SHAREHOLDER PRIMACY AND THE INTERESTS OF THE COMPANY: HOW ECONOMIC THOUGHT CAN BE TRANSFERRED TO LAW?

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ABSTRACT:

Economic reasoning has become so intrinsic to company law that it is getting harder to distinguish between legal and economical approaches in this field. Furthermore, in the scholarship of company law, it has become customary to combine comparative method and economic analysis of law. In this context, the contractual theory of corporations currently dominates economic analysis of corporate law. However, economic thought is not always clearly reflected in legal norms. A good example from corporate law field is the position of shareholders.

This article will therefore: (i) review the main arguments of contractual and agency theories of the corporation which support the shareholder primacy principle; (ii) analyse how this principle can be reflected in positive company law; and (iii) review to what extent the shareholder primacy principle is reflected by a legal concept of the interests of the company.

Keywords: Company law, law and economics, interests of the company, shareholder primacy

INTRODUCTION

In the scholarship of company law it has become traditional to combine comparative method and the economic analysis of law.[3] Some US scholars even imply that economics of corporate law is a synonym for corporate law jurisprudence itself.[4] In this context, the contractual theory of corporations currently dominates the economic analysis of corporate law. This theory explains the contractual origin of corporations and the enabling nature of corporate law norms. In addition, the theory incorporates economic agency theory and explains the superiority of shareholders' interests in corporate law, i.e. why company law norms (or 'the standard contract')[5] provide, or should provide, rules which primarily ensure the interests of the shareholders. According to some authors, the adoption of the shareholder primacy model is increasingly taken for granted in, *inter alia*, transition economies.[6]

However, economic thought is not always clearly reflected in legal norms. A good example from the field of corporate law is the role of shareholders. In most continental European jurisdictions, shareholders are viewed only as members of a particular company; while directors have fiduciary duties towards the company and so have no direct legal obligations towards shareholders. Economic theorists, on the other hand, claim that shareholders should be considered as principals, and directors (or managers) as their agents. Thus, managers would seem to have direct fiduciary duties towards the shareholders. Such a dichotomy in thought creates ambiguities and it is difficult to determine the line where economic arguments end and the legal position starts.

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[3] S. Grundmann, European company law: organization, finance and capital markets (2nd edn, Intersentia 2012) 41.

[4] B. Mcdonell and C Hill, 'Introduction: The evolution of the economic analysis of corporate law' in B. Mcdonell and C. Hill (eds) *Research Handbook on the Economics of Corporate Law* (Edward Elgar Publishing Limited 2012) 1.

[5] F. H. Easterbrook and D. R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 1–4.

[6] S. Deakin,'The coming transformation of shareholder value' (2005) 13(1) Journal of Corporate Governance and International Review 11.

Therefore, this article is aimed at shedding some light into such dichotomy by analysing the concept of the interests of the company.[7]

A CONTRACTARIAN APPROACH TO COMPANY LAW

The idea that contracts and companies (firms) are related was expressed in the transaction cost theory when Coase argued that long-term contracts are likely to create relationships that could be termed as 'firm'.[8] A similar idea was also expressed by Williamson, who stated that transaction cost theory 'poses the problem of economic organization as a problem of contracting'.[9] However, the origin of contractarianism is usually attributed to Alchian and Demsetz[10] and to Jensen and Meckling.[11]

According to Alchian and Demsetz, a firm is a 'contractual organization of inputs'[12] with a 'centralized contractual agent in a team productive process'.[13] This centralised contractual agent is not a firm but the residual claimant (shareholder) and is intended to monitor the inputs and outputs of other members of the team in order to prevent them from shirking. Following this line of thought, Jensen and Meckling formulated a definition of a 'firm' as a nexus of contracts.[14] Thus, a corporation is nothing more than a multitude of complex relationships, i.e. contracts between the legal fiction (the firm), the owners of the labour, material and capital inputs, and the consumers of output.[15] In this sense the 'behaviour' of the firm resembles the behaviour of a market, that is, the outcome of a complex equilibrium process.[16] Furthermore, a firm is an artificial creation and the emphasis should be on the conflicting objectives of corporate constituents. Thus, the idea of the interests of the company, from the economist's perspective, seems to be almost a meaningless concept.[17] However, this is not the case when one examines positive company law and related legal discourse on the interests of the company.[18]

