Barbarians at the gate? Activist investors and s 249N

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INTRODUCTION

Shareholder activism has been a key element of the recent debate in Australia concerning corporate governance and shareholder engagement in recent years. Part of that dialogue has involved the question of whether 'US-style' activism in the mould of Carl Icahn, Bill Ackerman and Daniel Loeb will make its way down under and start affecting ASX listed companies.

This note considers several recent cases involving different types of shareholder activists and their use of provisions in the Corporations Act to push their activist agenda along. This note focusses particularly on the scope of s 249N, although it draws on other provisions such as s 249D (relating to requisitioning members meetings) and those dealing with director and executive remuneration. Section 249N allows members with 5% of the votes that may be cast on a resolution or 100 members entitled to vote on a resolution to propose a resolution at a members' meeting by giving the company written notice of the proposed resolution. The members must also sign the notice.

Section 49N should be viewed in conjunction with other shareholder empowerment provisions including the power to:

- Requisition the company to convene a meeting of the members under s 249D (members with at least 5% of the votes that may be cast at the general meeting must sign the requisition)
- Hold a general meeting under s 249F (the same 5% voting threshold is required)
- Request a company to its members a statement about a proposed resolution or about any other matter that may be properly considered at a general meeting: s 249P. This applies where members with at least 5% of the votes that may be cast on the resolution or at least 100 members entitled to vote at the moment make the request.

Section 249D was changed in 2015 to drop the former 100 member rule.

While these provisions promote shareholder empowerment and engagement as they give members a voice and the capacity to raise matters within the decision making processes of the company, they also give rise to a tension with the management power typically given to the board of directors either under s 198A (a replaceable rule) or otherwise in the company's constitution. This raises the question of to what extent can activist investors use proposed resolutions to push their agenda whether in the best interests of the company or even to promote their own interests. This note considers the implications of several recent cases that have examined this issue.

WHAT IS AN ACTIVIST INVESTOR?

Activist investors come in many shapes and sizes. A simple definition of an activist investor is one who is seeking to influence the management of a particular company.[1] As to what the

[1] See du Plessis, Hargovan, Bargaric and Harris, *Principles of Contemporary Corporate Governance*, 3rd ed, Cambridge University Press, 2015, Ch 13.

activist may be seeking influence for, that can range of direct control through board representation, whether that is control for its own sake or board representation merely as a tactic to influence management policy.

Aside from board representation, activists typically criticise particular management decisions or policies with a view to pressuring the company to:

- increase dividends
- undertake a capital reduction such as a buy back
- make an in specie distribution to investors
- spin off one or more divisions of the company to focus on 'core business'
- close a loss making division of the business
- abandon or change expansion plans
- sell the company through a takeover or merger
- abandon or change capital raising plans
- change executive or board positions
- change remuneration policy

For present purposes we may draw a distinction between activist investors who are:

1) concerned with improving a company's economic performance. This may be ostensibly for the benefit of all investors but the activist is usually seeking a personal benefit of themselves through higher returns; and

2) those who are pressuring the company to make changes to its management as part of a social issues campaign. Organisations such as GetUp, Australian Centre for Corporate Responsibility and union investor campaigns fall into this latter category.[2]

In the former category we can place institutional investors who adopt an activist strategy as part of a diversified investment strategy, such as the recent examples involving UniSuper and Westfield, and Perpetual and Brickworks and Allan Gray and Roc Oil. We can also include specialist activist hedge funds and professional activist investors into this first category.

We can exclude individual activists such as Stephen Mayne or Jack Tilburn because they are unlikely to meet the 5% of votes or 100 member thresholds. This working definition also excludes proxy advisors and shareholder associations as they are not themselves investors, even though they are advocating for change.

