Political Roots of American Corporate Finance* (Princeton 1994) ix, where he sees that shareholders "specialize in risk-bearing"; and Fama, Eugene F. and Jensen, Michael C., 'Separation of Ownership and Control' (1983) 26 Journal of Law and Economics 301.
[67] Eg *Caparo Industries plc v Dickman* [1989] QB 653 (CA) 680 (Bingham LJ).

> it is, in my judgment, right to say that directors have a duty to consider how much they can properly distribute to members. They have a duty, as I see it, to remember that the members are *the owners of the company* [and] that the profits belong to the members.[68]

Harman J clearly stated that shareholders are the owners of the company; in effect, the profits of the company belong to them. However, in legal terms neither is true. The assets or profits of the company do not actually belong to shareholders. Shareholders do not own the company as they do not have any property right in the company. In his ruling, Harman J emphasized the residual nature of shareholders' interest in the company, and he did that by using rhetorical language and wording. Judgments can be oratories, which should not be understood literally. Thus, it is important to understand Harman J's message, but his exact words should not be quoted. This ruling does not, in fact, make shareholders the 'real' owners of the company.

Inland Revenue Commissioners v Laird Group plc

Another ruling is from the House of Lords, and this case also concerns the residual nature of shareholders' interest. Lord Millett stated in *Inland Revenue Commissioners v Laird Group plc* by these words:

> The *shareholders own the company*, but they entrust the management of its undertaking to the directors. To enable the directors to carry out their functions, shareholders give them a discretion to decide how much of the company's funds should be retained to pay creditors and carry on the business and how much can safely be returned to shareholders by way of dividend. By declaring a dividend,

[68] [1988] BCLC 570, 577 (emphasis added).

> the directors effectively release funds due to the shareholders from their power to retain them in the business.[69]

In their Lordships' ruling, Lord Millett clearly underlined shareholders' residual interest in the company when he explicitly mentioned that the undistributed profits of a company belong to them. Therefore, the payment of a dividend was not a payment from the directors, but a payment from the shareholders to themselves[70]. The payment of a dividend could not be a transaction relating to securities. Even so, neither can the payment of a dividend be a shareholders' payment to themselves as the company is not a partnership and the assets of a company are not shareholders' assets. Yet, their Lordships used metaphorical language to overturn the ruling of the Court of Appeal, where the payment of a dividend was regarded as a transaction relating to securities. The House of Lords gave a clear message; but again, by taking their words literally, this ruling can be misunderstood. There is no reason to argue that *Inland Revenue Commissioners v Laird Group plc* overruled, for example the ruling in *Short v Treasury Commissioners*.

Both *Re a company (No 00370 of 1987), ex p Glossop* and *Inland Revenue Commissioners v Laird Group plc* seem to accept the point that shareholders own the company. Still, these judgments do so only as supporting shareholders' residual interest in the company. The legal issues decided in the cases did not directly concern the ownership of the company; as a result, they do not really rule that shareholders own the company. Shareholders' 'ownership' in the company was part of the reasoning but not the ruling of the court. These cases do not change the law: shareholders do not own the company.

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[69] [2003] 4 All ER 669 (HL) 679 (emphasis added).

[70] In *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1 (HL) 66 Lord Millett's formulation was that in economic terms shareholders have "two pockets."

The conception of property has varied from period to period[71], but the company has not become property. However, it is a popular view that shareholders 'own' the company[72], and commentators use the same rhetorical language[73]. In contrast, I consider that the argument that shareholders own the company can only be used to emphasize shareholders' residual interest in the company. While the correct way to state shareholders' legal position in the company is formulate it similarly as, for example Davies does it: "shareholders own their shares, not the company"[74].

Shareholders' interests are predominant in the company, where they as a group have the largest and fullest interest. As explained above in chapter two, their interest is residual. Therefore, shareholders may even be called proprietors in the company[75]. But although shareholders' position has some similarities with owners generally, it is not enough for the ownership of the company. The ownership is a question of law. The significant difference is that shareholders do not share property in the company. So, they can own the company only 'loosely' since they do not have property rights there. Ownership describes a situation when a person has a property right in something[76]. In

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[71] Commons (1924) 291; Goodhart, Arthur L., *Essays in Jurisprudence and the Common Law* (London 1931) 40; Vandevelde, Kenneth J., 'The New Property of the Nineteenth Century: The Development of the Modern Concept of Property' (1980) 29 Buffalo Law Review 325, 325: "the meaning of the term 'property' has changed radically."

[72] Worthington (2001) 258.

[73] Eg Hollington, Robin, *Shareholders' Rights* (4th edn London 2004) 68: "The shareholders are the owners of the company"; *Palmer's Company Law*, vol 1 (25th edn London 1992) [6.001] (February 2002): "the shareholder is the proportionate owner of the company"; Pettet, Ben, *Company Law* (Harlow 2001) 164: "Reading the above, makes it possible to forget that the shareholders are the *owners* of the company" (emphasis original).

[74] Davies, Paul L., *Introduction to Company Law* (Oxford 2002) 257; see also Lynch Fannon, Irene, *Working Within Two Kinds of Capitalism* (Oxford 2003) 81: "To talk of the shareholders as owners is not an accurate description of reality"; however, see Davies, Paul L., *Gower's Principles of Modern Company Law* (6th edn London 1997) 504, where he notes that: "Company law has always found it more difficult to identify the principles upon which the actions of controlling shareholders, the 'owners' of the company, should be regulated" (quotation marks original); Arnold (1962) 202 uses quotation marks too as he states that: "This meant that the organization itself was the 'wealth' or the 'property'"; and ibid 353: "Then people dealing with these imaginary personalities deal with them as if they *owned* this sort of property" (emphasis original); furthermore, the message of Berle and Means (1932), for example 6-7, is that shareholders are only 'nominal' owners in a company.

[75] See eg Gower, L. C. B., *Gower's Principles of Modern Company Law* (4th edn London 1979) 423.

[76] Eg Penner, J. E., *The Idea of Property in Law* (Oxford 1997) 144: "'Ownership' simply describes the situation that obtains when a person has a property right in something"; in addition, as Pound, Roscoe, *An Introduction to the Philosophy of Law* (New Haven 1922) 224 says: "Ownership is a purely legal conception having its origin in and depending on the law."

sum, shareholders' property is their shares, not the company. Overall, shareholders' ownership does not sit in the definition of ownership since they do not have owners' rights in the company[77]. In brief, in law shareholders are not the owners of the company.

The question is then: who owns the company? The answer is: nobody. Yet, there are commentators who argue that this answer is not enough[78]. Indeed, political scientists, sociologists, philosophers, economists, and jurists have for centuries debated the personality of the state and the company, and their ownership[79]. A discussion about the nature of corporate personality still continues, although the problem has several times been declared dead[80]. The aim of this study is not to contribute anything extra to that discussion. The reason is simple: there is no need to view companies through the lens of ownership[81].

Companies do not need owners, and neither does company law, which might be more understandable without any metaphysical owners of the company. For shareholders, it is not important whether they own the company: their interest is their shares and shareholders' rights. Therefore, I formulate the point so that the ownership of a company is 'split' amongst shareholders in a such way that it disappears. Berle and Means state that the modern corporation destroyed shareholders' ownership as they

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[77] See the definition of ownership: Walker (1980) 910; Penner, J. E., *Mozley & Whiteley's Law Dictionary* (12th edn London 2001) 250; Honoré, A. M., 'Ownership' in Guest, A. G. (ed), *Oxford Essays in Jurisprudence* (2nd impression Oxford 1968) 107ff.

[78] Deakin and Slinger (1997) 134: "Yet the argument that *nobody* has ownership rights within the corporation is perhaps taking this point too far."

[79] See eg Gierke, Otto, *Political Theories of the Middle Age* (Maitland, Frederic William, trans) (Cambridge 1900); Hallis, Frederick, *Corporate Personality* (London 1930); Webb, Leicester C. (ed), *Legal Personality and Political Pluralism* (Carlton 1958); Iwai (1999) 583.

[80] Hart (1983) 36: "It is said by many that the juristic controversy over the nature of corporate personality is dead"; Cheffins (2003) 486 says that the dialogue concerning personality "largely ended" by the 1930s; but Foster, Nicholas H. D., 'Company Law Theory in Comparative Perspective: England and France' (2000) 48 AJCL 573, 574 proposes that a revival of company law theory and legal personality is taking place in the UK; about the corporate personality debate generally, see Hansmann and Kraakman (2000) 438; Pound (1959) 191ff and 209ff; Willoughby, Westel W., *The Fundamental Concepts of Public Law* (New York 1924) 44ff, where he sees that the roots of this long dispute run back to the differences between the metaphysics of Plato and Aristotle.

[81] Grantham, Ross, 'The Doctrinal Basis of the Rights of Company Shareholders' (1998) 57 CLJ 554, 588.

exchanged their assets in the company for liquid shares[82]. As a result, the ownership of the company can be only nominal but not legal.

In capitalism, the suppliers of capital are generally owners. However, in corporate capitalism shareholders own their shares, not the company. Companies are legal entities that have no owners. The two-tier ownership in company law means that shareholders own their shares, and the company owns its assets. For this reason, ownership in the company structure remains an individual affair[83].

3.3.3 Property and persons

Share capital distinguishes companies from incorporated bodies. Company law includes special requirements governing the maintenance of share capital[84]. Put simply, a company is the capital. The company as a going concern exists since it has its own capital and assets. A company makes business with its capital, and its assets are the source for the satisfaction of creditors' debts[85]. The prosperity of a company results from its capital[86]; in addition, it can be argued that shares have no value unless the company has property[87]. Capital and assets play a special role in companies, which are some kinds of storehouses of assets and property[88]. Initially, joint stock companies were understood as capital funds and a sort of machine into which shareholders put money and out of which they draw dividends. Companies are fundamentally capital and assets.

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[82] Berle and Means (1932) 6-7 and 286.
[83] See Demsetz (1967) 359; in contrast, the supporters of the form of ownership theory saw that the juristic person is not a person at all, but subjectless property destined for a particular purpose; thus, there exists collective ownership in a company; yet this conception seems to be "as false as useless"; see Pound (1959) 254ff.
[84] See above, chapter two 2.2.2.
[85] *Flitcroft's Case* (1882) LR 21 Ch D 519 (CA) 533-34; *Brady v Brady* [1988] BCLC 20 (CA) 40.
[86] *Birch v Cropper in Re Bridgewater Navigation Co Ltd* (1889) LR 14 App Cas 525 (HL) 546.
[87] *John Foster & Sons Ltd v Commissioners of Inland Revenue* [1894] 1 QB 516 (CA) 529 (Lindley LJ); ibid 530 (Kay LJ): "the property is a security for the value of those shares"; thus, if all the property of a company is 'robbed', the company and shares have no value; see *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA) 223.
[88] Arnold (1962) 353.

But company law has progressed further: the joint stock funds have become corporate bodies. The Acts of 1844 - 45 laid the foundations of the modern legal system: the company became a body of persons that associated together in a common purpose. Companies no longer had a joint stock since the entity itself was the joint stock company. Members of corporations did not associate at the level of assets but at the level of the company. The company as a concept was distinguished from partnerships, and the shadow of partnership law receded from companies. Companies and company law were born. The central issue in companies was not the assets but the nature of the company itself.

Obviously, there were direct consequences for this development to company law. First, under these circumstances, it was a fallacy to regard the joint stock company as a partnership[89]. The courts recognized that there are immense differences between joint stock companies and 'ordinary' partnerships; for example, in a joint stock company a shareholder is not able to dissolve the 'partnership'[90]. Companies started their own life, although in a great many aspects they still had partnership features.

Second, the nature of a company's assets should not decide the nature of a company and its shares. *Bligh v Brent*[91], a case concerning Chelsea Waterworks Company, was first cases to rule the point. The main assets of the company were the waterworks, and so real estate. Still, the ruling was clear: shares were personal property. As explained, the company controlled the joint stock, but neither the company nor the shares was this joint stock. In effect, the joint stock fund became the capital of the company[92]. The subscriptions of individual corporators constituted shares, which were

[89] *New Brunswick & C Co v Muggeridge* (1859) 4 Drew 686, 700 (Kindersley VC); *Birch v Cropper in Re Bridgewater Navigation Co Ltd* (1889) LR 14 App Cas 525 (HL) 543 (Lord Macnaghten): "The answer, as it seems to me, must depend on the principles applicable to companies limited by shares, and on the provisions contained in the Companies Act, 1862. It is, perhaps, rather beside the mark to discuss the general doctrines of partnerships and to examine particular cases of partnership contracts."
[90] (1859) 4 Drew 686, 701.
[91] (1837) 2 Y & C Ex 268.
[92] (1889) LR 14 App Cas 525 (HL) 546.

regarded as money. Although that is not the current position of law[93], this case clearly emphasized the independent nature of shares and the company. Consequently, the status of shares and a company remain the same whatever happens to the assets of the company[94].

Third, as companies were no longer considered funds, their position required the full recognition of law. The landmark ruling is *Salomon v A Salomon and Co Ltd*[95], where the House of Lords set the final seal on legal corporate existence. Companies became altogether different persons from their shareholders when they were accepted as 'real' persons in law. The company was seen as more than the arithmetical sums of the individual human beings constituting it. Thus, the position of company law was that the "corporation is not a mere aggregate of shareholders"[96]. This is also the current status of companies in law.

The nature of shares does not depend on the company's assets. In economic terms, the underlying assets have importance, but in legal terms there is no direct relationship between these assets and shares. This relationship between company assets and shares cannot be important in law.

As explained above, shareholders' property is their shares, to which rights are attached. Due to the rights, companies have duties towards shareholders, and if we use Hohfeld's terminology, these duties are correlatives of shareholders' rights[97]. But it should be noted that shareholders' rights are in the company, and also their duties are towards the company. Therefore, the basic relationships in the company exist between shareholders and a company.

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[93] See especially *Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279.
[94] See CA 1985 s 182(1)(a).
[95] [1897] AC 22 (HL); as Cooke (1950) 176 explains, joint stock funds were linked to the older corporation theory by this case.
[96] *Flitcroft's Case* (1882) LR 21 Ch D 519 (CA) 536.
[97] See Hohfeld, Wesley Newcomb, *Fundamental Legal Conceptions* (New Haven 1919) 5ff.

The full picture of the company is more complicated as companies generally have several shareholders. The company cannot only be a relationship between each member and the company: it is also a relationship among shareholders. Company law and the articles of association regulate shareholders' rights inter se[98]. The company, as a legal entity, mediates relationships between shareholders[99]. But since their rights are principally against the company, these rights by or against a member can only be enforced through the company[100]. This is the main rule, although in specific circumstances, members can directly enforce obligations against other members; one such area is shareholders' pre-emption rights[101]. The company is a legal unit that distributes burdens and benefits for shareholders[102]. These benefits are shareholders' rights, and burdens are their duties.

Companies have creditors and directors: the company also mediates their relationships. Company law gives protection to creditors, and in an insolvent company the law makes creditors' interests paramount[103]. The law sets duties for directors and governs the nomination of managers and their contracts[104]. However, shareholders have their rights and duties against the company, not against creditors and directors directly. This is the fundamental idea in company law even though it is in creditors' interest that shareholders have an obligation to pay their shares. The payment of shares is never shareholders' debt to creditors. It is a payment to the company, although the company might use the capital to pay its own debts. On the other hand, directors have duties in

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[98] *Welton v Saffery* [1897] AC 299 (HL); more below, chapter six 6.2.2.
[99] Davies (2002) 10; Kelsen (1992) 49.
[100] [1897] AC 299 (HL) 315.
[101] *Rayfield v Hands* [1958] 2 All ER 194; about the differences between the older and more recent authorities; see *Halsbury's Laws of England*, vol 7(1) (4th edn London 2004 reissue) 221.
[102] But this does not mean that the company is only an abbreviation of the various rights and duties that actually belong to particular individuals; about this bracket theory, see Stoljar (1973) 186ff; Pound (1959) 250ff.
[103] Eg *Brady v Brady* [1988] BCLC 20 (CA) 40.
[104] See eg CA 1985 ss 303 and 319.

companies, but they do not have these duties to shareholders. For example, directors do not owe fiduciary duties to single shareholders[105].

The company links shareholders as a group to creditors and directors. Shareholders, creditors, and directors have rights and duties in the company, but all these rights and duties have their correlatives in the company. Company law does not establish direct legal relations between these groups. For example, in *Salomon v A Salomon and Co Ltd*[106] there was one relationship between Mr Salomon and his company, and another relationship between A Salomon Co Ltd and its creditors. There was no 'real' relationship between Mr Salomon and the creditors. Consequently, even though company law governs the whole nexus of relationships, questions concerning every legal relationship should be decided separately.

In summary, the foundations of the company rest on property, but a company is not capital and assets. A share in the company is not a sum of money: instead, it a series of mutual covenants entered into by all shareholders. In the same way, the company is a relationship, in particular, among shareholders. In addition, there exist relationships between other groups of persons: the company is a "system of relationships"[107]. Company law is organizational law, and the company is a device organizing these separate rights and duties.

Companies have a dual nature: they are both unions of property and unions of persons[108]. But the most important point in companies and company law is not the relation between persons and assets. A unit of property cannot have power; the power in the company rests on the union of persons. The company and shares are a complex set

[105] *Percival v Wright* [1902] 2 Ch 421; *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479, 491 (Sir Richard Scott VC): "it is long established and basic law that the directors of a company owe their fiduciary duties to the company not to the shareholders."
[106] [1897] AC 22 (HL); in addition, Mr Salomon was both a shareholder and a debenture holder in the company.
[107] Coase (1988) 42.
[108] Commons (1924) 292; Berle and Means (1932) 1: "The corporation has, in fact, become both a method of property tenure and a means of organizing economic life."

of relationships between persons. At the top of the company is the relationship among shareholders[109], which is to my mind the most important point in company law.

Companies have partnership roots. Even so, property has a more central role in partnerships, where partners are the co-owners of the property. Property and assets have importance in companies because property is valuable. But property in a company can only have the role of underlying assets. Therefore, the emphasis of company law should be on the legal entity. The development of companies can be described in the following way:

> As a union of property the corporation has expanded from the primitive notion of physical objects held for one's own use to the notion of a going business operated by an association of persons in dealings with others. In this respect it avails itself of all the laws of creditor and debtor, principal and agent, employer and employee, buyer and seller, which have emerged out of the history of the common law, aided by the equity and statutes, and have built themselves up on the primary protection of title and possession of physical objects.[110]

Companies should not be thought of as property no more than they can be understood as individual human beings. Kelsen[111] explains that companies as legal persons are expressions of the unity of a complex of norms, ie a legal system governing the behaviour of a plurality of persons. In essence, company law regulates relationships between persons.

There exist several legal relations in the company, which is a nexus of these relationships. They form and sum peculiar relations between members of the corporate

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[109] See Roe (1994) viii; and also Hansmann and Kraakman (2000) 433, where they consider that much of organizational law regulates relations among shareholders.
[110] Commons (1924) 292.

group and between them and other members of society[112]. The company connects people having rights and duties in the corporation structure. These relations are mediated through the company itself, and therefore company law does not normally create any direct relationship between shareholders, creditors, and directors. In a similar way, there is no direct relationship between shareholders and the assets of the company.

3.4 Share value and fortune

The remaining analysis in this chapter concentrates on two questions: 1) what is the role of asset value in company law; and 2) how does the value of shares follow the fortunes of the company?

3.4.1 The role of asset value in law

Obviously, the assets of a company have some value. But these assets are the company's property, and shareholders' property is their shares. The underlying corporate assets have importance, but in legal terms there is no direct relationship between the assets of a company and its shares. The assets of a company determine neither the nature nor the value of shares.

Shareholders participate in the company through their shares[113]. Shares are rights of participation in the company on the terms of the articles[114]. Shareholders have the rights set by the company constitution and company law. It is clear that shareholders' rights do not include any direct right to the company's capital and assets.

A shareholder cannot retire from the company[115]. Company law does not offer any general withdrawal right: an individual shareholder is unable to dissolve the company. But a shareholder can put an end to his own quality as a shareholder by

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[111] Kelsen (1992) 48.
[112] Davis, John P., *Corporations*, vol 1 (New York 1905) 16.
[113] *Birch v Cropper in Re Bridgewater Navigation Co Ltd* (1889) LR 14 App Cas 525 (HL) 546-47.

transferring his shares to another person. Naturally, this person acquires the shares and becomes a shareholder. But as mentioned, the price paid for shares is a matter of contract. Company law does not rule that the price of shares should be the asset value per share. A 'locked-in' shareholder cannot require the company or other shareholders to buy him out at a price reflecting the value of the underlying net assets[116].

Shareholders are not part owners of the company; they are not entitled to have their shares valued by apportioning among all shares the total value of an undertaking[117]. The price of shares can be more or less than their proportional part of asset value: whatever the buyer and the seller decide and accept. A transaction price is not a question determined by the company or company law. Company law offers transferability for shares, but the transaction prices for shares are mainly beyond its scope.

Can we then say that there is no legal relationship between the assets of a company and the value of its shares? No, we cannot, because the law should not ignore a company's assets. The property of the company is, in a way, a security for the value of shares[118]. To explain this relationship, I analyse a recent ruling by the House of Lords.

In *Johnson v Gore Wood & Co (a firm)*[119], Lord Millett accepted that a company, which has its own assets and liabilities and its own creditors, is a legal entity separate and distinct from shareholders. In addition, he explicitly mentioned that the company's property belongs to it, not to its shareholders. Still, his Lordship declared that:

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[114] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA) 223.
[115] *New Brunswick & C Co v Muggeridge* (1859) 4 Drew 686.
[116] *Re a company (No 004475 of 1982)* [1983] Ch 178, 191, where the asset value of the shares was £175,000, but the offer for them was only £112,000.
[117] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA).
[118] *John Foster & Sons Ltd v Commissioners of Inland Revenue* [1894] 1 QB 516 (CA) 530; in addition, shares are 'second order property rights' and sometimes even like 'money in the bank'; see Penner (1997) 132; further, assets can be supposed to be back of 'pieces of paper', in the same way as gold was supposed to be back of the government issues of currency; Arnold (1962) 201.
[119] [2002] 2 AC 1 (HL) 61.

> On the other hand, although a share is an identifiable piece of property which belongs to the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets, and if these are depleted the diminution in its assets will be reflected in the diminution in the value of shares. The correspondence may not be exact, especially in the case of a company whose shares are publicly traded, since their value depends on market sentiment. But in the case of a small private company like this company, the correspondence is exact.[120]

Lord Millett linked share value to the company's net assets. The correspondence can be illustrated with an example where the sole asset of a company is a cash box containing £100,000. This is the example mentioned in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[121], and in their decision Lord Millett quoted that case and the same facts. Indeed, it is most understandable that the value of a company and its shares will be nil if all the money is robbed. The value of shares reflects the changes of a company's assets, which argumentation can be supported by the idea that a company's undistributed profits belong to the shareholders[122]. In consequence, shareholders are economically in the same position whether they or the company have the assets. However, from the legal perspective this cannot be true since a company's property belongs to it, not to shareholders. Lord Millett explained this point in their decision, too.

The view of Lord Millett is problematic. The correspondence between the company's assets and share value works only when the value of shares is the company's net asset value per share. Yet, we cannot say that the value of shares , even in the above-

[120] Ibid 62.
[121] [1982] Ch 204 (CA) 223.

mentioned cash-box company, should be the asset value, ie £100,000 divided per share. If the total value of the company's shares is £90,000 or £110,000, in both cases the exact correspondence is impossible. As Lord Millett mentioned, the correspondence is not exact in the case of a company whose shares are publicly traded, but the explanation for this is not only the 'market sentiment'[123]. Therefore, an exact correspondence can only exist when the value of shares is the net asset value per share. The fundamental problem with this correspondence is that nothing in company law rules that share value is equal to the asset value. Shareholders do not have a right to retire from a company at the asset value; the law does not declare that the proportional asset value is the right value for shares. The value of shares *may* depend upon the amount of property the company possesses[124]. Thus, I conclude this point by stating that there *can* exist this kind of correspondence between a company's assets and the value of its shares, but the law does not rule that the asset value *should* be the right value of shares.

The question rises: how Lord Millett's words should be understood? This study sees that his view supports the assumption that the value of shares is their asset value if nothing else is shown. The proportional asset value is like a "formal value"[125] for shares. However, the market price for shares in public companies is typically something else than their net asset value. In addition, the law generally accepts that the market price is the right and true share value[126]. But neither is the value of shares in private companies fixed to the asset value[127]. Both in public and private companies, shareholders have the right to determine the value of their shares: nothing requires that

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[122] Lord Millett in *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 (HL) 679; in [2002] 2 AC 1 (HL) 66, he considered that the payment of dividends is like a transfer of "money from one pocket to the other".

[123] About market prices, see below chapter 4.

[124] See *John Foster & Sons Ltd v Commissioners of Inland Revenue* [1894] 1 QB 516 (CA) 530.

[125] See Hadden, Tom, *Company Law and Capitalism* (2nd edn London 1977) 68.

[126] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA) 125 (Evershed LJ); *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 32 (Plowman J): "since this is not a case of a purchase of assets, but of a purchase of shares, the market price on the Stock Exchange of those shares is cogent evidence of their true value."

this decision should rest on the asset value. The asset value of shares has no function as a rule or principle in company law, but it is an assumption of the law. In conclusion, the law supposes that the company's assets have importance in share valuation. What is this importance then? The point is generally a question of markets, and thus reviewed in the following chapter.

3.4.2 Value and fortunes

There is a clear relationship between share value and a company's business. Simply, share value rises when companies are successful. In contrast, if they fail, there is a great risk that shares loose their value. Share value has a strong correspondence with a company's economic success.

The Court of Appeal formulated the relationship between the shareholder and the company in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* in this way:

> When the shareholder acquires a share he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting.[128]

The value of shares depends on the success and value of the company's business. Share value generally fluctuates "in line with the fortunes of the company"[129]. The reason for this is shareholders' residual interest in the company. All improvements in the profitability of the company are likely to be reflected in the share price. However,

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[127] See eg *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324 (HL) (Sc) 368, where the minority shareholders were entitled to recover more than only "the break-up value of their shares."
[128] [1982] Ch 204 (CA) 224.

company law does not rule that share value should rise when a company's business is successful. Actually, law and the courts are often even unable to say whether business is advancing or not. The questions of commercial judgment are not decided in the courts but in companies. There exists indoor management rule[130], and the law cannot insist on success in business[131].

The relationship between the success of a company and the value of its shares is a question of fact. The rising value of shares is an economic consequence from the gain in business. My formulation is that economics, and also common sense, says that there is this kind of relationship. The task of the law is to recognize this economic connection. The rising value of shares in prosperous companies is an economic market rule because investors generally think in this way.

In addition, the relationship between success and share value is more than an assumption. Therefore, I argue that it is actually a presumption of law: the law believes on this consequence. The regulation of insider dealing rests on this idea, and let us have an American example case:

> In *Securities and Exchange Commission v Texas Gulf Sulphur Co*[132], the directors of the company had information that a remarkably rich ore drill core had been discovered from the company's mineral exploration site. Some directors purchased personally and through their agents shares of the company on the basis of this material inside information. The use of this information was unlawful insider trading.

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[129] *Re Elgindata Ltd* [1991] BCLC 959, 1004 (Warner J).
[130] See eg *Burland v Earle* [1902] AC 83 (PC); *Carlen v Drury* (1812) 1 V & B 154.
[131] *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8, 14 (Hoffman J): "all decisions concerning the business of the company involve the risk that other decisions may turn out to have been better."
[132] (1968) 401 F 2d 833 (United States Court Of Appeals Second Circuit).

The found mineral reserves were both literally and legally 'material information'. As stated earlier in *List v Fashion Park Inc*[133]: "The basic test of materiality ... is whether a reasonable man would attach importance ... in determining his choice of action in the transaction in question." This then encompasses those facts "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities"[134]. The information about these material reserves was a material fact as it affected "the probable future of the company" and also "the desire of investors to buy, sell, or hold the company's securities"[135].

Naturally, this is an American case from the field of insider regulation. However, I consider that the case is capable of explaining more generally the relationship between the company's success and share value. Company law 'knows' that the value of shares follows the fortunes of the company because reasonable men believe it, ie the market operates in this way. Yet, in individual cases shareholders decide the prices of shares. Shareholders and the market may also behave differently than it is anticipated[136]. Nevertheless, company law has this kind of presumption concerning share value.

In summary, there is no direct legal relationship between the assets of a company and its shares. Company law does not rule that the net asset value shows the value of shares although this value might be a formal value for them. In addition, it is an economic fact that share value follows the fortunes of a company but this point is economic rather than legal in nature. Overall, the company is a relationship between shareholders, and the value of shares is decided in this relationship. In the next chapter, I examine how share prices are set on the markets.

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[133] (1965) 340 F 2d 457 (United States Court Appeals Second Circuit) 462.
[134] Ibid quoting *Kohler v Kohler Co* (1963) 319 F 2d 634, 642.
[135] (1968) 401 F 2d 833, 849; the Criminal Justice Act 1993 s 56(1)(d) uses term "a significant effect" on the price.
[136] See Davies (2003) 766, where he considers that at the field of insider dealing it might be permissible to argue that information was not significant but the disclosure had just a bigger effect.

CHAPTER 4

MARKETS AND SHARE PRICES

> *Everyone knows that the market gets things wrong. Few have the temerity still to cling to the perfect-market hypothesis. Those of us who have experienced stock-market sentiment from the inside know that often there is no explanation other than psychology for apparent failures to recognize value.*
> Paul Lee, in Questions of Value (2004) 4.

4.1 Introduction to value and price

A company, whose earnings are the source of shareholders' return, is a system of financial relationships. Shares are valued for their expected payoffs[1]: the current market price is the present value of these payments. Yet, a company's prosperity and shareholders' return are unknown; therefore, share value can only follow economic expectations. Overall, the valuation of shares is complex.

Price and value have a different nature: price is an objective datum, but value is ultimately a matter of opinion and thus a subjective assessment of worth. Pricing in markets follows the 'laws' of supply and demand. Price is the ratio in which objects exchange. Further, market prices are normally public information. In contrast, value can only have meaning when it is related to a particular person: the process of valuation takes place in the individual mind. In addition, valuation is always a forward-looking activity since the current value of shares depends in a critical way on their future value.

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[1] Eg Davies, R., 'Valuation of Shares' in Firth, Michael and Keane, Simon M. (eds), *Issues in Finance* (Oxford 1986) 193, 194; Brealey, Richard A. and Myers, Stewart C., *Principles of Corporate Finance* (6th edn Boston 2000) 63: "We just discount the cash flows by the return that can be earned in the capital market on securities of comparable risk"; see also *Dean v Prince* [1954] Ch 409 (CA) 420 (Evershed MR): "a sound and obvious basis of [valuation] would be in accordance with the expectation of profit for the future."

Nevertheless, these two concepts are linked together as price is a function of the valuation by parties.

The fundamental question is: who determines value for shares? Naturally, the main rule is that shareholders decide the value of their shares. The prime aim of this chapter is to explain the way in which share valuation occurs on the stock markets.

4.2 Investment and risk

Return, risk, and time are the central elements in investment. Investing means laying out money in the expectation of a future return[2]. The term 'investment' is wide, covering shares, bonds, unit trusts, pension schemes, life assurance policies, futures and options, bank accounts, and other 'paper' assets[3].

In the economic sense, individuals' objective is to maximize their welfare and lifetime consumption. Economic man invests to be able to enjoy the benefits of his increasing wealth later. Shares are investment assets that have an extremely important role in the savings and investment industry[4]. If bank accounts are ignored, company shares and government bonds are the fundamental investment products. Such financial assets constitute an important source of wealth in society.

Capital markets, where companies acquire share capital by issuing shares, provide and allocate investment funds. In order to grow and expand, companies should be able to attract funding from investors. In the company, share capital's economic

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[2] *Inland Revenue Commissioners v Rolls-Royce Ltd* [1944] 2 All ER 340.

[3] Commodities and goods can also be investments, for example diamonds and tulips, and one of the first economic crises was the tulip mania in 1636 - 37, where a rare tulip bulb reached the value of 12 acres of city-centre land; see Kindleberger, Charles P., *Manias, Panics and Crashes: A History of Financial Crises* (4th edn Basingstoke 2002) 109 and 223; Cohen, David, *Fear, greed and panic: The psychology of the stock market* (Chichester 2001) 19.

[4] Black, Andrew, 'Introduction' in *Questions of Value* (London 2004) xv, xv: "The value of corporations is of great importance to everyone in our society. Our future depends on it, since a lot of our money is invested in the equity market in the form of pensions and other savings;" in addition, as he mentions, individual persons are predominantly indirect share investors through other financial products; in effect, more than 80% of quoted shares in British companies are controlled by institutional investors; see eg *Company Law Reform: Modern Company Law For a Competitive Economy – Final Report*, vol I (London 2001) [6.22].

function is to create more capital. The expectation of profits fuels share investments since a company's surplus is the source of shareholders' return. This profit 'belongs' to shareholders, who are the recipients of a company's residual cash flow. In a similar way, if a company is unprofitable, there is no return for share investors.

A shareholder takes an economic risk when he invests in shares[5]. Share capital will be lost first if a company fails, and the strong variety of possible outcomes from share investment increases the risk. Equities are high-risk and high-return investments; naturally, the expected high return is the temptation but the uncertainty of return is the danger. Risk means that the actual return on investment can be lower than shareholders expected when the shares were acquired.

Shares offer return with risk. But as investment theory says, nobody commits funds unless his supposed return is in balance with the risk. Consequently, the return of shareholders should be more than a risk-free return[6]. Therefore, stocks are regarded as the best long-term investment, and shareholders expect to get an equity risk premium due to carrying risk[7]. Furthermore, the riskiest shares must offer extra return because the required rate of return should be proportional to the amount of risk. In other words, shareholders' expected return should be large enough to compensate the risk.

Financial products are able to reduce investors' risk through risk spreading and risk pooling; investors' desire is to transform their risk, and equity risk is a specific risk that can be reduced in this way. Share investors minimize their specific risk by diversification, which is "by constructing portfolios of assets that exploit any offsetting risks between the returns on assets in the portfolio and thereby reducing overall risk"[8]. To diversify, shareholders invest in shares of several companies. Investors prefer

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[5] *Re Elgindata Ltd* [1991] BCLC 959, 1000 (Warner J); Brealey and Myers (2000) 61: "Everybody knows that common stocks are risky and that some are more risky than others."
[6] See eg Brealey, R. A., *An Introduction to Risk and Return from Common Stocks* (2nd edn Oxford 1983) 142: "any extra return from common stock is a reward for taking risk."
[7] Siegel, Jeremy J., *Stocks for the Long Run* (3rd edn New York 2002) 6: "the total return on equities dominates all other assets."
[8] Blake, David, *Financial Market Analysis* (2nd edn Chichester 2000) 8.

portfolios that offer the highest expected return for a given degree of risk. These diversified portfolios are regarded as efficient.

The idea of diversification is not new, and the following example from the age of mercantile expansion in the sixteenth century explains it further:

> the discovery of the compass and advances in astronomy were accompanied by new ideas in shipbuilding and in rigging. The result was an increase in the size and range of ships for both fighting and commerce, two activities which were not very far apart in this period. The period of Hakluyt's 'voyages' begins; there are long expeditions across the great oceans to plunder and to trade. These expeditions involved great risks and a large capital outlay before the ship could sail, followed by a considerable period of waiting, running often into years, before a return on capital could be received. Hence, though there were individual shipowners of great wealth, possessing a number of vessels (as at Bristol), the commercial idea of a voyage was of a single venture. The wise man spread his risks, joining with others in their expeditions, chartering perhaps from a shipowner or becoming part-owner only in a ship.[9]

The economic ventures described were still partnerships; however, the idea of diversification is the same: investors spread their risk. They are most successful if they do not put 'all of their eggs in one basket'[10]. Indeed, diversification, which has been practised for centuries, offers a powerful way to manage risks. This idea is crucial in

[9] Cooke, C. A., *Corporation, Trust and Company* (Manchester 1950) 47-48.
[10] Diversification is "the means by which a wise man could achieve security in his old age"; Arnold, Thurman W., *The Folklore of Capitalism* (New Haven 1962) (originally 1937) 267.

modern portfolio theory, which sees that shareholders should reduce their firm-specific risk by diversifying their assets into shares issued by several companies[11].

Because diversification decreases the amount of risk, the attractiveness of shares as investments increases. Investors are willing to pay a higher price for shares, which become more valuable as part of a diversified share portfolio. Thus, this method can both reduce risk and create wealth.

On the other hand, shares are not only risky; they do not pay a fixed cash flow during their life and do not have any maturity date. Share investors cannot know what their return will be: they can only have some economic expectations. Still, if the anticipated return is high, investors are willing to pay more for the shares, and vice versa. Furthermore, when there is an imminent risk that the business of the company may be unsuccessful, investors pay less for the shares even if the return in the case of success would be high. In sum, shares as investment products offer a trade-off between the expected return and risk as their value depends on both factors.

4.3 The function of markets

Markets advance economic welfare, and more precisely they maximize wealth through contractual transactions[12]. The prime function of markets is to allocate resources optimally. Further, as prices in an efficient market reflect all the information, these prices are 'right'. A well-operating market is both allocationally and informationally efficient.

Buyers and sellers interact in a market place: markets facilitate exchange. Pricing in a market takes place through bidding and asking. But when a deal is reached,

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[11] Through diversification it is possible to cut the variability of returns by half, and most of this benefit is available with relatively few stocks; Brealey and Myers (2000) 167; moreover, the reduction of risk is called the insurance principle as the portfolio contains many independent sources of risk; see eg Bodie, Zvi and others, *Investments* (6th edn Boston 2005) 224.

[12] The term 'wealth maximization' is introduced by Coase, R. H., 'The Problem of Social Cost' in *The Firm, the Market and the Law* (Chicago 1988) (originally 1960) 95, where he assumes that when there are no transaction costs negotiations always lead to an agreement that maximizes wealth.

a contract is required for the exchange; it is fundamentally contract law that facilitates market transactions. In addition, markets promote welfare through reducing transaction costs, for example by standardized contract terms. A market is operationally efficient when the costs of its transaction services are low.

Companies and markets are institutions of capitalism. Anglo-American capitalism is stock market capitalism. In investment language, the term 'market' normally refers to the stock markets. Moreover, in genuine capitalism the stock markets measure the success of companies, and their market index may be a measure of national well-being[13]. Financial markets are vital for capitalism and for society.

Share markets have several special features. First, capital users and suppliers do not meet on the stock market. Shares are not issued to investors directly: instead, they are normally issued through financial intermediaries that have an important function in share offerings. But new issues of shares have no major role in stock markets since the function of the secondary market distributing existing shares among investors dominates the market. Second, investment markets are in their nature professional and global. Institutional investors, whose assets move fast between different investment products and from one country to another, govern stock markets. Third, share markets are very efficient. Share prices in the market are 'real' as the market 'knows' the value of shares. However, stock markets, like other markets, are never fully efficient, although economists used to suppose so[14].

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[13] See Dore, Ronald, *Stock Market Capitalism: Welfare Capitalism – Japan and Germany versus the Anglo-Saxons* (Oxford 2000) 10.

[14] Jensen, Michael. C., 'Some Anomalous Evidence Regarding Market Efficiency', (1978) 6 Journal of Financial Economics 95, 95: "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis"; Firth, Michael 'The Efficient Markets Theory' in Firth, Michael and Keane, Simon M. (eds), *Issues in Finance* (Oxford 1986) 1: market efficiency "can now be regarded as the accepted model of share price behaviour"; but see Shleifer, Andrei and Summers, Lawrence H., 'The Noise Trader Approach to Finance' (1990) 4 Journal of Economic Perspectives, No 2, 19, 19: the efficient market hypothesis crashed along with the rest of the market on October 19, 1987; Allen, William T., 'Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis' (2003) 28 Journal of Corporation Law 551, 553: "Were the ECMH true, it would reflect a mystery."

Markets have a pivotal role in the pricing of shares. In addition, market price is generally regarded as the true value of shares. How are values and prices determined in the market economy? What are the alternative methods in share valuation? I move on to these questions.

4.4 Value and price of shares

4.4.1 Market price and value

The history of finance theory is a mixture of abstract theorizing and practical application[15]. Indeed, the price and value of shares are both theoretical and practical issues. Furthermore, value and price are fundamental points in every market transaction, so let us start with a simple example:

> Mary has an apple that John wants to have. Its worth is fifty pence to Mary, and thus it is equal for her whether she has the apple or fifty pence. John thinks that the apple's value is one pound. They reach a deal as Mary sells the apple to John.

Since John values the apple higher, it is rational that he acquires it. The idea of wealth maximization is that the person who values assets highest should have them. The apple will be allocated optimally when this market transaction occurs. The transfer is an economic improvement that increases the total wealth in society by fifty pence, ie by the difference of John and Mary's valuations.

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[15] Milne, Frank, *Finance Theory and Asset Pricing* (Oxford 1995) 3.

What is the price for the apple, and who has the right to set it? There is no natural or right price for the apple because its price is a matter of bargain[16]. The price is a ratio of exchange, and Mary and John may price the apple as they please. This pricing is their business: they set its 'true' price, which is the monetary consideration given when the object is exchanged.

However, since price is a function of the parties' valuations, the possible price in our example is something between fifty pence and one pound. Simply, if John offers less than fifty pence, Mary does not sell it; if Mary asks more than a pound, John does not buy it. Nevertheless, the highest possible price, one pound, is no right price. Naturally, a bargainer with great skills might get the apple for fifty pence; on the other hand, if the seller is determined, the price might be a pound. The setting of the price is like a game between Mary and John[17]. In this bargaining game, both of them may try to hide their true valuation. Yet, the price is whatever Mary and John agree, but if they disagree about it, there is no transaction at any price. The economic assumption is that Mary and John behave rationally and reach a deal.

Of course, one possible price is seventy-five pence, which can be used to illustrate the wealth maximization available through the transaction. In consequence, Mary is twenty-five pence better off as she has seventy-five pence in cash but the apple was only worth fifty pence to her. The value of the apple is one pound to John, who paid only seventy-five pence for it, so he is also twenty-five pence better off. There is an equation of exchange between Mary and John at this price. Although that might be a fair conclusion, we cannot say that it is in the economic or legal sense the right price. The legal rule is freedom of exchange since persons may exchange commodities on

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[16] Every commodity might have a natural price, but as Adam Smith explains, the actual price can be above, below, or exactly the same as the natural price; Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, vol I (Campbell, R. H. and Skinner, A. S., eds) (Oxford 1976) (originally 1776) 72-73.

[17] Generally about game theory, Von Neumann, John and Morgenstern, Oskar, *Theory of Games and Economic Behavior* (3rd edn Princeton 1953).

mutually accepted terms. Parties are generally free to choose whether they enter into a contract. In addition, a buyer and a seller may behave opportunistically; their self-interest may be the guide in dealings with others. Nonetheless, the net gain available in our example is fifty pence, and the actual price determines only how the increasing wealth is divided between Mary and John. It is possible that Mary or John gains all the fifty pence, and the other nothing; however, the wealth created remains the same[18]. The amount of wealth depends on the valuation, but the distribution of gain is a consequence of success in bargaining. As the story clearly shows, value and price have different meaning in economic transactions[19].

Share transactions do not typically take place in this way. But the basic idea of pricing is identical: the price is a matter of bargain. Before I analyse the pricing of shares further, I change the story in my example:

> Mary has a painting, which John wants to acquire. The painting is worth five thousand pounds to Mary, but John values it at ten thousand pounds. It would be possible for John to buy it at a price between £5,000 and £10,000; however, Mary organizes an auction.

An auction is the most efficient way to sell art and shares: it is a market with a large number of possible buyers. Mary calls people to her auction and promotes it. She is successful, and there are several people, but those of interest are Paul and Robert. Paul thinks that the value of the painting is £11,000, and Robert regards its worth as £15,000.

At the auction John offers £10,000, and Paul is willing to pay up to £11,000. However, as Robert offers £11,001, he gets the painting. The person who values an

[18] The net gain is fifty pence even if John steals the apple, or a tyrant transfers it to him by force; see Dworkin, Ronald M., 'Is Wealth a Value?' (1980) 9 Journal of Legal Studies 191, 197.
[19] See also Glover, Christopher G., *Valuation of Unquoted Securities* (London 1986) 11: "The price at which A sells his car to B is unlikely to coincide with any of the interior valuations of A or B."

object highest should have it, and thus this asset is allocated in an efficient manner. Yet, the auction is only about the pricing, and Robert gets the deal simply by bidding. There is no need to pay the 'full' price for the painting, ie £15,000, which is as the highest value also the 'right' value for it. The price, which is £11,001, remains different from the highest valuation although there is this auction. But still, the wealth maximization and the net gain available depend on the valuations. In this case, the gain to society is £10,000, of which Mary gains £6,001 and Robert £3,999 through the auction.

Markets and prices play key roles in an economic approach. Since Adam Smith, economists have assumed that individuals trade because it is advantageous for them. When people exchange assets on mutually acceptable terms, goods move to the highest-valued use. The market economy rests on this idea. Markets are able to increase wealth since they are not a zero-sum game, and share markets operate in this way too. Yet, economic efficiency is concerned with the size of net gain but not with who gets it. Therefore, the pricing of assets is irrelevant to efficiency and wealth maximization.

The general equilibrium theory is a central idea in market economy: prices follow the laws of supply and demand[20]. Market theory shows that "as the price of a good rises, less is consumed as the consumer reduces his purchases or turns to substitute goods". On the other hand, as a price rises, the producers are willing to produce and supply more goods to the market. A market is in equilibrium when the quantity demanded is equal to the quantity supplied and neither consumers nor producers are willing to alter their actions.[21] But market prices are not predictable since the

[20] Choudhry, Moorad and others, *Capital Market Instruments* (London 2002) 3: "As in any market, pricing factors are driven by the laws of supply and demand, and price itself manifests itself in the *cost of capital* to a firm and the *return* expected by investors who supply that capital."
[21] Veljanovski, C. G., *The New Law-and-Economics: A Research Review* (Oxford 1982) 31-33.

equilibrium reached is always temporary in nature; in effect, the current price should be discovered[22].

Apples and paintings are goods that are consumed[23], but shares are financial assets and investment products. The utility of shares is very different from that of consumable goods since shares have value in exchange, not in use. The value of shares requires further explanation.

However, the basic ideas of value and price apply to shares. In the end, all values are subjective assessments of worth that take place in the individual mind. These interior values are in the eye of the beholder: the value depends on the view of the person valuing the object and the methods used in the valuation. Actually, it is therefore hard to determine any true values. By contrast, the price is an objective datum, so prices are real and generally well-known information. On stock markets, the price formation is open, and prices are public. Still, value and price have a different meaning in every market: the price is a consequence of bargaining. Understanding of both value and price is related to human motives and behaviour, which makes the valuation of shares more complicated[24]. Moreover, there exist several definitions for share value, which cannot thus be a simple concept[25]. I next analyse asset value, intrinsic value, and market value.