While rejecting the concept of the interests of the company, contractarian theory embraces the shareholder primacy principle, which substitutes, or is equated to, the interests of the company. However, if a corporation is nothing more than economic contracts obtaining among various constituencies, why does company law establish (to a different degree in different jurisdictions), or should establish, rules which primarily ensure the interests of the shareholders? The contractual theory of the corporation provides several arguments why the shareholder primacy principle and the respective model of the corporation in certain jurisdictions is, and should be, dominant. One of the main normative grounds for this model is explained using agency theory, while other main arguments refer to, *inter alia*, the special

[7] For the purposes of this article, the terms 'the interests of the company' and 'the purpose of the company' will be used as synonyms.
[8] R.H. Coase, 'The Nature of the Firm' (1937) 4(16) Economica 392.
[9] O. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (The Free Press 1985) 20.
[10] A.A. Alchian and H. Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62(5) The American Economic Review 777.
[11] S. Learmount, 'Theorizing corporate governance: new organizational alternatives' (2003) 14(1) Journal of Interdisciplinary Economics 159; M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305.
[12] Alchian and Demsetz (n 10) 783.
[13] ibid 778.
[14] Jensen and Meckling (n 11) 311.
[15] ibid 310.
[16] ibid 311.
[17] Easterbrook and Fischel (n 5) 12.
[18] For example, A. Keay, 'Ascertaining the corporate objective: An entity maximisation and sustainability model' (2008) 71(5) The Modern Law Review 663.

status of shareholders (residual claimants), and incomplete contracts, as well as offering broader efficiency and welfare arguments.[19]

At the core of agency theory there are different and conflicting relations among various corporate constituents.[20] It should be noted that the term 'contract' in this context does not have the meaning attributed to it by law. Agency theory states that there are two main actors at any given time (although they can be treated differently depending on the situation): the principal and the agent. The principal in this relationship is the stronger party since he has the authority and power to appoint and direct the agent. The agent, on the other hand, performs all the tasks with the authority delegated to him in the best interests of the principal.[21] An important factor in this theory is the assumption that both the principal and the agent are rational utility maximisers.[22] Consequently, such reasoning leads to conclusion that the agent might favour his own agenda and not the interests of the principal.

Because the agent is considered to be a utility maximiser, agency theorists have assumed that the relationships between the principal and the agent are problematic because of their human nature as clearly shown by Jensen and Meckling.[23] Under such presumptions, the agent is likely to neglect the interests of the principal in order to pursue his own agenda.

Due to the nature of the agent to prefer his own interests over the interests of the principal, conflicts of interest arise. These conflicts of interest are a secondary, undesirable outcome of the agency relations that create the so-called agency costs.[24] If agency costs are low enough, the principal will engage in monitoring the agent and will direct him to act in the interests of the principal. However, if the agency costs are high, the principal is likely to choose not to control the agent and instead to allow the agent to act as he sees it fit.

Due to these agency theory assumptions – that shareholders are the principals and managers are the agents of the shareholders – coupled with the fact that, due to the opportunistic behaviour of agents, the principals might incur agency costs, it is concluded that managers should act mainly for the interests of shareholders.[25] This leads to the reasoning that managers should have duties towards shareholders.[26] This, in turn, should be reflected in the legal regime, which should provide rules that limit agency costs to the maximum extent possible, and should align the interests of managers with the interests of shareholders. Thus, it could be argued that shareholder primacy model lies at the heart of agency theory. Furthermore, economic agency theory can be used as a normative ground for legal intervention in order to protect the interests of the shareholders.

