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CLASSIFICATION OF COMPANY'S SHARES IN THE LEGAL PRACTICE OF EUROPEAN COUNTRIES: IN SEARCH OF THE BEST MODEL

Master Thesis

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Doctor

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TABLE OF CONTENTS

LIST OF ABBREVIATIONS

1. 1S1V — one share - one vote.
2. CEM(-s) — control enhancing mechanism(-s).
3. EMCA — the European Model Company Act.
4. EU — the European Union.
5. GM — general meeting of shareholders.
6. IPO — initial public offering.

INTRODUCTION

The issuance of shares encompasses various aspects, starting from their form and ending with the rights attached to them. This is a complex, consistent process of filling a relatively empty notion of "share" with a content. Any distinction in type, scope, or in other characteristics of rights and obligations attached to shares will be reflected in specifics of mutual relations between a shareholder and a company, as well as in relations with other shareholders and stakeholders. Obviously, favourable and transparent conditions of shareholding create attractive investment environment, which is beneficial not only for an issuing company, but also for the economy of the country.

Problem of the research. There is no common structure of share ownership in companies within the European Union. This question is left for the Member States to legislate on it, and therefore, each Member State has its own regulatory framework, based on its legal traditions and level of development of legal knowledge. Differences in approaches of Member States vary from those leaving broad discretion to participants of corporate affairs for determining their relations, to those, advocating strict statutory rules. Thus, the corporate map of the European Union's Internal Market is diverse, creating incentives for jurisdiction shopping of companies in searching for a comfortable and safe harbor for conducting business. This, in turn, leads to a disproportional concentration of business from one jurisdiction to another. Accordingly, freedoms of establishment and of capital movement do not perform the function they are intended to, namely, harmonious development of all participants of the Internal Market, and pose threat to its effective functioning. In the same time, business environment of each country is unique, it reflects a specific development path and various intra-state processes. And usually country's unwillingness to allow certain tools is related to their inherent risks and country's reluctance to mitigate those risks. In view of the above mentioned, the problematic question arose: **which model of corporate shareholding will be able to suit demands of all participants of corporate relations in the European Union's Member States?**

Although different approaches on the capital and share structure exist, there is a lack of modern research which examines the combination of scientific findings for the purpose of evaluation how they work together. Therefore, the **scientific novelty** of the research is in joint evaluation of the specific models of assigned value of shares, rights attached to them and their forms of expression; in analysis of interrelation between these elements of share capital; and in

determining the model of effective share ownership, based on the current tendencies in the business and investment sectors.

Review of the literature showed, that opinions on the ownership structure and the ways of its development are diversified. In particular, the scholars are divided on those, who favour the idea of freedom of contract in corporate relations, and those, who oppose this. The formers advocate weakening of statutory regulation of corporate issues, leaving them for parties to negotiate in the articles of association and shareholders' agreement, while the latter believe that such approach would leave minority shareholders without due protection. More specifically, the debates surround issues of the "one share — one vote" standard and opposite concepts of multiple-voting and non-voting shares, par value and no-par value systems, bearer and registered type of shareholding, paper-based and dematerialized forms etc.

Petri Mäntysaari in the first volume of his series of books **"The Law of Corporate Finance: General Principles and EU Law"**[1] discusses various aspects of shareholding, including shareholders' interests, functions, their importance for the company, why do they need protection and what they are paid for by means of dividends distributions. This work provides the overall understanding of the nature of shareholders' participation in corporate affairs, their status and impact that they perform on the company and other participants.

European Model Companies Act (EMCA), a project of number of academics and practitioners from over 20 countries, intended to perform a function of model statute regulating corporations.[2] EMCA provides with a comprehensive and coherent regulatory framework for future development of the European company law. It includes, among others, the issues on nominal value and no-par value shares, various classes of shares, their different forms and contents, transferability and non-transferability, possibility of redemption etc. The paper also addresses the matters of contractual freedom of the articles of association and shareholders identification as important issues that should be considered when adopting national legislative measures.[3]

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[1] Petri Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*, Vol.1 (Berlin, Heidelberg: Springer-Verlag, 2010).

[2] Marco Ventoruzzo, "The New European Model Company Act," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (October 2015), accessed May 12, 2019, [interactive] https://corpgov.law.harvard.edu/2015/10/14/the-new-european-model-company-act/.

[3] Paul Krüger Andersen, Theodor Baums [and others], European Model Company Act (EMCA), *Nordic & European Company Law Working Paper* no.16-26, 2017, accessed March 29, 2019, [interactive] https://ssrn.com/abstract=2929348.

Due to a complex nature of the conducted research, it requires considering various particular aspects of shareholding. Thus, in preparation of this paper findings of the following scholars have been considered.

Marco Ventoruzzo in relation to multiple voting shares claims that they are "neither an anathema nor a blessing" and advocates their allowance, subject to statutory precautionary measures and appropriate protection to investors.[4] **Lucian Bebchuk and Kobi Kastiel,** in turn, argue that misalignment between those, who make decisions and those, who bear consequences, as inherent to dual-class companies, leads to incentives of extracting private benefits of control at the expenses of non-controlling shareholders.[5] **Zoe Condon** discusses sunset provisions as defensive tools against perpetual founders lock in control by means of multiple-voting shares.[6]

Non-voting shares are claimed to be "unhealthy hybrid between shares and bonds"[7] by **Mathias Siems**, while **Dorothy Shapiro Lund** argues that this tool is able to increase efficiency of corporate governance, by reducing free riding and passivity problems.[8]

Hans De Wulf argues about inadequacy of the concept of par value to offer protection to shareholders, as well as creditors, and illustrate the advantageous of the true no par value system, using Finnish approach as an example.[9]

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[4] Marco Ventoruzzo, "The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat," *ECGI Working Paper Series in Law,* paper N° 288/2015 (March 2015), 9, accessed April 28, 2019, https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2574236.pdf..

[5] Lucian A. Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," *Virginia Law Review*, Vol.103, no.4 (2017), 602, accessed April 19, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630.

[6] Zoe Condon, "A Snapshot of Dual-Class Share Structures in the Twenty-First Century: A Solution to Reconcile Shareholder Protections with Founder Autonomy," *Emory Law Journal*, Vol.68, no.2 (2018), 363, accessed April 19, 2019, http://law.emory.edu/elj/content/volume-68/issue-2/comments/dual-class-twenty-first-solution-protections-autonomy.html.

[7] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 116.

[8] Dorothy Shapiro Lund, "Nonvoting Shares and Efficient Corporate Governance," *Coase-Sandor Working Paper Series in Law and Economics*, 834 (2017), 32, accessed May 15, 2019, https://chicagounbound.uchicago.edu/law_and_economics/834.

[9] Hans De Wulf, "Shares in the EMCA: the Time is Ripe for True No Par Value Shares in the EU, and the 2nd Directive is Not an Obstacle," *European company and financial law review*, Vol.13, no. 2 (2016), accessed June 14, 2017, https://www.degruyter.com/downloadpdf/j/ecfr.2016.13.issue-2/ecfr-2016-0215/ecfr-2016-0215.pdf.

According to some scholars, for instance, Veronique Magnier and Patrick Barban,[10] as well as Philipp Paech,[11] the future of corporate securities is linked to the technology of blockchain, which will increase transparency of operations with shares and their simplicity.

The practical significance of the work is that its findings can be used by the broad spectrum of players, in particular:

1) **by European Union`s policy makers** — for systematization of the scientific progress, clarification of controversial issues and formulation of proposals for reformation of the regulatory framework;

2) **by companies, investors and shareholders** — for creation of the environment for long-lasting investments, enhancing stability and certainty of the investment climate, strike a balance between different classes of stakeholders and their interests;

3) **by lawyers** — for legal certainty in planning and performing of legal assistance and defence strategies;

4) **by scientists and students** — as a theoretical basis and ideas for further research on the models of shares in the European companies and their combinations.

The **aim** of the Master Thesis is, based on the systematisation of the theoretical and empirical findings, to analyse existing models of the corporate shareholding in the EU's countries in order to determine which model is best suit to demands of the contemporary business environment.

In order to achieve the aim of the research, the following **objectives** have been defined:

1) to disclose mutual relations between a company and its shareholders, to examine their mutual interests in each other, and to reveal the essence and specifics of their link through such object of property as shares;

2) to investigate existing approaches of the EU's countries in relation to share and capital structuring, including various control enhancing mechanisms, hybrid securities, par value and no-par value shares, and to discuss which model best influences company's performance and investment attractiveness.

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[10] Veronique Magnier and Patrick Barban, "The Potential Impact of Blockchains on Corporate Governance: A Survey on Shareholders' Rights in the Digital Era," *InterEULawEast: Journal for International and European Law, Economics and Market Integrations,* Vol.5, no.2 (2018), accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/inteulst5&i=332.

[11] Philipp Paech, "Securities, Intermediation and the Blockchain: An Inevitable Choice between Liquidity and Legal Certainty," *Uniform Law Review*, Vol.21 (2016), accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/droit2016&i=619.

In order to achieve the targeted aim of the Master Thesis and pursue the stated objectives, the following **methods** will be applied:

1) **method of analysis** will be used for assessment of the theoretical and empirical studies devoted to the subject matter of the research in order to define the concepts underlying the research, to explore their variations and peculiarities, and to investigate the practice of their application in different jurisdictions;

2) **historical method** will be applied for examining development path of concepts, which constitute the subject matter of the research, and for comparing ideas upon which these concepts were based in past with those of the present time;

3) **comparative method** will be used for evaluation of the approaches undertaken by the chosen jurisdictions for establishment of rules, which regulate issues of share ownership, and how these regulatory frameworks correlate with the trends and demands of the business and investment sectors;

4) **method of classification** will be used so that to establish common features of the shares of particular class, to define which rights should be treated as attributable to the specific class of shareholders, and to develop specific mechanisms for protection of shareholders` interests based on particularities of their class rights;

5) **synthesis method** will be applied so as, on the basis of sequential investigation of the specific issues on the value of shares, rights embodied in them and their forms of issuance, to draw the conclusion about efficient model of corporate shareholding.

The paper is divided into 2 chapters, which correspond the aim and objectives of the research:

I. «**Legal and factual nature of shares and interests of shareholders therein».** This chapter will examine the role of shareholders in a company, their interest, goals, behavior and matters that play crucial role for them in choosing a target for investing in. This chapter will also analyse the concept of shares, the nature of rights conferred by them to shareholders, their correlation with the share capital and shares' distinctions from the traditional objects of property.

II. **«On the protection of class rights and against class rights and other strategies of corporate structuring».** In this chapter the notion of classes of shares and class rights will be analysed. In particular, the concepts of common and preference shares, various control enhancing mechanisms, such as multiple-voting shares, loyalty shares, non-voting

shares, will be outlined and discussed. Additionally, this chapter will examine the concepts of par value and no par value shares, and reveal their benefits and drawbacks. Moreover, the chapter will reveal existing types of shares and forms of their issuance, and assess peculiarities of their issuance and transfer, as well as rationality of their emission. The findings of this chapter are based on the complex analysis of corporate legal practice of various Member States, including Germany, Finland, France, the United Kingdom, the Netherlands etc. In concluding this chapter, the answer to the central question of this work regarding "best model of shares" will be given.

The defendant statements of the research can be formulated as follows:

1. Shares are an empty construction, a shell, which is filled with substance differently for each particular case of shareholding.

2. Universal model of shareholding is the freedom for shareholders and a company to determine their own best model of cooperation, subject to non-restrictive rational statutory limitations.

1. LEGAL AND FACTUAL NATURES OF SHARES AND INTERESTS OF SHAREHOLDERS THEREIN.

> "Law is normative. As a normative discipline, law must be applied, and it must be complied with by a very large number of real firms and real people. Its contents should be predictable and regarded as fair and reasonable. This also means that law and legal theories tend to be conservative. **Legal theories face a reality check every day when enforced in practice** *[emphasis added]*. As a result of the connection between law and real life, law can also give valuable information about the behaviour of real people and firms and about how society works."[12]

> "Economic theories are not law. It should take some time before an economic theory of the firm can be accepted in corporate law, and the number of theories that can be accepted is limited. One should think twice before aligning legal norms designed to be applied by real people and firms with an economic theory based on a few aspects of fictive people or firms."[13]

Company is a fiction that is located at the crossroads of legal and economic theories. So are the relations between the company and its various stakeholders and managers. Both legal doctrine and the economics try to make their contribution to the development of the concept of the firm and its role in the modern society. However, in doing so, they are guided by different purposes and therefore look at the same problems from different angles. As was cited above, the law is normative, and it is intended to regulate social relations that exist right now and in their contemporary forms.[14] This means that the law does not try to look in the future and to foresee how things will go. It tries to respond to current social events and occurrences as they appear. The economic theory, in turn, is teaching for the ways of determining shareholders' and company's values, ways of resolving tensions that arise in relations between principals and their agents, therefore, it operates with idealistic concepts that are aimed at making the world better (and the "corporate world" in particular). While the law punishes for wrongdoings, the economics tries to find out ways of encouraging *bona fide* performance or stands for performance that will benefit all parties to a deal (for example the concept of the efficient breach[15] in contract law). There is no such

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[12] Petri Mäntysaari, *Organising the Firm. Theories of Commercial Law, Corporate Governance and Corporate Law*, (Berlin, Heidelberg: Springer-Verlag, 2012), 57.

[13] *Ibid*.

[14] *Ibid*.

[15] The concept of efficient breach means that "a party should be allowed to breach a contract and pay damages, if doing so would be more economically efficient than performing under the contract." *Black's Law Dictionary* as cited by Christophe Quezel-Ambrunaz, "Remedies," presentation, Comp.contr.law in cont. of econom.analysis, *Université Savoie Mont Blanc*, 9.

legal category as "shareholder value" and there is no legal liability for failure to increase it,[16] although this concept and relevant calculations are frequently applied in economic papers.[17] "There are legal sanctions for board members and managers who fail to live up to legal expectations, but failure to comply with a text-book in economics or an economic theory will not trigger any enforceable legal sanctions as such."[18] Nevertheless, economic theories and concepts play a part in facilitating understanding of various normative issues, in their interpretation and in determining the vector of their further development.[19]

1.1. Shareholders as Owners, Investors and Monitors of Monitors

Whatever theory of the firm is taken as a basis for explaining the essence of the company, it is an immaterial artificial creature that exists mostly on paper and it "cannot act on its own in the physical sense. Somebody must represent it by taking care of its internal decision-making, somebody must represent it in its dealings with company outsiders… and company insiders… and somebody must represent it by taking care of its internal supervision and control."[20] All these functions are performed by various corporate bodies and officers, each of which has its own interests in the particular firm and own set of rights and duties towards this firm. The company also has a specific participant of its corporate affairs, which distinguishes it from all other types of firm. This participant is company's shareholders.

Shareholder is a company's primary participant. Company's life cycle begins with shareholders' contributions and ends with distribution of liquidation surplus to shareholders. Only shareholders, acting in their collective entirety, may determine the corporate purpose and the object of company.[21] The functions and role of shareholders depend on various factors, including, type of company, governing legislation, business environment, granted rights and capacities etc. What is

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[16] Petri Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*, Vol.1 (Berlin, Heidelberg: Springer-Verlag, 2010), 203.

[17] See: Herman Siebens (2002); Claudio Loderer, Lukas Roth, Urs Waelchli, and Petra Joerg (2010); Peter Koslowski (2000). Accessed March 25, 2019.

[18] Petri Mäntysaari, *The Law of Corporate Finance, op. cit.*, 169.

[19] *Ibid*.

[20] *Ibid*, 166.

[21] Günter H. Roth and Peter Kindler, *The Spirit of Corporate Law: Core Principles of Corporate Law in Continental Europe*, (C. H. Beck Hart Nomos, 2013), 94.

notable, not only shareholder chooses a company to invest in. The company itself, depending on priorities, prospects and other factors, may seek specific type of investors[22] for further cooperation.

The role of shareholders in the life of the company is disputed both in legal and in economic theories, especially regarding their status as "owners" of the company, and reflections on ways of maximizing their value. Also their status varies from one legal system to another by granting them different scope of protection and different powers, by assigning them a status of the core principal in whose interests the board and managers shall act (mostly in the USA and in the UK) or by developing ways of preventing oppression of one group of shareholders by another. What is more important about shareholders is that for different purposes they may be regarded **as a specific corporate body**, namely the General Meeting (GM) of shareholders, they may form **separate groups within this corporate body** (classes of shareholders), and in the same time they are **separate individuals or legal entities**, each of which has own interests in and against the company. The interests of each single shareholder "may conflict with the interests of other shareholders; with the interests of the company's other stakeholders; with what is required for the company to continue its existence as a legal person; and with what is required for the long-term survival of the firm."[23] Depending on underlying interests shareholders may be roughly divided on tree groups: **shareholders-owners, shareholders-investors and shareholders as members of an association (or parliamentarian)**.[24]

By making reference to the **"shareholder-owner"** in this work it is not assumed to support the idea that shareholders are owners of the company in the sense of property law. This research paper supports and presumes the point of view that stands for impossibility of claiming shareholders' ownership towards the company due to legal recognition of the latter as a person and due to the fact that "separate legal personality of corporations works in the same way as the legal personality of men. Neither free men nor separate legal persons are owned by anyone."[25] Therefore, the notion "shareholder-owner" for the purposes of this paper is used to describe certain conduct of shareholders, when they try to be involved in all spheres of company's life, when they have tight relations with management and thus are able to influence their decision-making process, and when,

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[22] David S. Boss, Brian L. Connelly, Robert E. Hoskisson, and Laszlo Tihanyi, *The Oxford Handbook of Corporate Governance*, (Oxford University Press, 2013), 261.

[23] Petri Mäntysaari, *The Law of Corporate Finance*, *supra* note 16, 185-186.

[24] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 61-63.

[25] Petri Mäntysaari, *Organising the Firm*, *supra* note 12, 113.

although being in contradiction to the legal theory, the overall conduct evidences on their supremacy over the firm, as in the case of the proprietorship.

"Membership in association" model of shareholding makes a stress on joint participation of all shareholders in pursuing common goals that would be impossible to achieve if acting individually.[26] This type of behaviour is usually referred to as "shareholder democracy" and stands for active participation of all members of the "community" in the life of the firm. Unlike shareholders-owners model of conduct, the main function of shareholders of this group is no to make a direct influence on the course of business, thus arrogating the function of decision-making, but to monitor management and to bring it to liability for wrongdoings.[27] Therefore, the decision-making function is left for managers and members of the board in this case, while shareholders perform supervision over its efficiency and intervene only in case of necessity.

"Shareholder-investor" is a passive mode of shareholding. Shareholders belonging to this group make financial contribution to the firm or purchase ownership over already made contribution in hope of earning returns.[28] The interest of shareholder-investor in the company itself is limited to prevention of any occurrences that are detrimental to the value of his/her investment or to possibility of enjoinment his/her rights over made investment and its revenues.[29] Therefore, this shareholder would prefer to participate in management only in cases when his/her investment decision is at stake. This type of shareholders' behavior is similar to that of providers of the debt capital, however, "whilst both contribute a fixed amount, only the shareholder hopes for open-ended capital gain in respect of the investment."[30]

There is an observation of Petri Mäntysaari that due to the fact that different shareholders have different interests, owing a legal duty on the side of board members and managers to act in the interest of shareholders is meaningless, unless it is a company with a sole shareholder.[31]

Another question that needs to be raised within a framework of shareholders-company relations is that of what is the interest on the side of the company in having shareholders? Some authors pose this question even in more categorical form, namely, why does the business form

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[26] Mathias M. Siems, *supra* note 24*,* 62.

[27] *Ibid*, 88.

[28] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd ed. (Oxford: Oxford University Press, 2014), ePub, 491.

[29] Mathias M. Siems, *op. cit.*, 150.

[30] Eilis Ferran and Look Chan Ho, *op. cit.*, 243.

[31] Petri Mäntysaari, *The Law of Corporate Finance, supra* note 16, 185-186.

envisaging shareholders, relevant degree of transferability of shares and the share ownership structure exist?[32] And how to explain this choice of business form?[33] It appears that the answer to this question lies outside the scope of the present research paper, however, one aspect of this issue is worth being touched upon for the purposes of the given research.