TECHNIQUES USED BY ACTIVIST INVESTORS

Activist investors may use a variety of techniques to achieve their aims. These may include soft informal approaches or formal written letters to the company, which may then be released to the public to put the target company under public pressure. Leaks to the media and formal media interviews are also a common tactic to increase the public focus on the tension within the company and to highlight the criticisms of the activist. This has been used most prominently by Mark Carnegie in recent times in Australia. Another emerging trend

[2] See further Kirsten Anderson and Ian Ramsay, 'From the Picket Line to the Board Room: Union Shareholder Activism in Australia' (2006) 24 C&SLJ 279.

has been the use of social media by high profile fund managers to criticise the company and build public support for their activist goals. This is used to great effect by well known US based activist investors such as Carl Icahn who has more than 250,000 followers on Twitter. Warren Buffett has more than 1 million followers on Twitter.

Aside from seeking to name and shame targets, activists may also use equity derivatives (such as swaps), options and stock lending to put their finger on potentially large amounts of shares without actually having to purchase the shares on market and flag a potential takeover to the market which may drive up the share price and lessen the activist's argument about under performance. The use of equity derivatives has been seen in recent activist moves involving Echo Entertainment, Qantas and Fairfax.

Activists may also use members' rights under the Corporations Act, such as making a push to vote against remuneration reports of publicly listed companies and requisitioning a members' meeting to vote on proposed resolutions including perhaps to remove directors or to appoint new directors. The power to propose resolutions at a members' meeting has been considered in two recent cases in the last 12 months which will now be discussed. However, before we discuss these recent cases it is worth noting the traditional view regarding the distribution of power between the board and the members meeting.

BALANCING POWER BETWEEN THE COMPANY'S DECISION-MAKING ORGANS

Section 198A of the Corporations Act provides a default rule that the business of the company is to be managed by, or under the direction of, the board of directors. This rule is either adopted or modified slightly by virtually all companies, although it may be preferable in some closely held companies that the board's management power be checked by the members or by a governing director/founding director which can be achieved by the wording of the constitution.

The role of the constitution is to allocate decision making power to the different decision making organs of the company, typically the board as a collective body (or someone to whom it has delegated particular authority) and the members' meeting. The typical distinction is between management power, given to the board, and control power which is given to the members' meeting.[3] Management power refers to the power to manage the business of the company, while control power refers to the traditional role of members deciding on who shall sit on the board and exercise the management power by being able to vote for or against directors. Certain types of significant decisions such as:

- whether the wind up the company voluntarily (see s 491)
- whether to approve related party transactions (see s 208)
- whether to approve a capital reduction (see s 256C)

are given specifically to the members' meeting for approval. If a company is listed on the ASX then the ASX Listing Rules may also require that certain management decisions obtain shareholder approval.

[3] See further Jason Harris, *Company Law: Theories, Principles and Applications*, 2nd ed, 2015, LexisNexis Butterworths, Ch 6.

Once the constitution has allocated decision making power to the organs of the company that power allocation can only be changed by amending the constitution. It is clear that the directors cannot use management power to distort the exercise of control power by the members, such as by issuing shares for the improper purpose of defeating an unwanted takeover or issuing shares to give themselves or someone else majority control of the members' meeting.[4]

It is also clear that the capacity of the members' meeting to pass resolutions cannot mandate how the directors are to exercise their management power, at least where the constitution or s 198A gives the board management power. This is often expressed as the *Parker* principle, after *National Roads & Motorists' Association v Parker* (1986) 6 NSWLR 517, where McLelland J said (at 522):

> 'it is no part of the function of the members of a company in general meeting by resolution, i.e as a formal act of the company, to express an opinion as to how a power vested by the constitution of the company in some other body or person ought to be exercised by that other body or person.'

This is supported by long standing authorities such as *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34; *Gramophone & Typewriter Ltd v Stanley* [1908] 2 KB 89.

More recently Barrett J explained in *Taiqi Investments (Aust) Pty Ltd v Winlyn Developments Pty Ltd* (2011) 86 ACSR 197; [2011] NSWSC 1218 at [19]:

> 'unless a clear contrary intention is shown, functions assigned to the company in general meeting are not exercisable by the board of directors and likewise those given to the board of directors are not exercisable by the company in general meeting.'