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[22] Schwartz, Robert A. and Francioni, Reto, *Equity Markets in Action* (New Jersey 2004) 67: "The term *price discovery* identifies the process by which a market finds a new equilibrium after a change in investor demand to hold shares."
[23] However, art can be an investment; eg Heilbroner, Robert, *Twenty-first Century Capitalism* (London 1993) 30: "a Rembrandt painting, which is certainly an embodiment of wealth, does not become capital unless it is no longer wanted for itself, but as a stepping stone for amassing still more capital."
[24] Mossin, Jan, *Theory of Financial Markets* (1973 New Jersey) 1: "No theory of finance can give a satisfactory explanation of security valuation or investment behavior if it fails to take into account relationships among individual investors' portfolio decisions"; Wicksell, Knut, *Value, Capital and Rent* (New York 1970) (originally 1893) 11: "without a reference to human motives and conduct there can be no understanding of price."
[25] For example, Helfert, Erich A., *Techniques of Financial Analysis* (11th edn Boston 2003) 390ff demonstrates eleven conceptions: economic, market, book, liquidation, breakup, reproduction, collateral, assessed, appraised, going concern, and shareholder value; in addition, companies and shares have discounted cash flow value (DCF), economic value added (EVA), current operations value (COV), future growth value (FGV), and value at risk (VAR); see eg Stern, Erik and Hutchinson, Mike, *The Value Mindset* (New Jersey 2004) 43ff, 65ff and 102.

4.4.2 Asset value

The simplest value for shares is their asset value[26], which is the company's net asset value per share. The basic idea in the asset value approach is to determine the value of shares from the perspective of the balance sheet. But the value of a company's assets in its financial statements is only the book value. This is normally the price that has been paid for the assets, so the individual assets are stated on cost basis rather than on value basis. The assets' book value is more a historical value than any real value since the aim of accounting principles is not to reflect actual business conditions[27].

It is possible to calculate a real asset value per share. This calculation requires that the value of a company's assets is known, but that is not generally so. The value of a company's assets should then be estimated. Yet, this valuation can be useless. For example, an industrial estate and machinery have a value for the company in its business but there may be no buyers for these assets. The liquidation value of a company's assets is typically less than the value of assets in a going concern. A company's assets are normally most valuable in its business; liquidation and break-up typically destroy rather than create value.

Physical assets have a declining role as the importance of intangible assets has grown dramatically. Traditional assets do not have any predominant role in business since companies create value to a large extent through processes and activities that are based on knowledge and innovation. It is pointless to calculate an asset value, for example for Microsoft Corporation.

In brief, the value of a company is rarely based on its assets. Furthermore, there are companies whose shares are systematically quoted under their asset value. It is

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[26] Shares have a nominal value, but that has a very restricted role in company law, and nothing to do with the real value of shares; see above, chapter two 2.2.2.

[27] *Re Press Caps Ltd* [1949] Ch 434 (CA) 441 (Somervell LJ): "but this figure, in accordance with what is very common practice, does not appear in the balance sheet as a valuation of the property as at the date of the balance sheet, but as its cost less depreciation"; Bodie and others (2005) 607: "The book value of a firm is the result of applying a set of arbitrary accounting rules to spread the acquisition cost of assets over a specified number of years."

paradoxical to notice that the net asset value is no market price for investment companies' shares; we know best their real asset value, however, these shares are generally traded at 20 per cent discount to it[28]. The asset value per share is no minimum, maximum, or real value of shares.

The value of shares follows the fortune of a company's business, but the value of its assets does not have a similar role. The asset value is not directly related to the earning power. It is unusual that the market price for shares is equal to their asset value. As a result, the net asset value is no right value for shares. In a going concern, it can only have a supporting role in share valuation[29]. Still, the asset value may have more importance when no other value is available, which is a quite normal situation especially in the case of a private company. Furthermore, asset value has a very central role when a company is liquidated because shareholders are then entitled to the value of a company's net assets[30].

4.4.3 Intrinsic value

Intrinsic value is an investment value for shares. The fundamental point is that shares derive value from the cash flow they generate. As Brealey formulates: "Investors are a mercenary bunch, and they prize common stocks only for what they expect to get out of them"[31]. This return is available in two forms: 1) shareholders receive yield, which is paid as a dividend; 2) shareholders can get capital gains when share price rises.

Intrinsic value for shares is calculated on the basis of the discounted future cash flows. The value of shares is the cash flow stream that they are expected to generate

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[28] See Kraakman, Reinier, 'Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive' (1988) 88 Columbia Law Review 891, 903; Jones, Charles P., *Investments* (8th edn New York 2002) 56; 'Low-priced investment trusts offer good value' Financial Times July 10 2004; and Shleifer and Summers (1990) 27: "When investors are bullish about closed-end funds, they drive up their prices relative to fundamental values, and discounts narrows or turn into premiums. When investors in contrast are bearish about closed-end funds, they drive down their prices and discounts widen."
[29] About this idea in company law, see above, chapter three 3.4.1.
[30] See below, chapter five 5.4.3.
[31] Brealey (1983) 67.

over their life, which amount should be calculated in today's money as a pound received today is worth more than a pound tomorrow. However, the main challenge for cash flow models is the nature of share investments: the return is unknown. Thus, the sum of future cash flows must be adjusted both by time and uncertainty. The value of shares then rests on the assumptions made.

Dividends, which are the periodic income from shares, have a fundamental role in share valuation. They are cash flows from the company to shareholders. The main benefit of shares is dividends; shares as objects are valuable in virtue of the utility of these payments. This is the central idea in dividend valuation models[32], where the assumption is that the value of shares should rest on dividend payments[33]. According to these models, the value of shares is the present value of future dividends. In brief, when these methods are used, share value is a function of the expected dividends and a discount rate.

Nevertheless, the main problem with dividend valuation is that the payment of dividends is not directly related to the prosperity of a company. There is no requirement that a company should pay dividends. For example, Microsoft Corporation paid a dividend for the first time in its history in 2003. But, of course, Microsoft's shares were valuable before that payment. Moreover, there is no sense to argue that Microsoft's shares would have been more valuable if the company had paid dividends earlier. We do not know, and neither does any financial model. In fact, the research of Miller and Modigliani proposes that a company's dividend policy has no impact on the valuation[34]. There should be no relationship between share value and dividend payments. On the

[32] See Choudhry and others (2002) 374ff, and as they explain there exist also dividend growth models; Davies (1986) 196 sees that the constant dividend growth model has become "the most widely employed theoretical valuation model."
[33] Eg Kay, John, *The Truth About Markets: Their Genius, their Limits, their Follies* (London 2003) 156, where he expects that dividends will receive more weight in share valuation; Brealey (1983) 68: the value of shares is the "discounted value of a continuing stream of expected dividend payments."
[34] Miller, Merton H. and Modigliani, Franco, 'Dividend Policy, Growth, and the Valuation of Shares' (1961) 34 Journal of Business 411; see also eg Copeland, Thomas E. and others, *Financial Theory and Corporate Policy* (4th edn Boston 2005) 688: "Dividend policy is irrelevant in all instances."

other hand, market oriented economists consider that a company's dividend policy gives signals to the market[35]. Share investors systematically prefer current dividends to capital gains later although investment theory says that they should not do so. Therefore, the market prices for shares with expected dividend payments may be higher than of those companies that do not pay dividends. In valuation of shares, the payment of dividends has more importance in practice than in theory[36]. Moreover, dividends have a different role in valuation of income and growth stocks. For these reasons, there seems be no firm answer to the role of dividends in share valuation.

Dividends are never enough for shareholders since they also expect to get capital gains due to the rising share price. Both dividends and capital gains are sources of cash flows to shareholders, who seek a return by way of income and anticipated capital gains. Simply, their total return is the sum of dividend payments and capital gains. In particular, when shares are 'growth stocks', the expected capital gains have much more importance than dividends. Naturally, dividends cannot have a crucial role when a company pays no dividends.

However, there is no sense just to suppose capital gains in future. Therefore, shares are generally valued by real business considerations and mainly on the basis of a company's profits. The earning power of the company is the most important determinant in share valuation. Its earnings are the real source of the future cash flows to shareholders; the value of shares is their proportionate share of these earnings. The prime method in share valuation from this perspective is the price-earnings (P/E) ratio[37], which figure shows the relation of share price to earnings per share.

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[35] Choudhry and others (2002) 378ff; Copeland and others (2005) 689; in addition, as they explain, due to the principal-agent concern and taxation, the payment of a dividend is never neutral to shareholders.

[36] Shleifer and Summers (1990) 26: "the Modigliani-Miller theorem does not apply in a world where sentiment affect security prices."

[37] Bodie and others (2005) 622: "Much of the real-world discussion of stock market valuation concentrates on the firm's price-earnings multiple"; Davies (1986) 200-1; and Siegel (2002) 95: "The most basic and fundamental yardstick for valuing stocks is the price-earnings (P-E) ratio"; however, he also sees, ibid 93, that the price of the stock is "always equal" to the present value of all future dividends

P/E ratios are quoted in financial newspapers, but these figures may be the current share price divided by the most recent earnings. Share investors, however, are more interested in the price relative to the future earnings. The expectation of future earnings growth is the most important single variable in the P/E ratio approach. Obviously, this point makes the price-earnings ratio problematic since investors need future information. The earnings of a company should be assumed using some financial calculation method; therefore, the computation can never be straightforward.

Price-earnings ratio has a role of a yardstick in evaluation of share value. The current figure can be high or low, yet a high P/E might show that investors think that the company has good growth opportunities. On the other hand, the P/E can be low because earnings are expected to remain moderate. Price-earnings ratio can be a misleading indicator for valuation: the multiplier needs explanations. These ratios may offer more comparative information than any firm knowledge about share value. Furthermore, a company that does not make profit has an infinite P/E ratio. In conclusion, the price-earnings ratio gives some relative information about share value, but a singular ratio is never right or wrong.

Dividends and a company's earnings are the fundamental points in stock valuation; still, neither of them is able to offer any right value for shares. Share valuation is more complex. Dealing with uncertainty requires sophisticated financial valuation methods, and during the last thirty years the fundaments of investment theory have transformed with huge steps. However, there exist strong controversies among academics and practitioners about the valuation. No theory or model is able to set the intrinsic value for shares since there are too many uncertain factors to reach a definite answer. It is almost impossible to prove whether a single calculation in the context of

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and not the value of future earnings, and so the valuing of shares through the discounted value of future earnings is "manifestly wrong and greatly overstates the value of a firm."

share valuation is correct or incorrect[38]. A share can have many intrinsic values because every person who makes the valuation reaches his own conclusion[39]. An intrinsic value can only be an estimate since the value reached rests on the assumptions and beliefs. Therefore, different models can just explain and interpret the ideas of valuation. Efficient markets offer more reliable estimate for share value than even the most advanced financial mathematics can provide. The result of markets "contains a wisdom that the theorists could not have replicated with pencil and paper alone"[40]. Different valuation methods can only assist investors in their investment decisions. The fundamental idea is that investors determine share prices on stock markets, where the principles of share valuation are translated into real-world practice.

4.4.4 Market value

Markets indicate the value of objects. The price at which a commodity is generally sold is its market price. Markets typically operate so that the price of any commodity "tends to uniformity"[41].

The market value of shares is what they are trading for today, ie the price that somebody pays for them at this moment. Shares obtain a value in exchange because their true value is the price available from markets. This current market price is normally an objective fact.

Since the volume of trades on stock markets is huge, shares can be bought and sold quickly, fairly, and efficiently. In efficient markets, the price of shares should be equal to their intrinsic value; in consequence, the market price forecasts the expected return from shares.

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[38] Jones (2002) 277.

[39] *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 38 (Plowman J): "the question of value is obviously one about which opinions may differ"; more below, chapter seven 7.3.2.

[40] Cowen, Tyler and Crampton, Eric, 'Introduction' in *Market Failure or Success* (Cheltenham 2002) 25; Davies (1986) 205: "It is unlikely that any satisfactory valuation will be possible in the absence of a market."

[41] Stigler, George J., *The Theory of Price* (4th edn New York 1987) 77.

The pricing on stock markets is distinctive since there is a bid-ask spread in pricing: investors can sell shares at the bid price and buy them at the ask price. Due to this spread, share markets in a way offer one price for buyers and another for sellers. However, in efficient stock markets the spread between these prices should be small.

Naturally, share transactions are completed at a certain price, which is a matter of bargain. A buyer acquires and a seller disposes shares according to an accepted pricing. Therefore, the parties of a transaction agree with each other about the price, but it does not mean that they have the same opinion about share value. Stock markets match bids and asks for shares, ie the personal valuation of a buyer and of a seller "interact to produce the 'exterior' values evident in the realm of exchange"[42]. Pricing in a market is not a co-operative operation as the interests of sellers and buyers are conflicting. A buyer's desire is a price that is as low as possible, and it is the opposite to the seller. Furthermore, every investor has an individual bid-ask spread because an investor's selling price for shares should be higher than the price he would himself be willing to pay for the particular shares. A rational investor does not buy and sell shares simultaneously at the same price.

Investors disagree about valuation because their beliefs about the return on shares are not homogeneous. The difference of opinions is the ultimate reason for all market transactions[43]. If investors do not disagree about the merits of share valuation, there would be no market transaction as no exchange will take place unless each party perceives some possible advantage for himself. When an investor values particular

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[42] Glover (1986) 1.

[43] Twain, Mark, *Pudd'nhead Wilson and Those Extraordinary Twins* (New York 2002) (originally 1894) 147 explains the basic idea of market transactions well: "it is difference of opinion that makes horse-races"; indeed, the shareholder in a public company may view the corporation as the holder of a betting slip views a racehorse; see Lipton, Martin and Rosenblum, Steven A., 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 University of Chicago Law Review 187, 194.

shares above their market price, he should acquire them[44]. In fact, share investors try to discover 'value shares', ie shares that are priced at a discount on their real value. By contrast, when an investor thinks that shares are less valuable than their current price, he sells them, and through the short selling he may sell shares even if he does not have them.

In reality, investors' assets are limited, and therefore a shareholder may sell shares even if he values them higher than the current market price because he prefers to acquire a more promising investment[45]. Investors desire portfolios that offer the highest expected return at the current level of risk. Valuation and investment decisions are always related to the prices of alternative investment products. As valuation is a relative concept, shares cannot be valued in isolation. Yet, as the success of investment is uncertain, investors can never really know whether they should buy or sell particular shares at the current price. Share transactions are always some kinds of educated guesses that take place on the market.

Investment theory says that prices on stock markets do not depend on the decisions of individual investors since every investor has only the role of a price taker, not of a price setter. The transactions made by a single investor should not have an appreciable impact on the prevailing share price. If an investor wants to buy or sell shares, he can do so at the market price. Capital market theories are therefore more interested in the behaviour of the market generally than the decisions of individual investors. The fundamental ideas of market mechanism propose that when a share is mispriced investors "tilt their portfolios toward the underpriced and away from the overpriced securities"[46]. The market mechanism corrects the mistakes in pricing, and

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[44] Eg Epstein, Richard A., *Simple Rules for a Complex World* (Cambridge, Massachusetts 1995) 250: "each person who acquires an interest in the firm will value it, at the time of purchase, more than the property or money paid to acquire that interest."

[45] Naturally, risk-seekers first 'gear themselves up' by borrowing money to increase their investment portfolio.

[46] Bodie and others (2005) 349.

the current price will immediately be the right one. As the anonymous market determines the prices of shares, Adam Smith's invisible hand operates on the stock markets too. In sum, the general presumption of the market economy is that the market should set prices right.

But the markets do not actually set prices, which is the task of investors. Their demand determines the prices and allocation of existing securities among them. In addition, market prices are, in fact, average prices as there are always investors that would sell shares at a lower price and those who would pay more for them. Through efficient markets everybody gets and pays the market price, which is the current consensus value for shares. As a result, a market is a system of proportional representation[47]. The price formation on well-operating stock markets is equal and democratic to every investor.

The market value of shares rests on economic expectations since their value depends on the future return. This relationship to the future makes valuation of shares complicated and their prices volatile. Moreover, the future price is not a single number, but rather a process in moving in time and subject to uncertainty[48]. Market price is a phenomenon since it is available only at the single moment. Share prices change rapidly: the most current price is immediately part of financial history. Theory of stock markets says that it is impossible to predict the future prices for shares as they follow the random walk hypothesis[49]. The unpredictability of share prices is a centrepiece in the efficient capital market hypothesis. Modern financial economics rests very much on these two hypotheses; however, both the random walk and efficient capital markets

[47] Friedman, Milton, *Capitalism and Freedom* (Chicago 1982) (originally 1962) 23.
[48] Luenberger, David G., *Investment Science* (New York 1998) 5.
[49] Eg Malkiel, Burton G., *A Random Walk Down Wall Street* (7th edn New York 1999); but see also Lo, Andrew W. and MacKinlay, A. Craig, *A Non-Random Walk Down Wall Street* (Princeton 1999), where they argue that market prices are predictable to some degree.

hypothesis are theories only[50]. The real stock market does not operate every time as predicted: economic reality is more complicated than theories[51]. Consequently, share markets are merely 'relative efficient'[52].

Share investment is not only science, but it is art too. The guessing of the market behaviour and the future share prices is central part of the investment business. Lord Keynes explains investment decisions in this way:

> professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.[53]

[50] About the collapse of the efficient market hypothesis, see above note 14; Grossman, Sanford J. and Stiglitz, Joseph E., 'On the Impossibility of Informationally Efficient Markets' (1980) 70 American Economic Review 393; 'Market inefficiencies prove we're only human' Financial Times October 25 2004.

[51] See Fama, Eugene F., *Foundations of Finance* (New York 1976) 168: economic models are "extreme simplifications of the world"; Coase, R. H., 'The Nature of the Firm: Meaning' in Williamson, Oliver E. and Winter, Sidney G. (eds), *The Nature of the Firm: Origins, Evolution, and Development* (New York 1991) 48, 52: "when economists find that they are unable to analyze what is happening in the real world, they invent an imaginary world which they are capable of handling."

[52] Lo and MacKinlay (1999) 7; Allen (2003) 552: stock markets are "pretty efficient".

[53] Keynes, John Maynard, *The General Theory of Employment, Interest, and Money* (New York 1997) (originally 1936) 156.

Of course, investors hope that the prices of shares they own rise in future, so they should be able to predict those ones that other investors will prefer. In particular, stock pickers try to find these kinds of shares.

Valuation of shares is a matter of taste and sentiment, and there exist investors with a different appetite. Some investors desire growth stocks, and some prefer value stocks. Further, share portfolios can be passive or active, and shares defensive or aggressive. Investment business is trendy business, where enthusiasm can lead to market bubbles and strong overshooting in valuation. A bull market, where shares are traded in a herd-like manner, may drive investors' expectations very high. For example, in the late 1990s the valuations of internet companies were absurd as the underlying motive to purchase shares was very speculative. Share prices separated from real values, but that bubble burst. Crashes and panics are part of security markets. In the end, the market will punish if shares are overvalued, and after crashes investors typically return to the basic valuation principles[54]. In general, stock markets are strongly driven by short-term price fluctuations. In addition, the structure of capital market incentives might push managers into 'manic efforts' to raise the price of shares. On the other hand, markets may undervalue shares if investors do not understand a company's long-term value[55]. These unpopular companies may then become interesting targets for corporate raiders.

Altogether, economic behaviour can be "impulsive and capricious," as Knight observes[56]. The wisdom of social science says: "the principal problem in understanding the actions of men is to understand how they think – how their minds work"[57]. As a result, share prices might sometimes be psychological rather than real. The common

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[54] Jones (2002) 15; 'Back to basics' Financial Times March 14 2005.

[55] See eg Lee, Paul, 'Investors and Long-term Shareholder Value' in Black, Andrew (ed), *Questions of Value* (London 2004) 3.

[56] Knight, Frank H., *Risk, Uncertainty and Profit* (Boston 1921) 53.

[57] Bridgeman, Percy, *Reflections of a Physicist* (2nd edn New York 1955) 450; quoted in Williamson, Oliver E., *The Economic Institutions of Capitalism* (New York 1985) 2-3; about behavioural finance, see eg Shleifer, Andrei, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford 2000).

expertise of markets can be wrong. However, the current market price is the most accurate value for shares whether there is boom or bust on the market. The market economy generally trusts on the operation of markets and their pricing.

Share value is not only linked to the prospects of a company since it follows the movements on stock markets in general, industry-wide conditions, and factors that are common to certain stocks. In addition, the value of stocks is related to macroeconomic climate. Normally, when interest rates rise, values of shares fall. For some companies, macroeconomic and industry circumstances may have a great influence on their profits and share prices. As markets pay a lot of attention to macroeconomic factors at national and international level, share investors may be more concerned about the macroeconomic development, for example in China than at the national level. Valuation of shares takes place in the overall financial environment. The valuation and pricing of shares is really an enormous guesswork.

The life of share investors may be hard: they have to deal with uncertainty. Valuation of shares is complex, and their value is a puzzle for the financial industry too. However, the main idea in market economy is that the operation of markets sets the prices, and through their common actions investors are expected to get share prices and values right. Shares are worth what investors pay for them, and shareholders should accept these prices if they want to buy or sell shares. The market can be right or wrong, but markets still offer the most reliable information about share value.

4.5 Liquidity of shares

Shares in public companies are marketable and mobile investment products. Liquid stock markets offer an exit option to investors. It is important that investors are able to convert their investment efficiently into cash. Shares are liquid when they can be bought and sold quickly with a relatively small price change.

Investors need both liquidity and diversification. As explained above, an investor is expected to do the best by diversifying his assets to different companies since both theory and practice support the idea that these portfolios are less risky than the concentrated ones. In addition, a diversified investment portfolio is more liquid because shares issued by several companies are easier to dispose. For investors, illiquidity means uncertainty about share prices, so these kinds of shares are more risky. Therefore, liquidity, in the same way as diversification, can make shares more valuable.

4.5.1 Liquidity versus control

Shares are transferable assets; on the other hand, shareholders have ultimate power in the company[58]. Shares offer liquidity on the market and control power in the company. Shareholders, like members of any organization, face a choice between 'exit' and 'voice'[59]. Further, liquidity and control are opposite and "antithetical" as there is a tension between them[60].

Investors who require liquidity do not desire control power. For these stock traders, a large share position in a company is typically unacceptable since that is not liquid. The Anglo-American stock market tradition sees that investors prefer liquidity to control. Modern corporations, where shareholders exchange control in a company for liquidity in the market, have a 'dispersed ownership structure'[61]. Share investors purchase liquidity at the cost of control[62]. In general, on stock markets exists preference for liquidity.

[58] See above, chapter two 2.4 and 2.3.2.
[59] Hirschman, Albert O., *Exit, Voice, and Loyalty* (Cambridge, Massachusetts 1970).
[60] Coffee, John C., Jr, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277, 1287-88.
[61] Berle, Adolf A., Jr and Means, Gardiner C., *The Modern Corporation and Private Property* (New York 1932) 286.
[62] Coffee (1991) 1329.

An investment portfolio that consists of shares in a single company is illiquid and hard to dispose. Indeed, selling of substantial share blocks is "a tricky exercise"[63]. A sale of a share block normally depresses the market price, and this discount is called 'blockage'[64]. Institutional investors with large share positions must accept price discounts in order to liquidate their shares[65]. Financial professionals and regulators understand that the selling of a big amount of equities causes a fall to share price[66]. For instance, new issues are generally sold below the price that shares subsequently trade because investors are encouraged to acquire the new shares. The Listing Rules accept that in open offers this issue discount can be up to 10 per cent of the current market price[67]. Naturally, share offerings and markets should not offer any real discounts but large stock transactions exert pressure on the market price of the particular shares. In brief, the pricing of shares follows laws of supply and demand.

In a similar way, buying a large block of shares raises the market price[68]. The law of demand plays an evident role in company takeovers, where an acquiring company is generally presupposed to pay a premium over the market price for the target's shares to get its control[69]. However, the ideas of share valuation do not require that a takeover price should be higher than the current market price, which is always the

[63] Cheffins, Brian R., *Company Law: Theory, Structure, and Operation* (Oxford 1997) 634; however, ibid 63, he also says that there are conflicting evidence about the prices at which blocks can be sold.
[64] Eg Glover (1986) 30: On the Stock Exchange large blocks of shares typically change hands at a discount to current market price."
[65] Coffee (1991) 1288-89; see also Stedman, Graham, *Takeovers* (London 1993) 87: "investors who hold large blocks of the target's shares may find that if they attempted to sell them in the market at the same time the price would fall"; still, some studies show that blocks are priced at substantial premiums, if large-block shareholders have been able to use their voting power to secure private benefits; see Barclay, Michael J. and Holderness, Clifford G., 'Private Benefits from Control of Public Corporations' (1989) 25 Journal of Financial Economics 371.
[66] Eg Asquith, Paul and Mullins, David W., Jr, 'Equity Issues and Offering Dilution' (1986) 15 Journal of Financial Economics 61, 61.
[67] UKLA Listing Rules 9.5.10.
[68] *Alabama Farm Bureau Mutual Casualty Co Inc v American Fidelity Life Insurance Co* (1979) 606 F 2d 602 (United States Court of Appeals Fifth Circuit) 611: "Of course, any person having rudimentary knowledge of securities trading would realize that a course of purchasing stock would tend either to increase the price of the stock or to avert a decline in price that might otherwise occur."
[69] About premiums, see eg Franks, Julian R. and others, 'Means of Payment in Takeovers: Results for the United Kingdom and the United States' in Auerbach, Alan J. (ed), *Corporate Takeovers: Causes and Consequences* (Chicago 1988) 221.

most accurate price for shares. It is the market mechanism that sets the premium since buying large quantities of shares inevitably bids up the price. As Stuart explains:

> The takeover bidder who wishes to purchase the stock of a target firm from its current shareholders must offer a price that meets or exceeds the shareholders' varying subjective estimates of value. Thus, purchasing larger and larger amounts requires the bidder to offer higher and higher prices.[70]

There will be no takeover if a bidder does not offer a price that shareholders of a quoted company widely accept. Obviously, a bid at the current market price offers shareholders nothing special. The bidder must pay a higher price to persuade them to sell shares to get the control in a company. The general ideas of supply and demand apply: more demand for shares means that their price rises until a new equilibrium through pricing is reached. Takeovers, like large share acquisitions in general, have influence on the market price. But pricing of shares cannot alone show whether these transactions create any extra wealth since it is this market mechanism that makes the premium[71].

Combining liquidity and power is difficult as conditions are seldom favourable for any stable and optimal mixture of exit and voice[72]. In companies, shareholders meet a trade-off between liquidity and control. Investors who strongly rely on exit have little interest in voice. In general, short-term investors prefer liquidity through markets, and long-term investors appreciate voting power in the company. Naturally, companies need both short and long-term shareholders, and capitalism should not focus too strongly on short-term market prices. In addition, both voice and exit can be overdone. Shareholder

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[70] Stout, Lynn A., 'Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law' (1990) 99 Yale Law Journal 1235, 1247.
[71] However, a central idea in many takeovers is to integrate a company's operations with those of the bidder, of course, there might then be available benefits that may make shares more valuable to the bidder; about takeovers, see more below, chapter seven 7.6.
[72] Hirschman (1970) 125.

activism may sometimes be a burden for the operation of a company; on the other hand, if shareholders sell strongly shares there is an immense danger of a price crash.

It is impossible to say whether liquidity or control is more important for shareholders. For some investors, the exit option prevails, and sometimes the voice option may be the main point. According to the Anglo-American stock market tradition, companies have dispersed shareholders that prefer liquidity to control. It is clear that liquidity is more valuable to shareholders with small blocks of shares because their shares are more liquid; therefore, these shareholders may 'vote with their feet'. When liquidity exists, it is a tempting choice, and some investors' sole interest is the liquidity. In contrast, power is more valuable to shareholders with large share positions because they ordinarily have real power in the company. In all institutions, the role of voice increases as the opportunities for exit decline. Moreover, a concentrated ownership structure in a company typically means that all the shares in the company become less liquid; thus, there are less liquidity benefits for any shareholder. But some investors, in particular, corporate raiders really want control power in companies. In conclusion, both liquidity and control are available through stock markets. Share investors have the choice since they may decide which one to desire. But due to the market mechanism, liquidity and control are costly, and therefore investors must be ready to pay a price premium to get them.

4.5.2 Value and price of liquidity

Every shareholder needs liquidity and markets for shares. Liquidity has an important role in investment decisions. Investors are willing to pay a higher price for liquid shares since these shares are easier to dispose. On the contrary, investors should get a financial compensation if they invest in illiquid shares. In general, small companies' shares have

a substantial liquidity risk[73]. Thus, investors are expected to pay a premium for liquid shares, and they get a discount for illiquid ones. Since the price of liquid shares is higher, liquidity increases the value of the particular shares. In contrast, illiquidity makes the price of shares lower, and so these shares are less valuable.

Illiquid shares are more risky to investors because of their market risk. But as investment theory says, markets should offer trade-off between risk and return. As a result, the expected return from illiquid shares should be higher: risks are priced through stock markets. Indeed, returns from shares with lower liquidity seem, on average, to be superior on the long run since shares that are "more sensitive to aggregate liquidity have substantially higher expected returns"[74]. Simply, share markets mechanism is able to price the liquidity of shares. Moreover, if the market operates efficiently, illiquidity is not only a risk to share investors because it is also an opportunity to get a higher return.

The idea in markets is clear: liquidity can increase share value. Markets set a price for liquidity, but the value of liquidity still rests on the decisions of investors. In consequence, it cannot generally be said how valuable liquidity is; we only know how liquidity is valued and priced on the stock markets.

4.5.3 Liquidity and the value of a company

A company's value follows its fortunes, and share value depends on the prosperity of the company's business. In principle, the value per share can be determined by dividing a company's overall value and earnings to every share, which is the central idea in cumputation of earnings-per-share ratios. On the other hand, the value of a quoted company is often calculated by multiplying the number of its all shares with the current

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[73] Eg Jones (2002) 133; Pastor, Lubos and Stambaugh, Robert F., 'Liquidity Risk and Expected Stock Returns' (2003) 111 Journal of Political Economy 642.
[74] Ibid 683; see also 'Minnows back in investors' favour' Financial Times March 11 2005.

market price. In this method, the value of a public company is derived from the price of its shares, not vice versa.

Yet, a company's market value is only a theoretical figure. First, investors do not buy companies; they can acquire shares only[75]. The market value of a company can be an informative figure, but not any real value or price[76]. Second, due to liquidity, we should not argue that the current market price for shares is the market value for all the shares. This kind of assumption is an oversimplification, which completely ignores the role of liquidity. The pricing of shares follows laws of supply and demand; therefore, to be able to buy every share in a company an investor should pay a market premium due to the market mechanism. In the same way, market price typically declines when blocks of shares are sold. In sum, the current market price for shares does not determine the value of all the shares in a company. As Stout explains: "the market value of the firm is the sum of the varying subjective valuations that each of its shareholders attaches to his or her holdings"[77]. A current market price for shares is not an accurate reflection of the market value of each and every one of a company's outstanding shares. From the perspective of shareholders, we can even say that they consider the value of their shares higher than the prevailing market price. Because share investors think in this way, they have originally acquired those shares. In addition, since they value their shares higher, they do not liquidate their investment at the current price. Once again, the decision about share value rests on shareholders. Until there are real share transactions, the value of a company's shares is unknown. Moreover, we should also notice that after these transactions, it is possible only to know the market price because the real value of shares may still remain hidden.

[75] See above, chapter three 3.3.1.
[76] As Glover (1986) 30 explains, the correct term is market capitalisation.
[77] Stout (1990) 1264.

Liquidity makes valuation of shares difficult because it can both increase and decline prices in share transactions. Liquidity means that a buyer must be willing to pay more to acquire a block of shares, which idea operates clearly in takeovers. Therefore, the value of a company's all shares should generally be higher than the value calculated on the basis of the current share price. Still, we cannot generally know what their value should be because shareholders set the value for shares. In conclusion, I state that liquidity really has an important role in the pricing of shares.

4.6 Value of shares in economics

Shares are valued on the basis of shareholders' expected return. A company's success in business, which is the source of shareholders' financial return, is the most important determinant in share valuation. However, as the future cash flows from shares are uncertain, the evaluation of shares is always an estimation resting on certain assumptions. Financial models are unable to set the intrinsic value for shares since there are too many unknown factors to reach a definite answer. Share value remains as a matter of an opinion.

In the market economy, markets determine prices, and this idea applies to shares too. Market value is the price at which buyers and sellers trade particular items in a marketplace. Market price is the real value for shares. In addition, due to market mechanism, liquidity has an important role in the setting of prices for shares.

As distinguished economists note: "Our world is a highly imperfect one, and these imperfections include the working of markets"[78]. On the one hand, it is true that stock markets are unable to set exactly right prices for shares since markets are never prefect. Share prices may diverge from the intrinsic share value. On the other hand,

[78] Cowen and Crampton (2002) 24.

economists and lawyers should not exaggerate the imperfections of markets[79]. Markets operate generally well, and market price is the most reliable value for shares. As a result, market prices deserve "substantial defence from courts and investors alike"[80]. A stock market quotation is "the best evidence of value" both in law[81] and in economics.

However, market transactions occur when share investors disagree about the value. Value and price have different roles in every market. Significantly, a buyer thinks he should acquire shares at the current price, but the seller considers that he should dispose them. There is no need to reach a consensus between them about the real value. Therefore, economists do not say that investors *should* buy or sell shares at the current market price; they think that it is important that investors *could* do so. Those economists who are the most in favour of the efficiency of markets might even argue that it is indifferent whether investors buy or sell shares at the current market price[82]. In sum, shareholders should have freedom of exchange.

Economists and markets cannot offer the *right* value for shares. The pricing of shares must rest on the decisions of share investors: the wisdom of markets comes from shareholders. Economists let shareholders determine the value of shares; moreover, they see that share value depends on the property rights. The ideas of property rights and freedom of contract are really central in the market economy. In essence, shares are intangibles, whose "value lies in the rights they embody"[83]. Shares are valuable because of shareholders' rights; further, shareholders have a general right to set the value for their shares. How are shareholders entitled to determine the value of shares? What law and the courts can say about share value? This theme is developed further in chapter seven.

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[79] See ibid.
[80] Allen (2003) 563.
[81] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA) 125.
[82] See eg Stout (1990) 1239.
[83] Pennington, Robert R., *The Law of the Investment Markets* (Oxford 1990) 2.

CHAPTER 5

EQUALITY OF SHARES

The great aim of the struggle for liberty has been equality before the law.
Hayek, F. A., *The Constitution of Liberty* (1960) 85.

5.1 The notion of equality

The aim of this chapter is to demonstrate that equality of shares is a point of great significance in company law; however, the companies' legislation does not explicitly declare shares equal. Rather, shareholders' status is more a matter of the company constitution and common law.

My perspective is pragmatic: the focus is on how courts consider shareholders' equal treatment under company law. The method used is inductive, ie the courts require that shareholders should be treated equally; thus, I argue that equality is a fundamental principle in company law. Since this argument rests on case law, my emphasis is on describing and explaining judicial reasoning. Further, as many important cases in the area are from the nineteenth century, I might have partly a historical view in this chapter. Even so, cases under review are still capable of demonstrating the current position of equality in company law.

Equality is not a simple concept. Moreover, it does not have any absolute nature since equality is not always "a standard to be rigidly applied"[1]. Yet, company law supports equality, and my intention is to review the equality that company law offers. The main point in this research is to propose that when shares have similar rights, their

[1] Walker, David M., *The Oxford Companion to Law* (Oxford 1980) 423.

value is equal *in law*. In this chapter, equality is reviewed generally, and share value itself is considered in chapter seven.

5.2 Equality and freedom

Equality and freedom are components of law, and they exist as elements in company law too. But legal concepts are often confusing, which point applies to both equality and freedom. Equality is a word with many meanings[2]. In addition, it is fair to say that English lawyers, and in particular business lawyers, are not enthused about equality[3].

5.2.1 Equality in law

It is said that equality is "at once the simplest and the most complex idea that shapes the evolution of the law"[4]. Nonetheless, this study tries to keep equality as simple as possible. My interest is equality before the law: in short, shareholders should be treated fairly according to the norms of company law. The aim of this study is to boost equality of rights and opportunities. To emphasize, my focus is not generally on economic[5], distributive[6], or natural[7] equality.

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[2] Bix, Brian H., *A Dictionary of Legal Theory* (Oxford 2004) 61: equality is "[a] basic concept in moral, political, and legal theory, but about which there is little agreement"; Dworkin, Ronald, *Sovereign Virtue – The Theory and Practice of Equality* (Cambridge, Massachusetts 2000) 2: "Equality is a contested concept: people who praise or disparage it disagree about what it is they are praising or disparaging"; Schwardzschild, Maimon, 'Constitutional law and equality' in Patterson, Dennis (ed), *A Companion to Philosophy of Law and Legal Theory* (Cambridge, Massachusetts 1996) 156, 169: "Equality is shorthand for many values, some of which conflict with one another, and some of which conflict with other values such as freedom."

[3] See eg Guest, Stephen, 'Why the Law is Just' (2000) 53 Current Legal Problems 31, 38: "Equality makes people think of bureaucratic, freedom-squashing, levelled-down socialism"; and also Tawney, R. H., *Equality* (London 1931) 24: "In England inequality is almost a religion."

[4] Fletcher, George P., *Basic Concepts of Legal Thought* (New York 1996) 121.

[5] As Nagel, Thomas, 'Equality' in Clayton, Matthew and Williams, Andrew (eds), *The Ideal of Equality* (Basingstoke 2000) 60, 60 explains, contemporary political debate recognizes four types of equality: political, legal, social, and economic.

[6] It is true that justice is not synonymous with equality, which is then, however, understood as distributive justice; see generally Dias, R. W. M., *Jurisprudence* (5th edn London 1985) 65ff; and in the area of company law especially Cheffins, Brian R., *Company Law: Theory, Structure, and Operation* (Oxford 1997) 472ff.

[7] About equal humanity and equality of result, see Weinreb, Lloyd L., *Natural Law and Justice* (Cambridge, Massachusets 1987) 167 and 176ff.

Consequently, as I see it, equality has two elements: equality in operation of legal rules and equality of opportunities to exercise one's will and employ one's substance[8]. First, shareholders are equal before the law, and those affected by the law are equal to one another. As a result, company law binds everybody: both majority and minority shareholders. Yet, this does not mean that every company law rule should have a similar effect on every shareholder[9]. Second, company law provides shareholders with similar opportunities when their rights are equal. On the other hand, a company might have different classes of shares, and obviously because the shares carry different rights they cannot be equal. But these kinds of shares are not a common practice in companies. In addition, their 'natural' inequality is a voluntary exclusion of the general principle. I stress that shareholders' rights are predominant: company law should protect these rights and offer corrective justice to shareholders. Moreover, as companies are governed by majority rule, equality is needed particularly to protect the interests of the minority. Majority power in companies is "subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities"[10]. Equality is one of these principles. This study aims to emphasize that equality is required in company law also to protect the equal value of shares. I argue that equality has a fundamental role in company law.

5.2.2 Freedom in law

In capitalism, free men are responsible for their own destiny: capitalism provides economic freedom. Obviously, capitalism does not mean that everybody may do whatever he pleases. For example, when someone owns something, it is his private

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[8] Pound, Roscoe, *The Spirit of Common Law* (New Hampshire 1921) 142.
[9] For instance, CA 1985 s 459 protects only minority shareholders but not majority shareholders; see *Re Baltic Real Estate Ltd (No 2)* [1993] BCLC 503.
[10] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) 671 (Lindley MR).

property, and ownership gives rights to the owner but law restricts others. Thus, there exists both positive and negative freedom[11]. This idea also prevails in company law.

The relationship between law and freedom is never simple. On the one hand, law and legislation restrict individual freedom: every law is contrary to liberty[12]. On the other hand, "the end of Law is not to abolish or restrain, but to preserve and enlarge Freedom"[13]. Further, without law the life of man would be "solitary, poore, nasty, brutish, and short," as Hobbes formulates it[14]. In sum, freedom is not a state of nature but an artifact of civilization[15]. Moreover, the existence of free markets does not eliminate the need for law. Legislation and government are essential as a forum to determine the 'rules of the game' and as an umpire to interpret and enforce the rules decided on[16]. Law makes freedom possible, and capitalism provides both freedom and law. This point is very true in the context of companies, which themselves are creatures of the law.

Liberty is the positive law's concrete recognition of individual freedom. The central legal elements in the capitalist society are property rights and freedom of contract. Therefore, law should offer protection to property rights and enforcement of contracts, which are of the utmost importance in the field of companies and shares too. Freedom in corporate capitalism is protected, supported, and restricted by the law. These restrictions of liberty are inevitable because shareholders' rights are created and shareholder protection is offered at the expense of some freedom.

[11] Berlin, Isaiah, 'Two Concepts of Liberty' in Liberty (Hardy, Henry, ed) (Oxford 2002) 166ff.
[12] Bentham, Jeremy, *The Theory of Legislation* (Ogden C. K., ed) (London 1931) 94.
[13] Locke, John, Second Treatise in *Two Treaties of Government* (Laslett, Peter, ed) (Cambridge 1960) (originally 1690) sec 57.
[14] Hobbes, Thomas, *Leviathan* (Waller, A. R., ed) (Cambridge 1904) (originally 1651) ch 13.
[15] Hayek, F. A., *The Constitution of Liberty* (London 1960) 54.
[16] Friedman, Milton, *Capitalism and Freedom* (Chicago 1982) (originally 1962) 15.

5.2.3 Synthesis of liberty and equality

Equality and liberty may contradict each other: attempts to advance equality might come at a cost in terms of freedom, and vice versa. However, Locke, Rousseau, and Kant, for example, consider that justice is found in a synthesis of liberty and equality. Justice can be realized by deducing social control through society from a postulated pact guaranteeing liberty and equality.[17] In a just social order, liberty and equality can be consistent[18]. Moreover, freedom can be derived from equality[19].

My argument is that company law supports both liberty and equality. It is a normal task of law to balance conflicting interests and values, although this might be difficult. Yet, company law sometimes prefers freedom and sometimes equality: in consequence, these principles cannot be absolute in their nature.

Company law aims to maximize satisfaction for the company as a whole, but it should also secure shareholders' fair participation in a company. It is possible to formulate this point by using the language of the law-and-economics movement: company law is interested in both the size of the pie and the slicing of it. This chapter reviews how this balance is kept in company law.

5.3 Equality as a presumption in company law

When all the shares in a company have similar rights and duties, these shares are equal. This equality, as in law generally[20], is based on proportionality: shareholders have in proportion to their shares an equal right to have a dividend in a going concern, and they get an equal share of the surplus if the company is wound up. Further, every shareholder has one vote for every share at general meeting. As the word share implies, shareholders share rights in the company.

[17] Pound, Roscoe, *Justice According to Law* (New Haven 1951) 24.
[18] Weinreb (1987) 10.
[19] Guest (2000) 42.
[20] See eg Finnis, John, *Natural Law and Natural Rights* (Oxford 1980) 163.

In the company, as in a partnership[21], there is a presumption of equality in the absence of agreement to the contrary[22]: both partnership law and company law still recognize the old maxim 'equality is equity'[23]. Equality should prevail if there is no good reason for any other basis for division[24]. This presumption is an important starting point in company law.

Shares are equal unless otherwise stated. But in a company with different classes of shares, shareholders' rights depend on the class of shares they hold. Further, shares may be issued with such rights and restrictions as the company by ordinary resolution determines[25]. The rights of those shares are then determined by the terms of issue or by the company's constitution.

However, quoted companies rarely have different classes of shares. Markets prefer companies with a straightforward share structure, and listed companies typically have only shares with similar rights. To focus on the heart of equality, I concentrate on companies where all shares fall within one class, and therefore the discussion does not cover special points concerning different classes of shares. Nevertheless, this study does not ignore different classes of shares because equality between different classes of shares is of great importance in company law. Moreover, case law on the equality of shares consists mainly of rulings governing companies with different classes of shares since this legal question has arisen especially when companies have ordinary and preference shares. Even so, those cases that have their main focus on class rights are very capable of explaining the equality of shares in general.

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[21] Partnership Act 1890 s 24(1).
[22] Sealy, L. S., *Cases and Materials in Company Law* (7th edn London 2001) 446.
[23] Eg *Re Accrington Corporation Steam Tramways Co* [1909] 2 Ch 40, 44 (Swinfen Eady J); in the case of husband and wife, see *Midland Bank plc v Cooke* [1995] 4 All ER 562 (CA).
[24] McGee, Andrew, *Share Capital* (London 1999) 8.
[25] Companies (Tables A to F) Regulations 1985 Table A ('Table A') art 2; by contrast, in the early case law it was held that a company could not alter its articles to issue preferred shares; see *Hutton v Scarborough Cliff Hotel Co Ltd* (1865) 4 DJ & S 672.

As mentioned, equality is one of the general principles of company law[26]. Further, the Second Company Law Directive Article 42 requires that Member States' laws "shall ensure equal treatment to all shareholders who are in the same position"[27]. In sum, I conclude that in English company law shareholders must be treated equally. To clarify the equality, I next review separately the notion of shareholders' equality in the case of economic surplus or loss, shareholders' pre-emption rights, and transfer of shares.

5.4 Equal economic surplus

Dividends and sharing net assets are the means by which shareholders are able to obtain their part of a company's economic surplus. A dividend is the company's profit paid to shareholders, and in a winding up shareholders share the value of a company' net assets.

Share capital has a central role in companies. Furthermore, a shareholder's main duty is to pay his shares. Hence, I start this review by analysing shareholders' equality in the payment of shares.

5.4.1 Payment of shares and responsibility for losses

Share capital represents equity investment in the company. It can be regarded as a financial fund that the company must have in order to operate. As shareholders' liability

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[26] See eg Davies, Paul L., 'The Notion of Equality in European Takeover Regulation' in Payne, Jennifer (ed), *Takeovers in English and German Law* (Oxford 2002) 9, 13; Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003) 618; further, Cheffins (1997) 492 sees that the presumption of equality "may play a useful role" in company law; in contrast, Drury, Robert, 'Fundamental Values in Company Law?' in Economides, Kim and others (eds), *Fundamental Values* (Oxford 2000) 339, 342 argues that equality is only a minimal presumption, but not a principle since companies may have several classes of shares.

[27] Second Council Directive 77/91/EEC [1977] OJ L 26/1, which applies to public companies; see Edwards, Vanessa, *EC Company Law* (Oxford 1999) 57, where she sees that this principle "is reflected " in UK company law; in addition, according to the UKLA Listing Rules 9.3.1, a listed company must ensure equality of treatment for all shareholders.

is limited, payment of share capital has particular importance if a company's business is unsuccessful and there are losses.

The main duty of shareholders is to pay their shares and this liability continues as long as anything is unpaid[28]. Ultimately, it is a fundamental idea in company law that shareholders' liability is limited. They are only obliged to pay the issue price of the shares that they have subscribed: their liability is limited to the amount unpaid on their shares[29]. This issue price must be at a minimum the nominal value of the shares[30]. But the issue price of shares is merely a matter of contract because there are only a few rules governing issue price in company law[31]. The current issue price is decided when particular shares are issued. The basic attitude of the law is freedom of contract in share issues[32]. In any case, shareholders' equality in this context means that every shareholder is responsible to pay his shares. In addition, limited liability has a central role in ensuring that all shareholders experience the same proportional gains and losses in the company[33].

