# Related Party Transactions: UK Model

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## Abstract

This paper analyses the regulation of related party transactions in the UK through two comparative lenses, one external, the other internal. The external comparison is between English law and the law on RPTs in the United States, especially in Delaware. The internal comparison is between the English corporate law applying to all companies and the additional rules applicable to companies quoted on the London Stock Exchange, both those with a premium listing on the Main Market and those traded on the Alternative Investment Market. The first external comparison highlights two features of the general regulation of RPTs in the UK. The first is the adherence of English law to the classical concept of a fiduciary and the second is reluctance to use assessment of the substantive fairness of the transaction as a test for the legality of the RPT and, in consequence, its reliance on wholly procedural controls. The first feature made it difficult for the general law to handle RPTs with shareholders, including directors in their capacity as shareholders. The second came into prominence when the private-ordering model which underlies UK company law led to the shift of the procedural controls from the shareholders to the board. For both problems, UK statute law developed some work-arounds, but without comprehensive revision of these underlying characteristics of the general law. The comparison with the rules for publicly traded companies shows how rules might develop when the starting point is a functional one. Substantial shareholders are as much subject to the constraints as directors and fairness opinions are routinely utilised. However, exchanges have become subject to much sharper regulatory competition than national legal systems. Rule-makers are cautious in their use of exchange rules to promote corporate governance objectives which go beyond what is internationally acceptable. As early as 1993 the London Stock Exchange seems to have pulled back from a widespread application of majority-of-the-minority shareholder approval for RPTs and this century it has wavered in its policies towards subjecting controlling shareholders to effective constraints on RPTs.

Keywords: corporate governance, related party transactions, fiduciary duties, stock exchange rules, controlling shareholders

JEL Classifications: K15, K22

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The comparison with the rules for publicly traded companies shows how rules might develop when the starting point is a functional one. Substantial shareholders are as much subject to the constraints as directors and fairness opinions are routinely utilised. However, exchanges have become subject to much sharper regulatory competition than national legal systems. Rule-makers are cautious in their use of exchange rules to promote corporate governance objectives which go beyond what is internationally acceptable. As early as 1993 the London Stock Exchange seems to have pulled back from a widespread application of majority-of-the-minority shareholder approval for RPTs and this century it has wavered in its policies towards subjecting controlling shareholders to effective constraints on RPTs.

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## 1. INTRODUCTION

The UK has a long history of legal regulation of related party transactions (RPTs). The relevant law emerged from court decisions based on general common law (or, more accurately, "equitable")[1] principles. These decisions were coincident with the emergence of a modern statutory system for the formation of companies by simple registration in the 1840s and 1850s. These early court decisions seem to have so impressed Parliament that it reversed its initial policy of including rules on RPTs in the legislation and left their development to the courts.[2] Not until the Companies Act 2006 were the equitable principles embodied in legislation and, even then, this was done on the basis of a 'high level' restatement, rather than a fundamental refashioning, of what the courts had produced. However, the claim of the UK to have a well-developed system of rules for RPTs rests as much on an analysis of the rules applicable to companies admitted to the Official List of the London Stock Exchange as on the general law, and, even then, only to those issuers which have chosen to have a 'premium listing'.[3] These rules were developed, initially by the Exchange itself, but since 2000, after its demutualisation, the rules have been in the custody of a separate market regulator, initially the Financial Services Authority, now the Financial Conduct Authority.

By contrast, the rules applying to companies in general – the modern version of the rules initiated by the courts in the 1840s and 1850s – are much less constraining of RPTs. They have perhaps three features which are salient in this regard. First, the concept of 'conflicts of

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[1] "Common law" is an ambiguous term in UK legal literature. Sometimes, it means rules developed by the courts rather than by the legislature. Sometimes, it means rules developed by the common law courts as opposed to rules developed by the chancery courts ("equity"). The two separate court systems were unified by the Judicature Acts 1873-1875, and priority given to equitable rules in cases of conflict, but the two streams of rules display a certain conceptual separateness, even today.

[2] See text attached to fnn 17 and 18 below.

[3] See n 71 below.

interest', which the courts used to identify the risk in RPTs, was used to bring transactions within scope of the rules where the parties were the company and a director (whether the director contracted directly or indirectly via a company or firm). This followed from a doctrinal analysis whereby the duty of avoid conflicts of interest was deduced from the existence of a fiduciary relationship between the constrained party and the company. Characterising the directors' relationship with the company as a fiduciary one was an easy step, but the British courts were reluctant to take it in the case of a shareholder, even a controlling shareholder, or a director acting in the capacity as shareholder. However, as we shall see, English law did develop some work-arounds to deal with the regulatory gap generated by this commitment to conceptual purity.

Second, English law permitted directors to escape from the consequences of entering into a conflicted transaction by obtaining the consent of the beneficiary of the duty, ie the company. More important, it permitted that consent to be given generally and in advance through a procedure laid down in the articles which shifted the locus of approval away from the shareholders (the default body) to the (disinterested) members of the board. Modern statute law has shown some uneasiness with this feature and has restored shareholder approval in some cases. This feature was closely linked with a third aspect of the English fiduciary rules, namely, that they relied wholly on procedural steps to manage the conflict. This had the beneficial effect that the claimant, in cases of failure to follow the prescribed procedure, had no need to deal with the issue that the transaction might have occurred in fact on no less favourable terms than those which would have prevailed at arm's length. However, it also meant that, if the procedure were followed, the courts had no power to scrutinise the fairness of the substantive terms of the deal. This issue came to the fore once the procedural requirements had been reduced to an undemanding level by the company's articles.

All three features represent something of a contrast with the law of Delaware (and US state corporate law more generally), despite the common origins of the two systems, symbolised by the fact that in both England and Delaware the court of first instance for corporate law disputes has the word ‘chancery’ in its title. In what follows, there will be developed a largely historical account of the English system which stresses an internal and, less strongly, an external contrast. The internal contrast is that between general corporate law and the rules applicable to premium listed companies and the external contrast that with the law of the US.

For the purposes of this paper the focus is solely on RPTs which take the form of self-dealing transactions, ie the insider contracts with the company, either directly or indirectly. Corporate opportunities, where the insider seeks to divert a business opportunity away from the company are left for another day. Even within self-dealing transactions, contracts and arrangements between a director and the company relating to remuneration are not dealt with in detail, on the grounds that, this century, specific “say-on-pay” rules have been developed separately from the general rules on self-dealing transactions.

## 2. THE GENERAL LAW

### 2.1 The Starting Point

Like US law, English law (and, more generally, the laws of the three UK jurisdictions)[4] developed rules governing transactions between directors and their companies by treating directors as fiduciaries. From the first third of the nineteenth century onwards directors were subject to fiduciary duties, either on the basis of a trust analogy (even though the assets of an incorporated business were vested in the company, not the directors) or on the basis that the directors were agents of the company. On either basis the directors were fiduciaries and were required, in particular, not to put themselves in a position where their personal interest (or a

[4] I will refer in this paper only to the law of England and Wales. Scottish and Northern Irish law is broadly similar, but Scottish law has some particularities which I ignore.

duty owed to a third party) conflicted with their duty to promote the success of the company. In an early case which still resonates down the years, Lord Cranworth said in *Aberdeen Railway v Blaikie Bros*[5] (1854): "no one, having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or even can have, a personal interest conflicting, or which possibly may conflict, with the interests those whom he is bound to protect."

Lord Cranworth also laid down the principle of procedural dominance. Addressing the argument that the terms of the conflicted transaction might have been as good as or even better than the open market terms, Lord Cranworth said: "So inflexible is the rule that no inquiry on that is permitted. The English authorities on this head are numerous and uniform." Consequently, there have been some notable cases where companies have been able to make windfall gains or avoid unrelated losses by relying on the equitable principle, even though the conflict was not causally relevant to the profit or loss.[6] This rider might be explained on the basis of a desire to maximise the deterrent effect of the rule or on the basis of the courts' desire (strong in the nineteenth century) to intervene as little as possible in the internal affairs of the company. That the latter was an important element in the courts' reasoning is suggested by their failure to develop the law so as to allow *plaintiffs* to challenge procedurally fair

[5] (1854) 1 Macq 461 (HL). In this case the railway company contacted with the plaintiff for the supply of "chairs" – the word referring here to a metal device for securing rails to sleepers. Blaikie was the chairman of company as well as managing partner of the supplying partnership, which unsuccessfully sued to enforce the contract.

[6] *Re Duckwari plc (No 2)* [1998] 2 BCLC 315 (CA) – director required to indemnify company in respect of the company's purchase of property (real estate) from the director at a fair price but without the required shareholder approval when the market for such property subsequently collapsed and the purchaser was forced to sell at a loss. (The case was based on the statutory provisions relating to substantial property purchases from directors – considered below – but the decision was clearly informed by the background fiduciary principles.); *J J Harrison (Properties) Ltd v Harrison* [2002] 1 BCLC 163 (CA) – director who had purchased corporate property (real estate) without full disclosure of facts relating to its value required to account for the profit made on the subsequent sales of the property at the enhanced value the property had acquired at the time of the sales through improvements made by the purchaser, not its value at the time of the purchase; the purchaser received credit only for out-of-pocket expenses.

contacts on the basis of substantive unfairness.[7] In any event, there has been no English equivalent of the Delaware decision in *Fliegler v Lawrence*[8] with its emphasis on the courts' role in assessing the substantive fairness of the transaction, even when the relevant procedural requirements have been met.

The core consequences of breach of the 'no conflict' rule were as follows. The company obtained an option whether to perform the conflicted contract, since the contract became binding on the company only if it was subsequently ratified by the shareholders. Irrespective of whether the contract was ratified, the conflicted director was liable to account to the company for any profits made from the transaction by him or her and to compensate the company for damages suffered by it. Conceivably also, non-conflicted directors who knew of the conflict of interest but nevertheless authorised the contract would be in breach of their core duty of loyalty (ie to promote the success of the company).

