CORPORATE GOVERNANCE ON INFORMAL AGREEMENTS AMONG THE SHAREHOLDERS

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Abstract

Corporate governance is the strategy by which a company is controlled and directed. Good corporate governance strategy can govern the strategic part of the company such as ensuring that the company functions in accordance with the Memorandum and Articles of Association. Even the company with best governance strategy fails in dealing with the character oriented part of the company. All corporate frauds from Sahara to Speak Asia happened when the company failed in governing the character oriented functions of its members. The informal agreements among the member very well happen when the members act in concert with the desire to get effective control. These agreements are not captured in the Articles of Association. Informal agreements are mainly done to restructure the regulatory framework and others have to complete the formal traffic and incur the transaction costs. It is to make the governance structure more compatible with the actual rail-freight transactions. When this process happens, there are higher chances of manipulation by the parties to the private agreements.

Informal agreements are legally unenforceable agreements. Private agreements have no binding effect on either the company or its shareholder as for as India is concerned. When some proceedings happen informally it is very clear from the start that it avoids legality and thus it also cannot seek for enforceability. The impacts these informal agreements have on the company through insider trading are against the best interest company and also result in market manipulation.

Keywords: *Private Agreements, Corporate Governance, Rawls Theory of Justice, Shareholder Activism and Acting in Concert.*

INTRODUCTION

Shareholder agreements are private agreements among the unidentified group of shareholders within the company acting for their own personal interests. These private agreements are usually not enforceable but the position differs in different jurisdictions. Indian jurisdiction does not enforce the private shareholder agreements unless it is incorporated into the Articles of Association.[1] The shareholder agreements pave way for restriction on transfer of shares through right of first refusal, right to offer, tag-along rights, drag-along rights etc. The varied reasons for non-enforceability of shareholder agreements unless incorporated in to the Articles and Memorandum of Association are discussed. Further the shareholders acting in concert by means of private informal agreements influence the nomination of board of directors and various other rights by acquiring the supermajority.

Rawls theory of justice elucidates the jurisprudential advantage of the private shareholder agreements being given public notice. The manipulation of control of the company by these agreements is also discussed. In UK executives' decisions are driven by their private, or inside, information. Executives use their inside information to lock in short-term gains, and to sell stock acquired prior to negative abnormal stock [2] Corporate governance needs to ensure that the best interest of the company is always protected. There exist several challenges in framing the governance strategies. Private shareholder agreements are one such hindrance to the best interest of the company. Shareholder agreements specify the rights and duties of shareholders when those prescribed by law and regulation are thought not to be appropriate by the contracting shareholders. The private shareholder agreements have the power to shift the effective control of the company. Thus, informal agreements must not be made enforceable in any jurisdictions unless they are given public notice by incorporating it into the Articles of Association.

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[1] *See* Shareholders Agreements: Clauses and Enforceability, Available at: http://indiacorplaw.blogspot.in/2010/12/shareholders-agreements-clauses-and.html, (Last Assessed: 18-06-2017, 20:45 PM).

[2] *See* Kyriacos Kyriacou, Kul B. Luintel and Bryan Mase, *Private Information in Executive Stock Option Trades: Evidence of Insider Trading in the UK*, Wiley on behalf of The London School of Economics and Political Science and The Suntory and Toyota International Centres for Economics and Related Disciplines, Economica, New Series, 77(308) (October 2010), pp. 751-774.

SHAREHOLDERS AGREEMENT RESULTING IN MANIPULATION OF CONTROL IN A COMPANY

Shareholder agreements are used mostly when at least some shareholders are actively involved in managing the company. Prominent examples include the shareholder agreements that govern joint ventures and venture capital-backed firms.[3] If there are private agreements among the active shareholders then there are certainly chances of manipulation of control. When the active shareholders influence the company, there will be manipulation of both control and management.

No jurisdiction mandates across-the-board shareholder approval for related party transactions, not even with controlling shareholders. This is because doing so might be excessively cumbersome when such transactions can be very frequent and could also raise conflict in voting issues. Indeed, 'majority of the minority' voting is a well-established institution in the U.S and U.K, two jurisdictions in which large companies typically lack a controlling shareholder, but is much less developed in continental Europe, where controlling shareholders have significant voting power.[4] The manipulation of private shareholder agreements will be higher in the jurisdictions where shareholders have reasonably large voting power. Shareholders have acquired greater power to use voting rights to unseat board members and hedge fund activists have adopted aggressive vote-trading strategies, enabling them to push through governance reforms or strategic changes at many underperforming firms.[5] In shareholder-centric jurisdictions like India the manipulation could be higher if the controlling shareholders act in concert.