This aspect is the **role that shareholders play in the life of the company.** Basically, points of view mostly come down to shareholders' function as providers of capital to be the primary one. However, some reservations need to be made in this regard. The first one is that, in fact, the most important source of funding of the company is retained earnings, while debt capital is considered the most popular way of raising additional funds.[34] This could be explained by relative simplicity of attracting debt capital comparing with the procedure of capital increase. Moreover, issuance of additional shares is not appropriate way of funding for closely held corporations (which are the most popular type of corporations in Europe) due to a number of reasons that will be described further in this paper. The second reservation concerns the fact that "…the amount of capital distributed by listed companies to shareholders in the form of dividends and share buybacks tended to exceed the amount of capital that they raised from shareholders."[35] Therefore, although the interest rates payable on loans might be high, they are paid once and on the basis of strictly defined terms of the loan agreement, thus, bringing more legal certainty as to the repayment of a contributed sum. Another important moment is that, from a legal perspective, buyers of already allotted shares[36] do not provide any funding to company's capital at all.[37]

However, there is no denying that funding company's equity capital is an important function. In fact, existence of sufficient amount of the equity capital helps the firm to: "reduce the risk of corporate failure; increase access to debt capital; reduce the cost of debt capital; and reduce the cost of new equity capital."[38] These functions flow indirectly from the fact of shareholders' contribution to the share capital and are regarded by Petri Mäntysaari as **shareholders' "ancillary services."**[39] And exactly these "ancillary services" are in his view the most important contribution

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[32] Petri Mäntysaari, *Organising the Firm, supra* note 12, 94.

[33] *Ibid.*

[34] *Ibid,* 95.

[35] *Ibid*.

[36] See more information in section 1.2.1., p.21.

[37] Petri Mäntysaari, *Organising the Firm*, op. cit., 95.

[38] Petri Mäntysaari, *The Law of Corporate Finance, supra* note 16, 207.

[39] Petri Mäntysaari, *The Law of Corporate Finance, supra* note 16, 188-193.

of shareholders to the long-term survival of the company.[40] Through the prism of performed ancillary services shareholders can be regarded as: "a mechanism that helps the company to raise debt capital at a lower cost; a mechanism to monitor the profitability of the company; a pricing mechanism for shares and the company; a mechanism to separate decision control and decision management and to avoid dead-lock situations; and a source of other ancillary services."[41]

Shareholders' capital allows firm to avoid incurring debt and necessity to repay borrowed money at a particular time.[42] This becomes especially important at the beginning of firm's existence, when it is impossible to make an accurate prediction as to the future cost-effectiveness of the business, as well as when and to which extent the firm would be able to make a repayment. The pricing for shares mechanism is important in relation to capability of shares to be used as means of payment.[43] Thus, instead of repayment amount of incurred debts the company may convert the amount borrowed capital into equity shares by means of the debt-to-equity swap. Separation of control and management functions is important in relation to the fact that "while the board monitors shareholders and other stakeholders as well as the organisation of the firm in the name of the company and on behalf of the firm, shareholders can, in limited cases, be given limited decision rights which enable them to monitor the monitors."[44] Thus, due to a broad scope of various ancillary functions that shareholder could perform, Petri Mäntysaari draws a conclusion that "shareholders are not functionless investors even when they remain passive."[45]

"The most fundamental interest of the firm is that of its own survival… in a competitive environment in the long term."[46] "In order to survive, the firm must prosper (make a profit). The firm needs a business model and a strategy."[47] Shareholders substantially contribute to the survival of the company, especially at the initial period of its existence. They are "providers of the primary form of loss-bearing capital"[48] that increases chances of the company to earn or to attract additional funds, and, subsequently its chances to survival, as far as the company is an aggregate of mutual

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[40] *Ibid*, 198.

[41] *Ibid*.

[42] *Ibid*, 188.

[43] *Ibid*, 190.

[44] *Ibid*, 192.

[45] *Ibid*, 193.

[46] *Ibid*, 172.

[47] *Ibid*, 174.

[48] Eilis Ferran and Look Chan Ho, *supra* note 28, 491.

covenants underpinned by financial interests. Therefore, as long as the company has funds, it has employees, it can rent and buy real property, raw materials, it can purchase services and all that ensure its existence. **The company exists for profit and because of profit. Whatever interests shareholders have, it is reasonable to suppose that the primary one is in the company itself,**[49] **since while the firm makes profit, for so long shareholders would have some piece of pie.**

Shareholders entering the company by way of purchasing its shares. In such a manner an investor or a merchant obtains a status of shareholder. This type of deal may take place between an investor and the firm, or between the investor and existing shareholder(-s). Referring to the aforementioned division of shareholders pursuant to the underlying interest: ”Payments made in connection with the founding of a company are typical in particular of the model of the shareholder as owner, since founder members are often closely associated with the company. The purchase – and also the sale of shares is, by contrast, an expression of an investor-oriented mode of becoming a shareholder.”[50]

While articles of association is a “constitution” of the firm that designate company’s internal structure and its relations with the surrounding world, shareholders’ agreement is a covenant determining rules of shareholders coexistence within the framework of a given company, **shares signify shareholders’ affiliation to the particular firm and determine rules of their cooperation with the firm for the benefit of both sides.** Investors may negotiate with the firm and existing shareholders terms upon which the investment would be made, and results of these negotiations will influence the scope of rights attached to the acquired shares.

Business community often operates with a term “share ownership structure,” which stands for a strategy of equity capital formation according to current demands of the firm and with a glance to its future prospects. The company usually chooses its ownership structure at the time of incorporation by prescribing in articles of association types and number of authorised shares. However, these parameters may be reconsidered in the course of time, thus, adjusting the business to a changing market and the changing world. Current stage of development of legal and economic thoughts knows diverse variations and combinations of shares that could be used as a tool for securing business, as well as for meeting demands of investors. A problem that a firm may face with when deciding on its capital structure is that not all types of shares may be permissible according to statutory rules of the country of incorporation. Different countries establish their own rules and

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[49] *Ibid*.

[50] Mathias M. Siems, *supra* note 24, 69.

limitations related to this subject matter, and these requirements vary substantially across the globe depending on political, economic and cultural specifics of making business in a particular country.

Consequently, **searching for the "the best model" of shares requires a complex analysis of existing models of shareholding, their particularities, the environment of their circulation (in other words the "business ecosystem" of the country) and purposes that they are designed to solve. To start with, it is worth exploring the nature of shares as such and shareholders' interests embodied in this construction.**

1.2. Legal Nature of Shares

"When a firm is incorporated, a stated number of shares will be authorized for issue by the promoters. The value of such shares is referred to as the authorized capital of the firm. However, the entire authorized capital need not be raised immediately. Often a portion of what has been authorized is held for issue at a later date, if and when the firm should require additional capital. What is actually issued is less than or equal to what is authorized, and the amount that is actually raised is referred to as the issued capital."[51] In return for an investment the company allots to an investor a portion of shares proportionate to his/her contribution. This proportion may be calculated on the basis of nominal value of shares determined in the articles of association, or on the basis of other technics applied in the country of incorporation. In case of shares with determined par value the portion of price that is paid in excess of shares' value is regarded as "share premium" and, as a general rule, is put on a separate share premium account.

It could be said that by having shares shareholders hold kind of a portion in the share capital. However, this in no way means that they have any claim to what they have contributed, or to the share capital of the company. Shares exist together with and in the same time separate from the share capital. **Unlike the share capital, shares are transferable objects of property. Even if mutual covenants of parties to a deal, or legislation stipulate restrictions on transferability of shares, this does not annul the fact of having this inherent feature. The share capital is not transferable by virtue of its nature. Moreover, as soon as share capital is contributed, it**

[51] Sunil Parameswaran, *Fundamentals of financial instruments*, (Singapore: John Wiley & Sons (Asia) Pte. Ltd, 2011), 97.

becomes the property of the company,[52] a static element,[53] which is not subject to any transfer of ownership.[54] Correlation of shares and the share capital could be illustrated on the following example. In case of selling certain amount of shares representing 100% of a share capital the subject matter of the deal will be respective part of the share capital, but not the capital itself.[55] This part of the share capital in essence is equal to the share capital, however, it is owned by a shareholder, while the capital is owned by the company and will remain with the company in any scenario up to the liquidation. Moreover, as distinct from participation in such business entities as partnerships, shareholders of the company could not demand their contributions (whether in cash or in a specific property) back. The possibility of this kind may only be decided by the company itself (shares buybacks) and only in limited cases.

In common law countries the most cited definition of shares is the one given by Farwell J. in *Borland's Trustee v Steel* (1901):

> "A share is the interest of a shareholder in the company measured by the sum of money, for the purpose of liability in the first place, and of the interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se… The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money… but is an interest measured by the sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount."[56]

In addition to the aforementioned phrase, in common law tradition the legal nature of shares is explained by making reference to the term **"chose in action"**. "Chose in action" as explained in *Torkington v. Magee* means "legal expression used to describe all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession."[57]

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52 Stephen Griffin, *Company Law: Fundamental Principles*, 4th ed. (Harlow: Pearson Longman, 2006), 131.

53 И. В. Спасибо-Фатеева (ред.), *Харьковская цивилистическая школа: право собственности*, (Харьков: Право, 2012), 152. [I.V. Spasibo-Fateeva [editor], *Kharkiv school of civil legal tradition: property law*, (Kharkiv: Law, 2012), 152.]

54 І.В. Спасибо-Фатєєва, "Доля в уставном капитале хозяйственного общества как объект права и ее соотношение с уставным капиталом, имуществом и корпоративными правами," in *Цивілістика: на шляху формування доктрин: вибр. наук. пр.*, І.В. Спасибо-Фатєєва, (Харків: Золоті сторінки, 2012), 405. [I.V. Spasibo-Fateeva, "Share in share capital of corporation as an object of law and its correlation with share capital, property and corporate rights," in *Civil Legal Tradition: on the way of forming doctrines*, I.V. Spasibo-Fateeva, (Kharkiv: Zoloti storinky, 2012), 45.]

[55] *Ibid*.

[56] Paul L. Davies and Daniel D. Prentice, Gower's Principles of Modern Company Law, 6th ed. (London: Sweet & Maxwell, 1997), 301.

[57] William S. Holdsworth, "The History of the Treatment of "Choses" in Action by the Common Law," *Harvard Law Review*, Vol. 33, No. 8 (June 1920), 997, accessed March 06, 2019. https://www.jstor.org/stable/pdf/1327628.pdf.

In case of shares the term "chose in action" obtain an additional characteristic of "personal property right to an **intangible thing** *[emphasis added]*,"[58] thus emphasising their floating nature and separate existence from any means of their material expression. Shares "cannot be taken into tangible possession either by the act of the law, or by the act of the owner, although the certificates of stock may be."[59] **They are "incorporeal, intangible things, which exist in idea, and are incapable of being subjected to actual possession."**[60] Moreover, shares do not have any link to the property of the firm, and they "remain personal property, regardless of the kind of property owned by a company."[61]

The approaches to understanding of the nature of shares in civil law countries do not substantially differ from those of common law, except for not employing the term "chose in action." In the Republic of Cyprus the definition of shares fixed in the legislation stated that: "The shares or other interest of any member in a company shall be personal estate, transferable in manner provided by the articles of the company, and shall not be of the nature of real estate."[62] Lithuanian Law on Companies defines shares as "securities" and makes an emphasis on rights conferred by them on their holders: rights to participate in management of the company, in distribution of dividends, in distribution of surplus after liquidation.[63] In literature, shares are often described as having the complex nature, which is reflected in their functions of denominating a financial stake in the company, of certifying membership rights, and in bearing a form of securities.[64]

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[58] Michael J. Duffy, "Is a Cause of Action a Castle? Statutory Choses in Action as Property and s 51(xxxi) of the Constitution"*, Melb. U. L. Rev.*, Vol. 42, no.1 (2018), 3, accessed February 15, 2019, https://www.westlaw.com/Document/I5afa7d83eeb011e8a5b3e3d9e23d7429/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0 13.

[59] Seymour D. Thompson, *Commentaries on the Law of Private Corporations,* (San Francisco: Bancroft-Whitney Co, 1895), 84, accessed February 12, 2019. https://heinonline.org/HOL/P?h=hein.beal/colwprvtin0003&i=407.

[60] *Payne v. Elliott, 54 Cal. 339, 35 Am. 80, 1 Wilgus Cas. 804,* as cited by Seymour D. Thompson, *Commentaries on the Law of Private Corporations, op. cit.,* 85.

[61] Simon Goulding, *Company Law*, 2nd ed. (London: Cavendish Publishing Limited, 1999), 205.

[62] "The Companies Law" (English translation and consolidation), Republic of Cyprus, Nicosia: Office of the Law Commissioner (2012), *Article 71*, accessed March 29, 2019, http://www.olc.gov.cy/olc/olc.nsf/all/E1EAEB38A6DB4505C2257A70002A0BB9/$file/The%20Companies%20Law,%20Cap%20113.pdf?openelement.

[63] "Law on Companies," Lithuania, 2000 (as last amended on 14 October 2014), *Article 40(1),* accessed May 08, 2019, https://e-seimas.lrs.lt/portal/legalActPrint/lt?jfwid=7cihrh1a9&documentId=9670ea90e8b311e4aecae0d86a561f87&category=TAD.

[64] Michael Arnold, et al., *Handbuch Börsennotierte AG : Aktien- Und Kapitalmarktrecht*, Vol. 4. neu bearbeitete Auflage, (Köln: Verlag Dr. Otto Schmidt, 2017), 162, accessed March 29, 2019, http://search.ebscohost.com.skaitykla.mruni.eu/login.aspx?direct=true&db=e000xww&AN=1985371&site=ehost-live&ebv=EB&ppid=pp_162.

The European Model Company Act (EMCA) introduces shares as "an equity participation entitling the holder to be a member of the company."[65] By taking such neutral position the EMCA made an attempt to suit approaches of different Member States in determining the scope of entitlement embodied in shares, and in the same time to put an emphasise that "it is impossible (and useless) to create shares to which no rights at all are attached."[66]

In essence, the core idea of shares is about having **specific contractual rights with a suspended period of obtaining possibility of their execution, which is linked to specific conditions that may or may not occur one day in the future**. Therefore, although being owners of shares, shareholders do not have an absolute right to receive entitlements granted by these shares. "…Instead of physical attributes inherent to physical object **shareholder**, holding a share certificate, **has not the bundle of rights, but merely their anticipation** *[emphasis added]*."[67]

The set of components attached to shares could vary depending on how shareholder's investment has been evaluated and **constitutes shareholder's "remuneration package"**[68] for contribution that is used in the interests of the firm.[69] These components are divided by Len Sealy and Sarah Worthington on three groups, comprising means that represent:

1) Shareholders' financial stake in the company.
2) Shareholders' interest in the company as an association.
3) Shareholders' rights as owners of a species of property.[70]

This division is taken as a frame for performing further analysis of the nature of shares and rights attached therein.

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[65] Paul Krüger Andersen, Theodor Baums [and others], European Model Company Act (EMCA), *Nordic & European Company Law Working Paper* no.16-26, 2017, 86, accessed March 29, 2019, [interactive] https://ssrn.com/abstract=2929348.

[66] *Ibid*.

[67] I.V. Spasibo-Fateeva (ed.), *supra* note 53*,* 158.

[68] Petri Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*, Vol.1 (Berlin, Heidelberg: Springer-Verlag, 2010), 198.

[69] *Ibid,* 198-199.

[70] Len Sealy and Sarah Worthington, *Sealy & Worthington's Cases and Materials in Company Law*, 10th ed. (Oxford University Press, 2013), 556.

1.2.1. Shares as financial stake

The procedure of setting up a company requires its founders to constitute a share capital and to decide upon rules of subscription to it. As Eilis Ferran and Look Chan Ho write in their book: "Company formation requirements mean that there must be at least one person who agrees to become a member of the company and, in the case of a company that is to have a share capital, to take at least one share."[71] This statement seems to be logical, since in order for a company to exist, there should be a someone's will to set it up and there should be some funds, which could ensure company's operations at least at the beginning of its activity.

Shareholders may perform the role of contributors of capital at various stages of the "life cycle" of the company. This "cycle" begins with subscription to a capital of a newly-created company,[72] and passing private placement[73] within "a relatively small number of select investors,"[74] goes to attracting investments on a large scale by means of initial and secondary (or seasoned) public offerings (IPO and SPO respectively).[75] The aforementioned stages are optional and companies may prefer to stay closed by remain on the first two stages of the equity financing path. Decisions about staying closed and going public are tightly linked to such characteristic of shares as their transferability. In closely held companies this characteristic is very limited by direct prohibition to transfer shares, by an internal requirement to obtain an authorisation for such transfer or by pre-emptive rights of remaining shareholders of the firm.

One observation needs to be made regarding the above mentioned term "secondary public offering" as used for describing the process of equity financing.[76] Within this context the term needs to be interpreted as referring only to the **dilutive** type[77] of secondary public offerings, which stands for an offer to buy shares directly from a company, which has already made an IPO.[78] This

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[71] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd ed. (Oxford: Oxford University Press, 2014), ePub, 367.

[72] Jean Tirole, *The Theory of Corporate Finance*, (New Jersey: Princeton University Press, 2006), 92.

[73] *Ibid*.

[74] Will Kenton, "Private Placement," Investopedia, accessed March 7, 2019, https://www.investopedia.com/terms/p/privateplacement.asp.

[75] Jean Tirole, *op. cit.*, 92.

[76] *Ibid.*

[77] Julia Kagan, "Secondary Offering," Investopedia, accessed March 18, 2019, https://www.investopedia.com/terms/s/secondaryoffering.asp.

[78] *Ibid*.

conclusion is based on the fact that "shareholders are providers of funding in their capacity as shareholders when they subscribe for new shares issued by the company or buy existing shares from the company."[79] Non-dilutive secondary public offering that takes place when existing stockholder (or several stockholders) of a company that has already made an IPO sells a large portion of his/her holdings in this company and thus earns all the proceeds from a deal.[80] This transfer of shares from one shareholder to another will not fill company's capital with additional funds. The company will receive nothing from this sale, except one or several new shareholders who step into the shoes of the leaving shareholder(-s). However, **although shareholders do not always perform the function of contributors of company's capital, there is always a portion of capital tied up to their shares**.[81] In case of shares sold on the secondary market, they similarly represent a fraction of the entire share capital as at the time of their first allotment, and entitle their new holders to a portion in the capital of the company proportionate to that held by previous holders,[82] provided that terms of the deal or shareholders' agreement do not regulate otherwise, and taking into account possibility of dilution of a block of shares (and accordingly a part of the capital represented by this block) among several acquiring investors.

Equity participation, although is performed by way of making contributions to the share capital, does not confer upon shareholders any right neither to the capital itself, nor to the property of the firm. The first issue is explained by the fact that **company's capital in itself represents nothing but an accounting code, which indicates property that has to exist, but not the one that really exists.**[83] All contributions of shareholders, being they in cash or in kind, are assigned monetary value[84] and gathered in one common pool. All subsequent changes to the amount of company's funds and property would not cause changes to its share capital. "The value of the corporate assets may be greatly increased by surplus profits, or be diminished by losses, but the

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[79] Petri Mäntysaari, *Organising the Firm. Theories of Commercial Law, Corporate Governance and Corporate Law*, (Berlin, Heidelberg: Springer-Verlag, 2012), 110.

[80] Julia Kagan, Investopedia, *supra* note 77.

[81] Petri Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*, Vol.I: Cash Flow, Risk, Agency, Information (Berlin, Heidelberg: Springer-Verlag, 2010), 198.

[82] *Birch v Cropper (1889)* 14 App Cas 525, HL, 543 as cited by Eilis Ferran and Look Chan Ho, *supra* note 71, 494.

[83] Р. Т. Батиста, Правовое регулирование акционерных обществ в Панаме: автореф. дис. ... канд. юрид. наук / Р. Т. Батиста. - М., 1978, С.80, as cited by *Харьковская цивилистическая школа: право собственности*, И. В. Спасибо-Фатеева [ред.], (Харьков: Право, 2012), 158. [R.T.Batista, Statutory Regulation of Companies in Panama, Doctoral Thesis, Moscow, 1978, 80 ascited by *Kharkiv school of civil legal tradition: property law*, [edited by] I.V. Spasibo-Fateeva, (Kharkiv: Law, 2012), 158.]

[84] Seymour D. Thompson, *Commentaries on the Law of Private Corporations,* (San Francisco: Bancroft-Whitney Co, 1895), 75, accessed February 12, 2019. https://heinonline.org/HOL/P?h=hein.beal/colwprvtin0003&i=407.

amount of the capital stock remains the same."[85] Capital stock is a relatively stable value that could be changed (reduced or increased) only according to the procedure stipulated by the legislation and upon having legitimate reasons for this.[86] Moreover, there is a default rule prohibiting making any payments to shareholders from the funds of the subscribed capital. For these purposes company law and company's internal rules establish a specific procedure for determining and calculating funds that could be distributed to shareholders.