### 2.2 Corporate Approval

In his famous article on the development of the rules relating to corporate conflicts of interest in the US,[9] Professor Marsh seems to have regarded this equitable principle as a prohibition on related party transactions by directors. Lord Cranworth certainly set out the position in unqualified terms. However, to regard the starting point as a prohibition seems always to have been an over-statement, both in US and UK law. In line with standard fiduciary law, a breach of the no-conflict duty by a director could be approved, ex ante or ex post, by the

[7] In equity, substantive fairness does play a residual role under the 'fair dealing' rule, which applies to conflicts of interest not caught by the self-dealing rule. See *Newgate Stud Co v Penfold* [2008] 1 BCLC 46: purchase of corporate property (a race horse) by the director's wife without full disclosure was not caught by the self-dealing rule (if she purchased in her own right and not as a nominee for the director) but was subject to the fair-dealing rule. This required the director who had authorised the transaction to show that 'the transaction was demonstrably in the best interests of the company' and that test was not satisfied by 'equating it with the lowest non-negligent valuation'. A duty of fair dealing is not codified in the 2006 Act. Arguably, the *Penfold* situation falls within s 177 (disclosure to the board – discussed below) which applies when the director is "in any way, directly or indirectly, interested in a proposed transaction with the company".
[8] 361 A 2d 218 (1976).
[9] H Marsh, *Are Directors Trustees?* (1966) 22 *The Business Lawyer* 35.

company (as the beneficiary of the duty) so as to make the transaction binding on the company and the director free of any liability. The question was, who constituted the company for this purpose? The mid-nineteenth century English judges had no difficulty in concluding that the shareholders could authorise (ex ante) or ratify (ex post) the conflicted transaction,[10] and there is little evidence that they thought anyone else (eg disinterested directors) could do so. The exclusion of the directors was not surprising, since at that time the dominant notion was that the shareholders were, and were alone, the company. Thus, the Company Clauses Consolidation Act 1845, providing in effect a set of internal rules for statutory companies, first delegated wide management powers to the board and then stipulated in its s 90 that 'the exercise of all such powers shall be subject also to the control and regulation of any general meeting specially convened for the purpose, but not so as to render invalid any act done by the directors prior to any resolution passed by such general meeting.' In other words, the shareholders by ordinary resolution could at any time instruct the directors how to exercise their management powers; the delegation of powers to the board expanded that body's powers but did not restrict the powers of the shareholders in general meeting (unless the board had already acted). It was not until the early twentieth century that the company's internal rules (articles) came to be seen as dividing up management powers as between the shareholders and the board, so that each was supreme in its own sphere. This division could be altered by the shareholders, of course, but only by altering the articles, which required a supermajority vote.[11] At this point, regarding the directors as the company, at least in some circumstances, would have been consonant with the new notion of the

[10] *Benson v Heathorn* (1842) Younge & Coll. Ch. 326; *Great Luxembourg Railway Company v Magnay (No. 2)* (1858) 25 Beavan 586.

[11] *Automatic Self-Cleansing Filter Syndicate Co. v Cuninghame* [1906] 2 Ch. 34. Under the UK Act a supermajority vote is normally three-quarters of those present and voting, and an ordinary majority one half.

division of powers within the company,[12] but by then corporate practice had rendered this particular issue moot within the self-dealing context, as we see below.

The crucial mid-century development in England was not acceptance that shareholders might approve *ad hoc* a proposed or recently completed RPT, but rather that the shareholders, by provisions in the company's articles, could alter the rules of the game in a more fundamental way. The courts accepted that authorisation of conflicted transactions could be given by the shareholders, not only ad hoc, but generally, either in relation to a particular class of conflicted transactions or by reference to a particular procedure. The articles were accepted as the mechanism for giving this generalised approval. Because the articles were, and still are,[13] a contract binding all the members for the time being of the company and the company, they automatically operate so as to generate the consent of the shareholder body to whatever general approval provisions the articles contain. Repeated *ad personam* contracting with each new investor was not required; the articles continue to bind all the members for the time being of the company until altered by the requisite supermajority vote of the shareholder body.

English companies quickly made good use of the facility to modify the basic equitable rule through the articles, most commonly by shifting the approval requirement to the board, and did so within twenty years of incorporation by registration and with limited liability being made available in the middle of the 1850s.[14] There are four pieces of evidence about this development. First, there are the reported decisions of the courts applying provisions in the articles adopted by particular companies. The leading (and noticeably early) case was the House of Lords' (Supreme Court) decision in *Imperial Mercantile Credit Association v*

[12] It would still have been necessary to deal with the doctrinal point that the shareholders were entitled to the unbiased advice of all their directors and, if that was not available, the board could not act at all.
[13] Companies Act 2006, s 33.
[14] Essentially in the Joint Stock Companies Act 1856.

*Coleman* (1873).[15] The articles imposed a sanction[16] on a director who 'contracts with the company, or is concerned in, or participates in the profit of any contract with the company, or participates in the profits of any work done for the company', but only where the director did so 'without declaring his interest at the meeting of the directors at which such contract is determined on or work ordered'. The interest of the case, and the proposition for which it is normally cited, is not the notion that equity's self-dealing rule might be modified by the articles but for the rider that, where the articles require disclosure, it must be full disclosure. The court treated the shift performed in the articles from shareholder approval to board disclosure as in itself uncontroversial.

Second, there are the provisions of the 'model articles', which are provided by the legislature to reduce the transaction costs of forming companies. The first modern companies legislation, the Joint Stock Companies Act 1844, providing for incorporation by registration (albeit without limited liability, which followed only a decade later), contained a mandatory rule on self-dealing transactions.[17] However, that provision did not reappear in the Joint Stock Companies Act 1856, which took the innovative step of moving the internal rules of the company to a set of default rules (set out in a Table annexed to the Act). The company was

[15] (1873) LR 6 HL 189. In this case the company agreed to place debentures at a commission of 1.5% at the suggestion of a director whose partnership (with one other partner) had already agreed to place them at a commission of 5%. The director mentioned his interest in the partnership but not the numbers just stated.

[16] The article also excluded the director from voting on the contract. In this case and under the model articles discussed below it was standard to formulate the sanction in terms of a requirement to vacate office. In other words a director who put him- or herself in a conflicted position could no longer continue as a director. This formulation may have been influenced by what was commonly provided in relation to municipal corporations: see Municipal Corporations Act 1835, s 28. Not until the model articles of 1948 were the issues of disqualification from office, on the one hand, and the validity of and personal liability of directors for self-dealing transactions, on the other, formally separated, at which point vacation of office ceased to appear in the model articles as a sanction for self-dealing (see Table A, 1948, arts 84 and 88). Despite the express wording of the articles the courts in the nineteenth century viewed them as governing the issue of the validity of the transaction and the personal liability of the directors as well as continuation in office, as in *Coleman* itself where the claim was for the director to account to the company for the profit made by the partnership (all of it, not just his share). This approach to construction was explicitly approved in *Costa Rica Railway Co Ltd v Forward* [1901] 1 Ch 744 (CA), but it had long been adopted without comment.

[17] Section 29 rendered contracts in which the director was interested 'directly or indirectly' void unless approved by the shareholders in general meeting, with limited exception for purchases on market terms 'of an article or service which is respectively the subject of the proper business of the company.'

taken to have adopted the Table on registration as its articles of association, unless it positively chose something different, either in whole or in part.[18] It is not clear why the mandatory provision was removed from the Act and transformed into a default rule, possibly as a result of the demonstration by the courts (in particular in *Blaikie*) that they were capable of developing fiduciary principles so as to provide the basic rules and acceptance by the legislature that it was for the shareholders to decide whether to give up part or all of the benefit of those rules.[19] In any event, framed in terms of vacation of office,[20] the 1856 model provided that a director was not to be concerned in or participate in the profits of any contract with the company or the profits of any work done for the company, except in the case where the director was a shareholder in the company which contracted with or did work for the company.[21] Even in that case he was not to vote on the relevant resolution, subject to a penalty of £20 (about £700 today).[22]

However, the picture provided by the model articles attached to nineteenth century legislation suggests only a limited modification of the RPT rules. The models of 1862 (art. 57) and 1906 (art. 77) repeated essentially the same modification as in 1856,[23] as indeed did the 1929 model (art. 72). The third source of information suggests a much more extensive shift to

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[18] 1856 Act, s 9. In the 1856 Act the model articles were set out in Table B; in later Acts they were set out in Table A (so 'Table A' is commonly used as a generic way of referring to them, even today, when the model is no longer attached to the Act but set out in separate subordinate legislation).

[19] The Act was proposed by a government moved by a highly deregulatory policy. The responsible government minister introducing the Bill (Mr V Lowe) said: "We entirely repudiate as the basis of legislation the principle upon which the present Joint-Stock Companies Act is founded—that it is in the power of the Government to prevent the institution of fraudulent companies." As to legislative control of the management of companies: ""The clauses as to the management of the company I pass over, because the management we leave to the companies themselves. Having given them a pattern [ie the model articles] the State leaves them to manage their own affairs and has no desire to force on these little republics any particular constitution." (Mr Lowe, HC Deb, 01 February 1856, vol 140, cols 124 and 134).

[20] See n 16 above.

[21] It was probably anticipated that the director's shareholding would be a small one, but nothing in terms excluded controlling shareholdings from the exception, as was accepted in the *Costa Rica* case (above n 16). A director also had to vacate office if he held 'any other office or place of profit under the company', so that directorships at this time were viewed as non-executive positions.

[22] 1856, Table B, clause 47. This and the model articles from successive Companies Acts can be found in R Ramage, *Companies Acts: Model Articles and Table A* (2009).

[23] Except that, by 1906, vacation of office was no longer required if a director was appointed managing director or a manager of the company.

board approval occurred in articles actually adopted by companies than is reflected in the model articles. What became the leading book of precedents for practitioners in the company law area, *Palmer's Company Precedents*, provided the following precedent in its first edition, published in 1877,[24] for those who wished to move away from the model article on directors' contracting with the company.

> The company may make contracts with any of the directors upon such terms as the directors shall think fit; and a director shall not, by reason of the fiduciary relation subsisting between him and the company, be accountable for any profit made by him in respect of any such contract, nor, subject to the following proviso, in respect of any other contract made with the company in the profits of which he participates or in which he is otherwise interested; provided that the fact of his being so interested therein, and the nature of his interest be fully and fairly disclosed by him at the meeting of the directors at which the contract is determined on, if his interest then exists . . . No director shall vote in respect of any contract or matter in which he is individually interested otherwise than as a member . . .