Similarly, in *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 at 134, Greer LJ said:

> 'A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders.'

These statements highlight the inherent tension between the theory and reality of modern corporate law. The predominant agency theory of corporate law, with its shareholder primacy norm, makes it understandable for shareholders to believe that they are the owners of the company and the directors should be exercising management power only for

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[4] See *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

their benefit. But the shareholders are not the principal of the company, and the directors are not their agents. As Owen J explained in the *Bell* case:[5]

> 'It is, in my view, incorrect to read the phrases 'acting in the best interests of the company' and 'acting in the best interests of the shareholders' as if they meant exactly the same thing. To do so is to misconceive the true nature of the fiduciary relationship between a director and the company. And it ignores the range of other interests that might (again, depending on the circumstances of the company and the nature of the power to be exercised) legitimately be considered.'

Shareholder activists may talk of incompetent company managers wasting 'their money', but of course shareholders' equity funds are the property of the company and merely provide consideration for the equitable chose in action that the shareholders have against the company through their rights under the constitution and the Corporations Act.

Company directors have a duty to act in the best interests of the company as a whole, not merely address the concerns of particular investors. It is a delicate balance that the board must continually make by keeping the variety of corporate stakeholders happy while trusting that the shareholders (as the only stakeholder with the power to vote) do not vote them out of office.

With this balance in mind, we can now turn to consider two recent cases involving different types of shareholder activists using company resolutions to pursue their agenda.

USING MEMBERS' MEETINGS FOR SHAREHOLDER ACTIVISM

(a) *Re Molopo Energy Ltd; Molopo Energy Ltd v Keybridge Capital Ltd (2014) 104 ACSR 46; [2014] NSWSC 1864*

This case concerned attempts by a shareholder of Molopo Energy to require the company to undertake a substantial capital reduction and a return of capital to shareholders. The shareholder (Keybridge) held just over 5% of the shares at the relevant time (although it has since moved up to 19%). Keybridge's proposed resolution to undertake a capital reduction was rejected by the Molopo board as falling within the management power of the board under the company's constitution. That management power was expressed in the constitution to be subject to the requirement that any decision by the board to sell or dispose of the main undertaking must be ratified by the members in a general meeting.

Keybridge served the company with two further proposed resolutions. The first resolution proposed to amend the constitution so that management power of the board would be subject to a new power of the members in a general meeting to cause the company to reduce its capital. This came with a further ordinary resolution which was to implement the capital reduction that had been rejected by the Molopo board previously.

The push to cause the company to reduce its capital occurred at a time when the company was involved in significant litigation in Canada which could result in a substantial liability. If

[5] *Bell Group Ltd (in liq) v Westpac Banking Corp (no 9)* (2008) 39 WAR 1; [2008] WASC 239 at [4395].

the capital reduction occurred, then the company's ability to meet a future liability arising from the litigation would be questionable.

The court (White J) held that the members meeting could not require the company to propose a capital reduction because Chapter 2J of the Corporations Act provided for the decision about whether to undertake a capital reduction was to be made by the directors and, in certain situations, that decision then needed to be approved by the members' meeting. His Honour held that to allow a reduction to be proposed and effectuated by the members would lessen the protection given to creditors by Chapter 2J. Furthermore, if directors were required by the members to undertake a reduction of capital this could trigger liability for the directors under insolvent trading laws.

This was not a members' resolution that infringed on the management power of the board simply stated in the constitution, it was a members' resolution that tried to use a power given to the board by the Corporations Act itself, which was impermissible. Once it was determined that the resolution was improper, then the company had no obligation to distribute the resolution to the members or to convene the meeting for voting on the invalid resolution: *Turner v Berner* [1978] 1 NSWLR 66; *Parker*.