If shares are unpaid, the pro rata principle means that losses should be borne by shareholders in proportion to the subscribed capital. This ruling can be found in *Ex p Maude*[34], where Mellish LJ explained this as the true construction and meaning of company law. He observed that if any other idea were adopted it would make the way in which losses are borne depending upon the accident of whether the assets of a company could be immediately realized, or whether it is necessary to make a call in order to pay the debts. Therefore, losses should be divided along the lines found in partnerships, ie in

[28] See *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125 (HL) 136.
[29] CA 1985 s 1(2)(a).
[30] [1892] AC 125 (HL); CA 1985 s 100
[31] *Hilder v Dexter* [1902] AC 474 (HL) 480 (Lord Davey): "I am not aware of any law which obliges a company to issue its shares above par."
[32] For shareholders' pre-emption rights, see below 5.5.
[33] Hansmann, Henry and Kraakman, Reinier, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387, 424; see also Manne, Henry G., 'Our Two Corporation Systems: Law and Economics' (1967) 53 Virginia Law Review 259, 262, where he notes that the lack of limited liability would discourage particularly wealthy individuals' share investments.
[34] *Re Hodges' Distillery Co, ex p Maude* (1870) LR 6 Ch App 51.

proportion to the amounts that shareholders have agreed to pay[35]. For this reason, in the case of an unsuccessful business, shareholders bear losses in proportion to the subscribed capital, whether some shares happen to be fully paid or not. As Lord Macnaghten explained in *Birch v Cropper*, where *Ex p Maude* was followed:

> "[a shareholder] does not by such payment acquire any further or other interest in the capital of the company. His share in the capital is just what it was before. His liability to the company is diminished by the amount paid. His contribution is merged in the common fund. And that is all.[36]

Indeed, equality prevails between fully and unpaid shares: no shareholder should be at an advantage or disadvantage if some shares are not fully paid[37].

In summary, shareholders have an equal duty to pay their shares. Further, if shares are not fully paid, responsibility for losses is divided between shareholders in proportion to the amounts they have agreed to pay for their shares.

5.4.2 Dividends

Companies normally pay dividends to shareholders. The doctrine of capital maintenance[38] requires that dividends can be paid from distributable profits only[39]. But my aim is not to explore the rules restricting distribution of dividends: the focus is on cases where dividends are declared; in other cases, it can simply be noted that shareholders have an equal right not to have a return[40].

[35] Ibid 56.
[36] (1889) LR 14 App Cas 525 (HL) 543.
[37] (1870) LR 6 Ch App 51, 57 (James LJ).
[38] See above, chapter two 2.2.2 note 45 and text thereby.
[39] See CA 1985 s 263ff
[40] About the right to a dividend, see above, chapter two 2.3.1.

In the CA 1985, there is no explicit provision requiring that payment of dividends should be *pari passu* or on any other basis[41]. Table A art 102 states that dividends should be declared "in accordance with the respective rights of the members." But fundamental ideas in company law in this point still follow partnership law. As North J explained in *Re Bridgewater Navigation Co*:

> The implication of law between partners is, that they share equally in profits unless their contract provides to the contrary, and the right of shareholders to an equality in dividend in the absence of any provision to the contrary, rests on the same principle rather than any implication as to the construction of the memorandum.[42]

Apart from any special provision the maxim 'equality is equity' should apply[43]. Further, if we take more precisely a company law perspective, we can note that in *Harrison v Mexican Railway Co* Jessel MR stated that:

> all the holders of shares are entitled to rank equally as regards dividend, without any preference or priority between themselves; but if it does clearly appear upon the articles of association that that was not the meaning of the original contract, then there is no such implication of law as to the meaning of the memorandum of association, that implication being rebutted by the clear terms of the contemporaneous instrument.[44]

[41] See also McGee (1999) 8.
[42] (1888) 39 Ch D 1 (CA) 9.
[43] *Re Accrington Corporation Steam Tramways Co* [1909] 2 Ch 40, 44 (Swinfen Eady J).
[44] (1875) LR 19 Eq 358, 365.

In addition, in *Hutton v Scarborough Cliff Hotel Co Ltd*, Lord Westbury simply considered that shares are "*inter se* equal and of equal rights and privileges" [45].

The fundamental view of the law is that a company's shareholders share its profits, which means that they have an equal right to dividends, unless the company constitution, or the terms of share issue, state otherwise. Further, while shareholders' rights are different in a particular company, there must exist different classes of shares. Actually, it is worth noting that when there has been disagreement about the equality of dividends, such companies typically have both ordinary and preference shares: in fact, all three quotations above are from these kinds of cases. Yet, when the main point is the right of ordinary shares to dividends, it is possible to quote Davies' canons of construction:

> *Prima facie* all shares rank equally. If, therefore, some are to have priority over others there must be provisions to this effect in the terms of issue.[46]

Ordinary shares have an equal right to dividends. As Lord Macnaghten said in *British and American Trustee and Finance Co Ltd v Couper*[47]: "it follows as a self-evident proposition that the interests of the shareholders in respect of their shares as regards dividend and everything else must be equal."

But before I leave the question of dividends, there is one very important dimension to review, which is the relationship between the payment of shares and the amount of dividends. I discussed above the notion of losses if some shares are unpaid.

[45] (1865) 4 DJ & S 672, 677, it should be noted that in this decision equality of all shares was seen as a part of the company's nature and as a fundamental principle; thus, it was considered that it is not possible to alter the articles to allow the issue of preferential shares, but this ruling was later explicitly overruled and alteration authorised by *Andrews v Gas Meter Co* [1897] 1 Ch 361 (CA).

[46] Davies (2003) 621; it should be mentioned that in the current edition there is no reference to any case but there was still an explicit reference to *Birch v Cropper* in the 4th edition of the book; see Gower, L. C. B., *Gower's Principles of Modern Company Law* (4th edn London 1979) 421.

[47] [1894] AC 399 (HL) 417.

Now I explore the sharing of profits under the similar circumstances. Naturally, the significant point is whether dividends should be paid in proportion to the nominal value or the amount really paid upon when a company has partly paid shares.

The House of Lords' decision in *Oakbank Oil Co v Crum*[48] gives explicit answers to this question. The company's articles stated that the dividend is "to be paid to the members in proportion to their shares"[49]. However, it actually paid dividends in proportion to the amount paid upon shares. A shareholder, who was a recent purchaser of shares, challenged the principles on which dividends had hitherto been allocated. This shareholder was successful since the House of Lords affirmed the decision of the court: all shares were entitled to participate equally in dividends, without regard to the amount paid upon them. Because the articles stated that the dividend should be paid in proportion to shares, there was no doubt that the term 'shares' could only mean their nominal value. English company law still follows this decision: dividends are payable to shareholders in proportion to the nominal value of shares, and thus irrespective of the amounts paid up. This principle is affirmed by The House of Lords, in particular, in their decision of *Birch v Cropper*[50].

Of course, it is possible to ask whether it is fair that partly paid shares, or even totally unpaid ones, get an equal dividend with fully paid shares. First, the main argument against payment of dividends in proportion to the paid-up capital is that it would totally ignore the point that shareholders are in any case liable to pay for their shares because their "whole liability remains to the extent to which it has not been satisfied by paying it," as Lord Selborne noted in *Oakbank Oil Co v Crum* [51]. In this case, he further explained shareholders' liability in these words:

[48] (1882) LR 8 App Cas 65 (HL) (Sc).
[49] It was a copy of the Companies Act 1862 Table A art 72.
[50] (1889) LR 14 App Cas 525 (HL).
[51] (1882) LR 8 App Cas 65 (HL) (Sc) 70.

> a man may make himself liable to a large amount for the engagements of the company, which he may eventually be called upon to pay, and that he has, until he has actually been called upon to make that payment, no interest which can possibly make it reasonable that he should share in a dividend in respect of what has not been paid up, does not seem to me to be a proposition so plainly and obviously reasonable as to make it wise to approach the construction of any instrument with the presumption that this must certainly be its meaning.[52]

The relationship in a company is not so simple that it would be possible to say that it is right and fair to pay dividends in proportion to the amounts paid up on shares. Shareholders do not by such payment acquire any further interest in the capital of the company[53].

Second, as Lord Selborne stated, the right to dividends must depend "entirely upon the true construction of the contract contained in the memorandum and articles of association of this company"[54]. There was no reason to argue whether it is fair or not to pay an equal dividend to every share when it was fair and right to pay shareholders those dividends that were agreed to pay. This was the correct way, although it might have been reasonable and fair that dividends in this particular company had been paid in proportion to paid-up capital[55], but those particular articles stated otherwise. As Lord Blackburn declared, it was not a matter for their Lordships to consider what the right or the best course was; by contrast, they decided the true construction of these articles and the actual contract in this company[56]. Their arguments clearly support the contractual nature of the company and shareholders' rights. In sum, shareholders should participate

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[52] Ibid.
[53] (1889) LR 14 App Cas 525 (HL) 543.
[54] (1882) LR 8 App Cas 65 (HL) (Sc) 69.
[55] See ibid 70 (Lord Selborne) and 80 (Lord Fitzgerald).
[56] Ibid 75-76.

in dividends equally, also in the case of unpaid shares if it is not particularly agreed otherwise.

On the other hand, in accordance with CA 1985 s 119, a company authorised by its articles may pay dividends in proportion to the amount paid upon each share. A company can, through its constitution, determine that shareholders are not entitled to receive the same dividend if there exist shares that are not fully paid. Really, the articles generally do so while Table A art 104 declares that "[e]xcept as otherwise provided by the rights attached to shares, all dividends shall be declared and paid according to the amounts paid up on the shares." In fact, art 104 has thus turned the assumption in *Oakbank* around because dividends are paid according to the paid up amounts if it is not determined otherwise by the company constitution.

While quoted companies do not typically have unpaid shares, the rule governing the payment of dividends to unpaid shares might not have particular practical importance. Nevertheless, both common law and statutory rules clearly imply that there is a strong presumption for shareholders' equal dividend: the payment of dividends in proportion to the amount paid up on shares is possible only if it is authorised by the articles. Although art 104 of Table A generally does it, the main presumption of law remains that every share should get the same dividend. Shareholders are entitled to participate in dividends equally unless the contrary is stated. In addition, since my prime interest is fully paid ordinary shares, it is clear that these shareholders have an equal right to dividends.

5.4.3 Sharing of net assets

Shareholders share a company's surplus assets if the company is wound up, which can be done voluntarily by a decision at general meeting or compulsorily by the order of the court[57].

In the context of the sharing of a company's net assets, the story of Bridgewater Navigation Company is of special significance. There are four reported cases concerning this company and the sharing of assets in a winding up: 1) a decision by North J and the Court of Appeal[58], 2) which was reversed by the House of Lords[59]; and 3) one further decision by North J[60], 4) which this time was varied by the Court of Appeal[61]. In this research, there have been some references to the first two cases, which are the most interesting ones in this saga.

The facts, described briefly, were that Bridgewater Navigation Company was a canal company, whose working plant was transferred by a special Act of Parliament to another company. Because all the business had been sold, it was decided that the company should be wound up with a view to distribute the purchase money to shareholders. The company had both ordinary and preference shares, and furthermore some of its shares were not fully paid. According to the company's articles, preference shareholders were entitled to a preference dividend of 5 per cent but they had no preference to capital. After the payment of such a preference dividend, all the remaining profits were divisible among shareholders.

However, first it should be mentioned that the legal question considered in the series of cases was not the paying of dividends, because the litigation arose during the

[57] See Insolvency Act 1986 ss 84 and 122.
[58] *Re Bridgewater Navigation Co* (1888) LR 39 Ch D 1 (CA).
[59] *Birch v Cropper in Re Bridgewater Navigation Co Ltd* (1889) LR 14 App Cas 525 (HL).
[60] *Re Bridgewater Navigation Company* [1891] 1 Ch 155.
[61] *Re Bridgewater Navigation Co* [1891] 2 Ch 317 (CA).

winding up. A company can no longer pay dividends at this stage[62]. Further, both preference and ordinary shareholders had received their dividends. The articles clearly stated preference shareholders' right to the dividend and that dividends should be paid in proportion to the amount paid up on shares. Dividends were paid in accordance with the articles; in effect, there was no disagreement about their payments. Overall, the ruling in *Oakbank Oil Co v Crum* was followed in this case although nothing was explicitly declared about dividends. Obviously, there was no need to rule anything about shareholders' right to dividends since that was not the main point in the case. But significantly, *Birch v Cropper* is a case that rules about the division of profits and net assets more generally than *Oakbank* did. Therefore, it might be possible to refer just to *Birch v Cropper* when it is argued that in accordance with English company law dividends should be paid in proportion to the nominal capital, and thus irrespective of the amounts paid up[63]. Yet, I think that the main authority as far as it concerns payment of dividends is *Oakbank* as explained above.

The disagreement in *Birch v Cropper* was about the sharing of net assets since the articles stated that the dividend should be paid in proportion to the paid up capital, but the articles contained no provision governing the distribution of assets in winding up. In addition, ordinary shares were partly paid up, but preference shares were fully paid. Therefore, these preference shareholders, of course, argued that net assets should be divided in proportion to the paid up capital; in contrast, ordinary shareholders were in favour of a division in proportion to the nominal capital. In any case, in the dissolution the company first returned to all shareholders their paid-up capital, and in this process the liquidators adjusted shareholders' unequal contributions[64]. As a result, it was first calculated whether there existed any surplus to share among shareholders. In

[62] Eg *Re Crichton's Oil Company* [1902] 2 Ch 86 (CA) 95 (Stirling LJ): "after the commencement of a winding-up dividend is no longer payable."
[63] For example, Morse, Geoffrey, *Charlesworth Company Law* (17th edn London 2005) 491.
[64] In accordance with Companies Act 1862 s 133.

this case, there remained a large part of the purchase money that should be divided to shareholders.

In their ruling of *Re Bridgewater Navigation Co*[65], the Court of Appeal held that "the true equitable mode"[66] is to share net assets in accordance with the amounts paid up on shares. Yet, the House of Lords considered otherwise: their Lordships reversed this decision by the Court of Appeal. In *Birch v Cropper*[67], it was ruled that liability of shareholders for the unpaid balance of their shares must not be regarded. Therefore, net assets should be divided, not in proportion to the amounts paid on shares, but in proportion to the shares held. As Lord Herschell explained their ruling, this point was to be "determined upon general principles of equity"[68], and thus "the determination of the question at issue must be arrived at upon principles wider and of more general application"[69]. He further observed that no principle can be laid down ensuring perfect equality, but the principle adopted by the Court of Appeal appeared in his view "to raise the inequality to a maximum"[70].

What were their Lordships' main arguments in their decision? First, they followed explicitly *Ex parte Maude*[71]: since the articles were silent, it would be natural and equitable that both losses and benefits should be shared in the same proportion, which is pro rata in proportion to the subscribed capital. Second, their observations were similar to those in *Oakbank Oil Co v Crum*[72]: shareholders' liability must have special importance, and it should be treated as a contribution as valuable as the actual paid capital. Lord Herschell gave an extreme opposite example of thought when he explained that if all ordinary shares were actually totally unpaid, then these shares would have no

[65] (1888) LR 39 Ch D 1 (CA).
[66] Ibid 25 (Cotton LJ).
[67] (1889) LR 14 App Cas 525 (HL).
[68] Ibid 531.
[69] Ibid 533.
[70] Ibid.
[71] *Re Hodges' Distillery Co* (1870) LR 6 Ch App 51.
[72] (1882) LR 8 App Cas 65 (HL) (Sc).

economic right or interest in the company if it were seen that shareholders share net assets only according to the amount paid up on shares. Naturally, this idea could not pass any test of equity.[73] As a result, the ruling of the House of Lords was that net assets ought to be divided among shareholders in proportion to the shares held, not in proportion to the amounts paid up on them. This is the ruling of *Birch v Cropper*, which as a principle governs division of losses, dividends, and net assets in English company law.

In addition, it should be noted that the House of Lords in *Birch v Cropper* was clearly willing to distinguish companies from partnerships. By contrast, in *Griffith v Paget*[74] Jessel MR considered that the general principles of partnerships should apply to companies that actually, in his view, are commercial partnerships although subject to certain statutory limits. In this case, the Master of the Rolls formulated the status of partnership law in this way:

> When the partnership comes to an end, the right to the share of profits comes to an end also; and you distribute the assets, after providing for the profits earned up to the time of the dissolution, in proportion to the partners' shares of the partnership capital. That is the general rule of law in a commercial partnership.[75]

Indeed, according to then prevailing partnership law on a final settlement of accounts the capital of the business should "be divided amongst the partners in the proportions in which they contributed it and not equally"[76].

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[73] (1889) LR 14 App Cas 525 (HL) 535.
[74] (1877) LR 6 Ch D 511.
[75] Ibid 515.
[76] Lord Lindley in his Supplement on the Partnership Act 1890; quoted from I'Anson Banks, R. C., *Lindley & Banks on Partnership* (17th edn London 1995) 500; but in modern partnership law the point is differently; see ibid 500-1 and 541.

But their Lordships pointed out very explicitly in *Birch v Cropper* that companies are not partnerships, and therefore partnership law does not apply to them. As Lord Fitzgerald formulated it:

> The error seems to me in supposing that there is an exact analogy between an ordinary commercial partnership and a statutable undertaking called into existence under the Joint Stock Companies Act and regulated by the statute and its own memorandum of association and articles. There may be likeness in some particulars, but there is no real analogy.[77]

In a very similar way, Lord Macnaghten considered that shareholders' rights depend on the principles applicable to companies and the provisions of the Companies Act, but as he added, it was "rather beside the mark to discuss the general doctrines of partnerships and to examine particular cases of partnership contracts"[78]. He continued that "[t]he scheme of the Act and the directions to be found there are, I think, a safer guide than any analogies can be"[79].

Their Lordships in this decision formulated a company law principle from the background that companies are really companies, not partnerships, which are governed by their own act and the company constitution. The questions of company law should be decided in their own scheme, and rules in company law can be different from partnership rules. Hence, *Birch v Cropper* is an important case in the development of company law. It is part of the story of how company law became a discrete subject.

In essence, *Birch v Cropper* was a ruling concerning different classes of shares, and so the legal question in the cases where it has been explicitly followed has typically

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[77] (1889) LR 14 App Cas 525 (HL) 541.
[78] Ibid 543.
[79] Ibid.

been the same: whether preference shareholders have a right to participate in the company's surplus assets. For example, as Astbury J stated in *Re Fraser and Chalmers Ltd* [80]: "All shareholders are entitled to equal treatment unless and to the extent that their rights in this respect are modified by the contract under which they hold their shares." Thus, the provision that gave preference shareholders a priority for repayment of capital in winding up did not negate their right to participate in surplus assets. It was generally considered that although preference shareholders have a preference to repayment of capital, they still share surplus assets[81]. So, if the memorandum and articles contained no provisions for the point of surplus, net assets must be divided equally in winding up among all shares. This idea was prevailing in company law after *Birch v Cropper* as far as it concerned the rights of ordinary and preference shareholders in winding up. Although my special interest is not the rights of different classes of shares, I cannot leave the story of Bridgewater Navigation Company before mentioning three important points.

The first one, preference shares in Bridgewater Navigation Company were entitled to a preference dividend of 5 per cent, but the rest of the annual profits belonged to ordinary shareholders. On the other hand, following the House of Lords' ruling in *Birch v Cropper*, all shareholders were after that payment equally entitled to surplus assets in winding up. The problem is: what were profits and what were surplus assets? This explicit question arose in the following *Re Bridgewater Navigation Co*[82] cases, where the Court of Appeal declared that the special funds in the company were actually profits, not assets. However, it might be very artificial, and even absurd, to investigate the origin of any surplus assets, as Lord Simonds in *Scottish Insurance Co Ltd v Wilson*

[80] [1919] 2 Ch 114, 120.
[81] See eg *Re Epsuela Land and Cattle Co* [1909] 2 Ch 187; *Re William Metcalfe and Sons Ltd* [1933] 1 Ch 142 (CA).
[82] *Re Bridgewater Navigation Company* [1891] 1 Ch 155; [1891] 2 Ch 317 (CA).

& Clyde Coal Co Ltd[83] later pointed out. In that case, Viscount Maugham declared he had doubts about whether the Court of Appeal reached the correct decision in their above-mentioned decision [84]. But in English law there seems to be no case that actually overrules this Court of Appeal decision in *Re Bridgewater Navigation Co*. Still, that decision is generally just distinguished by the courts[85]. As Davies notes, the last one of *Bridgewater* cases can be ignored[86]. I do so since my prime focus is on the rights of ordinary shares. Yet, my conclusion is that the Court of Appeal's ruling in *Re Bridgewater Navigation Co* about this point has never explained the real position of law well.

The second matter, which later arose as the legal question in several cases, is whether the rights of preference shareholders as mentioned in the articles are exhaustive. In this point, the House of Lords ruling concerning preference shareholders' right to dividends in *Will v United Lankat Plantations Co Ltd*[87] has distinctive importance. In this company, preference shareholders were entitled to a cumulative preferential dividend at a rate of 10 per cent per annum on the amount for the time being paid up on shares. However, there was nothing explicitly mentioned about whether preference shares are entitled in any other way to share profits. But almost twenty years after preference shares had been issued in accordance with the company's general meeting resolution, there arose disagreement about how the substantial profits should be distributed among ordinary and preference shareholders.

The House of Lords held that in the distribution of profits preference shares were not entitled to anything more than 10 per cent dividend. They affirmed the ruling of the Court of Appeal that preference shareholders' right to dividends stated by the

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[83] [1949] AC (HL) (Sc) 462, 489.
[84] Ibid 482; however, the report of the case, ibid 463, mentions that *Re Bridgewater Navigation Co* [1891] 2 Ch 317 (CA) was approved.
[85] *Re Catalinas Warehouses and Mole Co Ltd* [1947] 1 All ER 51; *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353; *Re Saltdean Estate Co Ltd* [1968] 1 WLR 1844.
[86] Davies (2003) 622.
[87] [1914] AC 11 (HL).

company's articles was exhaustive: consequently, these shares were not entitled to participate in any further profits. In their judgment, Viscount Haldane[88] made an observation that the case raised "a question of great interest from a business point of view, but it is difficult to see how it can be said to raise any question of general legal principle," because he considered that the point of dispute is one of construction that is always related to the terms of the particular instrument, which in this case was the articles of association. He added: "it is only to a limited extent that other cases decided upon different documents afford any guidance." His fundamental point was that their Lordships should only decide what the rights of preference shareholders were in this case and under the particular articles of this company.

In their ruling, Viscount Haldane stressed the contractual nature of the articles with the following words:

> My Lords, I should have thought that if we were dealing with an ordinary case of two individuals coming together, and if a document were produced saying 'You are to have a cumulative preferential dividend of 10 per cent.' or whatever might be the equivalent in the circumstances of the bargain, it would be naturally concluded that that was the whole of the bargain between the parties on that point. You do not look outside a document of this kind in order to see what the bargain is; you look for it as contained within the four corners of the document.[89]

He did not hold that the articles are silent about the terms of distribution; thus, it was reasonable to expect to find all the rights regarding dividends specified in the terms of

[88] Ibid 15ff.
[89] Ibid 17.

issue. Earl Loreburn[90] agreed and considered that the right of preference shareholders should be construed as they stand in the articles. In addition, he regarded the whole case as "an attempt to add to terms of the contract by screwing something out of the articles which the framers of the contract ... [n]ever thought of." Lord Atkinson[91] shared their view and came "to the conclusion that the dividend prescribed was the only dividend the shareholder was to receive." As a result, preference shareholders were entitled to their preferential dividend only.

Ultimately, this House of Lords' ruling in *Will v United Lankat Plantations Co Ltd* shows the current status of law as far as it concerns preference shareholders' right to dividends. The rights as stated in any relevant document are exhaustive since preference shareholders have a right to the dividend expressly stated, but they do not share any further dividends[92].

The third point is an inevitable consequence of the second one: if the right of preference shareholders to dividends is exhaustive, the question arises whether the same idea applies to net assets. *Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd*[93] is the landmark case in the area, and in this case the ruling of *Birch v Cropper in Re Bridgewater Navigation Co Ltd*[94] was explained. While in *Birch v Cropper* Lord Macnaghten pointed out that preference shareholders "must be treated as having all the rights of shareholders, except so far as they renounced those rights on their admission to the company"[95], by contrast, in *Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd* Lord Simonds explained these remarks in this way:

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[90] Ibid 18-19.
[91] Ibid 19.
[92] See *Re Isle of Thanet Electricity Supply Co Ltd* [1950] 1 Ch 161 (CA) 171 (Wynn-Parry J).
[93] [1949] AC 462 (HL) (Sc).
[94] (1889) LR 14 App Cas 525 (HL).
[95] Ibid 546.

> But, in my opinion, Lord Macnaghten can have meant nothing more than that the rights of the parties depended on the bargain that they had made and that the terms of the bargain must be ascertained by a consideration of the articles of association and any other relevant document, a task which I have endeavoured in this case to discharge. I cannot think that Lord Macnaghten intended to introduce some new principle of construction and to lay down that preference shareholders are entitled to share in surplus assets unless they expressly and specifically renounce that right.[96]

Indeed, in common law the future generations of judges develop law further. In this case, Lord Simonds and the majority of the House Lords[97] performed this task when they held that there is no rule in law that preference shareholders should equally share surplus if otherwise is not explicitly and specifically stated in the articles. Their Lordships clearly considered that the consistency of preference shareholders' rights in law is important. As Lord Normand expressed the point:

> I see no ground on which it may be supposed that the declaration of rights as regards dividends is exhaustive, but the declaration of rights as regards property is not exhaustive. There is as good reason and it is equally easy to define exhaustively the one set of rights as the other.[98]

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[96] [1949] AC 462 (HL) (Sc) 490.
[97] Lord Morton dissenting.
[98] Ibid 496.

Therefore, while until 1949 "the balance was strongly"[99] in favour that preference shareholders also have a right to further participation in the case of surplus assets, by this ruling the House of Lords overruled this assumption in company law.

The ruling of *Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd* explains the current status of law too. The presumption of the law is that if preference shareholders have a preference as far as the repayment of capital, the rights set out in the document describe the totality of their rights to capital. In the same way as with dividends, the description of their rights is exhaustive. In brief, when a preference to capital is given to preference shareholders, they do not participate in any surplus remaining after that capital has been repaid unless an express right is given[100].

All three points above mean that, in fact, the cases of Bridgewater Navigation Company were only a start in a saga of rulings governing preference shareholders' rights. Further, quite a long series of court rulings after them has not been a very rational story. For example, Davies notes that "the courts have had to evolve various canons of construction which, even more unfortunately, have fluctuated from time to time, thus overruling earlier decisions and defeating the legitimate expectations of investors who purchased preference shares in reliance on the construction adopted earlier"[101]. However, he is able to add that: "a reasonably clear finale now appears to have been reached"[102]. In summary, the prevailing idea in law is that preference shareholders' rights are exhaustive in their stated form.

Nevertheless, the story of Bridgewater Navigation Company explains the present notion of shareholders' equality. Case law after *Birch v Cropper* has mainly

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[99] Mackinnon, K. W. and Buchanan-Dunlop, R. (eds), *Palmer's Company Precedents*, vol 1 (17th edn London 1956) 779.
[100] *Re Isle of Thanet Electricity Supply Co Ltd* [1950] 1 Ch 161 (CA).
[101] Davies (2003) 621.
[102] Ibid.

focused on the presumption concerning preference shareholders' rights[103]. The general presumption of company law is, however, that shareholders have equal rights in the company unless otherwise agreed by the issue documents, by the articles, or by the memorandum. Fundamentally, in the case of ordinary shares there is no reason to consider that the rights of these shares could be different. To conclude, ordinary shareholders should equally share the net assets of a company in the same way as they are responsible for losses and share dividends.

5.4.4 Reduction of capital

Share capital can be returned to shareholders following the statutory procedure concerning reduction of capital. In consequence, shareholders share the assets of the company, and the only aim of a reduction can be distributing a company's assets to its shareholders[104]. Further, there are many similarities with division of net assets and reduction of capital. But it is important to notice that reduction of capital is governed by its own special rules under company law.

Under CA 1985 s 135, a company may reduce its share capital subject to confirmation by court. In addition, a special company resolution is required, and in the articles there must be an authorisation to do so[105]. A company might wish to reduce its share capital when that is much greater than its net assets, or just return money to shareholders. In the latter case, capital is simply divided to shareholders. Nevertheless, due to the nature of share capital great importance is placed on the interests of creditors when share capital is reduced, but that is not the prime subject in this study. The focus is on how assets should be divided among shareholders in reduction of share capital.

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[103] Thus, the onus of proof about their rights is thrown to preference shareholders, but the rights of shareholders is a matter of the particular documents; see *Re Isle of Thanet Electricity Supply Co Ltd* [1950] 1 Ch 161 (CA) 167; 173 (Wynn-Parry J); *Re Powell-Cotton's Resettlement* [1957] 1 Ch 159.
[104] *Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd* [1949] AC 462 (HL) (Sc).
[105] See also Table A art 34.

Overall, CA 1985 s 135 authorises a company to reduce its share capital "in any way"; therefore, any scheme of reduction can be sanctioned by the court[106]. According to CA 1985 s 135(1)(c), a company may pay off any paid-up share capital that is excess to its wants. When the court is satisfied that the interests of creditors are secured, it may in accordance with CA 1985 ss 136 and 137 make an order confirming the reduction on such terms and conditions as it sees fit. The principal purpose of requiring the confirmation from court is to ensure that formalities especially protecting creditors have been strictly observed and that the reduction treats shareholders fairly[107]. I ask how shareholders are treated fairly.

In *Re Jupiter House Investments (Cambridge) Ltd*, Harman J explained the way in which shareholders should be treated and the court's discretion in this way:

> The discretion ... will, however, only be exercised in favour of confirmation of the reduction where the court is satisfied (a) that the proposed reduction affects all shareholders of equal standing in a similar manner, or that those treated in a different manner from their equals have consented to that different treatment.[108]

He put it clearly and precisely: shareholders should be treated equally in reduction of capital; moreover, shareholders may be treated in a different manner only if they accept it. As a result, court practice requires that shareholders must be treated equally[109], ie in a similar way. If shareholders are treated in another way, the court does not accept the reduction of capital. In brief, shareholders' equal treatment is the requirement of the courts in the reduction of share capital.

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[106] *Poole v National Bank of China Ltd* [1907] AC 229 (HL).

[107] Davies (2003) 243-44; about matters relevant to confirmation, see also *Gore-Browne on Companies*, vol 1 (45th edn Bristol) (loose-leaf) 26[5] (Update 50).

[108] [1985] 1 WLR 975, 978.

[109] *Re Ratners Group plc* (1988) 4 BCC 293, 295; *Re Thorn EMI plc* (1988) 4 BCC 698, 701 (Harman J), where he used the word "equitably".

On the other hand, the courts have discretion in reduction of capital. In *Re Barrow Haematite Steel Co*[110], it was explicitly stated that it is not essential that the reduction should be made equally on all shares, although prima facie in the absence of any agreement to the contrary the reduction ought to made in that way. North J explained:

> The Act provides for the reduction of the capital, and the capital of the company may be reduced, for instance, by-one fourth, either by reducing the shares all around by one-fourth, or by reducing half of them by half, and the other half not at all.[111]

As he stated, it is possible that the reduction may be applied to some shares only. The reason for the partial reduction in this case was the loss that the company had sustained. Therefore, North J adopted the rule that the reduction must be borne by those shares upon which the loss sustained ought to fall. As a conclusion, he ruled:

> If, by contract among the shareholders, some of the shares are primarily liable to bear the loss to the relief of others, those are the shares upon which the reduction should be made. If, on the other hand, all the shares ought to bear the loss, the reduction ought to be applied to them all, either equally, according to the figures, or rateably, if the shares happen to be of different amounts, and, in my opinion, the law is clear, that the reduction to be made must be *prima facie* equal, according to the position of the parties, and *prima facie* it must be made

[110] (1888) LR 39 Ch D 582.
[111] Ibid 594.

> on all the shares of the company, unless there is some express provision to the contrary.[112]

North J considered that in the particular case no injustice was done to shareholders; thus, the proposed reduction was fair. Moreover, he said that if an attempt had been made to reduce all shares, or even for some reason not to reduce preference shares at all, he would have had a right to refuse to sanction the resolution. But in the current case, there was nothing unjust or inequitable in the proposed reduction of capital; in fact, a very large majority of preference shareholders themselves were of the same opinion.[113] The case explicitly shows that the equal reduction of share capital is not always fair and equitable because under the special circumstances an uneven reduction of capital might be the only fair way. The decision in *Re Barrow Haematite Steel Co* has subsequently been followed in other cases, for example in *Re Agricultural Hotel Co*[114], where Kekewich J sanctioned the resolution to reduce the whole company ordinary capital apart from any reduction of its preference capital. Still, the judge explicitly hoped that the Court of Appeal would settle the rules governing reduction of share capital[115].

Indeed, appeal decisions were to come, and the most important of these cases is the House of Lords ruling in *British and American Trustee and Finance Co Ltd v Couper*[116]. In this case, the company had carried on business in England and the United States, but it was found impossible to operate in this way any longer. Therefore, it was decided that the company should cease to carry on business in the United States, and the aim was to transfer its American investments to its American shareholders. Consequently, their shares in the British-American company would be cancelled through a reduction of capital. The idea was that only English shareholders remained as

[112] Ibid 594-95.
[113] Ibid 602-3.
[114] [1891] 1 Ch 396.
[115] Ibid 398.
[116] [1894] AC 399 (HL).

shareholders in the ex-British-American company. Shareholders approved this arrangement at two extraordinary general meetings. Yet, there was one shareholder against the scheme.

The dissenting shareholder, Mr Couper, who opposed the confirmation was first successful as North J dismissed the petition; in addition, the Court of Appeal affirmed his decision. But the House of Lords reversed their decisions and held that the reduction was within the powers of court. Since the arrangement was fair and equitable, there was no reason why it should not be confirmed. In their reasoning, their Lordships observed that the statutes do not prescribe the manner in which reduction of capital is to be effected. As a result, the court has discretion in confirming a scheme. They did not see any danger in the conclusion that the court has a power to confirm the particular scheme, or reasons to have doubts that this had not been the intention of the legislature. About the interests of minority shareholders, Lord Herschell explicitly pointed out that:

> There can be no doubt that any scheme which does not provide for uniform treatment of shareholders whose rights are similar, would be most narrowly scrutinised by the Court, and that no such scheme ought to be confirmed unless the Court be satisfied that it will not work unjustly or inequitably. But this is quite a different thing from saying that the Court has no power to sanction it.[117]

The confirmation of the scheme was held to be within the power of the court: there was no ground for refusing to do so. Further, the scheme did not involve any result either unjust or inequitable. The House of Lords confirmed the resolution to reduce share capital.

[117] Ibid 406.

Obviously, this scheme of capital reduction did not deal with every shareholder precisely in the same fashion. But as Lord Watson[118] stated, if that had been the law it would have been manifest that in some cases the result might be unfortunate. He also pointed out that a scheme where some members retain their shares unreduced and the shares of others being extinguished upon their receiving a just equivalent, can be greatly to the advantage of the company. The House of Lords considered that this was so in this particular case. Lord Macnaghten explained the interest of the company and its shareholders further in this way:

> The person whose shares are bought gets money or money's worth. The persons on whose behalf the company buys have their own shares improved by the value of the shares extinguished. If the parties to the transaction come to the conclusion that the bargain is a fair one, why should the Court say that there is preference on the one side or on the other? If there is nothing unfair or inequitable in the transaction, I cannot see that there is any objection to allowing a company limited by shares to extinguish some of its shares without dealing in the same manner with all other shares of the same class. There may be no real inequality in the treatment of a class of shareholders although they are not all paid in the same coin or in coin of the same denomination.[119]

The reduction of share capital was approved although all shareholders were not treated exactly similarly since there was no real inequality or unfairness in the arrangement. The House of Lords clearly observed that the company and the great majority of shareholders were more capable of saying what was good and fair for the company and its shareholders than the single opposing shareholder, who was actually not even

[118] Ibid 408ff.
[119] Ibid 415-16.

suggesting that the majority would have been acting oppressively in the case. The House of Lords took a pragmatic view: what is good for the company and its shareholders should not be against the law when it is not unfair or inequitable[120]. The ruling follows the general idea in English company law: it is up to the company and its shareholders to decide company matters, and therefore it is not the task of the courts "on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom"[121]. If the point is formulated in a more modern way, it is possible to state that the ruling in *British and American Trustee and Finance Co Ltd v Couper* is a good example of law-and-economics thinking in company law. The law should support the business of a company, and this decision really did.

There is still one important case to explore, which is *Re Chatterley-Whitfield Collieries Ltd*[122]. The case is, again, about a company with two classes of shares. The preference shares had a right to 6 per cent cumulative dividend, and on the case of winding up these shares were entitled in priority to repayment of capital together with any arrears of dividend, but they did not have any further participation right in the company's assets. When the company's colliery undertaking was nationalised under the Coal Industry Nationalisation Act 1946, it ceased to carry on its principal business. The company was going to receive special compensation under the Act, but before the payment the company was willing to reduce its share capital and return to preference shareholders their whole share capital. Yet, some preference shareholders were against the resolution to reduce capital in the proposed manner and opposed the petition to confirm it.

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[120] In *Poole v National Bank of China Ltd* [1907] AC 229 (HL) 240 Lord Macnaghten formulated his view very similarly to sanction the proposed reduction of capital: "I can see no objection to it if it is a prudent and businesslike measure, not unfair to any shareholder and not detrimental to the public."
[121] *Carlen v Drury* (1812) 1 V & B 154, 158 (Lord Eldon); see also *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA) 23.
[122] [1948] 2 All ER 593.

Preference shareholders suggested that there should be a reduction of capital falling equally on two classes of shares. These dissenting shareholders were, also in this case, successful at first since Peel J[123] refused the confirmation of the resolution because he regarded it as unfair. But the Court of Appeal[124], by a majority, reversed his decision and confirmed the proposed reduction of capital: they held that preference shareholders should not be entitled to object to the repayment of their shares. Greene MR justified their decision with the following passage:

> It is, of course, the case that the company will not be precluded from producing some other scheme, but the only scheme which has been suggested as being fair and equitable is one providing for a *pari passu* reduction of both classes of shares. Such a reduction would still leave the company saddled with £100,000 of preference capital carrying a rate of dividend which in present circumstances it is not to be expected that the company will be able to earn, and in so far as the preference capital thus left does not 'earn its keep' it will have to be fed at the expense of ordinary shareholders. This does not appear to me to be fair and equitable. And what perhaps is of almost equal importance, it appears to me to be bad finance and bad business in the case of a continuing company.[125]

The reasoning shows distinctive economic thinking: what is not good finance and business cannot be good law either. The Master of the Rolls also mentioned that since preference shareholders were not entitled to participate in the surplus assets, the possible reasonable expectations of preference shareholders were not enough to make their treatment inequitable in the reduction of capital at the level of practice or principle.

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[123] *Re Chatterley-Whitfield Collieries* [1948] 1 All ER 911.
[124] [1948] 2 All ER 593.
[125] Ibid 599-600.

In contrast, ordinary shareholders would have been treated unfairly if the company had carried the burden of capital that it did not need. His point was that the "obscurely drafted" section in the special Act displaying a certain amount of "amateurishness" did not affect the power of court to confirm the reduction of capital.[126]

Asquith LJ in his opinion pointed out that the proposed reduction was fair, although the alternative *pari passu* reduction might have been equally fair, or even more nearly to ideal justice. But as he said, it has never been laid that the capital reduction scheme must be perfect: it was enough that the scheme was fair. By contrast, it was not fair and reasonable that preference shares should have been kept alive, "as it were, on oxygen hoarded" by the other class of shares. Thus, he was sceptical about the superior equity of *pari passu* repayment, and in any case he did not hold that the existing scheme would be unfair. As a result, the proposal was confirmed although Evershed LJ was dissenting.[127] Subsequently, the House of Lords[128] held that the proposed reduction was fair and equitable and should be confirmed because there was no ground to suppose anything else under the provisions of the special Act.

Both the Court of Appeal and the House of Lords accepted that the reduction of capital in *Re Chatterley-Whitfield Collieries Ltd* was fair and equitable because it was carried out in accordance with preference shareholders' rights in winding up. Therefore, as the case shows, there is a clear relationship between reduction of capital and winding up. The reduction of capital in that case was fair because "the well known practice of the courts ... is based on the recognised analogy of priorities as to capital in winding-up"[129]. Obviously, there should be analogy to both directions. The equality of shares in the reduction of capital supports the idea that in the same way there must be equality as

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[126] Ibid, in particular, 594-95 and 598.

[127] Ibid 601-2 (Asquith LJ) and 602-9 (Evershed LJ); the dissenting argumentation is not covered here.

[128] *Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd* [1949] AC 512 (HL), where their Lordships followed the majority ruling, with one dissentient, in *Scottish Insurance Co Ltd v Wilsons & Clyde Coal Co Ltd* [1949] AC 462 (HL) (Sc).

[129] [1948] 2 All ER 593, 596 (Greene MR).

far as it concerns the division of company surplus. This point of view prevails although the court does not have similar discretion in the winding up as it has in the reduction of share capital. Even so, there is a clear link between winding up and the reduction of capital since they are actually alternatives to each other. However, both these alternatives are not always available, and winding up a company can sometimes be "disastrous", as it was in *British and American Trustee and Finance Co Ltd v Couper*[130]. Therefore, as Lord Macnaghten formulated: "It is for the company, and for the company alone, to judge of the prudence of the course proposed"[131]. In sum, shareholders should be able to decide what is done, but it is the law that secures the fair and equal treatment of all shareholders.

Shareholders should be treated in reduction of capital similarly and equally if otherwise is not agreed. However, the court may use its discretion, and it can authorise, under special circumstances, a scheme where shareholders are not treated exactly similarly. In these cases, this uneven reduction should be in the interests of the company and its shareholders; furthermore, it should be in any case fair and equitable to every shareholder. As clearly mentioned in *British and American Trustee and Finance Co Ltd v Couper*, if the scheme does not provide uniform treatment of shareholders with similar rights, it is the task of the courts to scrutinize most narrowly these arrangements. The equal economic treatment must in these arrangements be reached in the manner that the court confirms. Therefore, I conclude this part stating that shareholders' treatment in the reduction of capital should always be economically equal, and it is the task of the courts to ensure that it happens.

In summary, shareholders should share a company's surplus and loss equally. Dividend and net assets can be divided unequally only if it has been agreed, and in the case of preference shares this agreement can be done implicitly too. But as far as it

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[130] [1894] AC 399 (HL) 413.
[131] Ibid.

concerns ordinary shares, their right to dividends and net assets is equal. The courts can authorise the reduction of capital otherwise than equally only if shareholders are, in any case, treated fairly and equitably. In brief, company law really secures shareholders' economic equality.

5.5 Shareholders' pre-emption right

A company can increase its share capital by issuing new shares when it is authorised to do so by the articles[132]. The general idea in company law is that shareholders determine the share capital of a company[133]. In addition, share offerings rest on the principle that shareholders have a pre-emption right to subscribe the new shares issued. The Companies Act 1862 Table A art 27 already declared that "all new shares shall be offered to the members in proportion to the existing shares," which provision was contained in Table A until 1948. Companies have thus through their articles determined that shareholders have this pre-emption right[134]. Yet, in English common law there has never been any strict rule that recognizes shareholders' pre-emptive rights[135]. But the Second Company Law Directive[136] changed the status of the law. Since 1980, the pre-emption right has been a statutory principle: in consequence, CA 1985 s 89 requires that a company should offer the new shares to shareholders on a pre-emptive basis.

The objective of the pre-emption rule is to protect shareholders from the dilution of their residual rights in the company[137]. When there are more shareholders sharing the profits and net assets of the company, there is a risk that less will be available for

[132] CA 1985 s 121 and Table A art 32.
[133] *Fraser v Whalley* (1864) 2 H & M 10, 29 (Wood VC): "That is a matter wholly for the shareholders"; see also *Punt v Symons & Co Ltd* [1903] 2 Ch 506, 516-17 (Byrne J).
[134] Furthermore, the Listing Rules has required the existence of shareholders' pre-emption rights; see the current provisions in the UKLA Listing Rules 9.5.1ff.
[135] See MacNeil, Iain 'Shareholders' Pre-emptive Rights' [2002] JBL 78.
[136] Second Council Directive Article 29.
[137] See generally *Pre-emption Rights: Final Report – A study by Paul Myners into the impact of shareholders' pre-emption rights on a public company's ability to raise new capital* ('*Paul Myners' Report*') (London 2005).

existing shareholders as dividends or in liquidation. Moreover, if a company issues new shares directly to investors, there is a danger that fewer investors will be willing to buy existing shares, or they may be willing to do so only at a lower price than before the share issue. Naturally, this risk is imminent if a company makes a share issue to outsiders at a price below the prevailing market price. The pre-emption right is a part of shareholder protection but it is also at the same time a shareholders' right. Shareholders have a right to subscribe the new shares, and every shareholder may personally decide whether to have them.

Ultimately, the main rule in share issues is that new shares have to be offered to existing shareholders in proportion to their shares[138]. These rules include that the issue price of shares must be the same for each shareholder. Shareholders are treated equally when shares are allotted to every shareholder in proportion as nearly as practicable equal to his existing proportion in nominal value of his holdings of the aggregate of relevant shares[139]. They must be offered in this way to existing shareholders before an offer can be made to the general public. Moreover, it should be noted that when shares are issued in proportion to existing shares, it does not typically have any significant effect on existing shareholders' real position whether new shares are issued at a discount to the market price[140]. It is possible to say that shareholders' pre-emption rights effectively protect shareholders' rights in the company and their equality there.

Still, shareholders' pre-emption right is only a default rule, which can be set aside by a decision of the company[141]. The CA 1985 s 80 allows pre-emptive rights to be overridden by general authority given to the directors; further, under CA 1985 s 95 the rights may be removed by special resolution. The excluding of shareholders' pre-

[138] See CA 1985 ss 89-96.
[139] Ibid s 89(1)(a).
[140] See MacNeil (2002) 81.
[141] Eg Companies Act 1862 Table A art 27 stated that shareholders' pre-emptive right is "[s]ubject to any Direction to the contrary that may be given by the Meeting that sanctions the increase of Capital."

emption right is understandable because companies should be able to raise capital through the most appropriate method[142].

Obviously, shareholders need more protection from the law if new shares are not offered to them on a pre-emptive basis. Company law protects shareholders' interest in the context of share offerings in several ways. The first step is that shareholders must accept the issue of shares to outsiders by the articles or by a special resolution[143]. However, in practice, statutory pre-emptive rights "can be disapplied with relative ease and afford an individual equity shareholder precious little assurance"[144]. Shareholders' protection cannot rest simply on majority authorisation, and this is particularly so in the case of shareholders' equality.

Second, the authority of the directors to issue shares may be for a particular purpose only[145]. Although their authority is general they must use their powers to issue shares bona fide interest for the benefit of the company[146]; further, that power should be used in proper purpose[147]. For example, in *Howard Smith Ltd v Ampol Petroleum Ltd*[148] the Privy Council considered that it is unconstitutional for the directors to allot shares having a purpose to try to destroy an existing majority in order to create a new one. The directors had improperly exercised their powers: the allotment was invalid. The aim of a share issue may not be to change the balance between shareholders, so the directors should use their power to the extent that a shareholder should be able "to maintain his proportionate equity"[149]. Company law really restricts how the directors could use their fiduciary power to issue new shares.

[142] See eg *Pre-emption rights: Paul Myners' Report* (2005) 3.
[143] CA 1985 s 95(1).
[144] Davies (2003) 635.
[145] *Fraser v Whalley* (1864) 2 H & M 10.
[146] More generally laid down in *Percival v Wright* [1902] 2 Ch 421; in the case of share issue, see eg *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77.
[147] *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA); especially about an improper motive in the share issue, see *Hogg v Cramphorn Ltd* [1967] Ch 254; share issues is an area where directors' improper purpose has generally been under the courts' review, see eg Davies (2003) 385ff.
[148] [1974] AC 821 (PC).
[149] *Katzowitz v Sidler* (1969) 301 NYS 2d 470 (CA of New York) 477.