Subject to full disclosure to the board and non-voting, therefore, directors under the above model could contract, directly or indirectly, with the company via its non-interested board members. The author of the work, Sir Francis Beaufort Palmer, commented that the omission of the model article and the substitution of something along the lines of his precedent were 'common'.[25]

Fourth, research into the articles of association actually filed by companies on registration shows that by the end of the nineteenth century some 90% per cent of companies had moved to a board approval rule.[26]

### 2.3 English and US law on RPT at the beginning of the twentieth century

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[24] London, Stevens, 1877, p 270 (Miscellaneous Clauses XXVI).
[25] Ibid, p 177.
[26] Guinnane, Harris and Lamoreaux, *Contractual Freedom and Corporate Governance in Britain in the Late Nineteenth and Early Twentieth Centuries* 23-24 (ssrn.com/abstract=2911402)

Thus in England, within a short period of time after incorporation by registration with limited liability had been made available, the rule established by the mid-century courts had been transposed through private ordering from a rule based exclusively on ad hoc shareholder approval of conflicted transactions to one which added board disclosure/approval to the available procedures, which then became the dominant procedure for handling RPTs. Marsh, in his seminal article, describes the US position as follows: "It could have been stated with reasonable confidence in 1910 that the general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged . . ."[27] So, by the beginning of the twentieth century, in both countries disinterested board approval had become the dominant mechanism for white-washing RPTs with directors, but there were two contrasts between the two sets of rules. First, as a doctrinal matter, Marsh presents the US courts as having modified the rider to the equitable rule about beneficiary approval so as to characterise the board as "the company" for the purposes of giving the beneficiary's consent. As we have noted above, the English courts had taken the view mid-century that only the shareholders could waive the benefit of the duty. Although the English courts might have been tempted to take a similar step as the US courts by the end of the century,[28] it was unnecessary for them to do so, because the English companies had achieved the same result via amendments to the articles which provided for board approval.

Marsh mentions[29] that a similar step was available to US companies via amendments to the company's constitution, but presents such amendments as not giving protection against court scrutiny of the fairness of the RPT. Thus, the second difference between England and the US was the more important one, ie that the shift to board approval in the US was accompanied by

[27] Above n 9 at 39-40. Marsh adds the rider that a contract in which a majority of the board was interested was voidable irrespective on any issue of fairness.
[28] Text attached to nn 10-12 above.
[29] Above n 9 at 45.

a rider of court scrutiny on grounds of substantive fairness, whilst no such development occurred in England. In fact, in the US court scrutiny became more important, at least in terms of legal doctrine, as the twentieth century progressed. As Marsh puts it, "By 1960 it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation."[30] Moreover, state statutes which apparently sought to make shareholder approval, disinterested board approval and court fairness determinations alternative routes to safety for RPTs were routinely interpreted by the courts as exposing even board or shareholder approved transactions to fairness review.[31]

Thus, the crucial divergence between US and English law was not the shift to board approval, which occurred in both jurisdictions, but the development of a substantive fairness assessment in the US and its absence in the UK. Neither the courts nor the legislature in the UK sought to introduce a fairness test. Even in the process of producing a high-level codification of directors' duties in the 2006 Companies Act, during which some reforms were adopted, the procedural orientation of English law for RPTs was maintained. What the codification achieved was a simplification of the structure of the rules, whilst preserving their outcome. The Act cut through the potentially complex relationship between the underlying equitable rule and the articles, but embodied the received result of that interaction. Section 177 provides that 'if a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors.' Formally, this is a disclosure rule, not a

[30] Above n 9 at 43.
[31] Above n 9 at 46-47 and, for Delaware law, *Fliegler v Lawrence* 361 A 2d 218 (1976). However, the courts' views have varied over time about the extent to which board or shareholder approval modifies the rigour of the courts' fairness scrutiny.

requirement for board approval.[32] The rationale of the section appears to be that if the board, knowing of the conflict, permits the company to contract, either at board level or below, then it is implicitly consenting to the conflict.[33] De facto, the law shifts the burden of dealing with RPTs onto the non-conflicted directors, who have to consider whether allowing contracting in the face of the conflict is consistent with their core duty of loyalty (to promote the success of the company for the benefit of its members).[34] If the disclosure procedure is followed, the transaction is not liable to be set aside and the director is not in breach of duty.[35] If it is not, then the standard fiduciary consequences follow (unless shareholder approval is obtained).[36] Section 177 is a minimum standard. The company can make shareholder approval mandatory through appropriate provisions in the articles but the burden is on those who wish it to adopt this procedure.[37] So, contractual freedom was maintained in 2006, but the law finally got around to placing the default position where practice suggests it will normally end up, ie with board disclosure.

### 2.4 Legislative restoration of shareholder approval in the UK

Board approval has some obvious advantages over shareholder approval. Depending on the composition of the shareholder body, the board is likely to have a more expert view of where the company's interests lie when entering into transactions and, depending on the size of the

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[32] For this reason, perhaps, the section does not exclude the interested director from voting on any contract to which the disclosure is relevant, though, subject to exceptions, the current Model Articles do so.

[33] The Act does not require notification ad hoc. The director may give a 'general notification' of an interest (eg that he or she holds a certain percentage of the shares in a another company) and this will cover all future contracting to which that interest is relevant, so long as the nature of the interest does not change (ss 177(2) and 185). This is particularly important for sub-board contracting where the director may not know of the contracts before they are entered into.

[34] This is the formulation of the directors' core duty of loyalty which the codification adopts (s. 172).

[35] s 180(1)(b).

[36] Section 178: 'the consequences of breach . . . of sections 171 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied.' So, no codification of the remedies for breaches of directors' duties.

[37] S 180(1). Somewhat unclearly s 180(4)(b) appears also to allow the articles to supplement the statutory procedure for handling self-dealing transactions, but what it does and does not allow is one of the minor mysteries of the Act, especially when read together with s 232(4). See Davies and Worthington, *Gower's Principles of Modern Company Law* (10th ed, 2016) paras 16-126 to 16-127.

shareholder body, board approval is likely to be quicker and less costly. On the other hand, depending on board dynamics, the risk with board approval is that it disguises rather than neutralises conflicts of interest, even if 'interested' directors are excluded from voting. A dominant director does not necessarily need a vote to influence board decisions, and all directors may have an incentive not to enquire too closely into the terms of the transaction in exchange for similar treatment when they engage in self-dealing. Board approval can be, and normally is, accompanied by ex post disclosure to the shareholders in the company's annual statements of at least 'material' self-dealing transactions, but it may require a particularly persistent shareholder to work out whether the conflict of interest infected the terms of the contract.

The UK legislature's response to the risks of board approval were two-fold. An initial and minor response was to make disclosure to the board the minimum standard. Parliament did not seek a general reversal of the standard practice reflected in *Palmer*, though it did seek to put a floor under it. Before the 2006 codification, there was no apparent reason why the articles might not permit RPTs even without board disclosure, though it seems they rarely did so. The Companies Act 1929[38] introduced a mandatory rule requiring the disclosure to the board of directors' interests in contracts with the company.[39] It attached a fine to non-disclosure, but the dominant view was that the section had no impact on the civil consequences of self-dealing, ie self-dealing in accordance with the articles but in breach of

[38] S.149. In fact, this provision was not recommended in the prior *Report of the Committee on Company Law Amendment*, 1926, which otherwise shaped the Act's content. It was introduced by the Government, under Opposition pressure, late in the legislative passage of the Act. (H C Deb, vol 220, col 1306, 25 July, 1928). However, the Committee had recommended that provisions in the articles removing or reducing directors' liability for breach of duty should be rendered ineffective, and the Act contained (and still contains) that rule. The mandatory rule of disclosure to the board for conflicted transactions was in line with the policy underlying that move, although technically the RPT articles discussed above did not exempt a director from liability but defined the scope of the obligation to which the director was subject.

[39] It permitted 'general' notification, ie an interest once notified did not need to be re-notified in relation to each relevant contract, so long as the interest remained the same.

the section did not render the contract voidable or open the director to civil liability.[40] Often this distinction did not matter because companies' articles made compliance with the statutory disclosure rule a pre-condition for escape from the equitable self-dealing rule. In other words, the statutory provision had a reflexive impact on the articles in practice adopted by companies.[41] However, despite Opposition pressure in the legislature for this, the statutory reform did not prohibit voting by interested directors, but for companies seeking listing the Stock Exchange rules were changed in the same year to add this requirement.[42]

The second and more significant legislative response, whilst staying within the procedural paradigm, was to restore shareholder approval for RPTs in a limited range of circumstances where experience suggested that the risks attached to board approval were particularly acute. This assessment of experience was not based on any theoretical or even general empirical enquiry. Rather, it was a response to corporate scandals across the years,[43] often revealed by a still existing but now rarely used power of the relevant government department to appoint inspectors (usually a leading lawyer and a leading accountant) to report publicly on the affairs of a company which has generated adverse public attention.[44] These exceptional cases are now gathered together in ss. 188 to 225 of the Companies Act 2006.

What the scandals revealed was often, not so much a classic RPT, as the purchase by the company of assets for the directors' personal use or the selling of directors' consent to a

[40] *Hely-Hutchinson v Brayhead* [1968] 1 Q B 549 (CA).
[41] The disclosure approach of the 1929 Act clearly influenced the drafters of the 2006 Act. What the 2006 Act codified was, thus, not just the result of the interaction between the equitable rule and the articles, but the impact of the 1929 Act on the practice of drafting corporate articles. A purely criminal sanction for non-disclosure is retained in the 2006 Act, but only for interests in existing contracts (and assuming the interest has not been disclosed at the proposal stage – s. 182).
[42] London Stock Exchange, *Rules and Regulations of the Stock Exchange*, 1929, App. 35, Rule 162.B.7 (*Conditions precedent for applications for official quotation*). Issuers seeking official listing had to include in their articles a provision discounting votes by interested directors.
[43] The shareholder approval provisions had their origins in the companies legislation of the late 1920s, the immediate post-war period and the Companies Act 1980.
[44] Thus, the government proposals for reforms eventually made in the Companies Act 1980 state that one of their aims was to "remedy weaknesses in the law which has been demonstrated by recent company investigations notably in connection with loans to directors and the private interests of directors." (Department of Trade, *The Conduct of Company Directors*, Cmnd 7037, November 1977, para 1)

transaction in exchange for some part of the value of the transaction. Such action was already unlawful, though consent requirements could provide an easier path for holding the directors to account.[45] In terms of RPTs one target was contracts with directors which increased their emoluments without changing their headline salary. Loans to directors and other forms of credit provision were subject to shareholder consent requirements, as was the less obvious technique of long fixed-term service contracts. Whilst long fixed terms had no immediate impact on salary, they provided potentially large pay-offs, by way of contractual damages, if the director were removed from office.[46] In more recent times, these initial provisions have been developed into a general principle of a 'say-on-pay' for shareholders.