SHAREHOLDER PRIMACY AND POSITIVE LAW

It is challenging to establish in simple terms how the theoretical shareholder primacy principle is reflected in positive company law. First of all, the concept of shareholder primacy can mean different things for different authors. For example, it can mean:

[19] For an overview of arguments for and against shareholder primacy (including from the property rights theory of the corporation, etc.), see: A. Keay, 'Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?' (2010) 7(3) European Company and Financial Law Review 369.
[20] Jensen and Meckling (n 11) 308.
[21] A practical and illustrative example on the principal-agent relations is given by Posner. See: E. Posner, 'Agency Models in Law and Economics' (2000) University of Chicago Law School, John M. Olin Law and Economics Working Paper No. 92 <http://ssrn.com/abstract=204872> accessed 15 December 2015.
[22] Jensen and Meckling (n 11) 308.
[23] M.C. Jensen and W.H. Meckling, 'The Nature of Man' (1994) 7(2) Journal of Applied Corporate Finance 4.
[24] Agency costs in agency theory are defined as a sum of: '(1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, (3) the residual loss'. See, Jensen and Meckling, (n 11) 308.
[25] A. Shleifer and R.W. Vishny, 'Survey of Corporate Governance' (1997) 52(2) The Journal of Finance 737.
[26] Although from legal point of view, there are arguments against agency between managers and shareholders. See. Keay (n 19).

1. the model of the corporation reflected in the positive law of certain jurisdictions (for example, the USA[27] or other Anglo-Saxon jurisdictions);[28]
2. the standard shareholder-orientated normative model of the corporation;[29]
3. one of the corporate governance theories[30] (for example, which claims that the main control of the corporation is vested in shareholders as a class and the fiduciary duty of the management bodies is to maximise the wealth of the shareholders;[31] or which claims that the purpose of the company is the maximisation of shareholder wealth);[32]
4. part of the contractual theory of the corporation, which explains why company law mainly ensures, and should ensure, as a priority, the interests of the shareholders *vis-a-vis* other stakeholders;[33]
5. the cultural norms and other practices aside from company law as described by Deakin.[34]

Moreover, contractarian scholars usually do not extensively discuss which specific legal norms reflect the shareholder primacy model of the corporation.[35] Some authors stress the regulation of the fiduciary duties, while others use the purpose of the company as a criterion reflecting the legal shareholder primacy model.[36]

Perhaps one of most explicit shareholder models of the corporation is provided by H. Hansmann and R. Kraakman.[37] In these authors' opinion, if the jurisdiction in question does not establish co-determination rules for employees, or any other participation in corporate governance for other stakeholders, one of the main legal indicators of shareholder primacy model *vis-a-vis* other stakeholders (in the normal course of business[38]) could be the legal concept of the interests of the company. Of course, the single criterion of the interests of the company does not show the real power of shareholders in a particular corporate governance system, which also depends on such factors as concentration of ownership, corporate governance structure, and division of legal powers/competences between general shareholder meeting and other corporate bodies. Nevertheless, at a macro level, the legal concept of the interests of the company, in the authors' view, indicates a normative model of the corporation in a particular jurisdiction and serves as a guiding principle for the interpretation of various legal norms, for example, fiduciary duties, inquiry proceedings, or the validity of the transactions contradicting the purpose of the company. Thus, the meaning behind the interests of the company could have not only theoretical, but also practical implications.

The interests of the company can be formulated by legislature *expressis verbis* and can be further explained through the fiduciary duties of the management bodies (for example, by

