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Kenichi Osugi
Professor of Commercial Law at Tokyo Metropolitan University

Protecting Minority Shareholders During Shifts in Corporate Control

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Protecting Minority Shareholders During Shifts in Corporate Control *

Kenichi Osugi **

I. The Theme

This paper discusses legal devices that protect minority shareholders from possible harm caused by shifts in corporate control. There are two main topics as follows. 1) Often influential families own all or substantially all shares of prominent companies in Asia. Those families sometimes sell some of their shares to the investing public and let the companies "go public." This is the first issue, named "a birth of outside shareholders." 2) The other issue comes up when a (sometimes foreign) business enterprise wants to acquire another business. Also (often foreign) investment funds buy out Asian companies. This is the second issue, named "formation of controlling power." The author would like to focus on those two situations without discussing minor problems.[1]

Before starting my legal argument, I would like to mention two items. Firstly, contrary to popular opinion, it is not unique to Asian economies for influential families to own large companies. Rather, it is seen in European countries as well.[2, 3]

Secondly, the OECD Principles of Corporate Governance provides us with two aspects of the issue. Its Preamble states, "[t]here is no single model of good corporate governance." Therefore, we should not consider the existence of controlling shareholders as evil. True, family-owned companies in some Asian countries played an essential role in towing developing economies up close to the level of developed

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* In preparing this paper, I owed much to a monograph, "What should Laws on Combination of Companies be like – Legislature and Interpretation [*Ketsugô Kigyô Hô no Rippô to Kaishaku*]," (Yûhikaku Tokyo 1995) by Prof., Dr.iur. Kenjirô Egashira. It is a comprehensive Dissertation on the theme, and I recommend Japanese readers to consult this book.

****** Associate Professor of Commercial Law at Tokyo Metropolitan University, Faculty of Law. LL.B. at Tokyo University in 1990. Visiting Fellow at Columbia Law School in New York during 1997-99.

[1] *See* footnotes 4, 12 and 18 for the whole picture of control shifts and related issues.

[2] Also interlocking share holding such as in Japan is also observed in Western economies. It is safe to assume that the US economies in 1920s was even more complicated in hierarchical share ownership. In that respect, the enactment of the Public Utility Holding Company Act of 1935 in the US, aiming at handling this issue, deserves world-wide attention. *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, 3rd ed (West Publishing 1995), at Chapter 15.

[3] Asian peculiarity seems to lie in the tendency that prominent families and corporate managers often have close ties with state administration and/or politics. *See* Curtis K. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998). If this is the case, some concerns in state-owned companies, such as bureaucratic organisation and low motivations, must also hold in some Asian large family enterprises. As to state-owned companies, *Cf.* OECD PROCEEDINGS, CORPORATE GOVERNANCE, STATE-OWNED ENTERPRISES AND PRIVATISATION (OECD 1998).

countries in the latter half of the 20th century. On the other hand, **1.E. of the OECD Principles** puts an emphasis on efficient and transparent markets for corporate control. We thus should make shifts in corporate control more transparent and fair.

II. Controlled Companies in the process of Going Public – A Birth of Outside Shareholders [4]

Let us suppose a situation in which a large shareholder decided to sell part of her stakes in a large company and get the company listed on a stock exchange. She wants to maintain her influence on the company. However, she may abuse this controlling position after the outside shareholders participate in the company. On the other hand, going public as such could have several advantages. It can enhance the company's ability to raise needed funds from the investing public; small investors can support, as well as benefit from, fast-growing enterprises. In addition, if suitable professional salaried managers successfully replace the owner-managers (blockholder-directors) while the latter keep monitoring function over the former[5], going public motivates professional managers better and it also relieves the controlling family of the burden of choosing among family members a CEO candidate of the next generation and training him/her to be a manager. Therefore, going public with retention of controlling stakes is not necessarily harmful.