For this paper, the most important case where the legislature restored the requirement for shareholder approval was a sale to or acquisition from a director of a company (or of its holding company or a person connected with such director) of a substantial non-cash asset where the company was the counterparty. This was done in the Companies Act 1980. The corporate scandals, noted above, had identified some examples of the use of such deals to transfer wealth to directors. "Substantial" transactions are defined as having a value in excess of £100,000 (in 1980 £50,000) or more than 10% of the value of the company's assets, provided that the transaction is worth more than £5000 (£1000). So except for very small companies (in asset value terms) a wide range of transactions is picked up. 'Connectedness' is also widely defined[47] so as to bring in companies in which the director and connected persons can control at least 20% of the voting rights (or where they simply have an interest in

[45] From the late 1920s gratuitous payments to directors for loss of office in connection with the transfer of the company's assets or shares had been made subject to shareholder approval, whether the payments were made by the company or the transferee (or, indeed, anyone else). In the case of asset transfers the payments are treated as held on trust for the company; in the case of share transfers, on trust for the selling shareholders. This remedial structure suggests that the risk was conceived to be that directors could cream off to themselves part of the consideration the purchaser was willing to pay.

[46] Since 1948 the UK Companies Acts have contained a mandatory rule permitting the shareholders to remove a director at any time by ordinary resolution – but subject to the payment of compensation for breach of contract.

[47] Ss 252-4. In particular, the statutory definition brings in a wider range of family members than either the common law or the Listing Rules.

this proportion of the voting equity) and a partnership in which the director or a connected person is a partner, as well as the members of the directors' family (again widely defined). In this category of case, therefore, the board disclosure rule is replaced by shareholder approval. It is likely that in the case of publicly traded companies the shareholder approval rule operates as a near-prohibition on this class of transaction.[48] For this class of company, the original equitable control of shareholder approval probably has only a very minor role: the law oscillates between the far ends of the spectrum – board disclosure (for most RPTs) and prohibition (for specific cases).

The consequences of a breach of the shareholder approval requirements follow the usual pattern under the fiduciary rule. The transaction is voidable and, whether it is avoided or not, the director is liable to account for profits made or to indemnify the company against losses.[49] In the case of a transaction with a connected person, the interested director is liable unless he or she took all reasonable steps to secure the company's compliance with the shareholder approval requirement. Moreover, the position of others involved in the transaction is made clear. Both the connected person (if any) is liable as are the directors who authorised the transaction (whether with the director or a connected person) unless they did not know 'the relevant circumstances constituting the contravention'.[50]

[48] "There are substantial costs to approval and ratification, in particular in the case of large listed companies. As a result, then, these rules operate as *strict default rules*; we would expect there to be only a limited degree of contracting around the rule." (Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties. Joint Consultation Paper*, 1998, para 3.67 (emphasis in original). Nevertheless, the Commissions did not recommend any significant changes to the shareholder approval requirement, even in the case of quoted companies.

[49] In one respect, the statutory remedies are more demanding than the equitable ones. In equity, when directors sold their own property to the company, the company could avoid the transaction but could not affirm it and claim the directors' profits, unless the director was mandated to acquire the property on behalf of the company: *Burland v Earle* [1902] A.C. 83 (PC).

[50] Given the width of the 'connected person' definition, this is not an inconceivable situation.

In addition to the references to recent scandals the government's legislative proposals[51] relied on the argument that listed companies were already subject to similar provisions under the Stock Exchange rules, which we discuss further below. As we shall see, there is evidence that the Stock Exchange rules at that time were more demanding than the rules introduced in the statute, since they required shareholder approval at the 1% or £20,000 level. However, as a result of changes introduced by the Exchange in 1993, the listing rules were substantially relaxed. In an ironic twist, the position was reversed and the statute require shareholder approval to a wider range of director transactions than the LR.[52]

Overall, with the exception of directors' remuneration, the dominant rule in English law is that RPTs are subject to a procedural control, which consists of disclosure to the board. In limited cases, of which property transactions are the most important example, the legislature has restored the principle of ad hoc shareholder approval with which the mid-nineteenth century judges began. Court review of the substantive fairness of the transaction is not part of the RPT rules.

### 2.5 Controlling shareholders

In line with its 'classic' approach to fiduciary duties, English law does not accept that shareholders, as such, are fiduciaries. Conventionally, a fiduciary is someone who has agreed to act on behalf of another and to put that person's interests above their own. Whereas a director fits this analysis quite neatly (the company being the beneficiary of the duty), it is difficult to categorise a controlling shareholder as someone who has agreed to subordinate its interests to those of the non-controlling shareholders.[53] Consequently, English law, unlike

[51] Above n 44, para 16-18.
[52] However, a wider range of related parties is covered by the LR. See text attached to nn 83-87 below.
[53] This is an illustration of the distinction between the concept of an agent in law and in economic theory: in the latter agency is a broader category because it embraces those with the factual power to affect the welfare of the principal. On the latter basis it is appropriate to treat the controlling shareholder as an agent of the non-controlling shareholders. See R Kraakman et al, *The Anatomy of Corporate Law* (3rd ed, OUP, 2017) 29-31.

Delaware, does not regard a controlling shareholder (or, still less, a substantial but not controlling shareholder) as owing fiduciary duties to the minority shareholders or to the company. This developmental failure has hobbled English law in two respects in relation to RPTs, though, as we shall see, some work-arounds have been devised. First, RPTs between the company and a shareholder are in principle outside the fiduciary constraints described above. Second, the rules applied to directors' RPTs are open to being undermined when the conflicted director votes as shareholder to approve the transaction.

The second issue emerged at an early stage in a Privy Council appeal from Canada, *North-West Transportation Co Ltd v Beatty* (1887).[54] A director proposed to sell a steamer he owned to the company and, after full disclosure to the shareholders, the latter voted to adopt the contract on behalf of the company, the necessary majority being achieved, apparently, only thanks to the votes of the director. The court rejected the claim that, as we would now put it, that majority-of-the-minority approval was required. The adoption of the contract was "a pure question of policy, as to which it might be expected that there would be differences of opinion, and upon which the voice of the majority ought to prevail; to reject the votes of the defendant . . . would be to give effect to the views of the minority and to disregard those of the majority."

Although the facts of the case were never fully established, because the defendant relied from the outset on the ratification argument, the price paid by the company for the ship appears not to have been unfair and the company certainly needed a replacement vessel for the one which had been lost. Nevertheless, the riskiness of the principle was revealed in a second Privy Council appeal from Canada less than twenty years later. *Cook v Deeks*[55] (1916) was a

[54] (1887) 12 App. Cas. 589 (PC). It is interesting that the *Palmer* precedent of a decade earlier, quoted above, assumed that for a director to vote as a shareholder on a conflicted transaction was legally uncontroversial. See the final words quoted.
[55] [1916] 1 A C 554 (PC).

corporate opportunities case in which three out of the four equal director/shareholders diverted the opportunity to a new company in which only they were involved and then had the bright idea of passing a resolution at a shareholders' meeting of the four-person company to the effect that the latter company had no interest in the opportunity. Faced with the earlier decision, the court distinguished it on the ground that in *Beatty* the director had been selling his own property to the company, whilst in *Cook v Deeks* the directors were appropriating something which already belonged ("in equity") to the company. In an expropriation case, ratification was not possible, so that the question of whether the controlling shareholder could vote did not arise. This set off a long, unresolved and unproductive debate about the circumstances in which a corporate opportunity "belongs" to the company. More important, it left many core RPT transactions subject to approval by the controlling shareholders.

The issue was effectively addressed only in the 2006 Act which provided that a director (and those connected with him) could not vote as shareholders on a resolution to ratify a breach of duty by the director. This in effect reversed *Beatty* and required majority-of-the-minority approval for breaches of duty, including RPTs. Even so, the gap was not quite filled since shareholder *ex ante* authorisation, for example in relation to substantial property transactions, appears not to be covered by the reform.[56] Provided the director secures shareholder approval before the transaction is effected, it appears a director can vote as shareholder in favour of it.

The first, and larger, problem of the exclusion from fiduciary duties of RPTs by controlling shareholders has not been subject to legislative reversal, but there have been a number of work-arounds. The first came from acceptance that it was possible to justify the imposition of constraints on shareholder RPTs other than on the basis that the controlling shareholder was a fiduciary. Recognising the force behind the economists' power-based definition of agency, the legislature (though not until 1980) provided a mechanism for non-controlling

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[56] S. 239.

shareholders to challenge on the basis of "unfair prejudice" the conduct of the affairs of the company by its controllers, a provision wide enough to encompass decisions taken by shareholders as well as those taken by the board. Faced with the need to apply a broad standard without much legislative guidance, the courts have taken refuge in a "contractual" approach: unfair prejudice consists of acting in a way inconsistent with the informal understanding present among the members when the company was set up or generated when the shareholder joined the company. Thus, in a modern-day *Cook v Deeks* it is likely that the court would find that the company was established on the basis that all four members had an equal right to participate in its management and profits, so that the diversion of the opportunity to the new company would amount to unfairly prejudicial conduct of the affairs of the company. Equally, an RPT on one-sided terms with one or some of the members would likely be regarded as a breach of an implicit 'equal treatment' agreement among the members. Here, therefore, court evaluation of the substance of the terms of the RPT would be important for the establishment of unfair prejudice; mere procedural impropriety carries less weight under an unfair prejudice standard than in equity. The typical remedy provided by the court in these cases is an exit right on 'fair' terms. So, the claimant in *Cook* would probably have obtained a right to be bought out by the others at a valuation of the company which included the diverted opportunity.