The absence of shareholders' rights to property of the company is explained by company's separate legal personality meaning that company, being "a person in the eyes of the law,"[87] is the sole owner of the property contributed to it, and "shareholders cannot withdraw their share of firm assets at will…, nor can the personal creditors of an individual owner foreclose on the owner's share of firm assets."[88] Moreover, due to separate legal existence of the company shareholders are not regarded as its owners from the legal point of view. In this respect the status of shareholders is similar to that of creditors of the firm, meaning that they have specific legal instruments issued by the company with limited rights and duties attached to them.[89]

Shareholders' financial entitlement in legal terms consists of "simply a right or share in the proceeds or profits of the stock proportioned to the amount of his contribution, together with an ultimate right to receive back his contribution, or so much as may remain thereof, upon the dissolution or closing up of the corporation."[90] Therefore, "shares give their holders the right to share in capital growth *of the firm [author's note]* as well as in whatever income is distributed by the company from time to time."[91] What is notable, it appears that **shareholders' entitlements are closely linked to profitability of company's performance**. This is the case with payments of dividends, as well as with residual surplus remained after dissolution of the company. If the company has made profit, there would be some funds available for sharing among shareholders

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[85] Wm. L. Jr. Clark, *Handbook of the Law of Private Corporations, (*St. Paul: West Publishing Co, 1897), 257, accessed February 12, 2019. https://heinonline.org/HOL/P?h=hein.beal/halwpvc0001&i=1.

[86] И. В. Спасибо-Фатеева [ред.], *Харьковская цивилистическая школа: право собственности*, (Харьков: Право, 2012), 348. [I.V. Spasibo-Fateeva [editor], *Kharkiv school of civil legal tradition: property law*, (Kharkiv: Law, 2012), 348.]

[87] John Armour, Henry Hansmann, Reinier Kraakman, "The Essential Elements of Corporate Law. What is Corporate Law?" (discussion paper No. 643, Harvard Law School, July 2009), 8, http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraakman_643.pdf

[88] *Ibid*, 7.

[89] Petri Mäntysaari, *Organising the Firm, supra* note 79, 113.

[90] Seymour D. Thompson, *supra* note 84, 856.

[91] Eilis Ferran and Look Chan Ho, *supra* note 71, 663.

after settlement of all debts ranking ahead. Moreover, shareholder may prefer to sell his/her shares instead of relying on periodic payment of dividends[92] and profitability of the company, its market capitalization will play crucial role in determining the amount of premium that investors would be ready to pay for these shares. In addition, dividends may also perform information function for investors, as far as sustainable dividend policy performed consistently could bring confidence to potential investors about future prospects of the firm[93] and thus strengthening their intention to invest. Therefore, **whatever interest in the company shareholders have, they will definitely have some sort of benefit, if the company makes profit**.[94]

However, **the right of shareholders to get return on their investments is not absolute**.[95] "Actual making of payments to shareholders during the life of the company depends on many internal choices made by the firm."[96] Even in case of surplus profits, shareholders do not have an automatic claim for dividends to be paid, as far as this procedure is governed by company's articles of association and usually relies on assessment of whether and to what extent available funds can be distributed or they need to be retained for funding company's upcoming projects.[97] Shareholders also do not have an automatic right to their part in corporate funds remained after winding up of the company, since the procedure of creditors' claims have priority to shareholders' residual rights as a default rule (unless some shareholders have not bargained priorities in ranking). Nor can shareholders dispose their shares at will, as far as this intention faces various internal (especially in private companies) and statutory rules before shareholder will make a deal. This type of risk inherent to shareholder-company relations is what distinguish holder of shares from holder of debt instruments, since "provider of debt finance is usually contractually entitled to receive interest,"[98] and the interest rate, as well as conditions and terms of debt repayment, are normally predefined and contractually fixed.

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[92] *Ibid*.

[93] *Ibid*, 665.

[94] Petri Mäntysaari, *The Law of Corporate Finance, supra* note 81, 197.

[95] Eilis Ferran and Look Chan Ho, *supra* note 71, 495.

[96] Petri Mäntysaari, *The Law of Corporate Finance, op. cit.*, 163.

[97] Eilis Ferran and Look Chan Ho, *op. cit.*, 306.

[98] *Ibid*, 495.

1.2.2. Shares as means denoting shareholders' participatory interest

"Distinction between allotment and issue of a share mirrors that between **being a shareholder and being a member of a company** *[emphasis added]***.** A person to whom a share has been allotted may be a shareholder but that person does not become a member until registered as such on the company's register of members.[99] A shareholder is entitled to dividends in respect of the shares but **rights such as attending meetings and voting on resolutions are membership rights which are held by members and not by mere shareholders** *[emphasis added]*."[100]

Holding financial stake in the company mostly stands for passive participation in its life cycle, since after the full price of shares is paid, there is no other financial duties on the side of shareholders in relation to the made investment. Membership in the company denotes possibility of regular active participation in company's affairs. This becomes possible by way of participation in the general meeting of shareholders (GM), which represents not only a body of the company, but also a forum for shareholders for exchanging their ideas and thoughts about the current state and the future of the company. Being an organ of the company, **the GM stands in one line with the management and supervisory boards in their authority to act as the company itself, and not "merely to represent the company as its agent under an authority derived from some superior corporate source."**[101] Moreover, notwithstanding different technics of indirect control that could be applied by powerful shareholders, in legal terms the GM represents the only way for shareholders to perform their formal control powers assigned to holding shares and stipulated by shareholders' agreement and articles of association.[102]

Membership rights could be divided to those that are proportional to shareholding and to those that equally belong to all shareholders, i.e. absolute rights.[103] "A single share will give a shareholder the right to demand information from the company, and this right will not increase as a matter of law with the shareholding. On the other hand, rights such as the right… to vote in general

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[99] Eilis Ferran and Look Chan Ho, *supra* note 71, 388.

[100] *Spitzel v Chinese Corp Ltd (1899)* as cited by Eilis Ferran and Look Chan Ho, *op. cit.*, 388.

[101] Len Sealy and Sarah Worthington, *Sealy & Worthington's Cases and Materials in Company Law*, 10th ed. (Oxford University Press, 2013), 179.

[102] Beate Sjafjell, *Towards a Sustainable European Company Law: A Normative Analysis of the Objectives of EU Law,* (Wolters Kluwer, 2009), 77, accessed April 09, 2017, https://lrus.wolterskluwer.com/store/product/towards-a-sustainable-european-company-law-a-normative-analysis-of-the-objectives-of-eu-law/.

[103] Andreas Cahn and David C. Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA,* (Cambridge: Cambridge University Press, 2010), PDF, 470.

meetings do increase in proportion to the holding, except in the case of voting by a show of hands under UK law."[104]

The right to vote gives shareholders a possibility to have a say on the quality of firm's management. In such a way a shareholder demonstrates his/her consent or objection to the way in which his/her investment is treated and to react accordingly. "At one extreme, shareholders can simply vote with their feet by selling their shares."[105] Or they can make an attempt to change company's "driving force," and hope that this will change company's route. **"Exit is an "economics" solution, like switching bakeries when the bread is stale, while voice is a "political" solution, like voting for a more responsive government official."**[106] "Voice is generally more expensive than exit, and thus may be used less when multiple interests are present… In the case of a shareholder, voice may improve not only her corporation, but the entire market in which the corporation is active, and, while it is possible to exit from a deteriorating corporation, it may not be possible to exit from the market that suffers from the corporation's failure."[107]

There are three major theories explaining the nature and purpose of shareholders' voting rights. They are: "a rights-based, or **"doctrinal" theory**, that is the most traditional; an instrumentalist, **"economic" theory** that is currently the most influential; and a systemic, **"political" theory** that mixes the other two in an analogy to political democracy and is often expressed by US courts."[108]

The core idea of the **doctrinal theory** is that membership in the company inherently creates entitlement to vote.[109] This is an essential characteristic of shareholder's status as a member of the company, and is a "constituent element of a share" itself.[110] In the view of this theory the voting right may be called as: "the prime right of the shareholder, the essential characteristic of equity, the most important administrative right of members or one of the shareholder's essential participatory and creative rights as co-owner of the company."[111] The theory is based on recognition

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[104] *Ibid*.

[105] Luc Renneboog and Peter Szilagyi, "Shareholder engagement at European general meetings," in *Boards and Shareholders in European Listed Companies*, Massimo Belcredi, Guido Ferrarini (Cambridge University Press, 2013), 318.

[106] Andreas Cahn and David C. Donald, *supra* note 103*,* 467.

[107] *Ibid*, 468.

[108] *Ibid*, 469.

[109] *Ibid.*

[110] Brändel, in *GroßKommAktG* (1992: § 12 mn. 4) as cited by Andreas Cahn and David C. Donald, *Ibid*.

[111] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 87-88.

shareholders as co-owners of the company, and, therefore, they are vested with some influential rights, which serve as means protecting rights of each co-owner against each-other.[112]

The **economic theory** is based on recognition of shareholders as residual claimants, who "benefits from its [company's] success and suffers from its [company's] failure without the cushioning effect of contractual guarantees."[113] Voting rights due to the theory "act as a channel" connecting shareholders' will and managerial discretional powers and "like a nerve running from a burned hand to the brain, the vote channels signals of pain or pleasure to the company's management."[114] In such a way, voting rights of shareholders facilitate their cooperation with management, and put together their efforts for company's profit maximization. Another pillar on which the economic theory of voting rights is based is considering a firm as a closed system of negotiated interests and rights (nexus of contracts), which is unable to evolve independently with the course of time, and thus requires some driving force in order to meet challenges of the unforeseen future.[115] Shareholders using their voting rights could adapt the company to circumstances that could not be foreseen at the time of its creation, thus increasing efficiency of its business performance. "Through the exercise of decision rights, shareholders can alter and adapt the terms of a contract over time, and through appointment rights they can monitor, ratify or correct the course of management."[116]

Political theory examines the company through the lens of a democratic society, where "shareholders have individual rights comparable to citizens in a democracy and voting rights serve as a channel of control to keep management accountable to those rights."[117] Although voting rights serve as a link between shareholders and management similar to the economic theory's attitude, in a given case they do not represent a wealth maximisation tool. They appear as some sort of control powers, by virtue of which shareholders can react on "wake-up calls" coming from the managing body of the firm, thus protecting themselves from managerial abuse of discretion. "Voting legitimizes management power by making management accountable to the will of the

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[112] Andreas Cahn and David C. Donald, *supra* note 103, 469.

[113] *Ibid,* 471.

[114] *Ibid*.

[115] *Ibid,* 472.

[116] *Ibid*.

[117] *Ibid,* 473.

shareholders."[118] Moreover, similar to the doctrinal theory, these powers are treated as inherent to shareholders as members of a corporate society.[119]

Whatever theory of voting rights is applicable, they all have one thing in common: they all describe shareholders' **potential ability** to "influence… certain decisions (e.g. mergers) that can be made only in specific ways (e.g. in a general meeting) and with a specified weight (e.g. one vote) for each share."[120] However, it could so happen that this potential may face grave obstacles on the way of its implementation, and consequently may result in shareholders' apathy and depreciation of their investments. **The theory does not take into account the fact that interests of shareholders within one firm may differ so substantially as to be totally opposite and directed against each other. The theory also does not count that voting rights may serve not only as means for protecting made investments, but as a powerful source of benefits received in excess of the dividends returns.**

"…The strength of voting rights as a governance technique is also its basic weakness: they must be exercised **by an aggregate of individuals, each of whom makes an independent decision** *[emphasis added]*… In the best of cases, this can lead to mass collaboration that brings creative energy from a number of sources to bear on a single problem, but in the worst of cases it can lead to apathetic non-participation."[121] This statement sharply describes a state of affairs that may appear in a company with dispersed shareholding. Investors with minor equity participation, especially in case of presence of one or several blockholders, tend to be reluctant to push and maintain their positions. "Dominant shareholders have strong incentives to participate and vote at meetings, which should technically boost turnout levels. However, their presence exacerbates 'rational apathy' among minority investors, i.e. the perception that their vote would make little difference."[122] Consequently, small shareholders prefer either to use "free riding" strategy of gaining profits from equity participation, relying on managerial and majority shareholders' activity, or to sell their shares in case of disenchantment in their investment decision.

The situation is completely different in private companies. Due to a small number of shareholders involved and due to a comparable low degree of liquidity of shares, investors

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[118] Andreas Cahn and David C. Donald, *supra* note 103*,* 473.

[119] *Ibid*.

[120] *Ibid*, 469.

[121] *Ibid,* 474.

[122] Luc Renneboog and Peter Szilagyi, "Shareholder engagement at European general meetings," in *Boards and Shareholders in European Listed Companies*, Massimo Belcredi, Guido Ferrarini (Cambridge University Press, 2013), 321.

negotiating terms of future investments tend to pay a high attention to voting rights attached to their future shares. In public companies, especially in listed, "if shareholder oppression occurs, stock is easily transferable and there are usually many shareholders that can unite together to voice their opinion."[123] "But shareholders in close corporations are few in number… and no individual would buy an oppressed shareholder's stock to assume the position of a minority shareholder."[124] Therefore, **the issues of investor's participation in the board, or having a right to appoint a member of the board, or having veto rights on particular issues are first of all the questions of investor's security.** Moreover, board participation may also serve as a separate purpose of investing, therefore the shareholder will need additional mechanisms for protecting his/her position from oppressive majority shareholder conduct.[125]

The scope of powers that shareholders are able to exercise is usually determined by provisions of the domestic legislation, while specifics of voting rights attached to shares of a particular company could be determined by articles of association or by shareholders' agreement. Company law generally confer shareholders with appointment rights and with a voice on some decisions that are fateful for the company's life.

Rights of shareholders to appoint and to remove directors give them a significant influence over the composition of the board, and therefore these rights are commonly treated as the main source of shareholders' control powers.[126] Herewith, these control powers may be exercised directly by appointing a person who's program and credentials satisfy shareholders' expectations as to the future of the firm, as well as indirectly, by forcing the actual director(-s) to pass some decisions or perform some acts for shareholder(-s) under the threat of non-re-election in future, thus influencing the firm's course.[127]

Decision rights of shareholders could include voting on amendments to the articles of association, on disposal of strategic or valuable assets, decisions regarding structural integrity of the company (mergers, divisions etc.).

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[123] Wiliam Meade Fletcher et al., Fletcher Cyclopedia of the Law of Corporations § 5717 (pern. ed., rev. vol. 2000) as cited by Nick Daniels, "What are the Interests of a Shareholder as a Shareholder", *T.M. Cooley J. Prac. & Clinical Law*, Vol.8 (2006), 307, HeinOnline, accessed April 02, 2019, https://heinonline.org/HOL/P?h=hein.journals/tmcjpcl8&i=317.

[124] *Ibid*.

[125] *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000), *Wilkes v. Springside Nursing Home*, Inc., 353 N.E.2d 657, 662-63 (Mass. 1976) as cited by Nick Daniels, *Ibid,* 307.

[126] David C. Donald, "Shareholder Voice and its Opponents," *Journal of Corporate Law Studies*, Vol.5, no.2 (2005), 338, accessed April 02, 2019, https://doi.org/10.1080/14735970.2005.11419937.

[127] Mathias M. Siems, *supra* note 111, 89-90.

For voting to be exercised it is not enough simply to have this right. The shareholder also needs something to vote for. Moreover, since shareholders' rights could only be applied by them voting as a corporate body — GM — the meeting needs to be convened and shareholders need to take part therein. Another important moment may arise, when shareholders need to react quickly on circumstances in order to take an attractive opportunity, or to save the company from insolvency, and there is no time for waiting until the next annual GM. **The right to require convocation of annual or extraordinary shareholders' meeting, the right to be informed about convocation, and the right to place an issue on the agenda of the GM also form a part of "membership package" of shareholders acquired shares.**

"The right to vote on a decision or an appointment is limited to a right to *veto* the decision or appointment unless the person with the voting right also **has a right to bring the matter up for a vote** *[emphasis added]*. For example, if the board had the sole right to propose an amendment to the constitutional documents, even if the shareholders had a right to vote on and approve such amendments, the board could simply refrain from making a proposal, and in this way render the voting right useless until the shareholders appointed new directors willing to propose the matter."[128] As a general rule, there are minimum shareholding requirements necessary for convocation of the GM and for placing an issue on the agenda. These requirements vary among different countries and may also stipulate other conditions. For example, in Finland, the minimum shareholding for requesting GM needs to be 10%, while there are no specific requirements for placing items on agenda.[129] In Germany and France, the requirement for convocation amounts to 5% and 5% (or EUR 500 000 in Germany) for placing items on agenda.[130]

Informing shareholders about forthcoming GM, its date and place can be made directly to shareholders, through company's website, or by means of publication in media. Failure of informing shareholders about planning GM is presumed to has been made accidentally, hoverer the legislation or by-laws may provide exceptions to this rule. For example, the *Companies Act 2006* does not treat as accidental non informing about the GM shareholders in case, when this GM has been convened upon the requirement of shareholders or has been called by shareholders.[131] "Although a company's accidental failure to give notice to a member will not normally invalidate a meeting, a deliberate act

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[128] Andreas Cahn and David C. Donald, *supra* note 103, 483.

[129] OECD, OECD Corporate Governance Factbook 2017, 2017, 57, accessed April 04, 2019, http://www.oecd.org/daf/ca/corporate-governance-factbook.htm.

[130] *Ibid*.

[131] Companies Act, the United Kingdom, 2006, Section 313 (2), accessed April 04, 2019, http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf

or omission on the part of a company that has the effect of preventing a member from receiving proper and adequate notice of the meeting will render the meeting invalid."[132]

"General meetings are the formal forum where firms present relevant matters to shareholders, and where shareholders vote upon these matters and put questions to management."[133] Being a body of the company it comprises each and every shareholder to whom shares are allotted. Holding shares in such a case plays a role of "an entry ticket" to the private membership club, notwithstanding whether or not a participant is entitled to vote in this club. The right to attend the GM and to speak therein come from **"the nature of the general meeting as the 'shareholders' voice."**[134] The legal prescriptions of this kind are quite rare,[135] hoverer, **it is generally presumed that shareholders have this right, unless internal acts regulate otherwise**. "Alongside the right of attendance, shareholders – and in many countries also their proxies – typically have the possibility of addressing the general meeting, so as to influence the opinions of other shareholders. Legally, however, a right to speak is mostly not explicitly laid down by statute. Instead, it results more from an interpretation of the overall complex of general meeting, soft law, and, indirectly, provisions affecting the shareholders' right to ask questions."[136]

For shareholder to take an effective part in management of the company the crucial role plays awareness of the current state of business and future prospects. Knowing performance indicators of different generations of board members gives possibility to compare effectiveness of their performance and to come to a decision as to appropriate candidate to vote for on the forthcoming elections. **Awareness of current state of affairs gives possibility to react, to fight for a firm, to ask questions and demand answers from managers, to timely file a lawsuit in case of detection of a wrongdoing.** Corporate environment is known for having asymmetrical circulation of information therein. This asymmetry is inherent to the status of shareholders, who do not take part in daily management of the company, and usually generate incentives to extract private benefits on the side of managers or corporate controllers, since shareholders cannot properly

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[132] See e.g. *Royal Mutual Benefit Building Society* v *Sharman* [1963] 1 WLR 581 in Stephen Griffin, *Company Law: Fundamental Principles*, 4th ed. (Harlow: Pearson Longman, 2006), 385-386.

[133] Luc Renneboog and Peter Szilagyi, *supra* note 122, 320.

[134] Mathias M. Siems, *supra* note 111, 109.

[135] "Kodeks spółek handlowych" (Commercial Companies Code), Republic of Poland, *Article 406, Article 406,[1]* 2000, accessed April 05, 2019, http://isap.sejm.gov.pl/isap.nsf/DocDetails.xsp?id=WDU20000941037. "Civil Code", Netherlands, Book 2, *Article 2:38*, 1992, accessed April 05, 2019, https://www.ilo.org/dyn/natlex/natlex4.detail?p_lang=en&p_isn=91671&p_country=NLD&p_classification=01.03.

[136] Mathias M. Siems, *op.cit.*, 110.

monitor their behaviour.[137] Therefore, **similar to voting rights, information gives sort of control to those who is armed with it**.