Third, company law restricts the way in which shareholders can by majority vote decide to issue shares. The power to disapply shareholders' pre-emption rights can be given by the articles or by a special resolution, and in both cases there is a requirement for a three-quarters majority of shareholders[150]. A simple majority is not enough to decide that shareholders' pre-emption right is disapplied. Further, there are more restrictions for majority power. As in general, shareholders must exercise their votes "bona fide for the benefit of the company as a whole"[151], which refers to the interest of shareholders as a group[152]. This consideration can be done by taking an "individual hypothetical member" and asking "whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit"[153]. So, if shareholders' pre-emptive rights are overridden, that could be done by majority resolution when it can be said to be beneficial to all shareholders. Moreover, even though it is normally for shareholders, not for the courts, to determine whether the resolution is bona fide for the benefit of the company, the courts may intervene if the decision can not reasonably be regarded as being in the interests of the company and its shareholders[154]. Sometimes, the interests of the company and a hypothetical shareholder have been explicitly equated with the interest of a minority shareholder. In the area of share issues in a private company, *Clemens v Clemens Bros Ltd*[155] is this kind of special case, where the majority shareholder was prevented from authorising a share issue, because as a result, the shareholding of the minority shareholder would have fallen below 25 per cent. Yet, the ruling in *Clemens* might be a quite special one, and the case has seen partly undermining majority rule in company law[156]. Nevertheless, in this part of the study it is enough to conclude that even if shareholders can by majority power

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[150] CA 1985 ss 9 and 95.
[151] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) 671 (Lindley MR).
[152] *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA).
[153] Ibid 291 (Evershed MR).
[154] *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA).
[155] [1976] 2 All ER 268.
[156] Joffe, Victor, 'Notes of Cases – Majority Rule Undermined?' (1977) 40 MLR 71.

override shareholders' pre-emptive rights, the law restricts the majority's power to do so as it does in the case of directors' power. In sum, company law protects shareholders' right to new shares issued in several ways.

Since my prime interest is equality of shareholders, *Mutual Life Insurance Co of New York v Rank Organisation Ltd*[157] is a case of paramount importance in this field. The company offered for sale to the public 20 million shares, and half of them were made available on a preferential basis to existing shareholders, except those resident in the United States or Canada. These shareholders, and their agents, were excluded from the offer because of the securities legislation in those countries. Mutual Life Insurance Co of New York and other plaintiffs, who were Americans, alleged that the company discriminated against American shareholders. They argued that shareholders were not treated equally.

Goulding J dismissed the action since he held that shareholders in this particular case had been treated fairly. The directors exercised their powers in good faith and in the interests of the company. The reason for excluding American shareholders from participation in the offer was their personal situation; moreover, their exclusion did not affect the existence of their shares or the rights attached to them. It was explicitly mentioned in the case that shareholders do not have any right to expect that their interest remain constant in the company. In conclusion, it was not required that all shareholders should be treated identically when there was a special reason why the American shareholders could not be treated in a similar way. Equality was not seen as an absolute principle in company law. As a result, shareholders could be treated differently since there was a very good reason for it, and furthermore the treatment of all shareholders was fair.

[157] [1985] BCLC 11.

It is interesting to note that the case has many similarities with another Anglo-American shareholders' equality case, ie the House of Lords ruling in *British and American Trustee and Finance Co Ltd v Couper*[158]. The reduction of share capital there was approved, although all shareholders were not treated exactly similarly when there was nothing unequal or unfair in the arrangement. The reduction of share capital in the proposed way was seen as a good business decision in that case. Both *Mutual Life Insurance Co of New York v Rank Organisation Ltd* and *British and American Trustee and Finance Co Ltd v Couper* show very well that requirement of absolutely equal treatment should not override arrangements that have been reached in the best interests of the company when shareholders are treated fairly. I conclude this point so that company law supports the company in its function, but it should not be a restriction on business operations when those are good for the company and its shareholders.

However, conclusions from the decision in *Mutual Life Insurance Co of New York v Rank Organisation Ltd* should be drawn carefully. The case does not declare that a company can in a share issue offer new shares to some shareholders and exclude others if there is a special reason to do so. First, in the case shares were not offered to any shareholder on a pre-emptive basis since the transaction was an offer for sale, not a rights issue. As Goulding J explained, the purchasing of shares was "not tied in any way to the holding of any particular number of shares"[159]. Shares were not offered to any shareholder in proportion to his shareholding, and therefore the exclusion of American shareholders did not affect the existence of their shares or the rights attached to them. The case, in fact, rather implies that if the transaction had been a rights issue, American shareholders could not have been excluded in the way that was done in the offer for

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[158] [1894] AC 399 (HL).
[159] [1985] BCLC 11, 25.

sale[160]. As explained in the case, the company was also advised not to do the transaction in that way.

Second, since the arrangement was done at the market price, there was no real discount in the share price, but existing shareholders were only given preferential treatment in the allocation. As Goulding J stated, it was not even known "whether the transaction had any effect upon [shares'] market price"[161]. In consequence, it is possible to imply that if there had also been a special discount for the non-American shareholders, the transaction would not have been acceptable. It should be noted that in this case the legality of the share offer was not challenged at all as far as it concerned shares offered to the general public, and it is quite difficult to see how the situation of shareholders could generally be better if all the shares had been offered to the public without giving this preferential treatment to the non-American shareholders. I summarise these two points by saying that the ruling of *Mutual Life Insurance Co of New York v Rank Organisation Ltd* does not show that equality is not required in share offerings. As Goulding J formulated, "equality of individual shareholders in point of right, does not always require an identity of treatment"[162]. Accordingly, this case explicitly recognized equality between shareholders in share offerings.

Pre-emption rights in share issues provide equal protection to shareholders against a dilution of their interest in the company. If shareholders' pre-emption right is disapplied, company law controls how the majority and the directors may use their power in these decisions. The fundamental idea of the law is that shareholders should be treated similarly in share offerings if there is no special reason to do otherwise; in

[160] In addition, Davies (2003) 637 considers, in general, that these kinds of arrangements would be fairer if the rights of the American shareholders were sold for their benefit; naturally in *Mutual Life Insurance Co of New York v Rank Organisation Ltd* this would not have been possible as it was an offer for sale; in sum, I understand Davies' words so that if that had been a rights issue, the selling of the American shareholders' rights would have been the only acceptable way to organize this transaction.
[161] [1985] BCLC 11, 24.
[162] Ibid.

addition, shareholders should always be treated fairly as *Mutual Life Insurance Co of New York v Rank Organisation Ltd* clearly requires.

5.6 Right to transfer shares

Shareholders have the freedom to choose whether they become members of a company. In addition, they decide whether to subscribe new shares even if they are issued on a pre-emptive basis. Still, my main interest is not how to become a shareholder, and thus I next set the focus briefly on shareholders' equality in transfer of shares.

5.6.1 Free transferability of shares

Shares are generally freely transferable, and the right to transfer of shares is one of shareholders' normal rights. In general, shareholders are free to transfer their shares unless the articles explicitly restrict it[163].

In public companies, shareholders have legally full freedom to transfer their shares, which can be sold at the current price on the markets. These shares are commodities that are bought and sold in transactions between willing buyers and sellers as they please. Share transactions are matters of markets, but company law itself has no important role in these transfers.

Significantly, the current market price is available for all shareholders: it can be regarded as equal to them. However, the markets do not, of course, give any guarantee that all shares of a company are really saleable at the prevailing price. Real prices in share transactions depend on the depth and breadth of the market, ie on demand from other investors.[164]

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[163] See *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA); about the transferability of shares, see more above, chapter two 2.4.
[164] See above, chapter four.

In private companies, transferability of shares is related to the particular provisions in the articles. As mentioned in chapter two, it is normal for private companies to place some restriction on the free transferability of their shares.

If the transferability of shares is restricted, those provisions bind every shareholder. Moreover, shareholders should be treated equally in cases where shares are transferred. For example, as explained in *Re Smith and Fawcett Ltd*[165], the directors must use their power to accept a share transfer in the same way as all their fiduciary powers: "They must exercise their discretion bona fide in what they consider ... is in the interests of the company"[166]. The directors should use their power for the benefit of the company: they may not discriminate against shareholders if the interests of the company do not give them a reason to use their discretion. Shareholders should be treated in these cases both equally and fairly, but naturally the directors are able to refuse a transfer of shares since they have this power under the articles when that decision is in the interests of the company[167]. Yet, as we can notice, also in the case of a private company, the law protects shareholders' right to transfer their shares, although private companies normally have in their articles some kind of restriction on free transferability[168].

Shareholders in public companies are free to decide whether to sell their shares; in effect, they have an equal exit right out of the company through the markets. On the other hand, the restrictions on free transferability bind every shareholder in private companies; thus, these shareholders' right to transfer their shares is legally equally restricted.

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[165] [1942] Ch 304 (CA).

[166] Ibid 306 (Lord Greene).

[167] However, when the directors are able to approve the new members they "presumably act according to the majority view," as Evershed MR saw it in *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA) 292.

[168] Shareholders' pre-emption right in share transfers and the fair price under these provisions is under review below, chapter 7.3.2.

5.6.2 A company's power to purchase own shares

Free transferability of shares achieves new dimensions if the acquirer of shares is the company itself. Shareholders' equality has more importance in these cases. Further, since company law recognizes the doctrine of capital maintenance, a company's power to purchase its own shares cannot be a simple matter.

When a company acquires its own shares, the transaction has actually the same effect as the reduction of share capital: assets are transferred from the company to its shareholders. Indeed, the courts have noticed this point too. Therefore, the House of Lords in *Trevor v Whitworth*[169] ruled that a company has no right to acquire its own shares. The House of Lords reached this conclusion although the articles authorised the company to purchase shares, since their Lordships took the view that reduction of share capital is exceptional and inconsistent with the nature of the company. Lord Herschell pointed out this relationship, declaring that: "the stringent precautions to prevent the reduction of the capital of a limited company, without due notice and judicial sanction, would be idle if the company might purchase its own shares wholesale, and so effect the desired result"[170]. Thus, the company capital should not be reduced otherwise than in the manner permitted by the statutes, and the employment of company money in the purchase of its own shares was considered illegitimate. The interest of creditors was the main reason why the House of Lords ruled that a company has no power to purchase its own shares, and therefore these purchases were *ultra vires*. As Lord Macnaghten explained, the power to purchase own shares would have been void even if the right

[169] (1887) LR 12 App Cas 409 (HL); in addition, it should be mentioned that before this decision there were cases where the purchasing of company own shares was not regarded as illegal; eg *Re Dronfield Silkstone Coal Co* (1880) LR 17 Ch D 76 (CA), where the purchasing was accepted to get rid of a shareholder who caused difficulties.

[170] (1887) LR 12 App Cas 409, 416.

were set in the memorandum[171]. As a result, the memorandum and articles together were not able to authorise a company to purchase its own shares[172].

The general rule of the law in CA 1985 s 143(1) is still that a company may not acquire its own shares. But since the Act of 1981 and under CA 1985 s 143(3), the general rule does not apply when shares are purchased in accordance with Chapter VII[173]. These exceptions are nowadays so wide that it is possible to argue that the general rule is, in fact, that a company may purchase its own shares[174]. Yet, a company is permitted to acquire its own shares only if the correct procedure is followed, otherwise the purchase is illegal. The aim of these rules is above all to protect the creditors of a company, but the purchase of own shares is also a matter of shareholders' equality.

A company may purchase its own shares when it is authorised to do so by the articles[175], and it may acquire only shares that are fully paid[176]. The protection of creditors' interest requires that a public company must fund purchases out of distributable profits[177]. The shares acquired should be cancelled, and the company's share capital should be reduced[178].

My prime interest is the way in which shareholders' equality is protected. As the main risk to shareholders in share issues is that new shares are issued at too low a price, in the purchase of own shares the danger is that the company acquires shares from some shareholders at too high a price. Therefore, first the terms of each purchase must be approved in general meeting. There are different detailed procedures for authorising purchases through private deals and via the Stock Exchange: the protection of

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[171] Ibid 436.
[172] *Re Denver Hotel Co* [1893] 1 Ch 495 (CA) 506 (Lindley LJ).
[173] CA 1985 ss 159-181.
[174] Dine, Janet, *Company Law* (4th edn Basingstoke 2001) 140-41.
[175] CA 1985 s 162(1); and the standard authorisation is in Table A art 35.
[176] CA 1985 s 143(3).
[177] Ibid ss 160(1)(a) and 162(2); and the exception in the case of a private company can be found in s 171ff.
[178] Ibid s 160(4).

shareholders varies depending whether the purchase is an off-market or market purchase. When shares are listed and the purchase is on the exchange, that is a market purchase, and otherwise it is not[179]. Market purchases create less risk to equality shareholders since the rules of the Stock Exchange transactions will apply and purchases will be executed at the current market price[180].

Under CA 1985 s 164, off-market purchases may be made only on the terms that are authorised by special resolution of the company. It should be noticed that this resolution is not effective if a shareholder whose shares are to be purchased exercises his voting rights[181]. A company may also enter into a contingent purchase contract where the company becomes entitled or obliged to purchase those shares[182]. Yet, it is very obvious that these kinds of contracts are not typically useful for quoted companies because the price of these transactions is difficult to determine beforehand.

Market purchases should under CA 1985 s 166 get authorisation in general meeting, but in this context only ordinary resolution is required. This authorisation may be general or limited to a particular class, and it may be conditional or unconditional[183]. The maximum number of shares to be acquired, and the maximum and minimum prices, must be specified[184]. However, in the case of a market purchase members are not able to approve the actual contracts of purchase that take place on the market by the company's stockbroker. In any case, CA 1985 s 169 provides that the company should disclose the purchases of its own shares. In addition, these market transactions should be executed following the rules of the Stock Exchange. Chapter 12 of the UKLA Listing Rules sets out special rules that apply to companies wishing to purchase their own listed securities,

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[179] Ibid s 163.
[180] See eg Davies (2003) 257.
[181] See CA 1985 s 164(5); in contrast, generally shareholders that have a special interest are entitled to vote; see *North-West Transportation Co Ltd v Beatty* (1887) LR 12 App Cas 589 (PC); *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA).
[182] CA 1985 s 165.
[183] Ibid s 166(2).
[184] Ibid s 166(6).

whether as a market purchase or an off-market purchase. There are, for example, special requirements for substantial market repurchases. The repurchases of more than 15 per cent of a company's shares must be carried out by a tender offer to all shareholders[185].

In summary, English company law accepts that companies may purchase their own shares. During recent years, this statutory facility has become more popular. It can be said that these share buy-backs are an essential component in quoted companies' financial armoury[186]. Overall, it is important that companies may purchase their own shares, which is indeed in the interests of the company and its shareholders. However, it should be noted that company law and market rules offer special protection to shareholders' equality when a company's own shares are purchased.

5.7 Equality of shareholders

The basic idea of equality in law is that equals should be treated alike. Company law supports and protects shareholders' equality. Shareholders are entitled to expect that their treatment is equal in a company where they have shares with similar rights. In addition, their equal treatment might generally be regarded as "the most straightforward organizing principle" in company affairs[187]. As a result, shareholders share a company's surplus and loss in proportion to their shares: dividends should be paid them equally, and they have a proportional right to the company's net assets. The rule of law is that even unpaid shares are entitled to the same dividend and to an equal share of net assets, unless the contrary is stated.

Yet, it is possible to specify the rights attached to shares by the company constitution. Dividends can be paid only to the paid share capital, which is actually the general practice according to the current articles. In addition, if a company has different

[185] UKLA Listing Rules 12.4.2.
[186] Pettet, Ben, *Company Law* (Harlow 2001) 309.
[187] Cheffins (1997) 490; but see also, ibid 495, where he considers that "policy-makers should resist being side-tracked by arguments based on the idea of equal treatment."

classes of shares, it is obvious that these shares cannot be equal since they explicitly have different rights. Further, the prevailing presumption in company law is that preference shares' rights are exhaustive, not equal. But this inequality is a special feature of different classes of shares; therefore, we should not be confused by preference shares' rights. In contrast, the rights of ordinary shares are equal in their nature.

In reduction of share capital, the courts require that shareholders should be treated in a similar manner, and prima facie equally. On the other hand, the courts have accepted that under special circumstances, and under their strict control, reduction of capital is possible even if shareholders are not treated absolutely similarly when they are treated fairly and equitably. Still, shareholders must be economically treated in the same manner. Although "they are not paid in the same coin," shareholders should get equal proportion in "money or money's worth"[188]. So, if the rights of shareholders are different in a company, the law can even require that shareholders should not be treated equally, but this idea does not, of course, apply to ordinary shares.

Shareholders have an equal pre-emption right to subscribe the new shares in share issues in proportion to their existing shares. However, this pre-emption right is a default rule, which can be set aside by a company's decision. When it is in the interests of the company and its shareholders, this right can be disapplied, and under very special circumstances a company may, in an offer to sale, offer its shares only to part of its shareholders. But there must be good and special reasons to do so, and shares must then be offered at the market price.

Shareholders have the right to transfer their shares. Their freedom is naturally greatest in quoted companies, where shares are freely transferable. In these companies, shareholders are legally free to buy and sell shares. On the other hand, restrictions on free transferability bind every shareholder in private companies. In addition, the general

[188] *British and American Trustee and Finance Co Ltd v Couper* [1894] AC 399 (HL) 415-16 (Lord Macnaghten).

rule of company law has been that companies have been prohibited from purchasing their own shares but the statutory facility has permitted it when the correct procedure is followed. In the same way as in issues of new shares, so also in these share buy-backs, interests and equality of shareholders are protected under special requirements of company law and market rules.

The rights and interests of shareholders in the company are in proportion to their shares. The ordinary shares of a company are equal, and equality is proportionality. But the companies' legislation has never explicitly stated that all shares should be equal. Therefore, the status of shareholders has been explained in cases like *Birch v Cropper*, where Lord Fitzgerald pointed that:

> My Lords, I am clearly of opinion that the only equitable principle to be acted on in this case is that of *equality*. That is an equitable principle, and, in giving effect to that rule, each and every shareholder should receive in respect of his share an equal proportion of this surplus.[189]

Lord Herschell formulated the idea in the same case in this way:

> shareholders are on the same footing, equally members and holding equal shares in the company, and it appears to me that they ought to be treated as equally entitled to its property. It may be that the principle which I recommend your Lordships to adopt will not secure absolutely equal or equitable treatment in all cases, but I think that it will in general attain that end more nearly than any other which has been proposed.[190]

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[189] (1889) LR 14 App Cas 525 (HL) 542 (emphasis original).
[190] Ibid 538.

Obviously, what Lord Herschell explained is not a recommendation, but it is the position of English company law. According to company law, shares are equal unless otherwise stated. Therefore, it might be possible to argue that shares are generally born free and equal in law. The exceptions of absolutely similar treatment in the reduction of share capital, or under the special circumstances in an offer for sale, are not able to change this major principle of law. In summary, the courts have clearly recognized equality as a principle of company law.

Still, the courts have been unwilling to declare equality as a principle that overrides the interests of a company and its shareholders; furthermore, they have been unwilling to limit their own discretion. Thus, in English company law equality is not absolute in nature. The view of English law has been more pragmatic than dogmatic; indeed, English law generally works in this way. However, it should be noted that in the cases where shareholders have not been treated identically, there is no reason to say that their treatment in economic terms has not been equal since this has been the requirement of the law and the courts. I conclude this chapter by stating that ordinary shareholders should be treated equally, and thus shareholders' economic equality is a fundamental principle in company law. At the end, I quote Lord Macnaghten, who observed in *British and American Trustee and Finance Co Ltd v Couper* that:

> it follows as a self-evident proposition that the interests of the shareholders in respect of their shares as regards dividend and everything else must be equal.[191]

That is the real equality of shares in company law: the principles of law require that shareholders must be treated equally.

[191] [1894] AC 399 (HL) 417.

When shares have equal rights in the company, they rank equally. Shareholders' interest in a company is proportionate to the number of their shares. But whether majority and minority shareholders can ever have any real equality in companies that are governed by majority rule is a point under review in the next chapter.

CHAPTER 6

MAJORITY POWER AND MINORITY PROTECTION

> *What, then, is this law business about? It is about the fact that our society is honeycombed with disputes. Disputes actual and potential; disputes to be settled and disputes to be prevented; both appealing to law, both making up the business of the law.*
> K. N. Llewellyn, *The Bramble Bush* (1930) 12.

6.1 Introduction

In this chapter, the relationship between majority and minority shareholders is examined. On the one hand, the main principle is that companies are governed by majority rule, which means that power rests on the majority. A consequence is that companies are sometimes identified with their majority shareholders. On the other hand, all shareholders have, in proportion to their shares, rights in the company. As explained above in chapters two and five, the rights of ordinary shares are equal. Yet, the idea in company law is not only to provide rights to shareholders but also to offer protection to them. Overall, company law must balance the interests of individual shareholders and the company as a whole.

My analysis here starts with an overview of constitutional matters in the company. Thereafter, I explore the principle of majority rule, minority rights, and the statutory protection offered against oppression by the majority. The intention is to demonstrate that minority shareholders are not at the mercy of majority shareholders since the law protects them. The important point is that this minority protection may make their shares more valuable.

6.2 The company constitution

The memorandum and articles govern a company's constitutional structure. They have an essential role in setting shareholders' rights, which are fundamentally contractual in nature. Through the company constitution, it is possible to determine that a company has shares with different rights. However, my focus is not on different classes of shares. Instead, the aim is to emphasize that the company constitution is subordinate to the law.

6.2.1 Memorandum and articles of association

The memorandum and the articles of association form the constitution of a company. I formulate their function very briefly: the memorandum is the company's outward-looking informative document, and the articles are an inward-looking set of rules governing the running of the company. As my interest is the relationship between shareholders, I concentrate on the articles.

The formation of a company requires that the registrar of companies is provided with a memorandum and the articles[1]. The term company implies that a number of people associate for a common object. The CA 1985 s 13(3) states that from the date of incorporation the subscribers of the memorandum of association "shall be a body corporate". Although the statute declares so, however, incorporators do not become a company. They merely set it up together: in consequence, companies are "made *by* them but not *of* them"[2]. The word association does not describe the company as a thing that is formed; it rather describes the act of associating and the formation of a company[3].

The essential feature of the company as a legal entity is its public registration: a company is formed by the registration. From the date of registration, it becomes

[1] CA 1985 s 10.
[2] Ireland, Paddy, 'Company Law and the Myth of Shareholder Ownership' (1999) 62 MLR 32, 42 (emphasis original).
[3] *Smith v Anderson* (1880) LR 15 Ch D 247 (CA) 273 (James LJ).

"capable forthwith of exercising all the functions of an incorporated company"[4]. Moreover, if it is a public company, it needs a trading certificate from the registrar before it can start its business[5]. In brief, it is the law that empowers the creation of companies with a distinct corporate personality, and the main enabling function of company law is to make this formation of companies possible. Companies are indeed creatures of law.

As the company is registered, the memorandum and the articles bind the company and its members[6]. Subscribers to the memorandum become the first members, and the memorandum, among other points, states the amount of the share capital and the division of it into shares of a fixed amount[7]. The articles of association form the core of a company's organizational structure; they are primarily concerned with the internal affairs of the company. In general, companies adopt a model set of articles provided by the Companies Act[8]. In any case, the articles and company law together place shareholders at the centre of corporate power structure, and this power is my prime interest in this chapter. But before analysing this power, I first explore the contractual nature of the company constitution and its alteration.

6.2.2 Contractual nature of the company constitution

The basic relationship in a company is contractual since companies exist only because some people want to incorporate a business and become shareholders. It is natural that CA 1985 s 1(1) states that:

> Any two or more persons associated for a lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the

[4] CA 1985 s 13(4).
[5] See ibid s 117(1).
[6] Ibid s 14(1).

requirements of this Act in respect of registration, form an incorporated company.

Further, the CA 1985 s 14(1) stresses the contractual relationship, declaring that "the memorandum and the articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member." In essence, the memorandum and the articles are the fundamental documents of the company, and there cannot be a company without them.

The CA 1985 s 14(1) does not explicitly state with whom members are to be deemed to have covenanted. This section seems mainly to describe the formation of the company, but it does not explain what the company is. The section even ignores the company as a separate legal entity when it merely mentions "as if ... signed and sealed by each member" without saying anything about the company itself. As a whole, the wording of this section is "difficult to construe or understand"[9]. However, the role of the company constitution has been widely explained in case law: the memorandum and the articles are regarded as a statutory contract between each member and the company, and furthermore the articles regulate shareholders' rights inter se[10]. The articles of association govern the rights of shareholders[11], and the basic idea is that shareholders have such rights as the memorandum and the articles give them[12]. A company's constitution has contractual force between shareholders; in addition, this artificial

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[7] Ibid s 2(5)(a).
[8] Ibid s 8 and Companies (Tables A to F) Regulations 1985 Table A (hereinafter 'Table A').
[9] *Hickman v Kent or Romney Marsh Sheepbreeders' Association* [1915] 1 Ch 881, 897 (Astbury J); *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) 671 (Lindley MR), where it was considered that the exact nature of this contract is very difficult to define.
[10] *Welton v Saffery* [1897] AC 299 (HL) 315 (Lord Herschell); see also *Wood v Odessa Waterworks Co* (1889) LR 42 Ch D 636, 642 (Stirling J); *Salmon v Quin & Axtens Ltd* [1909] 1 Ch 311 (CA); affirmed by [1909] AC 442 (HL).
[11] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 375 (Lord Wilberforce).
[12] *Short v Treasury Commissioners* [1948] AC 534 (HL) 545 (Lord Porter).

contract binds future shareholders too. In sum, the articles compose a bargain between shareholders[13], who are contracted with each other under these terms.

But as the first words of CA 1985 s 14(1) states, the company contract is: "Subject to the provisions of this Act." Indeed, this statutory contract has many distinctive features. The memorandum and articles derive their binding force from the terms of the statute, and only the registration of the company can make the articles a statutory contract. In addition, shareholders are entitled to rely on the memorandum and articles as they are registered. Therefore, the articles bind members as registered even if they are not in this form in accordance with the concurrent intention of signatories[14]. The articles cannot be rectified on the grounds of mistake, and it is not possible to imply a term into them in order to give business efficacy[15]. Investors in a public company should be entitled to assume that the whole constitution is contained in the articles[16]. In sum, the statutory contract in the company differs very considerably from normal contracts.

The purpose of the memorandum and the articles is to define the position of shareholders in this role, but not to bind them in their capacity as individuals. The definition of shareholders' position must be consistent with the statutes; for example, an attempt to define the company's constitution in a way that members were required, after their shares were fully paid, to make further contributions was regarded as invalid[17]. The articles do not give rights to persons, or bind them, in a capacity other than that of a member[18].

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[13] See *Will v United Lankat Plantations Co Ltd* [1914] AC 11 (HL) 16-17 (Viscount Haldane).
[14] *Scott v Frank F Scott (London) Ltd* [1940] Ch 794 (CA).
[15] *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCC 471 (CA); on the other hand, the articles are a business document, and thus they should be construed to give them reasonable business efficacy when the particular construction is admissible on the language of the articles; see also *Holmes v Keyes* [1959] Ch 199 (CA) 215 (Jenkins LJ).
[16] *Re Blue Arrow plc* [1987] BCLC 585.
[17] *Bisgood v Henderson's Transvaal Estates Ltd* [1908] 1 Ch 743 (CA).
[18] *Hickman v Kent or Romney Marsh Sheepbreeders' Association* [1915] 1 Ch 881; *Beattie v E & F Beattie Ltd* [1938] Ch 708 (CA).

The memorandum and articles are subordinate to the statute. Companies are creatures of the law: they owe their being to the statute to which they are bound[19]. A clause contained in a company's articles is invalid if it seeks to override a provision of the Companies Act. For instance, a shareholder's ability to petition for the winding up of a company cannot be excluded or limited by the articles[20]. Furthermore, even if the rule of the statute were enabling, this does not mean that it can be displaced. The company cannot fetter its statutory powers, although individual shareholders may lawfully make a private agreement on their own behalf[21]. However, such private contract does not bind the future shareholders[22]. The power of shareholders to bind themselves through the corporate contract is more limited than through a private contract.

Shareholders' rights are created by statute and contract. But it is difficult to propose that the relationship in the company would be predominantly contractual in nature[23]. Company law is not contract law[24]; therefore, companies should not be reduced to nexus-of-contracts[25]. Shareholders' rights are not just a bundle of contractual rights[26]. Nonetheless, the statute does not purport to settle the rights of members inter se but leaves them to be determined by the articles[27]. In addition, it should be noted that

[19] *Welton v Saffery* [1897] AC 299 (HL) 324 (Lord Macnaghten).
[20] *Re Peveril Gold Mines Ltd* [1898] 1 Ch 122 (CA).
[21] See *Russel v Northern Bank Development Co Ltd* [1992] 1 WLR 588 (HL).
[22] [1897] AC 299 (HL) 331(Lord Davey): "Of course, individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, or an exceptio personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders."
[23] The effect of case law is that the memorandum and articles "fall short of being a contract in any ordinary sense"; *Company Law Reform: Modern Company Law For a Competitive Economy – Company Formation and Capital Maintenance* (London 1999) 2.6.
[24] See eg Hansmann, Henry and Kraakman, Reinier, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387, 440: "At its essential core, organizational law is property law, not contract law"; yet, it should be remembered that the company is not a relation between persons and property but a relationship between persons; see above, in particular, chapter three 3.3.3.
[25] See especially Ireland, Paddy, 'Property and contract in contemporary corporate theory' (2003) 23 LS 453, 457ff.
[26] *Inland Revenue Commissioners v Laid Group plc* [2003] 4 All ER 669 (HL) 678 (Lord Millett); *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) 66 (Lord Russel).
[27] [1897] AC 299 (HL) 315 (Lord Herschell).

only members are involved in the formation of a company because it as a distinct person does not yet exist. As a result, I consider that the term contract might imply the way in which a company is formed and shareholders' rights are set but it cannot explain the nature of the company and the relationship between shareholders.

To conclude, the law makes companies, and the company constitution as a contract is subordinate to it. The company, which is a legal person, gets its existence from the statute, not from a contract. Moreover, the articles can be regarded as a social contract regulating shareholders' rights[28]. The relationship in the company between shareholders is more social than contractual; in short, it is company law that governs this relationship.

6.2.3 Alteration of the company constitution

The company constitution is alterable, but unlike contracts generally the corporate contract may be altered without the consent of all the contracting parties. The articles can be altered by special resolution, ie by three-quarters majority vote of those members who are entitled to vote at general meeting[29]. This is extremely important because company contract is long-term in its nature: it is necessary that companies and shareholders can adjust themselves to the changing circumstances of business environment. Company law gives a special majority of shareholders power to modify the company constitution.

Company law regards a company as an ongoing organization: for this reason, any regulation or article purporting to deprive the power to alter the articles is invalid[30].

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[28] Ibid.

[29] See CA 1985 ss 9 and 378; in addition, s 2(7) provides that a company may not alter its memorandum, except in cases where an express provision is made by the Act, but in practice everything in the memorandum is alterable; see ss 2(2), 4, 17, 28, 121 and 135.

[30] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) 671 (Lindley MR); *Walker v London Tramways Co* (1879) LR 12 Ch D 705.

A company cannot contract out power to alter its articles [31]. In a company, shareholders enter into a contract made upon the terms of alterable articles[32], and they are not entitled to assume that the articles remain in a particular form.

Since the company constitution is subordinate to company law, a company may not alter its articles to override the provisions of companies' legislation. For example, CA 1985 s 16 explicitly states that a company may not, without the consent of the members, alter the terms of its articles to increase members' liability. Moreover, the articles cannot be altered in a way that would be inconsistent with the terms of the company's memorandum[33].

The company constitution can be altered by the support of a special majority. But there is one very central check on this ability to alter the articles: the majority must exercise their power in good faith, and the alteration of the articles should be beneficial to the company as a whole. As Lindley MR explained in *Allen v Gold Reefs of West Africa Ltd*:

> the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.[34]

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[31] *Punt v Symons & Co Ltd* [1903] 2 Ch 506.
[32] *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA) 26 (Atkin LJ).
[33] In addition, if a provision in a company's memorandum conflicts with one contained in the articles, the provision in the memorandum takes preference; see eg *Welton v Saffery* [1897] AC 299 (HL).
[34] [1900] 1 Ch 656 (CA) 671.

The power in a company should be exercised bona fide in the interests of the company, but not for any collateral or non-corporate purpose[35]. The validity of a special resolution requires that majority shareholders use their voting power in good faith and for the benefit of the company as a whole. In *Greenhalgh v Arderne Cinemas Ltd*, Evershed MR explained the meaning of this phrase in the following way:

> In the first place, I think it is now plain that 'bona fide for the benefit of the company as a whole' means not two things but one thing. It means that the shareholder must proceed upon what, in his honest opinion, is for the benefit of the company as a whole. The second thing is that the phrase, 'the company as a whole', does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body.[36]

In addition, the Master of the Rolls mentioned that:

> I think that the matter can, in practice, be more accurately and precisely stated by looking at the converse and by saying that a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders, so as to give the former an advantage of which the latter were deprived.[37]

The interests of a company equate with the interests of its shareholders[38]. Therefore, those who use the power in a company have to regard the interests of all shareholders.

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[35] About the discretion of directors, see especially *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA); *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).
[36] [1951] Ch 286 (CA) 291.

Company law does not only give power to the majority to alter the constitution; it also offers protection to the minority. In cases where majority shareholders act in a discriminatory way, it is the task of the courts to protect minority shareholders. For example, the addition of a provision in order to enable the majority to expropriate the minority shareholders was not justified because it was not made in good faith and for the benefit of the company as a whole[39]. The majority could not force this kind of article by the power provided by the Companies Act. If the majority fails to purchase the shares of a minority by agreement, it cannot do so compulsorily through an alteration of the articles[40].

On the other hand, company law does not require that shareholders in voting for a special resolution "dissociate themselves altogether from the prospect of personal benefit and consider whether the proposal is for the benefit of the company as a going concern"[41].

Peter Gibson J formulated this principle bluntly in *Re Ringtower Holdings plc*[42]: "The law is not so foolish as to prevent a shareholder from voting in his own private interests provided that the resolution is not discriminatory." Thus, the majority may use power in the company and decide what is in the interests of the company, and the courts generally assume that decisions have this basis. The interests of a company may then equate with the interests of the majority[43]. But company law sets a clear borderline: the majority may not use power in the company to discriminate the minority.

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[37] Ibid.

[38] *Brady v Brady* [1988] BCLC 20 (CA) 40 (Nourse LJ).

[39] *Brown v British Abrasive Wheel Co Ltd* [1919] 1 Ch 290; *Dafen Tinplate Co Ltd v Llanelly Steel Co* [1920] 2 Ch 124.

[40] [1919] 1 Ch 290, 295-96 (Astbury J); it should be noted that the compulsory acquisition of the minority's shares has been possible under the statutory rule since 1928; CA 1985 ss 428-30 are under review later in this study; see below, chapter seven 7.6.2.

[41] [1951] Ch 286 (CA) 291; see also *North-West Transportation Co Ltd v Beatty* (1887) LR 12 App Cas 589 (PC); *Burland v Earle* [1902] AC 83 (PC); in contrast, *Clemens v Clemens Bros Ltd* [1976] 2 All ER 268.

[42] (1989) 5 BCC 82, 101.

[43] See *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 381 (Lord Wilberforce).

Significantly, the company constitution has contractual elements, which prevail particularly when a company is formed. Hoffmann LJ explained the role of the articles in *Re Saul D Harrison & Sons plc* in this way:

> The articles of association are just what their name implies: the contractual terms which govern the relationships of the shareholders with the company and each other. They determine the powers of the board and the company in general meeting and everyone who becomes a member of a company is taken to have agreed to them.[44]

The contract contained in the articles is one of the original incidents of the share[45]. But as mentioned, this company contract is subordinate to company law. Further, company constitution is, and should be, alterable by special resolution with the support of special majority. The alteration of the articles should then be beneficial to the company as a whole, and the majority may not use the power in a discriminatory way. On the one hand, company law together with the articles gives power to the company and the majority shareholders; on the other hand, the law sets restrictions on the use of the power to protect the minority. Next, I analyse the role of majority rule, and after that I review closer the special protection offered to minority shareholders.

6.3 Company power and majority rule

Companies are controlled by shareholders, who is the only group having votes in the company. Majority rule is a democratic and pragmatic principle in company law. In addition, in a company the interests of the majority are paramount in the last resort[46].

[44] [1995] 1 BCLC 14 (CA) 17.
[45] *Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279, 288 (Farwell J).
[46] See also Wedderburn, K. W., 'Shareholders' Rights and the Rule in *Foss v. Harbottle*' [1957] CLJ 194.

However, if all questions were decided only by majority rule, there would be little need for any other company law rules governing the relationship between shareholders. Further, if the minority were completely at the mercy of the majority, there would be few persons willing to become minority shareholders. At bottom, the scope of majority rule is restricted by other rules and principles of company law.

6.3.1 Ultimate power and company organs

The object of companies is to make profit for shareholders. Consequently, ultimate power in companies rests on shareholders, who use their power by votes attached to shares. They are entitled to exercise powers of the company and to control its operations. In brief, it is shareholders' business to manage their own affairs in a company[47]. Moreover, it is up to them to set the company constitution and to control its directors. Company law places shareholders in the driving seat of the company[48]; they are the highest masters in a company[49].

Naturally, as a legal person, the company, like associations and collectives generally, needs a structure for institutional decision-making. It is possible to use a metaphor describing companies as group-persons having a group-will[50], and from this perspective company law regulates shareholders' common action. Indeed, in the company shareholders act collectively through the medium of general meeting[51].

A large number of shareholders cannot run a company; rather, the directors conduct its business. In particular in public companies, shareholders are investors but the company needs professional managers to govern its business. The board of directors

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[47] See eg *Carlen v Drury* (1812) 1 V & B 154; *MacDougall v Gardiner* (1875) LR 1 Ch D 13 (CA); *Re Langham Skating Rink Co* (1877) LR 5 Ch D 669 (CA).
[48] Davies, Paul L., *Introduction to Company Law* (Oxford 2002) 255.
[49] *Foss v Harbottle* (1843) 2 Hare 461, 493 (Wigram VC): the members at general meeting are "the supreme governing body" of the company.
[50] Like eg Maitland in Gierke, Otto, *Political Theories of the Middle Age* (Maitland, Frederic William, trans) (Cambridge 1900) xxvi.
[51] *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL) 630 (Lord Oliver).

must steer the company's business, and modern capitalism is managerial capitalism[52]. The board of directors, together with general meeting, are the principal organs of the company[53]. Moreover, the role of the directors is described simply: they are the agents of the company. As a legal person, the company cannot act itself: it can only act through its directors[54]. Directors and managers represent the directing mind and will of the company, and in practice they control what it does[55]. In the company, the directors control the business, and shareholders control the directors. Therefore, shareholders can always by an ordinary resolution remove the directors[56]. In sum, in the company's legal structure, shareholders' power is above the board of directors.

However, the Companies Act does not state that the management of the company has to be vested in the directors. The allocation of decision-making power over the company's business policy is a matter of the articles of association[57]. In any case, Table A art 70 declares that "the business of the company shall be managed by the directors who may exercise all the powers of the company". But this authority of the directors is subject to the provisions of the Companies Act, the memorandum and the articles, and furthermore to any directions given by special resolution. Thus, the general meeting "may curtail the future powers of the directors by a special resolution"[58]. Shareholders may, in fact, usurp power from the directors without altering the articles[59]

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[52] In general, about the point, see Berle, Adolf A., Jr and Means, Gardiner C., *The Modern Corporation and Private Property* (New York 1932).

[53] But shareholders are not organs of the company; in contrast, see eg Farrar, John H., 'The Duties of Controlling Shareholders' in *Takeovers, Institutional Investors, and the Modernization of Corporate Laws* (Auckland 1993) 383, 386, where he says that: "In a sense, both the majority and minority are themselves organs of the company."

[54] *Ferguson v Wilson* (1866) LR 2 Ch App 77, 89 (Cairns LJ); as Rajak, Harry, *Sourcebook of Company Law* (2nd edn Bristol 1995) 66 formulates the general point: companies are "independent in law but dependent in fact."

[55] *H L Bolton (Engineering) Co Ltd v T J Graham & Sons Ltd* [1957] 1 QB 159 (CA) 172 (Denning LJ).

[56] CA 1985 s 303(1); in addition, shareholders, in general, appoint the directors; see Table A art 73ff.

[57] But the general meeting must have exclusivity in certain matters: CA 1985 ss 2(7) and 9 the alteration of the memorandum and articles; s 80 the authority to allot shares; ss 121 and 135 the alteration and reduction of share capital; and the Insolvency Act 1986 s 84: winding up of the company.

[58] Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003) 303.

[59] Contrast, before the existing wording of Table A 1985 art 70 the conclusion was the opposite; see *John Shaw and Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 (CA) 134 (Greer LJ); and generally *Scott v Scott* [1943] 1 All ER 582, 585, where Lord Clauson formulated that: "the professional view as to the control

when that is done by special resolution[60]. Altogether, shareholders have ultimate power in the company but they can use this power only at general meetings and under the requirements of the company constitution and company law[61].

6.3.2 Majority rule

Shareholders collectively have ultimate control over the company. Still, their power in the company is the power of a majority since company law does not require shareholders' unanimity. The majority has power to bind the minority in matters within the powers of the company. Companies are governed by majority rule, and the majority is normally a simple majority of members' votes.

It is a cardinal rule of company law that the majority is entitled to exercise the powers of the company and to control its operations. The powers of a company are vested in the majority, which generally has the power to decide for the company by decisions made at general meeting.

Ordinary shareholders have one vote for every share[62]; as a result, in general meeting they have votes in proportion to their equity investment. Democracy in companies is thus a democracy of capital. Yet, voting takes place in the first instance on a show of hands, where every member has one vote, but shareholders have the right to

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of the company in general meeting over the actions of directors has, over a period of years, undoubtedly varied."

[60] Thus, the ruling of *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34 (CA) is still valid: the directors cannot be compelled to comply with the resolution of general meeting passed by a simple majority.

[61] However, it is argued that shareholders only have formal control in the company since they are not in a position to exercise it; in particular, the fragmentation of share ownership in the Anglo-American company has shifted shareholders' power to managers: in consequence, according to Roe, Mark J., *Strong Managers, Weak Owners – The Political Roots of American Corporate Finance* (Princeton 1994) 6, this restructuring actually turned the "corporate law on its head"; but I have in this study a legal perspective, and thus I underline that shareholders have both the right to use and *not* to use their control power in the company; see more above, chapter two 2.3.2.

[62] Table A art 54.

demand a poll where the amount of shares and votes matter[63]. The majority of a company is a majority of the shares represented at the general meeting[64].

Companies are mainly governed by simple majority rule; therefore, more than a half of members' votes in general meeting is needed for ordinary resolution. Companies appoint[65] and remove[66] the directors by ordinary resolution, supported by the majority of shareholders. In addition, since the directors are nominated by majority rule, shareholders have no right to appoint directors in proportion to their shares[67]. Consequently, in this way the majority of shareholders are the masters in a company.

The company is a separate legal entity, and following the rule in *Foss v Harbottle*[68] the company, not individual shareholders, is the proper plaintiff even if the wrong has been done against the company itself. The company should bring the action, and thus it is up to the directors or the company at general meeting to decide whether an action is brought in its name. A minority shareholder is not in a position to bring an action in the name of a company to enforce the company's rights[69]. Simply, "the minority is a minority and not the majority" regardless of whether they are profoundly convinced that the decision not to sue is wrong[70]. As Mellish LJ explained in *MacDougall v Gardiner*[71], this point is not at all a technical question but it makes a very serious difference in the management of the company's affairs: if every member had the right to file the bill, there is a real risk that everything concerning the affairs of the company would be litigated. Otherwise, as Kay LJ formulated it in *La Cie de Mayville v*

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[63] CA 1985 s 373 and Table A art 46.
[64] *Attorney General v Davy* (1741) 2 Atk 212 (Hardwicke LC): "It cannot be disputed, that wherever a certain number are incorporated, a major part of them may do any corporate act; so if all are summoned, and part appear, a major part of those that appear may do a corporate act."
[65] Table A art 78.
[66] CA 1985 s 303(1).
[67] Ibid s 292 provides that each appointment shall be voted individually.
[68] (1843) 2 Hare 461.
[69] *Beattie v E & F Beattie Ltd* [1938] Ch 708 (CA) 718.
[70] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 10 (Sir Robert Megarry VC).
[71] (1875) LR 1 Ch D 13 (CA) 25.

Whitley[72], "we should have companies torn to pieces by litigation of this kind." For these reasons, the rule is that unless there is a majority for the litigation, it should not proceed.

It is really an elementary principle in company law that the courts do not interfere with the internal management of companies[73]. In general, the majority of shareholders have ultimate power to decide the affairs of a company, and it is not the task of the courts to rule their business[74]. Company law supports the presumption that shareholders together make resolutions that follow their shared interests in the company. The law and the courts are not able to decide what is good for the company and its shareholders: as a result, shareholders by majority vote should have the final word to say.

Ordinary resolutions in the company are passed by a simple majority of shareholders' votes[75]. However, important organic and constitutional changes require a special resolution and a three-quarters majority of shareholders' votes. As explained above, the alteration of articles should be made through a special resolution with a three-quarters majority[76]. These fundamental decisions in a company demand stronger support from the shareholders than ordinary resolutions. Naturally, the wider support from shareholders ensures that the decision is beneficial to all shareholders and the company as a whole.

The majority principle is a pragmatic and efficient rule in company law since shareholders' unanimity is not a realistic alternative, particularly in public companies. However, while decisions in the company are made by majority rule, there is a threat that the majority might use the power in the company to further their own interests to

[72] [1896] 1 Ch 788 (CA) 807.
[73] *Burland v Earle* [1902] AC 83 (PC) 93 (Lord Davey).
[74] *Carlen v Drury* (1812) 1 V & B 154; *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA).
[75] About the definition of ordinary resolution, see *Bushell v Faith* [1970] 1 All ER 53 (HL) 56 (Lord Upjohn).

the detriment of the minority. Therefore, company law cannot just accept majority rule; it should also safeguard minority shareholders against the abuse of majority power. In brief, the law must provide special minority protection.

6.3.3 Minority protection

Shareholders are presumed to make by majority vote resolutions that follow their shared interest as suppliers of equity capital. But it is possible that in certain cases there exists a conflict of interests between majority and minority shareholders. Moreover, the majority may abuse their position. Under certain circumstances, minority shareholders need special protection of law. I next analyse the exceptions of majority rule and minority shareholders' specific rights.

6.3.3.1 Exceptions of majority rule

The companies' legislation modifies majority rule: in certain matters, there exists a requirement of 'supermajority'[77], which is more than a simple majority of shareholders' votes. According to CA 1985 s 378, a three-quarters majority of shareholders' votes is required in extraordinary and special resolutions. As mentioned above, the CA 1985 s 9 requires that the articles of association should be altered by special resolution. Obviously, the three-fourth-majority rule offers more protection to minority shareholders since the resolutions need wider support from shareholders. Furthermore, if the requirement were even higher, eg 90 per cent, or even unanimity, that would mean more protection to the minority. However, as noted, it is important that the company constitution is alterable; in addition, in constitutional changes the higher requirements of a majority would easily lead to deadlock situations, which are not good for

[76] CA 1985 s 9.
[77] In addition, this kind of requirement can be set by the articles.

companies and their shareholders in general[78]. Company law sees that a majority of three-quarters in these situations is the right way to strike a balance between the interests of majority and minority shareholders. Nevertheless, the requirement of special resolutions in certain cases cannot be enough to protect the interests of minority shareholders.

