'Shareholder Supremacy in a Nexus of Contracts: A Nexus of Problems'

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SUMMARY

This article focuses on shareholder supremacy and exclusivity derived from a view of the company as a nexus of contracts. The nexus of contracts theory is the dominant theory within English company law. It defines the company as a contract between private individuals. The shareholders and the company are recognized as the only parties to that contract. While corporate membership is reserved exclusively for shareholders, the rest of the stakeholders are viewed as external to the company. The article will question the theoretical and doctrinal validity of shareholder supremacy and exclusivity within this context. It argues that while the nexus of contracts theory promotes shareholder exclusivity in a rather dogmatic manner, not only the law but also the courts have limited the rights of shareholders to a significant extent. The article does not place into doubt the importance of shareholders within the corporate context; after all the shareholders are the capital providers of the company. It does however criticize the current status quo in English company law where theoretically the shareholders are sitting on the corporate throne in a company which includes no one else but them, but in practice their supremacy is challenged by the courts to such a degree that it is difficult to exercise even the rights stemming from their shares and to have access to effective remedies against managerial abuse. The article will therefore underline the controversies inherent in the nexus of contracts theory. It will shed light on the distorted application of the theory within English company law. It argues that the theory should be reformed to adjust to the new reality. On the one hand, it should certainly protect the rights of shareholders stemming from their shares and it should allow for effective shareholder protection against mismanagement. On the other hand, the theory should adopt a more inclusive definition of the company that will not leave the stakeholders off its context. Especially those stakeholders who clearly have a contractual relationship with the company should be factored into corporate governance.

Therefore, the article will argue against the doctrinal dominance of shareholder exclusivity and supremacy by arguing that they nowadays flow from a flawed interpretation of the nexus of contracts theory. The article will focus on shareholder protection; it will examine section 994 of the Companies Act 2006, which provides for one of the main remedies against directorial abuse. The jurisprudence of the courts embodies a clear mismatch between theory and practice. Absolute shareholder supremacy should have entailed an enhanced level of protection to match the status of shareholders as the only members of the company. After all, the nexus of contracts theory defines the interests of the company as the interests of the shareholders. Yet, the judicial stance on this matter proves that the courts have actually curtailed the protection granted to shareholders by the Companies Act 2006; this clearly testifies to the deeply problematic nature of shareholder supremacy within the context of the nexus of contracts theory. The article will therefore argue that the dominant views in theory, academia and law, which continue to recognize a notion of absolute shareholder supremacy and exclusivity, flow mostly from ideology rather than reality. Ideological dogmatism has resulted in a very narrow, and in many ways distorted, definition of the company; one which left only *the shareholders within its context albeit and paradoxically with a limited set of rights to control the management. The article argues that the current law should be reformed, aiming at creating a more inclusive company where shareholders would actually enjoy a bundle of rights appropriate for capital providers. The law should also be reformed so that stakeholders whose interests are integrally linked with the company's fortune – such as employees and creditors – should be factored into the company. This is in the interests of both the company and the shareholders.*

1 THE ENGLISH COMPANY AS A NEXUS OF CONTRACTS

The theoretical conception behind the English company is the so-called 'nexus of contracts' theory. It is 'a fact that narrow contractarian models of the corporation have dominated academic thinking[1] in the UK'. According to the nexus of contracts theory, the company is simply a private affair between shareholders. It is simply a nexus of contracts renegotiated by the individuals involved in it – the shareholders – with the principal aim of maximizing their own profits and utility[2] as well as the market value of the company through 'allocative, productive and dynamic efficiency'.[3] The shareholders are the only members of the company within this context. Companies are 'simply legal fictions which serve as a nexus of contracting relationships among individuals'[4]; hence it is an exclusively private affair devoid of any social considerations. They consist of many 'different kinds of relations that are worked out by those voluntarily associating in a company'[5] and they form 'the substance of the corporate fiduciary duty'.[6] Therefore, from its very conception the founding theory of the English company accepts that the company as an entity is simply a collection of private contractual relations. This has been viewed as the founding principle on which shareholder exclusivity has been based. The theory defines the company as the outcome of a network of contractual agreements. The shareholders' relationship with a company is deemed to be of a contractual nature as it derives from a contract: the articles of association. Each company in the UK has articles which form the constitution of the company.[7] The articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other.[8] However, other stakeholders fit into this model comfortably too. Both employees and creditors are parties to contractual

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[1] Tomasic Roman & Akin bami Folarin, *Towards a New Corporate Governance After the Global financial Crisis*, 22(8) Int'l Co. & Com. L. Rev. 247 (2011).

[2] Alchian, A. & H. Demsetz, *Production, Information Costs and Economic Organisation* 62 Am. Econ. Rev. 777 (1972) and *see* Cheffins, *infra* n. 49.

[3] Mayer, C., *Corporate Governance, Competition and Performance*, 24 J. L. & Soc'y 152 and 155 (1997).

[4] Jensen, M. & W. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure* 3 J. Fin. Econ. 305 (1976); Fama, *infra* n. 9, at 310.

[5] Easterbrook, F. & Fischel, D. *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1426 (1989).

[6] Smith, T., *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 Mich. L. Rev. 214, 217 (1999).

[7] S. 17, Companies Act 2006.

[8] Wood *v.* Odessa Waterworks (1889) 42 Ch D 636.

agreements with the company, on the basis of which they provide their services and capital to the legal person. Since stakeholders are also parties to contractual agreements with the company, the recognition of shareholders as the only actors in a contractual relationship with the company is rather problematic. The articles of association which form the contract between the company and the shareholders are a contract of special nature. They present many particularities that distinguish it clearly from mainstream contracts such as the contracts signed by employees and creditors. The latter are covered by employment law and contract law respectively, which set out a specific set of rights and obligations flowing from the contracts in question which are binding on both parties. The relevant functions of the articles of association which clearly distinguish them from a mainstream contract are examined next in this article.

The definition of the company as a collection of private contractual relationships[9] is quite consistent with the dominance of individualism within company law. Since, the company is a collection of contractual relationships which are exclusively of a private nature, the company is devoid of any social responsibility. It should be left intact from any regulatory interference which would place limitations upon the right to use the free enterprise tool as shaped exclusively by its signatory parties and owners: the shareholders. However, there lies a significant contrast at the core of the theory in question. The company is not a 'thing' capable of being owned. It is a nexus of contracts, 'written and unwritten, among owners of factors of production and customers'.[10] While the theory provides the grounds for granting absolute primacy to shareholders as the exclusive members of the company in the name of liberty, individualism and lack of state intervention, it regards the company as a network of interrelated contracts which can simply not be owned. The latter is viewed like a collection of interlinked contractual relations which reflect the bargain between the different contractual parties and their intention to pursue profitability on a voluntary basis. The recognition of an owner of the network of interrelated contracts is therefore rather inconsistent with the very nature of the theory in question. Hence, there is a grey area as to the theoretical foundations of the shareholder ownership of the company even in the core of the theory which has laid the foundations of the English company. The controversy in question embodies the challenging nature of the task to solidly justify shareholder exclusivity in either law or theory and demonstrates that the source of the popularity of the former is mostly detected in ideology.