"The information rights of shareholders come in three basic forms: inspection upon request; routine, regular disclosure; and *ad hoc* disclosure of significant events."[138] Right to request information generally performed in the course of the GM or for preparation to the GM. The first scenario is about "information about a matter that is not already fully disclosed but lies within the proper interest of a shareholder in the company."[139] In other words, shareholders may ask for some clarifications about subject matter concerned that fall within the competence of the management board. The second scenario deals with situations, when shareholders need to prepare for voting on the upcoming GM regarding issues as disposal of assets, mergers, changes in corporate structure.[140] In such cases shareholders may demand relevant documentation to be presented to them before the GM, in order to have time for examining data and making necessary conclusions.[141] Routine disclosure is performed on a regular basis and generally concerns "accounting and financial information, significant company policies, actions and events, as well as potential conflicts of interest."[142] As a general rule, this type of disclosure is required from companies listed on stock exchange. *Ad hoc* disclosure stands for necessity to disclose so-called in the Market Abuse Directive "inside information," providing that this information is able to affect the market value of shares and there is no reasonable grounds to keep this information secreted.[143] Inside information may include: "changes in control and control agreements; changes in management and supervisory boards;…operations involving capital increases or the issue of debt securities… mergers, splits and spin-offs" etc.[144] *Ad hoc* disclosure requirement is also generally common to listed companies.

This section shows that **"the purpose of the general meeting cannot be reduced to a vote. Instead, the meeting acts as a 'forum for rendering account', forcing management to**

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[137] Alessio M. Pacces, *Rethinking Corporate Governance: the Law and Economics of Control Powers*, (London and New York: Routledge, 2012), 30.

[138] Andreas Cahn and David C. Donald, *supra* note 103, 510.

[139] *Ibid,* 512.

[140] *Ibid*.

[141] *Ibid*.

[142] *Ibid,* 514.

[143] *Ibid,* 524.

[144] Committee of European Securities Regulators, "Market Abuse Directive: Level 3 – Second Set of CESR Guidance and Information on the Common Operation of the Directive to the Market," CESR/06-562b (July 2007) as cited by Andreas Cahn and David C. Donald, *Ibid,* 525.

face criticism and questions from shareholders and enabling participants to state their positions."[145] Participation in the GM, and correspondingly a possibility to act as a corporate body, can be regarded as a primary membership right of shareholders, which is acquired together with shares and can be implemented upon fulfilment of a procedure of admission to membership (eg. entering company's register of shareholders). The primacy of this right is based on the fact that it functions as a departure point for exercise of other rights granted by the share ownership. All other rights are either exercised during the GM or would be meaningless without possibility to take part in the GM (eg. the right to require convocation of the GM, the right to place an issue on the agenda of the GM etc).

1.2.3. Shares as objects of property

"Shares are recognised in law as objects of property which are bought, sold, mortgaged and bequeathed. They are typical items of property of the modern commercial era."[146] However, it would be a mistake to place shares on the same shelf with traditional objects of property, due to their strong link with the issuing company and due to some unique features stemming from the specific nature of the environment of their circulation.

The first important feature of shares is that although they are actively traded and remain in circulation, ***de facto*** **they never present the real subject matter of a deal.**[147] In other words, shares in themselves are not of any interest to acquirers. They serve as an intermediary object, as means for denoting or calculating other "assets," which stand behind shares and which the party to a deal is interested in.[148] Shares are considered as representing a particular portion of the share capital. Unlike German style limited liability companies such as German GmbH, French SARL or Polish Spółką z ograniczoną odpowiedzialnością, the share capital of which is divided on portions owned by shareholders, **in public companies limited by shares** (AG, SA and Spółka akcyjna respectively) **there is an intermediary object of property — shares — that stands between shareholders and the capital, and represents the portion of a capital without making a direct link to it.** However, investor when purchasing shares is interested not so much in the number of

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[145] Mathias M. Siems, *supra* note 111, 109.

[146] Paul L. Davies and Daniel D. Prentice, Gower's Principles of Modern Company Law, 6th ed. (London: Sweet & Maxwell, 1997), 302.

[147] I.V. Spasibo-Fateeva, *supra* note 54, 406.

[148] *Ibid*.

shares acquired, **but which percentage of the share capital they represent**, because the later determines the scope of material and personal rights that he/she will receive as an outcome of a share deal. Moreover, the same number of shares at different times may represent different portions of share capital, as the company issues new shares within the authorised limits or increases its capital. The scope of rights and the value of shareholders' claims will fluctuate correspondingly to the percentage of the represented capital, as far as **shareholders' benefits are linked not to the amount of share ownership, but to a proportion of this ownership in relation to the whole equity capital.**

Another valuable asset that may be traded together with shares is **control powers**, which are viewed by some scholars as being **a separate item of property.**[149] These control powers may have different forms of appearance, and may be linked either to shares, or may be fixed separately in the shareholders' agreement as granted to a specific investor(-s), thus making control individualized. "The right of common stock to vote in director and fundamental transaction elections has monetary value. All other rights being equal, a class of common stock with voting rights will sell at a higher price than a second class of common stock without voting rights because of the premium that tender offer bidders will pay to buy voting control of a target."[150]

On the other hand, it appears that shares being representation of the share capital that is a sole property of the company, in a like manner constantly remain under firm's proprietorship. The reason for this assumption is based on the fact that it is impossible for holders of shares to take their property away from the joint corporate fund.[151] **What *de facto* changes in share deals is the beneficial owner of benefits coming from the share ownership.** Even in case of share buy-backs, it is wrong to say that the company returns to itself the ownership over shares, since they are inseparable from each other. The company repays to shareholder his/her "remuneration"[152] for the made investment and in such a way the **shares simply become inactive, as far as no-one since that time is entitled to receive revenues from them.**

Another important characteristic of shares as objects of property is the form of their existence. Shares may circulate in immaterial form or may be externalized by means of share

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[149] Paul L. Davies and Daniel D. Prentice, *supra* note 146, 302.

[150] Joel Seligman, "Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy," *Geo. Wash. L. Rev.* (1985-1986), 710, accessed May 24, 2017, https://heinonline.org/HOL/P?h=hein.journals/gwlr54&i=697.

[151] Seymour D. Thompson, *Commentaries on the Law of Private Corporations,* (San Francisco: Bancroft-Whitney Co, 1895), 73-74, accessed February 12, 2019. https://heinonline.org/HOL/P?h=hein.beal/colwprvtin0003&i=407.

[152] Petri Mäntysaari, *The Law of Corporate Finance, supra* note 81, 198.

certificates. However, it is generally accepted that share certificates are not equivalent to shares and they serve simply as means evidencing the share ownership. "…A share certificate is **merely the paper representative of an incorporeal right of a stockholder** *[emphasis added]*. It is nothing more than the symbol or paper evidence of a proprietary right. It stands on a footing similar to other muniments of title. In other words, the act of subscribing for the shares gives title to the subscriber, and the certificate neither constitutes nor is necessary to it; it is only evidence of title… **The certificate transfers nothing from the corporation to the stockholder, but only affords him the evidence of his rights** *[emphasis added]*."[153] Even in case of bearer shares, where ownership is closely linked to possession of a certificate, the certificate only specifies entitlement to particular shares,[154] but does not constitute shares itself. Therefore, shares owned by shareholders are "intangible and rest in abstract legal contemplation,"[155] and they could not be taken into physical possession similar to share certificates evidencing their allocation.[156]

In addition, it is worth mentioning specifics of ownership rights over such non-standard object of property as shares are. Shareholder as an owner neither enjoys the full complex of ownership rights in relation to shares, nor bears the full responsibility for the owned property.[157] This is a result of the granted limited liability, and consequent separation of ownership and control. Thus, shareholders on the one hand are secured against company's creditors, but on the other hand they are deprived from the possibility to manage their property at will. "Differently from the typical owner, shareholders who are not also the corporate controllers (non-controlling shareholders) **do not have *residual rights of control*: that is, the rights to discretionally manage the firm's assets in circumstances not disciplined by any contract entered into by the firm.**"[158] Moreover, the possibility of selling shares is not absolute for shareholders as well, and not always presents an effective defence tool against oppression. The first thesis is explained by different limitations and conditions of transferability of shares that could be stipulated by legislation or by company's internal acts. The second statement means that the value of shares is calculated upon the price that an investor is ready to pay for them. However, the volume of this price constantly fluctuates, and its

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[153] Seymour D. Thompson, *supra* note 151, 76-77.

[154] Charles Wild, Stuart Weinstein, *Smith and Keenan's Company Law*, 14th ed. (Harlow: Pearson Longman, 2009), 195.

[155] Wm. L. Jr. Clark, *Handbook of the Law of Private Corporations, (*St. Paul: West Publishing Co, 1897), 258, accessed February 12, 2019. https://heinonline.org/HOL/P?h=hein.beal/halwpvc0001&i=1.

[156] Andreas Cahn and David C. Donald, *supra* note 103*,* 263.

[157] Lorraine Talbot, *Critical Company Law*, (Routledge-Cavendish, 2008), 113.

[158] Alessio M. Pacces, *supra* note 137, 26-27.

magnitude to a great extent depends on the internal and external risks affecting shareholding in a particular firm. In such a way, it appears to be useless to plan an option of exit in advance, since at the time of plan implementation the shares may be worthless. "…The power to sell shares does not offer individual shareholders much protection from director incompetence for the same reason that the power to use emergency exits does not offer much protection to partygoers in a burning nightclub; neither strategy works well when everyone tries to employ it simultaneously."[159] Therefore, these characteristics evidence on relatively small level of certainty that shareholders have in relation to their share ownership as compared to ownership over conventional assets. This uncertainty, and respectively high risks on the side of shareholders as for the future of their investments, are deemed to be their price for granted limited liability.

[159] Blair, M., & Stout, L., "Specific Investment and Corporate Law," *European Business Organization Law Review*, Vol. 7, no 2, 2006, 482, accessed March 28, 2019. https://doi-org.skaitykla.mruni.eu/10.1017/S1566752906004733.

2. ON PROTECTION OF CLASS RIGHTS AND AGAINST CLASS RIGHTS AND OTHER STRATEGIES OF CORPORATE STRUCTURING

2.1. Shareholders as a Common Pool and as a Specific Class

Equality of shares is presumed[160] for all types of companies (private and public) and in all countries that have more or less developed company law. In the absence of provisions to the contrary in the articles of association, all issued shares of a company constitute a **common pool with equal rights** as to the voting, distribution of profits and distribution of remained surplus after company's liquidation. However, e**quality of rights attached to shares does not mean equality between shareholders holding these shares**. Although each share may carry equal rights to financial returns and voting entitlements, the scope of their enjoyment depends on the amount of shares owned by each particular shareholder. In light of this, it is extremely important to draw a clear **distinction between differences in the scope of rights and their variation,** since in the first case one will deal with a single class of shares, while the second case provides existence of different classes of shares.

"Classes are often created to give different voting rights to different shareholders. Separate classes may also be used to give special dividend rights to some investors. Another reason for multiple classes… is to allocate only to certain shareholders gains and losses from certain assets or pools of assets of the company. Put simply, **the creation of different classes of shares allows a company to tailor a variety of forms of equity participation to suit the needs of different investors, as well as the finance and investment strategies of the company** *[emphasis added]*."[161] As discussed in the first part of this research paper, the interests of shareholders vary among themselves, as well as in relation to interests of the company. One shareholders may prefer grater financial returns to personal participation in company's affairs, while others may regard possibility to set or to influence the business course of the company as means for profit maximisation or for pursuing their own goals. Being able to suit demands of investors by offering them favourable terms of business increases company's bargain power and its investment attractiveness. The extent of preferential rights an investor may receive as a remuneration for

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[160] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd ed. (Oxford: Oxford University Press, 2014), ePub, 497-498.

[161] Brian Blugerman, "Share Classes and Special Rights," *Conyers Dill & Pearman* (2008), 1, accessed April 24, 2019, https://www.conyersdill.com/wp-content/uploads/2018/06/Article_168_Share_Classes_and_Special_Rights.pdf

contribution depends on "how much *the investor is [author's note]* willing to pay and how eager the company is to get *his/her [author's note]* money; it is a business transaction like any other."[162]

Definitions of what constitutes a "class of shares" usually include to this notion shares with "uniform",[163] "equal,"[164] "same"[165] or "identical"[166] rights and obligations as distinct from other shares in a company. In practice, however, this task appears to be more complicated, since companies with a complex share structure may attach to shares uniform/equal/same/identical rights, which are voting, capital or dividends rights, but differentiate as to the scope of their enjoyment by different groups of shareholders. EMCA also emphasises that approaches may vary among countries as to whether shares with different nominal value (or accountable par) can be regarded as forming separate classes due to mismatches in proportions to the capital that different shares represent.[167] Moreover, as was mentioned in the case *Greenhalgh v Arderne Cinemas Ltd [1945]* shares could be in different classes for some purposes (variation of class rights) and in the same class for others (e.g. when voting for director appointment).[168] Therefore, the questions of what exactly fall within the meaning of "class rights," and to which extent company's arrangements trigger variation of rights attached to a class of shares, are important with respect to whether a special procedure for passing a decision by shareholders is required.

EMCA in searching for a balance in determining what constitutes a change to the rights of a class, for which a qualified majority within the affected class is required, provides with some fixed cases of class rights variation, which includes introduction of a new class of shares in the company with dual-class structure and cancellation of shares of a particular class.[169] The same

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[162] Jesper Lau Hansen, "The Nordic corporate governance model – a European model?," in *Perspectives in company law and financial regulation: essays in honour of Eddy Wymeersch,* [edited by] Michel Tison, Hans de Wulf... [et al.], (Cambridge University Press, 2009), 156.

[163] "Companies Act," the United Kingdom, 2006, *Article 629 (1),* accessed April 24, 2019, http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf.

[164] "Companies Act," Sweden, 2005, *Chapter 4, Section 1*, accessed April 24, 2019, http://law.au.dk/fileadmin/www.asb.dk/omasb/institutter/erhvervsjuridiskinstitut-skjultforgoogle/EMCA/NationalCompaniesActsMemberStates/Sweden/THE_SWEDISH_COMPANIES_ACT.pdf.

[165] "Aktiengesetz," (Stock Corporation Act), Germany, *Section 11,* accessed April 24, 2019, https://www.gesetze-im-internet.de/englisch_aktg/index.html.,

[166] Paul Krüger Andersen, Theodor Baums [and others], European Model Company Act (EMCA), *Nordic & European Company Law Working Paper* no.16-26, 2017, *Section 5.08*, 99, accessed April 24, 2019, [interactive] https://ssrn.com/abstract=2929348.

[167] *Ibid*, 100.

[168] *Greenhalgh v Arderne Cinemas Ltd* [1945] 2 All ER 719, [1946] 1 All ER 512, CA as cited by Eilis Ferran and Look Chan Ho, *supra* note 160, 525.

[169] Paul Krüger Andersen, Theodor Baums [and others], *Section 5.09.*, *op.cit.*, 100.

approach could be found in German law on public companies, requiring adoption of separate resolutions by each class of stock together with the resolution of the GM for capital increase and capital reduction.[170] The required majority for passing these resolutions is established on the level of at least three quarters of votes of the each class of stock, as well as of the share capital represented at the GM at theme of passing a decision.[171]

Another approach could be found in the case-law of the UK, where reduction of the capital is treated as alteration of class rights only when consequences of reduction impede shareholders from enjoyment of rights they are owed. For example, in *Saltdean Estate Co Ltd [1968]* reduction of the share capital by means of paying off preference shareholders was found by the court not to be a variation of class rights, since the articles of association stipulated a right of preference shareholders to first receive a capital return in case of winding up the company before the ordinary shareholders.[172] Therefore the court concluded that "repayment of preference shares in accordance with their (usually special) rights to participate in capital is not a variation of a class right for this purpose."[173] There is also another example of the procedure of reduction of the capital (*Re Old Silkstone Collieries Ltd [1954]*), where a company first declared payment a compensation awards to all shareholders, and later passed a decision to cancel the class of preference shares.[174] The court held that there is a variation of class rights in a given case, since preferred shareholders have been promised a right to participate in compensation payments, and then this right has been unfairly revoked by means of passing a decision of repayment of shares.[175] English courts pay particular attention to differentiation between rights of shareholders as a class and enjoyment of these rights and "where a company acts merely to affect the rights of a class of shareholders without expressly altering such rights, that act will not be construed as a variation but merely as an act which changes the enjoyment of those rights."[176]

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[170] "Aktiengesetz" (Stock Corporation Act), Germany, *supra* note 165*, Section 182, Section 222.*

[171] *Ibid.*

[172] *Saltdean Estate Co Ltd, Re [1968] 1 W.L.R. 1844* as cited by Stephen Griffin, *Company Law: Fundamental Principles*, 4th ed. (Harlow: Pearson Longman, 2006), 146-147.

[173] *Saltdean Estate Co Ltd, Re [1968] 1 W.L.R. 1844* as cited by *Palmer's Company Law*, (Thomson Reuters), Vol.2, Chapter 6.030 - Preference shares, accessed April 24, 2019, https://login-westlaw-co-uk.skaitykla.mruni.eu/maf/wluk/app/document?src=doc&linktype=ref&context=42&crumb-action=replace&docguid=I47FF8921092311E1805DCAF42650B07B&return=true.

[174] *Old Silkstone Collieries Ltd, Re [1954] Ch 169* as cited by Stephen Griffin, op. cit., 148.

[175] *Ibid*.

[176] Stephen Griffin, *Company Law: Fundamental Principles*, 4th ed. (Harlow: Pearson Longman, 2006), 147.

One more approach to regulation of the procedure of alteration of class rights could be illustrated on the example of Finland. Finish Limited Liability Companies Act has a general provision that a decision "on the amendment of the articles of association to the effect that share classes are combined or the rights of an entire share class are otherwise reduced"[177] triggers a specific procedure for variation of class rights.[178] In addition to the aforementioned rule the Finish law requires obtainment of support of the qualified majority (⅔) of each share classes represented at the GM for passing a decision "on the merger in a merging company, the demerger in a demerging company, the company going into liquidation, the termination of liquidation and, in a public company, the directed acquisition of own shares."[179]

As it is evident from the analysis of the aforementioned legislative practice, the approaches to defining class rights and their protection vary among countries. "The more broadly the expression 'rights attached to a class of shares' is interpreted, the more protection is afforded to minorities, and vice versa."[180] Although being an effective tool against oppression of vulnerable shareholders, **unduly broad range of cases that invoke rules for variation of class rights may cause incentives on the side of particular classes of shareholders to block any decisions that may reduce their stake or influence**, and thus, to block company's attempts for passing strategic decisions. In particular, this could be the case with issuance of new shares, which is advocated by the EMCA.

It appears that the starting point for considering cases where strong protection against changes to class rights is justified could be an analysis of companies with the most defenseless position of small shareholders. In our view, **the most vulnerable position** from this perspective **is that of the non-controlling shareholders of private companies**. This is explained by the fact that ownership and management in such companies are usually concentrated in hands of controlling shareholders and minority shareholders are normally excluded from performing influence on the course of business. Using dual-class share structures in these companies, especially in cases of disproportionate allocation of control and equity rights, puzzles the situation even more and substantially increases the probability of abuse. The aforementioned weakness of non-controlling

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[177] "Limited Liability Companies Act," Finland, unofficial translation of the Ministry of justice of Finland, 2012, *Section 28*, accessed April 24, 2019, https://www.finlex.fi/fi/laki/kaannokset/2006/en20060624_20110981.pdf.

[178] This decision needs to be passed by the **qualified majority (⅔)** of the votes cast and the shares represented at the meeting and **supported by a qualified majority** within each of the share classes represented at the meeting and by **consent of the majority** within each share class whose rights are to be reduced. *Ibid*.

[179] *Ibid*, *Section 27 (3)*.

[180] Eilis Ferran and Look Chan Ho, *supra* note 160, 528.

(or non-voting) shareholders in dual-class private companies is supplemented by inherent low liquidity of shares of this type, which additionally decreases proportionally to deterioration of minority shareholders' status. The aforementioned risks could be mitigated *ex ante* on the stage of negotiating conditions of investment to the private company. Important role in this case plays full disclosure of the corporate structure of the company, so that the approximate evaluation could be made as to how the power will be allocated and whether resistance will be feasible. Domestic legislation may serve as additional source of protection by means of stipulating a requirement of getting consent of share classes regarding decisions that could detrimentally affect rights or enjoyment of rights by these classes. In cases where legislation prescribes only general terms regarding variation of class rights, courts could perform *ex post* control over legitimacy of changes to the corporate structure by exercising their interpretative functions to the extent (broad or narrow) necessary in each particular case (provided that domestic legislation confers courts with such interpretative powers).