In *Burland v Earle*[79], Lord Davey considered that it is an elementary principle of the law relating to joint stock companies that the courts will not interfere with the internal management of companies when they act within their powers. His Lordship also pointed out that the courts have no jurisdiction to do so. However, as he noted, there is an important exception "where the persons against whom the relief is sought themselves hold and control the majority of the shares in the company, and will not permit an action to be brought in the name of the company"[80]. Consequently, the courts allow minority shareholders to bring an action in the name of the company in cases where the acts complained of have a fraudulent character, or where they are beyond the powers of the company. Overall, majority rule and the rule in *Foss v Harbottle* have exceptions. In *Edwards v Halliwell*[81], Jenkins LJ stated that there are four kinds of exceptions allowing an individual shareholder to bring an action on behalf of a company:

1) where the act complained of is wholly ultra vires the company;
2) where the matter in issue requires the sanction of a special majority;
3) where a member's personal rights have been invaded;
4) where a fraud has been perpetrated on the minority and the wrongdoers are in control in the company.

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[78] Easterbrook, Frank H. and Fischel, Daniel R., *The Economic Structure of Corporate Law* (Cambridge, Massachusetts 1991) 233 simply state that: "the more power minority shareholders have, the more likely is deadlock."
[79] [1902] AC 83 (PC) 93.
[80] Ibid.
[81] [1950] 2 All ER 1064 (CA) 1066ff.

To illustrate, first shareholders cannot by majority vote confirm illegal and ultra vires actions[82]. For this reason, a misapplication of the funds of a corporate body cannot be ratified by any majority of members[83].

Second, a company is not enabled to disregard the regulations that require the passing of a special resolution as a condition of performing the act in question[84]. The court may also grant an injunction to an individual shareholder prohibiting the majority from acting in breach of the articles[85].

Third, the rule in *Foss v Harbottle* has no application when shareholders' personal rights are infringed. If majority shareholders are abusing their powers and depriving the minority's individual rights, these shareholders are entitled to come before the court to maintain their rights[86]. A shareholder has a right to get the dividend paid in accordance with the articles once the company has declared it[87]. In addition, a member has a personal right to have his vote counted, and he can sue to enforce that right[88].

Finally, there are cases of fraud on the minority where the wrongdoers themselves control the company, and therefore the rule should be relaxed in favour of the aggrieved minority[89]. Fraud in this context bears a wide equitable meaning: the essence of the matter is an abuse or misuse of majority power[90]. Accordingly, majority shareholders may not propose a benefit themselves at the expense of a minority; for example, the majority may not sell assets of the company and keep the consideration because the minority should be entitled to their share of profit[91]. Since shareholders'

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[82] See also *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204 (CA); *Smith v Croft (No 2)* [1988] Ch 114.
[83] *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237, 254 (Vinelott J).
[84] *Cotter v National Union of Seamen* [1929] 2 Ch 58 (CA) 70 (Romer J); see also *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503 (CA).
[85] *Salmon v Quin & Axtens Ltd* [1909] 1 Ch 311 (CA); [1909] AC 442 (HL).
[86] *MacDougall v Gardiner* (1875) LR 1 Ch D 13 (CA) 25-26 (Mellish LJ).
[87] *Wood v Odessa Waterworks Co* (1889) 42 Ch D 636.
[88] *Pender v Lushington* (1877) LR 6 Ch D 70.
[89] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482.
[90] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 12 (Sir Robert Megarry VC).
[91] *Menier v Hooper's Telegraph Works* (1874) LR 9 Ch App 350, 354.

right to participate in a company is protected, the majority is not allowed to use their power to get themselves money, property, or other advantages that belong to the company[92]. Indeed, majority shareholders are not permitted to make presents to themselves and in this way to oppress the minority[93]. In these cases of fraud, the minority are entitled to sue to protect what really belongs to the company and indirectly to them.

Altogether, these exceptions of majority rule give minority shareholders power to protect themselves and their rights in the company. Furthermore, one of the exceptions explicitly requires wrongdoers' control in the company; in fact, this fraud on the minority exemption is often regarded as the only real relaxation to the rule of *Foss v Harbottle*[94]. So, company law recognizes that the existence of a majority shareholder means that minority shareholders need even more protection of the law. In sum, the exceptions of majority rule allow minority shareholders to challenge in court decisions made by majority power.

Yet, the general idea is that decisions in companies are made by the support of a majority, and the exercising of this power is not a reason to challenge a decision in court. Shareholders are not debarred from voting or using their voting power to carry a resolution in circumstances where they have a particular interest in the subject matter of the vote[95]. In *North-West Transportation Co Ltd v Beatty*[96], it was held that the resolution of a general meeting to purchase a vessel from the majority shareholder was valid although it was carried by the votes of the majority shareholder. Thus, all shareholders, including the majority shareholder, may use their voting power to protect their personal interests, and they are not required to dissociate themselves altogether

[92] *Burland v Earle* [1902] AC 83 (PC) 93.
[93] *Cook v Deeks* [1916] 1 AC 554 (PC) 564 (Lord Buckmaster).
[94] See Wedderburn, K. W., 'Shareholders' Rights and the Rule in *Foss v. Harbottle*' [1958] CLJ 93, 93.
[95] [1902] AC 83 (PC) 94.
[96] (1887) LR 12 App Cas 589 (PC).

from their own prospects[97]. The vote of the majority must prevail unless the adoption is brought by unfair or improper means[98]. The task of the court is not to substitute the opinion supported by the majority by its own opinion but rather it should assess whether the decision-making process is vitiated by being or being likely to be directed to an improper purpose[99]. Moreover, as the majority has the power to decide that proceedings are brought in the name of the company, in the same way it also have the right to decide the opposite. Vinelott J formulated this point in *Taylor v National Union of Mineworkers* in the following way:

> it is open to a majority of the members, if they think it is right in the interests of the corporate body to do so, to resolve that no action should be taken to remedy the wrong done to the corporate body and such a resolution, if made in good faith and in what they considered to be for the benefit of the corporate body, will bind the minority.[100]

In essence, it is up to the company and the majority to decide whether an action should be brought in the name of the company. An individual shareholder cannot bring an action before the question is decided by general meeting. Further, a shareholder cannot bring it if the irregularity of a company's internal affairs is cured by members' decision in general meeting[101].

However, majority power does not give majority shareholders unrestricted power to bring an advantage to themselves and a disadvantage to the minority. The power that majority shareholders control is not their power but the power of the

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[97] *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA) 290 (Evershed MR).
[98] (1887) LR 12 App Cas 589 (PC) 600 (Sir Richard Baggallay).
[99] *Smith v Croft (No 2)* [1988] Ch 114, 186 (Knox J).
[100] [1985] BCLC 237, 254-55.
[101] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA) 210, 222; *MacDougall v Gardiner* (1875) LR 1 Ch D 13 (CA) 25.

company, which should be exercised in the interests of the company and all its shareholders. Company law does not allow the power to be used in an unfair or improper way: the use of power may not be illegal, fraudulent or oppressive towards those shareholders who oppose it[102]. The right of a shareholder to vote in his selfish interests does not entitle him with impunity to injure his fellow shareholders[103]. Majority shareholders cannot appropriate the property of a company to themselves and use their own votes at general meeting to prevent their being sued by the company[104]. They cannot ratify fraud on the minority, and it is both the right and duty of the courts to prevent that kind of oppression being imposed on the minority[105]. In addition, when wrongdoers are in control, it is required that this decision should be made by the support of independent shareholders only[106]. Therefore, majority power in these situations should rest on the majority inside a minority.

To conclude, the principle of majority rule has exceptions that offer special protection to minority shareholders. Company law empowers minority shareholders, within the exceptions of the rule of *Foss v Harbottle*, to challenge majority decisions in court. However, the courts have never strongly supported minority shareholder litigation. On the contrary, the aim of the rule in *Foss v Harbottle* itself was to stop this kind of litigation[107]. Only in exceptional cases, minority shareholders have been able to claim the protection of court, and therefore they have often been "virtually defenceless"[108]. The attitude of the courts is still that a minority shareholder should have a case strictly within the properly defined boundaries of the exceptions to proceed with

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[102] *North-West Transportation Co Ltd v Beatty* (1887) LR 12 App Cas 589 (PC) 594.
[103] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 16.
[104] *Atwool v Merryweather* (1867) LR 5 Eq 464n; see also *Peters' American Delicacy Company Ltd v Heath* (1939) 61 CLR 457 (High Court of Australia) 505.
[105] *Brown v British Abrasive Wheel Co Ltd* [1919] 1 Ch 290, 294 (Astbury J.)
[106] *Smith v Croft (No 2)* [1988] Ch 114.
[107] See eg *MacDougall v Gardiner* (1875) LR 1 Ch D 13 (CA) 25 (Mellish LJ).
[108] Hoffmann, L. H. H., Foreword to First Edition in Hollington, Robin, *Shareholders' Rights* (4th edn London 2004) xi.

his action[109]. The law has actually been more like a handbrake for shareholder activism through litigation[110]. In sum, company law supports rather than restricts majority power in the company. However, the courts do not compromise shareholders' individual rights, which rest on the company constitution and company law. The rule in *Foss v Harbottle* does not apply when shareholders' personal rights have been infringed.

6.3.3.2 Minority shareholders' specific rights

Since companies are governed by majority rule, the rights of individual shareholders should be restricted[111]. In any case, shareholders have both economic rights and control power in the company[112]. Shareholders' rights are their interests, which are protected by legal rules[113]. In addition, it is possible to say that, as in societies generally, shareholders' individual rights are legal promises from those who use the majority power[114].

In the first stage, shareholders can protect their economic interests in a company by using their voting power in general meeting. However, the majority uses power in the company. This power protects shareholders as a group but it cannot offer protection to an individual shareholder when the interests of shareholders are conflicting.

By contrast, shareholders' economic rights are in proportion to their shares. Consequently, all shareholders have an equal economic participation right in the company, and therefore it should not matter whether they are minority or majority shareholders. Ultimately, every ordinary shareholder should receive the same dividend, and he should get his proportionate share of a company's net assets if the company is

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[109] See especially *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).
[110] Eg Blanchard, Julian, 'Who Are Shareholders? –Search for Identity and Role' (1999) 11 Corporate and Business Law Journal 165, 166.
[111] [1982] Ch 204 (CA).
[112] See above, chapter two 2.3.
[113] Generally eg Fitzgerald, P. J., *Salmond on Jurisprudence* (12th edn London 1966) 217.
[114] See especially Dworkin, Ronald, *Taking Rights Seriously* (6th impression London 1991) 204-5.

wound up[115]. Even if majority shareholders have the power to govern a company's business, they do not have the right to decide how its success should be divided among shareholders[116]. Economic rights remain proportional to the amount of shares although the company is governed by majority rule. Shareholders' individual rights are indeed their rights, not the rights of the company. In addition, as already mentioned, company law gives minority shareholders power to sue the majority and the company if their individual rights are invaded[117].

Company law provides some governance rights to individual shareholders or a group of them. For example, shareholders having one-tenth of a company's share capital can require the directors to convene an extraordinary general meeting[118]. Members holding one-twentieth of the total voting rights, or 100 members, may ask the company to give notice concerning a resolution at the next general meeting[119]. So, minority shareholders can even take an initiative to alter the company's constitution, although in practice the articles are rarely changed by an initiative from individual shareholders. Furthermore, a shareholder has the right to give notice to propose a person as a director of the board[120]. Nonetheless, these rights do not change the fact that decisions in a company are made by majority rule, but these rights make it possible that minority shareholders can take an active role in certain matters.

Minority shareholders have some special statutory rights to challenge in court decisions made by the support of a majority. This kind of issue is the alteration of the constitution since CA 1985 s 5 allows minority shareholders that hold at minimum15 per cent of share capital to challenge the purported alternation of the objects clause in the memorandum. Moreover, if the status of a public company is altered by a special

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[115] More above, chapter five 5.4.
[116] Eg *Griffith v Paget* (1877) LR 5 Ch D 894: a majority cannot decide the mode of distribution among members since the division should be in accordance with shareholders' rights.
[117] *Edwards v Halliwell* [1950] 2 All ER 1064 (CA) 1067 (Jenkins LJ).
[118] CA 1985 s 368.
[119] Ibid 376(1)(a) and (2).

resolution, and it becomes a private company[121], this change is fundamental for the company and its shareholders. The status of a public company is specially protected due to its importance to shareholders. The application to re-register a public company as a private one may be challenged by shareholders representing not less than 5 per cent of shares, or by not less than 50 company members[122]. But the normal way to take public companies private is to make a takeover offer and to buy out minority shareholders. The possible change of a company's status is typically done after these operations. Thus, this example might be a theoretical rather than practical way to protect minority shareholders in public companies[123].

In summary, the specific rights of minority shareholders do not change the main principle that companies are governed by majority rule. Yet, the legislation gives some rights to minority shareholders in relation to the governance of the company. Furthermore, in special cases, minority shareholders may challenge decisions made by majority power. Majority shareholders indeed exercise power in a company but company law restricts the use of it and also gives minority shareholders rights to protect themselves and their interests.

6.4 Oppression of minority shareholders

While company law gives power to majority shareholders, there is no reason to argue that minority shareholders should generally be protected from the use of this power. However, company law should protect minority shareholders from *abuse* of majority power. Yet, the distinction between use and abuse of power is not always absolutely clear. But as explained above, fraud on the minority is one area where common law steps in to protect the minority. In addition, company law protects minority shareholders

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[120] Table A art 76(b).
[121] See CA 1985 s 53ff.
[122] Ibid s 54(2).

from oppression by the majority, which is regarded as a tyrannical misuse of power[124]. Before exploring minority shareholders' statutory remedies against oppression and unfair prejudice, I first analyse briefly the relationship between shareholders in different kinds of companies.

6.4.1 Relationship in public and private companies

Company law governs both public and private companies. But since relationships in these companies have their own special features, different company law rules and principles apply on companies with peculiar nature. This point is very true in the case of remedies available against unfair prejudice by majority shareholders.

In a small private company, the shareholders are often the real entrepreneurs of its business: such shareholders are typically directors and employees in the company. A private company can be very much like a partnership, where shareholders are said to be quasi-partners[125]. Shareholders in a private company can be in substance partners that carry on their business by means of the machinery of a limited company[126]. These companies have a strong partnership background, and in cases of small private companies company law still recognizes many ideas of partnership law[127]. It is difficult to find any 'separation of ownership and control'[128] in these close companies. Private companies are not peculiarly capital-raising devices. Therefore, shareholders' investment in share capital does not play such a central role in these companies, and shareholders' contributions as full-time workers and directors of the company may have

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[123] For takeovers and squeeze-out, see below, chapter seven 7.6.
[124] See *Re Baltic Real Estate Ltd (No 2)* [1993] BCLC 503, 507 (Knox J).
[125] Although, as Lord Wilberforce observed in *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 380: "A company, however small, however domestic, is a company not a partnership or even a quasi-partnership."
[126] *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch 426 (CA) 434 (Warrington LJ).
[127] *Re Smith and Fawcett Ltd* [1942] Ch 304 (CA) 306 (Lord Greene): "Private companies are in law separate entities just as much are public companies, but from the business and personal point of view they are much more analogous to partnerships than to public corporations."
[128] About this term, see above, chapter three 3.3.2.

more importance[129]. It is possible that all the profits of a private company are distributed as directors' remuneration[130]. In contrast, in public companies the relationship between members and the company, and among the shareholders inter se, is not as personal as it is in close companies and partnerships. Shareholders in quoted companies are plain investors, whose interest is their shares and shareholders' rights.

The relationship in private companies has special features: in these companies, company law protects also shareholders' interests and their legitimate expectations. In *Re Sam Weller& Sons Ltd*[131], Peter Gibson J observed that: "The word 'interests' is wider than a term such as 'rights'". He also considered that the term suggests that "members may have different interests, even if their rights as members are the same"[132]. In *Ebrahimi v Westbourne Galleries Ltd*[133], Lord Wilberforce explained that shareholders "are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure". In effect, shareholders in these companies can be in substance partners, or quasi-partners. As a result, equitable principles derived from partnership law apply to private companies. These equitable considerations arise in particular when the company is a small one, but that alone is not enough. Lord Wilberforce put the idea in this way:

> The superimposition of equitable considerations requires something more, which typically may include one, or probably more, of the following elements: (i) an association formed or continued on the basis of a personal relationship,

[129] Manne, Henry G., 'Our Two Corporation Systems: Law and Economics' (1967) 53 Virginia Law Review 259, 278 describes private companies in this way: " Generally, in small business, a few individuals, perhaps each with some specialized function to perform, associate in order to exploit an idea. Their contribution may be capital; it may be an invention; it may be a long-term employment contract; it may be organizational ability; or it may be some other form of property, such as land, machinery, or raw materials."
[130] Eg the company in *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) had never paid any dividends.
[131] [1990] Ch 682, 690.
[132] Ibid.
[133] [1973] AC 360 (HL) 379.

> involving mutual confidence – this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all, or some (for there may be 'sleeping' members), of the shareholders shall participate in the conduct of the business; (iii) restriction on the transfer of the members' interest in the company – so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.[134]

On the whole, equity enables "the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way"[135]. The interests of members in private companies are not limited to the strict legal rights under the constitution of the company[136]: the legal relationships do not tell the "whole story" in quasi-partnerships[137]. Therefore, these companies are not governed only by strict majority rule. A shareholder in a private company has still to demonstrate some special relationship of mutual confidence, or special circumstances, which create a legitimate expectation beyond the articles of association[138].

On the contrary, when the relationship between shareholders is not personal and "the association is a purely commercial one", their relationship is then "adequately and exhaustively laid down in the articles"[139]. The requirements from partnership law do not

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[134] Ibid.
[135] Ibid.
[136] See *Re a company* [1986] BCLC 376, 378 (Hoffmann J); *Re Fildes Bros Ltd* [1970] 1 All ER 923, 926 (Megarry J), where it was seen that in a private company one must have regard not merely to the articles, but also to what the parties are shown to have agreed in any other manner.
[137] *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 (PC) 117 (Lord Millett).
[138] *Re Posgate & Denby (Agencies) Ltd* [1987] BCLC 8; *Re a company (No 00314 of 1989), ex p Estate Acquisition and Development Ltd* [1991] BCLC 154.
[139] [1973] AC 360 (HL) 379.

govern the relationship in public companies, where equitable considerations should not arise between shareholders. In public companies, there is little room for shareholders' legitimate expectations outside the articles: the legitimate expectation is that the affairs of a company are properly conducted within the framework of its constitution. For example, a shareholder in a public company cannot have a legitimate expectation to remain a director and to have a participating role in the affairs of the company[140]. Further, a shareholder does not have a legitimate expectation that the articles would not be altered by special resolution in a way that enables his office to be terminated[141].

In a public company, it is very difficult to argue that there could be legitimate expectations beyond the rights arising by the articles of association. The concept of legitimate expectation does not apply in the context of public companies[142], where equitable considerations should not restrain the majority from using the power that they have under the company constitution and company law. In the absence of a personal relationship, a shareholder in a public company cannot reasonably and legitimately expect more than that the affairs of the company will be conducted in accordance with its articles and the Act[143]. On the other hand, this means that shareholders in listed public companies are entitled to assume that the whole constitution is contained in the articles, which should, in any case, be read together with the companies' legislation[144].

There is one important further dimension to mention about public quoted companies. A company has a majority shareholder when there exists a single shareowner that holds more than a half of voting power. This shareholder holds legal

[140] *Re Tottenham Hotspur plc* [1994] 1 BCLC 655.
[141] *Re Blue Arrow plc* [1987] BCLC 585, 590 (Vinelott J).
[142] *Re Astec (BSR) plc* [1998] 2 BCLC 556, 589-90 (Jonathan Parker J); *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14 (CA).
[143] [1998] 2 BCLC 556, 588.
[144] [1987] BCLC 585, 590; however, in *Re a company* [1986] BCLC 376 evidence could be brought to show that a shareholder in a public company had a legitimate expectation to remain a director when the company was not listed, and thus in practice there was no market where shares could be sold; but in this study the public company is understood as a company with quoted shares, and therefore the company in this particular case was not a 'real' public company.

control in the company. Yet, often this majority shareholder is not actually a single shareholder but a group of shareholders like a family. However, sometimes the biggest shareholder who has less than a half of voting power might have an actual majority when the ownership of shares is dispersed. But from the perspective of a minority shareholder, control of the company is still "elsewhere"[145] since he cannot elect a director onto the board, cannot remove a director, and is dependent on the majority for any dividends. In general, that is the position of all shareholders in public companies: none of them has control in the company but they all have it. I formulate this point by stating that in listed companies every shareholder is a minority shareholder[146]. In consequence, the need for protection of minority shareholders against oppression by a majority is not similar in public companies.

To conclude, the exercise of majority power in private companies is subject to equitable considerations. By contrast, in public companies there is little room for equity derived from partnership law. Shareholders in public companies do not have legitimate expectations outside the articles of association since the relationship between these shareholders is set in the company constitution. In addition, in public companies there does not typically exist any majority shareholder. Thus, remedies against unfair prejudice and just and equitable winding up are mainly available only in the case of a private company. I next set the focus on these remedies.

6.4.2 Unfair prejudice

The concepts of unfair prejudice and just and equitable winding up are analogical with each other. Overall, the history of winding-up orders is longer but the statutory remedy against unfair prejudice is more a recent concept. Yet, I start the following discussion

[145] *Re H R Harmer Ltd* [1958] 3 All ER 689 (CA) 705 (Jenkins LJ); about the control in the case of a public quoted company, see *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).

with unfair prejudice because that is the most important minority shareholder remedy in this area.

In their report in 1945, the Cohen Committee considered that there was a need to strengthen private companies' minority shareholders in resisting oppression by the majority[147]. They recommended a new section in the Companies Act, under which the court should be empowered, instead of making a winding-up order, to make such other order, including an order for the purchase by the majority of the shares of the minority at a price fixed by the court[148]. This recommendation was translated into the Companies Act 1948 s 210. The current provision in CA 1985 s 459(1)[149] states that:

> A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

The CA 1985 s 461(1) provides that if the court is satisfied with the idea that the petition is well founded, it may make "such order as it thinks fit for giving relief in respect of the matters complained of." The court may make all or any of a number of orders specified in CA 1985 s 461(2), which include orders regulating the future conduct of the company's affairs, requiring the company to do or refrain from doing some act, and an order under CA 1985 s 461(2)(d) providing for the purchase of the petitioner's shares by other members of the company or the company itself. The last one

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[146] See also Boros, Elizabeth J., *Minority Shareholders' Remedies* (Oxford 1995) 14-15.
[147] *Report of the Committee on Company Law Amendment ('Cohen Committee')* (Cmd 6659) (London 1945) [60].

is the most common remedy, and my interest is in these minority shareholders' buy-out orders[150].

In essence, if a company's affairs are conducted in an oppressive way against the interests of the minority, the court orders an appropriate remedy. In *Scottish Co-operative Wholesale Society Ltd v Meyer*[151], the parent company was ordered to purchase the shares of minority shareholders because it had behaved in an oppressive manner. It was held that the majority shareholder had exercised its power and authority in the company "in a manner 'burdensome, harsh and wrongful'"[152]. Still, CA 1985 s 459 does not only give protection against illegality and invasion of legal rights: unfairly prejudicial is deliberately imprecise language chosen by Parliament since the earlier attempt in the Companies Act 1948 s 210 had been too restrictively construed. As the Jenkins Committee formulated: "if the section is to afford effective protection, it must extend to cases in which the acts complained of fall short of actual illegality"[153].

According to CA 1985 s 459, the criterion by which the court decides whether it has jurisdiction to grant relief is fairness. The test of unfairness is objective, and therefore it is not necessary for petitioners to show that the persons in control of a company have acted knowingly unfair or in bad faith[154]. Moreover, courts are free from technical considerations of legal rights because they have wide power to do what appears to be just and equitable. The CA 1985 s 461 enables, but does not compel, the court to make an order under this section. Although the court has very wide discretion,

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[148] Ibid 95.
[149] As amended by the Companies Act 1989.
[150] There are some very rare cases where the majority shareholder is ordered to sell his shares to the petitioner, eg in the case of a football club in *Re a company (No 00789 of 1987), ex p Shooter* [1990] BCLC 384.
[151] [1959] AC 324 (HL) (Sc).
[152] Ibid 342 (Viscount Simonds).
[153] *Report of the Company Law Committee ('Jenkins Committee')* (Cmd 1749) (London 1962) [203], whose recommendations were put into effect by the Companies Act 1980 s 75.
[154] *Re Bovey Hotel Ventures Ltd* (31 July 1981 unreported) (Slade J); quoted in *Re R A Noble & Sons (Clothing) Ltd* [1983] BCLC 273, 290; *Re Sam Weller & Sons Ltd* [1990] Ch 682; *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479.

"it does not sit under a palm tree"[155]. Justice and fairness indeed mean different things to different men, and the court cannot do whatever an individual judge happens to regard as fair. The CA 1985 s 459 offers fairness in the business context, and unfairness to a member requires some breach of the terms in the company's affairs[156]. As Hoffmann J said in *Re Posgate & Denby (Agencies) Ltd*[157]: "Section 459 enables the court to give full effect to the terms and understandings on which the members of the company became associated but not to rewrite them". In addition, the conduct must be both prejudicial and unfair, and if the conduct is only unfair or prejudicial, the requirements of the section are not satisfied[158].

The standard example of CA 1985 s 459 cases is a company where shareholders have entered into association upon the understanding that each of them will participate in the management of the company. For instance, in *Re a company* [159] a minority shareholder of an unlisted public company had a legitimate expectation that he would continue to be employed as a director; hence, his exclusion from the management was unfairly prejudicial to his interests as a member. Even though every director of a company is subject to the possibility of being removed by majority resolution, the special circumstances can be grounds for a complaint under s 459[160]. Further, the amount of directors' remuneration is not only a commercial decision. If majority shareholders decide by majority power to pay themselves excessive directors' fees, they may conduct the affairs of the company in a manner that is unfairly prejudicial to minority shareholders' interest[161].

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[155] *Re J E Cade & Son Ltd* [1992] BCLC 213, 227 (Warner J).
[156] See especially *O'Neill v Phillips* [1999] 1 WLR 1092 (HL); *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14 (CA).
[157] [1987] BCLC 8, 14.
[158] *Re a company (No 005685 of 1988), ex p Schwarcz (No 2)* [1989] BCLC 427, 437 (Peter Gibson J).
[159] [1986] BCLC 376.
[160] See *Re Estate Acquisition & Development Ltd* [1995] BCC 338, 349-50 (Ferris J); but in this particular case the member was unable to point the special circumstances, and so the petition was dismissed.
[161] *Re a company (No 002612 of 1984)* (1986) 2 BCC 99, 453; affirmed *Re Cumana Ltd* [1986] BCLC 430 (CA); see also *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042 (CA).

Managerial decisions in a company cannot normally amount to unfairly prejudicial conduct[162], although the decisions of the management are unwise or inefficient. It is not for the court to resolve disagreements on matters of commercial judgment. Yet, serious mismanagement could constitute unfairly prejudicial conduct. A remedy under s 459 is available in cases where what is shown is really mismanagement, rather than a difference of opinion on the desirability of particular commercial decisions, and further this mismanagement is sufficiently serious[163]. In addition, if majority shareholders exercise their power for an improper purpose and use assets of a company for their personal benefit, the remedy under s 459 is available[164].

The intention in this study is not to cover all situations where the courts have found the behaviour of a majority unfairly prejudicial against the minority. But I consider some more examples concerning the constitutional relationship in the company. First, the company constitution is alterable by the decision of special majority. But under special circumstances, the passing of a resolution to alter the company's articles could be unfairly prejudicial to the interests of minority shareholders[165]. Second, payment of a dividend to shareholders depends on the recommendation of the board and the resolution of general meeting to follow it. Companies are not required to pay any dividend even if they are profitable. Still, the payment of low dividends is capable of amounting to conduct unfairly prejudicial to the interests of minority shareholders[166]. In practice, it is often the combination, like excessively high directors' remuneration and unjustifiably low dividends, which constitutes unfairly prejudicial conduct towards the minority. The test of unfairness under CA 1985 s 459 is objective, and if the remuneration and dividends cannot be

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[162] *Re Sam Weller & Sons Ltd* [1990] Ch 682, 694 (Peter Gibson J).
[163] *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 404-5 (Arden J); compare Peter Goldsmith QC (sitting as a deputy judge) in *Re Legal Costs Negotiators Ltd* [1999] 2 BCLC 171 (CA) 185, where he held it possible but generally unlikely that serious mismanagement could constitute unfair prejudice.
[164] *Re Elgindata Ltd* [1991] BCLC 959.
[165] *Re Kenyon Swansea Ltd* [1987] BCLC 514.

justified by commercial criteria, the conclusion might be that the company has been managed in a way unfairly prejudicial to the minority shareholders.[167] Third, a company can increase its share capital by issuing new shares provided it is authorised to do so by the articles, and share offerings rest on the principle that shareholders have a pre-emption right to subscribe the new shares issued by the company. Nevertheless, even if it is a rights issue to all shareholders on a pro rata basis at a proper share value, the decision concerning share issue is capable of being unfairly prejudicial when it is known that some shareholders are unable to take up the shares offered. The court may grant an injunction against increasing company's share capital by majority power.[168]

But the idea is not that CA 1985 s 459 would offer no-fault divorce to shareholders in a private company. A minority shareholder cannot demand that his shares are purchased although he has lost trust and confidence in other shareholders.[169] What is required is an act or omission by the company and majority shareholders, which should be unfairly prejudicial to a minority shareholder in his capacity as a member of the company. Therefore, s 459 does not enable a locked-in minority shareholder to require the company or majority shareholders to buy him out at a price that he considers adequately to reflect the value of his shares[170]. As Lord Hoffmann explained in *O'Neill v Phillips*, what s 459 really does is setting of equitable restraints to majority shareholders to exercise the rights under the articles in an unfairly prejudicial way. But the concept of shareholders' legitimate expectation "should not be allowed to lead of a life of its own," and equitable restraints should not be set in circumstances where they

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[166] *Re Sam Weller & Sons Ltd* [1990] Ch 682.
[167] *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479.
[168] *Re a company* [1985] BCLC 80; affirmed sub nom *Re Cumana Ltd* [1986] BCLC 430 (CA); see also *Re a company* [1986] BCLC 362.
[169] *O'Neill v Phillips* [1999] 1 WLR 1092 (HL) 1104 (Lord Hoffmann).
[170] *Re a company (No 004475 of 1982)* [1983] Ch 178; *Re Phoenix Office Supplies Ltd* [2003] 1 BCLC 76 (CA).

traditionally have no application[171]. As a result, this ruling has eliminated fanciful but legally baseless expectations of minority shareholders[172].

In summary, in cases of unfair prejudice the main questions determined by the court are: 1) whether the affairs of the company have been conducted in a manner that is unfairly prejudicial to the interest of minority shareholders; 2) if so, whether the appropriate remedy is to order the majority shareholders to purchase the shares of the minority; and 3) if so, on what basis the price of shares should be determined[173]. In this study, I do not explore any further when the remedy under CA 1985 s 459 is available for minority shareholders. Yet, I conclude that one situation in which a member of a company may bring himself within s 459 prevails when he is able to show that the value of his shares has been seriously diminished or jeopardised by the unfair conduct by those who control the company[174]. Overall, unfair prejudice can make the value of minority shares lower. Still, the points concerning the value of shares are discussed in the next chapter. Therefore, I move on to review just and equitable winding up.

6.4.3 Just and equitable winding up

Shareholders have been enabled to petition for winding up of companies since 1848[175], which orders have been made especially in cases where members are in substance partners and the particular facts could justify dissolution of partnership between them. In *Re Yenidje Tobacco Co Ltd*[176], the winding up of a private company was seen just and equitable as there was a deadlock between two opposing shareholders. The winding-up order was the way to put an end to the state of things that could not have been contemplated by the parties when the company was formed.

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[171] [1999] 1 WLR 1092 (HL) 1102.
[172] Pennington, Robert R., *Pennington's Company Law* (8th edn London 2001) v.
[173] See *Re Elgindata Ltd* [1991] BCLC 959, 961 (Warner J).
[174] *Re Bovey Hotel Ventures Ltd* (31 July 1981 unreported); quoted in *Re R A Noble & Sons (Clothing) Ltd* [1983] BCLC 273; and [1991] BCLC 959.
[175] The Joint Stock Companies Winding-up Act 1848 s 5.

The statutory power to wind up companies is set in the Insolvency Act 1986 s 122(1)(g) that states: "A company may be wound by the court if the court is of opinion that is just and equitable that the company should be wound up." Indeed, 'just and equitable' are words of the widest significance: they do not limit the jurisdiction of the court to any particular case. In consequence, each case depends on its own special circumstances.[177] But just and equitable winding up is draconian in nature since it ends a company and distributes the value of its net assets to shareholders. A winding-up order is like the execution of a company by the order of the court[178]; of course, the courts should be careful when they are asked to pass a death sentence on the company on the grounds that it is just and equitable to do so. It is a drastic decision to take against the wishes of the majority in a solvent company.[179]

But courts have this jurisdiction, and a private company was wound up by the court's order in *Ebrahimi v Westbourne Galleries Ltd*[180], which is the classic case in this area. The company made good profits, which were totally distributed as directors' remuneration, and therefore no dividends were ever paid. The House of Lords considered that the shareholders had joined in the formation of the company on the basis that all shareholders were entitled to participate in its management. While the majority repudiated that relationship between shareholders, the minority shareholder lost his right to share the profits of the company. The proper course under these circumstances was to dissolve the company by a winding-up order since the minority shareholder was at the mercy of the majority shareholders and unable to dispose his interest in the company. The just and equitable provisions came to the assistance of the minority shareholder.

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[176] [1916] 2 Ch 426 (CA).
[177] *Re Blériot Manufacturing Aircraft Co Ltd* (1916) 32 TLR 253, 255 (Neville J).
[178] Carr, C. T., *The General Principles of the Law of Corporations* (Cambridge 1905) 124.
[179] *Re a Company (No 00314 of 1989), ex p Estate Acquisition and Development Ltd* [1991] BCLC 154, 161 (Mummery J).
[180] [1973] AC 360 (HL).

The prime aim of this study is not to review winding-up cases widely, but I take some examples more. In *Loch v John Blackwood Ltd*[181], the managing director with his wife had the control power in the company, and he managed the business as his own. The directors did not recommend any dividend since their intention was to keep other shareholders in ignorance of the company's position and affairs to acquire their shares at an undervalue. In the circumstances of the case, and regarding the domestic character of the company, the minority shareholders were entitled to a winding-up order. Similarly, in *Re a company (No 00370 of 1987), ex p Glossop*[182] the board and majority shareholders consistently refused to recommend and pay dividends, and therefore the minority shareholder's legitimate expectation of getting dividends from the company was defeated. The judge held that such conduct could make it just and equitable to wind up the company. In *Virdi v Abbey Leisure Ltd*[183], it was accepted that there had existed understanding between shareholders that the company would not be involved in other businesses without the consent of all shareholders. It was equitable to ignore the provisions of the company's constitution, which entitled the directors to carry the company's operations after all the business was sold. In addition, due to the particular circumstances of the case, the minority shareholder had a right to refuse to sell his shares under the provisions contained in the articles of association. Thus, the minority shareholder's petition for a winding-up order should not have been struck out.

Managerial decisions do not normally amount to unfairly prejudial conduct under s 459[184]; thus, it is very understandable that the misconduct by the directors cannot be grounds upon which the courts consider it just and equitable to wind up a company[185]. In addition, although the company might be unprofitable, or the situation in

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[181] [1924] AC 783 (PC).
[182] [1988] BCLC 570; relief under CA 1985 s 459 could not be granted because of the technical objection that was removed by the amendment of the Companies Act 1989.
[183] [1990] BCLC 342 (CA).
[184] See above note 162ff.
[185] Re *Anglo-Greek Steam Co* (1866) LR 2 Eq 1.

the company may not be economically hopeful, that is not itself a reason for winding up on just and equitable grounds[186]. A winding-up process cannot be used as a means of evoking a judicial decision concerning the probable success or non-success of a company in its business.[187] Business decisions should be made in the company, not in the courts. However, if it is really impossible to perform the business of a company, a winding-up order may be available even in the absence of insolvency[188]. But the impossibility of the business must then be a proven fact, not just a question of different commercial opinions. Further, a winding-up order is available if all the company's commercial objects as set in the memorandum are unattainable[189].

In cases of oppression and unfair prejudice, a minority shareholder is typically locked into the company. As Lord Cross explained in *Ebrahimi v Westbourne Galleries Ltd*[190], what the minority shareholder really wants is not to have the company wound up but to get a proper price for his shareholding. It is not in the interests of a minority shareholder that the company is wound up; however, that may be the best way for him to get his share of the value of the business. In *Ebrahimi v Westbourne Galleries Ltd*, a winding-up order was given since the minority shareholder had lost his entitlement to management participation. Since the relationship between shareholders was broken, the conclusion was that the association must be dissolved. In fact, liquidation can be a clear way to dissolve a business. In addition, a liquidator is in a better position than any other valuer to determine the value of shareholders' claims as considered in *Virdi v Abbey Leisure Ltd*[191].

[186] *Re Langham Skating Rink Co* (1877) LR 5 Ch D 669 (CA); *Re Anglo-Continental Produce Co Ltd* [1939] 1 All ER 99; it should be noted that in this case the petition was presented by the company as an outcome of a resolution passed by the majority of shareholders, but not by a three-fourths majority.
[187] *Re Suburban Hotel Co* (1867) LR 2 Ch App 737.
[188] Ibid.
[189] *Re Perfectair Holdings Ltd* [1990] BCLC 423.
[190] [1973] AC 360 (HL) 385.
[191] [1990] BCLC 342 (CA).

On the other hand, the making of a winding-up order can be unfairly prejudicial to minority shareholders. For example, a company may have a lot of goodwill, as the case was in *Scottish Co-operative Wholesale Society Ltd v Meyer*[192], where the House of Lords ordered the purchase of the petitioner's shares notwithstanding it could have wound up the company on the just and equitable ground. Minority shareholders were entitled to get more than only the break-up value of their shares. As the Cohen Committee mentioned in their Report: "In many cases, however, the winding-up of the company will not benefit the minority shareholders, since the break-up value of the assets may be small, or the only available purchaser may be that very majority whose oppression has driven the minority to seek redress"[193]. Naturally, there is no sense in arguing that in these situations the law could offer remedy to minority shareholders if it actually just offers to the majority a way to buy out the minority at a bargain price. As a result, in certain circumstances a winding-up order is a fair remedy, but there are also situations in which it is not. The alternative that was preferred by the courts in *Virdi v Abbey Leisure Ltd* and in *Scottish Co-operative Wholesale Society Ltd v Meyer* was the one that offered a better remedy to the minority shareholder and thus a higher value for his shares. Still, the aim of remedies against unfair prejudice is not to offer the best available price for minority shares. The court fixes shares a price that is fair to both minority and majority shareholders; in addition, that price should correct the unfair prejudice to which minority shareholders have been subjected[194]. However, as mentioned, I do not analyse this point any further in this context because the value of shares is an issue under discussion in the next chapter.

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[192] [1959] AC 324 (HL) (Sc).
[193] *Cohen Committee* [60].
[194] *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479, 488 (Sir Richard Scott VC).

There is a strong parallel between the notion of just and equitable and the notion of fairness in CA 1985 s 459. As Lord Hoffmann observed in *O'Neill v Phillips*[195]: "The parallel is not in the conduct which the court will treat as justifying a particular remedy but in the principles upon which it decides that the conduct is unjust, inequitable or unfair." Therefore, the conduct can be unfairly prejudicial although it does not justify an order to wind up the company. In practice, petitioners often claim relief under CA 1985 s 459 and alternatively a winding-up order on the just and equitable ground under s 122(1)(g) of the Insolvency Act 1986. But a winding-up order on the just and equitable ground is always a remedy of last resort[196]. According to the Insolvency Act s 125(2), the company should be wound up only if the court sees that as fair and equitable "in the absence of any other remedy"[197]. In general, this other available remedy is an order under CA 1985 s 459 for the purchase of minority shareholders' shares, which is the main remedy available for minority shareholders in cases of unfair prejudice.

Ultimately, company law should support companies in their function. Overall, the death sentence of a company in the form of a winding-up order is available only under very special circumstances. In *Re a company (No 00314 of 1989), ex p Estate Acquisition and Development Ltd*, Mummery J formulated the role of the courts in unfair prejudice cases in the following way:

> Under ss 459 to 461 the court is not, therefore, faced with a death sentence decision dependent on establishing just and equitable grounds for such a decision. The court is more in the position of a medical practitioner presented with a patient who is alleged to be suffering from one or more ailments which

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195 [1999] 1 WLR 1092 (HL) 1100.

196 Re a *company (No 004415 of 1996)* [1997] 1 BCLC 479.

197 This statutory injunction has been supplemented by the Practice Direction dated 22 February 1990; see [1990] 1 WLR 490.

can be treated by an appropriate remedy applied during the continuing life of the company.[198]

A winding-up order on just and equitable grounds terminates the existence of a company but under CA s 461 there is a wider range of remedies available, although in practice the main remedy is a buy-out order concerning the shares of the minority shareholder. Still, both just and equitable winding up and CA 1985 s 459 confers on the court a very wide jurisdiction and discretion, which power should be controlled carefully in order to prevent it from becoming a means of oppression by dissident minority shareholders. The threat of proceedings should not be used to bring pressure on the majority to accept the price he demands for his shares.[199] But where justice and equity require the courts should order as a remedy of last resort to liquidate the company. The prime remedy in these circumstances is, however, CA 1985 s 459; in consequence, the importance of just and equitable winding-up orders has actually declined.

6.5 Conclusions of majority and minority relationship

Companies are governed by majority rule: ultimate power in the company rests on a majority of shareholders. Therefore, as in societies generally, the policy of the company is set by majority power. Company law gives the majority shareholders power to decide on behalf of the company, and these decisions bind the dissenting minority. In addition, it is not a task of courts to resolve disagreements on matters of commercial judgment. Business decisions should be made in companies, not in the courts.

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[198] [1991] BCLC 154, 161.

[199] *Re a company* [1986] BCLC 362, 367-68 (Hoffmann J); about the blackmailing actions, see also *Pavlides v Jensen* [1956] Ch 565, 569.

Shareholders use their control power at general meeting, where they can vote with their shares as they please. Their motive is irrelevant unless it amounts to fraud or oppression. Yet, any power that majority shareholders control is not theirs but the power of the company that should be exercised in good faith and for the benefit of the company as a whole. Majority rule does not give a majority an unrestricted alibi to use power in the company for their own personal interests. Decisions made by majority power may not be discriminative towards the minority. Company law does not allow majority shareholders to oppress the minority; they may not exercise their power to bring an advantage to themselves and a disadvantage to the minority. If the majority uses the power in a fraudulent way, the minority may challenge these decisions in court. Majority rule and the rule in *Foss v Harbottle* comprise exceptions, of which the most important is fraud on the minority when the wrongdoers control the company. Therefore, although the task of the courts is not to substitute an opinion of the majority by its own opinion, company law and courts protect the minority when majority shareholders abuse their power. Majority power in the company is "subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities"[200].

The memorandum and the articles of association set the constitutional structure in a company. The company constitution is a statutory contract between each member and the company; furthermore, the articles regulate shareholders' rights inter se. A majority gets its power from the company constitution and the Companies Act. However, the exercise of majority power in private companies is subject to equitable considerations. The relationship in private companies has special features since company law does not only protect shareholders' rights but also their interests and legitimate expectations. The concept of unfair prejudice enables the court to take into

[200] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) 671.

consideration not only the rights of the members under a company's constitution but also their legitimate expectations arising from agreements and understandings of the members inter se. Yet, a shareholder that claims protection against unfair prejudice has to demonstrate some special circumstances that create a legitimate expectation. In essence, he must show that the behaviour of the majority is both unfair and prejudicial.

The protection against oppression and unfair prejudice is "an equitable supplement to the common law of the company"[201]. The legislator has seen that minority shareholders should have more protection than the common law has offered. Further, in a wider sense these remedies against oppression are exceptions to the rule in *Foss v Harbottle* because in the cases of just and equitable winding up and unfair prejudice, a minority shareholder is empowered to bring an action against majority shareholders in his own name and on behalf of the company.

But the remedies against oppression and unfair prejudice are available only in small owner-managed companies. In public companies, there is little room for equitable considerations: instead, shareholders' legitimate expectation is that the affairs of a company are properly conducted within the framework of its constitution. Remedies against unfair prejudice are not available in public companies, where shareholders' rights under the articles of association and the Companies Act are "an exhaustive statement"[202] of shareholders' interests. Naturally, this also means that shareholders in a public company should be entitled to assume that the whole of the constitution is contained in the articles. Therefore, in cases of public companies the focus of company law should be clearly on the company's constitution and companies' legislation. Furthermore, it is understandable that company law offers less protection against oppression by the majority in public companies, which do not normally have any majority shareholders.

[201] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 384 (Lord Cross).

The exceptions of majority rule provide extra protection to minority shareholders. In addition, they have some specific minority shareholders' rights. However, I stress that the most efficient minority protection is available through the protection of shareholders' rights. Even though companies are governed by majority rule, shareholders' economic rights are in proportion to their shares. These rights are not at the discretion of the majority. So, majority shareholders may control the company's business, and their opinion should prevail, but they do not have a right to determine how the success of a company is divided among shareholders. It is the company constitution and Companies Act that set shareholders' rights. In addition, the law gives minority shareholders the power to sue the majority to protect their individual rights from invasion. Fundamentally, ordinary shareholders have an equal economic participation right in the company, and it should not matter in these terms whether they are minority or majority shareholders. I argue that the best shareholder protection is available through the efficient support of these participation rights.

"The ultimate problem of the law is balance", and the courts need "a sense of tact and balance" in their judgments[203]. This is very true in the case of company law since one of its central aims is to set a balance in the interests of individual shareholders and the company as a whole. Overall, minority protection in company law is a complicated area. The tension between the claims of justice in the particular cases and the position of the claimant as a member of a private company "has often proved difficult to resolve"[204]. Predominantly, English company law has mainly balanced in favour of the majority[205]. As a result, for most of the first century of company law

[202] Ibid 379 (Lord Wilberforce).
[203] Fuller, Lon L., *Legal Fictions* (Stanford 1967) 137.
[204] Lord Justice Chadwick in the Foreword in Joffe, Victor, *Minority Shareholders: Law, Practice and Procedure* (London 2000) v.
[205] The situation in the USA does not seem different if we share the view of Manne (1967) 281: "Unless minority shareholders in small corporations have made adequate advance preparation, they will not receive adequate protection from either the market or the legal system."

minority shareholders were "virtually defenceless"[206]. It is possible to formulate this point even more strongly as some commentators do:

> Until recent years, the position of the minority shareholder in a private company was sufficiently precarious, and the protection afforded to him by the law and the courts was so restricted, that in general the wise course was *not to invest* in this way.[207]

Before the introduction of s 210 of the Companies Act 1948, minority shareholders were often unable "to obtain any redress from the courts to stop the majority acting in an oppressive manner"[208].

