

Intra-Corporate Dispute Arbitration and Minority Shareholder Protection: A Corporate Governance Perspective

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1. Introduction

The protection of minority shareholders is becoming an increasingly important issue in corporate governance. Private enforcement by shareholders has also been regarded as a vital catalyst in improving board accountability. English law has long allowed for shareholders to use arbitration to resolve disputes with a company, with its board, and among themselves and thereby obtain redress. In practice, however, the shareholders of listed companies rarely use this mechanism for resolving disputes.¹ With the exception of the US, there is no evidence to suggest that shareholders of listed companies are using arbitration to enforce their rights and corporate governance in any other country where arbitration is commonly used to resolve corporate disputes, such as Germany, France, Denmark, Italy, Hong Kong and Singapore.

In the UK and other common law jurisdictions, no research has been carried out on the relationship between arbitration and corporate governance. Even though London is the centre of the global financial market, there is currently no research on the use of arbitration to promote corporate governance and deliver risk management. Dispute resolution is a crucial ancillary service to the financial world. This is why the Commercial Court of England and Wales has introduced the Financial List to provide a range of dispute resolution services for the market.² Arbitration should rise to the challenge, too.

Hence, in this article, the author explores the role and function of intra-corporate dispute arbitration (ICD arbitration) and investigates whether ICD arbitration would promote shareholder-centred corporate governance or whether it would compromise the intended effects of corporate governance. In section 2, the author explains the basis for ICD arbitration in England, in particular, how a company's constitution can provide a basis for such arbitration and how such an approach fits into the existing framework of corporate governance. In section 3, the author examines how the Companies Act provisions, the court's inherent power, the UK's derivative action regime, issues of multi-party arbitration, and conflict of laws problems can affect minority shareholder protection in ICD arbitration. In section 4, the author discusses the benefits of ICD arbitration and how corporate governance can be promoted in the light of current developments in UK capital markets. In section 5, the author concludes by recommending some reforms for increasing the utility of ICD arbitration.

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¹ J. Armour, B. Black, B. Cheffins and R. Nolan, "Private enforcement of corporate law: An empirical comparison of the US and UK" (2009) 6 *Journal of Empirical Legal Studies* 687.

² G McMeel, "A new financial court for London: the Financial List" (2016) 1 (Feb) *Lloyd's Maritime and Commercial Law Quarterly* 1.

2. What Is the Legal Basis for ICD Arbitration? Is It Consistent with the Ethos and Policy of Corporate Governance?

Contract-based arbitration

In English law, party autonomy is the cornerstone of ICD arbitration³ and is reinforced by contractual principles in company law.⁴ In business associations, the company is regarded as the nexus of contractual relationships between shareholders and between the shareholders and the company.⁵ The essence of such party autonomy-based corporate dispute resolution is to treat the company's constitution, which contains an arbitration clause, as a binding agreement between the shareholders and the company and among the shareholders *inter se*.⁶ The parties to this corporate contract are the company and its members.⁷ Other investors, such as corporate bondholders, are not considered here as privy to the company's constitution, as their relationships with the company and among the bondholders are governed by debentures—another set of contracts.⁸ An arbitration clause in the constitution will bind parties privy to the company's constitution.⁹ It is not certain if the constitution also makes the board collectively, and its directors individually, privy to the constitution.¹⁰ In *Battie v E&F Beattie Ltd*,¹¹ the court ruled that the directors could not invoke an arbitration clause in the constitution when named as defendants in a shareholder derivative suit.¹² This is because the directors were not privy to the constitution. Yet this does not prevent the shareholder from relying on the clause, being a party to the constitution, to resolve a dispute through arbitration, i.e. bringing a derivative action in arbitration against the directors. Furthermore, because directors are bound by the rules in the constitution with regard to their appointment and removal as well as the determination of some aspects of their remuneration, it can be argued that they are bound as a party when their rights and duties are stated in the constitution. Although the UK Companies Act 2006 (2006 Act) never affirms the corporate constitution's status as contract, the judicial attitude and academic commentators regard it as quasi-contract—an instrument that enables parties to privately order their affairs in the company and that has a binding effect, similar to a contract, on the parties.¹³ It is safe to say that creditors, employees and other contractors of the company—collectively described as the company's stakeholders—are not privy to the

³ Party autonomy as the basis of arbitration is also a recognised legal principle in other common law and civil law jurisdictions.

⁴ J. Coffee, "Shareholder versus managers: the Strain in the corporate web" (1986) 85(1) *Michigan Law Review* 1; However, the theory of the firm as a nexus of contracts does not gain much traction in other countries, i.e. France, Germany and Singapore. See R. Kraakman et al., *The anatomy of corporate law: a comparative and functional approach* (Oxford: Oxford University Press, 2004).

⁵ F. Easterbrook and R. Fischel "The corporate contract" (1989) 89(7) *Columbia Law Review* 1416; for a critique of this theory, see Marc Moore, "Private ordering and public policy: The paradoxical foundations of corporate contractarianism" (2014) 34(4) *Oxford Journal of Legal Studies* 693.

⁶ This is also the approach adopted by the European Court of Justice in *Powell Duffryn Plc v Petereit* (C-214/89) [1992] E.C.R. I-1745; [1992] I.L.Pr. 300. For an American approach, see C. Ravanides, "Arbitration clauses in public company charters: an expansion of the ADR Elysian Fields or a descent into Hades" (2008) 18(4) *The American Review of International Arbitration* 371. This is similar to the New Corporate Arbitration Rules of 2003 in Italy, see A. Anglani and F. Liguori, "Italy's new arbitration laws" (2007) *The European Arbitration Review* 49.

⁷ *Powell Duffryn* [1992] I.L.Pr. 300 at [10].

⁸ Disputes arising out of corporate debentures have traditionally been settled through arbitration, especially for companies with a large international investor base.

⁹ *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 Ex. D. 88 CA; *Hickman v Kent or Romney Marsh Sheepbreeders' Association* [1915] 1 Ch. 881.

¹⁰ In *Beattie v E&F Beattie Ltd* [1938] Ch. 708 at 719–720 CA, the Court of Appeal refused to stay derivative proceedings against a shareholder director on the basis of an arbitration clause stipulated in the articles, stating that the claim concerned the plaintiff in his capacity as a director, whereas he was only bound by the clause in his capacity as a shareholder.

¹¹ *Beattie* [1938] Ch. 708 at 719–720.

¹² See also G.D. Goldberg, "The Controversy on the Section 20 Contract Revisited" (1985) 48 *Modern Law Review* 158.

¹³ See Moore, "Private ordering and public policy: The paradoxical foundations of corporate contractarianism" (2014) 34(4) *Oxford Journal of Legal Studies* 693.

company's constitution.¹⁴ Therefore, without more, they are not and cannot be parties to the company's constitution and cannot invoke any provision in the agreement to enforce their interests and rights. That is to say, these corporate constituents cannot rely on an arbitration clause in the company's constitution to resolve a dispute. Equally, companies cannot rely on an arbitration clause in the constitution to compel an employment dispute with its employees. Creditors cannot rely on this clause to enforce a loan agreement.¹⁵ Companies cannot use this clause to resolve a contractual or tortious dispute with the company's auditor, notwithstanding the fact that the auditor is acting as the company's gatekeeper in the interest of the company. Even though non-members cannot rely on the clause in the constitution, the 2006 Act does not preclude the inclusion of an "outsider" party to the constitution. In addition, the duty to arbitrate could be imposed through the use of a signed employment or engagement agreement, i.e. with the directors and auditors calling for arbitration or referencing the duty to arbitrate in the company's constitution.