The company has been deconstructed[11] or 'disaggregated'[12] into a 'number of complex, private consensual transactions or contract based relations … the parties involved in those contracts … include shareholders, managers, creditors, customers and employees'.[13] It could be subsequently argued that in a nexus of contracts all constituents who form a party to any contractual relationship with the company appear to be on an equal footing.[14] Therefore, it is clear that the exceptional status handed to shareholders in the form of complete supremacy does not derive from the theory. 'If the company were owned by the shareholders, there could not be a nexus of contracts.'[15] A nexus of contracts implies the existence of a network of contractual relationships on equal footing. Each of the members of the network enjoys a contractual relationship with the legal person. The recognition of shareholder supremacy within this theoretical construction, let alone of shareholder exclusivity, cannot be viewed as a by-product of the theory. The article argues that the theory has been misinterpreted to promote a principle – shareholder supremacy – which sits quite uncomfortably within its context.

2 Are the Articles of Association a Regular Contract?

The articles of association constitute the contract which binds the company with its shareholders. The contractual nature of the articles gives birth to the contractual relationship between the company and its shareholders. However, in contrast to mainstream contracts, such as an employment contract or a loan contract, the articles of association present a set of particularities which render the inclusion of shareholders within the list of contractual actors controversial. There is a certain degree of legal uncertainty which is linked with the question as to who can enforce the rights stemming from the articles of association. Astonishingly enough, the shareholders – the signatories of the contract – may be denied the right to invoke rights stemming from that contract if they hold an additional capacity. If a shareholder of a company acts as its solicitor or accountant, for example, his ability to invoke rights stemming from the articles is anything but guaranteed. The lack of certainty as to whether the parties to a contract have the capacity to rely on its provisions is indicative of the set of challenges that are to be faced when one attempts to view the relationship between the company and the shareholders as a contractual one in its traditional sense.

The courts have not been very helpful in providing us with a clear interpretation of the concepts in question. In *London Sack*,[16] Scott LJ said that the contract, which was created between the members under the predecessor to section 33, did not constitute a contract between them 'about rights of action created entirely outside the company relationship such as trading transactions between members'. Great confusion was created when, despite what was initially thought, shareholders could not actually enforce the 'contract' when they held an additional role within the company such as that of a solicitor or accountant. In such a case, shareholders may find it difficult to enforce rights stemming from the 'contract', because they are considered 'outsiders'. The courts refuse to grant them the rights provided for by the articles even though they are considered to be a contract. The courts demonstrated a sense of ambiguity when dealing with this issue which led to two different lines of cases which represent two different types of approach in relation to this matter. In *Eley*,[17] the court held that the articles were a matter between the shareholders among themselves or the shareholders and the

[9] Fama, E., *Agency Problems and the Theory of the Firm*, 88 J. Pol. Economy 288, 290 (1980).

[10] Abugu E.O. Joseph, *Primacy of Shareholders' Interests and the Relevance of Stakeholder Economic Theories*, Co. Law. 210 (2013).

[11] Keay Andrew, *The Corporate Objective* 28 (Edward Elgar 2011).

[12] Johnson L., 92 Columbia Law Review 2215, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92, p. 2221 (1992).

[13] Andrew, *supra* n. 11, at 28.

[14] Easterbrook F. & Fischel D., *Voting in Corporate Law*, 26 J. L. & Econ. 396 (1983).

[15] Eisenberg M., *The Conception that the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. Corp. L. 825 (1999).

[16] London Sack and Bag *v.* Dixon [1943] 2 All ER 763.

[17] Eley *v.* Positive Government Security Life Association (1876) 1 Ex D 88.

company. They did not create any contract between a solicitor and the company. This was so even though the solicitor had become a member of the company sometime after the articles had been signed.

This means that there is a subtlety in the definition of an 'outsider' in these circumstances. He is a person unable to enforce the articles or be affected by the contract in the articles. When the person seeking to enforce the articles has effectively two relationships with the company, he may be both an 'outsider' in the sense discussed in *Eley*, but at the same time a shareholder of the company. In this case he might find it difficult to enforce the articles. In *Hickman*,[18] Astbury J cited a number of cases and went on to say: 'An outsider to whom rights purport to be given by the articles in his capacity as outsider, whether he is or subsequently becomes a member, cannot sue on those articles treating them as contracts between himself and the company to enforce those rights.'

In another line of cases which demonstrated an entirely different judicial approach on this matter, the court ruled in *Salmon*[19] that Salmon, who was a managing director, was able to enforce his right of veto by way of the contract in the articles. Here the court effectively supported that every shareholder has the right to enforce the articles of the company; a shareholder who also holds a position as an outsider (such as managing director, solicitor, etc.) can, wearing his shareholder hat, enforce the contract in the articles, even if the direct result of that enforcement is of benefit to him wearing his outsider hat. This proves that the definition of the relationship between the company and the shareholders as contractual could be a challenging matter. The nature of the contract binding the company with its shareholders presents certain particularities which render its inclusion in this nexus of contracts problematic. And if such a level of uncertainty and lack of clarity exists at the very foundations of English company law, it is evident that an equal level of uncertainty will be met across many of the corporate functions that involve shaping a balance between shareholders and stakeholders.

The two lines of rulings demonstrate the difficulties encountered when attempting to treat the articles as a typical contract within the framework of contract law. In contrast, the document regulating the internal affairs of the company and the relationship among its components is distinctive, giving birth to rights and obligations that are consequently unique. The agreement upon this principle is instrumental for an understanding of the position of shareholders within the English company and within the framework of English company law.

It is therefore evident that the position of the shareholders in a company which is defined as a collection of private contractual relationships raises many important questions related to its validity. In *O'Neil*,[20] the company was defined as 'an association of persons for an economic purpose … the terms of the association are contained in the articles of association'. Therefore, the company has an economic purpose which is the by-result of consent among the individuals constituting its composite members.[21] By buying shares, one can therefore become a party to this agreement respecting the purpose of the association, agreeing to its terms and accepting its limitations but also taking advantage of the right to participate in the majority required to alter the terms of the agreement. This is integral in the notion of membership, but whether a contractual nature can be granted to those rights and obligations is an issue that would require more solid legal justification.

3 Can risk justify shareholder supremacy within a nexus of contracts?

Shareholder supremacy and exclusivity are justified by the importance ascribed by contractarian theorists to the status of the shareholders as the 'residual-risk' bearers. The shareholders are deemed as the 'residual-risk' bearers because they are at the bottom of the list of actors who are to be compensated in case of corporate insolvency. They can retrieve part of their investment only after the rest of the stakeholders have been compensated for the losses they suffered due to corporate insolvency. According to the contractarian theorists, shareholders are the only group who are granted membership rights, because they are regarded as the only residual claimant group within a company.[22] It can be argued that this shows an increased level of risk undertaken by shareholders. But, it can also be argued that this is clear proof that the various contractual relations which comprise the company are indeed on an equal footing. When a company becomes insolvent the creditors and employees are satisfied first on the basis of their respective contracts. In the most critical moment for the company the contractual relationship between the company and its creditors takes precedence over shareholders' rights. Even company law recognizes that the claims of the aforementioned stakeholders stemming from their respective contracts should come at the top of the insolvent company's agenda. The shareholders are the final actors to be compensated only in cases where this is indeed possible. Company law therefore recognizes that in the most critical moment for the company, the claims stemming from these contracts, as provided for by employment and contract law respectively, take precedence over the articles of association. It is therefore, hard to justify shareholder exclusivity on a contractual basis. The former is based on the fact that the shareholders are signatory parties to the articles of association. Yet the latter are set aside when the company is insolvent leaving them at the back of the queue.