On the other hand, during recent decades the law has provided more protection to minority shareholders in private companies, in particular under the statutory concept of CA 1985 s 459. In effect, the trend in company law has been towards the recognition of minority shareholder protection, and the position of minority shareholders is nowadays clearly stronger than it used to be. Remarkably, we can quote further the commentators above:

> In consequence, taking up an investment as minority shareholder in a private company may now be regarded as a sensible investment proposition, provided the terms of entry are carefully framed.[209]

Naturally, that is the way in which company law should operate: to support companies to accumulate capital, but not to make share investments unwise. Yet, the position of

[206] Hoffmann in Hollington (2004) xi.
[207] Dawson, I. J. and Stephenson, I. S., *The Protection of Minority Shareholders* (Croydon 1993) v (emphasis added).

minority shareholders has been strengthened by the support of the statutes mainly in private companies. In public quoted companies, shareholders might still face particular difficulties as both the defective state of common law and the detailed design of statutory remedies cause them problems[210]. But since public companies are very different in their nature, shareholder protection in these companies should be available in a different way. I emphasize that these shareholders can often get more protection from the markets than from company law. In particular, as explained in the next chapter, the Takeover Code has a central role in the protection of quoted companies' minority shareholders.

In chapter seven, I raise my main question: what is the value of shares in company law? The aim of this discussion is to give the answer to the question when share value is a matter of law and when a matter of fact. In addition, since value is generally a matter of opinion, I also ask whose opinion should prevail. In capitalism, every man is responsible for his fortune: in consequence, share value is more a private matter than a company's affair. So, the answer to the value of shares is found mainly outside majority rule, although the majority has a special role in setting the value of shares too.

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[208] *Re Legal Costs Negotiators Ltd* [1999] 2 BCLC 171 (Ch) 178 (Peter Goldsmith QC).
[209] Dawson and Stephenson (1993) v.
[210] Boyle, A. J., *Minority Shareholders' Remedies* (Cambridge 2002) 12.

CHAPTER 7

VALUE OF SHARES IN LAW

> *Everyone knows that there is no topic about which greater differences of informed opinion may sometimes exist than the value of shares in a private company unless it be the authenticity and value of certain pictures.*
> Lord Salmon, *Sutcliffe v Thackrah* [1974] AC 727 (HL) 760.

7.1 Introduction

Shareholders own their shares and, according to property rules, owners are entitled to determine the value of their property. This is a central idea in the market economy and company law.

In reality, the legal framework in every society is complex since relationships cannot "be painted in any one picture"[1]. Share valuation is not purely a matter of private property. First, shareholders' entitlements are protected by liability rules, in which situations the courts determine an objective value for shares. Second, companies are governed by majority rule, and this principle has importance in share valuation. For instance, the valuation accepted by a special majority is capable of binding every shareholder in a company takeover.

In this chapter, I review share value from the legal perspective; my focus is on situations where their value is determined objectively or collectively. The most central question is whether the value of majority and minority shares are equal in company law. I propose that company law fundamentally supports the equal value of shares.

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[1] Calabresi, Guido and Melamed, A. Douglas, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 Harvard Law Review 1089, 1128.

7.2 Property and liability rules

When an entitlement is protected by property rules, it can be removed from its holder only through a voluntary transaction. The idea of liability rules is to protect entitlements against invasions.

In voluntary transactions, the parties agree upon pricing. The fundamental point under property rules is that anyone may say what the value of an entitlement is. Consequently, prices in market transactions are matters of contract. A seller has a veto if a buyer does not offer enough: no one can take private property from the holder unless he is willing to sell it[2]. An owner has a right to value his entitlement subjectively.

Following these general principles, shareholders may determine the value of their shares; as a result, share value is a subjective assessment of worth. Shareholders have a right to accept whether to transfer their property at a price available, an idea which generally applies to both private and public companies.

Property rules are never enough in legal relationships: liability rules are required in order to protect entitlements in cases where a voluntary contract is not reached. These rules are important if an entitlement is destroyed or transferred by the power of law. Under liability rules, the value of property becomes objective; consequently, the decision about value must be taken by some organ of the state, not by the parties themselves. The owner can no longer set the value for the property but it is ultimately determined by the court. Further, the value is required in the context of compensation, not of pricing. Since valuation is collective, individual preferences about the worth may be ignored. In general, this hypothetical value is the price that the holder would receive if the entitlement were sold. Obviously, the value set by court is more a legal point than

[2] The point is stated clearly in *Silsbury v McCoon* (1850) 3 NY 379 (CA of New York) 381 (Ruggles J): "It is an elementary principle in the law of all civilized communities, that no man can be deprived of his property, except by his own voluntary act, or by operation of law."

a price accepted by an owner under property rules. Liability rules are demanding because they require the courts to answer valuation questions[3].

Liability rules step in when entitlements are destroyed or markets fail. Shares cannot be destroyed, but their value can be ruined. For instance, when the value of minority shares is damaged by oppression, CA 1985 s 459 offers a statutory remedy. Moreover, under certain circumstances, company law provides that shares should be transferred compulsorily. In these situations, an objective value for shares is required.

7.3 Objective value of shares

The valuation of shares is a challenging problem: 1) the value of shares rests on their expected future return[4]; 2) there is no abstract value for shares since their worth is related to specific circumstances[5]. Share value cannot be a single definite figure because the return is simply unknown: the worth is an estimation based on opinion. Further, evaluation always takes place in a particular situation, and thus shares may have several different values depending on the view of the person valuing them and the context where the valuation occurs. In brief, value is a word with many meanings.

A shareowner is entitled to value his shares subjectively, but when their value is determined by the power of law, valuation must have an objective basis. What is the objective value of shares, and how is it set? Naturally, the most objective value is the market price of quoted shares.

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[3] Whincop, Michael J., *An Economic and Jurisprudential Genealogy of Corporate Law* (Aldershot 2001) 126.

[4] Above chapter four 4.4.3.

[5] Eg Eastaway, Nigel A. and others, *Practical Share Valuation* (London 1998) 3: "There is no such thing as a value of share in isolation. There is however a value of a specific number of specific shares in a specific company in a given set of circumstances, real or hypothetical"; Solomon, Lewis D. and others, *Corporations: Law and Policy – Materials and Problems* (4th edn St Paul 1998) 213: "In response to the question, 'How much is a business worth?', one must ask 'Why do we want to know?' Valuation of a business is best viewed as a process directed to a particular end."

7.3.1 Market quotation as value

Quoted shares have a market price, ie the price at which they currently trade in the market place. Law generally accepts the current market quotation as the true value of shares. In *Re Grierson, Oldham & Adams Ltd*[6], Plowman J observed that "the market price on the Stock Exchange of those shares is cogent evidence of their true value"[7]. Moreover, to emphasize the point, it is possible to say that the price on the stock market is, "as a matter of law", the real value of shares[8]. Due to the market price, the valuation of listed shares is typically "a fairly straightforward exercise"[9]. Indeed, these shares are valued with reference to the quoted price[10].

Nevertheless, the value of shares is a question of fact. Law does not actually rule that the stock market price is their true value since share value is always related to particular facts. The market price might be a convenient way of getting at such a value, but there might be abnormalities affecting the market. Overall, matters of fact are capable of proof, and thus value is subject to evidence and demonstration. Market quotations can be replaced, while a market value is not "conclusive evidence" of the worth[11].

The stock market price is "a satisfactory indication" of share value[12]; in other words, a stock market quotation is "the best evidence of value"[13]. The burden of proof rests on those arguing that the market price is not the real value of shares. But some criticism based on evidence against a market price is never enough to discharge the onus of proof since law generally supports market valuation. Those who want to "go behind

[6] [1968] Ch 17, 32.
[7] See also *Short v Treasury Commissioners* [1948] AC 534 (HL) 542 (Lord Porter).
[8] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA) 125 (Evershed LJ).
[9] Lowry, John and Dignam, Alan, *Company Law* (2nd edn London 2003) 222.
[10] *Salvesen's Trustees v Commissioners of Inland Revenue* [1930] SLT 387, 390 (Lord Fleming).
[11] *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 32.
[12] *Re Press Caps Ltd* [1949] Ch 434 (CA) 447 (Wynn-Parry J).
[13] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA) 125.

the Stock Exchange markings" have a heavy onus[14]. In fact, it is difficult to find cases where this high burden of proof is successfully discharged; so, the market value of shares can be challenged more in theory than in practice[15].

Market prices are consequences of investors' decisions. Moreover, business people are more capable of judging their own affairs than courts[16]. This fundamental idea applies to share valuation: courts are extremely unwilling to displace a market value by the support of opposite evidence, even if it might be partly convincing. The views of shareholders should not be substituted for the view of court. Shareholders as the owners of their private property determine the value of their shares. As a result, the objective value for quoted shares is the subjective value accepted by shareholders. To repeat, company law lets shareholders set the value for their shares.

Market price is the best indication of share value. However, at the current market price some shareholders buy shares, and others sell them. Share transactions exist because investors disagree about the merits of share value. The prices in market transactions do not represent a real value to those shareholders who do not wish to sell their shares. Accordingly, even in the case of a quoted company, it is possible to argue that the value of shares is obviously higher than their market price since shareholders do not sell their investment at the current price. The market price is not always the right value for shares in law. In effect, the real value of shares might remain hidden although they have a public market price[17].

In conclusion, market price is the objective value of quoted shares, but it cannot have an absolute role in law because individual shareholders may subjectively determine the value of their shares. Share prices are matters of contract; therefore, the market price is merely a question of fact. Broadly speaking, the value of shares becomes

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[14] *Re Press Caps Ltd* [1949] Ch 434 (CA) 447.
[15] Eg Hollington, Robin, *Shareholders' Rights* (4th edn London 2004) 258 sees that the value of shares in quoted companies is uncertain and a matter of opinion only to a "limited extent".
[16] Eg *Re Bugle Press Ltd* [1961] Ch 270 (CA) 276-77 (Buckley J).
[17] See chapter four 4.5.3.

much more important as a legal point when their value does not rest on the pricing accepted by every shareholder. Takeovers of quoted companies, which are under further discussion later in this chapter, are these kinds of transactions.

7.3.2 Fair value under the articles in private companies

Private companies typically impose restrictions on the free disposition of shares. Generally, the directors approve the new member to whom shares may be registered, or there might be a pre-emption clause in favour of existing members[18]. Further, the articles may, under certain circumstances, require shareholders, or their estate, to transfer shares to particular persons at a prescribed price. I explore the nature of these 'retirement' provisions: my focus is on how share value is set under the articles.

The restrictions on transfer and the provisions for compulsory transfer are valid, ie company law accepts them. The landmark case is *Borland's Trustee v Steel Brothers & Co Ltd*[19], where the articles stated that a shareholder is compelled to sell his shares to particular persons if he dies, becomes bankrupt, or is otherwise willing to transfer them. Under the terms of the articles, shares should be transferred at the 'fair price', which was further specified as their 'par value'. Farwell J explained that the articles constitute a binding contract between shareholders, and the provisions were not void as being repugnant to absolute ownership. In addition, the requirements in the articles, which were fixed bona fide for every shareholder, were not against the bankruptcy law because the price was not shown to be less than what was otherwise obtainable.

The memorandum and the articles are a statutory contract between each member and the company; moreover, the articles regulate shareholders' rights inter se[20]. Through the statutory contract, shareholders may agree on restrictions that set a specific

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[18] See above, chapter two 2.4.2.
[19] [1901] 1 Ch 279.
[20] *Welton v Saffery* [1897] AC 299 (HL) 315 (Lord Herschell); see above, chapter six 6.2.2.

price for shares under certain circumstances[21]. The basis of valuation is fundamentally contractual since shareholders have collectively accepted the provisions in the articles of association[22]. Shareholders should follow the contractual terms.

A transfer price, in accordance with the formula set out in the articles, binds shareholders who have agreed to it through the company constitution. The articles mainly produce a somewhat rough but ready machinery for the valuation of shares. Still, it is another question whether the transfer price, under the clause, may be of any value, even less than the current value of shares, or just their nominal value. In *Phillips v Manufacturers' Securities Ltd*[23], the price under the articles, which included a compelled selling of shares, was 1s per share, or a higher price fixed by general meeting. The facts in the case clearly show that a shareholder was directed to sell his shares "at a gross undervalue": his shares were obviously more valuable than this 'fair value' under the articles. Nevertheless, the construction of the articles authorised this compelled sale of shares at a price less than their real value. Further, there was no evidence that majority shareholders had acted oppressively or fraudulently, or otherwise had misused power conferred by the articles. In conclusion, the court accepted that the transfer price could be about 5 per cent of the true value of the shares.

On the other hand, it should be noted that in *Phillips v Manufacturers' Securities Ltd* there was no bankruptcy. The provisions that set the transfer price below fair value may be against bankruptcy law as declared in *Borland's Trustee v Steel Brothers & Co Ltd.* Moreover, requirements in the articles are subject to equitable considerations, and therefore shareholders may challenge the unfair pricing of shares in

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[21] See also *Attorney-General v Jameson* [1905] 2 IR 218, 237 (Holmes LJ): these provisions in the articles are "legal, and bind the Company and its members as well as any outsider who is permitted to purchase a share."

[22] Provisions may even constitute a binding contract, ie a put option for a shareholder to require his shares to be acquired; *Rayfield v Hands* [1960] Ch 1.

[23] (1917) 86 LJ Ch 305 (CA).

court[24]. Obviously, if the price prescribed for shares is less than their fair value, there are serious doubts regarding the fairness of this provision. In sum, it is possible to argue that to be effectively binding the price under the articles must be at least the fair value of shares[25].

Consequently, the transfer price under the articles, in their standard form, is the fair value of shares. Shares in private companies will not normally be transferred to persons who are not members as long as any member is willing to purchase them at a fair value. This is the typical idea when shareholders have a pre-emption right for existing shares. Similarly, if the company articles contain provisions compelling a shareholder to sell his shares, the set price under these clauses seems to be their fair value.

Who sets the fair value of shares? The pre-emption provision normally states that shareholders may mutually accept a fair value for shares, or otherwise the company's auditor acts as an expert and values the shares. So, when a shareholder transferring his shares agrees the price with the purchasing member, the general ideas of property rules apply: the fair price is a matter of a specific contract. However, cases where the price is reached under consensual arrangements are less interesting from the legal perspective. My focus is on cases where the auditor determines the fair value.

Under these provisions, what is the fair value of shares? Above all, fair value is the view of the particular auditor since the articles do not typically give any formula for valuation. "A valuation is only an expression of opinion," as Wynn-Parry J said in *Re*

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[24] *Virdi v Abbey Leisure Ltd* [1990] BCLC 342 (CA) 350 (Balcombe LJ): "If in the present case it may be equitable to ignore the provisions of the company's constitution which prima facie entitle the directors to carry on the business of the company after the sale of the Pavillion, I do not see why it would not be equally equitable, if this had been a case where Mr Virdi was bound by art 27 to sell his shares to the majority at whatever price the accountant might fix, to ignore those provisions also"; in addition, see *Re a company (No 00330 of 1991), ex p Holden* [1991] BCLC 597; *Arenson v Arenson* [1973] Ch 346 (CA) 363.

[25] *Tett v Phoenix Property and Investment Co Ltd* [1986] BCLC 149 (CA) 163 (Robert Goff LJ): "there is, so far as I am aware, no principle of policy inhibiting an agreement between members of a company ... if other members ... are willing to buy [shares] at a price *at least* as great as their *fair value*" (emphasis added); *Re XYZ Ltd* (1986) 2 BCC 99,520; 99,527 (Hoffmann J): "I say nothing ... about cases in which the articles provide for some arbitrary or artificial method of valuation."

Press Caps Ltd[26]. There are no strict rules of thumb or accountancy principles that can strictly fix the basis for calculation[27]. The fair value of shares is ultimately the personal view of the person valuing them; in addition, there are several methods to value shares in a private company[28].

On the whole, the valuation of shares is a matter of controversy: "the question of value is obviously one about which opinions may differ"[29]. In *Borland's Trustee v Steel Brothers & Co Ltd*, Farwell J explained the valuation of shares in a private company in this way:

> It is impossible ... for any one to arrive at any actual figure, as to which it may be said it is clear that that is the value, or something within a few pounds of the value.[30]

In share valuation, many questions are matters of judgment[31]: it is illusory that an auditor can determine the correct or true value of shares. Naturally, the expert only gives his estimate of share value: one auditor determines one value, and another auditor another value. As Hoffmann LJ stated in *Zubaida v Hargreaves*[32], share valuation "involves questions of judgment on which experts may differ without forfeiting their

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[26] [1949] Ch 434 (CA) 447.

[27] *Gold Coast Selection Trust Ltd v Humphrey (Inspector of Taxes)* [1948] AC 459 (HL) 473 (Viscount Simon): "Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible"; *Re Holt* [1953] 1 WLR 1488, 1492 (Danckwerts J): "It seems to me that their opinions are indeed properly described as guesswork"; *Joiner v George* [2003] BCC 298 (CA) [101] (Sir Christopher Slade): "there cannot be said to be exclusively one correct answer."

[28] Eg *Re Claridge Holt & Co Ltd*, Times November 23, 1966 (Plowman J): "there is room for a fairly wide difference of honest opinion about values and methods of valuation."

[29] *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 38 (Plowman J); see also *Dean v Prince* [1954] Ch 409 (CA) 419 (Evershed MR); *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 (PC) 118 (Lord Millett).

[30] [1901] 1 Ch 279, 291.

[31] *Gillatt v Sky Television Ltd* [2000] 2 BCLC 103 (CA) 112 (Mummery LJ): "a valuation is pre-eminently a matter of judgment for the independent accountant entrusted with the task."

[32] [1995] 1 EGLR 127 (CA) 128.

claim to professional competence"[33]. It is difficult to say whether the specified value for shares is right or wrong[34]. Further, the significant legal point is that the courts do not interfere in matters of opinion[35]. Therefore, a judge's view about the most appropriate approach in valuation can be irrelevant[36].

The basis of valuation can be difficult to establish: the expert is not obliged to give reasons for his decision[37]. Auditors do not generally state how the fair value of shares is reached in the particular case, ie they do not give 'speaking' certificates. Actually, case law earlier discouraged any reasoning because if a speaking valuation had been made on an erroneous basis, it could be impugned[38]. But there was no way of questioning a valuation if the auditors declined to give reasons for the result they had arrived at: the fewer details presented, the less the valuation could be brought into dispute. As Harman J noted in *Dean v Prince*, "silence is golden" used to be a sensible point in share valuation[39]. However, the legal distinction between speaking and non-speaking awards is nowadays clearly rejected[40].

Nonetheless, the fair value determined by the auditor binds the parties. In *Campbell v Edwards*, Lord Denning MR explained the force of an agreed valuation:

> If two persons agree that the price of property should be fixed by a valuer on whom they agree, and he gives that valuation honestly and in good faith, they are bound by it. Even if he has made a mistake they are still bound by it.[41]

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[33] See also *Collier v Mason* (1858) 25 Beav 200, 204 (Sir John Romilly MR): "I have frequently had to refer to the enormous discrepancy in *bona fide* valuations."
[34] *Dean v Prince* [1954] Ch 409 (CA) 427 (Denning LJ): "it is so much a matter of opinion that it is very difficult to say it was wrong."
[35] Ibid.
[36] *Zubaida v Hargreaves* [1995] 1 EGLR 127 (CA) 128.
[37] See eg *Re a company (No 00330 of 1991), ex p Holden* [1991] BCLC 597.
[38] See *Burgess v Purchase & Sons (Farms) Ltd* [1983] Ch 216.
[39] [1953] Ch 590, 596; *Re a company (No 006834 of 1988), ex p Kremer* [1989] BCLC 365, 369 (Hoffmann J): "If the independent valuer is well advised, he will do no more than certify the figure which in his opinion is the fair value of the shares."
[40] *Jones v Sherwood Computer Services plc* [1992] 1 WLR 277 (CA).
[41] [1976] 1 WLR 403 (CA) 407.

At common law, the parties are bound by the figure fixed by the valuer[42]. When he arrives at a price fairly and honestly, and without bad faith, it must stand. For this reason, the opinion of the auditor is final, binding, and conclusive, ie the valuation will not be reviewed in court[43]. Although a valuer might make a mistake, in doing what he is authorised to do, the valuation is still binding[44]. However, if the expert, due to the mistake, departs from his instructions in material respect, for example he values a wrong company or a wrong number of shares, the determination can be subject to challenge in court[45].

An expert should use his judgement and come to a result which is his fair opinion about the value of particular shares. In his task, the expert is a mutual valuer who acts impartially and holds the scales fairly between the opposing interests of parties. The determined value must be fair and equitable to both vendor and purchaser[46]. In setting the fair value, what the seller gives up in value and what the buyer acquires in value in the particular transfer should be taken into account. Shares should not be valued by reference only to their value in the seller's hands but also to their value in the purchaser's hands[47]. Altogether, the basic idea of these provisions is to determine a fair value and a suitable price for a retiring member's shares.

Yet, in the market economy fair value and price is normally the market price. Therefore, the expert actually aims to determine a reasonable market price for shares,

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[42] *Arenson v Arenson* [1973] Ch 346 (CA) 363 (Lord Denning MR).
[43] *Baber v Kenwood Manufacturing Co Ltd* [1978] 1 Lloyd's Rep 175 (CA): it would be wrong to frustrate the agreement by alleging a mistake in the expert's opinion.
[44] Ibid 179 (Megaw LJ): "[the parties] accept the risk, which applies equally either way, that an expert may err."
[45] *Jones v Sherwood Computer Services plc* [1992] 1 WLR 277 (CA); *Macro v Thompson (No 2)* [1997] 1 BCLC 626 (CA); moreover, the auditor could be liable for damages if he reaches an incorrect valuation through negligence; *Arenson v Casson Beckman Rutley & Co* [1977] AC 405 (HL), but it should be noted that a professional valuation is not negligently given even if it turns out to be wrong; *Sutcliffe v Thackrah* [1974] AC 727 (HL) 760 (Lord Salmon); see more below, in particular, note 97ff and related discussion.
[46] See *Re a company* [1986] BCLC 362, 369 (Hoffmann J); *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 (PC) 118 (Lord Millett).
[47] Eg *Whiteoak v Walker* [1988] BCC 122.

which is the general idea of fair value[48]. The articles may explicitly mention that the fair value of shares is a hypothetical price between a willing buyer and a willing seller[49]. Generally speaking, the perspective of auditors is very much alike regardless of the exact provisions in the articles. In sum, auditors normally try to set a fair market price for the shares.

In his task, the auditor must carry out the valuation with reasonable professional skill[50]. An expert has a duty to act "in accordance with a practice of competent respected professional opinion"[51]. The fair value of shares should be a professional view, or a reliable and informed opinion, made on an objective basis. Yet, it is obvious that there exists no single and right method to determine fair value for shares. In practice, the bases for valuation of shares in a private company are: 1) dividend basis, 2) asset basis, and 3) earnings basis.

7.3.2.1 Dividend basis

Dividends are the cash flow from a company to its shareholders. Still, first it should be noted that the role of dividends is a controversial issue in market valuation[52]. Second, company law does not require that a company's profits should be distributed as a dividend, which is a discretionary payment. As a result, although dividend yield has great importance, these payments are ordinarily unable to show the value of shares. Naturally, this is very true if no dividends have been paid for several years[53].

Nevertheless, shares are valued on the basis of dividends since this income is a meaningful consideration. It is argued that an estimate of dividend yield demonstrates

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[48] See eg *Sudbrook Trading Estate Ltd v Eggleton* [1983] 1 AC 444 (HL) 487-88 (Lord Scarman).
[49] Eg *Goldstein v Levy Gee (a firm)* [2003] All ER (D) 12; *Re Castleburn* (1989) 5 BCC 652.
[50] *Zubaida v Hargreaves* [1995] 1 EGLR 127 (CA) 127.
[51] *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582, 587.
[52] Above chapter four 4.4.3.
[53] *Attorney-General of Ceylon v Mackie* [1952] 2 All ER 775 (PC); see also *Re a company* [1986] BCLC 362, 369, where Hoffmann J considered that the value of a private company's shares was related "hardly at all" to the prospect of dividends since they were unlikely to be paid.

share value in a private company because these shares are not marketable[54]. Obviously, when this method is used, every ordinary share has an equal value. But experts mainly consider that dividend method is appropriate for minority shares only[55]. Indeed, majority shareholders, and their advisors, typically argue that shares of the minority should be valued on the dividend basis[56].

Dividend yield has traditionally been of particular importance in estate duty valuations. However, as Lord Fleming pointed in *Salvesen's Trustees v Commissioners of Inland Revenue*[57], it would be "quite fallacious" to value shares merely on the basis of paid dividends. According to him, it is not right to ignore those company earnings that have not been distributed as dividends[58]. In the same way, in *Re Lynall*[59] Plowman J noted that both the appropriate dividend yield and the prospective dividend affect share value; in addition, the possibility of capital appreciation should be considered. More generally, as Nourse J observed in *Re Bird Precision Bellows Ltd*[60], a dividend basis is relevant when a company has a record of paying significant dividends. Following these views, the focus in share valuation should be more on the profits available for distribution than on the actual dividend payments.

Overall, share valuation has developed; in effect, the role of dividend yield in the valuation of private companies' shares seems to be declining. In case law, experts

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[54] Compare *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 47 (Lord Hanworth MR): "The price at which shares in a sound industrial undertaking will be sold on a stock exchange is not determined by the yield of the dividends alone."

[55] Livens, Leslie, *Tolley's Share and Business Valuation Handbook* (5th edn Croydon 1999) 61; Glover, Christopher G., *Valuation of Unquoted Securities* (London 1986) 191 and 264; Gregory, Alan and Hicks, Andrew, 'Valuation of Shares: A Legal and Accounting Conundrum' [1995] JBL 56, 64.

[56] Eg *Macro v Thompson (No 3)* [1997] 2 BCLC 36; in this saga, a gross dividend yield basis was used as one of the elements in share valuation; see *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354.

[57] (1930) 9 ATC 43, 48.

[58] See also *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479, 488 (Sir Richard Scott VC): "if the court were to conclude that dividends have been kept at an unreasonably low level ... the court would not direct that the shares should be valued by reference to historical dividends."

[59] [1969] 1 Ch 421, 444.

[60] [1984] BCLC 195, 209.

rarely value shares on the basis of dividend yield[61], although some of them still regard dividends as the main method in the valuation of minority shares[62]. In sum, court rulings in company law do not emphasize the importance of dividend yield in share valuation. At bottom, case law supports the idea that shares should be valued merely on the basis of a company's earnings and net assets[63]. For example, Nourse J accepted in *Re Bird Precision Bellows Ltd*[64] that the appropriate basis involves both these factors. Further, in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[65] Lord Millett did not mention dividend basis at all when he explained share valuation in unquoted companies. I completely agree: asset and earnings bases should be preferred to dividend yield when shares are valued.

7.3.2.2 Asset basis

Shareholders participate in a company, and it is obvious that a company's assets have importance to shareholders[66]. In consequence, share value is related to these assets. Yet, it should be noted that the value of shares follows more the fortunes of the company than the value of its assets[67].

The net asset value per share is problematic since the value of a company's assets is mainly unknown and should be estimated. But even more importantly, in the legal sense it is not possible "to treat a share as being an interest in the company's

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[61] Eg *Guinness Peat Group plc v British Land Co plc* [1999] 2 BCLC 243 (CA), where the expert for the appellant regarded the dividend yield basis as appropriate for preference shares.
[62] Eg Livens (1999).
[63] Furthermore, a hybrid basis is a combination method where a company's surplus assets are valued separately, and their worth is added to an earnings based valuation; see eg *Richards v Lundy* [2000] 1 BCLC 376; *Re a company (No 002612 of 1984)* (1986) 2 BCC 99,453.
[64] [1984] BCLC 195, 209
[65] [2002] 2 BCLC 108 (PC) 118; see also *Gillatt v Sky Television Ltd* [2000] 2 BCLC 103 (CA) 112 (Mummery LJ): "there is more than one possible approach to such a valuation of shares in a private company: an earnings basis, an asset basis, a discounted cash flow basis, or a combination of these approaches."
[66] *M'Connel's Trustees v Commissioners of Inland Revenue* [1927] SLT 14, 17 (Lord Fleming): "A share in a limited company gives the holder a right, not only to participate in a division of the profits, but also to participate in the division of the capital."
[67] See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).

assets"[68]. Simply, shareholders are not part owners in a company[69]. It is not convincing to argue that the value of shares is their net asset value[70].

A company's assets do not ordinarily show its earning power, which is the most important factor in share valuation. An asset basis valuation cannot look forward in an appropriate way. Therefore, a company's earnings rather than its assets are more significant in share valuation; the value based on an estimated profit stream is preferable to one based on net assets. A company as a going concern should generally be valued on an earnings basis[71].

Case law widely supports the idea that shares are valued on the basis of company earnings. The capitalised value of a company's earning capacity is capable of showing the value of shares[72]. As Lord Millett noted in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[73], it is difficult to find justification for an asset based valuation in the case of a going concern[74]. Further, in *Attorney-General of Ceylon v Mackie* Lord Reid stated that the value of an established business as a going concern generally exceeds the total value of its tangible assets[75]. If it were otherwise, shareholders should liquidate a company that has so negative goodwill and actually destroys capital. Finally, following the view of Staughton J in *Buckingham v Francis*[76],

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[68] *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 57 (Romer LJ); see also *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL) 626 (Lord Buckmaster): "no shareholder has any right to any item of property owned by the company."
[69] *Short v Treasury Commissioners* [1948] 1 KB 116 (CA).
[70] See above, chapter four 4.4.2.
[71] Eg *Parkinson v Eurofinance Group Ltd* [2001] 1 BCLC 720.
[72] See eg *Re a company (No 002612 of 1984)* (1986) 2 BCC 99,453; 99,485 (Vinelott J).
[73] [2002] 2 BCLC 108 (PC) 118.
[74] See also *Re Howie and Crawford's arbitration* [1990] BCLC 686; and (1986) 2 BCC 99,453; 99,483: it is unfair to deprive a shareholder of his share in the going concern value of the company.
[75] [1952] 2 All ER 775 (PC) 779; however, as his Lordship mentioned, "that cannot be assumed to be universally true"; see also *Jones v Jones* [1971] 2 All ER 676, 680 (Ungoed-Thomas J): it is common ground that a going concern valuation materially exceeds a break-up valuation.
[76] [1986] BCLC 353, 354.

the break-up value of the assets can be used as a long stop for the value of the company's business if the value as a going concern is less[77].

In any event, as Denning LJ said in *Dean v Prince*[78], an asset basis is an appropriate way in share valuation once the going-concern basis is rejected. If a company's business is not profitable, or it is just barely profitable, the value of shares should be ascertained through the break-up value. Accordingly, as David Mackie QC, sitting as a deputy judge, explained in *Plat v Plat*[79], valuation based on estimated future income stream is generally preferable to the method based on the net assets, but the uncertainties in the income position of the business meant that an asset value was preferable in this particular case. In sum, when an earnings basis valuation is possible, this method should be used.

Moreover, net asset method is used in particular to value shares of investment companies. For instance, in *Goldstein v Levy Gee (a firm)*[80], the auditor adopted the net asset approach for the shares of a property company. In the typical way, once the method is used, the valuer first took the values of properties shown in the accounts, and then made adjustments to take account of the changes in the value of particular properties[81]. Obviously, asset basis is most understandable in the case of a 'money box' company, whose potential in business simply rests on its assets[82].

Yet, shareholders are unable to reach a company's assets. In *Re Macro (Ipswich) Ltd*, Arden J explained the point in the context of minority holdings with the following words:

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[77] See also *Re Phoenix Office Supplies Ltd* [2002] 2 BCLC 556, where one of the experts decided to revise his valuation upwards to the net asset value; on the other hand, the net asset value may be used in the opposite way; eg *Whiteoak v Walker* [1988] BCC 122, where the auditor checked that the estimated profits had "a sound asset backing".

[78] [1954] Ch 409 (CA) 428.

[79] [1999] 2 BCLC 745.

[80] [2003] All ER (D) 12.

[81] In addition, as generally on a break-up basis, the transaction costs, including the contingent tax, were deducted.

[82] See *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1 (HL) 62, where Lord Millett even saw that there is an exact correspondence between the assets of the company and the value of shares in a small private company; more above, chapter three 3.4.1.

> In principle I reject a valuation method which aims to find the fair value of the minority shareholding by reference to net asset value. The ability of the plaintiffs to unlock that value by liquidation is in my judgment uncertain.[83]

Indeed, as mentioned above, a share is not a proportionate share of the assets of the company. A shareholder who owns 10 per cent of shares in a company is not legally entitled to 10 per cent of its assets[84]. In effect, some experts consider that in the case of minority shares, the assets basis should never be used[85]. In addition, it is said that the liquidation value as a lower limit to share value is "a dangerous assumption"[86].

Nevertheless, not even majority shareholders are part owners of the company: this study understands the ruling of *Short v Treasury Commissioners*[87] in this way. Law does not share the idea that a majority shareholder should be considered "for practical purposes" to be a part owner of the undertaking[88]. A company owns its assets, and shareholders' entitlement is their shares, not the company's assets, which are never shareholders' property "in law"[89].

A majority shareholding in a company does not in itself give a right to demand that these shares should be valued on an asset basis. In *Guinness Peat Group plc v British Land Co plc*[90], the Court of Appeal disapproved the conclusion that the minority shares were actually valueless since it was possible that the majority shareholder,

[83] [1994] 2 BCLC 354, 409; however, Arden J accepted a method where the net asset value per share had a role; see also *Lloyds Bank plc v Duker* [1987] 3 All ER 193, 196, where John Mowbray QC, sitting as a deputy judge, considered that the value of minority shares should not be expected to reflect the asset value "to any appreciable extent."
[84] See also *Re Howie and Crawford's arbitration* [1990] BCLC 686: the expression of fair market price is not equivalent to a proportional part of the net asset value.
[85] Glover (1986) 238; see also Hamilton Baynes, T. A., *Share Valuations* (2nd edn London 1973) 101: the value of minority shares "does not depend on, although it may be influenced by, the value of these assets."
[86] Glover (1986) 39.
[87] [1948] 1 KB 116 (CA); [1948] AC 534 (HL); more below 7.5.
[88] Contrast Glover (1986) 62.
[89] *Re Duffy* [1949] Ch 28 (CA) 32 (Lord Green MR).
[90] [1999] 2 BCLC 243 (CA).

through its preference shares, could get all the net asset value of the company in liquidation. Under these circumstances, the minority shares could have value because their value still remained as a question of fact that should be decided on the basis of evidence.

The focus of this study is on the equal value of shares. For this reason, I next explore whether the asset basis valuation may be used for minority shares with a discount due to their status. Generally speaking, there are commentators and experts who argue that this kind of discount is possible in this context[91]. Yet, there are company law cases where the point was considered differently, ie when an *asset basis* is used in share valuation, there should be *no* discount or premium for minority and majority shares. The following cases explain the conclusion.

Dean v Prince

In *Dean v Prince*, the company had no expectation of making a profit. Harman J[92] held that the value of a block of shares conferring control should include something above their break-up value. But the Court of Appeal[93] reversed his decision with a statement that the court should not interfere in matters of opinion, and the auditor could reject the going-concern basis of valuation. The auditor was right in *not* attributing a special value to these shares on account of their carrying control. All the shares were valued as a whole, and this value was divided rateably amongst every share equally[94]. Both majority and minority shares had the same value in this break-up basis valuation.

[91] For example, Livens (1999) 99 says that minority shareholders are entitled to a pro rata share of the net asset value only "[i]n the event of impending liquidation"; moreover, she notes that the minority discount on an asset basis may be "50% or more"; Griffin, Stephen, *Company Law: Fundamental Principles* (3rd edn Harlow 2000) 142-43 considers that in asset valuation method the discount for minority shares is from 5 to 30 per cent; see also *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, where the opinion of the plaintiffs' expert was that this discount is 10 per cent.

[92] *Dean v Prince* [1953] Ch 590.

[93] *Dean v Prince* [1954] Ch 409 (CA).

[94] It should be mentioned that the articles of the company provided that "the fair value shall be the auditor's valuation of the current worth of the company's shares."

CVC/Opportunity Equity Partners Ltd v Demarco Almeida

CVC/Opportunity Equity Partners Ltd v Demarco Almeida is a Privy Council ruling where Lord Millett explained generally the bases of share valuation. As he formulated:

> There are essentially three possible bases on which a minority holding of shares in an unquoted company can be valued. In descending order these are: (i) as a rateable proportion of the total value of the company as a going concern without any discount for the fact that the holding in question is a minority holding; (ii) as before but with such a discount; and (iii) as a rateable proportion of the net assets of the company at their break up or liquidation value.[95]

His Lordship's wording follows the idea in *Dean v Prince*: there is no discount in the case of a minority holding if shares are valued on an asset basis. The question about a discount can arise only when the going concern value, ie the earnings basis, is adopted. Lord Millett's opinion is understandable: the net assets basis as a method means that shares are valued as if the company were liquidated. Since majority and minority shares have equal rights in liquidation, the approach should be similar in this 'hypothetical liquidation'[96]. In essence, the idea of asset method is that the net value of company assets is divided amongst shareholders in proportion to their shares. This study considers the point in this way.

[95] [2002] 2 BCLC 108 (PC) 118.

[96] Of course, the situation becomes more complicated if a company has both ordinary and preference shares; see above, chapter five 5.4.3 and *Guinness Peat Group plc v British Land Co plc* [1999] 2 BCLC 243 (CA).

Goldstein v Levy Gee (a firm)

Still, the valuation of shares is diverse, and even though asset basis is used, some experts argue that another reduction may be required in the case of a minority shareholding. In *Goldstein v Levy Gee (a firm)*[97], the auditor adopted the net asset method for the shares of an unlisted property company. But his valuation included, among other points, an extra reduction of 12.5 per cent due to the company's non-listed status.

Lewison J held that this reduction in portfolio based valuation "fell below the standard to be expected of a competent accountant"[98]. The discount for lack of marketability should not have been used since the valuation was made on the net asset basis[99]. However, to be negligent, the end result in the valuation should have fallen "outside of permissible range"[100], and to determine this question, the valuation was assessed on the basis of what a competent accountant could have done. Lewison J considered that it was possible that even a competent accountant could generally make a similar deduction because of unmarketability of shares[101]. Thus, notwithstanding the mistake, the auditor's valuation was still "within the bracket", ie the result in valuation fell inside the margin of error[102]. The expert made an error in the method, and thus his valuation was wrong, but the valuation itself was not negligent[103].

In summary, I propose that the three cases above share the idea that in valuation on a net asset basis there should be no discount for minority shares. Consequently, the view of company law is that the asset value for every ordinary share is the same. As

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[97] [2003] All ER (D) 12.
[98] Ibid [93].
[99] In his reasoning, Lewison J, [118], referred to Glover (1986) 209: "It hardly needs saying that such a discount is only appropriate where a capitalisation rate has been selected from marketable investments such as quoted securities."
[100] [2003] All ER (D) 12 [122].
[101] Indeed, it might be that there is "no pattern at all in these discounts"; see Glover (1986) 209; Gregory and Hicks (1995) 67: "accounting profession undertakes valuations in a rather ad hoc fashion."
[102] See, in general, *Merivale Moore plc v Strutt & Parker* [1999] 2 EGLR 171 (CA); *South Australia Asset Management Co v York Montague Ltd* [1997] AC 191 (HL).
[103] To be negligent, the auditor must even reach a value that no reasonable valuer could have arrived at; see in particular *Re Benfield Greig Group plc* [2000] 2 BCLC 488; [2002] 1 BCLC 65 (CA).

Lord Herschell noted in *Birch v Cropper*, shareholders are "equally entitled" to a company's property[104]. According to the law, majority and minority shareholders have an equal right to company assets. Hence, the auditor has discretion to determine whether to use the asset basis, but if he uses it, shares should be valued pro rata. Indeed, some experts clearly share this view too[105]. Yet, there are also experts who think that a discount for minority shares is possible on an asset basis valuation, which was also the case in *Goldstein v Levy Gee (a firm)*[106]. As I see it, from the legal perspective accountants who do so make a mistake, but there will be legal consequences from their error only if the end result is outside the permissible range of valuations. Ultimately, *Goldstein v Levy Gee (a firm)* shows that share valuation made by auditors can be a risk for shareholders.

7.3.2.3 Earnings basis

As mentioned, the earning potential of a company is the most important determinant in share valuation. First, the value of its business is the capitalised sum representing its future profits. Second, shareholders are the ultimate beneficiaries of the enterprise: the value of their shares follows the fortunes of the company. Share value is principally set on an earnings basis, in which method the starting point is to evaluate a company's business as a going concern.

However, future profits are unknown. They can only be estimated; thus, this estimate is a matter of opinion, fact, and evidence. Still, as case law shows, the assessment of future profits should be made on a 'best guess' basis[107]: the valuer must

[104] (1889) LR 14 App Cas 525 (HL) 538.
[105] Eg Glower (1986).
[106] In addition, see *Re a company (No 004415 of 1996)* [1997] 1 BCLC 479, 487, where Sir Richard Scott VC in the context of CA 1985 s 459 regarded a discount for minority shares as possible although the method is an asset based valuation.
[107] *Buckingham v Francis* [1986] BCLC 353.

perform his task without undue caution or exaggeration. The intention is to determine the most probable earnings for the enterprise.

A company's future profits are normally estimated on the basis of past profits because the earnings record is the best indication for prospects. Valuation in this method starts by determining the maintainable profit[108]. This assessment is done on a going concern basis, where the idea is to set the normal or average yearly profit for the company: its profits are not likely to fall below this level in the absence of unforeseen and exceptional circumstances[109]. A company is supposed to earn this profit in the future[110]. As a result, this base earnings figure is not actually a profit forecast although the future trend of earnings matters in the estimation[111]. Moreover, if a company makes losses, it does not normally have a maintainable profit, so these unprofitable companies must be valued rather on an asset basis[112].

In *Whiteoak v Walker*[113], the auditor arrived at future maintainable profits for a company by using a three-year average; the court considered this method acceptable as a matter of judgment. In a similar way, in *Matlaszek v Bloom Camillin (a firm)*[114], the maintainable profit was regarded as a weighted average of the previous years. Still, the maintainable profits cannot just be calculated since some adjustments are required to past profits. One important adjustment in a business run by its proprietors seems to be making a deduction if the company has paid artificially low remuneration to

[108] Eg *Re John Reid & Sons (Strucsteel) Ltd* [2003] 2 BCLC 319; *Parkinson v Eurofinance Group Ltd* [2001] 1 BCLC 720.
[109] Eg *Re a company (No 002612 of 1984)* (1986) 2 BCC 99,453; see also *Phoenix Office Supplies Ltd* [2002] 2 BCLC 556, 586, where one of the experts in his determination of the maintainable profits ignored the loss of the previous year since it was "atypical", but Blackburne J found his valuation "somewhat unrealistic."
[110] *Re a company (No 006834 of 1988), ex p Kremer* [1989] BCLC 365, 368.
[111] See *Re Ghyll Beck Driving Range Ltd* [1993] BCLC 1126, where the probable future profits were accepted to include expected growth as the company had been running for a comparatively short time.
[112] *Matlaszek v Bloom Camillin (a firm)* [2003] EWHC 2728, [9] (Park J).
[113] [1988] BCC 122.
[114] [2003] EWHC 2728.

shareholders for their work[115]. Overall, the probable future level of earnings is typically a point of disagreement: it is an economic view resting on particular facts.

The assessment of profits must be translated into value of shares. In general, share value is reached when the maintainable profit is multiplied by a price-earnings ('P/E') ratio, which is the main tool in share valuation[116]. The idea is that every company or business sector has its own ratio related to its special factors. On the other hand, it is possible to say that the P/E as a multiplier shows the yield required from a particular business.

To arrive at a P/E ratio, an earnings per share figure is required. This calculation is simply mathematics where a company's maintainable profit is divided by the number of all shares. In fact, it is the easiest part in share valuation. In addition, it is clear that every share in a company has the same earnings per share figure.

Determination price-earnings ratio is the most sensitive stage in share valuation: it is also the main arena for dispute between experts. But as Jacob J stated in *Re Planet Organic Ltd*[117], the ratio has to be identified by some method or other. A typical way to select the figure is to begin with P/Es for quoted companies in the most comparable business sector[118]. This means that the valuer takes a market perspective with an aim to determine the market value for the estimated earnings per share. In consequence, the fair value for a private company's shares is derived from stock market quotations. The expert makes a hypothetical question asking what the earnings multiple would be if the particular company were quoted.

Finding an appropriate P/E figure is problematic since there are several differences between quoted and private companies. Public and private companies are

[115] See ibid; *Re Planet Organic Ltd* [2000] 1 BCLC 366.
[116] In the context of quoted shares, see above, chapter four 4.4.3.
[117] [2000] 1 BCLC 366, 373, where he also considered that P/E ratio is "the near undecidable problem."
[118] See eg *Re* a *company (No 002612 of 1984)* (1986) 2 BCC 99,453; in addition, in recent case law, there are also experts' references to special private companies' P/E indices; eg [2000] 1 BCLC 366.

rarely similar to each other; they are typically "on a different planet"[119]: neither can their P/E figures be comparable[120]. Above all, private companies are much smaller than listed ones. Further, private companies do not ordinarily have a long history of consistent profits: their success in business is more uncertain[121]. Moreover, shareholders typically participate in private companies as full-time workers and directors: such a company is more a 'people' business, where share capital and shares do not have the most central role in its gain. All these factors mean that the price-earnings ratio in the case of a private company should be lower than those of quoted companies. Simply, P/E figures adapted from listed companies must be discounted when they are used in the valuation of a private company's shares.

In addition, the marketability of shares adds to the value of shares in listed companies[122]. In contrast, shares of private companies are never freely saleable when the articles of association include restrictions on the transfer of shares. These restrictive articles typically have a depressing effect on share value. Obviously, when the auditor determines the fair value under these provisions, he cannot value shares as if they were freely transferable. Shares in a private company are never as liquid as quoted shares. The presumption is that these shares thus have a lower value. A further discount in the P/E figure is required because of the limited marketability of a private company's shares.

The above-mentioned discounts for the P/E figure due to the status of a private company are mainly regarded as a single discount. It may then be called a discount for the lack of marketability[123], although the factor is not related only to the marketability

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[119] Ibid 373.
[120] *Re Phoenix Office Supplies Ltd* [2002] 2 BCLC 556, 588-89.
[121] *Re John Reid & Sons (Strucsteel) Ltd* [2003] 2 BCLC 319, 331 (Kevin Garnett QC): "I understood the basis for [the discounted P/E] to be that there is generally less information available about a private company and a purchaser would therefore be more cautious"; see also *Matlaszek v Bloom Camillin (a firm)* [2003] EWHC 2728, [28].
[122] See above, chapter two 2.4.4.
[123] Eg Eastaway and others (1998) 11.

of shares. For example, in *Re a company*[124] the accountants, in their evidence, proposed a discount to reflect the unmarketability of a private company's shares. Naturally, it is mainly an academic question whether there should be one or two discounts because of the status of a private company since it is the total amount of the discount that primarily matters.

In any case, the valuer takes a comparable P/E ratio from stock markets and discounts the figure to make it appropriate for a private company's shares. The applied discounts for private companies seem generally to be about 50 per cent; ie these P/E figures are half those of the quoted companies' shares in similar business sectors[125]. However, the discount can be smaller or bigger, depending on the particular circumstances of the company, and also on the stock market condition.[126]

Once the auditor, under the company articles, determines the value for shares, it is his task to set the right P/E. For instance, the risk related to the investment can be incorporated into the selected price-earnings ratio[127]. Nevertheless, if a non-speaking award is given, the amount of any discount is quite impossible to specify[128]. Still, if an auditor selects an unreasonably low or high P/E ratio, he might be negligent in his task. That negligence is a point decided by law, but the valuation itself stands and is not reviewed in court.

Re Phoenix Office Supplies Ltd [129] offers an example of how a P/E is determined if the court has jurisdiction to do that. In this case, one expert supported a "conservative" figure of 7, and another was in favour of an "overgenerous" figure of

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[124] [1986] BCLC 362; see also *Re a company (No 002612 of 1984)* (1986) 2 BCC 99,453; 99,486, where Vinelott J called this point the "long-term holding factor".