Shareholder activism refers to efforts by investors to use their voting power as a catalyst for corporate change.[6] If the shareholders directly or indirectly, or through one or more subsidiaries or transactions or acting in concert with one or more persons or companies, holds

[3] *See* Gilles Chemla, Michel A. Habib and Alexander Ljungqvist, *An Analysis of Shareholder Agreements*, Journal of the European Economic Association, Oxford University Press, 5(1) (Mar., 2007), pp. 93-121

[4] *See* Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Edward Rock, **The Anatomy of Corporate Law, A Comparative and Functional Approach**, (2nd Edition), Oxford University Press, p.167.

[5] *See* David Yermack, *Shareholder Voting and Corporate Governance,* Annual Review of Financial Economics, Vol. 2 (2010), pp. 103-125.

[6] *Id.*

any combination of voting stock, representing more than 25% of any class of voting stock of an association, and that voting stock would enable the shareholders to elect one-third or more of the association's board of directors, including nominees or representatives of the shareholders currently serving on such board, cause the associations stockholders to approve the acquisition or corporate reorganization of the savings association or exert a continuing influence on a material aspect of the business operations of the association.[7] . Partly due to the mastery of voting tactics, in recent years, hedge funds have enjoyed success in shareholder activism.[8]

If the shareholder itself is a director then these private agreements would certainly conflict with the fiduciary duties of the director. Corporate governance is underlined by two features of the corporate form. The first is investor ownership, which implies that ultimate control over the firm often lies partly or entirely in the hands of shareholders. The second is delegated management, which implies that shareholder influence is usually exercised indirectly by electing directors. Jurisdictions with shareholder-centric laws such as the UK, France, Japan, and Italy provide shareholders non-waivable removal powers as well as nomination powers. Board-centric Delaware the dominant U.S. jurisdiction weakens removal powers by allowing staggered boards and discouraging special shareholder's meeting. The correlation between appointment and removal powers breaks down principally for German companies, whose shareholders have strong appointment rights but can only expel directors from lengthy terms by means of a supermajority vote.[9] The directors are personally accountable for the profit since it is derived from a breach of the fiduciary duty not to make secret profits.[10] In shareholder-centric country like India if the private agreements are enforceable then the directors who are ultimately the shareholders, there are immense chances of breach of fiduciary duties by the directors. This will result in poor management and control of the company.

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[7] *See* Richard Coll, Rusty Conner, Jeffrey L. Hare, David Krohn and Michael Reed, *Private Equity Investments in Financial Institutions: Evolving Standards and Regulatory Guidance*, The Journal of Private Equity, Euromoney Institutional Investor PLC, 13(4) (FALL 2010), pp. 51-57.
[8] *supra note* 6.
[9] *supra note* 4, at pp 56-62.
[10] *See* Graham Virgo, *Profits Obtained In Breach Of Fiduciary Duty: Personal Or Proprietary Claim?,* The Cambridge Law Journal, Cambridge University Press on behalf of Editorial Committee of the Cambridge Law Journal, 70(3), (November 2011), pp. 502-504.

SHAREHOLDERS AGREEMENT RESTRICTING THE TRANSFERABILITY OF SHARES IN A COMPANY

Fully transferable shares in ownership are yet another basic characteristic of the business corporation that distinguishes the corporation from the partnership and various other standard form legal entities. Transferability permits the firm to conduct business uninterruptedly as the identity of its owner's changes, thus avoiding the complications of member withdrawal that are common among, for example, partnerships, cooperatives, and mutual funds. This in turn enhances the liquidity of shareholders' interests and makes it easier for shareholders to construct and maintain diversified investment portfolios.[11] The rights of shareholders to choose members of the board of directors, approve mergers and acquisitions, authorize new equity issues, and amend the firm's Articles of Association give them ultimate power over important corporate decisions. Conversely, a large concentration of voting power in the hands of management tends to negate the discipline of corporate governance.[12] The transferability of shares can be restricted by the interested group of shareholders by means of informal agreements.

Shareholder agreements generally grant the parties the following rights such as the option to put their stakes to their partners or to call their partners' stakes, at a strike price typically set at fair value, tag-along rights or co sale agreements, drag-along rights, demand rights or registration rights which allow the parties to force their partners to agree to taking the firm public in an initial public offering (IPO).[13] In the prospectuses for initial public offerings, IPO firms usually specify share-lockup agreements that restrict insiders and other pre-IPO shareholders from selling their shares before a certain date. The lockup agreement provides a commitment to the market that insiders will not immediately cash out their shareholdings following the IPO.[14]

All major jurisdictions now impose some kind of direct ban on insider trading on the basis of nonpublic price-sensitive information about the issuer. Insider trading is motivated by

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[11] *supra note* 9, at pp-11.
[12] *supra note* 8.
[13] *supra note* 3.
[14] *See* Hsuan-Chi Chen, Sheng-Syan Chen and Chia-Wei Huang, *Why Do Insiders Sell Shares Following IPO Lockups?*, Financial Management, Wiley on behalf of the Financial Management Association International, 41(4) (WINTER 2012), pp. 813-847.