In public companies, disproportionate allocation of control is also likely to cause misuse of power on the side of majority shareholders to the detriment of minority. For European public companies dispersed ownership similar to that in the USA is not inherent and similarly to private companies they usually have a small group of shareholders to whom the lion's portion of control powers pertains. These powers may be gathered by means of holding of a substantial block of shares that enable performing influence over remaining minor shareholders or may be concentrated in hands of particular persons by allotting to them shares with multiple voting rights. This control enhancing mechanism (CEM) is known for splitting voting rights from profit rights, so that holding of insignificant amount of equity allows performing the total control over the firm. This overbalance on the side of one part of shareholders, although being consensual, that is negotiated and agreed among shareholders, should not lead to *bad faith* depreciation of other shareholders' stakes. Therefore, **in case of apparent domination of one shareholder in a firm, the remaining ones need to have appropriate mechanisms for protection of what they are owed due to original agreements.** This could be achieved by means of weighting the voice of non-controlling class of shareholders in issues that directly concern their rights, i. e. **by having a separate say on any changes to their right or on their scope of enjoyment**.

In public companies with equal voting power per share and equity participation proportional to shareholding (or fixed) minority shareholders also need protection, but not that strong as in the aforementioned cases. It appears that the question of issuance of new shares or

creation of a new stock in such companies could be decided by the GM without necessity of a separate consent of shareholders' classes involved, or at least this question may be specifically addressed in the articles of association or shareholders' agreement without having a mandatory provision in the legislation in this regard.

There is one more sensitive issue about class rights and their variations. It could happen that a **company needs to properly react on opportunities and challenges coming from the outside, and to pass decisions that may be uncomfortable for particular classes, but beneficial for the company as a whole.** In this case shareholders' class may block decisions that they find unfavourable, and in such way drive a company to adverse outcomes. In this respect as a bright example may serve a question on reduction of capital through cancellation of a class of shares or limiting its number. As mentioned above, some countries, as well as EMCA, treat this decision as interference to class rights, and it is hard not to agree with this. However, in the case when the balance sheet evidences that things go wrong and that it would be better to repay particular shares now, than to go to liquidation in several years,[181] the issue about protection of class rights turns be in conflict with the question about company's survival. It appears that interests of the firm, especially those of survival, prevail over the interests of separate groups of shareholders, and it would be much beneficial for all parties if a company continues its operation and stays afloat during the critical period, while the parties are fighting in trial about whether the variation of class rights has or has not taken place. Therefore, in our opinion, the **GM of shareholders should have a final say on issues when the interests of the whole firm are at stake**. Therefore, fixing in the legislation cases that are unequivocally amounted to variation of class rights need to be drafted in a way so as to live a room for maneuver in the event of emergency or "weighty financial reason for the company to do so."[182] If the particular event triggering variation of class rights has been fixed in the articles of association, without being stipulated by the legislation, it should be presumed that parties have reached an agreement in this regard and the freedom of contract needs to be respected.

One of the most famous examples of dividing shares on classes is **creation of the common and preferred stocks**. These stocks are complex notions since they may comprise not only

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[181] For example, this could be the case with preference cumulative shares. After several years of difficulties and not-declaring dividends, the company may end up with a huge amount that should be repaid to preferred shareholders before any distribution to the common stock is made. Charles R. Korsmo, "Venture Capital and Preferred Stock," *Brooklyn Law Review*, Vol.78, no.4 (2013), 1176, accessed April 30, 2019, https://heinonline-org.skaitykla.mruni.eu/HOL/P?h=hein.journals/brklr78&i=1199.

[182] Expression is used in the Finish Limited Liability Companies Act for justification of certain decisions that contravene to the ordinary course of affairs. "Limited Liability Companies Act," Finland, *supra* note 165, *Section 4 Chapter 9, Section 6 Chapter 15*.

common and preference shares, but also different variations of these shares, i.e. classes. Thus, although the term "stock" may serve as a synonym for the term "share" in some cases and some jurisdictions, in the civil law world these notions are commonly compared as general and specific categories. Within these stocks shares may be designed in different ways. It is notable that classifications of shares as belonging to a particular stock significantly vary among scholars. Thus, one includes non-voting shares to the ordinary stock,[183] while others classify them as being a distinctive feature of the preferred stock.[184] These differences could be explained by the fact that different jurisdictions have different rules regarding shares and their variations. For the purposes of this research we consider common and preferred stocks as representing equity instruments and as a hybrid of debt and equity instruments respectively. Therefore, we address issues inherent to equity shares in the section devoted to the common stock, while the section about preferred stock focuses on financial aspects of so-called mezzanine financing.[185]

2.1.1. Common stock and its variations

Ordinary shares represent a default rule for equity participation in the company. "They confer the right to "equity" in the company and, in so far as members can be said to own the company, the ordinary shareholders are its proprietors. It is they who bear the lion's share of the risk and they who in good years take the lion's share of profits."[186]

As a general rule, companies could not operate without issuance of ordinary shares. Our research revealed several cases of having provision in the legislation that explicitly stipulates a requirement that a company shall maintain a class of ordinary shares. This can be illustrated on the example of the Lithuanian Law on Companies, which requires that: "Ordinary shares shall constitute the majority of shares in a company. Preference shares may constitute not more than 1/3

[183] Stephen Griffin, *supra* note 176, 141.

[184] Mads Andenas and Frank Wooldridge, *European comparative company law*, (Cambridge University Press, 2009), 176.

[185] Spencer G. Feldman, "Preferred Stock: A Privileged If Peculiar Class," The Practical Lawyer (June 2012), 59, accessed April 30, 2019, [interactive] http://files.ali-aba.org/thumbs/datastorage/lacidoirep/articles/TPL1206_Feldman_thumb.pdf.

[186] Paul L. Davies and Daniel D. Prentice, Gower's Principles of Modern Company Law, 6th ed. (London: Sweet & Maxwell, 1997), 318.

of the capital."[187] Another example could be provisions of the German Law for public companies (Aktiengesetz), which allows issuance of non-voting preferred stock to the amount that does not exceed half of the share capital.[188] Taking into account the fact that the aforementioned class of shares represents the only one possible deviation from the principle of shareholders' equality,[189] it turns out that the remaining half of the share capital needs to be presented by the ordinary shares. The reason for claiming that a company should have at least a common stock could be the fact that there needs to be something to compare with in order to say that certain shares constitute a deviation or preference. Moreover, it could be said that existence of shareholders of the common stock harmonizes the corporate environment, since in case of only non-voting shares there would be no such corporate body in the company as the GM, and in case of only multiple voting stock their preferential voting rights would lose their value and would be meaningless.

Within the framework of the common stock the most popular variation is that of the scope of voting rights that each share entails. The default rule is a **"one share - one vote,"(1S1V)** which is "**a corporate voting mechanism that makes control exactly proportionate… to the capital invested by tying cash flow rights to the voting rights for these shares** *[emphasis added]*. It is based on the assumption (i) that shares entail economic ownership (cash flow rights) and voting power (voting rights) and (ii) that cash flow rights should be exactly proportionate to voting rights since shareholders are interested in higher share value and thus will equally vote to promote that interest so as to maximise the value of the company."[190] The 1S1V rule has a lot of proponents as well as those, who find this concept outdated. Those who advocate 1S1V generally base their viewpoints on potential threats coming from models with disproportionate allocation of equity and voting rights. Arguments in favour of the dual-class share structure can be summarized as claiming that the 1S1V is an outdated concept of the Industrial Age, which does not pay due account to the driving forces of the new economy that are human capital and intangible assets, i.e. "the importance of protecting the entrepreneur and his vision."[191]

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[187] "Law on Companies," Lithuania, 2000 (as last amended on 14 October 2014), *Article 42 (1)*, accessed April 28, 2019, https://e-seimas.lrs.lt/portal/legalActPrint/lt?jfwid=7cihrh1a9&documentId=9670ea90e8b311e4aecae0d86a561f87&category=TAD.

[188] "Aktiengesetz," Germany, *supra* note 165, *Article 139 (2)*.

[189] *Ibid*, *Article 12 (2)*.

[190] Arman Khachaturyan, "Trapped in delusions: democracy, fairness and the one-share-one-vote rule in the European Union," *European Business Organization Law Review*, Vol.8, no.3 (2007), 342, https://www.westlaw.com/Document/I3FDFE9B1721A11E093D2C583C139DB77/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0

[191] Zoe Condon, "A Snapshot of Dual-Class Share Structures in the Twenty-First Century: A Solution to Reconcile Shareholder Protections with Founder Autonomy," *Emory Law Journal*, Vol.68, no.2 (2018), 356.

i. Shares with enhanced voting rights.

As was discussed above the **control over the company could be viewed as a separate item of property** acquired together with shares.[192] **Controlling powers** may take forms of exclusive capacity to appoint one or several members of the board, a privilege to have a seat on the board, to have a veto on decisions regarding particular issues etc., however when it comes to the **control**, this stands for the power to manage the company and to determine its direction. **The control is exercised by means of voting rights held in the amount that allows to outweigh the voting powers of opponents and to pass decisions reflecting the will of those who possesses the control.** There is also another powerful way for exercising control, which usually serves as complementary to the aforementioned and is to a great extent driven by it. This is the power to influence a composition of the board and to remove undesired directors. This exerts a pressure of directors' mode of conduct and on the way of performing duties, thus forcing them to act in the interests of a controller, rather than in the interests of the firm. "If directors can be fired by a single person or family, they will be impeded from exercising the fiduciary duties that they owe to all shareholders…When the top directors and the largest shareholders are one and the same, it is unrealistic to expect the board dutifully to make decisions that are beneficial to shareholders as a whole."[193]

In companies with homogeneous share structure (ordinary shares) the control is obtained by means of centering in the hands of a single person, or several persons acting conjointly, an equity stake in the amount that allows performing control. This concentrated ownership in turn creates "a strong link between controlling shareholders' control power and their personal wealth within the company,"[194] as far as the more voting rights the person exercises, the larger is his/her financial stake in the company, and correspondingly the more expensive will be costs of the victory and of the failure.

In order to separate the voting rights from equity stake the company may issue shares bearing several votes per share, i.e. **multiple voting shares**. These shares form a separate class and

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[192] See section 1.2.3. p.34.

[193] Tian Wen, "You Cant Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies From Listing on the Security Exchanges," *University of Pennsylvania Law Review,* Vol.162 (2014), 1499, accessed April 17, 2019, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=9447&context=penn_law_review.

[194] Shen Junzheng, "The Anatomy of Dual Class Share Structures: A Comparative Perspective," *Hong Kong Law Journal*, Vol.46 (2016), 484, accessed April 18, 2019, https://www.westlaw.com/Document/I929118589ccd11e698dc8b09b4f043e0/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.

allow their holders (generally founders of the company) to exercise an ultimate control over the firm "with holding a disproportionately low percentage of equity, while other shareholders, who own more residual claims to the company's assets, have little influence over corporate decisions."[195] This legal phenomenon is known as the **"separation of ownership and control."**[196] This control enhancing mechanism (CEM) is believed to facilitate the process of attracting additional funding to the firm without a threat for controlling shareholder to dilute his/her powers. Thus, while the companies with the uniform share structure generally prefer to abstain from going public and to use the debt finance as source of funding, companies with dual-share structure may freely balance their debt-to-equity ratio according to circumstances. "If controlling shareholders cannot use CEMs to secure their control… **these firms will be forced to increase their indebtedness, adopting an inefficient capital structure that will be more expensive and increase the riskiness of bankruptcy** *[emphasis added]*. From this perspective, the adoption of CEMs allows an efficient bargain between insiders and outside investors in situations where controllers are not willing to allow the issuance of more equity that would jeopardise their control, even when this refusal would impair the growth and financial stability of their enterprises."[197]

Another feature that flows from the separation of ownership and control is that selling cash-flow rights to the public may encourage controllers in dual-class companies to take "investment opportunities with highest net present value… even though they are risky or generate no substantial profits until sometime in future."[198] Possibility for controlling shareholder to pursue a policy oriented on long-term performance is believed to be one of the strongest argument favouring dual-class structures with shares bearing multiple voting rights. As mentioned above, this tool enhances controller's resistance to the pressures coming from the outside, as well as from the inside of the company. The inside pressure may originate from shareholders having different views and expectations as to the company's mode of operation and future prospects. Those shareholders, who are interested in quick financial returns may not favour company's long-term strategies generating no profit during several financial years, and may take a shot to remove unfavourable decision-makers. The threat of being ousted may insulate founders or managing shareholders from their

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[195] *Ibid*, 478.

[196] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property,* (New York: The Macmillan Company, 1932).

[197] Federico Cenzi Venezze, "The costs of control-enhancing mechanisms: how regulatory dualism can create value in the privatisation of state-owned firms in Europe," *European Business Organization Law Review,* Vol.15, no.4 (2014), 507, accessed April 16, 2019, https://www.westlaw.com/Document/IB8D072C097DE11E4BCAEA199EBCAE03A/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.

[198] Shen Junzheng, *supra* note 194, 488.

original strategy, and instead they start developing ways to enhance firm's short-term performance at the expense of long-term values.[199] **"With a long-term lock on control that a dual-class structure provides… founders can focus on the long term and make decisions that enhance long-term value free from short-term pressures and the constant risk of being ousted."**[200]

The questions of entrenchment and low equity holdings as inherent to shares with multiple voting rights serve as the main advantages of this type of shareholding and, at the same time, as one of the main threat to the wealth of minority shareholders and the source of agency problems. It appears, that these types of shares are especially dangerous for civil law jurisdictions due to specifics of corporate governance as mostly centered on conflicts of majority—minority shareholders' interests, rather than on the relations between shareholders and managers as in common law countries.[201] However, the analysis of current legislation of several EU Member States shows that multiple-voting shares are generally allowed, subject to some restrictions on the maximum number of votes per share. Exceptions could be illustrated by Germany, Spain, Slovenia, Portugal, where shares with multiple voting rights are not allowed.[202]

"Critics of dual-class structures believe that corporate founders entrenching themselves in their companies for the "benefit of the shareholder" is a toxic notion, fed to public investors so the founder can escape shareholder accountability."[203] In response to the argument that founders in order to pursue long-term goals need to "protect their vision from external market pressures"[204] the opponents argue that **combination of strong managerial powers with isolation from the market of corporate control and low equity holding creates a dangerous mechanism of pursuing own goals at the expenses of outside investors.** "A wide range of distorted choices may result from entrenchment and low incentives. Such distorted choices may include the appointment or retention of the controller or a family member as an executive rather than a better outside candidate, engagement in inefficient self-dealing transactions with an entity that is affiliated with the controller, the usurpation of an opportunity that would be more valuable in the hands of the

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[199] Lucian A. Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," *Virginia Law Review*, Vol.103, no.4 (2017), 611.

[200] *Ibid*.

[201] Arman Khachaturyan, "Trapped in delusions: democracy, fairness and the one-share-one-vote rule in the European Union," *European Business Organization Law Review*, Vol.8, no.3 (2007), 347.

[202] OECD Corporate Governance Factbook, 2017, 61-62, accessed April 27, 2019, [interactive] https://www.oecd.org/daf/ca/corporate-governance-factbook.htm.

[203] Zoe Condon, *supra* note 191, 353.

[204] *Ibid*, 363.

company rather than the controller, or other choices aimed at increasing private benefits of control at the expense of the value received by other shareholders."[205]

The problem of unlimited managerial power of shareholders holding relatively small fraction of financial interest in the company is tried to be addressed by domestic legislation of the Member States of the EU by way of setting limitations to the maximum amount of votes per share. These limits may have form of a concrete maximum number of votes that a share may bear, or may be presented by a proportion to the number of votes carried by other shares of the company. For example, the Polish Commercial Companies Code stipulates for private companies **maximum three votes per share**,[206] provided that all shares with enhanced voting rights are of the same nominal value.[207] Polish public companies are allowed to have **no more than two votes per share**,[208] provided that the company is not listed on the stock exchange. Multiple-voting shares for listed companies are prohibited.[209] In Hungary companies issuing shares with preferential voting rights are **not allowed** to attach to these shares **voting power exceeding ten times voting rights corresponding to shares' nominal value**.[210] In Sweden the law stipulates that "no share may carry voting rights which are more than **ten times greater than the voting rights of any other share** *[emphasis added]*."[211]

There are also jurisdictions that establish no mandatory limitations to the maximum amount of voting rights per share and leave it for the articles of association to decide upon this issue. These jurisdictions are, in particular, Finland, Denmark and by the United Kingdom, where determining of shareholders' fundamental rights is recognized to be a prerogative of contractual arrangements rather than a mandatory rule stipulated by the legislation.[212]

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[205] Lucian A. Bebchuk and Kobi Kastiel, *supra* note 199, 603.

[206] "Shares" (udziały) of Polish private companies need to be distinguished from "shares" (akcje) of public companies. The term "shares" is better applicable for akcje of public companies, while udziały could be literally translated as "part of the share capital." See more in Section 1.2.3. p.33.

[207] "Kodeks spółek handlowych" (Commercial Companies Code), Republic of Poland, 2000, *Article 174 (3;4)*, accessed April 28, 2019, http://isap.sejm.gov.pl/isap.nsf/DocDetails.xsp?id=WDU20000941037.

[208] *Ibid*, *Article 352.*

[209] *Ibid*, *Article 351 (2).*

[210] "Act IV on Business Associations," Hungary, 2006, *Section 188 (1),* accessed April 28, 2019, https://gss.unicreditgroup.eu/sites/default/files/markets/documents/Act%20on%20Business%20Associations.pdf.

[211] "Companies Act," Sweden, 2005, *Section 5 Chapter 4*, accessed April 28, 2019. http://law.au.dk/fileadmin/www.asb.dk/omasb/institutter/erhvervsjuridiskinstitut-skjultforgoogle/EMCA/NationalCompaniesActsMemberStates/Sweden/THE_SWEDISH_COMPANIES_ACT.pdf.

[212] Peter King, "The United Kingdom," in *Proportionality Between Ownership and Control in EU Listed Companies: Comparative legal study*, Shearman & Sterling LLP (commissioned by the European Commission), Exhibit C (Part II), 2007, 256, accessed April 28, 2019, [interactive] https://ecgi.global/sites/default/files/study-exhibit_c_part2_en.pdf.

As of today, a lot of scholars' attention is vested in the phenomenon of **loyalty shares.** This concept is commonly used in France and was introduced in 2014 as a mandatory rule for listed companies.[213] Moreover, recent corporate reforms in several jurisdictions resulted in introduction of loyalty shares to the Italian (in 2014 for public companies)[214] and Belgian (starting from May 1, 2019 for public listed companies)[215] legal systems.

The idea of loyalty shares is to "award control and/or cash flow rights to long-term or "loyal" shareholders who hold their shares for a specified period of time (the "loyalty period")."[216] According to the French model of loyalty shares, **shareholders of public companies (sociétés anonymes) are granted additional vote per share, if during the period of at least two years shares are registered in the name of these shareholders.**[217] Non-listed public companies need to prescribe in the articles of association possibility of issuance of loyalty shares, while for listed companies loyalty voting rights are the default rule, and they are conferred on shareholders automatically upon expiry of the loyalty period.[218] Due to a **limited maximum multiplier of voting rights** granted to holders of loyalty shares, they are believed to narrow disconnection between power and equity participation, while offering possibility to long-term investors to leverage their long-term investment.[219]

As distinct from shares with multiple voting rights, **the loyalty shares do not form a separate class of shares**, since preferential rights they hold are conditioned not on specific features that a share represents, but on the certain characteristics that a shareholder possesses. Therefore, the enhanced voting rights of shareholders in such a case represent "a premium for the shareholder

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[213] Marco Becht, Yuliya Kamisarenka and Anete Pajuste, "Loyalty Shares with Tenure Voting - A Coasian Bargain? Evidence from the Loi Florange Experiment," *ECGI Working Paper Series in Law*, Working Paper N° 398/2018 (April 2018), 4, accessed April 28, 2019, https://ecgi.global/sites/default/files/working_papers/documents/finalbechtkamisarenkapajuste.pdf.

[214] Augusto Santoro, Ciro Di Palma, Paolo Guarneri, Alessandro Capogrosso, "Deviations from the "One Share - One Vote" Principle in Italy: Recent Developments - Multiple Voting Rights Shares and Loyalty Shares," *Bocconi Legal Papers*, no.5 (2015), 143, accessed April 28, 2019, https://heinonline.org/HOL/P?h=hein.journals/bocclp5&i=149.