Overall, the unfair prejudice remedy works reasonably well for companies with limited membership, in effect quasi-partnerships, where an underlying informal agreement among the members can be established in fact, provided the minority shareholder is happy not to remain in the company but to be bought out at a fair value.[57] For companies with multiple members, and certainly for publicly traded companies, the underlying factual basis for the application of

[57] The courts are also likely to find in a company with few members that there was an understanding that the directors would conduct themselves in accordance with their fiduciary duties. Consequently, the unfair prejudice provisions provide a way of obtaining a remedy for breaches of directors' duties, alongside the derivative action.

the unfair prejudice remedy will rarely exist.[58] A second work-around approaches the problem from the opposite direction and expands the definition of a director to include a "shadow" director, ie someone in accordance with whose directions or instructions the board is accustomed to act.[59] This definition thus catches a controlling shareholder who exercises control beyond decisions taken at shareholders' meetings through, for example, persons it has appointed to the board. The idea is that those who exercise board power should be treated as directors even if they are not formally members of the board. The exceptional statutory rules requiring shareholder approval for substantial property transactions were applied to shadow directors when they were introduced in 1980.[60] However, the government havered about applying the general, codified duties in the 2006 Act to shadow directors and did so clearly only in an amendment of 2015: "The general duties apply to a shadow director of a company when and to the extent that they are capable of so applying."[61]

So, a controlling shareholder exercising influence via directions or instructions to the board must fully disclose to the board an interest in a proposed transaction directly or indirectly with the company. However, there is reason to doubt the effectiveness of this rule. The directors, appointed by the controlling shareholder, may simply implement what they understand to be in the controller's interests, without the need for directions or instructions from that person, so that the controller escapes from the "shadow director" category. This in principle may be a breach of the directors' duty of loyalty, but proof will be difficult, so that the directors face only a low liability risk by proceeding as they think the controller wishes. Even if the controlling shareholder falls within the shadow director category and discloses the

[58] But see n 133 below on the relevance of the unfair prejudice remedy to the controlling shareholder agreement now required in listed companies.
[59] Companies Act 2006, s 251.
[60] Now s 223 of the 2006 Act.
[61] S 179(5).

interest to the board, the board may still approve the transaction, again with little risk of liability unless their decision can be shown to be irrational and not just unreasonable.[62]

Providing an effective solution to controlling shareholder RPTs is difficult when the only options available are, as in English law, board or general shareholder approval. A majority-of-the-minority shareholder approval rule would be more constraining than the current English law, but, as we have seen, only in relation to substantial property transactions does English law approach this model. Even there, it fails fully to carry the idea through because the controller is apparently permitted to vote on authorisations.[63] An alternative approach is via third-party assessment of the fairness of the transaction, either by a court as part of a liability determination or by an expert as an aid to board or shareholder approval requirements, but, in line with its history, English statutory law has not taken any of these steps. Outside quasi-partnerships, general company law in the UK does not in fact deal effectively with RPTs with controlling shareholders.[64]

### 2.6 RPTs within groups

Where, as is often the case, the controlling shareholder is the parent company of a corporate group, there is, in any event, a good reason for being sparing with the application of majority-of-the-minority rules. Intra-group transactions are likely to be routine and the application of this requirement where the subsidiaries are not wholly owned is likely to be burdensome. We shall see below that the listing rules make use of the burdensome quality of unqualified RTP rules as a sanction for breaches of non-RPT rules designed to protect outside shareholders. However, to use RTP rules as the main protection requires caution if group operations are not to become unduly costly.

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[62] *Regentcrest plc v Cohen* [2001] BCLC 80.

[63] See text attached to n 56 above.

[64] Occasionally, other company law doctrines may be pressed into service, such rules on disguised distributions: *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626.

Group efficiency could be promoted by restricting the range of intra-group transactions to which the RPT rules apply. However, English law takes a more robust approach: it seeks to *exclude* the general law from intra-group transactions. "A body corporate is not to be regarded as a shadow director of any of its subsidiary companies" for the purposes of either the general fiduciary principles or the special rules requiring shareholder approval of RPTs.[65] Case law has extended this proposition to the directors of the parent company acting as such.[66] This provision apparently aims to prioritise the imposition of a common group policy over the goal of ensuring "fair" treatment of outside shareholders within groups. For example, the parent appears to be free to allocate a corporate opportunity to the group company which is best able to exploit it, without considering whether another group company has a better legal claim on it. Thus, the 'shadow director' work-around of the non-fiduciary character of controlling shareholders is not made available in respect of intra-group transactions whilst, as we have seen, the unfair prejudice provisions are generally ill-suited to companies with large shareholder bodies. Both these points provide some support for the mandatory bid rule, which has been part of UK takeover regulation since the late 1960s.[67] Given the weak legal protection for outside shareholders in subsidiary companies, the mandatory bid rule provides instead an exit right for all shareholders at the point at which the group relation is created via the takeover.

However, this insouciance about intra-group transactions stops once a group company is in the vicinity of insolvency. Under a provision of the Insolvency Act 1986, once the directors of a company ought to have realised that it has no reasonable prospect of avoiding insolvency, a duty is triggered requiring them to take all reasonable steps to minimise the

[65] S 251(3). In addition the substantial property transaction rules do not apply to any transaction between a holding company and its wholly-owned subsidiary or between two wholly-owned subsidiaries of the same holding company (s 192).
[66] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180
[67] Rule 9 of the UK Takeover Code.

potential loss to the creditors of that company.[68] This is the so-called ‘wrongful trading’ rule. The liability in the case of breach of this duty is to contribute to the assets of the company (if it does go into insolvency) an amount up to the additional loss caused to the creditors by the breach. This duty does apply to shadow directors and there is no exemption for parent/subsidiary relationships.[69] Consequently, a transaction between a financially troubled subsidiary and a parent company (which might or might not itself be financially troubled) designed to transfer value from the subsidiary to the parent could involve a breach of the wrongful trading duty on the part not only of the subsidiary’s directors but, potentially, also on the part of the parent, rendering it liable to restore to the subsidiary the value transferred.[70] So, English law as applied to groups is more solicitous of the interests of creditors than of outside shareholders.

**2.7 Summary**

- Through reliance on fiduciary law, English courts developed at an early stage an approval requirement for self-dealing transactions and a strong set of remedies for breach of the requirement (transaction voidable, director liable to account for profits and to indemnify the company against losses). But court review of the fairness of the transaction was not an element of the fiduciary requirements.
- Acceptance by the courts of the principle of private ordering quickly turned the requirement from one of shareholder approval into one of board disclosure.
- The legislature sought to restore the principle of shareholder approval only on an ad hoc basis, most notably in relation to substantial property transactions, and did not seek to introduce fairness review.

[68] Insolvency Act 1986, s 214.
[69] Insolvency Act 1986, ss 214(7) and 251.
[70] The transaction might also be a breach of the general undervalue transaction provisions of the insolvency legislation. Whether the parent’s directors are potentially liable is an open question.

- The fiduciary analogy worked less well in relation to controlling shareholders and, in another contrast to Delaware, English law failed to develop an effective set of constraints in respect of self-dealing transactions with controlling shareholders, except possibly in quasi-partnership companies.
- By extension, self-dealing transactions within groups were not effectively regulated either, but this seems to have been a positive policy choice by the legislature not to subject intra-group transactions to fiduciary standards (though the wrongful trading provisions in favour of creditors are applied to group actions).

## 3. RULES APPLICABLE TO QUOTED COMPANIES

### 3.1 Origins and scope

The above summary of the general law applying to English companies is in contrast to the rules developed, first, by the Stock Exchange and, later, by the statutory regulator,[71] for companies with a 'premium listing'[72] on the Main Market of the London Stock Exchange. Subject to exceptions, for example, in respect of small transactions or transactions in the ordinary course of business, the provisions of the Listing Rules differ on each point from the general law.

[71] The statutory regulator took over the function of setting the listing rules when the Stock Exchange was demutualised. That regulator was initially the Financial Services Authority (FSA) but, after the financial crisis, the Financial Conduct Authority (FCA). The current rules are set out, mainly, in Chapter 11 of the FCA's *Listing Rules*.

[72] Application for premium listing is voluntary; the company could apply for standard listing, to which Ch 11 of the Listing Rules (and other chapters laying down governance standards, such as 'comply or explain' adherence to the UK Corporate Governance Code) do not apply. But premium listing is thought to have larger cost-of-capital benefits for the issuer than standard listing. In addition, access to the FTSE indices, although these indices are not run by the regulator, is restricted to companies with a premium listing.

- As befits a regulator, the Stock Exchange did not need to fit those engaging in self-dealing transactions into an existing legal category, so that the fiduciary analogy did not set the starting point for its regulation.
- The basic control is ex ante disclosure to the market and shareholders plus, in some cases, approval by the shareholders and, where approval is required, approval in a strong form, ie majority-of-the-minority approval.
- Substantial shareholders are included within the scope of the RPT provisions of the Listing Rules and controlling shareholders are subject to additional constraints.

The current rules, promulgated by the FCA, are made under statutory authority (in the Financial Services and Markets Act 2000, as amended), but when the Stock Exchange itself was the rule-maker it necessarily operated by contract.[73] Issuers seeking official listing on the Exchange had to enter into an agreement with the Exchange, in which the related party transaction rules were embedded, either directly or be reference.[74] The Exchange's RPT rules grew out of a concern that the market and shareholders should be promptly informed about changes in the nature of the company's business and, in some cases, to approve them. The focus initially was on "substantial" acquisitions and realisations, ie the provisions which in their modern form appear in Chapter 10 of the Listing Rules. However, in the early 1960s a type of acquisition was identified which was characterised, not by its size, but on the basis that it "involve[d] a director, past director, substantial shareholder or past substantial shareholder of the company, a subsidiary company or a parent company."[75] Such transactions

[73] The Exchange gave up its role as the UK Listing Authority in 2000.

[74] The contract was originally termed the "General Undertaking" but in the early 1970s its name was changed to the "Listing Agreement". There was an obvious enforcement problem under the contractual approach, since cancellation or suspension of listing might harm the very shareholders the RPT rules were intended to protect. The FCA has a full range of administrative sanctions against both issuer and its directors.

[75] London Stock Exchange, *Memorandum of Guidance Regarding Acquisitions and Realisations of Subsidiary Companies, Businesses and Fixed Assets by Quoted Companies*, April 1964, para 2. This was originally "Class 4" of the four transaction classes dealt with in the Memorandum. Only in 1993 were RPTs separated out and dealt with in their own chapter of the Listing Rules.

had to be notified to the Exchange ex ante, and the Exchange was empowered to require a circular to the shareholders and shareholder ratification.[76] A decade later, it was stated that "normally" the Exchange would require a circular and ratification and ratification was to be on a "majority-of-the-minority" basis.[77] What exactly the practice behind the word 'normally' was and how, if at all, it changed is unclear but an internal Exchange note of 1975 stated that "as a practical matter a yardstick of 1% of the listed company's net tangible assets, or £20,000, has been used below which shareholders have not been required to approve a class 4 transection in general meeting."[78] In 1993 – in the first major revision of the listing rules since 1957 - the tripartite structure of RPTs according to size, which is discussed below, was adopted.[79] If the 1% yardstick in fact represented practice before that date, the reforms of the early 1990s represented a substantial back-tracking. Shareholder approval was required only at the 5% level – albeit on any one of an expanded set of ratios – which continues to be the applicable threshold for shareholder approval.[80] Below 5% but above 0.25% ex ante disclosure was required, but only to the Exchange, not to investors, a further apparent retreat from prior practice.[81] It was suggested at the time that the relaxation was intended to protect small listed companies from burdensome regulation;[82] if so, this rationale was undermined by the establishment of a separate Alternative Investment Market for small companies only two years later (the RPT rules for which we discuss below).

