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ALERT MEMORANDUM

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Staying Neutral - UK Supreme Court Re-emphasizes Primacy of Board Neutrality When Battles for Corporate Control Arise

Directors of UK companies which are “for sale” are not (unlike directors of Delaware companies) subject to *Revlon* type duties to take active steps to obtain the best price reasonably available to shareholders.

However, directors of UK companies are subject to a duty to act for proper purposes, which has been interpreted by UK Courts as requiring strict board neutrality when battles for corporate control arise. (This duty to act for proper purposes, which originated in common law principles, applies in addition to the restrictions on frustrating action applicable to listed companies under the UK Takeover Code.) The UK proper purposes duty would for instance likely prohibit directors of UK companies from taking actions permitted under the Delaware *Unocal* principles, such as the establishment of a poison pill in response to an unsolicited offer which posed a threat to corporate policy.

In an important recent case - *Eclairs Group v JKX Oil and Gas* - the UK Supreme Court re-iterated the primacy of board neutrality when battles for corporate control arise. In this case, the Supreme Court applied the proper purposes duty to invalidate certain actions taken by the board of a company subject to an alleged corporate raid to disenfranchise the voting rights of the alleged corporate raiders. This was despite the fact that:

- the directors genuinely believed that the alleged raid was deceitful, subversive and harmful to shareholders; and
- the directors had a basis to believe that the alleged raiders had not properly responded to requests issued by the company requiring the alleged raiders to disclose the nature of their interests in the company.

***Eclairs Group v JKX Oil and Gas*.**

Directors of UK companies are subject to a statutory duty to exercise their powers <u>only</u> for the purposes for which they are conferred – commonly known as the “proper purposes” duty. The UK Courts have historically interpreted the proper purposes duty as prohibiting directors from exercising their powers (most notably the power to issue new shares) for the purpose of defeating a bid or for otherwise influencing the outcome of a battle for corporate control. This is on the basis that decisions relating to the outcome of bids and other battles for corporate control are matters properly to be decided by shareholders, not directors.

The proper purposes duty was considered in this case, which involved an alleged covert corporate raid.

JKX Oil and Gas ("**JKX**") is an English company listed on the London Stock Exchange. JKX fell upon difficult times and its share price fell considerably. In 2013, the directors of JKX began to fear that the company was becoming subject to a clandestine raid by two shareholders (the "**Alleged Raiders**") who together came to hold approximately 40% of JKX's issued shares. The board believed that the objective of the Alleged Raiders was to depress JKX's share price and to ultimately take control of JKX "on the cheap".

Later in 2013, JKX sought to raise capital by issuing new shares but the proposed capital raise was frustrated by the alleged corporate raiders who refused to vote in favour of the shareholder resolutions required to implement it.

Under the UK Companies Act, a public company has the power to issue notices to persons appearing to be interested in shares requiring information in respect of those shares and those interested in them. In this case, the constitutional documents of JKX gave the directors the power to disenfranchise rights attaching to the relevant shares where the directors had reasonable cause to believe that the responses to these notices were inaccurate.

The board of JKX issued certain of these notices to shareholders believed to be associated with the Alleged Raiders. The board received responses to the notices but was not satisfied that the responses were accurate. Using the power in the constitutional documents, the board of JKX imposed restrictions on the relevant shares suspending (amongst other things) the right to vote at general meetings. As a matter of fact, the Court found that the directors of JKX genuinely believed that they were exercising their powers for the benefit of the company as a whole – that is, to hinder the cause of the Alleged Raiders which they believed was not in the interests of shareholders.

The Alleged Raiders challenged the restrictions imposed by the board of JKX on the basis that the board had exercised its powers for the improper purpose of ensuring that the Alleged Raiders were not able to vote at an upcoming shareholders' general meeting of JKX (the "**JKX Shareholders Meeting**".

The Supreme Court agreed with the Alleged Raiders that the board of JKX had exercised its powers for an improper purpose – being, to influence the outcome of the vote at the JKX Shareholders Meeting - and lifted the restrictions on the relevant shares. The facts that:

- the directors genuinely believed that their actions were taken in the best interests of the company to ward off a "deceitful" and "subversive" raid on the company;
- the directors appeared to have been motivated in part by permissible purposes; and
- the directors did have a basis to believe that the responses from the alleged raiders were not accurate,

did not save the actions.

Implications

As the Supreme Court expressly contemplated in its judgement, a battle for corporate control is likely to be the situation in which the proper purposes duty has the most significant role to play. This decision re-emphasizes the fundamental importance of the board neutrality policy in UK corporate law (which is also reflected in the UK Takeover Code) when battles for corporate control arise - the use of directors' powers (including the power to issue shares and, as this case emphasizes, other powers) for the purposes of influencing the balance of forces between shareholders will not be permitted. Importantly, this case also clearly illustrates that the reasons for the actions will not save them - that is, the board neutrality policy effectively overrides the directors' belief that they are acting in the best interests of shareholders. These principles will be particularly relevant to UK directors when considering their response to unsolicited transactions and/or corporate raids.

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