Careful drafting of a company's constitution is required to make ICD arbitration with non-members, i.e. company directors and company auditors, effective. First, the constitution can include the specific rights and responsibilities of the board and the specific rights and duties of the members.¹⁶ The constitution could then specify the method for addressing any dispute arising out of these rights and obligations, such as arbitration.¹⁷ One way of enforcing directors' duties is to bring a derivative action on behalf of the company, and the arbitration clause will cover this shareholder derivative action. Secondly, if the arbitration clause specifically covers shareholder derivative actions and third parties are aware of this clause in the company's constitution, it may be argued that the third parties, especially sophisticated parties such as the company's auditor, may have given implied consent to such arbitration.¹⁸ Such an arbitration clause may be reinforced further by an arbitration clause between the company and the auditor.¹⁹ The outcome may be that shareholder derivative action on behalf of the company against the company's auditor is covered by the arbitration clause. However, there is a limit to such a contractual approach of using the company's constitution as the basis for ICD arbitration. It stems from the unilateral alteration of the company's constitution by a super-majority vote of the shareholders at the meeting.²⁰ This can arise when an arbitration clause is to be included or removed from the company's constitution by a super-majority vote of the shareholders, making the dissenting shareholders bound by the newly devised clauses in the constitution.²¹ The dissenting shareholders would not be able to seek damages or an injunction against such an alteration. This may appear to be contrary to the contract approach of ICD arbitration, as the dissenting shareholders would not have redress.²² However, the contractual notion as the basis for ICD arbitration—treating a company constitution as if it were a contract—does not necessarily treat the insertion of an arbitration clause, or removal of it, as a breach of contract by the parties.²³ Because the

¹⁴ Investors (ex-shareholders) who sold companies' shares cannot rely on the arbitration clause in the constitution as they are no longer members of the company. They are not stakeholders nor other constituents in the same category as employees, creditors and directors.

¹⁵ However, it is not clear whether the arbitration clause can be relied on if a creditor's debt interest converts to an equity interest upon becoming a shareholder in the company.

¹⁶ In this way, directors can be made privy to the constitution.

¹⁷ This method is commonly used in the US. The corporate bylaws are detailed and often also include the duties of the board and the rights of shareholders in a contested takeover bid. See *Corvex Management LP v Commonwealth REIT* Unreported 8 May 2013 Cir. Ct. Balt.

¹⁸ B. Hanotiau, "Consent to Arbitration: Do We Share a Common Vision?" (2011) 27(4) *Arbitration International* 539; See also N. Junngam, "An MFN clause and bit dispute settlement: A host state's implied consent to arbitration by reference" (2010) 15(2) *UCLA Journal of International Law and Foreign Affairs* 399.

¹⁹ V. Sangiovanni, "Some critical observation on the Italian regulation of company arbitration" (2006) 7(2) *The American Review of International Arbitration* 281.

²⁰ A. Turkhtanov, "Right to fair trial as a curb on party autonomy: Russian Supreme Commercial Court strikes down optional arbitration clause" (2013) 79(3) *Arbitration* 338.

²¹ This point has never been explored in the UK.

²² See *Suda v The Czech Republic* (1643/06) Unreported 28 October 2010 ECHR at [49].

²³ In *Powell Duffryn* [1992] I.L.Pr. 300, European Court of Justice ruled that a jurisdiction clause in the statutes of a company is binding on all the shareholders, notwithstanding that some of the shareholders against whom the

parties are aware of arbitration being used as an alternative forum for dispute resolution, the parties may be regarded as implicitly consenting to any change to the constitution that may result in a change of forum for dispute resolution so long as such change follows the required procedure under the 2006 Act, i.e. holding a general meeting.²⁴ Interestingly, such an alteration may give rise to an unfair prejudice suit by the dissenting shareholders against the insertion or removal of an arbitration clause.²⁵ The majority shareholders may also need to prove that such amendment is “bona fide for the benefit of the company as a whole”.²⁶ Paradoxically, such a dispute may need to be resolved through arbitration.

Corporate governance and arbitration

This broad contractual approach to regulating the company’s internal affairs through the company constitution fits into the nexus of the contract theory of a corporation.²⁷ The aim of modern corporate governance, driven by the need to develop capital markets to provide companies with access to capital and investors with more investment channels, is to provide investor protection to enhance overall confidence in capital markets. Investors and shareholders are the primary constituents protected under corporate governance, serving the process of financialising companies.²⁸ In the US, shareholder derivative actions and investor securities litigation are regarded as the means of enforcing corporate governance and maintaining market confidence.²⁹ Considering this function of litigation, the Securities and Exchange Commission (SEC), the US financial regulator, and other prominent scholars of securities law consider that arbitration does not serve the purpose of corporate governance.³⁰ The UK does not follow the US enforcement philosophy—litigation as a means to protect investors’ interests by directly holding companies, directors and related third parties liable in the courts.³¹ Yet arbitration to resolve governance issues appears in various fora and forms, some of which also appear similar to mandatory arbitration. For instance, takeover disputes in the UK are primarily resolved by the Takeover Panel rather than in the courts.³² Disputes between consumer investors and securities brokers are referred to the Financial Services Ombudsman.³³ Disputes between traders over securities on the London Stock Exchange are not resolved through litigation, but through the internal

clause is invoked opposed the adoption of the clause or that they became shareholders after the clause was adopted; However, such an alteration may amount to a breach of the European Convention on Human Rights art.6(1). See *Suda v The Czech Republic* (1643/06).

²⁴ In Delaware, the court held that Delaware law places shareholders on notice that boards may change corporate bylaws at any time without shareholder approval, so long as the bylaw complies with the Delaware General Corporation Law s.109. Also see *North v McNamara* Unreported 19 September 2014 S.D. Ohio; *Boilermakers Local 154 Retirement Fund v Chevron Group* Unreported 12 April 2013, Del.Ch.; *Corvex Management LP v Commonwealth REIT* Unreported 8 May 2013 Cir. Ct. Balt.

²⁵ D. Milman, “Litigating domestic disputes within companies: continuity or change?” (2007) 22 *Company Law Newsletter* 1.

²⁶ *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch. 656 CA; *Greenhalgh v Arderne Cinemas Ltd (No.2)* [1946] 1 All E.R. 512 CA.

²⁷ There is debate about the nature of the UK’s company law ordering. See Moore, “Private ordering and public policy: The paradoxical foundations of corporate contractarianism” (2014) 34(4) *Oxford Journal of Legal Studies* 693.

²⁸ J. Fleur, “Financing as governance” (2011) 31(2) *Oxford Journal of Legal Studies* 391; R. Nolan, “The Continuing Evolution of shareholder governance” (2006) 65 *Cambridge Law Journal* 92.

²⁹ Stefano Grace, “Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the Acquis Communautaire” (2006) 15(2) *Journal of Transnational Law* 281.

³⁰ J. Coffee, “No exit? Opting out, the contractual theory of the corporation, and the special case of remedies” (1988) 53 *Brooklyn Law Review* 919; J. Coffee and D.E. Schwartz, “The survival of the derivative suit: An evaluation and a proposal for legislative reform” (1981) 81 *Columbia Law Review* 261; Others argue that US securities class actions make US capital markets less competitive. See Hal Scott and Leslie Silverman, “Stockholder adoption of mandatory individual arbitration for stockholder disputes” (2013) 36 *Harvard Journal of Law & Public Policy* 1187.

³¹ However, the situation may change as more funders are willing to finance the collective legal action. See J. Croft and M. Vandevelde, “Tesco faces £100m civil lawsuit over profit misstatement case brought by 125 institutional funds is filed at the UK’s High Court” (31 October 2016), *Financial Times*.

³² J. Armour, “The Divergence of U.S. and UK Takeover Regulation” (2007) 30(3) *Regulation* 50; E. Armson, “Models for takeover dispute resolution: Australia and the UK” (2005) 5(2) *Journal of Corporate Law Studies* 401.

³³ The final decision is binding on the brokers but not the consumer if the decision is not in the consumer’s favour.

complaint procedures. These disputes are normally those between trading members and do not extend to the normal ICD. This does not mean that these types of disputes cannot be categorised as an ICD or give rise to an ICD. Disputes between members may touch on voting rights and the economic rights attached to shares. For instance, in a late share settlement, a dispute regarding who has the right to cast the vote at the company meeting and how to compensate for the loss of such a vote is one between selling and purchasing shareholders. The company may also be involved in the dispute if it wrongly refuses to allow the purchasing shareholders to exercise their voting rights. Currently, such disputes are resolved through the complaint procedures of the London Stock Exchange rather than by institutional arbitration.