insiders' superior ability to forecast future performance.[15] Insider trading is generally perceived as evil and unethical.[16] European jurisdictions and Japan bar the officers, directors and controlling shareholders of listed companies from trading in their companies' securities prior to the disclosure of material nonpublic information. The U.S, by contrast, bars insider trading on undisclosed information in any security. Although all jurisdictions mandate stiff civil and criminal sanctions for illegal insider trading, the U.S. has traditionally mounted a much larger enforcement than other jurisdictions. Lower enforcement level in Europe and Japan probably reflect the higher burden of proof faced by prosecutors.[17] Opportunistic trades predict future firm-level returns and the opportunistic traders might be especially sensitive to the potential costs and penalties associated with illegal insider trading.[18] When private agreements are made between the insiders who are the controlling shareholders the levels of insider trading will be higher.

The Asian model of corporate governance is quite different from the US, UK and continental European model. The Asian companies are family-centric with close family control, controlled through an equity stake kept within the family, entrepreneurial, often with a dominant entrepreneur, so that decision-making is centralized, with close personal links emphasizing trust and control. Paternalistic in management style, in a social fabric dependent on relationships and social harmony, avoiding confrontation and the risk of the loss of face, strategically intuitive with the business seen as more of a succession of contracts or ventures, relying on intuition, superstition, and tough-minded bargaining rather than strategic plans, brand-creation, and quantitative analysis. In these scenario shareholders' private agreements would aggravate the restriction in the transfer of shares.

[15] *See* Richard W. Sias and David A. Whidbee , *Insider Trades and Demand by Institutional and Individual Investors*, The Review of Financial Studies, Oxford University Press. Sponsor: The Society for Financial Studies, 23(4) (April 2010), pp. 1544-1595.
[16] *See* Robert W. McGee, *Analyzing Insider Trading from the Perspectives of Utilitarian Ethics and Rights Theory*, Journal of Business Ethics, Springer, (91) (1),(Jan., 2010), pp. 65-82.
[17] *supra note* 11, at pp 170-171.
[18] *See* Lauren Cohen, Christopher Malloy and Lukasz Potoski, *Decoding Inside Information*, The Journal of Finance, Wiley for the American Finance Association, (67)(3), (JUNE 2012), pp. 1009-1043.

REQUIREMENT OF PUBLIC NOTICE IN REGULATING SHAREHOLDERS AGREEMENT

India has become one of the most important ventures for capital funds and equity players. Thus, there is an inevitable requirement for strengthening the corporate governance strategies. Though private shareholder agreements are generally included in the financing agreements, may be ineffective in providing any kind of protection to the investor.[19] Shareholder voting provides an effective means for shareholders to communicate with the board of directors, and boards usually take action in response to clear protest voting.[20] Majority voting has been one of the most popular and successful governance reforms.[21] Thus there is a requirement of disclosure of every shareholder decisions among the members of the company.

Private agreements are as result of legitimate expectations between the shareholders but they are not included into the articles of association which the courts will not protect. These agreements are made to avoid transaction costs when establishing a company or when admitting a new person to membership of the company. The private agreement or arrangement, always exist outside the articles and supplementing them. In *V.B. Rangaraj v. V.B Gopalakrishnan*[22] it was distinctly stated that the private shareholder agreements will not be enforced if was not incorporated into the AOA. The starting point of the court's analysis will be the AOA. If that cannot be demonstrated, the petitioner's case will fail.[23] The requirement of this condition is that every agreement made in the company should be made public.

U.S. corporate law and securities regulation have vigorously policed self-dealing transactions with controlling shareholders since the end of the 1970s. The UK City Code originated a tough mandatory bid rule, which ensured that minority shareholders would participate proportionally following the aggregation or sale of corporate control. And Japan has long subscribed to a strong equal-treatment norm, which limits the opportunities for controlling shareholders to exploit minority shareholders. However, only the U.S. closely fits

[19] *See* Kumar, Jidesh, Mehra, Richa, *Beware Rights of Shareholders,* International Financial Law Review , 25(10) (October 2006), pp. 40-41.
[20] *supra note* 12.
[21] *See* Stephen J. Choi, Jill E. Fisch, Marcel Kahan and Edward B. Rock*, Does Majority Voting Improve Board Accountability?*, The University of Chicago Law Review, 83(3) (Summer 2016), pp. 1119-1180.
[22] AIR 1992 SC 453, [1992] 73 Comp. Cas. 201.
[23] *See generally* Gower & Davis, **Principles Of Modern Company Law**, (9th Edition, 2012), Sweet & Maxwell South Asian Edition, pp. 725- 729.

the stereotype of a self-consciously board-centric jurisdiction, with the UK and Japan being better described as shareholder centric. France, Germany and Italy have traditionally been less keen to police related-party transactions with controlling shareholders. Criminal prosecution may be a powerful deterrent in some circumstances; it is inherently limited to only the most flagrant cases of opportunism by controlling shareholders.[24] Informal agreements are one that gives raise to opportunism by controlling shareholders.