[125] See eg *Re John Reid & Sons (Strucsteel) Ltd* [2003] 2 BCLC 319, 331, where an expert stated from her experience that discounts of between 33 per cent and 50 per cent are used, but in *Matlaszek v Bloom Camillin (a firm)* [2003] EWHC 2728, [28], the experts considered that in that particular case this discount should be 75 per cent or even more.

[126] See an example of an expert's report on the value of shares in Joffe, Victor, *Minority Shareholders: Law, Practice and Procedure* (2nd edn London 2004) 402ff.

[127] *Buckingham v Francis* [1986] BCLC 353.

[128] See *Re a company (No 006834 of 1988), ex p Kremer* [1989] BCLC 365.

[129] [2002] 2 BCLC 556; it should be noted that the decision concerning the applicability of CA 1985 s 459, and also the valuation of shares by the court, was reversed by [2003] 1 BCLC 76 (CA).

10.1. Blackburn J then did, as he said, the best he could and considered that the applicable figure is 8.1. Since P/E is a matter of fact, the ratio was set on the basis of expert evidence. The arguments of the expert supporting the conservative figure were more persuasive since the set P/E was nearer his opinion[130]. Yet, it should be noted that there was no disagreement about the point whether this private company's shares should have a lower P/E than quoted stocks have. On the whole, in case law the determined P/Es for shares of private companies have typically been between 4 and 10[131]. As the level of these figures implies, the P/Es of comparable quoted companies are discounted when they are applied to the shares of private companies. In short, these shares do not attract premium price/earnings ratios.

My main interest is the value of majority and minority shares, so I raise the most important point in this matter. In *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[132], Lord Millett noted that minority shares in a private company as a going concern are valued both without and with a discount due to their minority status. The question is whether auditors use a further discount for P/E figures when minority shares in a private company are valued on an earnings basis. Ultimately, there is a clear answer: auditors predominantly consider that there should be an extra discount for minority shares. As Lord Millett stated, it is "the common practice of auditors" to apply "a substantial discount" to minority shares when shares are valued under the articles[133]. In an auditor's valuation on an earnings basis, it is extremely likely that minority shares will be subject to a special discount.

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[130] Judges generally seem to feel that a conservative view is more appropriate than a speculative one; see in particular *Parkinson v Eurofinance Group Ltd* [2001] 1 BCLC 720.
[131] Ibid: P/E 3.5; *Buckingham v Francis* [1986] BCLC 353: P/E 4; *Matlaszek v Bloom Camillin (a firm)* [2003] EWHC 2728: P/E 4.25; *Richards v Lundy* [2000] 1 BCLC 376: P/E 6; *Re John Reid & Sons (Strucsteel) Ltd* [2003] 2 BCLC 319: P/E 6; *Marks v Sherred (Inspector of Taxes)* [2004] STC (SCD) 362: P/E 10; *Re Planet Organic Ltd* [2000] 1 BCLC 366: P/E 11.5.
[132] [2002] 2 BCLC 108 (PC) 118.
[133] Ibid; see also eg *Macro v Thompson (No 3)* [1997] 2 BCLC 36, 72 (Robert Walker J).

Obviously, it is in the interests of majority shareholders to support the idea that minority shares are less valuable. For example, in *Re Phoenix Office Supplies Ltd*[134] the majority shareholders proposed that the purchase price for minority shares under the articles should be substantially discounted to reflect their minority status. Further, the majority shareholders preferred the valuation under the articles to the valuation under CA 1985 s 459 because under that provision shares are generally valued on a pro rata basis[135]. As the case plainly shows, different ideas are followed when minority shares are valued under the articles and under s 459.

Yet, the fundamental idea under the articles is that the auditor may determine the fair value for shares. In *Re Castleburn* [136], the auditor made a speaking valuation showing explicitly that a special discount was applied for a substantial minority of 44 per cent in a private company. In consequence, a minority shareholder tried to challenge this valuation in court. Paul Bakes J considered that the articles did not require the auditor to value the shares on a pro rata basis, so the discount could be applied to a minority holding. The same conclusion was reached, for example, in *Re a company (No 006834 of 1988), ex p Kremer*[137] by Hoffmann J. Overall, the auditors may use their discretion and decide that minority shares are valued with a special discount. In general, it is possible to say that minority shareholders, in fact, bear a risk that accountants, in carrying out a valuation under the articles, apply a further discount to their shares[138].

The central question is, of course, why auditors apply a special discount for minority holdings. This study sees that there are three main reasons for their conclusion. First, minority shares are considered less valuable since they are supposed to fetch a lower price when they are sold. The higher value of majority shares is regarded as a fact, a view that auditors commonly seem to accept.

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[134] [2002] 2 BCLC 556; [2003] 1 BCLC 76 (CA).
[135] Discussed further below 7.4.
[136] (1989) 5 BCC 652.
[137] [1989] BCLC 365.
[138] See *Virdi v Abbey Leisure Ltd* [1990] BCLC 342 (CA).

But more importantly, judges widely share this auditors' view. From the legal perspective, the value of shares is a matter of fact, and commercial practice should matter in share valuation. As Wynn-Parry J said in *Re Press Caps Ltd*[139]: "A valuation ... may be made on one of a number of bases, but the final test of what is the value of a thing is what it will fetch if sold." The value of shares must be related to share pricing in practice.

In *Ocean Coal Co Ltd v Powell Duffryn Steam Coal Co Ltd*, Farwell J explained pricing of shares in this way:

> There may be... a considerable difference between the price at which a shareholder is willing to sell his shares, if he is desirous of selling a large or small number, and the price which he obtains for his shares may vary according to the number of shares he is proposing to sell ... [in] an offer of shares sufficient to give control of the Company, it may well be that a purchaser would be prepared to pay a much higher price for a number of shares sufficient for that purpose, whereas he would not be willing to pay such higher price if the number of shares was reduced below the necessary number.[140]

The judge clearly indicated that the price for a majority holding is generally higher per share. Further, Lord Salmon pointed out the same idea very precisely in *Arenson v Casson Beckman Rutley & Co*[141], where he considered that "there is normally a substantial difference between the value per share of a small minority holding and the value per share of the entire holding in a private company." Sometimes, this is

[139] [1949] Ch 434 (CA) 447.
[140] [1932] 1 Ch 654, 661.
[141] [1977] AC 405 (HL) 434.

formulated so that majority shares carry a control premium[142]. Finally, in *Re Howie and Crawford's arbitration*[143] Vinelott J explicitly ruled that in share valuation the size of the particular holding must be taken into account. In sum, judges generally accept the view that majority shares may be more valuable than minority shares.

Of course, this study should share the same view about this fact, even though questions of fact are never binding part in English precedents[144]. Nevertheless, I consider that the relationship between fact and law is more complicated since the value of shares is often a mixed matter of fact and law. Furthermore, this study emphasizes that English company law offers increasingly greater protection to minority shareholders. This protection is an important issue in share valuation too. Therefore, I review the value of minority shares *in law* more deeply later.

The second special point in valuation by auditors is that they are valuing the shares of a retiring member. The fundamental idea of the provisions under the articles is not that the transferor of shares should be able to get a 'full value' for his shares: discounts in share valuation might be appropriate. It is enough that a shareholder leaving the company gets a fair share price, which is typically less than their pro rata value. Indeed, neither commercial practice nor company law supports a practice that shareholders are allowed to leave the company at will and then 'put' their shares at their full value on other shareholders[145].

Third, it is a fact that company law offers special ways for majority shareholders to leave a company. In *Greenhalgh v Arderne Cinemas Ltd*[146], majority shareholders desired to sell their shares to an outsider. But the articles, in their common form, gave every shareholder the right to purchase the transferred shares at a fair value; thus, the

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[142] *Short v Treasury Commissioners* [1948] AC 534 (HL); *Re a company (No 002612 of 1984)* (1986) 2 BCC 99,453; 99,486 (Vinelott J); *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 410 (Arden J).
[143] [1990] BCLC 686.
[144] See eg Goodhart, Arthur L., *Essays in Jurisprudence and the Common Law* (London 1931) 1ff.
[145] See *O'Neill v Phillips* [1999] 1 WLR 1092 (HL) 1104-5; *Re Phoenix Office Supplies Ltd* [2003] 1 BCLC 76 (CA).
[146] [1951] Ch 286 (CA).

provisions were first altered by the support of the majority to sanction the transfer of their shares to the outside buyer. In brief, the majority shareholders 'lifted the ban' in the articles. As the case shows, the articles could not similarly restrict the transfer of majority shares; it is easier for majority shareholders to get the full value for their shares[147]. Ultimately, auditors seem to consider that majority power itself makes majority shares more valuable[148].

Indeed, companies are governed by majority power, and majority shareholders are able to nominate the auditors by their votes. In practice, majority shareholders might be in favour of those auditors who appreciate the value of their shares. In addition, after the valuation of a retiring member's shares, the auditors' re-appointment and future remuneration may directly depend on the support of those shareholders who have acquired shares at the fair price. In consequence, auditors may be fairer to the remaining members than to the leaving ones. There is a risk of a conflict of interests when a company's auditor values shares.

In *North Holdings Ltd v Southern Tropics Ltd*[149], Morritt LJ explained that minority shareholders often have a "belief" that "the auditor will feel beholden to the majority shareholders". Therefore, he proposed that, in certain cases, the court should appoint the expert to value shares. This could decrease the risk that the experts act, if we use the wording of Mummery LJ[150], like 'hired guns' in their task.

Case law offers a clear example where the interest of a minority shareholder was neglected in share valuation. In *Re Benfield Greig Group plc*[151], the auditors compromised their ability to act as an independent valuer due to their earlier commitments to the company. The auditors gave a valuation of £2.10 per share even though there was a recent share placement at the price of £4 per share since they were

[147] In addition, a special majority has power to liquidate a company.
[148] About this point more below 7.6.1.
[149] [1999] 2 BCLC 625 (CA) 639.
[150] *Guinness Peat Group plc v British Land Co plc* [1999] 2 BCLC 243 (CA) 254.
[151] [2000] 2 BCLC 488; [2002] 1 BCLC 65 (CA).

more interested to confirm their lower valuation in the context of estate duty than to determine a fair value for the particular shares. In consequence, the Court of Appeal reversed the decision of Arden J and remitted the case back to the Companies Court.

Altogether, there are several reasons why auditors consider that minority shares should be subject to a further discount in the earnings-based share valuation. In any event, the lower value for minority shares is generally their honest opinion; furthermore, judges seem to accept this professional view as a question of fact. The argument goes that the value of shares must depend on the opinion of experts. Simply, auditors may determine whether a special discount for minority shares is applied in share valuation on an earnings basis. As Denning LJ stated in *Dean v Prince*[152]: "if the auditor was of opinion that that was a fair method, no one can say that he was wrong." Overall, the fundamental idea under the articles is that the auditors set the fair value for shares.

7.3.2.4 Auditors' discretion

Valuations under the provisions of the articles are typically unpredictable in their outcome but nevertheless normally immune from challenge[153]. Still, the question arises whether the role of the law is only to state that auditors may value shares how they please? Consequently, are minority shareholders in particular at their mercy on this point? As Harman J noted in *Dean v Prince*[154], shareholders may be unwisely committing themselves to be bound by the opinion of the auditors although they might give a valuation that some members strongly distrust.

The starting point of law is, as explained above, that the parties are bound to the figure fixed by the expert. In blunt, shareholders cannot challenge auditors' valuation

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[152] [1954] Ch 409 (CA) 428.
[153] *Macro v Thompson (No 3)* [1997] 2 BCLC 36, 72 (Robert Walker J).
[154] [1953] Ch 590, 596.

even though the valuation is too low for minority shares[155]. The auditor has discretion in share valuation. In addition, mistakes in share valuation do not mean that experts are negligent. For example, that was the ruling in *Goldstein v Levy Gee (a firm)*[156], where the auditors erroneously applied a discount in valuation on an asset basis. In effect, the negligence of the auditors does not seem to have an important role in shareholders' protection in the context of share valuation[157].

But the status of company law is not that auditors may value shares however they prefer. First, the pro rata valuation of shares can explicitly be mentioned in the articles; it is increasingly common that the articles state so. Of course, auditors should then follow the terms of corporate contract[158]: shares must be valued on a pro rata basis[159]. The articles can rule how auditors should value shares. It is very understandable that minority shareholders require this principle to be included in the articles. As Oliver LJ noted in *Re Bird Precision Bellows Ltd*[160], this point in the articles is a "rather important provision" for them. From the perspective of minority shareholders, such a provision secures the equal value of their shares.

Second, company law offers more protection to minority shareholders. The most important factor in this progress is CA 1985 s 459. The ruling of *Virdi v Abbey Leisure Ltd*[161] explicitly shows that minority shareholders, under certain circumstances, may refuse to take the risk that auditors might value their shares at a discount. So, company law offers protection against unfairness in auditors' valuation. Thus, the whole approach of the courts to the valuations by auditors has significantly changed, as Harman J

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[155] See *Re Benfield Greig Group plc* [2000] 2 BCLC 488, 512-13.
[156] [2003] All ER (D) 12.
[157] Ibid [39], where Lewison J considered that it is difficult "to extract a coherent and principled approach to the question of valuer's negligence", and so there might be a need for a higher court ruling to resolve "the divergent streams of authority".
[158] See generally *Jones v Jones* [1971] 2 All ER 676.
[159] Compare eg *Re Castleburn* (1989) 5 BCC 652.
[160] [1985] BCLC 493 (CA) 505.
[161] [1990] BCLC 342 (CA).

explained in *Re a company (No 00330 of 1991), ex p Holden*[162]. Case law clearly implies that judges do not always regard the fair value for shares set by the auditors as fair in law generally, in particular in cases of oppressed minority shareholders. The fair value of shares is really related to the particular context[163]. In brief, judges do not fully share the opinions of accountants about the value of minority shares.

In conclusion, in private companies it is typical that auditors may determine a fair value for retiring members' shares. This value for shares is ultimately a professional view of the auditor. In the context of this study, it is important to notice that experts generally apply a special discount to minority shares, ie they mainly regard minority shares as less valuable than their pro rata value. Judges respect auditors' views of the share value, but as mentioned, in CA 1985 s 459 cases there is normally no discount due to the minority status. On the whole, I propose that these s 459 cases better explain company law's view of share value. Put simply, court rulings are legal judgments, and the valuations by auditors are mere commercial opinions. But before analysing case law under s 459, I first review the hypothetical value of shares.

7.3.3 Hypothetical value of shares

It is common ground that shares are valued on the basis of a hypothetical sale[164]. Shares have a value "according to the market"[165]; ie their value exists in the realm of exchange. Hypothetical value is the price available, and in the case of quoted shares their value is the current stock market price. As Lord Fleming explained in *Salvesen's Trustees v Commissioners of Inland Revenue*[166], there is no difficulty to determine the hypothetical value for quoted shares. For estate duty purposes, their value is the market price at the

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[162] [1991] BCLC 597, 602-3.
[163] Eg Hollington (2004) 259: "'fair value' in [the context of pre-emption articles] is more limited than in the context of a share purchase order under s 459."
[164] *Re Lynall* [1969] 1 Ch 421, 430 (Plowman J).
[165] *McIlquham v Taylor* [1895] 1 Ch 53 (CA) 64 (Lord Lindley); *Battle v Inland Revenue Commissioners* [1980] STC 86.
[166] [1930] SLT 387, 390.

date of the death, which is both the "sufficient" and "best" criterion of the price in this context[167].

Shares in a private company have a different nature because they do not have well-operating markets: there is no real current market price and value for these shares. Unquoted shares are, indeed, infrequently traded property; they do not have a demonstrable commercial value. In effect, the price for these shares should be presumed or even imagined[168].

What is the hypothetical value of unquoted shares? The general view of English law is that the principal value of all property is the price that it would fetch if sold[169]. Ultimately, the value depends on the available price: it is the price between a willing buyer and a willing seller[170]. As Wynn-Parry J said in *Re Press Caps Ltd*[171]: "the final test of what is the value of a thing is what it will fetch if sold." Thus, shares of a private company are subject to market valuation. In *Lynall v Inland Revenue Commissioners*[172], Lord Reid declared that the best way to determine the value of shares is to let the price be determined by economic forces by throwing a sale open to the competition. In sum, the hypothetical value of shares of a private company is the price that a hypothetical purchaser would pay for them on a hypothetical sale in the open market.

But the determination of a hypothetical price for a private company's shares is problematic as there is no open market for them. The two important reasons for this situation are: 1) shares of private companies are not generally interesting as an investment; 2) restrictions in their articles may make these shares unmarketable. I

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[167] *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) 47 (Lord Blanesburgh).
[168] *Re Holt* [1953] 1 WLR 1488, 1492 (Danckwerts J): "The result is that I must enter into a dim world peopled by the indeterminate spirits of fictitious or unborn sales."
[169] The idea comes from fiscal law; Finance Act 1894 s 7(5): "The principal value of any property shall be estimated to be the price which, in the opinion of the Commissioners, such property would fetch if sold in the open market at the time of the death of the deceased."
[170] See also *Re Howie and Crawford's arbitration* [1990] BCLC 686.
[171] [1949] Ch 434 (CA) 447.
[172] [1972] AC 680 (HL) 695.

explore these factors, focusing on the hypothetical value of majority and minority shares.

In a private company, shareholders are typically more participants than investors: the relationship among them is personal. Further, shareholders do not participate only through share capital but they are normally also directors and workers in the company[173]. Share capital and shares have a different role in private companies.

An acquisition of shares in a private company, in practice, means that the buyer should step into the seller's shoes. This makes the selling of shares more complicated since there may be some personal requirements for the buyer. In addition, he should be willing to take the role of a shareholder with its personal features. After all, the typical buyer for shares in a private company is, as Danckwerts J noted in *Re Holt*[174], "rather the exceptional kind of investor who [has] some special reason for putting his money into shares of this kind."

There are fewer willing buyers for shares of private companies. Shareholders may find that it is difficult to 'get rid of' these shares because there is no adequate market. Of course, the limited number of possible buyers decreases share price, an idea which coincides with the practice that in share valuation these shares are regarded as less valuable than the shares in comparable public companies.

The common traditional view is that minority shares in a private company are quite uninteresting because those "shares do not give a purchaser the opportunity to control the company, or to influence the policy of the directors to any great extent"[175]. Following the same idea, Peter Smith J put the position of a minority shareholder in *Rock Nominees Ltd v RCO (Holdings) plc (in liquidation)* in this way:

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[173] See *Re a company* [1986] BCLC 362, 369, where Hoffmann J considered that the value of a private company's shares in a going concern was most related to shareholders' ability to pay themselves remuneration by way of salary.
[174] [1953] 1 WLR 1488, 1501.
[175] Ibid.

"It is self-evident to my mind that ordinarily, such a small shareholding [of 2.48 per cent] in a private unlisted company has little or no worth in the sense that its ability to receive dividends is likely to be restricted, its ability to influence the board is likely to be restricted and its ability to sell the shares is likely to be restricted."[176]

A minority shareholder in a private company may feel himself quite disabled. In effect, shares of a private company are rarely attractive as investments. Some commentators have a view that it used to be so that the best advice was not to invest in these shares at all[177].

Shares of a private company typically have "a close and small market"[178], ie their market is among existing shareholders. In *Re a company*, it was considered in this way:

The purchaser would be able to get little or nothing for his shares on a sale to a third party but they would be worth more to the majority shareholders[179].

Simply, the evident buyers for these shares are the majority shareholders. This as a starting point gives them a strong bargaining position if minority shareholders sell their shares. In economic terms, there is no need to pay the full value for these shares;

[176] [2003] 2 BCLC 493, 513; see also Pettet, Ben, *Company Law* (Harlow 2001) 253: "the minority holding carries no control, can vote no director onto the board, can remove no director, and is dependent on the majority for any dividends."
[177] Dawson, I. J. and Stephenson, I. S., *The Protection of Minority Shareholders* (Croydon 1993) v; see also above, chapter six 6.5.
[178] *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 44 (Lord Hanworth MR).
[179] [1986] BCLC 362, 368; the same idea can be found in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 (PC) 118 (Lord Millett): "An outsider would normally be unwilling to pay a significant price for a minority holding in a private company."

therefore, a minority shareholder might be able to exit a private company "only at an unrealistically low price"[180].

Still, if nobody is willing to buy the particular shares, they are not valueless, even if that might be true in economic terms. In law, the point is different. For example, in *Re Ghyll Beck Driving Range Ltd*[181] Vinelott J considered that the investment value of the minority shares could be taken "for practicable purposes as nil". However, this was not his conclusion under CA 1985 s 459. It is clear that company law does not support the idea that if majority shareholders are not willing to pay anything for minority shares, they can have these shares for free. As Denning LJ noted in *Dean v Prince*:

> "Test it this way: suppose it had been Prince who had died, leaving only 30 shares. Those 30 shares, being a minority shareholding, would fetch nothing in the open market. But does that mean that the other directors would be entitled to take his shares for nothing? Surely not."[182]

Similarly, the willingness of other shareholders to buy shares does not determine their hypothetical value. The intention is to set a reasonable price for shares, not the price that the buyers would really pay for them[183]. Moreover, the hypothetical price as a concept is based on an assumption of an open market from which no buyer is excluded[184].

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[180] Davies, Paul L., *Introduction to Company Law* (Oxford 2002) 23.
[181] [1993] BCLC 1126, 1131.
[182] [1954] Ch 409 (CA) 427-28.
[183] *Battle v Inland Revenue Commissioners* [1980] STC 86, 91 (Balcombe J): "one does not postulate a particular vendor or a particular purchaser"; *Commissioners of Inland Revenue v Crossman* [1937] AC 26 (HL) 50 (Lord Blanesburgh): "it is unnecessary to inquire by whom the property would hypothetically have to be offered."
[184] *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 43 (Lord Hanworth MR); *Re Holt* [1953] 1 WLR 1488; *Inland Revenue Commissioners v Gray (surviving executor of Lady Fox deceased)* [1994] STC 360 (CA) 372 (Hoffmann LJ): "The concept of the open market involves assuming that the whole world was free to bid, and then forming a view about what in those circumstances would in real life have been the best price reasonably obtainable."

Yet, the hypothetical value of shares is a question of fact[185]; as a result, the price available must be ascertained on expert evidence. Overall, as mentioned above, auditors and other experts typically consider that the value of minority shares per share is lower than the worth of majority shares[186]. Lord Millett noted the same point in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[187], stating that the common practice of auditors is "to apply a substantial discount to reflect the fact that the shares represent a minority holding." Since experts of share valuation widely think that the hypothetical price for minority shares is less than their pro rata value, the courts have also accepted this as a matter of fact in their decisions[188].

In particular, for fiscal purposes the governing idea is that the value of shares is related to the size of the particular shareholding. For example, in *Lloyds Bank plc v Duker*[189], John Mowbray QC, sitting as a deputy judge, held, on the basis of the evidence before him, that a majority shareholding in a private company was "worth markedly more" per share than minority holdings in the same company. In addition, he noted that the value of the assets was expected to find "at least a substantial reflection" in the value of majority shares[190]. By contrast, the value of minority shares was not expected to reflect the net asset value "to any appreciable extent". Following similar ideas, in *Battle v Inland Revenue Commissioners*[191] Balcombe J considered that the value of a minority holding would represent "a substantial discount on the asset value of

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[185] *Gold Coast Selection Trust Ltd v Humphrey (Inspector of Taxes)* [1948] AC 459 (HL); *Duke of Buccleuch v Inland Revenue Commissioners* [1966] 1 QB 851 (CA) 872 (Danckwerts LJ); *Guinness Peat Group plc v British Land Co plc* [1999] 2 BCLC 243 (CA) 253 (Mummery LJ).
[186] Eg Glover (1986) 67; Hollington (2004) 263: "In the real world the value of a minority shareholding in an unquoted private company is usually much less than its pro rata value."
[187] [2002] 2 BCLC 108 (PC) 118.
[188] Eg *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 409 (Arden J): "Because this was a private company, the *market* value of a share forming part of a minority shareholding would be very small" (emphasis original); *Re Bird Precision Bellows Ltd* [1984] BCLC 195, 201 (Nourse J): "it is a matter of common occurrence for a shareholder to acquire shares from another at a price which is discounted because they represent a minority holding."
[189] [1987] 3 All ER 193.
[190] Ibid 196.
[191] [1980] STC 86, 91.

those shares"[192]. Indeed, it should be mentioned that in the field of estate duty the statute law has explicitly ruled that majority shares should be valued by reference to their asset value instead of the market value used in the case of minority shares[193]. Therefore, tax law even requires that different methods should be used in setting a hypothetical value for majority and minority shares. In sum, it seems to be very clear that in the field of taxation the value of majority and minority shares is not equal.

Further, the decisions in tax cases reflect the notion that the hypothetical value of minority shares depends on the particular size of a minority holding. In *Hawkings-Byass v Sassen (Inspector of Taxes)*[194], the special commissioners decided that it was appropriate to value the largest shareholding in a private company with a premium of 20 per cent. The determined value for the 18.16 per cent holding was £307 per share, but the value for both the 11.09 and the 9.09 per cent holdings was £256 per share. The view of the special commissioners was that these minority shareholdings could reasonably be expected to fetch different prices on an open market. As this case explicitly shows, all minority shares do not have the same value in tax law.

However, it should be remembered that valuation always takes place in a particular context. Therefore, majority shares might be widely considered to be more valuable in tax law, but the inevitable conclusion is not that it would be the same in company law. As Evershed MR explained in *Dean v Prince*[195], the analogy is not "conclusive" between cases where shares are valued for estate duty purposes and in company law[196].

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[192] See also *Re a company (No 004475 of 1982)* [1983] Ch 178, where an offer for shares based on an open market was £112,000 but the net asset value of the shares was regarded as £175,000.
[193] See *Barclays Bank Ltd v Inland Revenue Commissioners* [1961] AC 509 (HL); *Re Duffy* [1949] Ch 28 (CA) 32 (Lord Greene MR): by this scheme, an existing state of law is "pulled to pieces, and as a result something is deemed to be a person's property that, in law, it is not."
[194] [1996] STC (SCD) 319.
[195] [1954] Ch 409 (CA) 420.
[196] See also eg Murdock, Charles W., 'The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares' (1990) 65 Notre Dame Law Review 425, 472: "While such discounts make sense in the tax setting, they are wholly inappropriate in a state court proceeding in which a minority shareholder seeks to be bought out because of oppressive conduct by the majority."

The ruling of *Re Benfield Greig Group plc*[197] offers an illustrative example of these different perspectives. The general aim of shareholders for tax purposes may be to reach a value that is as low as possible. In this case, the auditors were indeed successful in this part of their task because they managed to persuade the Inland Revenue to accept a low value for shares. Yet, when the auditors valued the shares of a minority shareholder on the same basis under the articles of the company, the Court of Appeal remitted the case back to the Companies Court. Accordingly, even if a valuation may be acceptable for tax purposes, it can be the opposite in company law. I consider that the decisions of tax cases are typically quite unable to show the value of majority and minority shares in company law[198].

But other than tax cases also suggest that in share valuation the size of the shareholding has particular importance. For example, in *Re Bird Precision Bellows Ltd*[199] Oliver LJ observed that the ordinary valuation principles take into account the proportionate size of the holding in relation to the issued share capital as a whole and the control of the company. In *Re Howie and Crawford's arbitration*[200], Vinelott J considered it in the same way by stating that the market price of shares normally depends on the proportion of the shares of the company comprised in the holding. Therefore, I do not argue in this study that the hypothetical value of majority shares would be regarded as higher only in the field of tax law. Still, I propose that the real position of company law is mainly found from CA 1985 s 459 cases, which I analyse below.

Finally, the restrictions in the articles on the transfer of shares may make shares in a private company unmarketable: the sale of shares to outsiders can be forbidden. The situation is typically that there "cannot be a real sale in the open market under the

[197] [2002] 1 BCLC 65 (CA).
[198] Contrast eg Sealy, L. S., *Cases and Materials in Company Law* (7th edn London 2001) 474-75, where he explicitly refers to valuation in tax law.
[199] [1985] BCLC 493 (CA) 499.
[200] [1990] BCLC 686, 689.

articles"[201], and thus the market of shares is 'closed'. As a result, it is impossible to find a market value for these shares, as Farwell J stated in *Borland's Trustee v Steel Brothers & Co Ltd*[202]. Furthermore, the greater is the restriction on transfer, the greater is the effect on share value. In brief, these restrictions may have "considerable effect in depreciating the value of the shares"[203].

How is the hypothetical value determined for shares that cannot have an open market value? The House of Lords settled these principles for the purpose of estate duty in their decision in *Commissioners of Inland Revenue v Crossman*[204]. According to the ruling, the hypothetical value of shares is the price that they would fetch if the bidder were entitled to be registered as a shareholder but the acquirer would then become subject to the restrictions on transfer in the articles. In practice, shares are valued with an assumption that the restrictive provisions are not imposed upon this particular sale. Shares are in a way thrown to a hypothetical open market where all the persons interested should have an opportunity to purchase. Therefore, in fiscal valuation the provisions in the articles are partly ignored: shares are supposed to be freely saleable even if they are not.

There are two important points that should be raised from the ruling of *Crossman*. First, under the articles the value of shares is set in accordance with the particular provisions that apply to the company and its shares. In general, auditors determine the basis of share valuation and the fair value of shares. By contrast, when estate duty is set, the valuation of shares is made on a different basis: the provisions of

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[201] *Salvesen's Trustees v Commissioners of Inland Revenue* [1930] SLT 387, 391 (Lord Fleming); *Re Sir William Thomas Paulin* [1935] 1 KB 26 (CA) 63 (Romer LJ): "An actual sale in open market is out of the question."

[202] [1901] 1 Ch 279, 291; *Lynall v Inland Revenue Commissioners* [1972] AC 680 (HL) 693 (Lord Reid): "In my view it is legally impossible for the shareholder to sell such shares in the open market or otherwise without first obtaining from the holder of the right of pre-emption an agreement not to exercise that right."

[203] [1930] SLT 387, 392; *Attorney-General v Jameson* [1905] 2 IR 218, 227 (Lord Ashbourne): shares absolutely free and unfettered in power of disposition are much more valuable.

[204] [1937] AC 26 (HL).

the articles and the auditors' view do not have a central role in this valuation. As a result, the fair pre-emption price of shares can be different from the hypothetical value for the purposes of estate duty. In *Crossman*, shares were really regarded, for purposes of estate duty, as more valuable than their 'fair value' under the articles. So, it is indeed impossible to argue that there could be a single general objective value for shares. Share value is related to the context of valuation.

Second, when shares are valued under the articles, their value is fundamentally contractual in nature since provisions of the articles set the basis of valuation; furthermore, the auditor normally has discretion to choose the most appropriate method in share valuation. However, for the purposes of estate duty, the law rules the governing ideas of valuation, ie shares should be valued on the basis of a hypothetical sale on an open market. The basis set is a question of law, so in these cases the law determines the principles that should be applied to the particular facts. In essence, the valuation of shares distinctively becomes a mixed point of fact and law. Remarkably, it should be noted that share valuation is also this kind of mixed matter in other cases[205]. The role of law is not only to accept the value stated in the articles or whatever experts might find reasonable. As *Crossman* explicitly shows, law can rule how experts should perform share valuation in certain circumstances.

To conclude, I have analysed in this section three different objective values for shares, namely market value, value under the articles, and hypothetical value of shares. I summarise, on the one hand, that all these values are questions of fact. Moreover, it seems to be a widely accepted fact that majority shares may have a higher value per share than minority shares: this idea prevails, in particular, in the context of tax law. On the other hand, the value of shares is not purely a question of fact. For example, it is

[205] See eg *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 (CA); Hicks, Andrew and Goo, S. H., *Cases and Materials on Company Law* (5th edn Oxford 2004) 235: "certain of the principles applied are said to be matters of law."

question of law that shareholders are bound to the value fixed by the auditor; furthermore, the courts decide when an auditor is negligent in his task. But more importantly, the law can set the basis of valuation as it does when the hypothetical value is determined for shares in a private company. Yet, it might be possible that the role of law in share valuation is not fully recognized. I propose that, in fact, *company law* generally accepts that the value of shares is equal. Therefore, I analyse the area of company law where this equal value of shares is a legal presumption.

7.4 The value of shares under CA 1985 s 459

The CA 1985 s 459 offers special protection to minority shareholders[206]. The most common remedy under these provisions is a buy-out order where court provides that majority shareholders or the company itself must acquire the petitioner's shares. I next review how the courts see the value of majority and minority shares in these cases.

As mentioned above, judges have widely accepted as a matter of fact that minority shares may be less valuable than their proportional value. Significantly, there are cases with the same view in the context of CA 1985 s 459. For example, in *Re a company*[207] Hoffmann J considered that it is common ground that an outsider would not be willing to pay more than a nominal sum for minority shares. Thus, he held that the potential value of the shares was lower in the hands of the minority shareholder. His conclusion was that "a discount from an aliquot share of the value of the business on a price/earnings basis is therefore required" when the fair value of these minority shares was determined[208].

In *Re a company (No 002612 of 1984)*[209], Vinelott J shared Hoffmann J's view about the value of shares as a question of fact when he considered that the value of the

[206] More above, chapter six 6.4.2.
[207] [1986] BCLC 362.
[208] Ibid 369; see also *Re a company (No 005134 of 1986), ex p Harris* [1989] BCLC 383, where Peter Gibson J directed that the fair price for the minority shares should be fixed on the discounted basis.
[209] (1986) 2 BCC 99,453; 99,484.

minority shares is higher in the hands of a majority shareholder as part of a controlling interest. However, his conclusion was that it would be unfair if the minority shareholder were bought out on the fictional basis applicable to a free election to sell his shares, or on any other basis that would involve a discounted price. As he noted, it would be inequitable that a majority shareholder whose conduct had been found unfairly prejudicial should be allowed to purchase the shares at their investment value. Therefore, he held that in these circumstances the fair value of the minority shares should be higher than the price available in a market transaction.

The same conclusion was earlier reached in *Re Bird Precision Bellows Ltd*[210], where Nourse J stated that the fair value of minority shares should be fixed pro rata according to the value of the shares as a whole without any discount. He regarded this as the correct course, although the fair value of shares should always be determined on the basis of facts in the particular case. Consequently, as he noted, there is no rule of universal application either that the price of a minority shareholding in a small private company should be fixed on a pro rata basis according to the value of the company as a whole, or that the price should be discounted to reflect the status of a minority holding. Yet, as a general rule, in the case of a forced sale in a quasi-partnership company, he saw that "the only fair method of compensating an unwilling vendor of the equivalent of a partnership share" is to fix the value pro rata without any discount due to the minority status[211]. On the other hand, when a minority shareholder has acted in a way to deserve his exclusion, he considered that share value could then be appropriately discounted since the shareholder could be treated as if he had elected to sell his shares, and so the selling price would be discounted too.

The respondents in *Re Bird Precision Bellows Ltd* appealed against Nourse J's judgment. They argued that the fair purchase price for minority shares is their open

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[210] [1984] BCLC 195.
[211] Ibid 201-2.

market price, and thus there should be a discount in the case of a minority holding. But the Court of Appeal[212] dismissed their appeal, and their Lordships explained that the judge was perfectly entitled to arrive at his conclusion. Under the statutory provisions, the court may exercise its wide discretion and order what is just and equitable between shareholders[213]. The law does not require the court to fix the value of minority shares solely by reference to their market value as a minority holding[214]. Instead, the idea of CA 1985 s 459 is to give the court jurisdiction to put right and cure the unfair prejudice that a minority shareholder has suffered at the hands of the majority[215]. Following this ruling, due to fairness, the value of shares in these circumstances is fixed pro rata according to the value of shares as a whole. In consequence, the value of minority and majority shares is regarded as equal *in law*.

As Warner J noted in *Re Elgindata Ltd*:

> In a 'quasi partnership' case, such as *Re Bird Precision Bellows Ltd* was, it will often be fair to direct that the price of a minority shareholding which is to be purchased should be fixed on the pro rata basis.[216]

Equally, Balcombe LJ observed in *Virdi v Abbey Leisure Ltd* that s 459 case law, and in particular *Re Bird Precision Bellows Ltd*, shows "a general inclination towards a pro rata basis of valuation" [217]. Therefore, ordinarily the only fair course is to value shares

[212] [1985] BCLC 493 (CA).
[213] See also *Re Elgindata Ltd* [1991] BCLC 959, 1007 (Warner J): "the court has a wide discretion which it must exercise so as to achieve a result which is fair as between the parties in all the circumstances of the case."
[214] *Profinance Trust SA v Gladstone* [2000] 2 BCLC 516, 527 (Kim Lewison QC): "the court is [not] simply bound to award the market value of the shareholding at the selected valuation date."
[215] [1985] BCLC 493 (CA) 499-500; *Re Cumana Ltd* [1986] BCLC 430 (CA): a purchase order represents compensation for wrongs done to a minority shareholder.
[216] [1991] BCLC 959, 1007.
[217] [1990] BCLC 342 (CA) 350.

on the pro rata basis[218]. I summarise the current position of law in CA 1985 s 459 cases by quoting Lord Millett in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida*[219]: "normally the shares should be valued without any discount". As a result, the value of minority shares under these provisions is "their full value"[220].

Does the law then rule that in CA 1985 s 459 cases the value of shares must be equal? No, it does not, because, as mentioned, the value of shares is a question of fact. The value of majority and minority shares depends on the particular facts. In *O'Neill v Phillips*[221], which is one of the landmark cases in the area of s 459, Lord Hoffmann noted that "ordinarily" the fair value of minority shares is an equivalent proportion of the total issued share capital, ie shares must normally be valued pro rata and without a discount due to their minority status. As his Lordship considered, this pro rata basis is a presumption in the existing practice too. But he also stated that:

> This is not to say that there may not be cases in which it will be fair to take a discounted value.[222]

Thus, first there is no general rule about the valuation of shares under s 459: the value of minority shares may be fixed on a pro rata basis, or their value may be discounted to reflect their status as a minority holding. The court has discretion to set the fair value for shares on the basis of the particular facts. Nourse J's view in *Re Bird Precision Bellows Ltd*[223] is still current: there is no rule of universal application either way. Ultimately, the

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[218] *Richards v Lundy* [2000] 1 BCLC 376, 397; *Re Ghyll Beck Driving Range Ltd* [1993] BCLC 1126, 1134; *Re London School of Electronics Ltd* [1985] BCLC 273, 282 (Nourse J): "it is clear that the price must be fixed pro rata according to the value of the shares as a whole and not discounted."
[219] [2002] 2 BCLC 108 (PC) 118.
[220] *Re Phoenix Office Supplies Ltd* [2003] 1 BCLC 76 (CA).
[221] [1999] 1 WLR 1092 (HL) 1107.
[222] Ibid.
[223] [1984] BCLC 195.

fair value of shares is the value that the court determines to be fair with regard to all the circumstances of the case[224].

Second, it is possible that a minority shareholder has acquired his shares at a discounted price. In *Re Bird Precision Bellows Ltd*[225], Nourse J noted that in these circumstances it might be fair that the minority shareholder is bought out on the same basis as he himself has acquired the shares. If the price paid for the shares did not initially represent their value on the pro rata basis, the price under CA 1985 s 459 can be discounted to reflect this fact[226]. The fair price is indeed related to the particular facts.

Consequently, it should be asked whether it is a fact that minority shareholders may generally acquire shares in a private company at a discounted price. I do not believe that it is so because minority shareholders' bargaining position is weak. They are typically unable to get a full price for their shares on sale, and in a rather similar way, they are unable to get a discount when they acquire shares[227], in particular when they acquire shares from a majority shareholder. Finally, commercial practice does not offer any minority discounts, for example in share issues, either. By contrast, all new shares are issued in rights issues at the same price[228]. In any event, the focus of the court must plainly be on the particular case where the price for shares is determined. Therefore, there is no need to set a fair price for shares in general.

Third, what does it mean that the fair value of minority shares in CA 1985 s 459 cases is "ordinarily"[229], "normally"[230], or "often"[231] their pro rata value, ie the equal

[224] *Re Bird Precision Bellows Ltd* [1985] BCLC 493 (CA) 500 (Oliver LJ).
[225] [1984] BCLC 195, 202.
[226] *Re Elgindata Ltd* [1991] BCLC 959, 1007 (Warner J); on the other hand, it might be arguable that if a minority shareholder has initially paid more than a pro rata value for his shares, there should be a premium under s 459; see also *Richards v Lundy* [2000] 1 BCLC 376, 398 (Nicholas Strauss QC).
[227] There are also commentators who argue that minority shareholders should get their shares at a discounted price as they bear a special risk of opportunism; see eg Gordon, Jeffrey N., 'Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 California Law Review 1, 60.
[228] See above, chapter five 5.5.
[229] *O'Neill v Phillips* [1999] 1 WLR 1092 (HL) 1107.

value? In brief, there is a presumption in company law that every share has the same value in this context [232]. Further, since this is a presumption, it is rebuttable, ie there may be cases where the fair value of shares is not their pro rata value. However, there should be special reasons for this conclusion. As explained above, one reason is that a minority shareholder has acted in a way to deserve his exclusion[233]. Another reason may be that a minority shareholder has not, quite exceptionally, initially paid the full price for the shares. But as this equal value is a presumption, the person who argues that a minority shareholder deserves his exclusion has to show the reason for this conclusion. Similarly, the person who argues that a minority shareholder has not paid a full value for his shares has to prove this point too[234].

In summary, the general *principle* in CA 1985 s 459 cases is that shares are generally valued on a pro rata basis. The current law fundamentally proposes that every share has the same value in this context: the courts have accepted a pro rata valuation as the normal basis in these cases[235]. The fair thing is normally to treat quasi-partners in a private company equally[236]. Since this is a presumption of law, not a rule of law, the court has discretion to decide that a discount should be applied to minority shares if justice in a special case requires it. Thus, in company law in this area shares principally have an *equal* value, but share value in a particular case still remains a matter of fact related to the particular circumstances.

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[230] *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 (PC) 118.
[231] *Re Elgindata Ltd* [1991] BCLC 959, 1007 (Warner J).
[232] Eg Hollington (2004) 263: "there is a strong presumption that no such discount should be applied."
[233] *Re Bird Precision Bellows Ltd* [1984] BCLC 195; *Re Planet Organic Ltd* [2000] 1 BCLC 366, discount of 30 per cent was applied.
[234] See, in general, eg Fitzgerald, P. J., *Salmond on Jurisprudence* (12th edn London 1966) 73: a legal presumption means that "sufficient evidence" is required to establish the contrary conclusion.
[235] *Profinance Trust SA v Gladstone* [2002] 1 BCLC 141 (CA) 149 (Robert Walker LJ): "In a 'quasi-partnership' case where the petitioner is not at fault the court tends to favour an undiscounted share of the value of the company as a whole."
[236] [2000] 1 BCLC 366, 371 (Jacob J).

7.5 The value of majority shares and *Short v Treasury Commissioners*

Since my particular interest is the value of majority and minority shares, the ruling of *Short v Treasury Commissioners*[237] is special in this area.

But first, it should be noted that *Short* is more a 'war market' than a stock market case. The case, whose ruling is strongly related to its particular facts and circumstances, is quite exceptional. Nevertheless, it is an important case in English company law; for example, Davies considers that it is the "most interesting" case explaining the juridical nature of a shareholder's interest in the company[238].

The legal issue in *Short v Treasury Commissioners* was the compulsory acquisition of a company's shares, empowered by the Defence (General) Regulations 1939, for efficient prosecution of the war. The company was quoted, and thus the transaction price of shares was fixed by reference to the Stock Exchange price on the so-called critical date when the acquisition legally took effect. But the stock market value at that date, and also the transfer price for the shares, was lower than their *pro rata* value calculated from the value of the company.

Still, in their judgments both the Court of Appeal and the House of Lords accepted that the value of shares could be less than their appropriate part of the value of the whole undertaking. Once the regulation ordered that the price was "the value of those shares as between a willing buyer and a willing seller", the words 'any shares' referred to those individual shares, not to the company as a whole. In consequence, what was required was the valuation of shares, not of the company. The true method in valuation was share by share. Since this method had been used, the courts considered that the share price in the order was specified correctly.

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[237] [1948] 1 KB 116 (CA); [1948] AC 534 (HL).

[238] Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (7th edn London 2003) 617; see also Gower, L. C. B., *The Principles of Modern Company Law* (2nd edn London 1957) 322, where he points out that "the most important of these cases" are both *Short* and *Crossman* [1935] 1 KB 26 (CA); [1937] AC 26 (HL).

What are the important points in *Short v Treasury Commissioners*? I think that the principal idea of the ruling can be found from the words of Evershed LJ:

Shareholders are not, in the eye of the law, part owners of the undertaking.[239]

Further, as Lord Porter explained in the ruling of the House of Lords: "a shareholder has no direct share in the assets of a company"[240]. As a result, the value of a company as a whole, or the value of its assets, does not show the value of shares[241]. Ultimately, the value of all the shares of a company can be different from the value of the company as a whole. I think that this is the most significant point in the ruling of *Short*.

Yet, the case has dicta that have raised particular interest, as Evershed LJ noted in the Court of Appeal:

If an individual shareholder in a company owns such a number of shares in that company as gives him effective control of the company's affairs, it *may* well be that the value to be attributed to that holding, on a sale of it as a separate transaction, is a figure greater than the sum arrived at by multiplying the number of his shares by the 'market' value for the time being of a single share.[242]

Lord Uthwatt pointed out the same idea in the House of Lords in this way:

I desire only to add that if some one shareholder held a number of shares sufficient to carry control of the company, it *might* well be that the value proper to be attributed to his holding under the regulation was greater than the sum of

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[239] [1948] 1 KB 116 (CA) 122.
[240] [1948] AC 534 (HL) 545.
[241] More above, chapter three 3.4.1.
[242] [1948] 1 KB 116 (CA) 123 (emphasis added).

> the values that would be attributed to the shares comprised in that holding if they were split between various persons. The reason is that he has something to sell - control - which the others considered separately have not.[243]

Therefore, for example, Sealy notes that "there are dicta in that case which strongly support the view that where a majority shareholding is sold by a single seller to a single buyer, it is proper to value the holding more highly"[244]. Certainly, he is right: these dicta might propose so. Their Lordships, like English judges in general, accepted that majority shares could be more valuable than minority shares[245].

But there is a very important point to add: the value of shares is a question of fact. I think that is the reason why their Lordships used the words 'may' and 'might'. Further, as Evershed LJ observed, it is possible to displace market quotations by *evidence* since the regulation stated that the value of shares should be their price between a willing buyer and a willing seller[246]. So, the dicta in the case merely emphasized that the value of shares must be decided on the basis of particular facts[247]. To repeat, the price available from shares was considered as a matter of fact.

Equally, their Lordships in *Short v Treasury Commissioners* stressed the importance of a stock market quotation as the true value of shares. Evershed LJ observed that:

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[243] [1948] AC 534 (HL) 546 (emphasis added).
[244] Sealy (2001) 474.
[245] See also Davies, Paul L., 'The Notion of Equality in European Takeover Regulation' in Payne, Jennifer (ed), *Takeovers in English and German Law* (Oxford 2002) 9, 13, where he states referring to *Short* that "general British law accepts the idea that in principle controlling shares are worth more than non-controlling ones."
[246] [1948] 1 KB 116 (CA) 125.
[247] It should be noted that the ruling was related to the wording of the regulation; see eg [1948] AC 534 (HL) 543 (Lord Porter) : "if the regulation had stated that the shareholders were to receive the value of their shares calculated upon their value on the sale of their business as a going concern the appellants' claim would be correct, but to my mind the regulation makes quite a different stipulation."