These dispute resolution mechanisms are part and parcel of the UK's delegatised corporate governance in support of the financialisation of companies.³⁴ The non-statutory Corporate Governance Code, which applies to UK listed companies and is enforced on a basis of "comply or explain", rests its effectiveness on providing best practices and corporate disclosure. The non-statutory nature of the code both provides flexible rules of law to companies, and relies on market forces as a complementary means of management accountability. These dispute resolution mechanisms, especially the Takeover Law Panel, and the compounding soft law approach to corporate governance, distinguishes the UK framework from the US litigation-based corporate governance. The UK does not consider the court as the primary forum to provide investor redress and investor protection. In this way, as a framework for protecting investors, ICD arbitration does not conflict with the UK corporate governance framework of using a non-judicial mechanism to enforce governance norms (both statutory and soft-law ones).³⁵ ICD arbitration in listed companies would provide a different governance enforcement tool, and different types of redress, and increase shareholder engagement in corporate affairs.³⁶

3. To What Extent Can ICD Arbitration Provide Effective Redress to Shareholders, and What Practical Challenges Does It Present to Listed Companies?

The role of the Companies Act 2006

In this section, the author will examine two aspects. First, how can ICD arbitration be beneficial under the current corporate governance framework, including the provisions of the 2006 Act? Secondly, if ICD arbitration can provide better redress, what are the practical difficulties that investors of listed companies may face?

Before deciding to use arbitration, research should be conducted to ensure that the company law statutes would not either invalidate the arbitration agreements or nullify their effectiveness—in other words, it is necessary to ascertain whether, in a given jurisdiction, the subject matter is arbitrable.³⁷ Hence, an arbitration clause will need to be drafted to cover the dispute. There are differences between disputes arising out of a shareholder agreement, the company constitution and general company law. For a dispute arising out of a shareholder agreement or the company constitution, the remedies are primarily contractual. If the dispute arises out of provisions in the 2006 Act, remedies will depend

³⁴ Some critics consider that arbitration would delegatise corporate governance. See G. Shell, "Arbitration and corporate governance" (1989) 67 *North Carolina Law Review* 520, 517–575.

³⁵ G. Shaffer and M Pollack, "Hard vs. soft law: alternatives, complements, and antagonists in international governance" (2010) 94(3) *Minnesota Law Review* 706; E. Wymeersch, "Enforcement of corporate governance codes" (2006) 6(1) *Journal of Corporate Law Studies* 113.

³⁶ B. Quin, "Arbitration and the Future of Delaware's Corporate Law Franchise" (2013) 14(3) *Cardozo Journal of Conflict Resolution* 829.

³⁷ Y. Chernykh, "Arbitrability of corporate disputes in Ukraine" (2009) 26(5) *Journal of International Arbitration* 745; B. Shaw, "The Arbitrability of oppression claims" (2011) 69(1) *Advocate* (Vancouver Bar Association) 21; N. Poser, "Arbitrability of International Securities Disputes" (1986) 12(3) *Brooklyn Journal of International Law* 675.

on the provisions in the Act. If the remedy sought is specific performance or a temporary or permanent injunction, even though the arbitral tribunal may have such powers stipulated in the arbitration agreement,³⁸ the procedures to obtain such a remedy are far more complicated,³⁹ costly and uncertain than those for a compensatory or restitutionary remedy.⁴⁰ ICD arbitration can involve the validity of certain passed resolutions of a company.⁴¹ If the resolution was held to be invalid due to non-compliance with the provisions in the Act, the desired remedy is to set aside the transactions executed pursuant to the invalid resolution. Injunctive relief may be sought if the transaction is executory based on a disputed resolution. Shareholders may be able to claim their loss of investment against the company, the board or the majority shareholders if their personal rights were infringed or if the fiduciaries failed to execute their duties. To unwind the transactions, the court would need to declare the resolution invalid and to order the parties to unwind the transactions. These are powers that the arbitral tribunal would not have under the Arbitration Act 1996. This is because unwinding the transactions may affect third parties, e.g. the sale of a company asset to a third-party acquirer. Ordering a company to pass a new resolution is not within the arbitrator's power under the UK Arbitration Act 1996 s.48. Furthermore, the 2006 Act may not allow transactions based on an invalid resolution to be unwound.⁴² This is a major difference between UK company law and German company law. In Germany, many ICDs centre on the validity of a resolution that has been passed.⁴³ However, in the UK, such disputes rarely arise. This is because the 2006 Act emphasises transaction certainty. Such transaction certainty is reinforced by the 2006 Act in that it specifically provides that the validity of a resolution passed should not affect the acts conducted pursuant to the resolution. For instance, if a company director is not validly appointed, his or her acts should not be invalidated because of the invalid appointment. If a company fails to comply with company procedures, such non-compliance should not invalidate the resolution. In short, what redress shareholders may be entitled to depends largely also on how the 2006 Act regulates the effect of an irregular resolution.

The court's inherent power to grant redress may not be exclusive

There are provisions that specifically provide the courts with the power to grant particular orders or forms of redress. The English Court of Appeal has ruled that the specific provisions denoting the court's power to adjudicate do not exclude arbitration.⁴⁴ In other words, arbitration would not be in derogation of these company law provisions because the court has been mentioned only as a forum to obtain redress. The power conferred by company law to the courts would only exclude arbitration if granting such relief would have effect on a "third party". For instance, if an order was sought to dissolve a company, this would affect the interests of a creditor (a third party), so the arbitral tribunal would not have the power to grant such an order binding on third parties. A provision often used by minority shareholders in a closed company is the 2006 Act s.995 regarding unfair prejudice. Under this provision, the shareholders petition the court and allege that the affairs of the company

³⁸ In *Armstrong v Northern Eyes Inc* [2000] O.R. 48, 442, the arbitrator ruled that he had broad powers to grant both legal and equitable remedies, but not a statutory oppression remedy in the absence of the express conferral of such powers on the arbitrators by the parties. Hence, some equitable remedies can be granted by the parties so long as they agree to such conferral.

³⁹ J. Lee, "Court-subsidiarity and interim measures in commercial arbitration: A comparative study of UK, Singapore and Taiwan" [2013] 6(2) *Contemporary Asia Arbitration Journal* 227.

⁴⁰ The party may need to apply to the court to enforce the peremptory orders given by the tribunal under the Arbitration Act 1996 s.42.

⁴¹ F. Roth, "Arbitration and Company Law in Germany" (2015) 12(3) *European Company Law* 151.

⁴² On directors' appointment and the related transactions see Companies Act 2006 s.161(2).

⁴³ C. Borris, "Arbitrability of corporate law disputes in Germany" [2012] 15(5) *International Arbitration Law Review* 161.

⁴⁴ *Fulham Football Club (1987) Ltd v Richards* [2011] EWCA Civ 855; [2012] Ch. 333.

are being conducted in a way that is unfairly prejudicial to their interests.⁴⁵ If the court is satisfied with this claim, it has discretion to award a number of remedies. The fact that some of the remedies may affect third parties should not preclude arbitration, as it may grant remedies other than those with third-party effects.⁴⁶ One of the remedies under the 2006 Act s.995 is allowing the minority shareholders to bring a civil action against the board. This redress effectively bypasses the difficult issue of locus standi (legal standing) which has traditionally been an obstacle to minority shareholders in bringing proceedings against the board of directors, who are considered fiduciaries of the company. This procedural issue of lack of standing derives from the substantive law that sees the company as the proper person to hold the board accountable. It is questionable whether this is a remedy that an arbitral tribunal would have the power to grant. The question turns on whether arbitrators have the powers to adjudicate shareholder derivative actions. If an arbitral tribunal can adjudicate a shareholder derivative action, it should also have the power to grant such an action as a remedy.