The contractarians are attempting to re-invent the natural entrepreneurial risk-taking on the part of the shareholders which naturally stands at the heart of corporate activities as well as of capitalism itself. Shareholders are however assuming a calculated risk since they are protected by the principle of limited liability and they can foresee the risks inherent in their investment. Their risk-bearing character is so limited that it cannot justify their treatment as the supreme actors or the owners of the enterprise by the theory.[23] Their listing as

[18] Hickman *v.* Kent and Romney Marsh Sheepbreeders [1915] 1 Ch 881.

[19] *Quin & Axtens Ltd v. Salmon* [1909] AC 442.

[20] *O'Neil and another v. Phillips* (1999)UKHL 24 [1999] 1 WLR 1092.

[21] Bolodeoku, O.I., *Economic Theories of the Corporation and Corporate Governance: a Critique*, J. Bus. L. 418 (2002).

[22] Wen Shuangge, *The Magnitude of Shareholder Value as the Overriding Objective in the UK: The Post Crisis Perspective*, 26(7) J. Int'l Banking L. & Reg. 330 (2011).

[23] Abbasi Zubair Muhhamad, *Legal Analysis of the Agency Theory: An Inquiry into the Nature of Corporation*, 51(6) Int'l J. L. & Mgmt. 405 (2009).

the sole bearers of residual risk is inaccurate. Creditors and employees can face losses which will be much more damaging to their financial interests or livelihoods respectively. Shareholders can release themselves from the company at any moment by liquidating their shares and perhaps retrieving the entirety of their investment or even making some profit; this is not the case for the rest of the actors involved in the company, who have a much higher stake in its survival and success. Labour is significantly less mobile than capital; geography plays a much bigger role in this context. Employees often have deep and long-lasting personal and family roots with a particular place where the company is located and relocation can come at a high economic and personal cost. This is also the case for suppliers who, depending on their size, rely on the local market for their existence. Therefore, the fact that shareholders enjoy exclusivity within the corporate context is rather a reflection of the United Kingdom's prevailing and deeply rooted cultural principles of individualism and laissez-faire capitalism.[24] The roots of their status are mostly ideological.

4 Can shareholders claim a property right on a company defined as a nexus of contracts?

Theorists of the corporation 'eschew the concept of corporate ownership in assessing shareholders' rights and directors' obligations in the corporate system'.[25] Some argue that it is 'anomalous to view the shareholders as corporate owner'[26] as they perceive 'corporate constituents as factor providers, whose interests in the corporation are defined and regulated by contractual negotiations with the corporation'.[27] Therefore, it is logical to question the fundamentals of the theory by asking a very basic question: if the company is simply a nexus of contracts, of what exactly could the shareholder be the owner.[28] The majority of scholars argue that shareholder supremacy is based on the existence of a 'residual claim' on the part of the shareholders. More specifically, the private firm is characterized by the existence of divisible residual claims on the 'assets and cash flows of the organisation which can generally be sold without permission of the other contracting individuals'.[29] Hence shareholders could be viewed as having the greatest stake in the outcome of the company[30] and therefore the greatest interest in the right of control above any other stakeholders.[31] The theory in question views the shareholders as the most appropriate actors to monitor management as theoretically at least they are the most motivated actors to do so in order to safeguard their residual rights. However, it is now accepted that the separation of ownership and control,[32] which took place at least in the context of the public company, impacted on the capacity of shareholders to control the company. In most cases the shareholders are either unwilling to perform such a demanding role or they simply lack the information to do so. The legal rules which empower the management with the right to determine in absolute terms how to utilize and allocate the assets has an adverse effect on the validity of any argument that shareholders are the residual claimants.[33] Shareholders do not have any ownership claim on the assets of the company which are owed by the legal person that is the company. Directors of a company can therefore determine the management of those assets which may not involve handouts to shareholders. Shareholders are therefore not even entitled to receive dividends. Dividends fall within the exclusive discretion of the management which decides whether dividends are to be distributed to shareholders or not. The resignation of any sense of control over the corporate assets strips the supporters of shareholder exclusivity of any strong legal arguments that could justify this status. This is a status which at theoretical level adheres to shareholder supremacy while in practice it led to managerial dominance.

Shareholders as residual claimants guarantee performance of their contracts by investing their money to buy capital and technology[34]; therefore they assume a risk as the providers of the capital but that is distinguished from ownership of the firm itself which is a distinctive legal person. It is clear that capital and technology are owned by the company and not by the shareholders. Therefore, a distinction between the ownership of the shares and the ownership of the firm is clear. It is astonishing that such a contradiction lies at the foundations of the theory. Fama claims that 'as residual claimants the shareholders guarantee the performance of their contracts by putting up wealth *ex ante* with this front money used to purchase capital and technology that the corporation uses for its productive activitie's.[35] Therefore, the shareholders bear the residual risk, but the company itself retains its independence as a separate legal person. This statement is a necessary prerequisite that enables the understanding that the control over a firm's decisions is not necessarily within the ability of the shareholders[36] as the 'ownership of the residual claim on the corporation's assets and earnings … is not the same as ownership of the corporation itself'.[37]

[24] Fisher Deryn, *The Enlightened Shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 Make Directors Consider the Impact of Their Decision on Third Parties?*, 20(1) Int'l Co. & Com. L. Rev. 11 (2009).

[25] Bolodeokou Omotayo Ige, *Economic Theories of the Corporation and Corporate Governance: A Critique*, 4 (July) J. Bus. L. 411 (2002).

[26] *Ibid*.

[27] *See* Williamson Oliver, *Corporate Governance*, 93 Yale L. J. 1197 (1984).

[28] Clerc Christophe, *Questioning the Legitimacy of Shareholder Power*, in *Does Company Ownership Matter?* 97 (Touffut Jean-Philippe ed., Cheltenham: Edward Elgar 2009).

[29] Jensen & Meckling, *supra* n. 4, at 305; Fama, *supra* n. 9, at 311.

[30] Macey, R.J., *Fiduciary Duties as Residual Claims: Obligation to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 Cornell L. Rev. 1267 (1999).

[31] Van der Weide, M.E., *Against Fiduciary Duties to Corporate Stakeholders*, 21 Del. J. Corp. Law 57 (1996).

[32] Berle A. Adolph & Means C. Gardiner, *The Modern Corporation and Private Property* (2d revised ed., Transaction Publishers 30 Sept. 1991).

[33] Yan Min, *Agency Theory Re-examined: An Agency Relationship and Residual Claimant Perspective*, 26(4) Int'l Co. and Com. L. Rev. 142 (2015).

[34] Fama, *supra* n. 9, at 290.

[35] *Ibid*., at 288.

[36] *Ibid*.

[37] Bainbridge, M.S., *The New Corporate Governance in Theory and Practice* 32 (Oxford: Oxford University Press 2008).