Shareholder agreements are usually made to deal with matters which the parties do not wish to be known generally by the public and are not usually included in the articles of association.[25] To reduce disclosure errors in the future, regulators should focus on improving the transparency of insider disclosure.[26] Most company law and corporate governance codes encourage transparency in corporate matters and require the reporting of specific information. Under the UK Governance Code (2008), companies also have to explain the company's business model and overall financial strategy. Insider dealing is wrong and a criminal offence in most jurisdictions. Stock exchange regulations typically require all significant company announcements to be filed with them before being made public.[27] The problem of insider trading will be triggered if private agreements are enforceable.

The position private shareholder agreements can be very well explained using Rawls theory of justice. Rawls theory of justice can be described by two concepts listed below:

1. **First Principle**: (Equal Liberty). "Each person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all".

2. **Second Principle**: (Social Inequality). "Social and economic inequalities are to be arranged so that they are both (a) to the greatest expected benefit of the least advantaged and (b) attached to positions and offices open to all under conditions of fair equality of opportunity"[28]

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[24] *supra note* 17, at pp 310 – 311.
[25] *See* K Reece Thomas and C L Ryan, **The law and Practice of Shareholders' Agreements**, (3rd Edition), LexisNexis, pp-53.
[26] *See* William J. McNally and Brian F. Smith, *The Effect of Transparency on Insider Trading Disclosure,* Canadian Public Policy / Analyze de Politiques, University of Toronto Press on behalf of Canadian Public Policy.36(3) (September 2010), pp. 345-358.
[27] *See* Bob Trickery, **Corporate Governance Principals, Polices, And Practices**, (3rd Edition, 2015), Oxford University Press. pp-79-81.
[28] See, Brian Bix, **Jurisprudence: Theory and Context**, (6th Edition, 2014), Sweet & Maxwell.

Utilitarianism theory is contradictory of Rawls theory of justice. Utilitarianism theory measures good at the cost of right and explains that maximization of the good is right. Rawls, in contrary explains that both must operate independently. Any activity meant to achieve maximum benefit must not be at the cost of violation of rights. So, Rawls depicts that it is unjust to attain maximum satisfaction by means of violation of another person's right. In light of Rawls theory of justice, it can be portrayed that when private agreements are made it is certainly at the cost of the shareholders who are not a party to it, and this agreement is certainly against the best interest of the company.

CONCLUSION

Indian jurisdiction does not enforce informal agreements entered into by the shareholders unless incorporated into the Articles of Association. Whereas few jurisdictions like UK enforce private shareholder agreements if the court considers that the agreements give raise to equitable considerations.[29] But if the shareholder agreements are considered to have equitable considerations then there should not be any impediment in incorporating it into the Articles of Association. The very existence of impediments in incorporating any shareholder agreement into the Articles of Association depicts the agreement to have some private informal provisions, which is always against the best interest of the company. Incorporating the shareholder agreements into the AOA strengthens the corporate governance strategies. This will also curb the opportunism in the company.

Informal agreements restrict the transferability of shares by granting the contracting shareholders various rights. This ultimately results in insider trading. A well-designed and properly implemented insider trading policy creates an effective prophylactic against inadvertent insider trading, and provides a mechanism for a company to demonstrate that appropriate steps have been taken to prevent insider trading violations.[30] The informal agreements take a different course if the company is a party to the shareholders agreement.[31]

[29] *JE Cade and Son Ltd, Re* [1999] B.C.L.C. 213.
[30] *See* Jay A. Dubow and John Shasanmi, *The Importance of Having and Following a Strong Public Company Insider Trading Policy,* Business Law Today, American Bar Association, (October 2011), pp. 1-4.
[31] *Russell v. Northern Bank Development Corp Ltd*, [1992] 1 WLR 588.

The private shareholder agreements can result in manipulating effective control of the company. These agreements only serve the interests of the shareholders who are the party to the agreements. This situation is higher in jurisdictions that are shareholder-centric as the shareholders are already in a tendency to act in concert in such jurisdictions. This problem is much aggravated when the promoters turn into shareholders or directors.

Corruption, insider trading, unfair treatment of minority shareholders, and domination by company leaders are few instances of corporate governance problems. But these are unfortunate attributes of corporate governance that reflect human behavior everywhere.[32] These corporate governance problems in any jurisdiction will become colossal if private shareholder agreements are made enforceable.

[32] *supra note* 27, at pp. 118-119.