Derivative action

The shareholder derivative action is an action brought by shareholders on behalf of the company against a third party, such as the board of directors. The purpose of the action is to remedy the lack of enforcement by the company against the board of directors for failing to perform the board's duties.⁴⁷ Because the board of directors normally owes a fiduciary duty to the company and not to the shareholders,⁴⁸ a derivative action becomes an ex post tool used by shareholders to enforce the board's duties. Such an action is potentially an enforcement tool to prevent the board from engaging in illegal and illegitimate activities.⁴⁹ A minority shareholder can bring a derivative action and seek injunctive relief against an act of the board or an individual director.⁵⁰ Whether it is an effective action for a minority shareholder to obtain monetary compensation or an account of profits by corporate officers involved in illegal activities remains questionable. It depends on whether the corporate law provisions provide for monetary redress and whether there is sufficient financial incentive, provided by the legal regime, for the minority shareholder to institute these proceedings.⁵¹ Under the current 2006 Act, which follows the principle of no reflective loss,⁵² a minority shareholder who brings a derivative action will not receive direct monetary compensation if the board is found liable for damages to the company. As a result, there is little incentive for a minority shareholder to bring a derivative action because the legal cost required at the beginning of the proceedings, and the possibility of being responsible for the entire legal costs if the suit fails, are too high. Although the court has discretion in the ordering of costs, derivative action is uncommon in enforcing corporate governance in listed companies. In the US, the driving force for derivative suits is the claimants' lawyer, whose fees could come from the common fund of the class action settlement.⁵³

⁴⁵ See White Paper, *Modernising Company Law* (HMSO, 2002) Cm.5553-II, para.2.36.

⁴⁶ In *ACD Tridon Inc v Tridon Australia Pty Ltd* [2002] NSWSC 896, the court considered that a winding up order does not simply involve public policy considerations surrounding the process of winding up the company but that the operations of the order can affect third parties.

⁴⁷ Some US cases suggest that shareholder derivative action arbitration is against public policy. See *Lane v Abel-Bey* 4182 N.Y.S. 25 (1979) at 26.

⁴⁸ E. Lim, "Directors' fiduciary duties: A new analytical framework" (2013) 129(2) *Law Quarterly Review* 242.

⁴⁹ A. Reisberg, "Shareholders' remedies: the choice of objectives and the social meaning of derivative actions" (2005) 6(2) *European Business Organization Law Review* 227.

⁵⁰ Shell, "Arbitration and corporate governance" (1989) 67 *North Carolina Law Review* 543, 517-575.

⁵¹ A. Reisberg, "Derivative actions and the funding problem: the way forward" (2006) J.B.L. 445.

⁵² J. Lin, "Barring Recovery for Diminution in Value of Shares on the Reflective Loss Principle" (2007) 66(3)

Cambridge Law Journal 537.

⁵³ J. Farrar, "The Move from Private Enforcement to Public Enforcement and Now the Move to Litigation Funding of Shareholder Activism: Are We Entering a New Era of Access to Justice in Corporate Law?" (2015) 26(1) *European Business Law Review* 75.

In addition to the financial burden a minority shareholder must shoulder, judicial discretion in the control of the proceedings poses further legal uncertainty in a derivative action arbitration. Under the current regime, a minority shareholder must obtain court permission to continue the derivative action. Permission will be given if court action satisfies the factors specified under the provision. Based on the ruling in *Fulham Football Club (1987) Ltd v Richards*,⁵⁴ the mere mention of the court's power in the provisions does not preclude the arbitral tribunal from exercising a similar function, so long as such permission to continue the claim does not affect third parties. The question is whether the tribunal's decision to grant or refuse permission to continue the claim can be challenged.

A derivative action involves the shareholders (both minority and majority), the company, and the directors. Therefore, a derivative action is categorised as a set of multi-party proceedings. All the parties involved must have consented to arbitration. If a minority shareholder does not give consent to resolve the dispute through arbitration, a derivative action brought by another minority shareholder may not bind the non-consenting shareholder. In that case, the staying of non-consenting shareholders' court proceedings under the Arbitration Act 1996 s.9 may not be applied. The arbitral award will not bind the non-consenting shareholders, and hence it will not have a *res judicata* effect. To manage the risk of parallel proceedings⁵⁵ and to increase the certainty of the arbitration having a *res judicata* effect, parties should insert an arbitration clause in the company's constitution that specifically covers shareholder derivative action against the board of directors. In addition, there should also be a binding mechanism detailing how such a derivative action among minority shareholders may be brought. An arbitration institution, such as the London Court of International Arbitration (LCIA), can provide specific rules, and the company can incorporate these rules into the company's constitution. These rules must also be brought to the shareholders' attention.

Based on the court's contractual approach to the parties' dispute resolution agreement, derivative action under the 2006 Act does not mandate judicial approval of settlement and dismissal. The derivative suit, as many commentators have opined,⁵⁶ involves a set of procedural rules. These procedural rules are capable of being waived or contracted out to a more flexible procedural regime based on party autonomy. The arbitration of derivative suits does not curtail substantive statutory rights conferred on the party or diminish the substantive fiduciary duty of management. If the arbitral tribunal was able to be more flexible in its discretion to award costs—more friendly to shareholders—arbitration of derivative action could be used more frequently.⁵⁷

Multi-party arbitration

When an ICD arises involving a listed company, more than two parties are concerned.⁵⁸ Actions are likely to be based on the oppression provision of the 2006 Act,⁵⁹ derivative action under the 2006 Act Pt 11, or securities law actions based on the Financial Services and Markets Act 2000 or common law principles.⁶⁰ There are tens of thousands of shareholders in a listed company⁶¹ but this does not mean that a company is as unmanageable

⁵⁴ *Fulham Football Club* [2012] Ch. 333.

⁵⁵ B. Cremades and I. Madalena, "Parallel Proceedings in International Arbitration" (2008) 24(4) *Arbitration International* 507–540.

⁵⁶ P. Davies and S. Worthington, *Chapter 17 The Derivative Claim and Personal Actions against directors*, *Principles of Modern Company Law* (London: Sweet & Maxwell, 2012), pp.643–665.

⁵⁷ This would also raise the question of the equal treatment of both sides.

⁵⁸ The English Court of Appeal has also consolidated arbitration proceedings, based on parties' consent, in *Abu Dhabi Gas Liquefaction Co v Eastern Bechtel Corp* [1982] 2 Lloyd's Rep. 425 CA.

⁵⁹ Companies Act 2006 s.994.

⁶⁰ The framework governing the oppression provision and the derivative action, both of which are provided for in the Companies Act, has been moving towards an interest-based regime rather than rights-based one: J. Farrar and L. Boule, "Minority shareholder remedies—shifting dispute resolution paradigms" (2001) 13 *Bond Law Review* 281.

⁶¹ As of June 2015, there were 2,406 listed companies on the London Stock Exchange.

as it may appear.⁶² As mentioned above, the company may have an arbitration clause in its constitution that binds former, present and future shareholders who purchase company shares at the time such a clause is in the constitution. There can be a regime specifying how shareholders should be notified of, and participate in, the proceedings. The regime may also include how the arbitration is to be formed, the selection of the arbitrators, and the challenge of an arbitrator.⁶³ This regime can be designed by an arbitration centre under securities industry arbitration rules,⁶⁴ and the regime can be specifically incorporated into the company constitution. It will exclude those who became shareholders before there was an arbitration clause in the articles since a shareholder action would normally be confined to present shareholders. A shareholder action can be based on securities law,⁶⁵ which allows present and former shareholders to bring a claim if they suffer losses by purchasing or selling. A multi-party procedure may be used to join former and present shareholders who suffered losses due to the board's violation of securities laws.⁶⁶ It can give rise to an intra-corporate dispute, if, for instance, the board failed to disclose important corporate information and, as a result, shareholders who would have sold their shares in the company suffered a loss; all shareholders can be notified and determine if they wish to join an arbitration. To remove doubt, the company's constitution can specifically include securities disputes between the shareholders and the company and its board of directors. The problem is more closely related to former investors who have sold their shares: they are no longer shareholders of the company and hence are not bound by the arbitration clause in the constitution. They are free to initiate a securities law action against the board. This may then encourage current shareholders to sell their shares in the company and then bring an action in court, further depressing the company's outlook. If an ICD also includes a securities law-based issue between the shareholders and the board and arbitration is a forum where the shareholders can receive redress, this would not cause a large sell-off by the shareholders and thereby create a bleaker outlook for the company. Since this type of arbitration would also require disclosure to the market, transparency would not be compromised.

