Shareholder Litigation
and Corporate Governance

1.1 Introduction

This chapter is concerned with an indefinite but fundamental question that has received inadequate attention in the literature on corporate law theory in English law: what purpose lies at the heart of the company’s cause of action which justifies the use of derivative actions?

As will be seen below, shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. It cannot be viewed in isolation from a number of mechanisms which relate to corporate governance. A variety of social and market forces also operate to hold corporate officials accountable. These mechanisms and others, coupled with the regulatory authority of governmental agencies, constitute protections in the absence of private litigation. To the extent that these mechanisms effectively align the interests of managers and shareholders, there may be less need to resort to costly litigation as a means of protecting shareholder interests.¹ And so the question can also be formulated in the following manner: what role should be assigned to the derivative action that may, in turn, enhance the capabilities of these other mechanisms of accountability?²

The resolution of this question requires a distinction between two separate elements. First, the task is one of evaluating the respective merits of alternative mechanisms that may constitute an effective functional substitute for litigation. Secondly, building upon this initial evaluation, it is necessary to inquire into the theoretical rationales behind derivative actions. This introductory chapter is concerned with the first element. Chapter 2 will address the second.

² Although it is a pivotal concept in many fields, accountability remains an elusive concept—close to but different from responsibility. Accountability is best understood as a norm of governance, stipulating particular modes of wielding power and of responses to power. See further A Licht ‘Accountability and Corporate Governance’ (September 2002) available at <http://papers.ssrn.com/paper.taf?abstract_id=328401>.
The chapter proceeds as follows. Section 1.2 firstly identifies the limitations of the traditional view of the derivative action. Subsequently it explicates the relation between the derivative action and two concepts, namely ‘control’ and ‘agency costs’. Section 1.3 outlines some major techniques of accountability, which share the goal of reducing agency costs. Section 1.4 focuses on one such major alternative as it examines whether it is true that the market for corporate control may constitute an effective functional substitute for litigation. As will be seen, from a governance perspective (as opposed to a narrowly legal one), the interaction of the derivative action with the market for corporate control raises some interesting issues. Section 1.5 concludes the chapter.

1.2 Shareholder Litigation and Corporate Governance

1.2.1 Limitations of traditional view

The derivative action’s traditional *raison d’être* is ‘a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress’.³ In this case, although the right remains the company’s, it is appropriate to allow the individual shareholder to assert it on behalf of the company. The limited circumstances in which a derivative action may be brought are known as the ‘exceptions to the rule in *Foss v Harbottle*’.⁴ Under the common law, a derivative action is generally possible only if the applicant could invoke one of these exceptions.

The essence of the rule is that (1) the court will not ordinarily intervene if the matter is one that a company can ratify by its own internal procedure; and (2) the right to vindicate a wrong done to the company is vested in the company and prima facie the only proper plaintiff is the company itself.⁵ The exceptions are intended to ensure that the company is not improperly prevented from averting or remedying a wrong done by a self-interested board, or by majority shareholders acting improperly (‘in fraud on the minority’).⁶ This rule has long been seen in a number of commonwealth jurisdictions as a significant barrier to effective shareholder enforcement.⁷

³ *Smith v Croft (No 2)* [1988] Ch 114, 185.
⁴ (1843) 2 Hare 461; 67 ER 189.
⁵ These principles were applied in the case of *Foss v Harbottle* and are often applied by the courts as ‘the rule in *Foss v Harbottle*’. See KW Wedderburn ‘Shareholders’ Rights and the Rule in *Foss v Harbottle*’ [1957] CLJ 194, 195–8. See also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210 where the Court of Appeal referred to the rule in *Foss v Harbottle* as embracing both the ‘elementary’ proper plaintiff principle and ‘...a related principle, that an individual shareholder cannot bring an action in the courts to complain of an irregularity...if the irregularity is one which can be cured by a vote of the company in general meeting’.
⁶ CLR developing the Framework 124.
⁷ See, for example, A Beck and A Borrowdale *Guidebook to New Zealand Companies and Securities Law* (4th edn CCH 1990) 232. The English Law Commission conceded that these
Put simply then, the rule is a logical consequence of the fact that a company is in law a separate person which shareholders have agreed should be managed by its directors. The exceptions to the rule are thus necessary to prevent the rule from becoming a cover for unreviewable abuse. The use of the derivative action ensures that the wrong is remedied on behalf of the company, albeit at the instigation of an individual shareholder. In English law it has been described as an exception to the ‘elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested’.  

All this is hardly controversial. Anyone familiar with English company law will find an explication of this view in almost every textbook on the subject. However, the traditional view, envisaging both the necessity and the inevitability of vindicating a company’s rights, is not entirely satisfactory because of theoretical as well as practical barriers.

First, this view explains why derivative actions are allowed, but not what purpose they serve. It obscures a much more critical question, namely, what can be achieved through the use of derivative actions. Resolution of this question has remained beyond the ambit of academic discussion in English law. But if the derivative action is to play any role in the corporate governance of English companies, the question is what, if any, are the net benefits of these actions from a social or economic perspective for companies, shareholders, and the business community overall.

Secondly, this traditional view of the derivative action, envisaging both the necessity and the inevitability of vindicating a company’s rights, is troubling because litigation is sometimes infeasible and shareholders rarely initiate derivative actions. Exceptions are rigid, the law in this field is complex and obscure, and that this may well, in turn, deter minority shareholders from bringing such proceedings. Consultation Paper para 1.5 and see further Ch 4 below under 4.2.4.

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8 Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204, 210. That an action under one of the exceptions to Foss v Harbottle is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law (Wallersteiner v Moir (No 2) [1975] QB 373).


10 The writer distinguishes here between reasoning (ie the action is allowed in order to prevent a wrong going without redress) and a proper purpose in the wide sense of the word (ie what are the net benefits of these actions from, say, a social or economic viewpoint?). See also Brady v Brady [1989] AC 755, 779–80 (where the House of Lords noted that although in practice drawing a distinction between a reason and a purpose is not necessarily an easy task, a reason is not the same as purpose).

11 Probably partly owing to the theoretical nature of the question, in the absence of any meaningful litigation.

12 Even a modest one as envisaged by the Consultation Paper, the Report and recently implemented by the Government by means of CA 2006, Pt 11 (see Ch 4 below).
actions in England, for well-documented reasons.¹³ Further, shareholders often refrain from pursuing legal proceedings on behalf of the company because they lack funds, and they are hamstrung by the existing law from entering into imaginative arrangements whereby funds might be made available to them.¹⁴ For these reasons it is arguably unsatisfactory to rely exclusively on litigation when its occurrence is somehow fortuitous.

Finally, commentators have recognized that other mechanisms which relate to corporate governance constitute a more powerful check to managerial misbehaviour. This view has been put forward in the last few decades by drawing attention, on the one hand, to the operation of a number of non-regulatory constraints on managers’ discretion,¹⁵ and, on the other hand, to the costs of legal intervention.¹⁶ Most notable, it has been suggested that the market for corporate control provides a more systematic and economical regulation. These virtues of the market have caused some to begin and to conclude their consideration of how to control management behaviour with market-based solutions.¹⁷ This poses a challenging question right at the outset of our journey: is it possible to say that such market and social constraints prevent managers from engaging in wrongdoing to such a degree as to render legal intervention (such as by means of litigation) inefficient, considering its costs? Before it is possible to answer this, two concepts need to be explained first: ‘control’ and ‘agency costs’.

