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## Avinash Kumar



*Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship. He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi. Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi. He has qualified UGC - NET examination and has been awarded ICSSR - Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and*

*learning.*

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# **DIFFERENTIAL VOTING RIGHTS: THE UNDERLYING LINK BETWEEN ACQUISITIONS AND TAKEOVERS, MANAGERIAL CONTROL, AND OPPRESSION OF MINORITY SHAREHOLDERS**

AUTHORED BY - BHAKTI MAKHIJA

In its most basic form, DVR refers to and include voting or dividend rights. It indicates that not all equity shares are same in terms of voting rights. It's possible for shareholders to own shares with fewer voting rights or shares with higher voting rights. A shareholder must make a compromise in order to receive a greater dividend rate if he owns equity shares with additional voting rights. Similarly, a greater dividend rate goes to shareholders who have less or no voting rights.

This paper aims to answer *“Whether the Differential Voting Rights are used as an instrument to assert control over a company’s operations by founders and majority shareholders and does such control obtained is leading to oppression of minority shareholders? If yes, are these factors of control and minority shareholders oppression influencing takeovers or acquisitions.”*

The answer to the research issue was reached through theoretical study, which gathered data to lay the groundwork for determining whether or not minority shareholders are oppressed. Now that the foundation has been laid, I had to apply the Deductive research process to establish a connection between the takeover domain and reality.

This paper will attract the interest of the legal community because it addresses the legal gray area where unethical acts exist but aren't strictly unlawful because of legal loopholes. Minority owners of shares are grey areas in the law, without a well-drafted framework, including oppression and acquisitions by majority shareholders without the well-informed permission of other shareholders. Because there is no framework in place, everyone in the community have an opportunity to break the law and escape away with it. This essay examines that grey area. Consequently, assisting in giving the legal community further information regarding reality.

## 1. Managerial Control asserted through Differential Voting Shares

One of the most important—and delicate—factors in determining a company's effectiveness is managerial control over operations and decision-making. Businesses with a dual class capital structure, are provided control with instruments called Differential Voting Shares. The promoters and founders company typically retain shares with superior voting rights so they can run the business in the way they see fit.

### *Case study on Google:*

*Google's Board of Directors approved a resolution in 2012 to form a new class of non-voting Class C shares.<sup>1</sup> Prior to its scheduled recapitalization, Google's capital structure was made up of Class A shares, each of which has one vote for each shareholder. In contrast, each Class B share that a shareholder owned gave them 10 votes. The founders of Google, Sergey Brin and Larry Page, owned the majority of the Class B shares.<sup>2</sup> The founders possess the majority of the Class B shares since they provide them significant voting power over the corporation. Hence, eliminating the chance of being outvoted while making important decisions.*

Since more of Class A shares will reduce the voting power of Class B shares, Google decided to issue new Class C shares rather than more Class A shares.<sup>3</sup>

Control issues usually occur when an external investor with a stake in the company tries to challenge the current manager's authority and gain control in different ways. The authority of owners of distinct class shares to exert control varies, which impacts the control problem. More voting power might potentially provide stockholders greater influence over management.<sup>4</sup>

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<sup>1</sup> 'The New York Times Company' (The New York Times, 30 April 2012) <https://archive.nytimes.com/dealbook.nytimes.com/2012/04/> accessed 31 October 2023

<sup>2</sup> (Harvard Business Law Review (HBLR)) <https://journals.law.harvard.edu/hblr/> accessed 31 October 2023

<sup>3</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804> accessed 31 October 2023

<sup>4</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804> accessed 31 October 2023

***Case study on Facebook:***

*Facebook intended to issue nonvoting shares in order to raise additional funds. The choice of using nonvoting shares as a funding source was made because it allows them to raise and use a significant sum of money "without diluting the ownership stake" of Zuckerberg, founder of Facebook.<sup>5</sup>*

We can see that the founders of Google and Facebook and Google shared the goal of raising money "without diluting ownership stake" from the aforementioned case studies. Raising more money without reducing founder ownership is a common organizational strategy. Ensuring that the founder retains managerial and corporate control over the business is the fundamental goal of implementing this method. A company's founders want to own a significant enough share to have an impact on managerial control since that would allow them to run the business in a way that aligns with their vision. Founders frequently end up with the majority of voting rights because of their concern that outsiders would not share the same vision for the company. But, however, the founders are able to follow their goal in spite of investor opposition because of the power they have gained through their voting rights. The founders and other investors—minority stakeholders—cause friction between the two.<sup>6</sup>