There remains yet another multi-party issue. Who, in a listed company, is in fact a legal shareholder and therefore bound by the company's constitution? Shareholders who physically attend the shareholder meetings and cast votes are not necessarily the legal owners of the shares.⁶⁷ The company's constitution is supposed to bind only the members of the company—the legal owners of the shares.⁶⁸ Often, the legal owners are the nominee companies rather than the beneficial owners of the shares—the end investors. In reality, there may not be so many parties in an ICD. Rather, there will be a few nominee companies acting for their clients, who are the ultimate and beneficial investors. This gives rise to a conflict of interest. In a shareholder meeting, a nominee company can cast split votes,⁶⁹ positive for some shareholder clients and negative for others. However, in an ICD arbitration, since the nominee company will act as the legal person in the proceedings, it cannot act with two or several souls. Even if it acts as a legal representative, it must not act for two

⁶² Class action has been used in the US for many years, and the US model has been transplanted to Canada and Australia. See B. Hanotiau, "A New Development in Complex Multiparty-multicontract proceedings: Classwide Arbitration" (2004) 20(1) *Arbitration International* 39.

⁶³ In a class action arbitration, there can be a conflict between multiple class representatives as to the selection of arbitrators. This issue can be resolved by the arbitration panel in the process of the certification determination. If too many disagree with the selection, the parties can opt out of the class.

⁶⁴ An example is the arbitration rules developed by the US Financial Industry Securities Authority (FINRA).

⁶⁵ B. Black, "Arbitration of investors' claims against issuers: an idea whose time has come?" (2012) 75(1) *Law and Contemporary Problems* 107.

⁶⁶ For the general debate on collective legal actions in England, see R. Mulheron, "Recent milestones in class actions reform in England: a critique and a proposal" [2011] 127 *Law Quarterly Review* 288.

⁶⁷ L. Gullifer, "Ownership of Securities" in L. Gullifer and J. Payne, *Intermediated Securities* (Oxford: Oxford University Press, 2010), p.15.

⁶⁸ M. Yates and G. Montagu, *The Law of Global Custody*, 4th edn (London: Bloomsbury Professional, 2013).

⁶⁹ K. Schmolke, "Institutional investors' mandatory voting disclosure: the proposal of the European Commission against the background of the US experience" [2006] 7(4) *European Business Organization Law Review* 767.

conflicting clients.⁷⁰ It is also possible that the nominee company holds legal title to the shares for both claimant shareholders and defendant shareholders. There must be a mechanism for resolving this legal problem. This issue will be addressed in a future article.

Class action arbitration

In the UK, class action is not available for shareholders to collectively seek redress. The experience in the US shows that class action can benefit individual small investors if their claims can be organised collectively to increase their chances of obtaining redress. In the US, there is no presumption that class action arbitration would deny shareholders the right to obtain redress.⁷¹ However, US law requires that there should be a clear intention of class action arbitration because the shareholders should agree on the members of the group who will institute the action.⁷² An arbitration clause without such an intention may show that shareholders intend to arbitrate only on an individual basis. Whether shareholders can waive their class action right to arbitration will depend on whether such a waiver would deny their statutory right and hence invalidate it as against public policy.⁷³ In the US, one of the arguments made is whether such a right is substantive or procedural.⁷⁴ A substantive right cannot be waived by arbitration if it would deny parties the right to obtain redress. Yet, if such a right is procedural, the parties would have autonomy to decide. If this line of argument arises in the UK, it is unlikely to follow the US approach because the courts have specifically ruled that arbitrators can decide on substantive law issues based on s.995 unfair prejudice,⁷⁵ and arbitrators can grant remedies, as long as these remedies do not affect third parties. There is no clear view on the distinction between shareholders' substantive rights and their procedural rights regarding the statutory provisions. Shareholder derivative action is an example of this confusion. Professor Davies considered it a procedural right,⁷⁶ however, Professor Morris, from the viewpoint of conflict of laws, regarded it as substantive right.⁷⁷ In the UK, such a distinction would have more impact on the choice of law issue than the validity of class action arbitration or the waiver of class action arbitration. Class action arbitration in the form of representative suit does not alter the substantive law of directors' duties, which aims at protecting shareholders. It is imperative to incorporate a contractual mechanism—such as LCIA's institutional rules—that deals with the consolidation in the constitution.⁷⁸

⁷⁰ G. Miller, "Conflicts of Interest in class action litigation: An inquiry into the appropriate standard" (2003) *University of Chicago Legal Forum* 581.

⁷¹ Scott and Silverman, "Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes" [2013] 36(3) *Harvard Journal of Law & Public Policy* 1187.

⁷² T. Coyle, "Aggregating consumer arbitration claims after Italian Colors through litigation finance and securitization of legal claims" [2016] 12(3) *New York University Journal of Law and Business* 833.

⁷³ D. Webber, "Shareholder Litigation without Class Actions" [2015] 57(1) *Arizona Law Review* 201.

⁷⁴ M. Schwartz, "A substantive right to class proceedings: the false conflict between the FAA and NLRA" (2013) 81(5) *Fordham Law Review* 2945.

⁷⁵ *Fulham Football Club* [2012] Ch. 333.

⁷⁶ P. Davies and S. Worthington, *Chapter 17 The Derivative Claim and Personal Actions against directors, Principles of Modern Company Law* (London: Sweet & Maxwell, 2012), pp.643–665.

⁷⁷ In addition, it appears that the right of a shareholder to bring a derivative action with respect to wrongs done to a corporation is, in cases containing a foreign element, a matter of substance not procedure and, accordingly, is governed by the law of the place of incorporation. Notwithstanding, for purely English domestic purposes, the right has been regarded as a procedural device. See *Konamaneni v Rolls-Royce Industrial Power (India) Ltd* [2002] 1 W.L.R. 1269; *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316; [2005] W.L.R. 1157; Andrew Dickinson "Applicable law arbitrage—an opportunity missed?" (2005) 121 *Law Quarterly Review* 374.

⁷⁸ The LCIA Rules already contained a (fairly limited) joinder provision, which remains essentially the same (now art.22.1(viii)). In addition, the 2014 Rules will enable the arbitral tribunal to consolidate arbitrations, in two situations: first, where the parties agree to this in writing, and with the approval of the LCIA Court (art.22.1(ix)); and, secondly, where multiple arbitrations have been commenced under the same arbitration agreement, or under compatible arbitration agreements, between the same parties, provided that the arbitral tribunal has not been formed for the other arbitration(s) (art.22.1(x)). Article 22.6 grants a similar power to the LCIA Court where no tribunal has yet been constituted.

Conflict of laws problems

In the arbitration of a contractual dispute, parties can choose the governing law and the seat of arbitration.⁷⁹ In an ICD arbitration, the governing law will be the law of the country of incorporation if the dispute arises out of company law.⁸⁰ This follows the legal seat theory, which is currently the UK approach.⁸¹ However, an ICD arbitration may be categorised as a contractual dispute if it touches on the question of agency law. If this dispute is regarded as an “internal affair” of the company,⁸² the governing law could be that of a country other than the country of incorporation. The governing law, under the real seat theory, could be the law of the country where the company’s headquarters is located.⁸³ A listed company may have its legal seat in country A, its real seat (headquarters) in country B, and shares traded on an exchange in country C. An ICD could potentially be governed by the laws of three jurisdictions.⁸⁴ The applicable law, and whether the parties can freely choose the applicable law, will depend on the categorisation of the ICD. The categorisation of an ICD will also depend on the rules governing conflict of laws in the country that has jurisdiction over the disputed matter.⁸⁵ A shareholder may bring a derivative action on behalf of the company to challenge a director’s authority to enter into a transaction. Whether a director, as an agent for the company, has authority to enter into a transaction could be categorised as a contract law issue,⁸⁶ hence, the law of the headquarters, country B, may apply. However, this may not prevent country A from regarding it as a question of company law, and thus, the law of the country of incorporation would apply. This can arise if such a transaction requires shareholder approval as stipulated by the company law of country A. If the board failed to disclose such a transaction, and this is considered important corporate information, the law of the country of listing may apply. As it is possible that the countries whose laws are potentially relevant regard the application of certain company law provisions as matters of public policy or consider certain disputes not arbitrable, the arbitrators would have to carefully take into account all potentially applicable laws to ensure that they make a valid and enforceable award.

⁷⁹ A. Turkhtanov, “Right to fair trial as a curb on party autonomy: Russian Supreme Commercial Court strikes down optional arbitration clause” (2013) 79(3) *Arbitration* 338. In Ukraine, the agreement to govern intra-corporate relations by foreign law is null and void against public policy under the Ukraine Civil Code art.228. For the enforceability of the forum exclusive clause, see Brian J.M. Quinn, “Shareholder lawsuits, status quo bias, and adoption of the exclusive forum provision” (2012) 45 *University of California Davis Law Review* 137.