1.2.2 Derivative actions and agency costs

Derivative actions relate to a question of control—control of the corporate form. Put simply, derivative actions relate to the steps being taken on behalf of shareholders to redress the imbalance in the modern company form between control exercised by directors and managers and that exercised by shareholders.¹⁸ When Berle and Means published their treatise The Modern Corporation and Private Property¹⁹ in 1932 they proposed that those who own large public

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¹³ These are addressed in Chs 3 and 6 respectively.
¹⁵ That is constraints which the market imposes either by means of inducing self-interested devotion to shareholders’ interests or in the form of contractual arrangements. See generally H Butler and L Ribstein ‘Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians’ (1990) 65 Washington Law Review 1, 21–8.
corporations do not control them and, conversely, those who control such corporations do not have significant ownership interests in them.²⁰ Berle and Means pointed out that shareholders in large public corporations had in effect exchanged control for liquidity.²¹ They identified five major control types that apply to corporations.²² While their work was confined to public corporations, the types of control identified are applicable to all companies:

(1) **Private ownership**—this gives rise to control through complete ownership of the corporate form.

(2) **Majority control**—control that arises as a result of the ownership of a majority of the shares.

(3) **Control through a legal device**—the person who exercises the control does not own a majority of the issued shares but is nonetheless able to control the entity through, for example, the use of non-voting shares, or shares with weighted voting rights, etc.

(4) **Minority control**—this is where the particular group only holds a small number of shares but nevertheless is able to control the corporation. This can particularly be the case with public companies that have a large but scattered shareholder base such that a holder of perhaps as low a figure as 10% is able to exercise control.

(5) **Management control**—this occurs where the shares are widely held and there is no single group that has minority control. Often this is the case in public companies the majority of shares in which are held by institutions.

Members of a company do not in general ‘control’ the company and its operations. The reason for this is quite simply that the management and control of the company is vested in its board of directors.²³ This proposition itself supports the view that the modern corporation is an abstraction devoid of physical form, existing only in contemplation of the law and therefore incapable of expressing its will without the mediation of natural persons.²⁴ On any view, companies are contractual structures where the board of directors and majority shareholders control and dominate the affairs. Because of this, the law imposes on the natural representatives of the non-natural corporate form fiduciary obligations that

²¹ See, for example, N Wolfson *The Modern Corporation: Free Markets versus Regulation* (Free Press 1984) Ch 2, 20 et seq.
²² See P Redmond (ed), above n 20, 182 for a discussion of these. Control could also arise on the basis of agreements or understandings between members, minority control through other members’ apathy or inability to participate, and personal influence between shareholders. See, further MA Pickering ‘Shareholders’ Voting Rights and Company Control’ (1965) 81 LQR 248, 269–72; KW Wedderburn ‘Derivative Actions and *Foss v Harbottle*’ (1981) 44 MLR 202, 205.
²³ *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113, 134 per Greer LJ.
²⁴ P Redmond (ed), above n 20, 204.
operate over and above and in addition to any contractual rights and remedies. This is because the non-natural company form is in need of protection extending beyond normal contractual remedies. Where there is a breach of an obligation in favour of the company it follows naturally that it is the company that should be the person that takes the legal action. Indeed, that was the position in *Foss v Harbottle*, where the court held that in the case of a breach of the duties owed to the company, the proper plaintiff was the company itself.

Shareholders have their own contractual remedies which manifest themselves in the positive controls that may be exercised by them in, for example, voting to remove directors who do not represent the will of the shareholders. The difficulty is being able to win the proxy fight by getting sufficient numbers at the requisite meeting. If the numbers are not able to be mustered, the shareholders must revert to negative control measures, i.e., legal remedies, in order to redress the imbalance in control between the owners of the business and the directors/managers of the business. This is sometimes referred to as the tension between control and accountability.

In many public companies shares are very widely held and it is often very difficult to remove directors or to bring about change. This is exacerbated by the growth of institutional investment holdings and the inability or lack of desire on the part of those institutions to seek to exercise control over the management of companies. Therefore shareholders, particularly small shareholders, are to a very large extent, increasingly bound to rely on the aspects of negative control as opposed to positive control.

At the same time, in large companies managers are given significant discretion in the running of the business. Indeed, this discretion is so broad that it effectively means management control of these companies. This control can lead managers to act in their own interests rather than in the interests of the shareholders. For example, they might divert corporate assets to themselves or set out to achieve goals which are more closely aligned to the promotion of their own interests rather than those of the shareholders. The divergence of interests between

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26 (1843) 2 Hare 461; 67 ER 189.
27 CA 2006, s 168. This section replaced, without change, s 303 of CA 1985. Section 168(1) provides that an ordinary resolution is sufficient to remove a director, but requires that it be at a meeting so as to ensure the director’s right to be heard. A director has a right to protest removal under s 169.
28 See below under 1.3.1.2.
31 In the sense that they do not have a shareholder that owned, say, 10% or more of the equity.
32 On which see Ch 5 below under 5.3.1.
33 For more on this distinction, see E Herman *Corporate Control, Corporate Power* (Cambridge University Press 1981) Ch 4; PL Davies *Introduction to Company Law* (OUP 2002) Ch 9.
34 PL Davies, above n 33, 137.
managers and shareholders results in costs, usually described by economists as ‘agency costs’.³⁵ These costs can be generally divided into two categories:³⁶

1. Monitoring costs incurred by shareholders to ensure that managers are acting in the interests of the shareholders.
2. Bonding costs incurred by managers with the purpose of assuring shareholders that their interests are being pursued.³⁷

Law can play an important role in reducing agency costs. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents.³⁸ Indeed, research on corporate governance has identified a number of mechanisms or techniques of accountability intended to ensure that management acts in the best interests of shareholders. Agrawal and Knoeber, for example, investigated the effects on company’s performance of several alternative mechanisms to control manager-shareholder agency problems, including both structural and other internal and external control devices. Consistent with the notion that various control mechanisms can complement and substitute for one another, they found interdependencies in the effects of the various control devices on firm performance.³⁹ These results appear to be consistent with the notion that ‘the firm chooses among alternative mechanisms for minimizing agency costs’.⁴⁰

Put against this backdrop, ‘[t]he derivative suit is a monument to the problem of agency costs; it would make no sense to allow a shareholder to bypass the corporate management in bringing a suit against an officer if one could be confident that management always acted in the shareholders’ interests’.⁴¹ As will be seen in Chapter 2, derivative actions can reduce agency costs as they operate to deter mismanagement by imposing the threat of liability and therefore align


³⁶ I Ramsay, above n 30, 151.


³⁸ R Kraakman et al, above n 35, Ch 2; PL Davies, above n 33, 117–18; E Ferran *Company Law and Corporate Finance* (OUP 1999) 118.


the interests of managers and shareholders. Further, they can reduce one part of the agency costs, namely monitoring costs incurred by shareholders. Because shareholder co-ordination is not necessary in the case of the derivative action, it seems reasonable to believe that the availability of this action economizes on costs that otherwise would be necessarily incurred if shareholders were required to take collective action.

1.3 Alternative Devices to Control Agency Costs

As we saw in the previous section, research on corporate governance has identified a number of mechanisms or techniques of accountability intended to ensure that management teams act in the best interests of shareholders. Besides private litigation, these mechanisms are commonly subdivided, for descriptive purposes, into ‘external’ and ‘internal’ governance mechanisms. In order to understand what role should be assigned to shareholder litigation, it is necessary to consider first both the advantages and the limits of these mechanisms.

What follows is a brief outline of two ‘internal’ governance mechanisms, namely the right to vote and the company’s internal dispute-resolution machineries. Two major ‘external’ governance mechanisms are subsequently outlined: public enforcement and the role and importance of independent directors. It is worth emphasizing that the discussion here intends to be representative rather than exhaustive as it serves as a general background for the following chapters that will address more extensively some of the issues raised here.

1.3.1 Internal mechanisms

The regulatory framework within which companies operate provides mechanisms for shareholders to exercise their ‘voice’ in order to bring pressure to bear on directors. This can be done, inter alia, by meetings, proxy contests, or votes to remove directors from office. As will be seen below, however, it is simply not a

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42 For an in-depth analysis of the concept of ‘accountability’ and a new approach for discussing accountability and corporate governance, which builds on the study of social norms, see A Licht, above n 2.