Minority stakeholders place a higher value on corporate control over daily decision-making because they believe that control over the company will serve as a buffer against risks that they assume, like poor management agency expenses, and self-dealing. By using a balanced allocation of cash flow rights and control rights—the rights that will determine who will receive capital gains and a share of profits and how much they will receive—between founders and other stakeholders, the friction caused by the founders' vision and the risks taken by other investors (minority stakeholders) is often minimized.<sup>7</sup>

The founders will receive the majority of the controlling rights, which will allow them to pursue their objective for the company, and other stakeholders will receive the majority of the cash flow

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<sup>5</sup>

(Pre

14A)

<https://www.sec.gov/Archives/edgar/data/1326801/000132680116000053/facebook2016prelimproxysta.htm>  
accessed 31 October 2023

<sup>6</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804>  
accessed 31 October 2023

<sup>7</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804>  
accessed 31 October 2023

rights, which will protect them from agency fees.<sup>8</sup> For instance, suppose that in the case of Google, the Class A shareholders disapproved of the capital raising plan that involved the issuance of Class C shares because they thought it would increase the possibility that the founders would abuse their position of control and the risk of agency costs. The founders, after all, had a sincere belief that their plans for the company's future would result in a significant increase in its value. The Google founders would now have to give up on their company's goal unless they find another source of funds.

It's clear from the Google different hypothetical scenario above that the founders' original intentions for the business are sacrificed in order to give minority shareholders the ability to defend themselves against the possibility of agency expenses. The parties are therefore forced to choose between two flawed systems: either permit the controller to unilaterally reallocate control rights, which would protect the pursuit of their vision but expose the parties to high agency costs or grant minority shareholders a right of veto, which would protect against agency costs but might sacrifice their vision for the company.

The parties are forced to decide which risk is more costly—the founder's vision or exposure to agency costs—in order to distribute control rights. The answer to this question is firm- and person-specific, thus the parties will have to decide *ex ante* based on their respective bargaining positions and accept whatever *ex post* ramifications flow from that decision.<sup>9</sup>

It is clear from the study of the influence that the company's founders were able to acquire through differential voting rights that there is **an excessive control and power held by few people—the founders.**

## **2. Greater the power, the more dangerous the abuse: *Oppression of minority shareholders.***

As was previously said, a company's founders frequently have enough voting rights to affect the direction and decision-making of the business. Also, it goes without saying that a business must

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<sup>8</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804> accessed 31 October 2023

<sup>9</sup> (Corporate control, dual class, and the limits of judicial review - jstor) <https://www.jstor.org/stable/26915804> accessed 31 October 2023

follow the decisions made by the majority of its voting members. When founders own 2/3 of the voting rights, or 66% of the total, they're essentially in a position to make any company decision without taking the opinions of the remaining minority shareholders into account. Stated differently, minority shareholders might face oppression if their beliefs conflict with those of the majority shareholders. The scope of future exploitation by the majority shareholders is expanding due to the lack of legal framework remedies available to safeguard the oppressed stockholders.

Unless the minority shareholders can provide compelling evidence that the majority shareholders misused their authority, they've to accept the choices made by the majority shareholders. Even though common law contains ground rules designed to safeguard minority shareholders from majority shareholders abusing their power, courts have been hesitant to apply them because they have upheld their position of not interfering with a company's internal management or affairs.<sup>10</sup>

In the case of *Burland v. Earle*, Lord Davey ruled that "the court has no jurisdiction to interfere with the internal management of the companies acting within their powers."<sup>11</sup>

In essence, Lord Davey's opinions are correct since, both in practice and in theory, company decisions should be made in line with the opinions of the majority of voting shareholders. In situations where the founders possess sufficient voting rights to impact the decision-making processes and company's governance, according to law, the majority technically makes the choice. Therefore, the founders' claims of corporate control and governance would not be unlawful. Due to this, there is currently a legal gray area where minority owners' persecution will not be acknowledged unless they can provide evidence of explicit misuse of power and the majority shareholders' flagrant.

The Committee on Company Law Amendment's 1945 Cohen Report was the first to acknowledge the tyranny that minority shareholders suffered. By extending the reach of Section 210 of the Companies Act (UK) 1948 (and Corresponding Section 397 of the Companies Act 1956), it cleared the path for giving courts more authority to interfere with business affairs.<sup>12</sup> The Jenkins

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<sup>10</sup> (Wiley Online Library) <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1468-2230.1972.tb01325.x> accessed 31 October 2023

<sup>11</sup> *Burland v. Earle* [1902] A.C. 83, 93.

