

ORGANISING A SHAREHOLDERS ACTION GROUP

Background

Shareholder activism has become a subject of considerable debate over the last few years. In the USA much publicity has been given to activities of shareholders in pursuit of litigation for misstatements by companies and their directors or indeed plain fraud. The position in England is that shareholders have limited rights to claim damages against either the auditors of the company or the directors. The overriding principle is that having been elected directors are directly responsible to the company, not the shareholders, and manage the company with reasonable autonomy. Neither the shareholders nor the court have the power to second-guess that management process. If the directors get it wrong then shareholders will not re-elect them next time round.

Accordingly shareholder activism takes a very different form this side of the Atlantic. Indeed it might be said that shareholder activism here is a more constructive and positive activity altogether. This process does however leave the individual shareholder (or even the large institutional shareholder) with little or no ability to influence events alone. For this reason shareholders large and small are starting to club together into groups.

Voting power

The fundamental principal reflected in the law of England & Wales (and for that matter in other common law jurisdictions such as Ireland, Australia and New Zealand) is that the control of the company and its directors by shareholders is exacted through the annual general meeting. Shareholders control directors of the company through the election of those directors at the annual general meeting.

In companies quoted on regulated markets shareholders have the additional card of being able to exert some control over the remuneration of directors. Following the Cadbury and Greenbury Study Group Reports the Yellow Book, which regulates affairs on the London Stock Exchange, was amended to require companies to include in the report to shareholders and annual accounts a statement that it has followed the Code of Best Practice recommended by the Greenbury Report. Further, accounts have to include a report from the remuneration committee (of which usually the non-executive directors have control) to the shareholders containing specific disclosures in relation to directors' remuneration. Additionally, auditors are required to report on certain of the disclosures and whether the company

has complied with the Code of Best Practice. These reports are put to the shareholders and they can be either accepted or rejected.

Accordingly, the question of remuneration of the directors can become a battleground between shareholders and the management of the company.

Shareholders are entitled to require that a resolution should be put to a general meeting of the company and indeed have an entitlement to require that a company should call an EGM. Minority shareholders holding 5% of the voting rights or 100 or more shareholders with shares upon which an average of not less than £100 has been paid up can require a company to circulate a resolution for discussion at the company's AGM. They can also require the company to circulate a statement of no more than 1000 words regarding a resolution or business to be dealt with at any general meeting. In order to require the company to call an EGM the shareholders must control 10% of the voting rights.

It will be seen thus that although the powers of shareholders are somewhat restrictive, they can be used to positive effect by shareholders grouping together.

Shareholders' rights against officers of the company and professional advisors

Although the remedies open to shareholders to bring matters before the Court are limited, they can be effective in certain circumstances.

Minority shareholders have some protection under the law provided by Section 459 Companies Act 1985. Save for this provision, the courts place a restriction on the ability of minority members wishing to complain about the conduct of the majority. This is known as the rule in *Foss -v- Harbottle*. This restriction does not, however, apply if:-

- the act complained of is ultra vires the company or otherwise illegal;
- the individual rights of the member have been infringed;
- a special procedure has not been followed; and
- there is a "fraud" on the minority.

Section 459 enables a member to apply to the court for relief on the ground that:-

The company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of its members or that any actual or proposed act or omission of the company ... is or would be so prejudicial.

This is not the place to enter into the detail of that Section and the very substantial legal precedents that have been established under it. It can be a costly process with the outcome very much in the discretion of the court.

Statutory protection of investors

The law determines that neither directors nor professional advisors to a company have obligations to potential investors. There are certain potential liabilities to existing members. For instance, directors and auditors may be liable for false information given to shareholders. It is, however, quite difficult to prove the damage suffered as a result.

The position at English law in relation to the liability of auditors and directors to potential investors is often seen as overly restrictive and is very different from the position in the United States, where shareholder claims are very much part of the regulatory process.

In considering an investment a potential investor is bound to give some considerable weight to the last published results of the company. These will have been passed both by the directors and the auditors. Both will have effectively verified the results to be accurate. If, however, it turns out that they are inaccurate or indeed wholly false, there is no liability of the directors or the auditors to persons investing on the basis of those results, despite the fact that those investors will have relied upon them heavily in making the decision to invest.