43 To that one probably needs to add the role of professional agents of the board and the shareholders who inform and advise them: auditors, attorneys, securities analysts, credit-rating agencies, and investment bankers (so-called ‘gatekeepers’). As Coffee recently argued, effective corporate governance requires a chain of actors: directors, managers, and gatekeepers. No chain is stronger than its weakest link. On the role, evolution, and spectacular failure of these gatekeepers or ‘blind spot’ in the literature on corporate governance, see JC Coffee Gatekeepers: The Professions and Corporate Governance (OUP 2006).

44 For an extensive survey on corporate governance, see A Shleifer and R Vishny ‘A Survey of Corporate Governance’ (1997) 52 Journal of Finance 737. For theories associated with the development of corporate governance, see CA Malin Corporate Governance (OUP 2004) Ch 2.
part of the UK scene for these to be invoked in a co-ordinated manner as a means of ensuring accountability on the part of corporate management.²⁵

1.3.1.1 The right to vote

It is arguable that a major enforcement mechanism available to shareholders other than litigation is the right to vote.²⁶ The assumption is that managers will act in the interests of shareholders because otherwise shareholders might vote for their removal. Voting in the general meeting of shareholders is a key shareholders’ right and, naturally, central to corporate governance.²⁷ Yet in many cases shareholders will refrain from participating in general meetings and voting, even if it is made easy for them by electronic ways and means. This well-known phenomenon of ‘rational apathy’²⁸ is common not only for private shareholders, but also for many institutional shareholders (unless one goes so far as to oblige them to vote by law).²⁹ In companies with one or more principal shareholders, minority shareholders have no real influence even if they vote.³⁰ In groups of companies and particularly in multinational groups, the minority shareholders of the subsidiary and even those of the parent may simply not know where the real problems lie.³¹ In such cases what is needed for shareholders is to first find out the facts and then to consider the appropriate course of action, which could be a shareholders’ resolution or even an action to hold directors or others liable.³²

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²⁹ The option of mandatory voting is analysed in GP Stapledon ‘Institutional Investors: What Are their Responsibilities as Shareholders?’ in JE Parkinson et al (eds) The Political Economy of the Company (Hart Publishing 2000) 195, nn 145–155 and accompanying text. CA 2006, s 1277 (information as to exercise of voting rights by institutional investors) goes short of making it mandatory for institutional investors to vote and instead provides the Government with the power to make regulations requiring certain categories of institutional investors to disclose information about their exercise of the voting rights attached to shares. The CLR (Final Report, para 6.39) concluded that disclosure of voting by institutional shareholders was a desirable objective. There has been a growing trend internationally to require disclosure. There has also been an increasing trend by UK fund managers towards voluntary disclosure. See also, White Paper Company Law Reform (Cm 6456) (DTI March 2005) 3.1.
However, it is now widely recognized that shareholder voting in large companies tends not to be a potent force. The reason is that it suffers from a collective action problem. Voting in any case is not compulsory and for many shareholders there is a strong disincentive to vote. Attending a meeting in person may be expensive. The exercise of one’s vote does not give one any privileges unless one has control or one’s voice can be decisive. The act of becoming informed enough to vote intelligently requires an investment of time, which is a scarce resource. Yet a shareholder vote is unlikely to affect whether a proposal wins or loses. This is due to the level of concentration of ownership in the relatively dispersed UK market. The UK has an ‘outsider’ or ‘arm’s length’ system of ownership and control. The ‘outsider’ typology is used to describe the situation that exists because share ownership is dispersed among a large number of institutional and individual shareholders rather than being concentrated in the hands of a small number of families, banks, or other firms.

Table 1-1 below lists the incidence of block ownership in the larger companies of various nations; those with the highest score have the fewest companies with concentrated ownership, and hence their companies have the most diffuse ownership. Not surprisingly, the UK scored the highest. A similar pattern is evident when smaller companies are taken into account. As of 1996, just over 20% of the companies listed on the London Stock Exchange had a shareholder other than an institutional investor that owned 20% or more of the shares.

The result of the relatively dispersed UK capital market is that the cost and futility of becoming informed leads most ‘small’ shareholders to choose rational apathy. They do not take the time to consider particular proposals, and instead adopt a crude rule of thumb such as ‘vote with management’.

Collective action theory also tells us, critics argue, that shareholders will not make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort. A shareholder bears most of the

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53 BR Cheffins, above n 35, 238–41; I Ramsay, above n 30, 153.
56 Such as, for instance, is the case in some European countries, most notably Germany and France. For more on these differences, see E Nowak ‘Investor Protection and Capital Market Regulation in Germany’ in J Krahnen and R Schmidt (eds) The German Financial System (OUP 2004).
60 ibid.
cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free-ride on his efforts. Free-rider problems work in tandem with the rational apathy of the free-riders to discourage shareholder proposals from being made.⁶¹

Theoretically, agency costs between managers and shareholders may be reduced if shareholders increase control by forming voting coalitions.⁶² However, voting coalitions are usually temporary and are customarily forged with a specific aim (ie the removal of incumbent management).⁶³ In any case, a number of studies found that companies’ operating performance and valuations were not affected by shareholder proposals, and shareholder proposals did not appear to engender corporate governance policy changes.⁶⁴

Overall, then, several factors combine to ensure that shareholders in the UK are rarely poised to vote and take a hand in the running of the company. The most prominent factors include: (1) the costs of becoming informed so as to vote intelligently; (2) the minimal impact of the vote; (3) the possibility that

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63 ibid; see J Karpoff P Malatesta and R Walkling, above n 63.

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Table 1-1. Percentage of widely held firms* among 20 largest firms

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<tr>
<th>Country</th>
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<tbody>
<tr>
<td>Austria</td>
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<td>Belgium</td>
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<td>Italy</td>
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<td>Norway</td>
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<td>Finland</td>
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<td>Denmark</td>
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<td>Germany</td>
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<tr>
<td>Canada</td>
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<td>Switzerland</td>
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<td>Australia</td>
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<td>Japan</td>
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<td><strong>United Kingdom</strong></td>
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* In the sense that they do not have a shareholder that owned, say, 10% or more of the equity.
other shareholders may take a free ride on the efforts; (4) the uncertainty of outcome in the UK ‘arm’s length’ system of ownership and control; and finally (5) the *de minimis* incremental gain that will flow to a shareholder even should the action he supports be successful. Instead, shareholders in the UK choose apathy, tend to maintain their distance, and give executives a free hand to manage by relying more on the market and spreading their risks by investing in a number of companies.⁶⁵ It remains to be seen whether the measures taken by the Government recently to enable shareholders to have a constructive dialogue and increase their engagement with the company in which they hold shares will bear any impact on this.⁶⁶

1.3.1.2 The company’s internal dispute-resolution machinery

A natural enforcement mechanism available to shareholders other than litigation is the company’s internal dispute-resolution machinery.⁶⁷ However, as will be seen in Chapter 3, this machinery cannot always provide the right forum. For example, it fails to give a satisfactory solution when the perpetrators of the fraud are in control of the company. To illustrate this point, this section focuses on one of the major company’s internal dispute-resolution mechanisms, namely addressing questions to directors at the Annual General Meeting (AGM).⁶⁸

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⁶⁶ With effect from 20 January 2007, provisions linked to implementation of the EU Transparency Obligations Directive (Directive 2004/109/EC [2004] OJ L390/38) have been commenced. These include provisions on company communications to shareholders and others, which include provisions facilitating electronic communication. The ‘communications provisions’ are defined by CA 2006, s 1143 as ss 1144–1148 together with Schs 4 and 5 (of which Sch 4, para 3 and Sch 5, para 3 in particular relate to electronic communications; s 1168 under Pt 38 provides additional useful definitions). These provisions have been brought into force ahead of most other parts of the Act. This is for two reasons: first, to coincide with the implementation of the EU Transparency Obligations Directive; and, secondly, to allow early delivery of the benefits of e-communications—including significant cost-savings to business, improved accessibility to information, and enhanced immediacy of dialogue between companies and shareholders. See <http://www.dti.gov.uk/files/file36201.doc>.