<sup>12</sup> 'Arbitrability of Oppression' (Scribd) <https://www.scribd.com/document/449718771/Arbitrability-of-oppression> accessed 31 October 2023

Committee also acknowledged that it was necessary to shield minority shareholders against injustice. "Section 210 had to be amended to afford effective protection to minorities in circumstances such as those with which it is intend to deal," the committee stated in its report.<sup>13</sup>

Section 210 was not amended to include a clause allowing for the determination of whether a company's operations are oppressive. Despite the fact that two professional committees were appointed to produce research studies on company law have acknowledged the idea of minority shareholder oppression and the necessity of giving them legal protection. There is conflict in law because there is no legislation that defines oppression because judges are overly relied upon to make this determination. The main issue facing the minority is not only that others have expressed a different opinion; but it's also that they have to accept it, even in cases where their concerns are valid and well-founded.<sup>14</sup> To allow otherwise would be to defy the majority vote, which is an extreme measure made more grave by the fact that the court involved openly asserts its ignorance of interfering with a company's internal affairs.

Following the aforementioned advances in corporate law, the judiciary has only occasionally acknowledged oppression. The first two cases are *Re H. R. Harmer Ltd.* and *S.C.W.S. Ltd. V. Meyer and Another*, where Section 210 was correctly understood and put into practice to shield minority shareholders against persecution. But because the determination of what constitutes oppression rests only on judgment, rulings made were not consistent. In *Elder v. Elder*, two petitioners made Section 210 assistance requests where one of the petitioners was forced to resign as secretary and was dismissed from the Board. The other petitioner lost his job as a manufacturing facility manager. Both of these petitioners were stockholders. The reconstituted Board refused to buy the petitioners' shares when urged to do so. These realities were said to be oppressive. The Scottish Court of Session's Inner House, however, denied the petition, stating that the facts failed to show that the petitioners had suffered oppression as shareholders. Consequently, the ruling restricted the application of Section 210 by designating it as shareholder-exclusive.<sup>15</sup>

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<sup>13</sup> (Jenkins Committee on company law - JSTOR) <https://www.jstor.org/stable/41139654> accessed 31 October 2023

<sup>14</sup> (Wiley Online Library) <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1468-2230.1972.tb01325.x> accessed 31 October 2023

<sup>15</sup> *Elder v. Elder & Watson Ltd.*, 1952 S.C. 49,57

In the context of Section 397 of the Companies Act, the Supreme Court of India has accepted and applied the rationale of *Elder v. Elder* in *Shanti Prasad Jain v. Kalinga Tubes*.

Therefore, before oppression de facto is considered to be oppression de jure, substantial specific evidence is needed.<sup>16</sup> That is the point at which conduct becomes “oppressive,” or, to put it another way, “harsh, burdensome, and unlawful,” or “an element of lack of probity and fair dealing,” or “a visible deviation from the standards of fair dealings and a violation of the conditions of fair play.”<sup>17</sup>

While Section 210 (and related Section 397) can be viewed as a daring endeavour in and of itself, the Cohen Committee was disappointed that it was unable to provide the benefits that Minority Shareholders had hoped for.<sup>18</sup> The authority granted by that clause is unquestionably necessary, but putting it into practice will require a prudent, daring and well-resourced initiative. I agree that one of the main responsibilities of the law in this regard is to precisely outline the obligations and rights of all parties involved, including the owner/manager, external investors, established employees, in order to lessen the possibility of abuse and fraud. However, the law also needs to set reasonable, workable standards of conduct for management and directors.

When the minority has barely any voice and too much power is concentrated in a small number of hands and to make a difference, the boundaries of the democratic process are certain to become hazy. This phenomena frequently occurs in businesses, particularly during mergers and acquisitions.

### **3. Acquisitions and Takeovers: The relationship between Minority Shareholders and Managerial Control**

Regardless of whether one believes that hostile takeovers have detrimental effects on the society and economy or that they greatly improve capital markets, it is becoming clear that the takeover process needs more democratic and open democratic procedures. Despite their lack of glamour,

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<sup>16</sup> Rubner A, *The Ensnared Shareholder: Directors and the Modern Corporation* (Penguin 1966)

<sup>17</sup> (Wiley Online Library) <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1468-2230.1972.tb01325.x> accessed 31 October 2023

<sup>18</sup> (Wiley Online Library) <https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1468-2230.1972.tb01325.x> accessed 31 October 2023

ethical concerns are important and have a bearing on the decision-making process when it comes to investments. The rapidly evolving sector of corporate takeovers frequently exhibits legal and ethical overlap. It's important to understand that moral failings of today can lead to legal violations of tomorrow.<sup>19</sup>