[76] Ibid para 6.
[77] London Stock Exchange, *Admission of Securities to Listing*, 1973, ch 4, para 8.
[78] UK Listing Authority, CD-Rom, *Historical Listing Rules*, Vol 1, Item 15, *Admission of Securities to Listing*, 1975, ch 4, note to para 8 "for Departmental use only".
[79] LR 1993 11.8.
[80] That prior practice was more demanding than the rule adopted in 1993 is suggested by the Consultative Document preceding the revision of the Listing Rules. This proposed to set the figure for exemption from shareholder approval at 2% (LSE, *The Listing Rules: Consultation Draft*, November 1992, 11.7(h) and 11.8).
[81] Ex ante disclosure to the market was restored only in 2014. The prior Consultation Draft was a little more demanding in that it required disclosure to the Exchange also where the transaction has a value of £250,000 or more, whether or not it exceeded the 0.25% threshold (ibid).
[82] Timothy Gee, "The Yellow Book and the changing nature of city regulation" (1994) 9(1) *Journal of International Banking Law* 14.

It may be wondered why the introduction in the Listing Rules of the 5% level for shareholder approval did not shift the focus of regulation back onto the Companies Act, which, as we have seen, at that time required shareholder approval for the acquisition or disposal of non-cash assets with a value of £100,000 or more[83] – a figure likely to be achieved for RPTs in large listeds without breaking the 5% rule. This probably did happen to some extent, an ironic result since the government had promoted the statutory reform of 1980 on the basis that it was extending to all companies, but in a more relaxed way, rules already applicable to listed companies.[84] However, the statutory provision did not cover the whole of the ground. It had four limitations in particular. It applied (and still applies)[85] only to companies incorporated in Great Britain and so not to foreign-incorporated but London-listed issuers. Second, it permitted (and apparently still permits)[86] directors use their shares to vote in favour of authorising the transaction. Third, it did not (and still does not) apply to transactions with shareholders and, in particular, parent companies are excluded from "shadow director" category (so long as the group companies are going concerns).[87] Fourth, it applies only to the acquisition of property interests and not to transactions giving the director only personal rights against the company.

The modern version of the RTP rules is in Chapter 11 of the Listing Rules. In a little more detail, the current rules apply to transactions or arrangements between a company with a premium listing (or its subsidiary)[88] and a 'related party' of that listed company. The related party definition embraces:

[83] The statutory threshold was increased from £50k to £100k in 1990.
[84] Above n 51, para 16-18.
[85] CA 2006, s 190(4)(a).
[86] See text attached to n 56 above.
[87] See text attached to nn 65-70 above.
[88] See the *Bumi* case, below n 125.

(i) directors and shadow directors (or those who held such a position within the twelve months prior to the transaction) of the company or another company within the same corporate group;

(ii) 'substantial shareholders', ie subject to exceptions, anyone who controls 10% or more of the voting rights in the company or another company within the same group;

(iii) those who exercise 'significant influence' (not defined) over the listed company without being either a director or substantial shareholder;[89]

(iv) associates of the above.[90]

In addition, the controls are extended beyond transactions with a related party so as to include arrangements under which the listed company and a related party invest in or finance another undertaking or asset and to "any other similar transaction or arrangement . . . between a listed company and any other person the purpose and effect of which is to benefit a related party" [91] This is not a director-focussed starting point, in sharp contrast to the general law, but a set of rules designed to catch those who might be in a position to exercise influence so as to extract value illegitimately from the company.

There are two principal limitations on the reach of the Listing Rules. First, they do not apply to transactions "in the ordinary course of business" – potentially a loophole. The Rules indicate[92] that the FCA will have regard to the size and incidence of the transaction as well as

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[89] This is obviously a niche category. It could embrace, for example, a shareholder just below the 10% level who does in fact exercise significant influence (without, however, becoming a 'shadow' director) because the other shareholdings are highly dispersed.

[90] However, there are exemptions for "insignificant" subsidiaries (LR 10, Annex 1, para 9). The rules do not apply to a person who is a related party by virtue only of being a director or substantial shareholder (or an associate of these) in an insignificant subsidiary, ie one which contributed less than 10% of the profits or represented less than 10% of the assets of the listed company. If the insignificant subsidiary is itself a party to the transaction, then, in addition, the ratio of the consideration for the transaction to the market capitalisation of the listed company must be less than 10%.

[91] LR 11.1.5(3).

[92] LR 11.1.5A.

to unusual aspects of its terms and conditions when assessing whether the terms of this exception have been met. However, it is not clear how rigorously the FCA – or the Exchange before it – scrutinises transactions claimed by the issuer to be in the ordinary course of business. The main control over opportunistic use of this exemption appears to be the requirement that a company proposing to enter into a transaction which is or *may be* a related party transaction must seek the "guidance" of its sponsor as to the application of the LR.[93] A sponsor, normally an investment bank, is a requirement for and plays a crucial role in a public offering, for it is the sponsor which certifies to the FCA that the requirements of the Prospectus Rules have been complied with by its client.[94] The related party transaction is one of a set of post-offering instances when a sponsor is again required. The principal reason for supposing that the sponsor will generally carry out its related-party role effectively is that, otherwise, it risks the loss, temporary or permanent, of its sponsor status with the FCA and thus the loss or reduction of its lucrative IPO business.

Second, "small" transactions are exempted from the controls, even if not in the ordinary course of business. As is common throughout the listing rules, the size of a transaction is assessed by reference to any one of four ratios by which the value of a transaction can be determined.[95] The tests focus on the ratio of (a) the gross assets subject to the transaction to the company's pre-transaction gross assets; (b) the profits attributable to the transaction to the company's pre-transaction profits; (c) the consideration for the transaction to the market value of the company's ordinary shares; and (d) the "gross capital" of the business being acquired to the pre-transaction value of the company's gross capital.[96] If the proposed transaction falls below 0.25% on each of the above ratios, it falls outside the controls of LR

[93] LR 8.2.3.
[94] LR 8.3.1.
[95] The details of how to do these calculations are set out in LR 10 Annex.
[96] This test applies only to the acquisition of a business and differs from (c) in that liabilities are added to the market value of the shares, on both sides of the ratio.

11. It follows that, in relation to a large listed company, transactions fall outside the controls which nevertheless could provide for the diversion of value to a related party which, from the perspective of a related party who is at individual, could be significant.[97] The rationale for the exclusion is, presumably, that otherwise shareholders might have to assess transactions which, from the point of view of the shareholders as a whole, are not significant. The exclusion, in other words, demonstrates the shareholder protection basis of this chapter of the Listing Rules rather than a policy of reviewing directors' remuneration.

The LR make use of two types of control for RPTs falling within their scope. The first is (now) ex ante disclosure to the market and to shareholders, via the Exchange's regulatory news service (RNS); the second is ex ante shareholder approval on a majority-of-the-minority basis. The second means the listed company must ensure that the related party does not vote and takes 'all reasonable steps' to ensure that associates do not vote. However, in order to be subject to the shareholder approval requirement, the RPT must meet a further size criterion, namely that the transaction must equal or exceed 5% on at least one of the ratios mentioned above. Below that but above 0.25% it is a "smaller" transaction. This means that normally only very substantial RPTs are subject to shareholder approval.

Above the 0.25% floor disclosure is required in all cases, somewhat more elaborately in the case of transactions at 5% or above. The credibility of the disclosures is enhanced by a further use of the sponsor mechanism. At 5% or above the (disinterested) directors' circular must state that the board regards the proposed transaction as "fair and reasonable as far as the security holders of the company are concerned" and that the directors have been so advised

[97] LR 11.1.11 imposes a twelve-month aggregation rule to block one obvious opportunistic use of this exemption.

by the sponsor.[98] Between 0.25% and 5% the obligation is to obtain written confirmation from the sponsor in the same terms as the fairness opinion just mentioned.

In relation to listed companies, at least those at the top end of the spectrum, therefore, the Listing Rules seem apt to pick up large, one-off transfers of value to related parties, but not well designed to pick up smaller transfers, which may be repeated with some frequency.

Despite the focus of attention on ch 11 of the LR, rules applying to other UK markets also control RPT on those markets. In particular, the rules for AIM (Alternative Investment Market), the junior market run by the LSE and, in EU terms, not a regulated market, address the issue, in this case through rules set by the Exchange, rather than the FCA.[99] The AIM rules are substantially weaker than the Main Market rules.[100] They apply only at the 5% level and above (under the ratios discussed above), but, even at this level, make use only of the disclosure tool.[101] A third-party fairness mechanism is deployed. The announcement of the proposed RPT must include a statement that the uninvolved ("independent") directors, having consulted the company's nominated advisor,[102] consider the transaction fair and reasonable as far as the shareholders are concerned. As with sponsors on the Main Market, the role of the advisor is central in securing compliance with this requirement. Under the *AIM Rules for Nominated Advisors* the advisor is responsible for "advising and guiding an AIM company on its responsibilities under the AIM Rules for Companies" and must undertake "a prior review of relevant notifications made by an AIM company with a view to ensuring compliance with

[98] LR 13.6.1(5). A director who is a related party or an associate of that party is excluded from consideration of the fairness issue and must be stated to have been excluded: LR 13.6.2.
[99] RPT rules can also be found in other London markets, for example, NEX, a market for high-tech start-ups, not run by the London Stock Exchange.
[100] London Stock Exchange, *AIM Rules for Companies*, 2016, rule 13.
[101] There is, however, no exemption for transactions in the ordinary course of business. This exemption was removed in 2001.
[102] Or 'nomad', which performs a somewhat similar role in relation to AIM-quoted companies as does a sponsor in relation to Main Market companies. The nomad is normally a somewhat less grand financial institution than the international investment banks which appear as sponsors, but their incentives to act carefully are the similar.

the AIM Rules for Companies".[103] Advisors have been disciplined for failings in relation to fairness opinions connected with related party transactions and issuers for not keeping advisors fully informed or not reacting appropriately to advisor views.[104]

**3.2 Some limited empirical data**

The hypothesis derived from an analysis of the text of ch 11 of the Listing Rules was that few transactions by large companies would be caught by them. This is borne out by a limited examination of the incidence of RPT announcements via the Exchange's Regulatory New Service (RNS). In the three months to July 30, 2017 there were 9 RNS announcements required by ch 11 in relation to Main Market companies.[105] Of these 9 announcements, two concerned constituent companies of the FTSE 250 (ie companies by market capitalisation within the range 101 to 250 but not in the top 100 - the FTSE 100), one concerned a FTSE 350 company (ie one in the 251 to 350 range), and the remaining 6 concerned even smaller companies.[106] Four of the announcements related to RPT which required shareholder approval (approval appears to have been given in all 4 cases), whilst the remaining 5 fell within the 0.25 to 4.99% range on the class tests, thus requiring only a RNS announcement based on prior written fairness opinion from the sponsor.[107]