[27] K. Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' (2011) 59 American Journal of Comparative Law 29.
[28] J. Boatright, 'Shareholder Model of Corporate Governance' in R. W. Kolb (ed) *Encyclopedia of Business Ethics and Society* (SAGE Publications Inc. 2008) 1903.
[29] H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 Georgetown Law Journal 440.
[30] Mcdonell and Hill (n 4) 7; S. Bainbridge, *The new corporate governance in theory and practice* (Oxford University Press 2008) 8.
[31] ibid 8–10.
[32] Keay (n 19); Keay (n 18).
[33] Easterbrook and Fischel (n 5) 37.
[34] See Deakin (n 6).
[35] For example, Easterbrook and Fischel only broadly discuss shareholder primacy as normative and positive principle reflected in US company law. See: Easterbrook and Fischel (n 5) 37.
[36] Bainbridge (n 30) 8–10; Keay (n 19).
[37] Hansmann and Kraakman (n 29).
[38] In the case of insolvency it is common that the interests of the creditors and their protection become dominant, and thus they are secured *vis-a-vis* shareholder interests by company law or bankruptcy law norms respectively. See: J. Armour, G. Hertig and H. Kanda, 'Transactions with Creditors' in R. Kraakman and others (eds) The Anatomy of Corporate Law: A Comparative and Functional Approach (2nd edn, Oxford University Press 2009) 115–151.

identifying persons to whom such fiduciary duties are owed), or through other legal norms.[39] Furthermore, the purpose of the company can be interpreted as either a specific purpose applicable only to a particular legal form (company) formulated by legislature or courts, or as specific objects, aims and goals established in the articles of association or other internal documents of the company (for example, the provision of IT services, or the protection of investors). The analysis provided in the next part of this article is based on the concept of the interests of the company formulated by the legislature and courts of one emerging economy – Lithuania.

THE CASE OF LITHUANIA

The meaning of the purpose of the company in Lithuanian company law can be revealed through systematic analysis of various legal sources, especially statutory acts and case law.

The Lithuanian Civil Code distinguishes between public and private legal entities.[40] The purpose of the private legal entity (i.e. the purpose of the company, which is considered a private legal person under Lithuanian law[41]) is to meet private interests.[42] Linguistic analysis of the purpose of the private company can be interpreted broadly – it can be taken as meaning any private purpose and not necessarily interests of the shareholders of a particular company. Nevertheless, systematic analysis of law and intentions of the legislature[43] suggest that the term 'private interests' mainly refers to shareholder value maximisation, which is achieved through profit-seeking. According to the commentary of the Civil Code, private interests should primarily be understood as shareholder profit.[44] Thus, even though the Civil Code does not specifically refer to shareholder value maximisation, this maximisation seems to be the intent of the Civil Code. This conclusion is also partially supported by the provisions of the Law on Companies stipulating that management bodies must act for the benefit of (i) the company and (ii) its shareholders.[45] In addition, according to the Civil Code, fiduciary duties as a general rule are owned to the company, but management bodies are also obliged to act reasonably and fairly towards the members of other bodies of the company.[46] Guidance regarding listed companies is also given by the Corporate Governance Code,[47] which is applicable based on the 'comply or explain principle'. According to the Corporate Governance Code, the overriding objective of a company should be to operate in the common interests of all the shareholders by optimising shareholder value over time.[48]

Most extensively, the concept of the interests of the company is being discussed by courts in cases related to the fiduciary duties of management bodies, inquiry proceedings of

[39] Under Lithuanian law, the purpose of the company (and other interchangeable terms such as the interests of the company, or benefits for the company) are used in several articles of the Lithuanian Civil Code (for example, 2.39 (Name of the legal person), 2.47 (Articles of association of the legal persons), 2.81 (Bodies of the legal person), 2.114 (Recognition of legal person as being illegally established), 2.115 (Mandatory sale of shares), 2.122 (Transfer of voting rights), 2.83 (Invalidity of *ultra vires* transactions), 2.87 (Duties of the members of the legal person's bodies), 2.124 (Inquiry proceedings) and of the Law on Companies, for example, Article 19(8)).

[40] Civil Code 2000, Article 2.34 (1).

[41] Law on Companies 2000, Article 2(2).

[42] Civil Code 2000, Article 2.34 (3).

[43] The legislature's intent is based on the commentary of the Civil Code, which was written to a great extent by the scholars who drafted the Civil Code.