[215] Laga, "Did you know that under the new Belgian Companies Code…," 2019, 13, accessed April 28, 2019, [interactive] https://www.laga.be/content/dam/assets/lg/Documents/Laga_NCC-Did%20you%20know_BE-2019.pdf

[216] Jeroen Delvoie and Carl Clottens, "Accountability and short-termism: some notes on loyalty shares," *Law and Financial Markets Review*, Vol.9, no.1 (2015), 19-20, accessed April 18, 2019, https://doi.org/10.1080/17521440.2015.1032065.

[217] "Code de commerce" (Commercial Code), France, *Article L225-123 (1)*, accessed April 28, 2019, https://www.legifrance.gouv.fr/affichCodeArticle.do?cidTexte=LEGITEXT000005634379&idArticle=LEGIARTI000028813786&dateTexte=&categorieLien=id.

[218] *Ibid*, *Article L225-123 (3).*

[219] Paul Krüger Andersen, Theodor Baums [and others], European Model Company Act (EMCA), *Nordic & European Company Law Working Paper* no.16-26, 2017, 97, accessed April 28, 2019, [interactive] https://ssrn.com/abstract=2929348.

having displayed loyalty towards the company rather than being a right embedded into a class of shares."[220] It is also worth pointing that **basically "loyalty shares" are nothing but the ordinary shares of the common stock,** since they do not bear any preferential right in themselves, and this is shareholder's loyal conduct that determines the presence or absence of the reward. **In this respect, it appears that it would be better to say about existence not of special "loyalty shares," but about "loyalty reward" as granted to a particular shareholder upon fulfillment of certain conditions, and which is lost upon change of the owner.** This is especially the case when the right to loyalty reward is stipulated by the legislation as a default rule for all companies of the same type, without the necessity of having a contractual provision in this regard.

Shares with enhanced voting rights could be labeled as being a tool created specifically for public companies planning to make an IPO. They are credited to be "a way to make listing and going public more attractive for entrepreneurs, exactly because they allow combining the advantages of raising capital on equity markets with maintenance of control."[221] Notwithstanding that some jurisdictions do not restrict issuance of this CEM by private companies,[222] given the relatively broader flexibility that private companies have in designing corporate structure and anti-takeover defences, it appears that private firm's long-term strategies may be sufficiently protected without opting for enhanced voting rights per share. Moreover, this is complemented by the very nature of private companies, which provides for concentrated ownership and limited capacity for share transferring, thus preventing unexpected dilution of control.

Recently there has been a tendency towards **weakening of antagonism in relation of multiple-voting structures and liberalisation of national legislation in this regard**. This shift is believed to be caused by business outflows to jurisdictions with flexible statutory rules for corporate structuring. For example, Italian corporate reforms introducing multiple voting shares, as well as loyalty shares, happened a few months after one of the most important Italian corporations Chrysler-Fiat moved to the Netherlands "to take advantage of specific governance features of the Dutch system."[223] Another recently emerged trend is to justify dual-class structures with multiple-voting shares by a necessity **"to provide a talented founder with a lock on control because of**

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[220] Augusto Santoro, Ciro Di Palma, Paolo Guarneri, Alessandro Capogrosso, *supra* note 214, 165.

[221] Marco Ventoruzzo, "The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat," *ECGI Working Paper Series in Law,* paper N° 288/2015 (March 2015), 10, accessed April 28, 2019, https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2574236.pdf.

[222] See e.g.: Finish Limited Liability Companies Act, *Section 3, Chapter 3*; Danish Act on Public and Private Limited Companies, *Section 46*; in Italy see Augusto Santoro, Ciro Di Palma, Paolo Guarneri, Alessandro Capogrosso, *op.cit.*, 143.

[223] Marco Ventoruzzo, *op.cit.*, 3.

her superior business skills."[224] This statement appeared in response to several IPOs made by huge digital companies as Google, Facebook and Snap (which have a complex share structures, including non-voting and multiple-voting shares), resulted in extreme success for the companies themselves, as well as for their shareholders. There is a comment on Facebook's IPO saying that: "Even a strong distaste among institutional investors for the **company's retrograde governance practices is unlikely to diminish the economic success of the IPO** *[emphasis added]*. Investing is ultimately about return. While good corporate governance practices, by increasing board and management accountability, can provide a robust framework to drive shareholder value, **this IPO event itself presents a Hobson's choice: accept governance structures which diminish shareholder rights and board accountability, or miss out on what appears to be one of the hottest business models of the internet age** *[emphasis added]*."[225]

Summing up, this subsection describes a model of shareholding, which differs according to inherent enhanced voting rights attached to shares, and thus constituting a separate class. The subsection also examines loyalty shares, as being a preference, assigned not to shares, but to a particular person, therefore, not treated as constituting a separate class.

ii. Non-voting shares and shares with limited voting rights.

"The dispute over the use of nonvoting shares strikes at the heart of corporate law's greatest debate: whether shareholder activism should be welcomed as a beneficial force for corporate discipline, or whether it should be viewed as a distraction from the company's long term goals. Because voting is an important component of activism, discussions about dual-class shares tend to fall into one of these camps."[226] The question about non-voting shares returns us back to the discussion about threats of disproportional allocation of equity and voting rights among shareholders of the company,[227] but with a distinction that in the present case shareholders are completely silent with respect to issues arising in the company. By financing company through the means of non-voting shares, shareholders delegate to corporate insiders the entire control over their

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[224] Lucian A. Bebchuk and Kobi Kastiel, *supra* note 199, 610.

[225] Institutional Shareholders Services, "The Tragedy of the Dual Class Commons" (2012), http://online.wsj.com/public/resources/documents/facebook0214.pdf, as cited by Federico Cenzi Venezze, *supra* note 197, 516.

[226] Dorothy Shapiro Lund, "Nonvoting Shares and Efficient Corporate Governance," *Coase-Sandor Working Paper Series in Law and Economics*, 834 (2017), 18, accessed April 18, 2019, https://chicagounbound.uchicago.edu/law_and_economics/834.

[227] See subsection i) section 2.1.1 p.47.

investments.[228] Given that the classical concept of share ownership provides for combination of financial and participatory rights, in the absence of one of the elements the question arises as to whether we are still dealing with shares and not with "unhealthy hybrid" between shares and bonds." [229]

Non-voting shares of the common stock represent a rare occurrence in the EU and they could be met in jurisdictions promoting freedom of contract in corporate relations, such as the United Kingdom,[230] Finland[231] and Denmark.[232] As distinct from non-voting preference shares, those of common stock do not bear a right for preferential distribution of profits or preferential capital participation, thus they could not be regarded as hybrid financial instrument in the meaning accorded to preferred stock. **They are ordinary shares of the common stock that carry all the rights held by shareholder, except voting rights.** Therefore, in order to stress that non-voting shareholders have all complex of the remaining participatory rights, the legislation stipulates this as a default rule, unless articles of association provides otherwise.[233]

Non-voting shares constitute a separate class of shares and, therefore, shareholders, although being silent in the ordinary course of business, are subject to rules on protection against variation of class rights, and, therefore, have a say on issues affecting their investments.[234] Moreover, in order to balance the weak position of non-voting shareholders as compared to those, who have voting rights, legislation usually vests in non-voting shares a **possibility to receive a right to vote** in cases, when dividends are not paid during particular period of time.[235]

Notwithstanding threats that non-voting shares (as well as the overall idea of dual-class stock) may pose, it appears that this concept of shareholding provides more certainty regarding investment decision made, as compared to cases of non-controlling ordinary shares. The first reason for this conclusion is the fact that from the very beginning non-voting shareholders do not expect

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[228] Dorothy Shapiro Lund, *supra* note 226, 18.

[229] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 116.

[230] OECD, OECD Corporate Governance Factbook (2017), 62, [interactive] http://www.oecd.org/daf/ca/corporate-governance-factbook.htm.

[231] "Limited Liability Companies Act," Finland, *unofficial translation of the Ministry of justice of Finland, 2012*, *Section 3, Chapter 3. Section 28*, accessed April 24, 2019, https://www.finlex.fi/fi/laki/kaannokset/2006/en20060624_20110981.pdf.

[232] "Danish Act on Public and Private Limited Companies," Denmark, 2010, *Article 46*, accessed April 30, 2019, https://danishbusinessauthority.dk/sites/default/files/danish_companies_act.pdf.

[233] "Limited Liability Companies Act," Finland, *op.cit.*, *Section 4, Chapter 3.*

[234] Paul Krüger Andersen, Theodor Baums [and others], *supra* note 219, 96.

[235] *Ibid*.

participating in the decision-making process and consequently do not pay a premium for voting rights. As a result, their votes do not bear a risk of being depreciated in value as in the case of ordinary shares in the company with multiple-voting shares. The second reason is the aforementioned right (if provided) of non-voting shares to get voting capacity in cases, when shareholders do not receive what they are owed during reasonable period of time. In case of ordinary shares, their right to dividends is commonly treated as not being absolute, and directly dependent on the profitability of the company and availability of funds for distribution. Thus, non-declaring dividends are generally treated as justifiable and do not cause granting additional rights to dissentient shareholders. To the contrary, non-voting shares, even without preferential rights to dividends, being in the eyes of the law more vulnerable class than the ordinary shares, are allowed to be granted additional mechanisms in order to be able to resist to abusive conduct of controlling shareholders. In such a way, non-voting class of shares, usually comprising of a considerable number of shareholders, if equating to ordinary shareholders for the purposes of voting on particular issue, may constitute a strong opposition to controlling shareholders. Moreover, it appears that **in cases of dealing with multiple-voting shares, the value of ordinary shares drops significantly and they *de facto* may possess a status equal to that of non-voting shares**.[236]

Legislation or articles of association may stipulate creation of shares with limited voting rights, meaning that certain shares do not carry a vote on particular matters.[237] Limited voting rights could be granted to a class of shares, as well as to a particular investor. In this respect it is important to make a clear distinction and draft an appropriate provision in the articles of association so as to whom exactly the rights are allocated: to a person or to a class. The answer to this question would determine whether the rules on class rights are applicable to a particular case.

To sum up, this subsection is about deviation from the principle of the 1S—1V to the side of making shareholders totally silent. Non-voting shares described in this subsection represent the common stock, and thus, do not grant their holders priority rights to dividends and liquidation surplus distribution. Moreover, it was argued that ordinary shares in certain cases may be *de facto* equalized in status with non-voting shares in the meaning that the value of their vote may be depreciated.

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[236] Aswath Damodaran, "The Value of Control: Implications for Control Premiums, Minority Discounts and Voting Share Differentials," *NYU Journal of Law and Business*, Vol.8 (2012), 498, accessed April 29, 2019, https://heinonline.org/HOL/P?h=hein.journals/nyujolbu8&i=495.

[237] See e.g. "Limited Liability Companies Act," Finland, *supra* note 231, *Section 3 (2), Chapter 3.*

2.1.2. Preferred stock

"**Stockholders are corporate, lenders are contractual, and a well-understood wall separates their legal treatments. Preferred stock straddles the wall** *[emphasis added]*. The holder receives a share of stock issued pursuant to the same corporate code and charter as a share of common stock. The stock, viewed in isolation, carries the same vulnerabilities as a share of common stock and exists in the same regime of rights and duties. The issuer then adds contract rights to the stock—either financial preferences or a debt-like right to be paid certain sums on set dates—thus rendering it preferred stock."[238]

The aforementioned statement illustrates why the preference shares are generally referred to as a hybrid security.[239] Unlike shareholders of the common stock, who's financial and membership rights are presumed, unless otherwise has been agreed, the rights of the preferred stock need to be expressly granted by the articles of association or shareholders' agreement, since the presumption in this case works *vice versa.*[240] Hence, there is no necessity to prescribe in the articles of association or in the legislation a right of shareholders of the common stock to participate in the GM. They are presumed to be entitled to this, unless there is a provision to the contrary in the articles. In case of shareholders of the preferred stock, they would not be granted a right for additional participation in distribution of dividends, or right of redemption, if these rights are not expressly stipulated by the law or by internal acts. **By not having a full shareholders' capacity and, in the same time, not having any advantageous of the debenture-holders,**[241] **shareholders of the preferred stock "sit on a fault line between two great private law paradigms, corporate and contract law,"**[242] **and as an outcome "may get the worst of both worlds, unless the instrument creating the preference shares is carefully drafted."**[243]

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[238] William W. Bratton and Michael L. Wachter, "A Theory of Preferred Stock," *University of Pennsylvania Law Review*, Vol.161 (2013), 1819-1820, accessed April 30, 2019, https://ssrn.com/abstract=2214015.

[239] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd ed. (Oxford: Oxford University Press, 2014), ePub, 498.

[240] Paul L. Davies and Daniel D. Prentice, Gower's Principles of Modern Company Law, 6th ed. (London: Sweet & Maxwell, 1997), 316.

[241] *Ibid*, 317-318.

[242] William W. Bratton and Michael L. Wachter, *op.cit.*, 1815.

[243] Paul L. Davies and Daniel D. Prentice, *op.cit.*, 317-318.

A classical characteristic of preference shares is as carrying a right to a **fixed rate of return** paid before any dividend payments are made to ordinary shareholders[244] and a right to receive **proceeds of liquidation ranking ahead** of ordinary shareholders' claims.[245] Preference shares may have **a cumulative nature** in the meaning that non-declared dividends accumulate each year of non-declaring them, and subsequently the overall amount of arrearages must be paid off before any dividends may be distributed to the common stockholders.[246] This stable, pre-determined nature of payments coming from the company to its preference shareholders resemble relations between a debtor and a creditor in terms that "a liquidation preference is analogous to the principal a debtor owes to a creditor; the preferred dividend is analogous to the interest a debtor pays on that principal."[247] However, in case of bondholders, there is no option for the company to unilaterally decide on deferral of debt repayments as they fall due,[248] while the status of company's shareholders prevents owners of the preferred stock to claim distribution of dividends, as far as in the legal terms this does not constitute debt obligation, even though they have some features in common.

The **right of preference shareholders to dividends is dependent on the company's profitability just like in the case of common shareholders, while the amount of dividends paid will not reflect the company's performance**. As far as preference shareholders' returns are to a large extent linked to company's solvency, but not to capital gains, they prefer company not to involve in risky projects, even if the ordinary course of business generates only moderate income. Moreover, they would try to negotiate inclusion of additional instruments to their legal powers, which would allow them to resist opportunism of the common shareholders at their expense. However, the attitude of preference shareholders towards this issue may be changed by way of granting them a right to participate in distribution of profits and liquidation proceeds together with common shareholders on a pro-rata basis, after being paid their dividends and part in liquidation (**participating preference shares)**.[249] This would shift a balance in favour of strengthening position

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[244] Stephen Griffin, *Company Law: Fundamental Principles*, 4th ed. (Harlow: Pearson Longman, 2006), 142.

[245] Eilis Ferran and Look Chan Ho, *supra* note 239*,* 498.

[246] Charles R. Korsmo, "Venture Capital and Preferred Stock," *Brooklyn Law Review*, Vol.78, no.4 (2013), 1171-1172, accessed April 30, 2019, https://heinonline-org.skaitykla.mruni.eu/HOL/P?h=hein.journals/brklr78&i=1199.

[247] Ben Walther, "The Peril and Promise of Preferred Stock," *Delaware Journal of Corporate Law*, Vol.39 (2014), 168, accessed April, 30, 2019, https://digitalcommons.law.msu.edu/cgi/viewcontent.cgi?article=1576&context=facpubs.

[248] Sunil Parameswaran, *Fundamentals of financial instruments*, (Singapore: John Wiley & Sons (Asia) Pte. Ltd, 2011), 120.

[249] Charles R. Korsmo, *op.cit.*, 1172.

of preferred shareholders as members of the company, and would tie to some extent the profits of shareholders with those of common shareholders and the company.

The other rights of preference shareholders may include a right to convert preference shares to common, a right for shares to be redeemed, as well as various protections against actions that possess threats to the value of the preferred stock.[250] Rights that may accompany ownership of preference shares may have various forms and scope, however, they need to be distinguished from **priority shares** carrying specific decision-making powers that allow their holders to pass decisions on behalf of the company solely without cooperation with other shareholders.[251] These powers may include "making 'binding' proposals for the appointment, supervision and dismissal of members of the management and supervisory boards,"[252] or right to veto particular issues. In contrast preference shares are generally "about finance, not governance,"[253] even though some countries allow them to hold voting rights.[254] The very nature of these shares is designed for "pure investors, *who [author's note]* agree to have no voting right, but instead a preferential right to dividend."[255]

Summing up, this subchapter describes different concepts of shareholding, which differ according to variation of profit and voting rights attached to shares. Thus, the default model of shares is presumed to have proportional scopes of voting, distribution and capital rights. Any shift to one or another side of entitlements, creating certain preference in comparison to ordinary shares, will constitute a new share class. However, certain preferences, which are assigned not to shares, but to particular persons, do not constitute a separate class and are deemed to be personal reward of a particular shareholder. The subchapter also examined the concept of hybrid securities and discussed rationality of using certain CEMs for different types of companies and in different legal traditions.

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[250] *Ibid*, 1171-1172.

[251] Paul Krüger Andersen, Theodor Baums [and others], European Model Company Act (EMCA), Draft, *Nordic & European Company Law Working Paper* no.16-26, 2017, 95, accessed March 29, 2019, [interactive] https://ssrn.com/abstract=2929348.

[252] Mads Andenas and Frank Wooldridge, *European comparative company law*, (Cambridge University Press, 2009), 191.

[253] William W. Bratton and Michael L. Wachter, *supra* note 222, 1875.

[254] See e.g. Lithuania Law on Companies, *Article 42(7)*; French Commercial Code, *Article L228-11*.

[255] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 115.

2.2. Shares With and Without Par Value

The question of par value shares and shares without par value in its essence is a question about relation between shares and share capital. Par value is a "fraction of the legal capital that a share represents,"[256] the purpose of the par value is to "indicate the capital that shareholders have agreed to contribute, which is a matter of history and which is therefore fixed."[257] It is a minimal price that an investor needs to pay upon subscription to shares,[258] which is fixed at the time of incorporation and could be changed only through procedures of increase and reduction of the capital. In case of no-par value shares "there is no direct correlate between shares and capital,"[259] and, correspondingly, they exist sort of independently from each other. Their price is not fixed and is determined specifically for each time of issuance of new shares,[260] and, as a consequence, there is no prohibition for the new no-par shares to be issued at the price below their "historical values."[261] Shares without par value "represent the share for what it is — a fraction or aliquot part of the equity— and they do not import a notional token of value."[262]

As of today, the vast majority of the European countries preserve in their legislation the requirement for shares to be issued with a fixed par value and a requirement to maintain equality between the amount of the share capital and the total number of nominal values of all allotted shares.[263] The exceptions to this rule constitute two European jurisdictions: Finland, which introduces the true no-par value system in 2006, and Belgium with a specific procedure for unification of shares with different fractional values to a single uniform pool.[264]

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[256] Hans De Wulf, "Shares in the EMCA: the Time is Ripe for True No Par Value Shares in the EU, and the 2nd Directive is Not an Obstacle," *European company and financial law review*, Vol.13, no. 2 (2016), 221, accessed June 14, 2017, https://www.degruyter.com/downloadpdf/j/ecfr.2016.13.issue-2/ecfr-2016-0215/ecfr-2016-0215.pdf.

[257] James C. Bonbright, "No-Par Stock: Its Economic and Legal Aspects," *The Quarterly Journal of Economics,* Vol.38, no.3 (May, 1924), 441, accessed May 03, 2019, https://www.jstor.org/stable/1882331.

[258] Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law*, 2nd ed. (Oxford: Oxford University Press, 2014), ePub, 361.

[259] Niederer Kraft Frey AG, "Switzerland: European no par value shares – an overview," Mondaq, 1999, accessed May 01, 2019, [interactive] http://www.mondaq.com/x/7750/European+no+par+value+shares+an+overview.

[260] Sunil Parameswaran, *Fundamentals of financial instruments*, (Singapore: John Wiley & Sons (Asia) Pte. Ltd, 2011), 99.

[261] Hans De Wulf, *op.cit.*, 230.

[262] Report of the Committee on Shares of No Par Value (Cmd 9112, 1954) as cited by Eilis Ferran and Look Chan Ho, *op. cit.,* 363.

[263] See e.g. German Stock Corporation Act: *Section 8;* Lithuanian Law on Companies: *Article 38*; Dutch Civil Code: Book 2, *Article 80*.

[264] Hans De Wulf, *op.cit.*, 232.