The general principle of the CA 2006 is that companies should, subject to shareholder approval, be able to default to using e-communications. Individuals however will retain the right to receive information in paper if they wish. The company communications provisions set out in the Act apply to all companies, public and private.

⁶⁷ See in this respect Drury’s thesis that in a long-term relationship providing a forum for the dispute (such as the general meeting) is in many cases ultimately going to be more effective in promoting the continuance of that relationship than allowing an individual shareholder unlimited access to what might be described as the ‘discrete transaction oriented dispute-solving machinery’ of the courts. RR Drury ‘The Relative Nature of a Shareholder’s Right to Enforce the Company Contract’ [1986] CLJ 219, 223.

⁶⁸ On resolutions and addressing questions in AGM generally, see PL Davies, above n 33, 137–8; *Gower and Davies*, above n 9, 350–3; LS Sealy *Cases and Materials in Company Law* (7th edn Butterworths 2001) 178–88. The provisions in CA 2006, Pt 13 replace most of Chap IV of Pt XI of CA 1985 on meetings and resolutions. In addition to implementing detailed policy changes, Pt 13 implements two general changes. First, the law makes the previous ‘elective’ regime the default for private companies. This means, for instance, that private companies will no longer need to ‘elect’
Theoretically, the AGM, particularly the opportunity to ask questions, offers a unique forum for effective individual shareholder activism. Even though the outcome of voting on resolutions is de facto determined beforehand by the proxy voting system (mainly by institutional shareholder votes), the prospect of facing embarrassing questions can act as a mild deterrent to management considering self-interested action. Further, the AGM is perhaps ‘the sole occasion when company directors are immediately accountable to their shareholders’. The AGM provides a forum for frank and honest debate over allegations that might have negative reputational effects for the company at a later stage.

However, management’s discretion over the ‘business and conduct’ of general meetings, especially relating to controlling access rights and controlling the ‘question-and-answer’ time, may limit the extent to which individual shareholders can use the AGM to participate in corporate governance. Some companies may go to great lengths to anticipate likely activist attacks and, by inspecting the register, distinguish among the individuals attending the meeting those who are likely to be part of these attacks. There appears, therefore, to be some trepidation on the part of board members regarding the role of shareholder questions at the AGM and this may be behind some of the pressure from industry to reform the

to dispense with the AGM; they will not be required to hold an AGM in the first place. Secondly, the previous law was drafted on the basis that the main way in which shareholder decisions are taken is in general meetings. The new provisions proceed on the basis that in future this will not be the case for many private companies. Private companies will not be required in future to hold general meetings; instead provision is made for new procedures for decisions to be taken by written resolution. See Explanatory Notes on the Companies Act 2006, paras 520–521, available at <http://www.opsi.gov.uk/acts/en2006/ukpga_en_20060046_en.pdf>. The changes in the law derive principally from the CLR’s consultation on ‘Company General Meetings and Shareholder Communications’ and recommendations from Chs 2, 6 and 7 of their ‘Final Report’, together with two subsequent consultations; the Modernising Company Law White Paper of July 2002 and the Company Law Reform White Paper of March 2005.

On decisions taken outside of a general meeting framework see the provisions of Ch 2 of Pt 13 of CA 2006, which replace the former rules on written resolutions of private companies. A key change (apparent from ss 282 and 283) is that where the statutory procedure under CA 1985 requires unanimity, the procedure in CA 2006 does not. Consequently, the sections are more detailed than ss 381A–381C of the 1985 Act and set out the procedures for decisions taken outside of a general meeting framework. See, Explanatory Notes on the Companies Act 2006, para 530 above.


Gower and Davies, above n 9, Ch 15.

See in this respect the Australian case in NRMA v Parker (1986) 11 ACLR 1.
AGM in a way that would minimize the role of debate in an open forum, using the ‘question-and-answer’ technique.⁷⁴ Discussion of the reform of the AGM centres on the failure of shareholders to use this forum to any significant degree as a corporate control mechanism.⁷⁵ When all is going well, institutional shareholders, who have privileged access to company directors and management through private meetings, tend not to attend AGMs. Instead, they tend to leave the AGM to the pressure groups and querulous individual shareholders.⁷⁶ It has long been argued that the statutory law relating to the conduct of general meetings ‘ignore[s] the potential value of a statutory right to ask questions’.⁷⁷ Yet this appears to be the area identified as possibly the greatest source of value of the AGM, both as a tool in the service of accountability and as a means by which individual investors can gain insights not offered in the company reports.⁷⁸

⁷⁴ J Cook and S Deakin ‘Empirical Evidence on Corporate Control’ (ESRC Centre for Business Research, University of Cambridge, December 1999) 42.
⁷⁵ Ibid 43.
⁷⁶ Gower and Davies, above n 9, 338–9. See generally G Stapledon Institutional Shareholders and Corporate Governance (Clarendon Press 1996). It remains to be seen whether CA 2006, s 1277 (information as to exercise of voting rights by institutional investors) will have any impact on this practice. Recall that the section provides the Government with the power to make regulations requiring certain categories of institutional investors to disclose information about their exercise of the voting rights attached to shares. The CLR (Final Report, para 6.39) concluded that disclosure of voting by institutional shareholders was a desirable objective. There has been a growing trend internationally to require disclosure. There has also been an increasing trend by UK fund managers towards voluntary disclosure. See also, White Paper Company Law Reform (Cm 6456) (DTI March 2005) 3.1.
⁷⁸ J Cook and S Deakin, above n 74. CA 2006, following the Government’s White Paper Modernising Company Law (Cm 5553-I) (July 2002) para 2.18 and White Paper Company Law Reform (Cm 6456) (DTI March 2005) paras 3.1–3.2, may go some way to remedy this. For example, CA 2006, s 321 (replacing CA 1985, s 373) restricts companies’ ability through their articles, to exclude members’ rights to call a poll. The section provides for three effective types of demands for a poll, including a demand made by at least five members with a right to vote on the resolution or by a member or members representing not less than 10% of the total voting rights of all the members having the right to vote on the resolution (excluding any voting rights attached to any shares in the company held as treasury shares). See also, White Paper Company Law Reform (Cm 6456) (DTI March 2005) para 3.1.

On the vast potential for electronic communication technologies to facilitate access to company information and to overcome, to some extent, the collective action problems related to the AGM, see Modern Company Law for a Competitive Economy (Final Report 2001) paras 7.1 and 7.7 endorsed by the Government in the White Paper Company Law Reform, above, 3.1; E Ferran ‘The Role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions’ (2003) 4 EBOLR 491, 512–14; E Boros ‘Corporate Governance in Cyberspace: Who Stands to Gain What from the Virtual Meeting’ (2003) 3 JCLS 149 (detailing UK, Australian and US reforms). As mentioned above, CA 2006 contains a number of provisions facilitating the use of electronic communications. For example, s 333 (sending documents relating to meetings etc in electronic form) taken together with Pt 3 of Sch 4 allows a member to communicate with the company by electronic means where the company has given an electronic address in a notice calling a meeting or in an instrument of proxy or proxy invitation.
1.3.2 External mechanisms for reducing agency costs

1.3.2.1 Public enforcement

The performance of company directors is increasingly subject to legal regulation and self-regulation. There is a growing recognition that there is a role for a watchdog empowered to take action on behalf of shareholders by investigations, inspections, and the institution of civil and criminal proceedings. In fact, there are those who argue that the UK assigns its public bodies a significant deterrent role, both in investigating conflicted transactions and by means of the broad use of public suits and criminal sanctions to deter illicit self-dealing. Further, there are also corporate regulators such as the Stock Exchange and the (now statutory) Panel on Takeovers and Mergers. These bodies play an important role in deterring mismanagement and thereby reducing agency costs by enforcing corporate laws and the Stock Exchange Listing Rules.