5 The role of ideology in a nexus of contracts

The status enjoyed by shareholders in the English company is, therefore, not a result of an alleged property right over the corporation which simply no longer exists but a by-product of the dominant ideology which places individualism in the centre of corporate formations with a distaste of statist interventions. Such ideology encourages individualism and laissez-faire principles as 'corporate property was to be treated as private property demanding minimum government interference as this leads to inefficient allocation of capital'.[38] Shareholders invest their capital in the company and they benefit from its long-term sustainability and profitability. They benefit when reaping the profits of a company which operates on the basis of a long-term strategy that guarantees their investment. Their capital is allocated effectively when it sustains long-term corporate operations that result in profitability. The managers of a company which is defined as an exclusively private affair are nowadays encouraged to aim at short-term benefits.[39] The latter can be quickly distributed to shareholders and convince them that the company is managed efficiently. The shareholders will become restless only in cases where their interests are grossly neglected. As is explained in the final part of the article, in such a case they can attempt to resort to the judiciary. The latter will avoid interfering in corporate affairs unless this is deemed necessary. So, within the theory short-termism emerges as a managerial shield against potentially restive shareholders, who would otherwise remain apathetic. This is because short-termism conveys an illusion of a well-functioning company. It encourages further shareholder abstinence from exercising any control on management. Therefore, directors can exercise unfettered control on corporate affairs, but it will also impact on the shaping of a sustainable long-term corporate strategy. The latter would guarantee more stable prospects for all stakeholders involved, including the shareholders. It therefore becomes apparent that the current interpretation of the theory harms not only stakeholders and the society at large but most shareholders too.[40] This results in 'undue focus on share price, which is an unreliable and unpredictable means of assessing a company's performance or sustainability',[41] since it is prone not only to price manipulation but it can also be affected by external actors unrelated to the company. The price of shares rises in times of good economic climate or due to the announcement of a positive economic outlook for the economy or the sector as a whole. In the *Gaiman*[42] case, the court clarified that directors should take regard of the interests of shareholders both present and future. The judgment reveals an approach which renders short-termism as incompatible with a genuine interpretation of English company law. English company law underlines the importance shareholders have within the corporate context, but it also promotes a directorial behaviour which shall aim at serving the interests of the shareholders who may join the company at a later stage, hence encouraging the introduction of a long-term corporate agenda which is at odds with the nexus of contracts theory. Despite the prominence of the nexus of contracts understanding of the company in scholarship, there is 'no single strain of judicial authority supporting shareholder value and so it is not as legally embedded as its proponents argue'.[43] In *Fulham Football Club*,[44] the court stated that 'the duties owed by directors are to the company and the company is more than just the sum total of its members'. The dominance of the theory in question has resulted in extensive short-termism in English companies. In 2013 the Parliamentary Commission on Banking Standards criticized the pursuing of short-termism in the banking sector and recommended that company law should be changed to remove shareholder primacy in respect of banks, and require directors to ensure the financial safety and soundness of the company ahead of the interests of its shareholders.[45] Theories that attribute ownership to shareholders are 'outdated, over-abstracted, over-static and far removed from the modern business environment and social reality'.[46] The nexus of contracts theory is based on 'the philosophy of laissez-faire which assumes that the contractual relationship at work between capital and labour is an equal one, governed by market laws of demand and supply'.[47] However, 'contractual freedom has been regulated especially where the bargaining positions are unequal'.[48] Very few will place the importance of shareholders in doubt, however, their establishment as the only actor with a 'residual risk' is based on shaky foundations. Shareholders have a stronger negotiating position as they can exit the company at any point by liquidating their stock – even at a loss – should they decide to do so before insolvency. The other stakeholders will lack the ability to do that; their bargaining position against the company is weak as their livelihoods are much more dependent on the company.

The company has traditionally been viewed as a voluntary association between private individuals rather than as a creation of the state.[49] Neo-classical economists, including Coase, have viewed companies as a method of 'reducing the costs of a complex market consisting of a series of bargains among parties',[50] rendering unnecessary further regulation, especially on the part of the state. The focus is therefore clearly placed on the contract as the 'mechanism which brings about exchange',[51] and the company is viewed as possessing a

[38] Kiarie S., *At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?*, Int'l Co. & Com. L. Rev. (2006).

[39] Rahim Mahmudur Mia, *The Rise of Enlightened Shareholder Primacy and Its Impact on US Corporate Self-Regulation*, 25(12) Int'l Co. & Com. L. Rev. 412 (2014).

[40] Stout Lynn, *The Shareholder Value Myth* 6 (San Francisco: Barrett-Koehler Publishers Inc 2012).

[41] Kiarie, *supra* n. 38, at 334.

[42] *Gaiman v. National Association for Mental Health* [1970] 2 All E.R., 362, Ch. D.

[43] Keay Andrew, *Enlightened Shareholder Value*, Lloyd's Mar. & Com. L. Q. 341–346 (2006).

[44] *Fulham Football Club Ltd v. Cabra Estates Plc* [1994] 1 BCLC 363 (CA).

[45] Report of the Parliamentary Commission on Banking Standards, Changing Banking for Good, House of Lords, House of Commons, 2013. *See* http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf.

[46] Letza Steve, Sun Xiuping & Kirkbride James, *Shareholding Versus Stakeholding: A Critical Review of Corporate Governance* 12(3) Corp. Governance 243 (2004).

[47] Yavasi Mahmut, *A Socio-legal and Economic Introduction to Corporate Governance Problems in the EU*, 22(6) Com. Law. 163 (2001).

[48] Deryn, *supra* n. 24, at 12.

[49] Cheffins R. Brian, *Company Law, Theory, Structure and Operation* 41 (Clarendon Press 1997).

[50] Belcher, A., *The Boundaries of the Firm: the Theories of Coase, Knight and Weitzman*, 17 Legal Stud. 22 (1997).

[51] Alchian & Demsetz, *supra* n. 2, at 777.

central position in 'the contractual arrangements of all other inputs'.[52] However, even if a purely contractual basis for the company is accepted, it can be hardly viewed as independent from its regulatory background. The governance of corporations is indeed determined not only through contracts but also through law and societal norms which impact on the nature of the economic model adopted by each country. The interrelationship between these three pillars of corporate governance is indeed very complex and, as their character is deeply rooted in the cultural values, dominant in a given society.[53] It has to be noted that although contracts are the outcome of the agreement between private actors, they cannot be viewed in isolation from the state and the jurisdiction within which they operate. The contracts are written under the 'shadow of the state'[54]; therefore laws and societal norms affect the content of contracts and they determine the nature of corporate law and corporate governance because they constitute the background factors that the parties need to take into account when they negotiate. Neglecting the regulatory, normative and societal background of the contractual arrangement will not therefore insulate the company from external influences and interventions. The latter are indeed inherent even in the contractual agreement which binds its members. Under this theory, company law should have as its sole objective the maximization of shareholder value. To this end it must set default rules that maximize the efficiency of negotiating the nexus of contracts. In this way transaction costs can be reduced 'as negotiations do not need to take place in every single transaction … the emphasis is on investors' choices'.[55] The corporation in this framework is to be understood as 'the product of a series of organisational innovations that have had the purpose and effect of economising on transaction costs'.[56]