The question about true no-par system was firstly raised on the all-European level by the working group of the EMCA. EMCA proposes to give companies a choice to decide between par value and no-par value systems, which needs to be prescribed in companies' articles of incorporation.[265] The EMCA itself does not express its relation to the two models proposed, however, the article of one of the member of the working group, Hans De Wulf,[266] gives a clear sign as for the preference of the EMCA's developers. The article presents no-par stock as a system, which provides for flexible mechanisms of share issuance "at a price that is appropriate under the circumstances,"[267] "without new contributions or capital reductions… without any internal movement between items in the accounts."[268] The par value system, to the contrary, is criticised to be useless, since, although having a good reasoning for its existence, it never provides for what it is supposed to provide and is a source of excessive burden when it comes to capital increase.[269]

"Par value does two things, one of which is good and the other bad. Its good feature is that it measures definitely the liability of shareholders; its bad feature is that it sets this liability at the same figure for all times, regardless of the market conditions under which new issues are to be made."[270] The argument about the function of the par value stock to set "a limit of personal liability of shareholders"[271] is one of the most frequent for opposing the concept of no-par stock. The price of the newly issued par value shares usually consists of the amount of the nominal value and a premium paid in excess. The part of the price corresponding to the nominal value is credited to the companies' share capital, while the premium is placed in a reserve, which may or may not be distributable to shareholders, depending on governing rules of the particular jurisdiction.[272] In doing so, by fixing a mandatory rule that a certain portion of proceeds from allotting shares needs to be put to the share capital, it is believed that the par value protects creditors' interest and preserves funds inside the company. Moreover, the nominal value also plays role of being a minimum price

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[265] Paul Krüger Andersen, Theodor Baums [and others], *supra* note 251, 91.

[266] Hans De Wulf, "Shares in the EMCA: the Time is Ripe for True No Par Value Shares in the EU, and the 2nd Directive is Not an Obstacle," *European company and financial law review*, Vol.13, no. 2 (2016), accessed June 14, 2017, https://www.degruyter.com/downloadpdf/j/ecfr.2016.13.issue-2/ecfr-2016-0215/ecfr-2016-0215.pdf.

[267] *Ibid*, 247.

[268] *Ibid,* 251.

[269] *Ibid*, 239-241.

[270] James C. Bonbright, "No-Par Stock: Its Economic and Legal Aspects," *The Quarterly Journal of Economics,* Vol.38, no.3 (May, 1924), 465, accessed May 03, 2019, https://www.jstor.org/stable/1882331.

[271] *Ibid*, 458.

[272] Andreas Cahn and David C. Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA,* (Cambridge: Cambridge University Press, 2010), PDF, 167.

that an investor needs to pay upon subscription for shares. In case of no-par shares the question to which account the proceeds from the sale should be allocated is left for the management to decide upon. Therefore, the funds may be credited either to the share capital, or to unrestricted reserve, in full or in different portions, thus making them (or part of them) available for distribution to shareholders. This is argued to possess a threat of blurring the capital of the firm and leaving creditors without their "trust fund,"[273] as opposed to the company's premium account, which mostly serves the interests of shareholders.[274] Another aspect of the no-par stock, which is actively criticized by proponents of the par value system, is its flexibility in determining the subscription price, which is believed to pose **threats of issuing shares at unfairly low prices to the detriment of existing shareholders**.[275] The par value shares, to the contrary, has a no-discount rule that prohibits share issue at the price lower than their nominal value.[276]

The first comment that needs to be made with regard to the aforementioned problematic, is that, as a general rule, the **par value is fixed in the legislation and by companies on a relatively low level.** Germany is deemed to be the country with the highest statutory fixed minimum amount of the nominal value at 1 EUR.[277] So, the fraction of the sum paid for shares, which is intended to fill in the share capital is much smaller than the other one, which goes to the premium account. Moreover, when the nominal value is fixed on the level that low so as the issuance at the discount would only be possible if issued without consideration (0,01EUR or 0,01GBP), it becomes evident that the argument about the "trust fund" has exhausted itself, and the gained funds *de facto* rest on the accounts other than the share capital. So the arguments of opponents directed against no-par shares in relation to possibility of depreciation of the share capital's value to the detriment of creditors, in fact, finds it expression in the par value system. Moreover, **necessity to pass through the procedure of capital reduction in order to lower the value of shares and adjust it to the market value, does not increase the company's attractiveness in the eyes of investors and creditors.**[278] Shares' fall in price below the nominal value evidences on the tough period for the company, and manipulations with capital in such a case may cause the effect opposite to increase in

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[273] Joseph E. Goodbar, "No-Par Stock -- Its Nature and Use," *Miami Law Review*, Vol.3, no.1 (1948), 22, accessed May 02, 2019, http://repository.law.miami.edu/umlr/vol3/iss1/3.

[274] *Ibid*.

[275] James C. Bonbright, *supra* note 270, 466-467.

[276] Hans De Wulf, *supra* note 266, 222.

[277] *Ibid*, 222.

[278] *Ibid*, 239.

liquidity, may lower the demand for shares and the value of the firm as an investing target, and consequently may drive a company into liquidation. **The floating value on the no-par system allows company to ascertain the price reflecting the current state of affairs in the company.** This price reflects various factors, internal and external, related to the company and varying on the daily basis. "When the corporation is a mere shell holding assets that have been contributed but not yet applied to business operations, a share issue price derived by dividing the book value of the company's assets by the number of shares is reasonable. However, when a company becomes a going concern, its share price will include many other factors, such as goodwill and certain growth expectations. The par value and the requirement that shares be sold at par or above then becomes rather arbitrary."[279] Thus, the no-par system is, first of all, possibility to trade of shares at the market value. This value may not necessarily be fair, and one may argue that in the no-par system the price can be arbitrary fixed by the company and an investor has no possibility to make a check on the real value of the traded stocks. However, if investors are willing to pay money for a particular stock that implies that they find it as worth doing so, and **the nominal value appears not to provide appropriate protection against arbitrary pricing, at least because it is a similar random price once fixed upon incorporation**.

Another comment that is worth mentioning in this regard is that, although the idea of reasonable allocation of funds has been neglected due to the inefficiency of the applied approaches, it appears that the idea in itself should not be left aside in promoting the no-par value system. There is an idea, expressed by James Bonbright that it is necessary "to require a corporation to credit the entire proceeds of any stock issue to capital account instead of crediting a portion to capital surplus"[280] with a possibility of a compromise of 10% credited to the capital surplus.[281] In supporting this point of view, we find the proposed counting as hindering the very essence and the core idea of the no-par value stock as providing flexibility in allocation of funds within a company. However, the idea of stipulating a **statutory requirement to credit a particular percentage of proceeds from subscription to shares to the share capital could serve the function of creditors protection that the par value system was intended to perform**. The percentage could be fixed on the level of approximately **40%—50%** so as to put an emphasis on the fact that **issuance of shares is, first of all, the way of attracting additional funds to the company** for its projects and

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[279] Andreas Cahn and David C. Donald, *supra* note 272, 167.

[280] James C. Bonbright, "The Dangers of Shares without Par Value," *Columbia Law Review*, Vol.24, no.5 (May 1924), 466, accessed May 02, 2019, http://www.jstor.org/stable/1113988.

[281] *Ibid*.

development, for having possibility to raise debt capital at a lower cost, as well as for rescuing the firm against excessive indebtedness. In this regard, it is also worth mentioning the rules for allocation of the subscription price prescribed in the EMCA. The document suggests that in the case, when no decision has been taken regarding allocation, the default rule should be booking of the whole subscription price as a stated capital.[282] When there is no decision only in relation to the part other than that one booked as a capital, in determining whether it presents restricted or unrestricted equity the EMCA proposes to treat it as unrestricted.[283] Thus, being completely agreed with the first statement, the second one appears to be controversial. **Issuance of shares should not be accorded a default meaning of being a source of profits for shareholders. Even if the concept of no-par value shares allows booking proceeds to the unrestricted reserve, this should be performed according to the terms of issuance, but not presumed in the legislation or other acts of the similar nature.** Share issuance is not a business transaction, but a process of firm's expansion, in the sense of membership, as well as in the sense of company's future prospects.

"Nominal value of the company is a decisive constituency in the process of determination of (i) right for the dividend, (ii) voting rights of the company and (iii) proportion on the residual rights."[284] The par value stands for equality of shareholders' rights as attached to shares of equal nominal value. Variations of shareholders' rights in some par value systems are permissible upon creation of separate share classes, having different nominal value and bearing rights enhanced proportionally to the increase in the nominal value.[285] Differentiation in the amount of nominal value, as a general rule, does not in itself constitute ground for creation of the separate class of shares,[286] **the separate class is created upon the fact that rights of shareholders become diversified due to different proportions to the overall stated capital that the nominal value of their shares represent**. In the most conservative par value jurisdiction[287] — Germany — the only

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[282] Paul Krüger Andersen, Theodor Baums [and others], *supra* note 251, *Section 5.05*, 91.

[283] *Ibid*.

[284] Mária Patakyová and Barbora Grambličková, "Capital Doctrine in the European Union — a Lesson to Learn from Finland?" *The Lawyer Quarterly*, Vol 6, no 3 (2016), 144, accessed May 03, 2019, https://tlq.ilaw.cas.cz/index.php/tlq/article/view/196/178.

[285] See e.g. Lithuanian Law on Companies: *Article 17(2)*; Dutch Civil Code: Book 2, *Article 228(3)*.

[286] *Greenhalgh v Arderne Cinemas Ltd [1946] 1 All ER 512, CA,* as cited by Matteo L. Vitali, "Classes of Shares and Share Redemption in Italian and UK Company Law: the Peculiar Case of the Redeemable Shares," *Electronic Journal of Comparative Law*, Vol.10.2 (October 2006), 15, accessed May 05, 2019, https://www.ejcl.org/102/abs102-2.html.

[287] Hans De Wulf, *supra* note 266, 222.

possible variation of rights is issuance of the non-voting preference stock.[288] However, as far as dividends rights in this case are fixed, and the voting rights are absent, there is no sense for according other nominal value for the preferred stock, since the difference in voting power is compensated at the expenses of preferential dividends rights. Multiple rights are prohibited by the *Aktiengesetz*,[289] as a consequence of a mandatory uniform nominal value for all shares of the company. Some countries may, although requiring nominal value for shares, and allowing shares with different nominal values, may leave a room for the companies to deviate from the requirement of proportionality between rights and nominal values, and leave it for the articles of association to decide upon these issues.[290] This approach is inherent to the UK, where the freedom of contract among shareholders is considered as a cornerstone of this corporate environment, and is presumed to have the highest legitimacy in corporate relations. EMCA's favouring of the no-par system is to a large extent related to its core underlying idea that "mandatory law is only necessary in order to save transaction costs or combat externalities and that therefore, the starting point in all matters should be freedom for the articles of incorporation."[291] **No-par system stands for flexibility not only in relation to determining subscription price and its allocation to different accounts, but also in relation to rights attached to shares**. Complex dual-class capital structures as of Facebook and Google are the outcome of the no-par value system introduced in the USA at the beginning of the 20th century. Probably, the benefits of no-par value shares are more tangible for public companies involved in active listing, however, this should not hinder private companies from being incorporated under the no-par system. Therefore, we would like to support the idea expressed in the EMCA so as to provide companies with possibility to choose between par and no-par shares for their business activities.[292] It appears that, as of today, since the concept of no-par value shares to a major extent is unfamiliar for European legal systems, there is no necessity in promoting it to claim for complete abandonment of the par value system. This question should be left for companies to decide. Moreover, providing such an option is also a sort of flexibility of statutory regulation.

Summing up, this subchapter introduced and investigated concepts of par and no-par value shares, their pros and cons and way of further development. In particular, it was discussed that

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[288] "Aktiengesetz" (Stock Corporation Act), Germany, *Section 139*, accessed May 05, 2019, https://www.gesetze-im-internet.de/englisch_aktg/index.html.

[289] *Ibid*, *Section 12(2)*.

[290] Hans De Wulf, *supra* note 266, 241.

[291] *Ibid*, 251.

[292] Paul Krüger Andersen, Theodor Baums [and others], *supra* note 251, *Section 5.05*, 91.

fixing of par value on a low level is not a suitable strategy for protection of creditors' interests, since the par value in such a case does not perform a function it is intended to, namely filling of the stated capital. In the same time, although supporting introduction of the no-par value system to the legal systems of the EU countries, it was argued about the necessity to fix the minimum percentage of contribution to the share capital.

2.3. Types and Forms of Shares in the Digital Era

The question of types and forms of shares is in essence the question about shares' externalisation and transfer of ownership rights over them. As was previously discussed, the share in itself is intangible and could not be taken into physical possession.[293] However, for the purposes of their allocation to a particular person, they may have form of paper-based share certificates or exist in a dematerialized form through book-entry system. Transfer of the dematerialized shares is generally performed by means of entering relevant information about shareholder to the register of shareholders, while paper-based certificates are transferred from hand to hand preceded by endorsement and entering the register of shareholder or without these. Entering share register implies transparency of shareholding in a particular firm, which nowadays is promoted and encouraged worldwide. Thus, although legislation normally provides opportunity to choose between paper-based and dematerialized forms of share issuance, certificates may only be issued after shares have been registered,[294] except in cases of bearer shares.

Bearer shares exist only in certificated form and are the vehicle for shareholders to retain their anonymity and the size of shareholding. This anonymity generally gives raise to suspicious[295] and is substantially limited as of today in comparison to their original form, however, number of European countries still retain possibility of issuance of this type of shares for public companies.[296] The anonymity granted to owners of bearer shares stems from the simplified procedure of share transfer, according to which, the ownership is determined by the mere fact of physical possession of the certificate entitling to particular portion of shares in the company. Thus, bearer shares are

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[293] See subchapter 1.2. p.18.

[294] See e.g. Finnish Limited Liability Companies Act: *Section 9, Chapter 3*; Swedish Companies Act: *Section 4, Chapter 6*.

[295] Tax Free Today, "The fall of bearer shares and how to use them today," *Tax Free Today* (Jan 16, 2019), accessed May 05, 2019, [interactive] https://tax-free.today/blog/bearer-shares/.

[296] See e.g. German Stock Corporation Act: *Section 10*; Dutch Civil Code: Book 2, *Article 82*; Polish Commercial Companies Code, *Article 334*; Latvian Commercial Law, *Section 228* etc.

transferred by means of delivery of the share certificate, preceded by a legitimate cause for transfer,[297] while registered shares "are transferred *inter vivos,* preceded by a valid agreement plus an endorsement written on the instrument itself, and entry in the book of registration of shares."[298] Notwithstanding that the original purpose of bearer shares is quite lawful as providing simplified procedure of share transfer, in practice they became a tool for concealment of controlling holdings of large shareholder, a tool for tax evasion, money laundering[299] and even financing of terrorism.[300] This became possible due to absence of any registration, declaration or reporting requirements, that makes impossible, for example for tax authorities, to investigate "whether the correct amount of tax from the revenue of the securities transfers was paid, or whether such revenues were declared at all."[301]

In spite of all advantageous that bearer shares offer, as simplicity of transfer and anonymity, it is obvious that they are not able to outweigh possible negative effects extending to the global scale. Moreover, simplicity and relevance of using paper-based shares for listed public companies are doubtful, taking into account current technologies, which provide possibility of storing, counting, transferring and modifying securities in one click from any corner of the world. Currently, there is only one jurisdiction left in the world with "**truly anonymous and mobile bearer shares"[302] — the Marshall Islands in the Pacific**.[303] **All other countries have either banned bearer shares, or made them immobilized**, in the meaning that shares are required to be deposited to the trustee (usually banks), who keeps the bearer shares and may, in case of legitimate necessity, disclose information about their beneficiary to the relevant authorities.[304]

Anonymity of a beneficial owner may also be retained by means of separation of the registered share ownership from the economic ownership.[305] According to this model, an investor

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[297] Joao Nuno Riquito and Carlos Eduardo Coelho, "Chronicle of a Death Foretold," *International Financial Law*, Vol. 34, no.32 (2015), 32, accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/intfinr34&i=210.

[298] *Ibid*.

[299] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 137.

[300] Tax Free Today, "The fall of bearer shares and how to use them today," *supra* note 295.

[301] Ondrej Vondracek, "Are Paper Shares Harmful: A Case for Economic Analysis of Law in the Perspective of Behavioural Economics," *Common Law Review*, Vol.12 (2012), 29, accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/comnlrevi12&i=29.

[302] Tax Free Today, "The fall of bearer shares and how to use them today," *op.cit.*

[303] *Ibid*.

[304] *Ibid*.

[305] Mathias M. Siems, *op.cit.,* 143.

appoints intermediary to be registered as holders of shares in the company, while he/she keeps the status of the beneficial owner and receive all economic benefits from his/her investment.[306] In complex structures, consisting of several layers of intermediaries, "the distance between the top of the chain and the bottom of the chain means that there is often no way for the registered owner to know the identity of the beneficial owner."[307]

There is one another currently emerging system for registering share ownership and its transfer, which is based on the technology of **blockchain**. "Blockchain system works as a Peer-to-Peer system, a system where all participants act as a supplier and consumer of information, as opposed to a server-based system where a central server furnishes the information to all clients."[308] Information, which enters the system has a form of the cryptographic code, which is unique for each particular combination of words in the document or amount of shares transferred. Any change made in relation to the information stored on the blockchain (being it even an additional dot in the contract) is reflected in the new crypto-code. One of the main feature of the blockchain system is its inalterability, meaning that "in order to manipulate the register, it would be necessary to change all the past history of the register on a global scale: each and every version of the blockchain on all existing and active nodes would have to be similarly impaired,"[309] what is practically impossible. Information, entered such system may relate to the company itself (various information that according to the law needs to be disclosed to the public), as well as information about shareholders, capital structure etc.[310] Besides the function of register, the blockchain may also perform exchange function and similarly to transfer of such cryptocurrency as Bitcoin, it may transfer shares converted to tokens.[311] Although not being enough developed to the date, especially in terms of legal reasoning and regulation, the concept of the blockchain applied to corporate relations may lead to "an environment in which securities exist only as pieces of electronic code stored on numerous Internet servers, made resilient against fraud and error by using strong cryptographic

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306 Andrew Henderson and Kathleen Van Der Linde, "Uncertificated Shares: A Comparative Look at the Voting Rights of Shareholders (Part 2)," *Journal of South African Law,* Vol.2014 (2014), 724, accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/jsouafl2014&i=506.

307 *Ibid*, 730.

308 Veronique Magnier and Patrick Barban, "The Potential Impact of Blockchains on Corporate Governance: A Survey on Shareholders' Rights in the Digital Era," *InterEULawEast: Journal for International and European Law, Economics and Market Integrations,* Vol.5, no.2 (2018), 203, accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/inteulst5&i=332.

309 *Ibid*, 192.

310 *Ibid*, 198-203.

311 *Ibid*, 192-193.

processes. In this environment, disposers and acquirers will be able to transfer securities directly amongst themselves, thereby eliminating the need to use intermediaries such as banks, brokers, or custodians."[312] Due to the fact that shares, in essence, are intangible category, not linked to its material form of embodiment, logically, their shift to the system of the blockchain should not cause substantial controversies as to their nature. Security tokens do not[313] (and, probably, will not) substitute the meaning of shares, but similar to paper certificates in the real world, will serve as means denoting shares in the crypto-world.

To sum up, this subchapter presented current types and forms of shares, discussed their rationality, and reflected on the possible scenarios of their development.

2.4. "Best" model of shareholding or balancing flexibility and security in corporate relations

This paper presents different models of shareholding each having specific features that distinguishes one model from others. In practice, however, the number of possible combinations is innumerable and they substantially depend on bargain powers of all sides to a deal and framework of bargain established by the legislation. Stricter statutory rules leave less matters to the discretion of participants of corporate affairs, and decide on their own about the best model of shareholding, what may not always match the reality. On the other side, discretion may be vested in contractual arrangements so that corporate players are able to decide on their mutual cooperation by themselves. However, the contracts are incomplete[314] and one may not foresee all the challenges of the future, therefore, what is optimal today may appear not to be optimal tomorrow.[315] "Corporate voting structures… are irrelevant in the world of complete contracting, costless enforcement and homogenous shareholders. If all contracts are complete, then the corporate players are capable of: (i) fully foreseeing all the future contingencies; (ii) stating the course of action with respect to each contingency; and (iii) writing comprehensive contracts at zero cost… *Ex ante* complete contracting

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[312] Philipp Paech, "Securities, Intermediation and the Blockchain: An Inevitable Choice between Liquidity and Legal Certainty," *Uniform Law Review*, Vol.21 (2016), 613, accessed May 05, 2019, https://heinonline.org/HOL/P?h=hein.journals/droit2016&i=619.

[313] "Security Tokens Explained for Beginners," The Tokenist, accessed May 15, 2019, [interactive] https://thetokenist.io/security-tokens-explained/.