Of the 4 shareholder approval announcements, one was a classic RPT. The company, Evraz plc, a FTSE 250 company, proposed to dispose of a major asset to its controlling shareholder (holding 60% of the voting rights in the company), with three of the directors of the company

[103] London Stock Exchange *AIM Rules for Nominated Advisers*, 2016, Introduction and Rule OR2.
[104] For example, London Stock Exchange, *Public Censure and Fine - Nabarro Wells & Co Limited*, 2007, para 23 (advisor breach) and Stock Exchange, *Aim Disciplinary Notice AD 12*, 2014 (issuer breach).
[105] There was one more required in relation to a company listed on the 'International Stock Exchange', located in the Channel Islands, to which ch 11 also applies.
[106] There are roughly a further 250 issuers (*excluding* investment companies) with equity shares listed on the Main Market, sometimes referred to as the "small cap" companies.
[107] LR 11.1.10.

also being significant shareholders in the controller.[108] Two of the cases involved fund-raising exercises by the company, in which an already substantial shareholder intended to take part so as, apparently, to breach the 5% threshold, presumably on the "consideration" test.[109] The fourth approval announcement was a genuine outlier.[110] No RNS announcement was triggered by a director transaction requiring shareholder approval under the statutory substantial property transaction rules alone, a piece of supporting evidence for the proposition that this rule operates in practice as a prohibition.[111]

Of the five "smaller" transaction announcements, three were triggered by the special extension of the related-party definition which applies to investment companies.[112] This extension brings in "any investment manager of the closed-ended investment fund and any member of such investment manager's group."[113] One was a fund-raising in which a substantial shareholder proposed to participate.[114] The last announcement was a classic RPT: an adjustment to the terms of a lease where the lessor to the company was an associate of a substantial shareholder.[115]

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[108] RNS, Evraz Plc – EVR Announcement released 07:00 03-May-2017. Approval was later given at an EGM held on May 23, at which over 92% of the independent shareholders voted in favour. Evraz is an integrated mining and steel-making company, operating in Russia but headquartered in London.

[109] RNS, NewRiver REIT PLC – NRR Results of Capital Raising, Released 17:51 15-Jun-2017; RNS, Sequoia Economic Infrastructure Income Fund Ltd, 03 May 2017 – both in fact investment companies.

[110] RNS, World Trade Systems PLC - WTS Circular Released 18:03 18-Jul-2017. The company had been non-trading between 2001 and 2016, with its shares suspended. During this time it had received loans from a substantial shareholder to meet the administrative expenditures necessary to avoid the company being struck off. Although modest in absolute terms, the loans met the 5% test, given the reduced size of the company's assets. The proposed approval was a prelude to the restoration of the company's shares to trading.

[111] Above n 48.

[112] RNS, Ventus VCT plc – VEN, Related Party Transaction, Released 14:58 26-May-2017; RNS, Ventus 2 VCT PLC - VEN2, Related Party Transaction, Released 15:04 26-May-2017; RNS, NextEnergy Solar Fund Limited – NESF, Related Party Transaction with WiseEnergy, Released 07:00 30-May-2017. Since 2007 both open- and closed-end investment funds have been required to list in the premium segment, though the FCA has recently consulted on permitting open-ended funds to list in the standard segment and thus escape the RPT rules (*Review of the Effectiveness of Primary Markets: The UK Primary Markets Landscape*, Discussion Paper DP17/2, para 3.28.)

[113] LR 15.5.4 – though presumably such a person might be one with "significant influence" (or an associate) under the general definition.

[114] RNS, Assura PLC – AGR, Results of Placing, Released 16:52 20-Jun-2017.

[115] RNS, Motorpoint Group plc – MOTR, Smaller Related Party Transactions, Released 09:32 05-Jul-2017.

During the period in which 9 main market RPT announcements were released via the RNS, there were 93 announcements of RPTs concerning companies quoted on AIM (of which there are just under 1000),[116] despite the fact that there is on AIM no disclosure obligation below the 5% threshold. Thus, despite the headline requirement in the LR for majority-of-the-minority approval for RPTs, in practice the Exchange's disclosure rules for AIM companies are much more likely to trigger an RNS announcement. A substantial driver of AIM announcements was a funding exercise (debt or equity) which the company was proposing to undertake. Because AIM companies in general have a smaller capitalisation than Main Market companies and are at an earlier stage of their development, it is more likely that they will have a "substantial" shareholder (a founder or a subsequent outside supporter) than a Main Market company. That shareholder's participation in a fund raising may trigger the disclosure obligation.[117]

Moreover, investing in AIM companies is more risky than investment in Main Market companies. Where the fund-raising is driven by adverse developments in the company's business, it may be that only those with inside 'soft' information about the company (substantial shareholders and directors) are prepared to make an additional investment or to do so with sufficient speed. Here, however, there is a significant risk of unfairness to the outside shareholders. Are the insiders being appropriately or over-compensated for the risks they are undertaking? Consequently, disinterested director assessment, advisor monitoring and disclosure may perform a useful role in these cases. Of the 90 announcements, 60 were triggered by substantial shareholder participation in fund-raising and 28 by the director

[116] So, slightly more than the equity listings on the Main Market.
[117] The rules suggest that participation in a share issue on a purely pre-emptive basis does not fall within their controls (*Aim Rules for Companies*, 2016, *Guidance Note* to Rules 12 and 13). The LR make this exemption explicit: LR 11, Annex 1, para 2.

participation. In 9 cases both sources of funding were present. Overall, 88% of the AIM announcements were the result of funding exercises.[118]

### 3.3 Controlling Shareholders

Given that the definition of a "substantial" shareholder is pitched at the 10% level, it follows that the LR provisions on RPT apply *a fortiori* to a controlling shareholder in a Main Market company, for example, the parent company of a listed subsidiary.[119] However, in the case of a controlling shareholder routine transactions and arrangements between company and controller may be biased against the outside shareholders, who are not well placed to detect the unfairness. On the other hand, as noted, to subject routine parent/subsidiary transactions to disclosure and approval requirements would be to impose substantial extra costs of business carried on through this type of group structure. Initially, therefore, the rule-makers focussed their attention on the development of techniques to combat controlling shareholder opportunism which were different from the ones deployed to deal with RPTs in general. Recently, however, the general RPT rules have emerged in the controlling shareholder context as sanction for non-compliance with the special rules for controlling shareholders. Moreover, they have re-appeared in a particularly strict form: none of the normal qualifications to the application of the general rules apply. Developing controlling shareholder rules separately from the general RPT rules has the additional advantage that the special rules may be crafted so as to provide protection for non-controlling shareholders beyond the situations in which the transaction-based RPT rules apply.

[118] Surprisingly, there was only one case where it appeared that a director was also a substantial shareholder. The absence of RNS announcements about shareholder approval under the statutory regime is probably explained on the grounds that directors' share subscriptions do not involve the acquisition of property from the company or that they are a transaction between the company and the director in the latter's capacity as a member of the company (s 192(1)).

[119] In the more usual UK case where the parent is listed, transactions between it and non-listed subsidiary companies do not fall within the RPT rules, because only the listed company is directly subject to the RPT rules and the subsidiary is not within the category of related parties in relation to the parent (unless the subsidiary is an associate of a person who is "related" to the parent - this would be the case, for example, where a director of the parent held a substantial shareholding in the subsidiary).

Nevertheless, history shows that the Exchange, initially, and the statutory regulator, subsequently, have struggled since the early 1990s with conflicting fluctuating policy impulses as to how the special rules should be formulated. The business of the Exchange will not flourish unless, on the one hand, outside investors have confidence that they will not be treated opportunistically, but neither, on the other, will it flourish if controlled companies seeking funding are discouraged from listing in London and go elsewhere. The 1993 revision of the Listing Rules introduced the basic requirement that the applicant for listing "must be capable at all times of operating and making decisions independently of any controlling shareholder"[120] and, post-listing, that "all transactions and relationships in the future between the applicant and any controlling shareholder must be at arm's length and on a normal commercial basis."[121] One difficulty for regulators has been to identify mechanisms capable of making the post-listing element of this principle a reality in practice, without driving away controlled companies from the market. In 1993 the chosen mechanisms were a requirement that "significant" decisions were to be taken by directors independent of the controller and, where conflicts of interest were likely, that "arrangements" were in place to avoid detriment to "the general body of the shareholders of the company." In 1997, however, the board structure requirement (for an independent board for significant decisions) was dropped and reliance placed solely on the general fiduciary duties of directors. On the other hand, the "arrangements" requirement was strengthened as to require "specific contractual arrangements between the controlling shareholder and the company to govern the ongoing relationship between the two"[122] - though no specific mechanism for monitoring the contract was put in place. However, in 1999 the contract requirement was removed and replaced with

[120] Defined as one capable of controlling 30% or more of the votes at a general meeting or one able to appoint a majority of the board – a definition which has remained constant.

[121] LR, 1993, 3.13. Before that, the Exchange's rules had focussed on the admission stage and confined themselves to a general warning that conflicts of interest between a substantial and the outside shareholders might render the company's shares unsuitable for listing. See London Stock Exchange, *Admission of Securities to Listing*, 1984, ch 2, para 6.

[122] LR, 1997, 3.13.

a requirement to disclose how the independence requirement was to be met in the listed company.[123] And in 2004 the 'independent business' test was removed altogether as a condition for listing, though it still had some life as a continuing obligation.[124]

At this point the regulators had come close to giving up on producing effective additional regulation of controlling shareholders. In the first decade of this century, however, a number of controlled companies (sometimes not incorporated in the UK and thus not necessarily subject to the equivalent of the UK fiduciary standards) with largely foreign assets (often in extractive industries) sought to list in the premium segment of the Main Market. In some cases the general listing rules relating to RPTs were ignored on a widespread basis,[125] so that pressure to re-invigorate the additional rules concerning controlling shareholders returned. Investors initially proposed a novel approach, namely, that the free float requirement, then set at 25%, should be raised to 50% in order to give non-controlling shareholders a greater chance of being able to block company resolutions requiring super-majority approval. This proposal was opposed by the sell-side and by the FSA as inconsistent with its obligation to have regarded to the competitiveness of the UK capital markets. Instead, it responded by strengthening the conduct obligations placed on controllers of listed companies which had been relaxed so recently.[126] These reforms revolved around the re-introduction of the 'independent business' test for applicants for listing and the requirement for a formal

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[123] LR, 1999, 3.12 and 6.J.17. In any event, the value of the contract had been undermined by the (remarkably narrow) decision of Jonathan Parker J. in *Re Astec (BSR) plc* [1998] 2 BCLC 556 that its purpose was to protect the trading interests of the company, not to deal more generally with conflicts of interest between controlling and non-controlling shareholders.