The nexus of contracts theory places a focus on the network of contractual relations existing within a company, but it does not take into consideration and therefore analyse the different nature of the contracts involved. There are actors such as the employees and suppliers who sign contracts with the company, setting the specific legal framework within which they are going to supply either their personal labour or specifically defined products and services to the legal person that is the company. Therefore, stakeholders other than shareholders 'can have a stake in a portion of a company's surplus through their contracts with the company'.[57] It is not clear why, in an entity which is viewed as a network of interconnected contracts, supremacy is handed to the contract between the shareholders and the company. The shareholders are 'the only group whose contract with the company is relational'.[58] Other providers of finance or labour have contracts setting in detail how much interest or remuneration they should be paid. Shareholders have no guaranteed payments because the directors, as explained above, have absolute power over the level of dividends paid to shareholders. Therefore, it is clear that even if there was one shareholder who held all of the shares of a company 'he or she would not truly be the sole residual claimant, for many others' welfare would be affected by managers' decision at least ex post'.[59] Hence, the only time when shareholders are literally treated as residual claimants is when the company is insolvent or approaching insolvency.[60] So, the dominant theory views the shareholders as the owners who should enjoy absolute supremacy within the company, but shareholders lack the ability to control the corporate assets. Unlike ordinary principals, shareholders lack the ability to control the board and its decision-making process in many cases. And unlike residual claimants, shareholders are neither entitled nor in a position to demand dividends.[61]

6 Shareholders' protection within this context: the remedy of section 994 CA2006

The position of directors within the English company is evidently defined by the nature of the agreement on which the operation of the company is based. Section 17 of the Companies Act 2006 explicitly refers to the constitution of the company as the document which comprises the articles of association, along with any special resolutions that have altered their provisions in the course of the company's life and operation. Section 33 clarifies that the provisions of the articles bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions. The terminology employed is also of particular importance; the Companies Act does not make a reference to the 'shareholders' at this point. Instead, the preferred term is 'members'. This is an expression of the status of the shareholders as the only constituent members of the company. - English company law may accept the principle of shareholder primacy as one of its pillars and most distinctive features, but on key issues such as minority protection it 'has historically been very shareholder unfriendly'.[62] If shareholder supremacy was based on solid grounds, then shareholders should have had sufficient protection against abuse of directorial powers in the shape of effective remedies.[63] Minority shareholders are therefore left with the choice to found their claims on either section 994 of the Companies Act 2006 – in case of private companies – when the company is being run in an 'unfairly prejudicial manner' for their own interests, or to raise a so-called derivative action on the basis of sections 260–263. Common law provided little

[52] *Ibid.*

[53] Dine Janet & Koutsias Marios, *The Nature of Corporate Governance* (Edward Elgar 2013).

[54] Macey, *Corporate Governance, Promises Kept, Promises Broken* 31 (Princeton University Press, Princeton NJ 2008).

[55] Lee, J., *Shareholders' Derivative Claims under the Companies Act 2006: Market Mechanisms or Asymmetric paternalism?*, 18 Int'l Co. & Com. L. Rev. 11, 379 (2007).

[56] Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. Econ. Lit. 1537 (1981).

[57] Fisch J., *Measuring Efficiency in Corporate Law*, 31 J. Corp. L. 637 (2006).

[58] Padgett Carol, *Corporate Governance* 21 (Basingstoke: Palgrave Macmillan 2012).

[59] Keay Andrew, *The Enlightened Shareholder Value Principle and Corporate Governance* (London: Routledge 2013).

[60] Stout Lyn, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1193 (2002).

[61] Stout Lynn, *New Thinking on Shareholder Primacy*, in *Corporate Governance After the Financial Crisis* 31 (Vasudev P.M. & Watson Susan eds, Edward Elgar 2012).

[62] Dignam Alan & Galanis Michael, *The Globalisation of Corporate Governance* 245 (Surrey: Ashgate 2009).

[63] Chiu H. Iris, *Contextualising Shareholders' Disputes – A Way to Reconceptualise Minority Shareholder Remedies*, (May) J. Bus. L. 312 (2006).

protection to a shareholder who had been treated unfairly but lawfully by the majority[64]; this is a principle clearly reflected at *Foss v. Harbottle*. The two sets of articles have been applied and interpreted by the courts in a way that severely limits the ability of minority shareholders to exercise effective control on the powers of the management.

7 Section 994 of the companies act 2006 under the spotlight

The exercise of the remedy in question, which is the most popular form of minority shareholder protection in the UK, evidently results in the departure of the aggrieved shareholder from the ineffectively managed company rather than a change in the quality, style and methods of management that have led to the company suffering losses. Therefore, the successful invocation of the remedy of section 994 will result in the company getting rid of the protesting shareholder rather than the ineffective director who most likely would have breached the duty he owed to the company, therefore providing the grounds for successfully resorting to section 994. The management can benefit from the aggrieved and protesting shareholder's removal from the company, which will effectively remove a potentially menacing thorn from the directors' side. Companies naturally come in all shapes and sizes, from the publicly listed multinationals to the 'quasi-partnership'.[65] Section 994 is mostly relevant within the context of the latter as it provides for the ability of a shareholder to be bought out of the company; in the case of publicly listed companies a shareholder is in any case in a position to sell his shares to third parties. Shareholders are viewed as the exclusive members of the company. Section 994 is centred on the notion of 'membership interests'. As it was explained in the article membership in the English company is a contractual relationship.[66] The latter is at least in theory inclusive of the legal rights of a shareholder found within the statute as well as in common law and in the company's articles of association.[67]

Political theorists and constitutional lawyers have put in place mechanisms which promote majority rule while simultaneously protecting the rights of minorities which have to abide by majority rule. This is due to the recognition of the importance of protecting minorities when dissenting from majority view. This principle constitutes one of the most discernible aspects of a democracy. One cannot claim that the same delicate balance has been achieved at corporate level. If minority shareholders' remedies are all about assisting the shareholders to deal with cases of a breach of directors' duties which can lead to potentially significant losses, then the remedy in question has not only failed to deliver this aim, but has led to the directors removing an annoying source of complaints from their agenda. The minority shareholder might be able to release himself from the company on the basis of onerous requirements and reinvest elsewhere, but the company he left behind may sustain a failing system of management accompanied with an ineffective set of controls and checks. The practical inability to enforce a strict system of internal checks on the directors' actions, even in cases of a breach of duty, is a feature integral in the function and application of English company law. While the protection granted by section 994 is indeed extensive,[68] the courts have severely limited its scope of application. The effectiveness of section 994 as a means of affording effective minority protection is dependent upon the discretion of the judges when dealing with the notions of unfairness and legitimate expectations.[69] And this may lead to a lack of clarity as to the exact set of rules and criteria to apply in a given case. A purely contractarian view allows each shareholder to enforce the shareholders' agreement or the articles of association in a way which disregards the interests of other shareholders. The shareholders are recognized as the exclusive members and owners of the company, yet not only do they not control the management but they are not even provided with an effective range of remedies in case of managerial abuse. In fact the implementation of the remedy of section 994 by the courts demonstrates not only a lack of effective control upon the management of the company but also a clear undermining of the rights of the shareholders which stem directly from their shares such as the right to vote. In another Commonwealth jurisdiction – Hong Kong – in the *Luck*[70] case, the court blocked the shareholders' right to vote against a corporate resolution aiming at amending the company's articles of association as this was deemed as 'unfairly prejudicial' for the affairs of the company.[71] This approach seems to cut through even the absolute essential layers of protection of shareholders and to deprive them of the fundamental bundle of rights that flow directly from the ownership of their shares. It is astonishing that a jurisdiction can claim to have shareholder supremacy in its contractual core while failing to enforce even the core of shareholders' rights. The distance between theory and practice could not be any more evident. The right of a shareholder to vote 'his shares is a right of property which the shareholder is free to exercise in what he regards as his own best interest'.[72] Yet it seems that these rights could be set aside under certain circumstances while using the provisions aiming at shareholder protection. This is an irony of the law that highlights the necessity to reform the nexus of contracts theory and its legislative application.