[314] Oliver Hart, *Firms Contracts and Financial Structure*, (Oxford University Press, 1995), 29.

[315] Alessio M. Pacces, *Rethinking Corporate Governance: the Law and Economics of Control Powers*, (London: Routledge, 2012), 6.

leaves no room for *ex post* residual decision making, opportunism or divergent/heterogeneous preferences. Hence, all shareholders have identical tastes or preferences."[316]

Law is normative and it reflects objective reality of social relations.[317] Composition of the law consists of reasons, rules and consequences, so that one may suppose with a high degree of certainty which implications a certain legal rule may have if applied to a particular situation. As a legal category, shares stand for certain rights and obligations. These rights are acquired in order to have possibility to act in a certain way under certain circumstances and to have particular outcomes as a result of this activity. **Therefore, the question about which model of shareholding is the best is meaningless, unless it is addressed to a specific purpose: best model for what?** Proceeding from the purpose of shareholding, it would be possible to determine which rules are able to facilitate its achievement. And it appears that the answer to this question **should not be kept to broad categories** as, for example, "shareholders' wealth maximisation" or "enhancing company's value," due to their abstractness and uncertainty (what is the upper limit for wealth maximisation? what the company's value means?), **but should reflect the real purposes for which such construction as shares has been created**.

Each shareholder has own interests in the company and against it, so it appears to be impracticable to try to count them all. However, as has been argued in this paper, shareholders' interests could be roughly combined under a shell of behavioral characteristics, thus dividing them on shareholders-owners, shareholders-investors and shareholders-parliamentarians.[318]

Shareholder-owner model of behavior implies a high degree of shareholder's personal involvement in the company's life. As a rule, such shareholders are founders and their relation to the company is not purely as to the source of profits, but also as own project, as an embodiment of founders' ideas and business strategy, as a business associated with their personality. For shareholders-owners retaining control over **their** firm is of the major importance. Therefore, shareholders belonging to this type prefer corporate structures with enhanced voting rights, to hold a major equity stake in the firm and to attract additional capital by means of either debt instruments or by non-voting shares. These shareholders often perform the function of CEO in the company, or

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316 Arman Khachaturyan, "Trapped in delusions: democracy, fairness and the one-share-one-vote rule in the European Union," *European Business Organization Law Review*, Vol.8, no.3 (2007), 343, https://www.westlaw.com/Document/I3FDFE9B1721A11E093D2C583C139DB77/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0

317 Petri Mäntysaari, *Organising the Firm. Theories of Commercial Law, Corporate Governance and Corporate Law*, (Berlin, Heidelberg: Springer-Verlag, 2012), 57.

318 See subchapter 1.1. p.12.

participate in the management board. The best type of shareholding in such a case is a **controlling equity stake in a private company**, with relatively low degree of probability of hostile intervention to the corporate affairs from the outside, and in the same time with substantial flexibility in designing corporate structure. However, **flexibility should not lead to excessiveness, and therefore, it appears that shares with multiple voting rights in case of private companies are unnecessary.** Flexibility of rules for determining corporate structure of such companies gives enough protection for shareholders-owners for pursuing their goals. Multiple-voting shares are a tool for retaining control in the environment beyond the control, where there are no pre-emption rights on shares and there is a powerful market of corporate control, i.e. **in public companies**. It appears that disproportional allocation of control and ownership rights, despite all controversies, if granted to founders of public companies, would not cause those adverse effects as described in literature. Personal connection of a founder with a company, continuous and consistent strategy towards wealth maximisation, resistance to attacks would let the company to operate stably, to generate profit and to pay remuneration to employees and passive shareholders. The problems with lock in control accorded to a particular shareholder may arise due to a fact that with the course of time a founder "who was a superior leader at the time of the IPO might become ill fitting due to aging or changes in circumstances,"[319] or may decide to transfer shares to his/her heir or third party "who might not be as able, talented, skilled, or driven as *his/*her *[author's note]* predecessor."[320] One of the possible solutions to these problems may become incorporation to the terms of issuance of shares with enhanced voting rights "death or incapacity" or "separation" sunset provisions, so as multiple-voting shares automatically convert to common shares upon occurrence of the aforementioned events.[321] Another option to attain the same result is **recognition of multiple voting rights not as a distinct class of shares, but as a privilege of a founder, linked with his/her personality and management skills, which disappears with change in ownership**.

Shareholder-investor model is profit-oriented. This type of shareholders usually regards voting power not as a mechanism to dictate the course to the company, but more as an "emergency-brake function" setting bounds on excessive risk-taking or risk-averseness of management."[322]

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[319] Lucian A. Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," *Virginia Law Review*, Vol.103, no.4 (2017), 610, accessed April 19, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630.

[320] *Ibid*, 606.

[321] Zoe Condon, "A Snapshot of Dual-Class Share Structures in the Twenty-First Century: A Solution to Reconcile Shareholder Protections with Founder Autonomy," *Emory Law Journal*, Vol.68, no.2 (2018), 363, accessed April 19, 2019, http://law.emory.edu/elj/content/volume-68/issue-2/comments/dual-class-twenty-first-solution-protections-autonomy.html.

[322] Mathias M. Siems, *Convergence in Shareholder Law*, (Cambridge University Press, 2008), 88.

However, as long as they continuously receiving their financial entitlements, they are not likely to participate in the GM and exercise their voting powers. Accordingly, **it appears that non-voting shares suit best the goals of these shareholders, in private company if oriented on long-term shareholding, or in public if interested in short-term financial gains.** The choice between non-voting preferred or ordinary stock depends on the level of risk that an investor is willing to take: common stock with higher risk and higher financial returns, or preferred stock with priority in distribution, but fixed revenues, which do not depend on firm's performance. One more possibility for shareholders-investors is to have participatory preference shares, so as to be involved in both distribution sequences. This, probably, is the best option for investors, however, such enhanced profit participation would be reflected in the prize for shares. As far as profit sharing rights of shareholders-investors are not accompanied by any voting rights, they place their money under the management of directors and other shareholders[323] without possibility to intervene and influence the course of management. In order to overcome this disproportion in cases, when shareholders are deprived of their rights to financial stake, it is worth granting them voting rights during the period of not-declaring dividends. Especially this should be the case with non-voting preference shares (both participatory and non-participatory) due to their hybrid nature as combining elements of equity and debt instruments. **Except for voting rights and rights related to exercise of voting powers** (right to demand convocation of the GM, right to place an issue on the agenda of the GM etc.), **non-voting shares (both common and preference) should have all other membership rights** including rights to attend GM, to ask questions to directors and CEO, to demand and receive information etc.

Shareholders-parliamentarians model being a reflection of the idea of governance in the democratic society stands for equal opportunities of all members of the corporate community in decision-making, as well as, in profit and capital sharing. Voting powers from this angle are regarded as "a social choice mechanism, a way of moving from individual preferences over an array of alternatives… to group choices."[324] This model of corporate structure is better reflected through the lens of ordinary shares of the common stock as advocating proportionality between control powers and equity rights, and mandating the rule of one share — one vote. **The problem of this model of shareholding is that it could only work properly in the world of dispersed**

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[323] Alessio M. Pacces, *supra* note 315, 88.

[324] Grant M. Hayden and Matthew T. Bodie, "One Share, One Vote and the False Promise of Shareholder Homogeneity," *Cardozo Law Review*, Vol.30, no.2 (2008), 453, accessed May 06, 2019, http://scholarlycommons.law.hofstra.edu/faculty_scholarship/40.

shareholding, as inherent to the USA, where none of shareholders have a large controlling stake and all management is concentrated in hands of directors. In such a case, shareholders, due to their relatively small equity participation, do not have enough control powers for unilaterally influence the course of business. Therefore, only acting jointly they from "disorganized group of individuals"[325] become a powerful corporate body, which is able to exercise effective supervision over members of the management board, thus preventing them from extraction of private benefits at the shareholders' expense. **Corporate culture of the EU's jurisdictions inherently gravitates to concentrated model of ownership**, even in case of public companies. Therefore, **the ordinary shares of the common stock are mostly deprived from performing functions they are invented for — facilitation of collective decision-making and monitoring efficiency of management.** Non-controlling part of common shares in the EU's jurisdictions is generally silent and performs the role of non-voting shares, although not been intended for that.

As can be seen from the aforementioned, the design of share ownership reflects interests of shareholders investing in them. As interests vary, a shift in priorities occurs, moving from one to another side of the scale of corporate capacities. In order to be able to adjust corporate structure to interests of different groups of shareholders the company requires appropriate regulatory environment, which instead of placing restrictions, allow corporate players to freely determine the conditions of their cooperation through the lens of contractual freedom. The incompleteness of these contracts is solved by means of activity of corporate bodies acting within the framework of their competences, as well as by open-ended fiduciary duties owed to one another and to the firm.[326] Discussed in this paper system of no-par value shares would also contribute to the development of freedom of corporate structure, since it allows to employ different techniques of power allocation and risks distribution, without going into burdensome mechanisms of diversifying share classes with different par values and without resorting to pyramidal structures.

In order to sum up all set forth in this work, it is worth returning to its point of departure, to correlation between legal and economic theories and their applicability. In the ideal world, based on assumptions from the angle of economic efficiency, granting complete flexibility for participant of corporate affairs to structure their cooperation at own discretion would inevitably lead to stable and strong business environment inside the firm. However, when it comes to the real world, one may

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[325] Peter Nobel, "Stakeholders and the legal theory of the corporation," in *Perspectives in Company Law and Financial Regulation*, Michel Tison, Hans De Wulf, Christoph Van der Elst and Reinhard Steennot, (Cambridge University Press, 2009), 181.

[326] William W. Bratton and Michael L. Wachter, "A Theory of Preferred Stock," *University of Pennsylvania Law Review*, Vol.161 (2013), 1819, accessed April 30, 2019, https://ssrn.com/abstract=2214015.

face with asymmetry of information, agency costs, extraction of private benefits of control and other shortcomings not included to calculation formulas of economic papers. **Flexibility in the real world is a source of abusive conduct**, therefore it requires efficient mechanisms for prevention and elimination of bad faith. In the flexible legal environment **precautionary measures** are generally given to parties to a deal to decide on them in the course of bargain. However, as far as contracts are incomplete, one day *ex ante* preventive mechanisms may appear to be inefficient to resolve emerged controversies. The law as well as a contract could not foresee everything, therefore there should be someone who is able to examine relations between parties and to resolve appeared problem in each particular case. In such cases a crucial role to play is on the side of ***ex post* mechanisms**, presented by **courts and courts of arbitration.** They are vested with power to look in the essence of statutory and contractual provisions, and to compare them with the factual circumstances of the case, so as **to draw a line where the freedom ends and the abuse of discretion begins.** Efficient and strong judicial system, with century-old accumulated case law, is one of the main pillars of the famous contractual freedom of the UK's. In countries with weak level of legal culture and judicial development, broad discretion is likely to have adverse outcomes. Therefore, not only law matters, but also mechanisms of its implementation.

CONCLUSIONS AND RECOMMENDATIONS

In view of the conducted research, and due to its underlying objectives, the following conclusions and recommendations have been developed:

1. The factual nature of shares is that, although they are actively traded, *de facto* they never represent the real subject-matter of a share deal. They serve a function of denominating and formalizing rights and capacities, which stand behind shares and which a particular investor is interested in. Not the shares themselves, but specific rights, privileges and other "assets", stemming from them, as well as their combinations, constitute the main purpose of any share deal, and each shareholder has his/her own unique best model of shareholding, which reflects his/her interests, ambitions and expectations. Therefore, the question about which model of shareholding is the best is meaningless, unless it is addressed to a specific purpose: best model for what? And each shareholder gives his/her own answer to this question.

2. Shares are inseparable from the issuing company. Irrespective of whether they have or have not a link to a share capital, it is impossible for holders of shares to take them away from the joint corporate fund. What *de facto* changes in share deals is the beneficial owner of benefits coming from the shareholding. Therefore, it is **recommended** that the nature of share ownership to be considered as a sole prerogative of the company, while shares may have status of active, when they are allotted to a particular shareholder, or inactive, when no-one is entitled to receive revenues from them.

3. Granting unduly broad scope of protection to class rights, may cause incentives on the side of particular classes of shareholders to block any decisions that may reduce their stake or influence, and thus, to block company's attempts for passing strategic decisions. Therefore, it is **recommended** for Member States of the EU, upon prescribing in the legislation cases amounted to variation of class rights, which trigger specific procedures for passing decisions, to draft such provisions in a way so as to live a room for company's maneuver in the event of emergency. It is **recommended** in such cases, after receiving a negative response of the class voting, to allow transfer of this issue to the GM for deciding by the qualified majority. The GM as a corporate body representing all shareholders should have a final say on issues when the interests of the whole firm are at stake. However, when cases invoking procedure on variation of class rights have been decided solely by the articles of association (without being stipulated by the legislation), the freedom of contract needs to be respected.

4. Shares with multiple voting rights are the powerful tool for founders to preserve their ultimate control over the firm, while attracting additional funds. Employment of this tool for retaining control is justified in the environment beyond the founders' control, where there are no pre-emption rights on shares and there is a powerful market of corporate control, i.e. for public companies. For private companies, it is **recommended** to limit the use of this control enhancing mechanism, since the broad flexibility inherent to regulation of this type of companies, and a relatively low degree of probability of outside hostile intervention, make them a separate efficient tool for preservation of control over a company. Moreover, it appears that founders have stronger personal connection with a company and are more concerned about its long-term existence and reputation, than other shareholders. Therefore, it is **recommended** to consider the concept of multiple-voting shares as constituting a privilege of a founder, linked with his/her personality and management skills, which could not be transferred to other persons, and disappears automatically with change in ownership through conversion to common shares.

5. Non-voting shares may suit demands of those shareholders, wishing to attract additional funds to company without losing their controlling stake, as well as those, who regard shareholding primarily through the lens of gaining financial returns, and, therefore, they agree not to have any voting rights in exchange for enhanced revenues. For the latter, the most optimal variant of non-voting shares is that of non-voting participating preference shares, which on the one hand grant fixed priority claim to dividends and to liquidation surplus ranking ahead of shareholders of the common stock, but, on the other hand, strengthen positions of preferred shareholders as members of the company, and tie their interests to those of the firm.

6. The rule of one share — one vote, that is a reflection of the idea of the equality of shareholders, does not work properly in the EU's Member States, which inherently gravitate to concentrated model of ownership, even in case of public companies. Thus, non-controlling part of common shares are made silent and their status is equalized to that of holders of non-voting shares. This model works better in the companies with dispersed ownership, where no-one holds large equity stakes, and where shareholders generally represent a disorganized group of individuals, until it comes to protection of joint interests, and they become a powerful collective body exercising effective supervision over members of the management board.

7. The floating nature of the no-par value shares allows company to ascertain the price for shares, which reflects various factors related to the company, varying on the daily basis. This price may not necessarily be fair, however, if investors are willing to pay money for a

particular stock, that implies that they find it as worth doing so. Moreover, absence of a direct link to a share capital in no-par value system makes it possible to use various technics of corporate structuring, without necessity of creation of shares with different par values. It is **recommended** for countries to allow companies to choose between par and no-par value systems. Moreover, it is **recommended** to introduce together with no-par system a statutory requirement to credit a particular percentage (40%—50%) of proceeds from shares subscription to the share capital. In addition, in the absence of a decision regarding funds allocation, the default rules have to be as booking of the whole subscription price as a stated capital and booking of the part not related to the stated capital as a restricted reserve.

8. Paper-based share certificates as means evidencing share ownership de facto do not perform the intended function of simplified share transfer if compared with current technologies, which provide possibility of storing, counting, transferring and modifying securities in one click from any corner of the world. Accordingly, it appears that de facto there is no necessity of bearer shares anymore, not only because they exist only in paper-based form, but also due to the fact that they are not accepted by current business community, and adversely affect borrowing capacity of firms, as well as their reputation. Recently emerging technologies of blockchain and crypto tokens represent the future perspectives for development of the concept of corporate securities, their issuance, registration and transfer. The system of blockchain, due to its inherent openness and inalterability, would bring more transparency to operations with shares, as well as to other issues related to management of a company.

9. Freedom of articles of association and other contractual arrangements in order to work properly and bring intended outcomes require existence of effective ex post mechanisms for determining the scope of allowed freedom in each particular case. This function is best performed by courts and courts of arbitration, since judicial supervision allows to look in the essence of the governing provisions, and factual conduct of parties, so as to compare both with general requirements of law and justice.

Considering all aforementioned findings and recommendations, it could be concluded that all defendant statements mentioned in the introductory part of this Thesis have been confirmed.

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ABSTRACT

This paper outlines definition and description of the concept of shares, their legal and factual nature, specifics of capacities conferred by them. The Thesis also provides analysis of the notions of share classes and class rights, discuss the concept and constituent elements of dual-class companies, phenomenon of separation of control and ownership rights, employment of hybrid securities, as opposed to the companies with homogeneous share structure.

This research is based on the legal practise of various EU's Member States, with particular attention to the German and Finnish models, as representatives of the most strict and the most flexible corporate legal traditions in the EU. The research is directed on searching for the universal model of shareholding that is able to suit demand of all participants of corporate relations, as well as demands of the contemporary business environment in the EU.

Key words: private equity, shareholders, preferred stock, dual-class companies, no-par value shares.

Kudenko D. Classification of Company's Shares in the Legal Practice of European Countries: in Search of the Best Model, master thesis. Supervisor Prof. Dr. Virginijus Bitė. — Vilnius: Mykolas Romeris University, Faculty of Law, 2019.

SUMMARY

This Master Thesis is focused on the issue of the general nature of shares and variety of forms of their issuance inherent to the current stage of the corporate law development. The Thesis analyses the aforementioned concepts through the lens of shareholders' interests in a company, as being one of the main participants of corporate affairs, who's status and capacities are due to the rights enclosed to the shares held.

The Master Thesis is structured in two parts:

1. Legal and factual nature of shares and interests of shareholders therein.
2. On the protection of class rights and against class rights and other strategies of corporate structuring.

The first chapter analyses the concept of shares, the nature of rights conferred by them to shareholders, and the role of shareholders in a company. The second chapter reveals and assesses existing models of shares, their positive and negative aspects, peculiarities of their issuance, ownership and transfer. Moreover, the second chapter summarises the empirical data and discuss on the model of shareholding, which is best suited to meet demands of the contemporary business environment in the EU's Members States.

Established objectives of the research reflect the structure of the paper and are formulated as following:

1. To disclose mutual relations between a company and its shareholders, to examine their mutual interests in each other, and to reveal the essence and specifics of their link through such object of property as shares.
2. To investigate existing approaches of the EU's countries in relation to share and capital structuring, including various control enhancing mechanisms, hybrid securities, par value and no par value shares, and to discuss which model best influences company's performance and investment attractiveness.

The main problems analysed in the paper include: 1) differences between legal and economic theories of corporate shareholding in relation to their practical applicability to corporate affairs; 2) differences in approaches across Member States as to the level of statutory regulation of

corporate affairs; 3) diversified interests of investors regarding a company as a whole and their role in this company. These problems correspond to the aim of the research, which is a follows: “to analyse existing models of corporate shareholding in the EU’s countries in order to determine which model is best suit to demands of the contemporary business environment.”

On the basis of the conducted research, the Master Thesis concludes that shares in itself are an empty construction, which is filled with substance differently for each particular case of shareholding. This filling takes place on the basis of mutual interests of a company and investors in a particular bargain. The interest of company is measured by the amount of investor’s contribution, while investor’s interests are reflected in granted rights and capacities embodied in shares. Thus, the Thesis declares the freedom for shareholders and a company to determine conditions of their cooperation as the universal model of shareholding able to suit all demands. This freedom is not absolute, however, statutory limitations should not be unduly restrictive and should meet the requirement of rationality.

HONESTY DECLARATION

16/05/2019

Vilnius

I, __Dariia Kudenko__, student of Mykolas Romeris University (hereinafter referred to University)
(name, surname)

Faculty of Law, European and International Business Law

(Faculty /Institute, Programme title)

confirm that the Master thesis titled

"Classification of Company's Shares in the Legal Practice of European Countries: in Search of the Best Model":

1. Is carried out independently and honestly;
2. Was not presented and defended in another educational institution in Lithuania or abroad;
3. Was written in respect of the academic integrity and after becoming acquainted with methodological guidelines for thesis preparation.

I am informed of the fact that student can be expelled from the University for the breach of the fair competition principle, plagiarism, corresponding to the breach of the academic ethics.

(signature)

Dariia Kudenko

(name, surname)