The author is supposed to focus on the legal issues occurring *during* the listing process. Legal issues which may arise *after* listing process will be presented later by another participant. However, these two issues are inter-related. In the countries where post-listing legal protection of minority shareholders is pretty bad, law should limit the scope of listing controlled companies, since market (= pricing) mechanism cannot deal with the problems *ex ante* sufficiently that could arise after the listing.[6] Therefore, for instance, law should prohibit a large owner selling less than a certain percentage [probably two-thirds, or a half[7]] of her shares and thus obligating her to "open" the company widely to the general public. However, it is better to have the combination of enabling greater freedom when going public and tightening post-listing regulations,

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4 There are various ways, coupled and independently, for a company to be listed on a securities exchange, with a large shareholder retaining the controlling portion of the company. 1) the company's public offering of newly-issued shares (original distribution), 2) the controlling shareholder's distribution of part of her shares (secondary distribution), and 3) when the controlling shareholder is a corporation, the controlling company's transferring minority part of its shares in the controlled company to its own shareholders as in-kind dividends (partial spin-off), are often aggregately called "equity carve-out." When the controlling shareholder is a corporation, 4) tracking stock (letter stock) could be used for a similar purpose. In this chapter, however, the author mainly focuses on secondary distributions.

5 This rosy scenario was said to be observed often in *Zaibatsu* (pre-war Japanese conglomerates) companies in 1920s and early 1930s. Tetsuo Okazaki, "The Japanese Firm under the Wartime Planned Economy," in MASAHIKO AOKI & RONALD DORE (ED.), THE JAPANESE FIRM (Oxford 1994).

6 The New York Stock Exchange (NYSE) takes into accounts concentration of voting power in deciding whether to list a company or not. NYSE Listed Company Manual § 305.00. See also footnotes 10. The manual is available at <http://www.nyse.com/listedhome.html?query=/listed/listedcomanual.html>

7 The percentage shall be calculated based on not the large owner's holding but the outstanding shares of the company.

rather than the combination of narrower listing policies and looser post-listing regulations. Moreover, it may not be realistic to ban controlled companies from going public in many countries, since there have already been publicly held companies which are controlled by a blockholder.

Then, how should law regulate the listing process? The key is mandatory disclosure: large shareholders shall disclose information, and a disclosure statement shall include not only financial information of the company but information about the relationship between the controlling person and the controlled company.[8] In addition, both penal and civil sanctions should be applied against the blockholders who did not observe disclosure requirement.[9]

One more issue is worth attention. In principle, shareholders' rights enjoyed by controlling shareholders and those enjoyed by the investing public shall be the same. This rule may, however, need some flexibility. Some publishing companies, for instance, hoping to maintain their freedom of speech, want managers' independence and autonomy from eager capitalists. In a legitimate case like this, more adjustable regulations such as listing standards of stock exchanges[10] are generally more suitable to implement the "equality" policy, rather than rigid statutes. Techniques often used to stifle voices of outside shareholders are, 1) to use multiple classes of shares and distribute only non-voting shares to the investing public,[11] and 2) to come to an arrangement between a listed company and its controlling owner which gives disproportionately larger control upon her. These tactics could, however, do harm on the investing public and thus on the long-term development of national economy as well. It should be noted that the OECD Principles of Corporate Governance properly mention this issue in **principles 1.D. and 2.A.** and **Annotations** to those principles.

III. Buyouts – Formation of Controlling Power [12]

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[8] In the US, issuers, underwriters and dealers shall not distribute securities to the public unless they file a registration statement with the Securities and Exchange Commission (the SEC) and it gets effective, and the distribution is accompanied by a prospectus. Section 5 and section 4 (1) of the Securities Act of 1933 (15 U.S.C. §§ 77a et seq.). The term "issuer" include person controlling the issuer. Section 2 (11) of the Act. The information to be disclosed is detailed by section 7 of the Act and Schedule A annexed to the Act, which is further supplemented by SEC rules, *inter alia*, Regulations S-X (17 C.F.R. §§ 229.10 et seq.). Most of those statutes and rules are available at < http://www.sec.gov/about.shtml >

[9] The Securities Act in the US lists various sanctions against those who violate the disclosure requirements. Section 11 provides for civil liabilities, and Section 12 (a) secures the right of investors who were deceived by false statement to rescind the purchase contract. Penalties are set by section 24. The SEC is authorised several administrative powers by section 8A and section 20(b) and (d).

[10] NYSE Listed Company Manual §§ 313.00 (Voting Rights) and 314.00 (Special Rights of Certain Shareholders) are examples.

[11] *Cf.* Ronald J. Gilson, "Evaluating Dual Class Common Stock: the Relevance of Substitutes," 73 Va. L. Rev. 807 (1987).