The UK continues to rely heavily on the private enforcement of breaches of the duties and on soft-regulation in the form of non-binding corporate governance codes which put in place a set of standards to which directors shall adhere.[73] Although it is evident that the market can affect how directors act, it is necessary to have a means of external discipline such

[64] McGuiness Kevin & Copp Stephen, *Protecting Shareholder Expectations: a Comparison of UK and Canadian Approaches to Conduct Unfairly Prejudicial to Shareholders: Part 1*, 11(5) Int'l Co. & Com. L. Rev. 184 (2000).

[65] Grantham B. Ross, *The Doctrinal Basis of the Rights of Company Shareholders*, 57(3) Cambridge L. J.557 (1998).

[66] McGuiness Kevin & Copp Stephen, *Protecting Shareholder Expectations: A Comparison Of UK and Canadian Approaches to Conduct Unfairly Prejudicial to Shareholders: Part 2*, Int'l Co. & Com. L. Rev.219 (2000).

[67] Griffin Stephen, Shareholder *Remedies and the No Reflective Loss Principle – Problems Surrounding the Identification of a Membership Interest*, 6 J. Bus. L.468 (2010).

[68] Payne Jennifer, *Sections 459–461 Companies Act 1985 in Flux: The Future of Shareholder Protection*, 64(3) Cambridge L. J. 647 (2005).

[69] Lowry John, *The Pursuit of Effective Minority Shareholder Protection: Section 459 of the Companies Act 1985*, 17(3) Co. Law. 67 (1996).

[70] *Luck Continent Ltd v. Cheng Chee Tock Theodore* [2013] 5 HKC 442; [2013] 4 HKLRD 181.

[71] Fong Adrian, *Unfair Prejudice by Minority Shareholders of Listed Companies*, 131 (July) L.Q. Rev.367 (2015).

[72] *Re Astec* (BSR) Plc [1998] BCLC 556 at 584.

[73] Keay Andrew, An *Assessment of Private Enforcement Actions for Directors' Breaches of Duty*, 33(1) Civ. Q. J. 76–77 (2014).

as the ability to initiate legal proceedings.[74] Therefore, a laissez-faire approach leads to the undermining of the interests of the alleged owners of the company which is directly in contrast with the theory's basic assumptions. This is made even more evident by section 239 of CA2006 which allows shareholders to ratify directorial liability save certain exceptions. It is indicative of the lack of willingness on the part of the legislative and judicial authorities to intervene in corporate life unless this is rendered imperative. In *Re Elgindata*,[75] it was stated that a court would normally be hesitant 'in finding that a member had a right to expect from directors a reasonable standard of management … when investing in a company shareholders take a risk that management may prove not to be of the highest quality'. The shareholders are claimed to be the supreme class of actors within the company yet they are unprotected because that would negate the private character of the company. This is a serious defect of the theory that not only comes into conflict with its primary assumptions in relation to the status of shareholders but it also results in an admittedly low level of shareholder protection.

8 The unfair prejudice question

Sections 994–996 replace sections 459–461 of the Companies Act 1985, providing a remedy for a member when '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'. The meaning of unfair prejudice has been described by many parties as opaque and elusive.[76] Consideration was given to the meaning of unfair prejudice in *Re Bovey Hotel Ventures (31 July 1981)* unreported, quoted in *Re R.A. Noble & Son*.[77] Slade said: 'a member of a company will be able to bring himself within the section if he can show that the value of his shareholding in the company has been seriously diminished or at least seriously jeopardised by reason of a course of conduct on the part of those persons who do have de facto control of the company, which was unfair to the member concerned'. He suggested that the test should be an objective one: 'would the reasonable bystander observing the consequences of their conduct … regard it as having unfairly prejudiced the petitioner's interest?' This text was adopted by the court in the *R.A. Noble* case. In that case a clear distinction was drawn between the prejudice which was held to have occurred and the unfair element which was not shown. In *Re Macro*,[78] the court held that where conduct was unfairly prejudicial to the financial interests of the company then it would also be unfairly prejudicial to the interests of its members. In assessing the fairness of the conduct the court had to perform a balancing act in weighing the various interests of different groups within the company. The court did not interfere in questions of commercial management but where the mismanagement was sufficiently significant and serious to cause loss to the company then it could constitute the basis for finding unfair prejudice. The concept of unfairness is thus capable of being a very broad one indeed.

The concept of unfair prejudice is larger than the idea of infringement of legal rights. In *Re A Company*,[79] Hoffman J said that in a small company 'the member's interests as a member may include a legitimate expectation that he will continue to be employed as a director and his dismissal from that office and exclusion from the management of the company may therefore be unfairly prejudicial to his interests as a member'. This is of particular interest as the court appeared to have introduced an additional requirement to the statutory provision. Whilst section 994 is clear, the courts introduced the requirement of 'legitimate expectations' and therefore limited its scope of application to a significant extent.

The same view was taken in *Re Sam Weller & Sons Ltd*,[80] where the court refused to strike out a petition alleging unfair prejudice by a failure to declare an adequate dividend. The court emphasized that 'interests' should be considered as wider than 'rights'. This seems to slightly deviate from the contractual nature of the company. The court will look beyond the contract – the articles of association and focus upon any fundamental understanding of the parties involved which may have been breached by managerial conduct. That means that equitable principles may be introduced in the courts' thinking. That may expand shareholders' protection but it also creates a grey area which undermines legal certainty. Despite that, it is evident that a strict contractual approach may be difficult to define at this stage. The contractual approach in relation to remedies may prove problematic in more than one way. If the unfair prejudice remedy was based on contract then shareholders may have had the capacity to contract out of the remedy altogether.[81] This is not possible however as the availability of the remedy is rendered imperative by law and it does not fall within the freewill and the contractual willing of the private parties involved. However, these issues also demonstrate the shortcomings of the contractual theory and the malfunctions of its application.

It should be noted that this wide view seems to be more easily adhered to in cases where a small company is involved, but it has recently been litigated in a number of sporting contexts. In *Re Leeds United Holdings plc*,[82] the court held that: 'The legitimate expectations which the court has to have regard to under s. 459 (previous numbering of the current section 994) must relate to the conduct of the company's affairs, the most obvious and common example being an expectation of being allowed to participate in the affairs of the company.' However, the court went on to dismiss the section 459 action in that case because it was based on an expectation that a particular shareholder would not sell his shares without the consent of the other shareholders. This was held not to relate to the company's affairs and therefore fell outside section 459.