Initially the Courts decided that auditors and directors may owe a duty of care to potential investors (*JEB Fasteners Ltd -v- Marks Bloom & Co*) but this principle was firmly put down in the well known authority of the House of Lords, *Caparo Industries Plc -v- Dickman & Others*. The House of Lords decided in that case that the accounts and auditor's report were intended to provide members simply with information as to the company's affairs, make judgements on its management and thereby exercise effective control over the company in general meeting. Although the case cannot be over simplified, the House of Lords rejected the liability of auditors to shareholders on the basis that there is insufficient proximitous relationship between the two. It is this area that the principles of law here and the United States divide. This principle is much debated but as things currently stand it seems unlikely that it will change. The courts have made some inroads into it. There has been a recent case

in Scotland in which a lender was entitled to pursue auditors on the basis of the audited results but there was in that case a more direct relationship between the lender and the auditors (see *Royal Bank of Scotland Plc -v- Bannerman Johnstone Maclay (a firm) & Others*).

Statutory exceptions

There are, however, three major exceptions to the principles espoused by the House of Lords in *Caparo*:-

- Section 90 Financial Services & Markets Act 2000
- Sections 84 & 85 Companies Act 1985
- Section 118 Financial Services & Markets Act 2000

False or misleading statements

Section 90 of the FSMA provides that anyone responsible for listing particulars is liable to pay compensation to a person who has acquired securities to which the particulars apply and suffered loss as a result of the false or misleading statement. An accompanying statutory instrument provides basically that anyone who puts their name to the particulars is liable on them including the directors and the market sponsor or merchant bank. It is quite usual for the professionals advising in relation to the prospectus to limit their liability to certain sections of the prospectus. Section 90 applies to the main market but there are similar regulations for all public issues under the Public Offers of Securities Regulations 1995.

These statutory provisions provide the basis for legal actions by shareholders in relation to the issue of shares to the public in which unfortunately there have been many instances of false and misleading statements. Before compensation is payable there are certain prerequisites. The shareholder must prove reliance on the prospectus and the loss must derive from the false and misleading statements.

In addition to the statutory provisions there is also potential liability in the ordinary course under the principles of negligent misstatement.

Minimum subscription not achieved

In addition, there is a much less used provision in the Companies Act which supports the notion that the issue of shares must achieve a degree of success before it becomes binding on investors. This equates with a minimum prescription under the prospectus before it truly comes into effect. Prospectuses will usually contain a provision that the company is seeking to achieve a certain minimum level of investment. To support this concept, Sections 84 and 85 of the Companies Act provide that an allotment cannot proceed unless the minimum subscription is achieved. If, contrary to this provision, shares are allotted, the transaction is voidable and directors are personally liable for appropriate recompense.

Market abuse

The Financial Services & Markets Act 2000 has introduced a wide range of provisions under which the Financial Services Authority now acts. One of those upon which investors may increasingly rely is the concept of “market abuse”. This is defined by Section 118 of the FSMA. This includes behaviour that creates a false or misleading impression as to the supply of, or demand for, or as to the price or value of investments on the market.

Through the Financial Services Authority the losses suffered by shareholders as a result of market abuse can be made good by the court. This is a relatively untried provision although the Authority has started to make declarations of market abuse against directors and companies.

ORGANISING THE GROUP

Getting people together

Shareholders often feel isolated in that they have no knowledge of or communication with other shareholders.

Details of other shareholders are, however, available. These can be obtained from Companies House. Each company must file with the Registrar of Companies a list of its shareholders with its annual return. The list is a snapshot of shareholders at a particular date and is therefore historic but should prove relatively accurate as to current shareholders.

For a more up to date list, anyone is entitled to inspect the shareholder list at the registered office of the company subject to the payment of a small fee.

The share register will contain names and addresses from which phone numbers may be obtained or the addresses can be used for correspondence.

If the issue on which the group is organising relates to an offer to buy shareholders' shares, shareholders have to be careful in communications with other shareholders that they do not breach the City Code. That Code proscribes certain activities by shareholders. Shareholders must be careful when acting in concert that, for instance, they do not step over the mark under Rule 9 of the City Code that deals with mandatory offers. This is the best known provision of the Code but additionally, during an offer period, shareholders' activities are restricted. By way of example, Rule 19.5 of the City Code places substantial restrictions on shareholders conducting telephone campaigns in relation to an offer. The Code and compliance with it is overseen by the Take Over Panel, whose details appear at the end of this note.

How will the group operate?

Organising a shareholder group very much depends on the circumstances in which that group is to operate and the end goal.