Given the potential prejudice to creditors that could arise from a capital reduction, the court held that the second resolution (i.e. to effectuate the capital reduction) was also invalid as any such capital reduction would contravene s 256B, even if the constitution allowed it.

Keybridge proposed a further resolution to replace the existing directors which was challenged by the company as involving a potential future breach of duty as any newly appointed directors may be mindful to act in accordance with Keybridge's wishes and seek to implement the capital reduction. This was rejected by the court as being unsubstantiated by the evidence and this resolution was permitted to be distributed to the members. Subsequently, the company appointed a non-executive director proposed by Keybridge.

While Keybridge has so far been unsuccessful in its campaign to cause the company to return greater funds to shareholders, it was successful in securing a board position as a result of its activist stance.

(b) *Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia (2015) 107 ACSR 489; [2015] FCA 785*

This case concerned more than 100 members of CBA who proposed resolutions at the next members' meeting of CBA. The members were led by ACCR which has had a long running campaign relating to carbon emissions by projects funded by Australian banks. With greater public awareness and concern regarding climate change, many financial institutions have increased their reporting relating to carbon emissions.

The ACCR as representative for more than 100 CBA shareholders submitted written notice to CBA of 3 potential resolutions. These were expressed to be alternatives:

1. In the shareholders' opinion it would be best for the company to provide a report on carbon emissions produced by activities funded by the company and to disclose how the company was dealing with risks associated with 'unburnable carbon'; or

2. To express the shareholders' concern as part of the consideration of the company directors' report at the absence of a report on carbon emissions and the management of risks associated with unburnable carbon; or
3. That the company's constitution be amended to require the directors' report to provide information on carbon emissions arising from CBA funded activities.

The bank only included the third resolution with its AGM notice to members. It included information in the notice to members that stated it was of the view that the proposed resolution was not in the best interests of the company and its members. The bank claimed advised the ACCR that the other two resolutions were within management power and not matters within the power of the members.

ACCR sought declarations from the court that all three proposed resolutions were valid (although the parties accepted that the third proposed resolution was valid). ACCR challenged the legal status of the *Parker* principle and argued that as its resolutions were only advisory opinions of the members they were not binding on the company and not an infringement on management power. Furthermore, the ACCR argued that the second resolution was within the power of members to exercise a non-binding vote on the company's remuneration report.

The court applied the *Parker* principle and held that the bank's constitution did not provide the members' meeting with a power to make resolutions offering their opinion to the board, although this would not preclude the board seeking the views of members, but the members could not force the board to consider their views by passing an advisory opinion resolution.

The court also held that the power contained in s 250S (which requires the company give members a reasonable opportunity to ask questions and to give comments at the AGM) was inconsistent with any residual power to the members' meeting to give advisory resolutions. Furthermore, while members were given the power to make a non-binding vote on the remuneration report, this was not a power to vote on the entirety of the directors' report and hence resolution 2 was invalid.

Finally, the court held that as the letter under s 249N allowed for the resolutions to be put as alternatives, even if the first two resolutions were valid it was open for the bank to choose which resolution would be put to the AGM.

Although the ACCR was unsuccessful in changing the CBA constitution, or in giving advisory opinions it has obtained greater disclosure from all large banks on environmental emissions and it continues it activist program by attending bank AGMs and asking questions about environmental matters.

This case is significant because it confirms the force of the *Parker* principle and affirms the limitations on the power of a members' meeting to direct or advise the board on their exercise of management power.

CONCLUSION

Investor activists are not going away, and recent indications suggest that activist behaviour will become increasingly common for Australian companies. Section 249N is an important weapon in the activist's toolkit, but as these two recent decisions show that weapon is still limited to the proper power of the members' meeting which must not infringe or usurp the managerial power of the board unless the constitution of the company so provides. Even if an activist attempts to change the constitution, they cannot force the board to exercise a power that is specifically given to them by the Corporations Act rather than arising generally under their managerial prerogative under the terms of the company's constitution.

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