Yet it is impractical to rely exclusively on public enforcement. This is for a number of reasons. First, limits on funding and resources of corporate regulators means that they cannot, of necessity, pursue all breaches of the law. For example, the Government has never been willing to shoulder the cost of making the DBERR a day-to-day supervisor of company affairs, nor is the DBERR likely to be capable of doing that job. Further, although there are, for example, provisions for the appointment of inspectors to investigate the affairs of the company,
these are ad hoc and have not led to the systematic examination of corporate
governance by the regulatory authorities.\(^{85}\) Secondly, and more generally, there
is no reason to believe that the priorities established by a corporate regulator
for enforcement are necessarily the correct ones or are identical to those of each
and every corporation. This dictates a role for private enforcement.\(^{86}\) Thirdly,
there are several theoretical problems associated with government regulation of
company participants, such as restricting personal freedom and autonomy of
parties, lack of familiarity with the marketplace, or difficulties associated with
the introduction and implementation of regulatory measures (ie interest groups
may have too large an influence on the law-making process).\(^{87}\) Finally, when the
legal system assigns an enforcement role (or alternatively leaves room for) private
enforcers (ie through litigation) there is less need to rely on public agencies and,
in turn, the tendency of such public agencies to determine, sometimes arbitrarily
or for political reasons, not to enforce rights or duties it had previously guarded,
is likely to be higher.\(^{88}\)

1.3.2.2 Non-executive directors

Another way in which agency costs can be reduced is by increasing the role
and importance of independent directors on the board (more commonly
known in the UK as non-executive directors, hereafter ‘NEDs’). The thrust
of the argument is that NEDs are an effective means of ensuring management
accountability to shareholders. It is generally thought that their presence
contributes value to the company, or more specifically, to shareholder value,
through various roles they perform including: (1) reviewing the perform-
ance of the board and of the executive;\(^{89}\) (2) their monitoring role afforded by
their independence from management; (3) in taking the lead where potential
conflicts of interest arise;\(^{90}\) (4) their power to express views and take decisions
in line with shareholder interests; and (5) through their contributions to
strategy formulation.\(^{91}\)

\(^{85}\) DD Prentice, above n 45, 42. It could be argued that there is no need to have many cases in
order to achieve high levels of deterrence. For example, the use of few ‘test cases’ may be sufficient
to deter potential abuse by directors who are situated similarly at other companies. See further
Ch 2 under 2.3.3.1.

\(^{86}\) I Ramsay, above n 30, 152.

\(^{87}\) These issues are explored in detail in BR Cheffi ns, above n 35, Ch 4.

\(^{88}\) On why private enforcement serves a fail-safe function and ensures greater stability in the
application of law, see American Law Institute Principles of Corporate Governance and Structure:
Restatement and Recommendations (Tentative Draft No 1 1982) 220–1.

\(^{89}\) Report of the Committee on the Financial Aspects of Corporate Governance (Gee 1992)
para 4.5.

\(^{90}\) ibid para 4.6.

\(^{91}\) Report of the Committee on Corporate Governance (Gee 1998) para 3.8 (hereafter ‘Hampel
Report’); J Cook and S Deakin, above n 74, 7.
Reports of the Cadbury\textsuperscript{92} and Greenbury\textsuperscript{93} Committees as well as the Hampel Review, while stressing the importance of greater reporting to shareholders, have placed their main emphasis on a larger role for NEDs of the board in monitoring the performance of the company, including that of the executive directors.\textsuperscript{94} In a similar fashion it is believed that ‘…non-executive directors play a central role in corporate governance in UK companies. From the point of view of UK productivity and competitiveness, the progressive strengthening of the role of non-executive directors is strongly desirable’.\textsuperscript{95} The revised Combined Code\textsuperscript{96} provides the first quasi-official description of their functions.\textsuperscript{97} Building on the review undertaken by Higgs, it emphasizes that NEDs should not only monitor management but also contribute to the development of strategy.\textsuperscript{98} A core element of the Combined Code is its recommendation that the board be composed of at least half independent NEDs.\textsuperscript{99} Another is the separation of the positions of board chairman and chief executive officer (‘CEO’).\textsuperscript{100} The effect of both elements taken together is a functional distinction between management (executive directors) and control (NEDs led by the chairman). As all directors have the same powers, NEDs can also take the initiative in management decisions, and they are not restricted to post-decision approval as is the German supervisory board.\textsuperscript{101}


\textsuperscript{93} Directors’ Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury (Gee 1995).


\textsuperscript{96} Which was published on 23 July 2003 and applies for reporting years beginning on or after 1 November 2003. Following a review of the implementation of the Combined Code in 2005, the Financial Reporting Council (FRC) consulted on a small number of changes to the Code. These changes were incorporated in an updated version of the Code published in June 2006. The updated Code applies to reporting years beginning on or after 1 November 2006.

\textsuperscript{97} Combined Code para A.1.

\textsuperscript{98} ibid and Higgs, above n 95, paras 6.1 et seq.

\textsuperscript{99} Combined Code para A.3.2. Independence primarily means that there are no ‘relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgment’ (para A.3.1). It will be seen whether the new approach can provide ‘for the first time, a widely accepted definition of independence’ (Higgs, above n 95, para 9.12). As Barnard noted, ‘no definition will cover every situation and…traditional measures of independence…cannot capture those situations where even those directors who appear to be independent may not be because of social ties, a desire to be a team player or simple passivity’; J Barnard ‘The Hampel Committee Report: A Transatlantic Critique’ (1998) \textit{Company Lawyer} 110, 114–15. The CLR \textit{(Developing the Framework} para 3.148) conceded that independence cannot be legislated for since ‘the quality required is a state of mind and character and relevant experience, rather than some formal indication of independence’.

\textsuperscript{100} Combined Code para A.2.1.

\textsuperscript{101} K Hopt and P Leyens ‘Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy’ (January 2004), available at <http://ssrn.com/abstract=487944>. 
By comparison, in the US the presence of NEDs (more commonly known as ‘independent’ directors) on company boards is considered to be a key form of corporate governance control. There appears to be an increasing recognition across jurisdictions of NEDs with expertise in corporate governance as a new professional category.²⁰² According to Shepherd, this trend follows from increased institutional investor power and activism.²⁰³ There is further evidence that indicates a closer relation of CEO turnover to performance in firms where non-executive directors dominate the board.²⁰⁴ It also appears that NEDs of poorly performing companies lose their reputations and are frequently unable to find replacement positions.²⁰⁵

At the same time, there has been considerable debate over the effectiveness of NEDs.²⁰⁶ In a nutshell, the major concerns include the following. First, there are those who submit that the balance of research in the UK indicates that the link between board composition and either firm performance or board control over the CEO and executive management is either not significant, or at least not straightforward.²⁰⁷ Supporting this view, another study found no evidence of disciplining by NEDs.²⁰⁸ Further, Agrawal and Knoeber found evidence of a negative relationship between the percentage of outsiders on the board and firm performance. They suggest that outsiders may be added to boards for cosmetic reasons and that therefore additional outsiders reduce firm performance.²⁰⁹

Secondly, there are concerns as to the costs of running companies as the role of independent directors is expanded. For example, some argue that these directors increase the cost of running companies because of their lack of familiarity with the business²¹⁰ and there are concerns as to the costs of implementing the recent changes with respect to their expanded role (ie an army of human resources may be expected to be used in the appointment and training process envisaged by

²⁰⁶ For a recent summary of the debate see K Hopt and P Leyens, above n 101.
²⁰⁹ A Agrawal and C Knoeber, above n 39.
Further, one may wonder what the costs of this change in boardroom atmosphere will be, as well as the opportunity costs and other costs associated with lengthier meetings. On the one hand, a too confrontational boardroom, in which it is more likely that the question of whether the CEO should be replaced will be raised, may well lessen the CEO’s incentive to provide sufficient and prompt information to the board in an attempt to try and save his chair. On the other hand, if it is true that what prevents NEDs from acting as shareholder champions is an excessively cozy 'boardroom atmosphere,' then a diverse set of NEDs may make it more likely that tough questions will be asked.