> If a shareholder has 1,000 shares, then prima facie the price to be paid to him is 1,000 times the value of a single share.[248]

Furthermore, he noted that the Stock Exchange quotation was, "as a matter of law", the value of the shares[249]. The market quotation can be regarded as the real value of shares[250]. But since the value is a question of fact, the Stock Exchange price can only be "the best"[251] or most "cogent evidence"[252] of share value. In sum, market price as real value is a central assumption in law, and the special regulation and the ruling of the case reflected this idea. Still, from the perspective of law, market quotations can be replaced, but the burden of proof rests on those who argue otherwise[253].

The next point is whether the dicta in *Short v Treasury Commissioners* really propose that there is a presumption that the value of majority shares is higher than the current market quotation of shares. But as mentioned, the presumption of the law is that if a shareholder has 1,000 or 1,000,000 shares, *prima facie* the value of those shares is 1,000 or 1,000,000 times the value of a single share. This principle also applies to majority shares, although Evershed LJ noted that the value of majority shares might be greater than the sum arrived at through the current market value[254]. It is important to notice that both Evershed LJ and Lord Uthwatt used in their dicta the words may and might.

However, Evershed LJ pointed out that a majority shareholder "is able to sell something more than a mere parcel of shares"[255]. Similarly, Lord Uthwatt stated that a

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[248] [1948] 1 KB 116 (CA) 124.
[249] Ibid 125.
[250] See also [1948] AC 534 (HL) 548 (Lord Morton): "I think that the Stock Exchange prices afford a fair criterion of the value of each block of shares."
[251] [1948] 1 KB 116 (CA) 125.
[252] [1948] AC 534 (HL) 542.
[253] See also above 7.3.1 and below 7.6.5.
[254] [1948] 1 KB 116 (CA) 123.
[255] Ibid.

majority shareholder has something extra to sell, ie control of the company[256]. Do these dicta then demonstrate that majority shares are more valuable than minority shares? The answer is still clearly no. First, in an obiter dictum facts are applied to law, but their Lordships raised merely a matter of fact as they noted that majority shares may and might be more valuable than the prevailing stock market price. Their Lordships partly explained their opinion about the valuation of shares. In consequence, this makes the notion of their dicta distinct: company law accepts that majority shares might be regarded as more valuable than the prevailing market price for shares. Second, the value of majority shares, or of any shares, is a question of fact[257]. Incidentally, questions of facts are not decided on the basis of precedents, but with the support of evidence. Therefore, the dicta of *Short* are that the value of majority shares *can* be more than the current stock market price. In conclusion, and regardless of the dicta, the value of shares is a point of fact.

Finally, are majority shares really more valuable than minority shares? Significantly, there are, as explained above, experts who think so; moreover, legal authors often share this view too. For example, Pettet considers that it is "obvious" that the value of minority shares is less than their pro rata value[258]. In contrast, I think that the price available from minority shares in a private company is typically less than their proportional value since majority shareholders as obvious buyers can get them at a discounted price: there is no need to pay the full value for these shares. So, the value of minority shares is lower, especially if it is accepted that minority shareholders are, indeed, at the mercy of majority shareholders.

Undoubtedly, minority shareholders often have a weak position in a private company. However, for this reason special minority protection is required in company

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[256] [1948] AC 534 (HL) 546; ibid 543 (Lord Porter): a majority shareholder has "a potentiality of control" in a company.
[257] See in particular *Guinness Peat Group plc v British Land Co plc* [1999] 2 BCLC 243 (CA).
[258] Pettet (2001) 253.

law. The available protection, of course, has an effect on the value of minority shares: it can make their shares more valuable. On the whole, the protection *in law* may change shareholders' position *in fact*.

The idea in law is not to fix the value of minority shares solely with reference to their market value. The courts may look behind the hypothetical market prices, which they do, in particular, in CA 1985 s 459 cases that do not support the idea that majority shares should generally be regarded as more valuable. By contrast, the value of majority and minority shares is then ordinarily considered equal[259]. In conclusion, I formulate the point that the higher value of majority shares might be from the perspective of the law 'weak' as a fact.

But even more importantly, it should be stressed that the company in *Short v Treasury Commissioners* was quoted on the stock exchange. As noted above, it is considered that their Lordships even proposed that due to control of the company, majority shares should be valued above the current market price for shares. However, even if they really did so, the stock market considered was a market almost sixty years ago, and during wartime. The UK stock market is today very different from what it was in those days. Overall, their Lordships' view about stock markets may be quite non-current today.

According to modern stock market theory, minority shares are regarded as more liquid than majority shares. In chapter four[260], I stated that in Anglo-American stock markets there exists a preference for liquidity, ie the liquidity of shares can be more valuable than the control of a company. Due to the importance of liquidity, it is possible to argue that minority shares should actually be considered more valuable than majority shares. Therefore, the prevailing facts on stock markets might be just the opposite, as

[259] Above 7.4.
[260] See 4.5.1.

implied in *Short*, since the price available from majority shares is not generally higher than the current market price. As Glover explains:

> On the stock Exchange large blocks of shares *typically* change hands at a discount to current market price.[261]

Consequently, the expected price from majority shares may, in fact, be less than the current stock market value. The reason for this is again the liquidity of shares. In sum, it seems to be that their Lordships in their opinions in *Short* strongly underestimated the importance of liquidity. Naturally, their view is quite understandable because, at the time of the case, the nature of stock markets was very different.

In summary, in *Short v Treasury Commissioners* it was considered that the value of shares *can* be different from the value of the company as a whole, or from their market price. Yet, the case also emphasizes the role of market quotation as the real value of shares. However, the case does not state that majority shares are more valuable than minority shares because that is a question of fact; it only accepts that any shares *may* be more valuable than the current stock market price. So, when this case is followed, the fundamental idea remains the same: the value of shares is a matter of fact and evidence.

7.6 Share value in takeovers

Shares are transferable personal property, which means that a shareholder may sell his shares to a new owner at a price that is a bargain between the buyer and the seller. Their price is primarily a point of company law only in those private companies that have a

[261] Glover (1986) 30 (emphasis added); in addition, he says, ibid, that the reverse applies to unquoted shares: in private companies, large shareholdings "generally" have a higher unit price than small shareholdings.

pre-emption clause in favour of existing members[262]. But the focus of this review moves on takeovers of public companies. My fundamental question is the value of shares in takeovers from the perspective of law.

A shareholder is entitled to sell all his shares or some of them. Similarly, a new shareowner can buy as many shares as he desires. Even if he buys all the shares from one shareholder, he is not required to buy any shares from other shareholders. Simply put, share transactions are individual bargains between a buyer and a seller.

Naturally, the majority of a company's shares can be bought only from those shareholders who have them. The share price in these majority transactions is basically a matter of bargain since every shareholder may sell his shares at the best price obtainable. In addition, if somebody is willing to pay an extra price for majority shares, they can be regarded as more valuable. As noted above, experts and authors widely think that majority shares are, in fact, more valuable than their proportional value. It is often argued that in takeovers a premium should be paid for control of a company[263].

The pivotal question is whether majority shares are more valuable in takeovers. My claim is that the answer is very clearly no, they are not; on the contrary, shares have an equal value in takeovers. The reason for this conclusion is that minority shareholders are specially protected in this area. In this section, I explain how and why this protection is available, but before that I review the value of control power and the possibility of 'squeezing out' of minority shareholders.

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[262] Above 7.3.2.

[263] See eg Sabine, Martin, *Corporate Finance: Flotations, Equity Issues and Acquisitions* (3rd edn London 2003) 323; *Re John Reid & Sons (Strucsteel) Ltd* [2003] 2 BCLC 319, 331; however, as explained above, chapter four 4.5.1, this study suggests that premiums are paid due to liquidity.

7.6.1 The value of control power

Control of a company means power and extra freedom for those having it. Because of this power, a majority shareholder cannot be at the mercy of other shareholders. Ultimately, it is very true that both power and freedom are valuable.

In their famous book, Berle and Means state that:

> a position of 'control' is a valuable piece of property to its holder, and so regarded; its value arises out of the ability which the holder has to dominate property which in equity belongs to others.[264]

The special value of majority shares is a consequence from majority rule since power in companies rests on a majority. Furthermore, it is generally accepted that the power that majority shareholders have is valuable.

First, control really has value. But it should be noted that shareholders' property is their shares only: as a result, majority shareholders cannot 'own ' control power in a company[265]. This power does not legally belong to majority shareholders because they are only entitled to use it in the interest of the company as a whole[266].

The fundamental point is whether majority shareholders can still sell the power they have. Significantly, in some states in the USA, it is considered that control belongs to the company, and therefore any premium paid for it must go to the company[267]. By

[264] Berle, Adolf A., Jr and Means, Gardiner C., *The Modern Corporation and Private Property* (New York 1932) 244; in addition, they continue: "the law thus far has been unable to deal with the situation."
[265] Above chapter two 2.3.3; see also *Levy v American Beverage Co* (1942) 38 NYS 2d 517 (Supreme Court, First Department of New York) 526, where it was considered that the value of control is "a lawful property right of the controlling stockholders"; Berle, Adolf A., 'The Price of Power: Sale of Corporate Control' (1965) 50 Cornell Law Quarterly 628, 638, where he points out that the capacity to control is not a "property right", but rather "a corporate asset, not an individual one".
[266] See above, chapter six; and Berle (1965): "it is a corporate power, though exercised by individual stockholders."
[267] Johnston, Alexander, *The City Take-Over Code* (Oxford 1980) 203; see also Berle and Means (1932) 244; Boyle, Anthony John, 'The Sale of Controlling Shares: American Law and the Jenkins Committee' (1964) 13 ICLQ 185.

contrast, that is not the position in the UK, where it is approved that majority shareholders can get the premium. As Gower explains:

> Can [majority shareholders] then sell their controlling block for a larger price than that which other shareholders can obtain? In England it has always been assumed that they can.[268]

Generally speaking, this idea follows the ruling of *Short v Treasury Commissioners*[269]: the law accepts that control of a company may make majority shares more valuable. It is possible to profit from trading in control[270]. This is the conventional view of English law.

Second, it is, however, important to notice that, as Berle and Means point out, the special value of majority shares arises from the ability to dominate property that in equity belongs to others. This means that majority shareholders might be able to use their control position in a company for their personal profit at the expense of the company and other shareholders, which may even be called majority shareholders' 'looting power'. It is possible to argue that these opportunities for personal profit, which are not available to minority shareholders, ordinarily give majority shares their increased value[271]. It can be the exploitation of disproportional benefits from a company that makes majority shares more valuable.

Does company law then accept this? No, it does not since majority power in a company must be used for the benefit of all shareholders. To secure this, company law

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[268] Gower (1957) 524.
[269] [1948] 1 KB 116 (CA); [1948] AC 534 (HL).
[270] See especially Jennings, Richard W., 'Trading in Corporate Control' (1956) 44 California Law Review 1.
[271] Ibid 16; see also eg Barclay, Michael J. and Holderness, Clifford G., 'Private Benefits from Control of Public Corporations' (1989) 25 Journal of Financial Economics 371, where they claim that majority blocks are priced at substantial premiums, if large shareholders have been able to use their voting power to secure themselves private benefits.

offers protection to minority shareholders[272]. Remarkably, there are also special requirements concerning takeovers of public companies, ie these transactions are normatively regulated. In short, the regulation of takeovers does not support the idea that control power should make majority shares more valuable. Before analysing this regulation, I first review the compulsory acquisition of minority shares.

7.6.2 Squeeze-out of minority shares

The majority of a quoted company' shares can be sold to a single shareholder but there might still remain minority shareholders who are unwilling to sell their shares. The fundamental idea in law is that every shareholder has a veto: when the buyer does not offer enough, there is no need to sell shares. As ruled in *Brown v British Abrasive Wheel Co Ltd*[273], if a majority shareholder fails to purchase the shares of minority holders by agreement, the majority cannot do so compulsorily through an alteration of the articles. This expropriation of individual shareholders through majority power was unlawful oppression[274]. The court interfered, and this requirement in the articles was not efficient.

Obviously, the law conferred on minority shareholders a 'lock-up' right in takeovers. A majority shareholder was thus unable to get the whole of a company's shares in his hands without the consent of every shareholder. As a result, the power of minority shareholders was regarded as disproportional. The Greene Committee put it in this way:

> It has been represented to us that holders of a small number of shares of the company which is being taken over (either from a desire to exact better terms

[272] See above, chapter six 6.3.3 and 6.4.
[273] [1919] 1 Ch 290.
[274] See also *Dafen Tinplate Co Ltd v Llanelly Steel Co (1907) Ltd* [1920] 2 Ch 124

> than their fellow shareholders are content to accept or from lack of real interest in the matter) frequently fail to come into an arrangement which commends itself to the vast majority of their fellow shareholders, with the result that the transaction fails to materialise.[275]

The Committee considered that the minority was even able to oppress the majority. Therefore, a statutory provision requiring dissenting minority shareholders to sell their shares was proposed.

The compulsory purchase of minority shares was implemented by the Companies Act 1928[276], which as a statutory scheme made it easier to take companies over. The legislation gave a majority shareholder the right to buy the shares of a dissenting minority. In practice, it offered a convenient method of eliminating the still-remaining minority[277]. Minority shareholders were no longer able to hamper a takeover scheme as their squeeze-out from the company became possible by the power of the law.

According to the statutory provisions, if the holders of not less than nine-tenths of the shares affected by the offer had approved it, the majority shareholder became "entitled and bound to acquire" those remaining shares "on the terms on which under the scheme or contract the shares of the approving shareholders are to be transferred to the transferee"[278]. The basic concept was that a majority shareholder could acquire the shares of dissenting shareholders on the same terms on which the other shares had been bought out. Consequently, the offeror was given the right to acquire other people's

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[275] *Company Law Amendment Committee 1925-26 Report* ('*Greene Committee*') (Cmd 2657) (London 1926) 43-44.
[276] s 50; the Companies Act 1929 s 155.
[277] Eg Flisfeder, A. Maurice, 'Compulsory Acquisition of the Interest of a Dissenting Minority Shareholder' (1973) 11 Alberta Law Review 87, 87.
[278] The Companies Act 1928 s 50(1).

property. Yet, as the law gave this power, it also ruled the price for minority shares[279]. As a result, share price in this context was no longer a matter of bargain and fact, but became a point of law.

The CA 1985 s 430(2) states: "The offeror shall be entitled and bound to acquire those shares on the terms of the offer." Subsequently, the offeror must pay for the remaining minority shares the same price as he paid for the nine-tenths of the shares. There is no room to argue whether the value of these minority shares is less than the price paid for the nine-tenths majority. In sum, the law gives the majority shareholder the power to acquire these minority shares compulsorily but the law protects the dissentients from transferring their shares on less favourable terms than those given to the approving majority[280].

However, the CA 1985 s 430C provides minority shareholders extra protection when they are bought-out: they are entitled to apply to the court to specify terms of acquisition different from those of the offer. As the Greene Committee stated, minority shareholders should have "a right of appeal to the Court on any question of value or oppression[281]. In *Re Castner-Kellner Alkali Co Ltd*, Eve J explained the point:

> The function of the Court ... is to determine on what terms the dissentients are to be dispossessed of their investment ... it is for the Court to consider and decide whether [the offer] is an adequate and satisfactory one, and, if not, to substitute such other terms of purchase as in its discretion are fair and just.[282]

So, the court may order that the price of remaining minority shares should be higher than the price paid for the nine-tenths majority. This explicitly means that from the

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[279] *Re Carlton Holdings Ltd* [1971] 1 WLR 918, 925 (Brightman J): "The terms upon which that right is exerciseable ought therefore, in my opinion, to be defined with some strictness."
[280] *Re Castner-Kellner Alkali Co Ltd* [1930] 2 Ch 349, 355 (Eve J).
[281] Greene Committee 45.
[282] [1930] 2 Ch 349, 354.

perspective of law the offer price for the majority of shares is not a maximum value of minority shares because the courts may order otherwise.

On the whole, when the law gave the majority shareholder the right to squeeze-out the dissenting minority shareholders, it also gave the minority a right to challenge these compulsory acquisitions in court. The idea was, in this way, to set a balance to protect the interests of different shareholders. Even so, it should be particularly noted that the law orders the dissenting minority to get the *same* price for their shares. In this context, the law so secures the equal value of every share.

7.6.3 The Takeover Code

Majority shareholders might be willing to get a higher price for their controlling stakes. To get a premium, they can use their hold-out power. Simply, if a premium is not paid them, they do not accept the offer and there will be no takeover.

Although the prime idea in company law is that controlling shareholders may sell their shares at the best available price, this position is problematic. For example, as Gower notes:

> there are serious objections to allowing any shareholders to profit individually from the fact that they control the company.[283]

In general, the most serious of objections is that majority shareholders might get their premium by abusing their controlling position in the company. Therefore, the premium for majority shares might actually be paid for the possibility to loot the company by

[283] Gower (1957) 573.

stripping its assets or business opportunities. This point as a risk has been recognized, in particular, in American company law cases[284].

As noted above, the law requires that dissenting minority shareholders must after a successful takeover sell their shares at the same price. Company law does not promote shareholders' opportunism; in the same way, it should be asked why this kind of behaviour is accepted from majority shareholders. In short, should they really be able to get a higher price for their shares by the support of majority power?

It is true that the position of a majority shareholder has been used to gain personal benefits in takeovers. In consequence, majority shareholders have been able to get a higher price for their shares in takeovers. This often took place at the expense of minority shareholders. In the 1960s, there was mounting concern about unfair practices in the conduct of takeovers[285]. However, this problem was not settled through legislation but self-regulation, which has a central role in the governing of takeovers in the UK.

The City Code on Takeovers and Mergers has regulated takeovers since 1968 by providing an orderly framework for takeovers. As the Introduction para 1(a) states: "The Code is designed principally to ensure fair and equal treatment of all shareholders in relation to takeovers." In essence, the Code is an extension of this idea by offering equality of treatment and opportunity to every shareholder in public companies[286].

The Takeover Code is a standard of commercial behaviour[287]. It comprises 10 General Principles and 38 Rules, which are further divided into sub-rules. In this brief review, the focus is on General Principles 1 and 8.

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[284] Eg *Levy v Feinberg* (1941) 29 NYS 2d 550 (Supreme Court of New York) 556; see also Boyle (1964).
[285] Eg Remnant, Philip, 'The Takeover Panel' in Button, Maurice (ed), *A Practitioner's Guide to The City Code on Takeovers and Mergers 2002/2003* (Old Woking 2002) 1; see also Johnston (1980).
[286] As stated in Introduction para 4(a), the Code applies to offers for listed and unlisted public companies; in contrast, it is important to notice that CA 1985 ss 428-30F apply to takeovers of all companies; see *Fiske Nominees Ltd v Dwyka Diamond Ltd* [2002] 2 BCLC 123.
[287] The Code Introduction 3(a).

General Principle 1: All shareholders of the same class of an offeree company must be treated similarly by an offeror.

This principle is the core of the Code: the prime idea is that every shareholder should get the same price for his shares[288]. In practice, this principle simply requires that the price of every share must be equal in takeovers. Consequently, in mandatory bids, the offeror must pay for all the remaining shares the highest price he has paid for the shares in the last twelve months[289]. Premiums must be divided among all shareholders since they should get the same deal[290]. As a result, the Code secures the equal treatment of every shareholder.

General Principle 8: Rights of control must be exercised in good faith and the oppression of a minority is wholly unacceptable.

The intention of this principle is to make sure that minorities are not treated unfairly in takeovers. As Johnston notes, this principle might stem "from the widely held belief that minority shareholders are not as well protected under English law as under US and other codes of law"[291]. In sum, the Code strengthens minority shareholders' protection offered by the law[292], and it does so very explicitly by requiring that the price paid for every share must be equal in takeovers.

The area of the Code is the conduct of takeover bids. Thus, its does not govern the commercial merits of takeovers: it merely supports the free transferability of shares

[288] See also CA 1985 s 428(1): a takeover offer is "an offer on terms which are the same in relation to all the shares."
[289] The Code Rule 9.5.
[290] About this sharing rule, see also Davies, Paul and Hopt, Klaus, 'Control Transactions' in Kraakman, Reinier R. and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford 2004) 157, 177.
[291] Johnston (1980) 202.
[292] *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192, 209 (Browne-Wilkinson VC): the Code provides protection to the shareholders whose shares are the subject of a bid.

by facilitating takeover offers. The rules of the Code do not include machinery for setting the bid price for shares[293]. The two central points in the pricing of shares are: 1) the bidder determines the consideration that he is willing to pay for shares[294]; 2) shareholders decide whether they accept the offered price. Takeovers clearly rest on the principle of shareholders' decision making: the bid is successful if shareholders accept it. Naturally, the idea in takeovers follows majority rule: minority shareholders' ability to get the equal price for their shares depends on the acceptance of the majority. Still, it is important to notice that the Code prevents controlling shareholders from negotiating a higher share price from the bidder than is available to every shareholder.

Next, the question arising is whether the Code is a part of law. Simply, it is not since it is self-regulation[295]. However, English law has a positive attitude towards stock markets' self-regulation: the courts and legislation recognize the jurisdiction and authority of the Code. The general view can be found, for example from the Court of Appeal's ruling in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[296]. Further, the Financial Services and Markets Act 2000[297] and the Financial Services Authority directly support the function of the Takeover Panel[298]. In sum, the Panel is able to exercise "considerable de facto power", although it does not have any direct statutory basis for its operation[299].

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[293] See the Code Introduction 1(a).
[294] In mandatory offers, the bidder sets the price 'indirectly' by acquiring shares.
[295] *Re Chez Nico Restaurants Ltd* [1992] BCLC 192, 209: "The code does not have the force of law ... [but] the code is a factor of great importance."
[296] [1982] Ch 204 (CA) 224: "In our view the voluntary regulation of companies is a matter for the City"; see also *R v Panel on Take-overs and Mergers, ex p Datafin plc* [1987] QB 815 (CA); *R v Spens* [1991] 1 WLR 624 (CA) 632, where it was considered that "the Code sufficiently resembles legislation".
[297] Eg s 143.
[298] The Code "has been endorsed" by the FSA; see the Code Introduction 1(c).
[299] Drayton, Patrick, 'Regulatory Structures: The Relationship Between the Takeover Panel, the FSA and the Courts' in Payne, Jennifer (ed), *Takeovers in English and German Law* (Oxford 2002) 65, 65; on the other hand, the term self-regulation is partly an overestimation; see eg Davies (2002) 3: "Whether these rules may be termed accurately an example of 'self-regulation' is very much open to doubt, though that term is often used to characterize them."

Yet, the regulation of takeovers is changing due to the implementation of the Takeover Directive[300], which requires the introduction of a statutory framework for takeovers. As a result, takeover rules are cemented into European and English law. The regulation of takeovers will be part of the law, and the Takeover Panel is placed on a statutory footing[301]. The regulatory change is significant, although no important material changes are expected in the UK to the current takeover rules[302]. But from the legal perspective, the protection of shareholders in takeovers will take place within a statutory framework. Indeed, the Takeover Directive enhances minority shareholder protection since takeover rules will have binding effect as a part of law.

The regulation of takeovers gives special protection to minority shareholders in public companies. Remarkably, these provisions secure shareholders' equal treatment in takeovers as every shareholder should get the same price for his shares. In brief, under these rules the value of all shares is regarded as equal. Moreover, due to the Takeover Directive the regulation of takeovers will undoubtedly have the full force of law.

7.6.4 Takeover as collective action

It is sometimes argued that minority shareholders 'free ride' in takeovers since they get the same price for shares that might be less valuable. That can be true and problematic in certain cases. On the other hand, due to their better liquidity minority shares may be more valuable than majority shares. In effect, there are cases in which it is wrong that minority shareholders do not get a premium for their more liquid, and thus more valuable, shares. But the prime problem is that it is often quite impossible to say

[300] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids ('Takeovers Directive') [2004] OJ L 142/12; it should be noted that the main aim of the directive is to protect, in particular, minority shareholders, and to afford them "equivalent treatment" and "equitable price" for their shares; see Recitals (1), (2), (9), and Articles 3(a) and 5.

[301] The Directive has to be implemented by 20 May 2006.

[302] *Company Law Implementation of the European Directive on Takeover Bids – A Consultative Document* (2005 London) 4: the rules of the Directive "are considered to be broadly consistent with the existing Takeover Code provisions."

whether, in a particular case, liquidity or control is more valuable[303]. Even more importantly, determination of this point is not the task of law. I emphasize that the fundamental function of law is to set and protect rights, not to determine questions of commercial judgment. Consequently, shareholders themselves are entitled to value their property, which is the basic idea of property rules. Overall, I consider that takeovers should principally be explained as shareholders' collective action.

But before analysing that idea, I raise the point whether it is right that all shareholders get the same price for their shares in takeovers. In short, I think that this question is basically very similar to whether shareholders should get the same dividend per share or whether they should equally share a company's net assets in liquidation. Although a decision about dividends, or voluntary liquidation, rests on majority shareholders, this does not mean that majority power may be used to determine the distribution of dividends or a company's net assets. In contrast, that is a matter of shareholders' rights.

To illustrate, as Jessel MR explained in *Griffith v Paget*[304], majority shareholders cannot decide about the distribution of assets among shareholders because the "only proper mode" is according to their rights. Majority power may not be used to take away the bulk of the property belonging to other people, ie to the company and indirectly to all shareholders through their shares. So, if majority power is misused, the law steps in to protect the minority. There is no doubt: the law rules that the distribution of dividends and net assets must take place in proportion to shares[305]. I consider that shareholders' rights should be stressed in the context of takeovers too[306].

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[303] See above, chapter four 4.5.1.
[304] (1877) LR 5 Ch D 894.
[305] Above chapter five.
[306] See also Andrews, William D., 'The Stockholder's Right to Equal Opportunity in the Sale of Shares' (1965) 78 Harvard Law Review 505, 521: "each stockholder is entitled to share proportionately in the profits of the enterprise; from the stockholder's point of view a sale of stock is one very important way of realizing a profit on his investment; profits from stock sales ought to be regarded as profits of the

Of course, the basic situation in takeovers is not identical with dividends and surplus assets since the consideration is not from the company but from the offeror[307]. Freedom of exchange provides that majority shareholders should be able to sell their shares at a price as good as possible. Further, as stated in *Short v Treasury Commissioners*, the law accepts that majority shares can be more valuable than minority shares. Indeed, the law does not generally require that every share should have the same price and value.

But takeovers are fundamentally different from transfers of individual shares: they are collective actions supported by the law. These transactions' "external facade" and their "freedom from specific normative restrictions" are misleading[308]. It can be argued that they are, in a way, alternatives to a company's voluntary liquidation[309]: shareholders collectively decide to exit the company through a takeover scheme. Due to the statutory provisions concerning takeovers, it is possible by the support of a nine-tenths majority to decide that the offeror gets the right to acquire all shares in the company. Significantly, although shareholders do not vote in general meeting, they do so by accepting the takeover offer[310]. The prime point is that a widely supported decision on a takeover, as majority decisions generally do, binds every shareholder. In a takeover, shareholders can act as a single person[311] since they accept the offer collectively.

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enterprise subject to equal sharing among stockholders just as much as profits realized through corporate action."

[307] See eg Farrar, John H., 'Fuzzy Law, the Modernization of Corporate Laws, and the Privatization of Takeover Regulation' in *Takeovers, Institutional Investors, and the Modernization of Corporate Laws* (Auckland 1993) 1, 6, where he notes that the internal relationship in the company and the external relationship in the markets are different issues.

[308] Stern, Yedidia Z., 'The Private Sale of Corporate Control: A Myth Dethroned' (2000) 25 Journal of Corporation Law 511, 512.

[309] See also *Rock Nominees Ltd v RCO (Holdings) plc (in liquidation)* [2003] 2 BCLC 493; [2004] 1 BCLC 439 (CA).

[310] See Gower (1957) 523, where he discusses the relationship between majority and minority shareholders under a heading "Members' Acts outside General and Class Meetings".

[311] See eg Easterbrook, Frank H. and Fischel, Daniel R., *The Economic Structure of Corporate Law* (Cambridge, Massachusetts 1991) 185; Bebchuk, Lucian Arye, 'The Sole Owner Standard for Takeover Policy' (1988) 17 Journal of Legal Studies 197.

The principal idea of takeovers can be found from *Re Hoare and Co Ltd*[312], where a majority representing over 99 per cent of shares accepted a takeover scheme. This acceptance by an overwhelming majority was the main reason for regarding the scheme as fair[313]. As Maugham J observed:

> the view of the Legislature is that where not less than nine-tenths of the shareholders in the transferor company approve the scheme or accept the offer *prima facie*, at any rate, the offer must be taken to be a proper one.[314]

Naturally, this argument does not work if the price paid for every share is not the same: that kind of takeover is not a collective action either. Indeed, as Evershed LJ formulated in *Re Press Caps Ltd*[315]: in a takeover, all shareholders in a company "are being invited to join together in transferring to the transferee company the entire issued share capital and with it the control of the transferor company." So, every shareholder should get the same invitation as they are 'fellow' shareholders in the company. Incidentally, the right to squeeze out the remaining minority shares explicitly requires that it must take place on similar terms to those at which the other shares have been bought out in a takeover offer[316]. In sum, it is possible to state that only takeovers that rest on the idea of an equal offer at the same share price have a binding force in company law[317].

The Takeover Code and the Takeover Directive require that in takeovers there must be an equal offer to all shareholders, who may collectively accept or decline it. Moreover, if an offer is accepted by shareholders representing nine-tenths of the shares,

[312] (1933) 150 LT 374.
[313] See also *Re Bugle Press Ltd* [1961] Ch 270 (CA) 276 (Buckley J): "In the ordinary case of an offer ... the court pays the greatest attention to the views of [the] majority."
[314] (1933) 150 LT 374, 375.
[315] [1949] Ch 434 (CA) 445.
[316] CA 1985 ss 428-30.
[317] Eg *Re Chez Nico (Restaurants) Ltd* [1992] BCLC 192, where the method of acquiring shares did not constitute a takeover offer within the meaning of CA 1985 s 428, and therefore the statutory requirements for the compulsory purchase were not satisfied.

the offeror gets the right to squeeze out the dissenting minority at the price which has binding force to every shareholder. Takeovers as collective actions operate in this way.

7.6.5 The burden of proof in takeovers

Shareholders accept a takeover offer, in a way, by special majority decision. The principal idea is that they decide whether an offer price is acceptable. On the other hand, if they decline a bid, its price is principally too low. Takeovers fundamentally rest on the concept that buyers and sellers determine prices in their transactions[318].

As Maugham J stated in *Re Hoare and Co Ltd*[319], the acceptance by a large majority of shareholders is itself prima facie evidence that the offer price is proper. In essence, determination of share price is a matter of commercial judgment. The court is not entitled to set up its own view of commercial fairness in opposition to the overwhelming majority of shareholders[320]. The judge further observed:

> Accordingly, I think it is manifest that the reasons for inducing the court to 'order otherwise' are reasons which must be supplied by the dissentients who take the step of making an application to the court, and that the onus is on them of giving a reason why their shares should not be acquired by the transferee company.[321]

[318] As mentioned, the regulation of takeovers does not govern the merits of offers and their pricing; in addition, the idea in takeovers is not that an offeror should pay the full value of shares; eg Easterbrook, Frank H. and Fischel, Daniel R., 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 Harvard Law Review 1161, 1177, where they note that: "If the target's shareholders obtain *all* the gains from the transaction, no one has an incentive to make a tender offer, and thus no one will offer a premium for the shares" (emphasis original); see also *Rock Nominees Ltd v RCO (Holdings) plc (in liquidation)* [2003] 2 BCLC 493, 517 (Peter Smith J): the offeror is not expected to pay "pound for pound for the synergies".

[319] (1933) 150 LT 374.

[320] *Re Lifecare International plc* [1990] BCLC 222, 224 (Hoffmann J): "The court naturally starts with the assumption that the other shareholders are likely to know where their own interests lie as well as [a dissenting minority shareholder]."

[321] (1933) 150 LT 374, 375.

In *Re Sussex Brick Co Ltd*, Vaisey J formulated the same point in this way:

> I think that the applicant is faced with the very difficult task of discharging an onus which is undoubtedly the heavy one of showing that he, being the only man in the regiment out of step, is the only man whose views ought to prevail. That is the difficulty he is faced with in the present case.[322]

Where a takeover offer has been accepted by over 90 per cent of shareholders, there is a heavy burden on a dissentient shareholder to demonstrate that the offer is unfair and the price paid for shares is not the right one. Share price in a takeover is a current market price: in consequence, it is the true value of shares[323]. Although the offer price might be open to valid criticism, this price can still be fair and good enough[324]. In sum, those who want to show that the takeover price is actually wrong have a heavy onus if they try to challenge it in court[325]. There are very rare exceptions where minority shareholders have been successful in this task[326].

The correctness of a takeover price is, however, only a presumption since the pricing of shares is related to the particular circumstances. As Browne-Wilkinson VC explained in *Re Chez Nico (Restaurants) Ltd*:

> In my judgment the approach in *Re Hoare & Co Ltd* cannot apply to a case where the bidder is already a director and shareholder in the target company and it is shown that the information made available to the assenting shareholders falls far short of what should have been provided. The fact that

[322] [1961] Ch 289, 291.
[323] See also above 7.3.1.
[324] [1961] Ch 289; *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17.
[325] See also *Re Press Caps Ltd* [1949] Ch 434 (CA).
[326] Eg *Re Bugle Press Ltd* [1961] Ch 270 (CA), where, in fact, the aim of the majority was merely to abuse these provisions.

> 90% of the shareholders have accepted the bid cannot carry decisive weight if it is shown that their acceptance was obtained in ignorance of facts of which they should have been informed.[327]

A takeover offer cannot be fair and proper if shareholders do not receive enough information to be able to make an informed decision about whether to accept it. Obviously, shareholders' acceptance in such cases is unable to show that the offer price is right in this particular case. Under special circumstances, which in *Fiske Nominees Ltd v Dwyka Diamond Ltd* [328]was the close connection between the officers and shareholders in the offeror and offeree companies, the fact that 90 per cent of shareholders have accepted the offer does not have "any real weight, far less a decisive weight"[329]. Altogether, there are cases in which the onus of showing that the price is fair rests on the offeror. Furthermore, it should be noted that if the offer is not fair, the majority shareholder does not get the right to buy out minority shareholders under CA 1985 s 429 at any price[330].

But it should be emphasized that the offer price as share value also binds the majority shareholder. It is the requirement of the law that dissenting minority shareholders should get, at minimum, the offer price for their shares. Where a majority shareholder exercises under CA 1985 s 429 his right to buy out minority shareholders, the law is clear. As CA 1985 s 430(2) states:

> The offeror shall be entitled and bound to acquire those shares on the terms of the offer.

[327] [1992] BCLC 192, 207.
[328] [2002] 2 BCLC 123.
[329] Ibid 132.
[330] On the other hand, minority shareholders can still under CA 1985 s 430A have a right to be bought out; see [2002] 2 BCLC 123, where the deputy judge thus ordered an independent valuer to value the minority shares.

According to the law, the offeror must pay the offer price for minority shares: the court may order a different price per share only on an application made by a minority shareholder[331]. The offeror may decide whether he exercises the power of compulsory acquisition under CA 1985 s 429, but there is no room for him to challenge the price paid for minority shares. Simply, the share price is set by the companies' legislation.

On the other hand, when a minority shareholder exercises his right to be bought out under CA 1985 s 430A, the offeror is, in accordance with s 430B(2), entitled and bound to acquire a minority shareholder's shares on the terms of the offer. However, both minority shareholders and the offeror may make an application to court to order the terms on which the shares shall be acquired[332]. Accordingly, the court has discretion in setting the share price; moreover, the companies' legislation does not explicitly state that the court cannot order a lower price for these minority shares. However, the aim of the legislation is that a dissenting shareholder may not be penalised as a result of his dissent. As Brightman J pointed in *Re Carlton Holdings Ltd*:

> The Policy of the Act is that [a dissenting shareholder] shall receive no less favourable treatment than an approving shareholder.[333]

I understand this ruling meaning that in sell-out cases, which take place on request of a minority shareholder, share price should normally be the same as in the takeover offer. The general presumption concerning all cases is that the offer price is the right price. Therefore, if the offeror aims to challenge it under particular circumstances, he has an onus of proof. In addition, as noted, it is a heavy burden on every shareholder to

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[331] CA 1985 s 430C(1).
[332] Ibid s 430C(3).
[333] [1971] 1 WLR 918, 925.

demonstrate that the price paid for shares was not actually the right one. The governing idea in the takeover regulation is explicitly that all shareholders should get an equal price for their shares: as a result, it would be very surprising if the courts in certain cases accepted that the price of these shares can be lower only because they are, indeed, minority shares[334]. Due to the very limited number of reported cases, it is difficult to say anything firm about this point of the law[335].

7.6.6 Takeovers concluded

There has been a statutory intervention in the area of takeovers in the UK. The first step in this process was giving majority shareholders the right to squeeze out the remaining minority shareholders on the offer terms when acceptances exceed 90 per cent in a takeover offer. The second stage was the introduction of the Takeover Code to govern the conduct of takeovers: the main aim was to ensure that shareholders get 'fair play'. The fundamental idea in this self-regulation is that shareholders should be treated equally; in consequence, every shareholder should get the same deal. Third, rules of takeovers will next be implemented into English law by the requirements of the Takeover Directive. As a result, it will be the law that requires that shareholders shall be treated equitably in takeover offers.

In summary, the price paid for shares in takeovers is a point of fact: the bidder principally sets it, and shareholders decide whether they accept it. By contrast, the equal value of shares in takeovers is a rule of law: CA 1985 s 428-430F provides that the dissenting minority shareholders should get the same price for their shares, and the Takeover Code requires so as part of law that shareholders should be treated equally. Consequently, only takeovers that rest on the idea of an equal offer at the same share

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[334] Compare *Re Grierson, Oldham & Adams Ltd* [1968] Ch 17, 35 (Plowman J): "it is not unfair to offer a minority shareholder the value of what he possesses, i.e., a minority shareholding."

[335] For example, in *Fiske Nominees Ltd v Dwyka Diamond Ltd* [2002] 2 BCLC 123, the court denied giving any instruction to the independent valuer.

price to every shareholder have a binding force in company law. Moreover, if a public takeover offer is carried out against this principle, it is against the Code and the law. In brief, this kind of takeover offer is illegal.

7.7 Share value in law

English law does not rule that the value of shares is their proportional part of the value of a company as a whole, or the value of its assets, which idea can be found, in particular, from the ruling in *Short v Treasury Commissioners*[336]. Therefore, company law accepts that majority shares can be more valuable than minority shares.

The fundamental point is that share value is principally a matter of fact. In general, the value of shares is the price available from a willing buyer. This hypothetical value is ordinarily decided with the support of expert evidence. On the whole, experts in share valuation consider that majority shares have a higher value per share than minority shares simply since they carry controlling power in the company. In contrast, due to their status the price available for minority shares remains modest. Further, shares of private companies cannot be attractive as an investment, especially when their transfer is restricted under the articles of association.

Yet, the value of shares is not only a matter of fact. It is a point of law that in a private company, in the case of a pre-emption clause, shareholders are bound to the fair value fixed by the auditor. Further, the law determines the basis on which the hypothetical value should be set for shares. Significantly, share value is often a mixed question of fact and law. Moreover, since market quotation is the most objective value, and the best evidence of the value, for shares of listed companies, those who argue that the market price is not their real value have a heavy onus of proof. This fundamental idea prevails in takeovers too.

[336] [1948] 1 KB 116 (CA); [1948] AC 534 (HL).

The value of shares can be a point of fairness and equity. The courts do not regard as fair that minority shares in CA 1985 s 459 cases are bought out on a fictional market basis. They clearly favour the idea that every share should have a pro rata value, ie the value of majority and minority shares is equal under these provisions. Nevertheless, the court has discretion to determine what is fair under the particular circumstances of the case.

However, the equal value of shares is also a rule of the law. The provisions in CA 428-430F provide that the majority shareholder has to pay the same price for the dissenting minority shareholders' shares. When a majority shareholder exercises this right, the equal value of shares is a rule without exceptions. But more importantly, the Takeover Code and the Takeover Directive require that all shareholders must be treated equally in takeovers. In short, every shareholder should get the same price for his share since the law rules it.

In conclusion, the equal value of shares has a dual role in company law. First, equal value can be a legal presumption, and therefore, in these cases, those who argue otherwise have to show that share value is not equal. Second, in certain cases, the same value of shares is a rule of law, ie their equal value is a requirement of law. In addition, there might still be cases where the value of shares remains a matter of fact; therefore, under these circumstances, the law cannot determine the value of shares, although the judges may have to set some value for them on the basis of expert evidence.

CHAPTER 8

CONCLUSIONS

In this changed environment, the process of discounting minority shares – a major impediment to the minority shareholder receiving a fair price – is no longer justified.
Charles W. Murdock, Notre Dame Law Review (1990) 429.

8.1 The role of shareholders' rights

Shareholders participate in a company through their shares. The central idea is that ordinary shares rank equally, and thus shareholders have the same right to a company's profits and assets. Yet, company law does not require that shareholders should always be treated absolutely in a similar manner; for example, in a reduction of capital it can be enough that shareholders are treated fairly and equitably[1]. In any event, there ought to be a good reason why they are not on the same footing. In addition, shareholders' treatment must be economically equivalent: they should get equal proportions in "money or money's worth"[2]. I consider that shareholders' rights are the most important point in share valuation: these rights should be taken 'seriously'.

On the whole, it seems true that "the common law was originally a body of remedies, not a system of rights"[3]. In a rather similar way, when the courts have valued shares, the focus of their judgment has been more on the 'real' share value than on shareholders' rights. Company law does not generally rule that every share with similar rights should have an equal value.

[1] See eg *Re Thorn EMI plc* (1988) 4 BCC 698.
[2] *British and American Trustee and Finance Co Ltd v Couper* [1894] AC 399 (HL) 415.
[3] Simmonds, Nigel E., 'Introduction' in Campbell, David and Thomas, Philip (eds), *Fundamental Legal Conceptions as Applied in Judicial Reasoning by Wesley Newcomb Hohfeld* (Aldershot 2001) ix, xxiii.

8.2 Value of shares as a fact

The traditional approach in English law is that the value of property is the price available, ie the price between a willing buyer and a willing seller. The hypothetical value of shares is mainly a matter of fact and opinion. In effect, in share valuation the courts have bowed to the wisdom of businessmen[4]: their main function is typically hearing expert evidence and weighing up professional advice[5].

As noted in this study, there are experts who regard majority shares as more valuable than minority shares. Indeed, because of their control power, these shares might attract a higher price per share. For example, in takeovers it used to be the case that majority shareholders were able to get a better price for their controlling shares.

The value of shares is related to their return. As a result, it is arguable that majority shares may be considered more valuable only in the circumstances where majority shareholders are able to get some private benefits from a company by virtue of their power. Furthermore, quoted minority shares are normally more liquid than majority shares; due to the market 'blockage', the price available for majority shares may in fact be lower than the current stock market price. Significantly, the arguments in this study suggest that the higher value of majority shares is not a 'real' economic fact.

But even more importantly, the value of shares is related to available investor protection. Shareholders' protection makes shares more valuable[6]. Further, if majority shares are generally considered more valuable than minority shares, the point might show that the protection of minority shareholders' rights is weak[7]. Indeed, the position of minority shareholders, especially in private companies, has traditionally been

[4] Flisfeder, A. Maurice, 'Compulsory Acquisition of the Interest of a Dissenting Minority Shareholder' (1973) 11 Alberta Law Review 87, 105.
[5] Gregory, Alan and Hicks, Andrew, 'Valuation of Shares: A Legal and Accounting Conundrum' [1995] JBL 56, 56.
[6] See eg La Porta, Rafael and others, 'Investor Protection and Corporate Valuation' (2002) 57 Journal of Finance 1147.

precarious; yet, it is true that the law currently provides more safeguards to minority shareholders. As an American commentator noted fifty years ago, the courts "are manifesting a greater willingness to protect the minority shareholders against overreaching by a powerful majority"[8]. In essence, it is important to note that English judges have not accepted the idea that the courts should fix the value of shares solely with reference to their hypothetical market value. Indeed, the law has a role to play in setting the value of shares.

8.3 Value of shares in company law

It is a settled principle that shareholders do not own the company or its assets; in consequence, company law does not rule that the value of shares is their proportional value of a company's assets. In general, the courts consider that share value follows the fortunes of the company.

The market economy rests on the view that markets set values: in practice, shareholders as buyers and sellers determine share prices. Company law ordinarily accepts that a market price is the right value. However, as a matter of fact, market prices can be replaced with the support of evidence. Accordingly, in *Short v Treasury Commissioners*[9] it was accepted that majority shares might be more valuable than the current stock market price. On the other hand, in the context of a takeover the court may also order that the squeeze-out price of minority shares should be higher than the price paid for the nine-tenths majority. In any case, those who argue that the market price is wrong have a heavy onus of proof.

Share value is a pivotal point for every shareholder. As I see it, the protection of minority shareholders can be efficient only when the value of their shares is protected.

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[7] Eg Bergström, Clas and Samuelsson, Per, *Aktiebolagets grundproblem* (2a uppl Stockholm 2001) 80.
[8] Jennings, Richard W., 'Trading in Corporate Control' (1956) 44 California Law Review 1, 39.
[9] [1948] 1 KB 116 (CA); [1948] AC 534 (HL).

In my mind, the clearest way to protect their rights is to support the view about equal value in law. Remarkably, takeover regulation operates on the premise that every share is of equal value, and due to the Takeover Directive it will explicitly be a rule of law.

Shareholders are entitled to get their equal share when a company distributes profits or surplus assets. The principles of company law require that shareholders are treated equally. Obviously, it is coherent and consistent with this idea that the value of shares is considered equal in company law.

Ultimately, case law in CA 1985 s 459 cases supports share valuation on a pro rata basis. As noted in *O'Neill v Phillips*[10], the fair value of minority shares is ordinarily an equivalent proportion of the company as a whole. The presumption of the law is that every share has the same value in this context. However, the protection against unfair prejudice is fundamentally "an equitable supplement" to company law[11], and so the applicability of s 459 is a matter of equity. In consequence, the courts have discretion, and the value of shares is a point of equity. There cannot be a rule of universal application: the court determines the fair value of shares with regard to all the circumstances of the individual case. But the maxims of equity apply: equality is equity in share valuation too.

In summary, the governing idea in law is that shareholders may determine the value of their shares. Yet, in cases where share value is determined collectively, company law clearly supports the idea that every share has the same value, ie they are valued on a pro rata basis. The courts tend to favour this principle in CA 1985 s 459 cases, a presumption which follows equality as a default rule. In addition, the current market quotation is the most objective value for shares: naturally, this value is the same for every share. Further, in takeovers, the law rules that every shareholder is entitled to get the same price for his shares.

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[10] [1999] 1 WLR 1092 (HL) 1107.

I conclude this thesis stating that the value of shares is *normally* equal in company law. The root of my thesis is that the courts have generally adopted the correct approach towards the valuation of shares. The idea in law is that power itself in a company does not make majority shares more valuable than minority shares. For example, Roch LJ explained in *Re Legal Costs Negotiators Ltd*, in a case in which it was recalled that no discount should be applied to the minority shares, that if the affairs of the company are conducted well and so it prospers, the value of both majority and minority shares increases[12].

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[11] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) 384.
[12] [1999] 2 BCLC 171 (CA) 202.

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