[12] Wealthy individuals (insiders or outsiders) or an entity (a business enterprise or investment fund) can use several means to acquire controlling shares in a target company which could lead to the formation of controlling-controlled relationship as well as the tension between the controlling shareholder and leftover small investors. An acquirer could 1) buy up shares in

Both business enterprises and investment funds are potential buyers of underperforming companies. More and more foreign companies and funds are expected to acquire Asian businesses. A new trend is for such a fund to exercise a veto against management of the companies which they are investing in, in order to increase the share value and resell the shares at a higher price ("hands on" investment).

Buyouts could be harmful to small, individual investors. Suppose shares in a company are traded at USD 100, reflecting the bad management running the company, and another company announces a tender offer of $ 120. Many shareholders believe the fair value of the stock should be more than $ 150. However, they feel oppressed, since, if they do not apply for the offer, their share value will decrease after the consummation of the tender offer as the acquirer may exploit the target company. Moreover, the acquirer may offer an even lower price to leftover minority shareholders after the first buyout offer. Considering these risks, shareholders are being put under pressure, "to sell, or not to sell." Their decision is often distorted by several tactics used by the acquirer, which is the reason the law shall intervene in buyouts to prevent that from happening.

Compared to going public transactions discussed in Part II, even more detailed regulations on buyouts are needed in regard to both disclosure and substantive sides of transactions. Regulations in the US Securities and Exchange Act of 1934[13] provide reliable guidance on this issue. Section 14 (e) of the Act prohibits acquirers making misleading or false disclosures. In addition, the Act puts forth substantive (as opposed to procedural) regulations in order to relieve individual investors of undue pressure to sell their shares. For instance, section 14 (d)(7) provides that the an acquirer shall not exclude any shareholders in the target company from the offer, and shall, if he raises the share price at a later date, give this higher price even to the shareholders who responded to the offer before the revision was made (best price rule). This is only a part of the elaborately detailed regulation on substantive issues in tender offers.[14]

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the target in open markets (usually not practical way), 2) announce a tender offer to then-existing shareholders, 3) purchase a controlling portion from a then-existing controlling shareholder, 4) get the target to issue large numbers of new shares and allocate them to her, and/or 5) announce exchange offer to shareholders in exchange for shares of a new class of common stock issued by the company that gives to those shareholders higher dividends and lower (often no) voting rights— often used by incumbent managers to keep holding their offices. This paper will concentrate on tender-offer issues, and take up some issues of purchase in open markets as long as they relate to tender-offer issues. *See* Gilson, supra note 11 on the problems in exchange offers.

[13] 15 U.S.C. §§ 78a et seq.

[14] Section of 14 (d)(5) of the 1934 Act secures a right of shareholder to withdraw his application for the tender offer, and Section 14 (d)(6) requires an acquirer to purchase from all shareholders who applied for the offer on pro rata basis if the entire application exceeds the planned numbers of shares to be tendered. The SEC promulgated detailed rules that complement the 1934 Act. Regulation 14D – which consists of rule 14d-1 (17. C.F.R. § 240.14d-1) through 14d-10, and schedules 14D-1 and schedule 14D-9 –, and Regulation 14E – which consists of rule 14e-1 through rule 14e-7 –, regulate tender offers. Especially important are rule 14e-1 providing for the minimum and maximum periods for tender offers, and rule 10b-13 prohibiting an acquirer from buying the target shares out of tender offer proceedings during the offer period.

Nevertheless, the ’34 Act is not perfect in coping with shareholder oppression, as when a tender offer is partial, there will always be leftover minority shareholders. Would-be minorities fear the companies “going private,” which would deprive them of the ability to sell their shares in stock markets.[15] One way to deal with this problem is to give court judges the authority to review the transaction which forecloses leftover shareholders, just as done in US case laws.[16] Another way is simply to prohibit the acquirer from buying minority shares at lower prices than offered in the tender offer for a certain time period, such as 3 to 5 years after the consummation of the tender offer.

Probably a more sensible solution would be to introduce a legislature conferring an appraisal right on minority shareholders when a birth or change of a controlling shareholder in a company occurs, whether the company is either listed or non-listed. The price to be paid should be the fair value that the appraised shares would have had but for the formation of a controlling shareholder, as of the time of the formation.[17] This kind of solution is often found in European countries either as statutes or rules promulgated by self-regulatory organisations (SROs).