Therefore, although there have been a considerable amount of cases concerning the issue of corporate wrongs litigated in the context of unfair prejudice claims, the

74 Welsh M. & Jones R., *Toward a Public Enforcement Model for Directors' Duty Oversight*, 45 Vand. J. Transnat'l L. 347 (2012).
75 *Re Elgindata No. 1* [1991] BCLC 959.
76 Griggs Lynden & Lowry P. John, *Minority Shareholder Remedies: A Comparative View*, (Sept.) J. Bus. L. 466 (1994).
77 *Re R. A. Noble & Son* (Clothing) Ltd [1983] BCLC 273.
78 *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354.
79 *Re A Company* [1986] BCLC 376.
80 *Re Sam Weller & Sons Ltd* (Re A Company No. 823 of 1987) [1990] BCLC 80.
81 Paterson Paul, *A Criticism of the Contractual Approach to Unfair Prejudice*, 27(7) Co. Law.204, 212 (2006).
82 Re Leeds United Holdings plc [1996] 2 BCLC 545.

circumstances in which the court would grant a remedy in an unfair prejudice claim remain unclear and uncertain. The difficulties encountered by the courts might seem to suggest that this is not an issue that should have been left to the judiciary to interpret and at the end dilute but rather for the legislator alone so as to achieve clarity and legal certainty.[83] Section 994 'launches the courts on a discretionary voyage of discovery as the landmarks of established illegalities are obliterated on a judicial interpretation of what action amounts to unfair prejudice'.[84] But as it is the case when a notion is left to the discretion of an authority to define, there is always a question of the elasticity of its judgment criteria as judicial discretion may be exercised arbitrarily when well-defined parameters are absent. The problem here is that the concept of 'unfair prejudice' is now a pre-requisite for the application of section 994 and for the successful granting of the remedy in question to an aggrieved shareholder. However, the shaping of an unfair prejudice claim to qualify as a breach of the agreement made between the shareholders and the company or the shareholders *inter se* is constructed in a very broad sense and includes any understanding held by shareholders whether or not it is reflected in the articles.[85] And that 'understanding', which may not have been included in the formal agreement, is a fluid notion that can be interpreted and defined by the court almost on a case by case basis, further blurring the already difficult to discern boundaries of section 994. The courts are left with a vast scope of interpretation that leads to a considerable degree of legal uncertainty as the rules to be applied are anything but fixed.

9 The legitimate expectations question

In England the concept of 'legitimate expectations' has evolved with relatively little 'judicial consideration being paid to its rationale during the course of its evolution'.[86] The important case of *Re Saul D Harrison & Sons plc*[87] contains an extensive analysis of the operation of section 459 (former section 994) to protect 'legitimate expectations'. Hoffman said:

> In deciding what is fair or unfair for the purposes of s. 459, it is important to have in mind that fairness is being used in the context of a commercial relationship. 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 … Since keeping promises and honouring agreements is probably the most important element of commercial fairness, the starting point on any case under s. 459 will be to ask whether the conduct of which the shareholder complains was in accordance with the articles of association

The term 'unfairly prejudicial' was found as equivalent to the understanding of 'oppression' in *Elder v. Elder and Watson*[88]: 'A visible departure from the standards of fair dealing and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely.' The courts therefore are eager to look beyond and outside the actual contract – in the form of the articles of association – and to recognize an expectation, such as the expectation to participate in the management. Therefore, the courts have attached a requirement in granting the remedy to the shareholders and that is a vague expectation to participate in the management on the part of the aggrieved shareholder. This has further inhibited the shareholders in their attempt to resort to this remedy.[89] Directly or indirectly the concept in question is defined by reference to the parties' *ex ante* understandings and expectations; therefore the extent and the nature of the expectations and intentions of a variety of corporate actors form part of hypothetical assumptions. This means that section 994 gives effect to a hypothetical bargain characterized by a high level of generality.[90] It is only natural that at this stage generality is accompanied by uncertainty too as there is no pattern against which the legitimate expectations can be measured or assessed. At this point it is important to distinguish a shareholder's claim of legitimate expectations which deserve legal protection from others which do not; it is in this context that the scope of a court's power to grant the protection of section 994 is extremely wide.[91] It 'enables judicial interference in private bargains resulting in the imposition of judicial notion of fairness'.[92] That judicial attitude however reveals yet another flaw of the contractual theory in the context of which the contractual nature of the company should be adhered to. If the contractual nature of the company was to be literally or rightfully implemented, then private individuals should have been left to pursue their own choices and the 'invisible hand' of the market should have been left to operate with as little governmental interference as possible. It is an integral part of the contractual theory that state interference in corporate affairs is undesirable and in a way unnatural as it is distortive of the market in which voluntary exchange takes place.[93] Therefore, it appears that this judicial approach may come into conflict with the principles which stand at the foundations of English company law. It serves as a proof of the fact that the contractual theory appears to be dogmatically accepted by the legislature, academia and the courts, but its basic principles are set aside by both the judiciary and the modern corporate realities.

The question in relation to who has a legitimate expectation to participate in the management of the company is one which cannot be answered with any degree of certainty. The only shareholders who can clearly fulfil this requirement are the ones who had previously been directors of the company; despite their removal from the board they can claim that since they were previously a part of the management they still have a legitimate claim to continue as a part of it. There is an element of injustice in this, as directors may have been

[83] Cheung Rita, *Corporate Wrongs Litigated in the Context of Unfair Prejudice Claims: Reforming the Unfair Prejudice Remedy for the Redress of Corporate Wrongs*, 29(4) Co. Law. 103 (2008).

[84] Abugu E.O. Joseph, *A Comparative Analysis of the Extent of Judicial Discretion in Minority Shareholder Protection Litigation: The United Kingdom and United States*, 18(5) Int'l Co. & Com. L. Rev. 188 (2007).

[85] Paul, *supra* n. 81, at 133.

[86] Kevin & Stephen, *supra* n. 66, at 219.

[87] *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14.

[88] *Elder v. Elder and Watson* (1952) SC 49.

[89] Nwafor O. Anthony, *Unfair Prejudice Remedy: A Relief for the Minority Shareholders – a Comparative Perspective*, Int'l Co. & Com. L. Rev. 287 (2011).

[90] Goddard Robert, *Enforcing the Hypothetical Bargain: Sections 459–461 of the Companies Act 1985*, 20(3) Co. Law. 73 (1999).

[91] Fang Ma, *A Challenge for China: Is It Possible to Introduce Unfair Prejudice Remedies? Part 1*, 20(12) Int'l Co. & Com. L. Rev. 419–420 (2009).

[92] Atwal Harkamal, *Self-interest, Justice and Reciprocity in Unfair Prejudice*, 11 UCL Juris. Rev. 271 (2004).