⁸⁰ *Powell Duffryn* [1992] I.L.Pr. 300; *Centros Ltd v Erhvervs-og Selskabsstyrelsen* (C-212/97) [1999] E.C.R. I-01459; [1999] 2 C.M.L.R. 551; *Überseering BV v Nordic Construction Co Baumanagement GmbH* (C-208/00) [2002] E.C.R. I-9919; [2005] 1 C.M.L.R. 1. For analyses of the real seat and legal seat theories, see S. Rammeloo, *Corporations in private international law: A European perspective* (Oxford: Oxford University Press, 2001), pp.11–20.

⁸¹ At the EU level, there is no coherent approach. See J. Borg-Barthet, “A new approach to the governing law of companies in the EU: A legislative proposal” (2010) 6(3) *Journal of Private International Law* 589.

⁸² The OECD provides some guidance on what amounts to corporate governance related disputes. See OECD, “Exploratory meeting on resolution of corporate governance related disputes”, <http://www.oecd.org/daf/ca/corporategovernanceprinciples/meetingonresolutionofcorporategovernancerelateddisputes-exploratorymeetingstockholmamarch2006.htm> [Accessed 15 December 2016].

⁸³ This is under the so-called “real seat” theory. The German courts define the “real seat” as follows: “the place where the management office and the organs representing the company are engaged in business is the place where fundamental decisions of the management and control office are taken and effectively carried out”. See D. Coester-Waltjen, “German conflict rules and the multinational enterprise” (1976) 6(1) *Georgia Journal of International and Comparative Law* 206, 197.

⁸⁴ P. Smart, “Corporate domicile and multiple incorporation in English private international law” (1990) *Journal of Business Law* 126.

⁸⁵ J. Dammann, “A new approach to corporate choice of law” (2005) 38(1) *Vanderbilt Journal of Transnational Law* 51.

⁸⁶ See *Haugesund Kommune v Depfa ACS Bank* [2010] EWCA Civ 579; [2012] Q.B. 549.

4. Does the Use of ICD Arbitration Increase Shareholder Enforcement and Board Accountability?

Shareholders of listed companies in the UK rarely bring legal actions in the courts to enforce corporate governance.⁸⁷ As mentioned above, shareholders do not have the proper standing to bring a lawsuit in the courts against the board of directors. A derivative action also depends on obtaining the court's permission to continue the claim and on the availability of funding to bring the suit. In the US, litigation is an important element in corporate governance to ensure investor protection. The SEC has publicly denounced the use of arbitration for resolving disputes with the shareholders of listed companies. The SEC considers that the use of an arbitration clause could restrict the statutory rights conferred to investors because the arbitration clause would limit the remedies available to them.⁸⁸ In particular, the SEC considers class action to be the way that retail investors can obtain remedies efficiently, expeditiously and cheaply. An arbitration clause can deprive retail investors of their statutorily conferred rights. Despite the SEC's stance,⁸⁹ many listed companies continue to have a mandatory arbitration clause in their bylaws.⁹⁰ It should be noted that the UK has not adopted the US class action-led corporate governance. There are currently no procedures that facilitate lawyer-led shareholder actions against the board. Using arbitration in the UK would not deprive shareholders of the benefits of pursuing a class action, which has proved to be a cheaper way to obtain redress in the US. Therefore, the question for the UK is whether arbitration would provide the shareholders with more remedies—injunctive, appraisal, damages, and governance settlement⁹¹—than they would otherwise have. One positive argument is that shareholders would be more willing to refer a dispute to arbitration if they knew that the level of confidentiality would prevent the type of negative effect on share price produced by a lawsuit in court. Instead of publicly exposing the wrongs of management in the courts or in a shareholder meeting, arbitration is a way to rectify the wrong through a governance settlement. In a governance settlement, the board would contractually agree to take a particular course of action in corporate governance, such as agreeing not to table a resolution.

Shareholders may also bring actions against the board for damages suffered from the board's breach of securities law, for example, if the board fails to disclose certain corporate information leading to investor losses.⁹² In the US, securities litigation is important for ensuring capital market integrity and investor confidence.⁹³ In addition, class action is a more efficient, more expeditious and cheaper way for investors to obtain remedies. There has been a series of US court cases arguing for and against the use of arbitration to resolve

⁸⁷ In Australia, there has been an increase in shareholder class actions, despite its sharing the UK common law tradition. See J. Farrar, "The Move from Private Enforcement to Public Enforcement and Now the Move to Litigation Funding of Shareholder Activism: Are We Entering a New Era of Access to Justice in Corporate Law?" (2015) 26(1) *European Business Law Review* 75.

⁸⁸ The position of the SEC is that any such arbitration clause would be deemed to fall within the scope of the anti-waiver provisions of the Securities Act 1933 s.14 and the Securities Exchange Act 1934 s.29(a). See also S. Gruenbaum, "Avoiding the protections of the Federal Securities Laws: The anti-waiver provisions" (1980) 20(1) *Santa Clara Law Review* 49.

⁸⁹ The SEC would not exercise its delegated authority to accelerate the effective date of a company's registration statement if there is an arbitration clause in the company's bylaws. See also B. Black and J. Gross, "Investor protection meets the Federal Arbitration Act" (2012) 1(1) *Stanford Journal of Complex Litigation* 1.

⁹⁰ In *American Express Corp v Italian Colors Restaurant* 133 S Ct. 2304 (2013) and *Boilermakers Local 154 Retirement Fund v Chevron Group* Unreported 12 April 2013, Del.Ch., the courts held that arbitration of shareholder disputes was permitted if set out in the bylaws of the company.

⁹¹ Governance settlement is similar to the deferred prosecution agreements used in criminal cases against companies. See S. Gilchrist, "Paying your way out of trouble—the SFO and deferred prosecution agreements" [2012] 33(6) *Business Law Review* 150.

⁹² Patrick Hosking, "'Misled' investors line up to sue RBS for £3bn over rights issue", *The Times*, 2 September 2012, p.29.

⁹³ Coffee, "No exit? Opting out, the contractual theory of the corporation, and the special case of remedies" (1988) 53 *Brooklyn Law Review* 919; Coffee and Schwartz, "The survival of the derivative suit: An evaluation and a proposal for legislative reform" (1981) 81 *Columbia Law Review* 261.

securities law disputes.⁹⁴ The proponents of arbitration argue that the US Federal Arbitration Act 1925 allows an arbitration agreement to be used and that such an agreement should not be treated differently from other contracts.⁹⁵ The opponents argue that securities law intends to protect the investor; hence, securities law implicitly repeals the sections of the 1925 Act.⁹⁶ In the UK, there are currently no procedures for facilitating investor class action based on violations of securities law—mainly, the UK Financial Services and Markets Act 2000. Capital market integrity and investor confidence are reinforced through proceedings led by the Financial Conduct Authority and other non-private enforcement mechanisms. Therefore, the use of arbitration in the UK would not deny investors the benefits of class action shown in the US experience. On the contrary, arbitration may encourage smaller investors to bring their claims because arbitration would be faster and cheaper than litigation. The arbitrators may be more willing than the courts to hear the case rather than dismiss it at the outset to the detriment of the investor.

Arbitration as an alternative mechanism for shareholder activism

Shareholder activism denotes a concept in which shareholders take an active role in ensuring the board's performance and accountability.⁹⁷ It also involves the fiduciary duty of fund managers to identify claims and pursue them if they can bring value to the fund, to the interests of the beneficiary investor.⁹⁸ In the UK, activist funds are considered to be large and sophisticated shareholders.⁹⁹ Various strategies by activist shareholders have been used to demand that a board changes its course. Shareholders may demand a meeting with the board, write a confidential or open letter to the board, table a resolution to speak at meeting, or organise a shareholder revolt to vote down a resolution tabled by the board. UK shareholders rarely use lawsuits to force the board to change its course, for example, by requesting injunctive relief or demanding a governance settlement.¹⁰⁰ Lawsuits are more often used in the US and in other European countries to force a particular merger deal to lapse.¹⁰¹ Because the UK judicial system is not a favourable forum for shareholder activism,¹⁰²

⁹⁴ *American Express Corp v Italian Colors Restaurant* 133 S. Ct. 594 (2012). In *AT&T Mobility LLC v Conception* 131 S. Ct. 1740 (2011), the US Supreme Court refused to enforce class arbitration waivers on unconscionability grounds. In *Shearson/American Express Inc v McMahon* 482 U.S. 220 (1987), the Supreme Court upheld the arbitration provisions in brokerage contracts with respect to claims under the US Exchange Act. In *Wilko v Swan* 346 U.S. 427 (1953), the Supreme Court interpreted the non-waiver provision under the US Exchange Act 1933 s.14 as an expression of congressional intent to exempt claims under the statute from the US Federal Arbitration Act.