[44] V. Mikelėnas, G. Bartkus, V. Mizaras and Š. Keserauskas, *Lietuvos Respublikos Civilinio kodekso komentaras*. *Antroji knyga. Asmenys* (Justitia 2002) 97–99, 119.

[45] Law on Companies 2000, Article 19(8).

[46] Civil Code 2000, Article 2.87.

[47] Lithuanian Securities Exchange Commission and NASDAQ OMX Vilnius stock exchange. *The Corporate Governance Code for the Companies Listed on NASDAQ OMX Vilnius stock exchange, 2010*. Available online at: <http://www.nasdaqomxbaltic.com/files/vilnius/teisesaktai/The%20Corporate%20Governance%20Code%20for%20the%20Companies%20Listed%20on%20NASDAQ%20OMX%20Vilnius.pdf>, Principle 1.

[48] ibid 6. The role of other stakeholders and their interests seems to be limited to respecting their rights and interests established in law (ibid, principle 9).

the company and the validity of the transactions entered against the purposes of the company. Some of the most significant cases are analysed below.

Analysis of case law regarding fiduciary duties mainly reveals that the interests of shareholders (in the ordinary course of business) or the interests of creditors (in case of insolvency of the company) are taken into account when explaining the content of the interests of the company. In a case dealing with the duty of loyalty of members of the management body, the Supreme Court ruled that if management bodies strive to satisfy the interests of only one particular shareholder, this might be considered a violation of the duty of loyalty owned to the company.[49] Thus, in the authors' view, the Supreme Court indirectly upheld the position that acting in the interests of the company should mean acting in the interests of the shareholders *in corpore* (the shareholders as a class) and not in the interests of one shareholder (despite the fact that such a shareholder might be the majority owner of the shares). The Supreme Court analysed the profit maximisation rule as a requirement applicable to the company. The court stated that unprofitable transactions executed by management bodies of the company might reduce the value of the shares, and thus might violate the pecuniary rights of shareholders.[50]

However, the court's position and interpretation of the interests of the company is based on the status of the company. The more financial distress the company faces, the more the interests of other corporate constituents are discussed in the court's reasoning. The interests of the creditors are considered especially when a company faces insolvency proceedings. In several cases where the interests of creditors were at stake, the Supreme Court indicated that management bodies have to act for the interests of the company, and that these interests do not always coincide with the interests of shareholders.[51] This also means that members of the management bodies do not have any fiduciary duties to the creditors of the company in the ordinary course of business,[52] during which the main duty of the management bodies is to satisfy the interests of the shareholders.[53] However, in the event of insolvency, the interests of the creditors prevail.[54]

The interests of the company are also reflected in cases dealing with *ultra vires* transactions, where courts analyse such terms as 'profit maximisation', 'profit seeking' or 'not causing harm'. Under Lithuanian law, *ultra vires* transactions are transactions entered into by the management bodies of the company which contradict the purpose and aims of the company stipulated in the articles of association.[55]

There are various explanations of the interests of the company provided by courts in this context. However, the Lithuanian Supreme Court's overall rhetoric has changed over time to a less strict interpretation of the profit-seeking purpose of the company. For example, some time ago the Supreme Court noted that the company is a profit-seeking legal entity which has the purpose of receiving the maximum profit possible.[56] Thus, a duty to maximise – and not just to receive – profit, or not to cause harm, was introduced by the Court. In another similar case, the Supreme Court also established that even though profit-seeking as a purpose of the