### ***Analysis of Facebook acquisition of Instagram:***

The \$1 billion USD price that Facebook paid for Instagram made it the most expensive acquisition in the history of Internet corporations. On April 8, 2012, the acquisition proposal was made to Facebook's board of directors. On the other hand, the specifics of the agreement have been discussed since April 4, 2012, when Facebook's founder Mark Zuckerberg and Instagram's Kevin Systrom first spoke.<sup>20</sup>

Unlike the customary formal approach of discussing the deal with the boards of directors of both firms present. The specifics were worked out in Zuckerberg's residence with just one Facebook representative there. Weeks of work are needed from the accounting and legal departments to draft necessary documents, determine the valuation, and other tasks when a \$1 billion USD acquisition takes place. However, since Mark Zuckerberg owns 57% of the voting rights and 28% of the Facebook stock, none of these tasks were necessary for the Instagram acquisition.<sup>21</sup>

He coordinated the acquisition on his own without the board's approval by leveraging the voting rights he acquired through differential voting shares. The proposal was merely a formality and more of an presenting information than a consent seeking when it was brought before the board.<sup>22</sup>

From the acquisition mentioned above, it is clear that acquisitions and takeovers are largely influenced by the oppression of minority shareholders and founders 'combined extreme. The bulk

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<sup>19</sup> Gillis J and Casey J, "Securities Law and Regulation" (JSTOR) [http://www-jstor-org.opj.remotlog.com/stable/4478815?searchText=ethical+considerations+in+takeovers&searchUri=%2Faction%2FdoBasicSearch%3FQuery%3Dethical%2Bconsiderations%2Bin%2Btakeovers%26so%3Drel&ab\\_segments=0%2Fbasic\\_search\\_gsv%2Fcontrol&refreqid=fastly-default%3A195af568fa0ea5dff93446b8ac7dea03#metadata\\_info\\_tab\\_contents](http://www-jstor-org.opj.remotlog.com/stable/4478815?searchText=ethical+considerations+in+takeovers&searchUri=%2Faction%2FdoBasicSearch%3FQuery%3Dethical%2Bconsiderations%2Bin%2Btakeovers%26so%3Drel&ab_segments=0%2Fbasic_search_gsv%2Fcontrol&refreqid=fastly-default%3A195af568fa0ea5dff93446b8ac7dea03#metadata_info_tab_contents) accessed October 31, 2023

<sup>20</sup> 'In Facebook Deal for Instagram, Board Was All but out of Picture' (The Wall Street Journal, 29 October 2012) <https://www.wsj.com/articles/SB10001424052702304818404577350191931921290>\> accessed 31 October 2023

<sup>21</sup> 'In Facebook Deal for Instagram, Board Was All but out of Picture' (The Wall Street Journal, 29 October 2012) <https://www.wsj.com/articles/SB10001424052702304818404577350191931921290> accessed 31 October 2023

<sup>22</sup> 'In Facebook Deal for Instagram, Board Was All but out of Picture' (The Wall Street Journal, 29 October 2012) <https://www.wsj.com/articles/SB10001424052702304818404577350191931921290> accessed 31 October 2023

of voting rights are retained by the founders in order to maintain their influence. Zuckerberg owns 57% of the voting power even though he only owns 28% of Facebook's stock. In addition to granting the founder authority and huge influence, this also dehumanizes and makes others voiceless.

It's vital to remember that in this case, differential voting shares are being used as a means for control and oppression. Assume for the purposes of hypothetical discussion that Facebook only has a one share-one-vote policy. In this scenario, not only will it be nearly impossible for Zuckerberg to maintain the same level of control that he had with differential voting shares, but it is also highly unlikely that he will own more than 50% of Facebook, as this would complicate capital raising. Furthermore, since he does not own more than 50% of the company, he will not be able to make decisions without first consulting other shareholders, as he will no longer have the necessary voting power. This would imply a significant reduction in the potential for power abuse and tyranny, in addition to the decentralization of authority over company operations.

***Steps Forward and Conclusion:***

One may view the Differential Voting Rights as a "Double Edged Sword." The sword's wielder impacts its effectiveness. To keep it from affecting the corporation itself, the proper distribution of democracy and power in voting rights must be achieved. Just as a founder's control is crucial to realizing the company's vision, the remaining shareholders must also have sufficient clout to have their opinions taken seriously as well. Giving the minority shareholders' opinions its importance will benefit the company because it will serve as a second opinion and cautionary tale, making the founders reconsider their decisions. Consequently, denying the founder free reins in pursuance of vision.

A legal framework is required for the lawmakers to take into account minority shareholder opinions—especially when they differ from those of the majority—and contact a third-party to consult the decision's logic and legitimacy will help strike a balance. This would guarantee a reduction in the conflict b/w minority shareholders and founders as well as democratic decision-making in important areas like acquisitions and takeovers.