⁹⁵ *Doctor & Associates, Inc v Cassarotto* 517 U.S. 681 (1996); *CompuCredit Corp v Greenwood* 132 S. Ct. 665 (2012), the Supreme Court reaffirmed the principle that parties may agree to arbitrate claims arising under a federal statute so long as the statute does not contain a “contrary congressional command”.

⁹⁶ In *Shearson/American Express* 482 U.S. 220 (1987), the investors argued that the US Exchange Act s.29(a) (the anti-waiver provision) barred the arbitrability of claims arising under the Act. The court held that “the burden is on the party opposing arbitration ... to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue”. In *Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc* 473 U.S. 61 (1985), the court held that the opponent of arbitration must demonstrate “an inherent conflict between arbitration and the underlying purpose of the Exchange Act”.

⁹⁷ Farrar, “The Move from Private Enforcement to Public Enforcement and Now the Move to Litigation Funding of Shareholder Activism: Are We Entering a New Era of Access to Justice in Corporate Law?” [2015] 26(1) *European Business Law Review* 75.

⁹⁸ Investors may, in turn, owe fiduciary duties to the company in their activism. See I. Anabtawu and L. Stout, “Fiduciary duties for activist shareholders” (2008) 60 *Stanford Law Review* 1255.

⁹⁹ I. Filatotchev and O. Dotsenko, “Shareholder activism in the UK: types of activists, forms of activism, and their impact on a target’s performance” [2015] 19(1) *Journal of Management and Governance* 5; B. Wearing and Y. Millo, “Activist Investors in UK Quoted Companies and the implications for corporate governance” (ICAEW Report, 2011), <https://www.icaew.com/-/media/corporate/files/technical/corporate-governance/uk-corporate-governance/tecp1n10783-activist-investor-report-final-reduced.ashx> [Accessed 15 December 2016].

¹⁰⁰ A. Lahav, “Fundamental principles for class action governance” (2003) 37(1) *Indiana Law Review* 65.

¹⁰¹ T. Ogowewo, “Tactical litigation in takeover contests” [2007] *Journal of Business Law* 589.

¹⁰² Farrar, “The Move from Private Enforcement to Public Enforcement and Now the Move to Litigation Funding of Shareholder Activism: Are We Entering a New Era of Access to Justice in Corporate Law?” (2015) *European Business Law Review* 75; R. Tomasic and F. Akinbami, “Shareholder Activism and Litigation against UK Banks—The limits of company law and the desperate resort to Human Rights Claims?” in J. Loughrey (ed.), *Directors’ duties and shareholder litigation in the Wake of the Financial Crisis* (Cheltenham: Edward Elgar, 2013), pp.143–172.

arbitration can provide an alternative route for preserving governance values. In the US, activist hedge funds use litigation in a takeover to obtain redress.¹⁰³ In the UK, the Takeover Panel is an alternative to court litigation and is effectively a form of mandatory arbitration. This does not mean that in non-takeover cases, there is no scope for activism through arbitration. In a friendly merger case, shareholders may use arbitration to demand that more information be provided by the board before they cast their votes. After a takeover, investors can demand an appraisal remedy for their shares in arbitration.¹⁰⁴ Investors may use arbitration for a governance settlement¹⁰⁵ that requires the board to include more independent and non-executive directors from the minority group. In this way, arbitration is not a means to thwart shareholder activism but can be catalyst for investor-led governance. That is not to say that larger institutional investors such as pension funds and insurance companies would not benefit from mutual fund- and hedge fund-led activism.¹⁰⁶ In fact, in a governance settlement, they may be a free-rider of the success of shareholder activism.

Minimising adverse publicity

Shareholders can rely on exposing the wrongs of the board to enforce corporate governance. Legal action in court is a way to expose corporate wrongs and can increase the vigilance of the board in discharging their duties and the shareholders' return on investment. However, using court action to enforce corporate governance can also backfire by affecting corporate performance because court action can divert the board's attention, and the market can react to this type of shareholder enforcement, resulting in a negative effect on the company's share price. This is particularly true if "strike suits" based on frivolous allegations are being made. Shareholder activism is a preferred method of corporate governance in many jurisdictions.¹⁰⁷ Certain types of funds also employ various shareholder activist strategies to realise their investment. A court action against the board may result in the attainment of the shareholders' objectives. A fund management shareholder can use a potential court action to change a particular management course. Shareholders can commence court proceedings to obtain certain information that is otherwise unobtainable. They may even obtain an early settlement with the board or the company. Publicity is an important element in shareholder activism,¹⁰⁸ which relies on collaborative action from the market. Market analysts may speak negatively about the company, hedge funds may short-sell the company's stocks and public authorities may institute probes into the company. If such a dispute is to be constrained to resolution in arbitration, the publicity effect of using activist enforcement strategies in court will be largely diminished. ICD arbitration has the effect of managing the risk of over-activism by certain shareholders. This does not compromise the need for transparency in listed companies, because the company still needs to notify the exchange about an on-going arbitration. Shareholders will be bound by the confidentiality clause that requires them to not disclose information received in the course of arbitration. In this way, the company can also share more confidential information with shareholders. However, it should be noted that the company might not disclose information it would otherwise need

¹⁰³ *Corvex Management LP v Commonwealth REIT* ("Corvex") Md. Cir. Ct. 19 (February 2014).

¹⁰⁴ J. Lee, "Four Models of Minority Shareholder Protection in Takeovers" [2005] 16(4) *European Business Law Review* 803; J. Payne, "Minority Shareholder Protection in Takeovers: A UK Perspective" [2011] 8(2) *European Company and Financial Law Review* 145.

¹⁰⁵ Corporate governance reform through negotiated settlement has been pursued in class actions in the US. The aim is to increase managerial accountability to shareholders. The governance settlement can include creating a shareholder director-nomination committee, splitting the role of the CEO and the Chairman of the Board—making governance reform contractually binding.

¹⁰⁶ N. Harrison and F. Huntriss, "Hedge funds and litigation: a brave new world" (2015) 10(2) *Capital Markets Law Journal* 135.

¹⁰⁷ B. Cheffins and J. Armour, "The Past, Present, and Future of Shareholder Activism by Hedge Funds" (2011) 37(1) *Journal of Corporation Law* 51.

¹⁰⁸ L. Baixiao and J. McConnell, "The role of the media in corporate governance: Do the media influence managers' capital allocation decisions?" [2013] 110 (1) *Journal of Financial Economics* 1.

to disclose in litigation. This is because it may be easier to obtain extensive disclosure in litigation than in arbitration.

The serviceability of arbitration in value creation: Corporate value, shareholder value and social value

Public policy, in particular investor protection, has been a basis for preventing IDC arbitration for listed companies where the public interest might thereby be reduced.¹⁰⁹ Hence, the public policy question very much depends on behavioural assumptions regarding corporate constituents. In so doing, public policy questions could be framed as follows: would ICD arbitration enhance corporate value, shareholder value and social value? As already mentioned, ICD arbitration is rarely used in UK listed companies so the benefit of ICD arbitration for listed companies is therefore an empirical question. In increasingly shareholder-centred governance, ICD arbitration provides a forum for shareholders to enforce the board's duties instead of exercising exit strategies. To bring an ICD arbitration through a derivative action claiming a breach of the fiduciary duty owed by any director, officer or other employee of the company, the claimants need to be shareholders at the time that the proceedings are instituted. This would encourage shareholders to hold stocks for a longer term, hence fostering a longer-term investment culture.¹¹⁰ For investors in a listed company, ICD arbitration provides a forum to obtain redress, such as a governance settlement, regardless of whether company law provides adequate remedies. The advantage of using arbitration is that arbitrators can mould their decision to fit the needs of the particular business problem; arbitrators can arrive at management and policy decisions that courts would not attempt to make.¹¹¹

A UK listed company may be incorporated elsewhere and have an international shareholder base. Once its shares are traded on UK exchanges, English law becomes the applicable law for securities-related disputes. If the investor suffers damages due to the company's failure to disclose certain corporate information, such intra-corporate disputes on the misrepresentation of securities can be decided through ICD arbitration.¹¹² This type of arbitration can be achieved through an initial public offering (IPO) document specifically stipulating that ICDs will be adjudicated through arbitration.