[49] *AB „Klaipėdos Smeltė" v UAB „Birių krovinių terminalas"*, D. B. and R. M. [2008] No. 3K-3-73/2008 (Supreme Court of Lithuania).
[50] Ibid.
[51] *BUAB „Barklita" v G. B. and J. G.* [2009] No. 3K-3-528/2009 (Supreme Court of Lithuania); *BUAB „Panevėžio balsas" v UAB „Eksena"* [2009] No. 3K-3-244/2009 (Supreme Court of Lithuania).
[52] *„Panevėžio spaustuvė" v R. Š. , A. B. , A. G.* [2012] No. 3K-3-19/2012 (Supreme Court of Lithuania). „Klaipėdos Smeltė" *v* L. A. [2013] No. 3K-3-290/2013 (Supreme Court of Lithuania).
[53] ibid.
[54] ibid. *BUAB "LRG farmacija"* v D. B., K. B., L. K., M. V. ir G. A. [2013] No. 3K-3-234/2013 (Supreme Court of Lithuania).
[55] Civil Code 2000, Article 1.82.
[56] *BAB "Statūna" v UAB "Parama", UAB "Deklitas", J. S., J. Ž., P. R., D. R., S. R* [2004] No. 3K-3-263/2004 (Supreme Court of Lithuania). The Court ruled that a transaction is against the interests of the company if it is concluded with parties closely related to the members of the management body without obtaining prior approval from the general meeting of shareholders, as required under the law and articles of association, and for a price significantly lower than the market value.

company is not established in the articles of association, it is nevertheless the purpose of a private company and the foundation of its existence.[57]

However, in several later cases, the Supreme Court discussed only profit-seeking and not the maximisation of profit. For example, the court indicated that the sale of a property for a price significantly lower than the market price runs counter to the purposes of a private legal entity, i.e. to seek profit.[58] Likewise, excessively risky and unprofitable transactions might be recognised as contradicting the purpose of the corporation.[59] Moreover, in a more recent case, the Supreme Court expanded its interpretation by explaining that the general purpose of a private company is to satisfy private interests, and that profit-seeking is one of the means of achieving this purpose.[60] The court pointed out that unprofitable transactions cannot *per se* be a legitimate ground for invalidating a particular transaction, unless it is obviously harmful for a company and such harm cannot be rectified by other means (for example, through the personal liability of the managers). However, in light of the circumstances of the case, it seems that the purpose of such reasoning was mainly to stress the importance of the *favour contractus* principle and to limit the possibilities of the shareholders to dispute unprofitable transactions (such a claim is considered an *ultima ratio* remedy).

CONCLUSION

The legal concept of the interests of the company is one of the main indicators of the economic shareholder primacy approach. The concept can be used to link economic and legal thought in order to enrich interdisciplinary research in the field of company law.

Although various approaches regarding the purpose of the company exist, mainstream economic theories, including the nexus of contracts and agency theory, support arguments that the interests of shareholders should be dominant. In this regard, these theories correlate with positive law in any given jurisdiction, which means that such theories are either endorsed or rejected. Such a correlation may even occur without direct reference to a particular economic theory. However, a common ground for discussion between legal and economic scholars is required and such ground could be the concept of 'the interests of the company'.

As legal and economic approaches tend to use different jargon, in the authors' opinion, the legal concept of the interests of the company is one of the main indicators of the economic shareholder primacy approach. Analysis of legal rules and the case law of one of the emerging market countries – Lithuania – has revealed that the interpretation of the purpose of the company strongly supports the shareholder primacy model.

[57] *Akcinė bendrovė „Aksa" v R. M., UAB „Azovlitas"* [2006] No. 3K-3-312/2006 (Supreme Court of Lithuania). The Court ruled that a transaction for a price significantly lower than the market value runs counter to the purpose of the company, i.e. to pursue profit.

[58] BUAB „Artrio-2" v UAB DnB Nord lizingas, UAB „Lengvasvėjas", UAB „Vėjoratai" [2008] No. 3K-3-262/2008 (Supreme Court of Lithuania).

[59] UAB „Profsąjungų autoūkis" and kt. v Lietuvos profesinių sąjungų konfederacija, and others [2008] No. 3K-3-287/2008 (Supreme Court of Lithuania)..

[60] *BUAB „Balmeto Medis" v AB „Simega"* [2011] No. 3K-3-511/2011 (Supreme Court of Lithuania). In this case, the bankruptcy administrator of the insolvent company UAB "Balmeto Medis" disputed transactions concluded by the company as (*inter alia*) being against the aims and purposes of the company.