There is likewise some empirical evidence to suggest that the appointment of independent directors does result in an increased share price and therefore is perceived by some to be a positive development by shareholders.

A third group doubt whether in the absence of a close link between the NEDs and the directors these approaches can bring about real changes. A related argument is that because NEDs are expected to assume many roles, the outcome of such hyperactivity will be that CEOs of public companies will have much less freedom to serve their own interests, but also much less freedom (and less time) to make innovative and profit-generating business decisions. Further, as the role of the NED is expanded, the potential legal liabilities may also expand and the risk, or perceived risk, attached to the post may create some reluctance to accept such posts, unless the financial rewards provide sufficient inducement.

Overall then, there are mixed views on how effective the presence of NEDs on a board is as a mechanism to control agency costs. Similarly, the evidence as to whether increasing the role and importance of NEDs represents a positive focused disciplinary mechanism is equivocal. In any case, it is questionable...
whether their role may provide the same protection mechanisms that in the end achieve functionally similar results as litigation.

1.4 Derivative Actions versus Market Forces

The foregoing discussion suggests that there are serious limitations and constraints on the effectiveness of various tools that may work to reduce agency costs and thus align the interests of shareholders and managers. This is hardly a revelation. We have already mentioned that various control mechanisms can complement and substitute for one another to compensate for that. In fact, different mechanisms for dealing with agency cost problems may be used in different legal systems.¹²¹ For instance, it has been suggested that although the US and the UK have similar legal systems that share a common origin, their common history may be less important than the fact that they have developed quite different mechanisms for dealing with the same ‘agency cost’ problems that in the end achieve functionally similar results.¹²²

To illustrate, assume that there has been a materially false financial statement by company X in both the US and the UK. The issuance of a materially false financial statement may cause a significant drop in the company’s share price upon its discovery in both nations. In the US, this may elicit a derivative action; in the UK, institutional investors may protest to the board and demand corrective action. However, in both countries, responsible senior management may lose their jobs. Similarly, in both countries, a chief executive officer whose company’s share price and earnings under-perform the industry averages for a given number of successive quarters is likely to find himself out of office. The mechanism of his removal (a board coup d’état or a hostile takeover) may, however, differ between the two countries.¹²³

The question is then whether it is also true that an important mechanism such as the market for corporate control and the derivative action can complement and/or substitute for one another. From a governance perspective (as opposed to a narrowly legal one), the interaction of the derivative action with the market for corporate control seems a crucial issue. Likewise, this is an important question, because it can be argued that the effective absence of litigation remedies in the UK available to minority shareholders suggests that the combination of other mechanisms (for example, high disclosure standards) and an active, unconstrained

¹²¹ It is beyond the scope of this work to investigate in depth the reasons behind this. See, generally, E Glaeser and A Shleifer ’The Rise of the Regulatory State’ (2003) 61 Journal of Economic Literature 401; R Kraakman et al, above n 35, 225.
¹²³ JC Coffee, above n 122.
takeover market may constitute an alternative effective functional substitute for litigation (or other remedies that are more available in the US). Also, to the extent that this mechanism effectively aligns the interests of managers and shareholders, there may be less need to resort to costly litigation as a means of protecting shareholder interests.¹²⁴ The purpose of the following two sections is thus twofold: first, to examine from a theoretical perspective whether the slack created by the limited derivative action litigation in the UK may be taken up by a more active market in corporate control; and subsequently, to evaluate whether the way the UK market for corporate control works in the real world is also consistent with the theory that it can substitute for derivative actions in practical terms.

1.4.1 The market in corporate control—an effective functional substitute for litigation?

The ability of market forces as opposed to litigation (or the law more generally) to curb managers’ wrongdoing cannot be tested in the abstract, but rather should be tested country by country.¹²⁵ This requires an examination of the factors that influence corporate governance features most significantly, such as the degree of development and effectiveness of the market for corporate control in the UK.¹²⁶ There are a number of market mechanisms that, depending upon the circumstances, operate as well to align the interests of shareholders and managers.¹²⁷ These include the product market, the capital market, the market for corporate control, and the labour market for managers. The focus here is on the market for corporate control.

The modern economic theory of the corporation accords a central role to the market for corporate control in enhancing managerial efficiency and accountability.¹²⁸ In many ways, the market for corporate control is thought to be the evolutionary endpoint of stock market development.¹²⁹ The theory is straightforward—it is the threat of a bid that provides management with an incentive to

¹²⁴ S Deakin E Ferran and R Nolan, above n 1, 167.
¹²⁵ BS Black and R Kraakman ‘A Self-Enforcing Model of Corporate Law’ 109 (1996) Harvard Law Review 1911, 1914 (observing that ‘effective corporate law is context-specific, even if problems it must address are universal’).
¹²⁶ Including ownership concentration, courts’ expertise in corporate law and the effectiveness of the judicial system or the activism of institutional investors. Some of these important features will be examined in subsequent chapters. See further L Enriques, above n 16.
¹²⁹ BR Cheffins, above n 35, 119–21; A Singh A Singh and B Weisse ‘Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging
maximize shareholder-return since, if successful, this will make their company bid-proof because they have ensured shareholder loyalty. Similarly, market forces will cause managements to seek to prove that they are honest and efficient. This will encourage investment in the company, ward off a takeover and improve their own marketability. Conversely, takeovers can improve efficiency by transferring assets to those who can manage them more productively. Consequently, more effective managers emerge who can raise the firm's profitability and share price. Further, even if current managers are not replaced, an active market for corporate control presents a credible threat that inefficient managers will be replaced and thus ensures that the incumbent management actively seeks to maximize shareholder value and thereby raises corporate performance.

It would be useful, at this point, to examine the UK market by reference to the parallel market that exists in the US. As will be seen, the enforcement mechanisms of the US and the UK may be very different. This, in turn, may shed light on some of the unique features of the UK market.

In the UK, in theory at least, market forces can be quite potent. Miller observes that the UK has a more robust and less regulated takeover market than the US, while the US is more permissive towards derivative action litigation. Though this is hardly a new observation, Miller argues that these differences can be viewed as partly reflecting alternative approaches to controlling agency costs in the Berle–Means corporation. In the UK, agency costs are controlled by the threat or reality of a hostile takeover bid in which incumbent managers are


¹³¹ Singh Singh and Weisse, above n 129, 28.

¹³² For example, the federal principles which generate strong pressures for anti-takeover legislation at the state level in the US are not present in the UK. Moreover, compared to the US, there are few formal legal constraints on takeovers in the UK (even with the recent new framework laid down by Pt 28 of CA 2006 implementing the EU Directive on Takeover Bids (Directive 2004/25/EC), see below n 146)). See, for example, G Miller ‘Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast between the United States and England’ (1998) Columbia Business Law Review 51 (hereafter ‘G Miller “Special Symposium” ’). See also R Kraakman et al, above n 35, Ch 7. In a recent piece, Armour and Skeel, by examining the evolution of the two regimes from a public choice perspective, suggest that the content of the rules has been crucially influenced by differences in the mode of regulation. In the UK, self-regulation of takeovers has led to a regime largely driven by the interests of institutional investors, whereas the dynamics of judicial law-making in the US have benefited managers by making it relatively difficult for shareholders to influence the rules. Moreover, it was never possible for Wall Street to privatize takeovers in the same way as the City of London, because US federal regulation in the 1930s both pre-empted self-regulation and restricted the ability of institutional investors to coordinate. See J Armour and D Skeel ‘Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation’ Georgetown Law Journal, 2007, available at <http://ssrn.com/abstract=928928>.