ICD arbitration may be said to prevent case flows in the courts, thus reducing the precedential effect of company law cases. This has a negative effect on the development of company law by the courts. However, to what extent does the court still develop company law doctrine through case law? Most of the adjudications of company law cases take place in the lower courts, which focus on the facts rather than the law itself. As mentioned, shareholder litigation and investor securities litigation are not as prevalent in the UK as in the US, so it is difficult to argue that there is a case in the UK for such a social value enhancement. If extreme importance is attached to a legal question in English law, there is a way to apply for court review under the Arbitration Act 1996. In this way, ICD arbitration encourages longer-term investment, attracts listing on UK exchanges and does not compromise the existing social value of the courts developing judicial principles in company and securities law.

The growth of the private equity funds and hedge fund industry has significantly changed the relationship between boards and investors. Shareholder activism by private equity funds and hedge funds has attempted to remedy the deficiencies of the decoupling of ownership

¹⁰⁹ Black and Gross, "Investor protection meets the Federal Arbitration Act" (2012) 1(1) *Stanford Journal of Complex Litigation* 1; E. Ferran, "Are US-style investor suites coming to the UK?" (2009) 9(2) *Journal of Corporate Law Studies* 315.

¹¹⁰ Shareholder engagement can facilitate long-term investment. See E. Micheler, "Facilitating investor engagement and stewardship" [2013] 14(1) *European Business Organization Law Review* 29.

¹¹¹ Shell, "Arbitration and corporate governance" (1989) 67 *North Carolina Law Review* 517, 520.

¹¹² B. Black, "Arbitration of investors' claims against issuers: an idea whose time has come?" (2012) 75(1) *Law and Contemporary Problems* 107.

and control.¹¹³ This trend of shareholder activism will continue to influence how investors engage in corporate affairs. With the ageing population of developed economies, more investment will be in private equity funds and hedge funds that focus on risk-adjusted returns rather than fixed income.¹¹⁴ The increased economic pressure and fiduciary duty for private equity funds and hedge funds to monitor portfolio firms' performance and related governance means that litigation rights (claims) would be an important asset.¹¹⁵ As stated, the current UK legal environment is not in favour of US-style litigation-led private enforcement; thus, arbitration not only serves as an alternative catalyst for corporate governance but also reduces the negative effect of litigation-style shareholder activism. Litigation exposes listed companies to adverse publicity that could trigger irrational behaviour on the part of investors. It can also be used as a means of excessive leverage that serves the interest of private equity and hedge funds. At the extreme, shareholder activists can abuse the litigation process, and regulation of this problem gives rise to both theoretical and practical difficulties. Unlike in the US, where pension fund and institutional shareholders undertake the primary role of litigation-led private enforcement,¹¹⁶ UK institutional shareholders, holding 35 per cent of the public market securities,¹¹⁷ employ different investment strategies. Yet a large percentage of funding for private equity funds and hedge funds comes from institutional shareholders. Private equity funds and hedge funds are in a better position to use arbitration to monitor their portfolio firms because their investments are more focused on individual firms.¹¹⁸ Unlike institutional shareholders, they do not have a duty to diversify and can undertake more targeted monitoring of portfolio firms. Private equity firms often take a seat on the board, and this increases the chances that they will use arbitration to resolve disputes with the board—like the intra-corporate disputes of private companies.

Another benefit of arbitration-led governance by hedge funds is reducing the opportunity for hedge funds to use litigation in order to profit from short-selling.¹¹⁹ Although arbitration is subject to disclosure at the London Stock Exchange, the confidentiality of the proceedings reduces the company's exposure to short-term trading. As a result, arbitration increases corporate monitoring, which reduces agency costs but also reduces the chances of hedge funds short-selling company shares at the expense of other investors, resulting in a principal-principal conflict.

5. Recommendations and Conclusion

The company's constitution provides the best basis for ICD arbitration. The constitution should be carefully drafted to define the disputes covered and who is bound by the clause so as to enable individual directors who are not considered privy to the constitution to invoke the arbitration clause. The 2006 Act should be amended to specify whether company's directors will be bound by the ICD arbitration clause in the constitution. The constitution should also deal with the issue of the insertion or modification of the arbitration regime by a super-majority vote of the shareholders. The 2006 Act should include provisions confirming that the principle of majority rule will apply to the arbitration clause and that the dissenting

¹¹³ L. Ryan, "Shareholders and the Atom of Property: Fission or Fusion" [2000] 39(1) *Business & Society* 25.

¹¹⁴ KPMG International, *Growing Up: A New Environment for Hedge Funds* (London: KPMG/AIMA/MFA Global Hedge Fund Survey, 2015), p.9, www.kpmg.com/growingup [Accessed 6 December 2016].

¹¹⁵ J. Cox and R. Thomas, "Letting billions slip through your fingers: Empirical evidence and legal implications of the failure of financial institutions to participate in securities class action settlements" (2005) 58 *Stanford Law Review* 411.

¹¹⁶ C. Chen, "Institutional monitoring through shareholder litigation" (2010) 95 *Journal of Financial Economics* 356.

¹¹⁷ Office for National Statistics.

¹¹⁸ M. Schneider and L. Ryan, "A review of hedge funds and their investor activism: do they help or hurt other equity investors?" (2011) 15 *Journal of Management Governance* 349.

¹¹⁹ M. Fox, L. Glosten and P. Tetlock, "Short selling and the news: A preliminary report on empirical study" (2010) 54(3) *New York Law School Law Review* 645.

shareholders cannot challenge the validity of the arbitration on the ground that they have not consented to it. As derivative actions will be one of the main actions, the 2006 Act should clarify:

- if the arbitral tribunal has the same power as the court in granting permission to continue the claim; and
- whether the decision of the arbitration would have the effect of *res judicata*. The parties should also stipulate in the constitution what powers, especially in the area of disclosure and interim remedies, are conferred on the arbitrators.

These powers are particularly useful to the shareholders if they wish to benefit from the discovery regime that litigation would have. The constitution should also incorporate rules dealing with multi-party arbitration, especially in the areas of the appointment of arbitrators and the consolidation of multi-party claims. The 2006 Act can also provide model articles dealing with the appointment of arbitrators and the consolidation of multiple claims.¹²⁰ The 2006 Act should also provide solutions to the conflicts of interest stemming from the nominee companies holding legal titles to the shares on behalf of the end investors. Conflict of laws issues can pose a risk in the enforcement of the award if the applicable law is wrongly chosen and applied. An international instrument giving guidance on the applicable law in ICD arbitration would minimise the uncertainty that can reduce parties' willingness to use arbitration to resolve corporate disputes in cross-border investments.

¹²⁰ The ICC Arbitration Rules 2012 arts 10 and 23.4; the LCIA Arbitration Rules 2014 arts 22.2 and 22.6; the CI Arb Arbitration Rules 2000 art.7.3; CI Arb worked on the revision of the 2000 Arbitration Rules and, as a consequence, the new ones became effective in December 2015. The CI Arb Arbitration Rules 2015 are based on the UNCITRAL Model Law and do not contain express provisions on consolidation of proceedings. However, Appendix II paras 23 and 24 (p.49) mention multiple parties and consolidation of proceedings. Parties may wish to agree upon these matters at their preliminary meeting. Institution rules contribute to fair arbitration, see M. Farmer, "Mandatory and Fair—A Better System of Mandatory Arbitration" [2012] 121(8) *Yale Law Journal* 2346.