[93] *Ibid.*, at 274.

removed from the board due to a breach of duty, but if they hold shares in the company, they are recognized as having fulfilled one of the basic requirements set by the courts which will allow them to trigger section 994 successfully. There have been no clearly defined guidelines by the court as to who can claim such an expectation. And since the latter form a requirement for the section 994 remedy to be granted it is obvious that the application of the latter is based on obscure terms. Companies therefore are affected by the uncertainty arising from a section 994 action as the section has to be 'all things to all people'.[94] That is further supported by the view that in listed companies the court's approach will usually be that 'legitimate expectations of members are limited to compliance with the memorandum and the articles',[95] therefore they are strictly linked to the contractual agreement and its breach while not going above the contractual text. In *Blue Arrow*,[96] the courts were clearly unwilling to recognize any legitimate expectations beyond the constitution. The court stated that 'this is a public company, a listed company, and a large one and that the constitution was adopted at the time when the company was first floated on the Unlisted Securities Market. Outside investors were entitled to assume that the whole of the constitution was contained in the articles, read, of course, together with the Companies Acts. There is in these circumstances no room for any legitimate expectation founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public.'[97] Therefore in public companies the scope for manoeuvre is even slimmer. It is astonishing that despite all these deficiencies, which are integral in the implementation of section 994, the relevant remedy is still the principal of the remedies available to protect minority shareholders from oppression.[98]

O'Neill and Another v. Phillips[99] was the first case concerning section 459 to come before the House of Lords. Therefore, the terms 'unfair' and 'prejudice' have been defined in such a wide and general manner that the circumstances in which they can be applied cannot be delineated exhaustively.[100] The size of litigation caused concern as to a potential flood of cases[101] and *O'Neill* responded by adopting a narrower interpretation of 'unfair prejudice'. While one may assume that this would have enhanced legal clarity, it actually led to further narrowing down the ambit of section 994 by adding requirements to its application which go beyond the statutory text. Thus, the judicial approach to unfair prejudice in the UK has undergone what has been described as a 'conservative revisionism'[102] as the manner in which unfairness was constructed (in *O'Neill*) might lead to cases of injustice. In addition to that, the existing case law on this matter demonstrates that the court's approach to assessing the existence of unfairly prejudicial conduct is a result of their jurisdiction under section 994 'which has an elastic quality which enables the courts to mould the concepts of unfair prejudice according to the circumstances of the case,'[103] with an obvious impact on legal certainty. Lord Hoffman held that the existence of a quasi-partnership did not, of itself, give a right to a member to have his shares purchased; 'fairness' usually required some breach of the terms on which the member had agreed that the affairs of the company should be conducted. Section 459 had a very clear function and that was to protect shareholders against a breach of terms on which they had initially joined the company or from inequity in the sense noted by O'Neill. While that may seem to be bringing the focus back to a contractual approach, Lord Hoffman recognized that there may be cases where terms may be implied into an agreement and form part of the parties' wider understanding. That means that at least hypothetically there may be a conflict between the parties' understanding and expectations flowing from the contract and its express terms. This would be inconsistent with conventional contract law and underlines the difficulty to apply such an approach in company law. But there is an additional issue that needs to be taken into account as it sheds light on the malfunction of the contractual approach on shareholders' remedies. It is quite possible that there is a case of a breach of an expressed provision of the articles – an express term of a contract – yet the term in question is of a questionable validity[104] as it comes into contrast with the Companies Act 2006. For example there is a provision enshrined in the articles which renders a director irremovable from the board unless a special resolution is passed by the general meeting. Therefore, it would be quite controversial to argue whether the infringement of such a provision would constitute a breach of contract that could trigger section 994. In addition to that, in cases of breach of contract usually the aggrieved party is granted damages; in this case however the courts may prevent the aggrieved party from pursuing his claim even if an expressed term of the contract is breached. That reveals a fallacy of the contractual approach that highlights the problems inherent in the contractual understanding of the company.

10 Conclusion

The article challenged the dominant view in both academia and practice that the principles of absolute shareholder supremacy and exclusivity are solidly founded upon theory and law. It argued that the edifice of shareholder supremacy is based on shaky theoretical foundations and it should be reformed. Its reform is necessary because modern corporate reality has rendered the dominant theory obsolete. In practice shareholder supremacy has given its place to managerial dominance; the latter has shifted the focus of the company to short-term goals which are not only detrimental for the company as a whole but also for the shareholders more specifically. The dominant theory has therefore created a set of contradictive principles; it supports the ownership of the company by the shareholders yet it denied to the shareholders the rights normally granted not just to owners but

[94] Roberts Pauline & Poole Jill, *Shareholder Remedies – Efficient Litigation and the Unfair Prejudice Remedy*, (Jan.) J. Bus. L. 41–42 (1999).
[95] Sykes Paul J., *The Continuing Paradox: A Critique of Minority Shareholder and Derivative Claims under the Companies Act 2006*, 29(2) Civ. Just. Q. 211 (2010).
[96] *Re Blue Arrow* [1987] BCLC 585.
[97] *Re Blue Arrow* [1987] BCLC 585 at 590.
[98] Jennifer, *supra* n. 68, at 647.
[99] *O'Neill and Another v. Phillips* [1999] 2 BCLC 1.
[100] Clark Bryan, *Unfairly Prejudicial Conduct: A Pathway Through the Maze*, 22(6) Co. Law. 171 (2001).
[101] Iris, *supra* n. 63, at 315.
[102] Cheung Rita, *The Statutory Unfair Prejudice Remedy in Hong Kong: Part 3*, 29(11) Co. Law. 346 (2008).
[103] Tang Julia, *Shareholder Remedies: Demise of the Derivative Claim?*, UCL J. L. & Juris. 207 (2012).
[104] Iris, *supra* n. 63, at 314.

also to the providers of capital. And while the courts are in principle fervent supporters of shareholder supremacy, the case law on shareholders' remedies has effectively curtailed shareholders' rights to an unacceptable degree. It is therefore evident that shareholder supremacy is nowadays purely ideological; a degree of dogmatic adherence to ideologies which were rendered obsolete by reality created a problematic situation within company law which has the company and its shareholders as one of the main victims. Legislators should set aside any ideological dogmatism and reform the law so as to address these issues and prepare the company to adjust to the realities and the challenges of the twenty-first century while playing its societal role effectively. Section 172 of the 2006 Act was certainly not an effective step towards this direction. Section 172 includes a list of stakeholders whose interests have to be taken into account when the directors are exercising their duty to promote the success of the company. The reality is that nothing changed in relation to the composition of the corporation in the UK context. The fact that for the first time a variety of actors were included in the section which appears to be the legislative cornerstone of directors' duties in the UK led to discussions of a shift in the relevant landscape, bringing the country closer to a German-style stakeholder model where shareholder primacy is gradually set aside to establish a model where all the relevant actors find their place in the governance structure of the British company. The UK did not adopt a more pluralist stakeholder-orientated approach. Quite in contrast to that, section 172 reconfirmed the principle of shareholder supremacy. The shareholders retained their status as the exclusive members of the company. In addition to that, the duty of directors to have regard to the interests of other stakeholders is still owed to the company and only to it. The interests of stakeholders can be taken into account in so far as they are deemed compatible with the interests of the company. If the duty imposed by section 172 is breached, it is again for the company – and not for the stakeholders included in the relevant list – to act. Therefore, the only appropriate litigants are still the shareholders but in practice – as it was thoroughly explained in the article – even they face paramount obstacles in holding the management to account. Especially a minority shareholder is left with a minimal and quite restrictive set of choices when aiming at monitoring the management. Therefore, we ended up with a company where the stakeholders are excluded from it and the shareholders while nominally and theoretically dominant in reality face many challenges in their attempt to hold the management to account. Section 172 does not challenge the regime of directorial dominance. It creates a company where stakeholders are external and shareholders albeit supreme are not in a position to exercise the rights stemming from their shares. The law should be reformed to deal with this anomaly. Shareholders should be in a position to exercise the full range of rights stemming from their shares, including the effective monitoring of management, and stakeholders should be brought within the corporate context. Ideological dogmatism should be set aside for the sake of the protection of the rights of shareholders and stakeholders alike. In an era of globalization and increased corporate presence this is a goal that needs to be achieved.