¹³³ G Miller ‘Special Symposium’, above n 132, 52.
replaced if they fail to maximize the value of a firm’s assets. In the US, where hostile takeovers have been severely restricted, the derivative action has attained greater prominence as a management control device.

Although there is some plausibility to the theory that the systems reflect alternative approaches to the same public policy problem (ie they are both techniques of accountability) this view is not entirely satisfactory.¹³⁴ As it has evolved in the US, the derivative action is not an effective means for ensuring managerial competence. Derivative actions based on alleged mismanagement are extraordinarily difficult to win. The derivative action is most effective in dealing with cases of self-dealing or illegality, but these are not, or at least are not usually, the sorts of managerial behaviour against which the hostile takeover is directed. It follows that the derivative action and the hostile takeover are not substitutes for one another in a public policy sense.¹³⁵

Further, even the most prominent proponents of the market for corporate control in the US concede that this market may be inadequate to deal with one-time defalcations by managers.¹³⁶ In particular, it is argued that the most significant weakness in the market for corporate control solution as a deterrent to managerial misbehaviour lies in its ineffectiveness against so-called ‘one shot’ breaches of fiduciary duties by managers. Yet this is one of the major objects of derivative actions.¹³⁷ Directors and officers who have a chance to achieve unprecedented wealth through a single misdeed have less concern for their continued association with the company which provided them with that once-in-a-lifetime opportunity.¹³⁸ Therefore the takeover is generally considered more effective in displacing managers who have systematically underemployed or misemployed the company’s resources. The conclusion is that the markets for control and managements in the US both function best in those situations in which the derivative action normally does not apply: ordinary daily decision-making.¹³⁹ For these reasons, even the most fervent proponents of market-based solutions in the US believe that the derivative action has a role to play in redressing and deterring managerial misbehaviour.¹⁴⁰

Such a view, however, cannot easily explain the relative vibrancy of derivative litigation in the US as compared with the UK. Incumbent managers do not like derivative litigation because they are often the defendants; and even if they are not defendants, the derivative action threatens their authority to manage the company. A political explanation of the evidence must therefore be based on a more complex theory than one based solely on the power of incumbent management.

A more satisfying account can be provided when differences in the systems’ structure are taken into account. In the US, where corporate law is dominated by state governments, the political forces aligned against hostile takeovers are quite potent, generating legislation and judicial decisions that have suppressed takeover activity. In the UK, with its more unitary system, the political forces play out differently, and the system accordingly generates rules more accommodating to unfriendly takeovers. The UK Government as well appears to favour retaining an open takeover regime within the UK.

Given the more concentrated character of the British financial community (both in terms of institutional ownership and physical location in the City of London), reputational effects may matter more in the UK than in the US. With respect to derivative litigation, the differences stem largely from the political influence of the organized Bar. Because the English system until recently did not recognize any form of contingency fees, there is little support from the organized Bar to push for liberalization in the rules governing derivative litigation. Thus incumbent managers, who are generally hostile to derivative litigation, exercise a great deal of control over the scope of the remedy.

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¹⁴¹ G Miller 'Special Symposium', above n 132, 52.
¹⁴² ibid.
¹⁴³ ibid 53.
¹⁴⁴ Ibid. For general background and a stimulating account on the relationship and differences between the two legal systems see PS Atiyah and RS Summers Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory and Legal Institutions (Clarendon Press 1987).
¹⁴⁵ For example, the Government has recently decided not to implement an option provided by the EU Directive on Takeover Bids (Directive 2004/25/EC [2004] OJ L 142/12) in relation to the so-called ‘reciprocity’ provisions. This ‘reciprocity’ is provided by the Directive which applies where Member States permit companies to voluntarily choose to opt in to articles 9 and/or 11 and companies do so choose. In such circumstances, Member States can exempt opted-in companies from the provisions of those articles when they are the target of a bid from a company which is not itself subject to those articles. The UK Government did not, however, seek to make use of this option on the grounds that it could undermine the benefits of the current open takeover regime within the UK; be seen as ring-fencing UK companies from takeovers by third country companies and so lead to retaliation and have adverse consequences for international trade. See, Explanatory Notes to the Company Law Reform Bill [HL Bill 34], available at <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/en/06034toc.htm>. See further, CA 2006, Pt 28, Chap 2 and Explanatory Notes on the Companies Act 2006, paras 1230–1241, available at <http://www.opsi.gov.uk/acts/en2006/ukpgaen_20060046_en.pdf>.
¹⁴⁶ JC Coffee, above n 122.
¹⁴⁷ See the extensive discussion in Ch 6 below on the introduction of conditional fees in the UK and the incentive structures this may create.
In fact, it can be argued that if we focus on enforcement, it is clear that the
differences between the US and the UK are probably as great as between the US
and France (a nation generally thought to enforce its investor protection laws only
weakly).\footnote{JC Coffee, above n 122.} In the US, class and derivative actions are permitted, and plaintiffs’
attorneys may charge contingent fees, which are usually awarded by the court
based on a percentage of the recovery that the attorney obtains for the class. Under
the standard ‘American Rule’ each side bears its own legal fees (which means that
the plaintiff’s attorney faces only the loss of time and expenses invested in the
action if the action is unsuccessful and is not generally liable for the winner’s
legal expenses).\footnote{ibid. See further Ch 6 below under 6.2.2.} The recognition of contingency fees and the ‘common fund’
doctrine\footnote{See Ch 6 below under 6.2.2.} permitting attorney compensation out of the amounts generated for
the benefit of the corporation have created a strong interest group within the
organized Bar that favours a relatively liberal scope for the remedy. Because
the organized Bar is usually quite influential in the design of corporate rules, it
has been able to ensure a relatively wide-ranging derivative remedy despite the
remedy’s unpopularity among corporate managers.

In the UK, the reverse is generally true. Class actions and contingent fees\footnote{That is, US-style contingent fees. On conditional fees see Ch 7 below under 7.3.1.} are
not authorized, and the losing side must normally compensate the winning side for
its costs, which, in turn, may constitute a prohibitive deterrent to litigation.\footnote{JC Coffee, above n 122.} As
a result, while a highly entrepreneurial system of private enforcement has evolved
in the US that largely overcomes the collective action problems that dissuade
individual investors from suing, nothing comparable exists in the UK. This is not
to say that the US system is optimal. For one, litigation could in principle result in
over-deterrence.\footnote{As will be seen in Ch 2 below under 2.3.3.2.} On the other hand, absent similar enforcement mechanisms,
minority shareholders will predictably remain passive, even if they learn that
they have been defrauded.\footnote{JC Coffee, above n 122.} Differing political dynamics again help to explain
differences in legal institutions.\footnote{G Miller ‘Special Symposium’, above n 133, 53.}

With these observations in mind, let us examine now whether the way in which
the market for corporate control in the UK works in the real world is also consist-
ent with our observations so far that it cannot substitute for derivative actions.

### 1.4.2 Flaws in the operation of the market for corporate Control

Potentially, the market may offer a more attractive substitute for the derivative
action as an alternative technique of accountability. As will be seen, while these
market forces can operate to reduce ‘agency costs’ they are, nonetheless, imperfect and subject to limitations. For example, the product market in which a company operates may not be competitive, with the result that the company can be operating inefficiently without this inefficiency being disciplined by the market.¹⁵⁶ More importantly, a critical school has developed a multifaceted critique that has increasingly questioned the above textbook version of the market for corporate control.¹⁵⁷ Likewise, recent research has suggested that extra-legal mechanisms for controlling managerial power are less effective than they might be.¹⁵⁸ A number of other studies have cast doubt on the disciplinary hypothesis of the market for control. It is the purpose of the reminder of this chapter to consolidate these views and to highlight briefly some of the flaws and limitations of the market for corporate control.