Similarly essential is disclosure of a large block of shares. Section 13 (d) of the 1934 US Act requires a blockholder with 5 % or more share holding to disclose her ownership and its respective increase or decrease. This is because buying or selling by blockholders affects the market price of the company, thus the investing public should be informed of blockholders’ behaviour.

The above proposals may sound too complicated for some of the participants in the roundtable. However, consider this: takeovers benefit minority shareholders only in a regulated environment. At the same time, putting too much restrictions on takeovers will allow incumbent managers to defend themselves from the fear of hostile takeovers, which will erode competitiveness of a national economy. Thus, an optimal level of regulation is essential.[18]

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[15] Going private alone could cause serious harm on minority shareholders. In the US, SEC rule 13e-3 deals with the problem by way of disclosure requirement.

[16] Often this issue emerges as follows. The controlling shareholder incorporate a shell company and let the shell absorb the controlled company by a merger, in which the surviving shell gives only (often a too small amount of) cash to the minority shareholders (cash-out/ freeze-out merger). Naturally there are arguments in the US on “two step mergers.” *See* Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693 (1985).

[17] *Cf.* Santoni, The Developing Duties of Controlling Shareholders and Appropriate Restraints on the Sale of Corporate Control, 4 J. Corp. L. 285 (1979).

[18] Less important issues are, 1) allocation of controlling premium to minority shareholders, and 2) civil liability to minority shareholders owed by a previous controlling shareholder who transferred her shares to another (a new controlling shareholder).

In terms of the first issue, Section 27-13 (5) of Securities Trading Act in Japan compels a person who is planning to tender shares which is one-third or more of outstanding shares in a target company, to use a public (open) tender offer proceeding, and prohibit purchases out of the tender offer proceeding, either inside or outside stock exchanges. This rule enables minority shareholders to participate in controlling premium (a difference between a market price and the price offered to a controlling shareholder), but the author is suspicious whether you should the allocation of controlling premium to minorities,

IV. Concluding Remark

Protecting minority shareholders will accelerate the economic growth of a nation, because **"realising *long-term* value for the *entire* shareholders" is the closest index of development of a national economy**. This is especially true during the time when evolution and dynamics is more important than stability in corporate management.[19] Thus, law should enable creative destruction rather than build up a stable order.

Function is more important than form. As an example, Japan recently set up several stock exchanges that were especially aimed at venture businesses, but did not have enough useful skills to distinguish good ventures from bad, causing the rise and fall of "venture bubbles." Now most shares in venture businesses are being traded at much lower prices than just after they went public. Money flew to wrong places and was wasted. The author hopes Asian leaders understand that creating a stock market and letting new companies enlist will not necessarily increase national wealth.

Now, the author would like to depart a bit from legal arguments and express other perspectives and personal hopes. More and more Western companies, especially investment funds, are buying out Asian companies. As a result, we are seeing collisions of cultures here and there. The Asian side needs to show patience and have an open mind. For example, firing incumbent managers and/or employees to some extent should be recognised as necessary evil in the rapidly changing global economy. The Western side as well should fulfil their moral obligation of explaining to their Asian business counterpart the rationality or efficiency of the Western management style. The Western side also needs to care for fair distribution of the fruits of economic success, as suspicions are often demonstrated that Western funds do not pay Asian parties fairly or sufficiently.

In short, shifts in corporate control are the crossroads where Eastern and Western capitalism meet each other, and thus are filled with unknown possibilities and risks.

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and, if so, whether it is the best rule to achieve the goal. *Compare* Andrews, "the Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505, 517 (1965), to AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, at § 5.16. (1994); EASTERBOOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, at 117 (1991).

Regarding to the second issue, there are some cases in the US that ordered a previous controlling shareholder to pay damages, if he knew or could have known that the new controlling shareholder would abuse her power. *Eg*. Insuranshare Corp. of Delaware v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D.Pa. 1940); DeBaun v. First Western Bank & Trust Co., 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975); Harris v. Carter, 582 A.2d 222 (Del. Ch. 1990).

[19] *Cf*. Ronald J. Gilson, "Corporate Governance and Economic Efficiency: When do Institutions Matter ?" 74 Wash. U. L.Q. 327 (1996).