Common to all groups is the necessity to establish how the group will conduct itself, the setting of goals to be achieved and how they will be achieved.

Groups have tended to originate out of one, two or more shareholders becoming aggrieved at either losses suffered in their investment (which can include its complete obliteration), or an action of the company or another shareholder or proposal by either to act to which objection is taken. It is becoming quite common to see shareholders grouping together in advance of the AGM to exert collective influence on the appointment of directors and their remuneration.

The reason that shareholders come together in these circumstances is that one shareholder alone, even a quite substantial shareholder, is likely to have little or no influence but collectively a group will have greater or even possibly determinative influence. A body of shareholders holding more than 25% of the voting capital may not be able to pass a resolution but can act as a blocking mechanism to certain resolutions put to the shareholders.

Even if shareholders have less than 25% of the issued share capital a large body of shareholders can have an influence on the company and its management.

Using the press

The coverage of business matters has very substantially increased over the past few years. The Financial Times, for instance, has extended its coverage of UK companies in the second section of the paper to five pages. Journalists covering this area are as keen as any journalist to contribute interesting stories. There is a general interest in shareholder activities. Most recently the business press has had a consuming interest in shareholders objecting to the salary and benefit packages for company directors. Often local newspapers have an interest in local business affairs and will be only too happy to cover a dispute.

Clearly shareholders should be very careful about what is said to the press.

- Firstly although shareholders may object to the immediate actions or decisions of the directors/company, their long term interests are for the success of the company; some press coverage can have catastrophic effect on a company's future.
- A shareholder does not want to be met subsequently by an action for defamation. Newspapers will in any event themselves guard against this possibility and will exclude the more outrageous allegations and statements.

- Further, during an offer period the City Code regulates what can be said in statements to the press. Rule 19.1 requires that any statement must satisfy the highest standards of accuracy and the information given must be adequately and fairly presented.

Use of the Internet

The Internet does provide shareholders with an easy method of communication. Further, the various chat-rooms for investors provide a forum for discussion between shareholders.

Data Protection Act

Shareholders organising groups should be careful of the requirements of the Data Protection Act 1988. Under this Act those persons who hold/process data in relation to individuals must register under the Act with the Information Commissioner who is the regulator for both data and freedom of information.

A Constitution

Establishing the relationship between members of a shareholder group can be of absolutely vital importance. Groups might range from a loosely organised collective of people with a similar view to a group that takes action very precisely as one body.

An example of the former might be a group that wishes to oppose a particular resolution at a general meeting or indeed wishes to call an EGM or circulate a statement in relation to an EGM. Often there is insufficient time and a lack of inclination to set anything down in writing save to the extent that there will be central organisation of proxies.

Even if there is an informal understanding between shareholders on a particular course, some arrangement should be made as to which particular shareholders represent the general body and the extent of their authority. This can be important because there may well be quick developments in the course of the group's work.

On the other hand, in certain circumstances the less formality given to the group, the less likely is it that shareholders will fall foul of the City Code.

If shareholders are clubbing together to take formal action then it is appropriate that they should draw up and agree a form of constitution. That constitution will establish a contractual arrangement between the shareholders in relation to the common goal. An example would be a group established to commence litigation. It is absolutely vital that the constitution provides for membership, responsibilities of membership, a decision-making process, contribution towards the costs, the division of liability in the event of failure in the end goal, and the division of the profit from the venture.

Funding

The funding of a group is often the most difficult aspect of organisation. Whilst shareholders may feel strongly on a particular issue, they do not necessarily want to spend money in pursuing a common aim. Some funding is usually necessary because certain costs are bound to be incurred even if it be simply the cost of communication. For large groups, particularly those joining together to litigate, the costs can be very substantial. As above, the constitution must provide for the manner and amount of the contributions. These are usually organised pro-rata to shareholding so that there is a degree of fairness in terms of the outcome.

Organising proxies

The affairs of companies are regulated by the Memorandum and Articles of Association. The Memorandum sets out the purposes of incorporation. A company which operates outside the terms of its Memorandum is operating ultra vires which then affects its arrangements with third parties. This is today of less significance because the Memorandum will always contain general power for the company to undertake almost any business venture.