First, a number of analysts have pointed out that in the real world the market for corporate control has an inherent flaw in its operation: it is far easier for a larger company to take over a small one than the other way around.¹⁵⁹ In principle, it is possible that a small company may take over a larger and less efficient company, though the incidence of this is very small,¹⁶⁰ and in a takeover battle it is the absolute size that counts rather than the relative efficiency.¹⁶¹ Therefore the development of an active market for corporate control may encourage managers to ‘empire-build’ not only to increase their monopoly power but also to shield themselves progressively from takeover by becoming larger.¹⁶²

Secondly, takeovers are a very expensive way of changing management.¹⁶³ There are substantial costs associated with takeovers in countries like the US and the UK which hinder the efficiency of the takeover mechanism.¹⁶⁴ Either mounting a takeover or defending against one involves substantial transactions costs.¹⁶⁵ These costs, particularly when the bid is unsuccessful, may simply be dead-weight costs to the respective companies that do not produce any countervailing advantages. Likewise, because hostile takeovers involve substantial costs, it is highly probable that, so to speak, ‘small’ unfair self-dealing, in the absence of other means of reaction, will go undetected or at least unpunished.¹⁶⁶ Likewise, the

¹⁵⁶ I Ramsay, above n 30, 154 and the references therein.
¹⁵⁷ Singh Singh and Weisse, above n 129, 28.
¹⁶¹ Singh Singh and Weisse, above n 129, 28.
¹⁶² ibid.
¹⁶⁴ Singh Singh and Weisse, above n 129, 29.
¹⁶⁵ This last point is well illustrated in Table 2.4 in DD Prentice, above n 45, 37.
¹⁶⁶ L Enriques, above n 16.
efficient operation of the takeover mechanism requires that enormous amounts of information are widely available.¹⁶⁷ Specifically, market participants require information on the profitability of corporations under their existing management; nonetheless, it has been noted that such information is not easily available even in countries like the UK.¹⁶⁸

Thirdly, there is no evidence that corporate governance necessarily improves after takeovers. This is for the simple reason that most takeovers are not disciplinary, and in many of them the acquiring company is motivated by empire-building considerations.¹⁶⁹ Research has found recently that takeover markets in the UK, and hostile takeovers in particular, are not significantly related to poor performance.¹⁷⁰ In addition, the research found no significant relation between managerial disciplining and large outside share blocks held by financial institutions, individuals, families, and non-executive directors.¹⁷¹ This has led some to conclude that takeovers represent a poorly focused disciplinary mechanism.¹⁷²

Fourthly, it has been argued that takeovers can be used as a device to avoid honouring implicit contracts developed between workers and the former management.¹⁷³ This abandonment of implicit contracts can be argued to be socially harmful in that it discourages the accumulation of firm-specific human capital by workers.¹⁷⁴

Fifthly, the market for corporate control may have little or no application to private companies.¹⁷⁵ Yet private companies, although relatively less significant in economic terms, constitute the vast bulk of companies in the UK.¹⁷⁶ This inevitably limits the application of the market for corporate control. Similarly, the threat of takeover is irrelevant where the company is, to all intents and purposes, bid-proof.¹⁷⁷

Finally, there may be other forces that hinder this market that should be mentioned briefly. First, defensive tactics employed by managers of companies which are potential takeover targets are said to have a limiting effect on the openness of the market.¹⁷⁸ Secondly and more generally, the market for corporate

¹⁶⁷ Singh Singh and Weisse, above n 129, 29.
¹⁶⁸ ibid.
¹⁶⁹ ibid.
¹⁷⁰ J Franks and C Mayer, above n 108.
¹⁷¹ ibid.
¹⁷² ibid.
¹⁷³ Singh Singh and Weisse, above n 129, 29–30.
¹⁷⁵ Singh Singh and Weisse, above n 129, 30.
¹⁷⁶ At the end of 2001, there were 12,400 public companies (0.8% of the register) and 1,491,500 private companies (99.2% of the register); DTI Companies in 2001–02, Table A2. At the end of 2005 public companies constitute only 0.5% of the register. See, DTI Companies in 2005–2006, Table A2.
¹⁷⁷ For example, with a weighted voting structure or where the first indication of trouble wipes out the value of the company. DD Prentice, above n 45, 38.
control can vary significantly and, for various reasons, may apply only within a limited range.¹⁷⁹ For example, numerous companies are not the subject of capital market disciplines.¹⁸⁰ If a company is in a position to meet its funding requirements by using cash generated internally by the retention of profits, management will have a reduced incentive to run the business in manner which matches the expectations of the market.¹⁸¹ Similarly, the experience in the US suggests that companies in which the degree of inefficiency is not extreme enough to create a sufficient reduction in the share price to cause a takeover, and companies in which the degree of inefficiency is so extreme as to preclude a takeover because it is such a risky undertaking, fall outside this range and the market for corporate control may only weakly discipline these companies.¹⁸²

In short, it has been illustrated that the market for control has some serious flaws in its operation, and its effectiveness can depend on variables including the company’s size and organizational complexity, shareholding structure, the amount of information which is widely available, or defensive tactics employed by managers of companies which are potential takeover targets. Likewise, many takeovers are not disciplinary, and in many of them the acquiring company is motivated by empire-building. This is not to suggest that the market for control may not have an important role in the corporate governance system of an open and competitive economy such as the UK. It certainly has a vital place.¹⁸³ However, it is perhaps easy to overestimate the beneficial effect upon management performance of the threat of the takeover bid.¹⁸⁴ Similarly, takeovers are a costly and imperfect way to discipline errant managers. Finally, and more importantly for the discussion which follows, whether their role can be said to deal with the same ‘agency cost’ problems that in the end achieve functionally similar results as derivative actions is a different question altogether.

1.5 Conclusion

There are three key conclusions that this initial discussion seems to point to. First, it needs to be acknowledged that shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. It cannot be

¹²⁴ Therefore such defences as are available to directors and managers of English companies are mostly in the form of marketplace tactics such as buying and selling assets, entering into contracts that might make a firm an undesirable target, and so on. See G Miller ‘Special Symposium’, above n 132, 52.
¹⁷⁹ I Ramsay, above n 30, 154 and the evidence therein.
¹⁸⁰ J Parkinson, above n 158, 118.
¹⁸¹ BR Cheffins, above n 35, 120.
¹⁸³ E Ferran Company Law and Corporate Finance (OUP 1999) 122; E Ferran, above n 130; K Hopt, above n 130.
¹⁸⁴ Gower and Davies, above n 9, 750 and the references therein.
viewed in isolation from a number of mechanisms in the chain that is corporate governance. These include, for example, structural as well as internal and external control devices for minimizing agency costs. Secondly, a brief examination of some major control devices has revealed that there are flaws and constraints in their effectiveness. The point here is not that these mechanisms are not important but rather that they are imperfect and that the disciplinary framework they impose is far from complete. Their effectiveness varies from industry to industry, from firm to firm, and from time to time. Thirdly, in focusing on one major control mechanism, namely the market for corporate control, it was illustrated that the derivative action and the hostile takeover are not substitutes for one another in a public policy sense. This is for two reasons, one theoretical and the other practical: (1) the market for control functions best in those situations in which the derivative action normally does not apply—ordinary daily decision-making; (2) the market for control has some serious flaws in its operation, and its effectiveness is subject to variables. It follows that an unconstrained takeover market may not constitute an effective functional substitute for litigation and it would be unsafe to rely solely on markets as a substitute for other forms of control.

Although this is hardly a revelation, it seems consistent with the notion that various control mechanisms can complement and substitute for one another. This, in turn, suggests that the derivative action may have a role in minimizing agency costs. In relation to litigation, the crucial question then becomes: in what way or ways can the derivative action provide a supplementary mechanism to these other mechanisms of accountability? It is the purpose of the following chapter to inquire into these important issues.