Curbing Aggressive Shareholders?

BY KID SCHWARZ, PROFESSOR OF CORPORATE LAW, LAW FACULTY MAASTRICHT UNIVERSITY, THE NETHERLANDS

Assessing the corporate structures in Europe and focussing on the tasks and primary responsibilities of the various corporate bodies inevitably leads to the classical distinction between the Anglo-American approach and the Continental European model. In the first approach there is an implicit assumption of alignment between equity partners and directors as the company exists for the benefit of the shareholders, and the primary fiduciary responsibility of the directors is to the shareholders, aiming to achieve maximized shareholders' results. In the second model the corporate goal to be served by the directors extends beyond shareholders' interests to the other stakeholders, such as creditors, employees, suppliers, and even the corporate social environment, creating competition between the various stakeholders and an entangled position for management. One would assume that the position of the shareholders' meeting in the first model is preponderant whilst in the Continental European model the responsibilities of directors are to all stakeholders, thus diminishing the influence of shareholders.

An analysis of the relative position of corporate bodies shows that in both approaches the influence of shareholders on corporate policy is considerable and that majority-vote resolutions of the shareholders' meeting, also on items that are traditionally decided by management, are to be taken very seriously. The theme "Curbing Aggressive Shareholders?" is well chosen. Reports from various countries show that shareholder activism is a relatively new phenomenon that creates upheaval in corporate relations, because small minorities of activist shareholders, forming a majority of the votes in the general meeting, seek to gain control over the company by especially instructing management on their strategy or their policy of financing the corporation's business.

From the company's perspective, one could argue that the situation in which shareholders reveal themselves as activists is highly similar to that of a hostile takeover attempt. In both situations a potential shift of control is at stake, triggering questions such as who is in charge of defining the corporate strategy and the corporate policy as a whole. As in hostile takeover situations, in cases in which the majority of shareholders is absent at shareholders' meetings, thus paving the way for activist shareholders, management should at least be able to carefully assess the interests of other interested parties. In addition to specific corporate interests such as the independence and the continuity of the organization, the interests of other shareholders and, depending on the corporate goal, other stakeholders such as creditors and employees, also hold an important position. In weighing these interests management may decide that the alternative policies advocated by the activists or the impending takeover are undesirable. The question is whether management is then able to ignore a majority-vote resolution or is empowered to take defensive measures. The disadvantage of delegating this fundamental authority is the high concentration of power with management. This danger must be clearly recognized. This situation holds an incipient risk of conflict of interest. In case of aggressive shareholders or takeover attempts, the position of the incumbent management is under threat. Far-reaching possibilities for management to ignore shareholders' wishes or to activate anti-takeover devices could then lead to management rejecting any suggestion to modify corporate policies or to seriously assess the plans of the parties interested in taking over the company.

The European efforts in creating a level playing field for the market of corporate control have not been not successful. The EU Takeover Directive (2004/25/EC) is a strong example of permissive legislation, that will uphold the tradition of various cultural and technical barriers against takeover attempts without the support of management. An interesting question to be answered in the near future is whether these barriers, like the issuance of defensive preference shares with friendly relationships can be used not only as a deterrent to ward off bidders on the corporate stock, but may also serve as an instrument to muzzle the activist shareholder.

The difference between the situation in which a change of control is achieved by a public bid or silently by a minority making use of shareholders' absenteeism to *de facto* control the shareholders' meeting is that in the first situation control over the company is gained through paying a fair price for the shares including a takeover premium, whilst in the second situation the shareholders' meeting is controlled by a party only representing a small percentage of equity, unless the threshold for an obligatory bid is met, not offering a proper exit for factual minority shareholders. In the latter situation the matter of allocation of functions between the various corporate bodies, more specifically between management and shareholders' meeting carries extra weight. It is generally accepted that equity partners in companies may be involved with and may even interfere in management thus narrowing the line between "ownership" and

"control" without losing the bliss of limited liability. Dealing with activist shareholders presents the question to what extent management is obliged to accept the demands of these shareholders. The position of management could be interpreted as the power to prepare, fix and implement policy whilst questions relating to the structure and organization of the company are decided by the shareholders. This constitutional separation of powers was and is subject to considerable infringement. In the days when shareholders as investors in public companies played a docile role, the greater power in the company was for obvious reasons often with management. The widespread use of anti-takeover devices and oligarchical constructions in combination with the fact that shares are distributed amongst a large number of shareholders as well as the fact that management is made up of experts which give it so much know-how, also based on the regular contact with the shop floor, were responsible for this situation. The (danger of) excessive concentration of power in the hands of management disturbed the balance of the dualistic structure of corporations potentially resulting in a disputable corporate governance.

The cure for this problem in most jurisdictions is the re-definition of the position of capital suppliers, stimulating an active approach as shareholder voting is considered to be an important way to improve corporate governance. Redefining that position goes hand in hand with the strengthening of the shareholders' position in terms of cutting back anti-takeover barriers and oligarchical constructions as a result of corporate governance discussions and installing the statutory rights to, for example, pose questions to management and auditors and to directly dictate the contents of the shareholders' meeting.

Activist shareholders, like hedge funds, seem to benefit from the momentum raising their position from troublesome gadfly to powerful entity that cannot be ignored. Would they have to be curbed and, if so, how would we go about it?