More importantly for shareholders, the Articles of Association contain the constitution of the company and regulate the relationship between shareholders and directors. Before taking any steps in relation to the management of the company, shareholders should read the Articles of Association carefully. These Articles are often adopted from a standard form which is annexed to the Companies Act 1985. Shareholders will be familiar with the reference to the relevant tables of those annexures. One cannot look alone, however, at those tables. One must look at the company's articles because these very often alter these statutory provisions.

The manner in which general meetings are called and the conduct of them will be contained within the Articles. Usually every shareholder is entitled to attend the general meeting and vote on any resolutions put to the meeting. It is often difficult for shareholders to attend meetings in person. Meetings tend to be held during working hours. For this reason proxy votes are an important tool in the armoury of shareholder groups.

At many general meetings votes are taken by a show of hands. For important decisions, however, a poll will be called. This is effectively a secret ballot which shareholders attending may vote and may act as proxies to register the vote of the absent member. The Articles are likely to prescribe the form of proxy and may also prescribe the timing for the registration of the proxy. Shareholders should be particularly conscious of any requirements. It must also be remembered that if a corporation holds shares, a duly authorised representative may attend on its behalf.

In hotly contested meetings, technicalities required by the Articles or law can be of considerable importance and important votes can be excluded by a failure to follow the correct procedure.

As a matter of practice it is dangerous to appoint only one person to represent all the group's shareholders since for unforeseen reasons she/he may not be able to attend the meeting itself.

Litigation

Groups of shareholders often litigate. They may bring an action in opposition to steps which are perceived as oppressive of the minority under Section 459 Companies Act 1985 or, as has become increasingly common, bring an action for damages based upon inaccuracies and misleading statements in public offers of shares.

It is a vital prerequisite of any litigation that there is a firm constitution dealing with all possibilities that may arise during the litigation. As above, this will deal for instance with the decision making process (usually through an elected committee).

Institutional shareholder groups

In recent years the institutional shareholders who hold the vast bulk of shares in the UK, particularly on behalf of pension funds and other investment funds, have clubbed together in relation to particular issues arising in companies in which they have holdings. This has happened both on an organised and an ad hoc basis. By way of example, a number of institutions that were shareholders in Railtrack Plc organised themselves into a group to persuade the Government to make a payment to shareholders for the assets that were transferred to Network Rail. On a standing basis, two substantial groups have developed under the auspices of the National Association of Pension Fund Managers (NAPF) and the Association of British Insurers (ABI). These two organisations have developed networks for shareholders in relation to corporate governance and the joining together of institutions to exert influence as shareholders over the management of companies. There are many well known instances in which this co-operation between shareholders has had a profound effect.

Regulators

The regulatory bodies can be very useful to shareholders in any campaign. As above if it is suspected that there has been some form of market abuse as defined by the FSMA a complaint can be made to the FSA. Although this may be a low cost option for shareholders care should be taken in the compilation of any complaint to ensure the best results.

As mentioned above if there is an offer open to shareholders those making the offer must comply with the City Code. A failure to do so may cause shareholders to complain to the Takeover Panel.

If the shareholders suspect fraud by the company or its officers then a report to the police can be made.

Useful addresses

THE ASSOCIATION OF PRIVATE CLIENT INVESTMENT MANAGERS & STOCKBROKERS
112 Middlesex Street
London
E1 7HY

Tel: 020 7242 7080
Fax: 020 7377 0939
Email: info@apcims.co.uk

THE ASSOCIATION OF BRITISH INSURERS
51 Gresham Street
London
EC2V 7HQ

Tel: 020 7600 3333
Fax: 020 7696 8999
Email: info@abi.org.uk

FINANCIAL SERVICES AUTHORITY
25 The North Colonnade
Canary Wharf
London E14 5HS

Tel: 020 7066 1000
Email: consumerhelp@fsa.gov.uk

FINANCIAL OMBUDSMAN SERVICE
South Quay Plaza
183 Marsh Wall
London
E14 9SR

Tel: 020 7964 1000/0845 080 1800
Fax: 020 7964 1001
Email: complaint.info@financial-ombudsman.org.uk

PROSHARE (UK) LTD
Centurion House
24 Monument Street
London
EC3R 8AQ

Tel: 020 7220 1730
Fax: 020 7220 1731

THE PANEL ON TAKEOVERS & MERGERS (THE TAKEOVER PANEL)
PO Box No 226
The Stock Exchange Building
London
EC2P 2JX

Tel: 020 7382 9026
Fax: 020 7638 1554
Email: consultation@disclosure.org.uk

INFORMATION COMMISSIONER
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