[124] FSA, *Review of the Listing Regime*, CP 203, 2003, para 5.27 – 28.

[125] The *cause célèbre* was Bumi, a UK-incorporated company but whose main asset was a subsidiary incorporated and operating in Malaysia and which engaged in the RPT. See FCA, *Final Notice: Asia Resource Minerals plc (formerly Bumi plc)*, June 2015, imposing a fine on the company for non-compliance with the listing rules of some £4.5m. On the "influx" of controlled companies onto the London market see Brian Cheffins, "The Undermining of UK Corporate Governance(?)" (2013) 13 *Oxford Journal of Legal Studies* 503, especially §2.

[126] FSA, *Enhancing the Effectiveness of the Listing Regime*, CP12/25, 2012 and *Feedback on CP12/25: Enhancing the effectiveness of the Listing Regime and further consultation*, CP13/15, 2013.

agreement between the controlling shareholder and the listed company, together with a more imaginative set of sanctions to sustain the newly restored rules.

All companies applying for premium listing must show that they will be conducting an independent business, but there is now much more bite behind this requirement in the shape of a revised set of indicators of non-independence which target controlled companies in particular.[127] Some of the contra-indicators, by putting the applicant company's access to premium listing in doubt, constrain its freedom to engage in certain categories of related party transactions. These include situations where the majority of the applicant's revenues result from business carried out directly or indirectly with the controlling shareholder, where it does not have access to funding other than from its controlling shareholder and where it has granted security over its assets in connection with funding from a controlling shareholder. In these cases, therefore, we see a new technique for controlling RPTs, ie a near-prohibition on certain types of transactions with the controller in the case of companies seeking a premium listing.

Second, once admitted to premium listing, a company with a controlling shareholder (ie one who with associates has control of 30% of more of the voting rights) must enter into "a written and legally binding agreement" with the listed company which provides that "transactions and arrangements with the controlling shareholder (and/or any of its associates) will be conducted at arm's length and on normal commercial terms" (as well as committing the controlling shareholder and associates to do nothing which would hinder the company's compliance with the Listing Rules).[128] There is a monitoring function and a sanction attached by the Listing Rules to the agreement. Monitoring is in the hands of the independent directors

[127] LR 6.1.4.
[128] LR 6.1.4B,D.

(as defined by the UK Corporate Governance Code),[129] who are required to state each year in the company's annual report whether they agree with the statement required of the controlled company that it has entered into a control agreement with the controlling shareholder and that the controlling shareholder has abided by its terms during the year. The independence of the certifying directors is thus a crucial element in the scheme. This appears at first sight to be assured by the requirement that the appointment and annual re-appointment of an independent director requires the separate approval of the non-controlling shareholders as well as of the shareholders as a whole. However, if non-controlling shareholder approval is not obtained on a first vote, there is a 90-day delay before a nomination may be considered by all the shareholders on a simple majority basis.[130] In addition, in order to avoid manipulation of the shareholder vote, it is required that the voting rights of all the shares in any class of premium-listed shares be equal and that the voting rights of different classes of premium listed shares be proportional to the interest of each class in the company's equity[131] - the first time a 'one share, one vote' requirement has been introduced into English law or regulation.

The sanction if there is no control agreement or the independent directors cannot agree with the statement required of the company is that the RPT rules apply to the listed company with particular rigour. In particular, it cannot take advantage of the 'ordinary course of business' nor the small (less than 0.25%) exemptions nor avail itself of the dispensation from majority-of-the-minority approval for RPT under the 5% threshold.[132] In the conditions noted, the RPT rules apply automatically in their unqualified form, ie the FCA does not have to make a

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[129] The requirement for independent directors (at least half of the board) is a 'comply or explain' obligation under the UK CGC, but the LR in effect make it mandatory for controlled companies, since, without them, the required compliance statement will not be available, though the LR are not precise on the proportion of independent directors the board must contain.

[130] LR 9.2.2A, E and F. In two recent cases, Sports Direct and Ferrexpo, where non-controlling shareholders suffered losses from related-party transactions, the controlling shareholder made use of its voting rights at the second stage to secure the appointment of its preferred directors. See Bobby V Reddy, *The Fat Controller - Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies*, Cambridge Faculty of Law Legal Studies Research Paper 47/2017, pp 17-19.

[131] LR 7.2.1A

[132] LR 11.1.1A-D. The FCA has a dispensing power.

determination to this end. However, if the company ignores the unqualified RPT rules, the impact of the scheme will be heavily diluted if the FCA does not enforce at that point.[133] In effect, the scheme is that all RPTs, no matter how trivial, become subject to majority-of-the-minority approval in the conditions noted. This is a burdensome requirement for the listed company, but also one targeted at the mischief the control agreement addresses. It is likely to prove a strong inducement to controlling shareholders to enter into and abide by the terms of control agreements. In essence the overall scheme here is a fairness requirement, policed by directors independent of the related party, and sanctioned by the threat of shifting the policing to the minority shareholders. Its weakness is its failure to guarantee that the independent directors are in fact independent of the controlling shareholder.

However, this twisted story does not end here. In a partial *volte face*, in 2017 the FCA proposed to exempt controlling shareholders which are sovereigns from *both* the general related-party rules and the additional post-listing constraints on controlling shareholders.[134] This proposition was advanced on two bases. First, sovereign-controlled companies were already free to apply for listing on the "standard" basis (ie compliance with the EU minimum requirements only) and thus escape all the additional regulation attached by the UK rule-makers to premium listing. It was better to have sovereign controlled companies adopt some of the additional regulation required for premium listing than none of it. Second, "we believe that investors and the market are sufficiently able to assess the additional risks arising from sovereign ownership. Those making decisions to invest in the securities of sovereign

[133] It is possible that a minority shareholder could seek to have a court declare the transaction not binding on the company if the required shareholder approval is not obtained or that the shareholder could make use of the "unfair prejudice" remedy in s.994 of the Companies Act 2006 (on the latter see Cheffins, above n 125, p 529.

[134] FCA, *Proposal to create a new premium listing category for sovereign controlled companies*, CP 17/21, July 2017. Related parties other than the controlling shareholder would remain subject to the general rules (and the additional rules would apply to a non-sovereign controller in the unlikely event that both types of controller were present).

controlled issuers will wish to do so taking into account the nature of the sovereign owner."[135]

Neither argument is without weight, but, equally, neither is compelling. The more general driver for this change seems to have been the FCA's fear that the London market was becoming unattractive for large overseas issuers – standard listing because it carried few cost-of-capital benefits and premium listing because it carried obligations suitable for UK incorporated companies but not of broader relevance. In a Discussion Paper earlier in the year, the FCA floated the creation of an "international segment" in the market, in order "to create a new, credible listing option for large international companies which may wish to access UK markets but may feel that current UK listing requirements are not fully appropriate. For example, this may be attractive to companies where there is a founding family or government that wishes to retain control rights that are incompatible with a conventional premium listing."[136] There was not sufficient agreement among consultees for the FCA to proceed with this broad idea, but the proposal in relation to sovereign-controlled companies is a slimmed down version of it, which the FCA feels will attract support.[137] [fn to Isaacsson and Celik?]

## 4. CONCLUSION

At the beginning of this paper, two comparisons were mooted: first, a cross-jurisdictional comparison between the general English and US (especially Delaware) law on RPTs and, second, an internal English comparison between the general law and the specific rules applying to quoted companies. As to the first, the dominant mechanism for handling

[135] Para 3.7.
[136] FCA, *Review of the Effectiveness of Primary Markets: The UK Primary Markets Landscape*, DP 17/2, February 2017, para 3.21.
[137] CP 17/21, para 2.4.

directors' RPTs in both jurisdictions is disinterested board approval. Doctrinally, this result was achieved somewhat differently in the two cases. In English law board approval emerged very quickly in the nineteenth century because the English courts accepted that the 'no conflict' principle was a default rule, out of which the shareholders could contract via appropriate provisions in the articles. In the US board approval emerged more as a result of judicial and legislative development of fiduciary doctrine than through private ordering, though private ordering played a subordinate role in the US as well. Now that the Companies Act 2006 in the UK has endorsed board approval, the two systems seem even closer in terms of functional result.

A significant difference, continues to exist, however, in the ways the two systems respond to the risks of inadequate scrutiny under a board approval mechanism. In the general English law the main mechanism is partial restoration by statute of the initial fiduciary starting point, ie prior shareholder approval of conflicted transactions. This is done for classes of transaction where the legislature has perceived the risks of inadequate board scrutiny to be substantial. By contrast, Delaware has a general scrutiny mechanism in place in the shape of court review of substantive fairness of the transaction, even if it has been approved by the board. Thus English law sticks firmly to the notion that the courts should in principle stay out of fairness assessment, whilst Delaware law places greater weight on substantive assessment by the courts, even if the threat of substantive assessment is deployed by the courts in large measure to control boards' approval procedures.

In the case of shareholder RPTs there is a bigger contrast between the two jurisdictions. Controlling shareholders fell outside the doctrinal scope of English fiduciary law, and so the law developed, rather slowly, a number of piecemeal and incomplete mechanisms for dealing with this category of RPT. By contrast, Delaware brought controlling shareholders within the fiduciary fold and in fact applied the substantive fairness test in a particularly constraining manner to them.

Turning to the internal comparison between general English law and the rules applying to publicly traded companies, there is at first sight a stark contrast between the two. The Listing Rules require majority-of-the-minority approval in some cases and embrace not only directors (and associates) but also, not just controlling, but also ‘substantial’ shareholders (and associates). As we have seen, however, a limited investigation of RNS announcements suggests that the 5% threshold means that large listed companies are rarely caught by the majority-of-the-minority approval requirement or even by the ex ante disclosure and fairness opinion requirements operating at the 0.25% threshold.[138] However, the disclosure requirement does have a significant impact on AIM companies, even at the 5% level, probably because of their smaller capitalisation and more concentrated shareholding. In addition, the related-party provisions of the LR probably do have a significant role in enforcing and sanctioning the “control agreement” requirements now applied to controlling shareholders – though the FCA is clearly uncertain whether controlling shareholders in foreign companies should be subject to the listing provisions on RPTs.

[138] Especially as awards under employees’ share schemes and long-term incentive schemes are excluded from ch. 11 of the Listing Rules (LR 11, Annex, para 3). However, there is now an elaborate set of ‘say on pay’ requirements under the 2006 which require disclosure and approval in these cases.

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