

34-AB46-4336

SHAREHOLDER PRIMACY AND CORPORATE GOVERNANCE: A UK PERSPECTIVE

MR. ANURAG VIJAY¹ AND NIDHI SINGH²

ABSTRACT

Corporate governance is the system by which companies are directed and controlled. Broadly, corporate governance can be categorised into two major systems: (a) the Anglo-American “outsider” system represented by the United Kingdom and America, and the Continental “insider” system exemplified by Germany and Japan. The recent decade has seen advancements in technology, production and growth in trade. With the increase in international trade, a need has been felt for better corporate governance. In the 1990s, Europe witnessed a greater rhetoric of Anglo-American shareholder primacy as a result of the superiority of the Anglo-American regime. This in turn also affirmed the belief of many scholars that the Anglo-American corporate governance system featuring shareholder primacy would become the formulation of best corporate governance practices. This belief was challenged after a series of scandals in the new millennium revived the “stakeholder” argument.

The stakeholderism perspective is palpable in the growing shareholding concentration and stakeholder-related information disclosure under the Anglo-American corporate governance practice. However, there has been a persistent debate in the UK over whether shareholder primacy should continue to take precedence. It appears the UK has taken a *third way that merges elements of the shareholder and stakeholder approaches*. For example, many stakeholder proponents have considered the Enlightened Shareholder Value (ESV) principle under the UK legislation as a sign that the UK is departing from the shareholder-orientated pattern.

Interestingly, many also believe that the financial crisis was attributable to the overriding shareholder primacy paradigm. In light of the recent developments in the field of global corporate governance practices, the paper seeks to contribute to the recurring theme of the objective of the corporation by exploring the origins, recent changes and future developments of the corporate objective (more specifically, shareholder primacy) in the UK context. In doing so, we will conduct a study of the characteristics of UK shareholder-orientated rules and recent changes in the field that have impacted the governance structure of companies. The paper aims to give a critical account of the practices reflecting shareholder primacy in the UK in the wake of the financial crisis. The paper also explores the factors that have motivated the UK’s corporate governance regime to move in a stakeholder direction.

The reason for the uniqueness of the UK’s corporate governance is that it is on the boundary of the two models. A drift from the Anglo-American shareholder-orientated regime calls for an examination of UK corporate governance, which is one of the underlying objectives of this paper.

Key Words: Shareholder primacy, UK corporate governance, financial crisis, Anglo-American system, corporate governance.

INTRODUCTION

“Corporate Governance has only recently emerged as a discipline in its own right although the strands of political economy it embraces stretch back through centuries” (World Bank, 1999).

¹ Advocaet Delhi High Court, Law Centre II, University of Delhi.

² Nidhi Singh, Co-founder & Partner, BlackPearl Chambers, MSc Law and Finance, University of Oxford, United Kingdom.

The term “corporate governance” emerged in the late 1970s in the United States of America after the Watergate scandal to describe the objective of controlling the corrupt overseas behaviour of big companies. Corporate governance has emerged as an independent discipline owing to the surge in hostile takeovers and corporate collapses (Tricker, 2012). There are two models of corporate governance: the Anglo-American model (the United States and the United Kingdom) and the continental model (Germany and Japan). Both models are characterised by their distinct ownership patterns, managerial strategies and structural elements (Aguilera, 2007). While distinguishing between these models, it is important to look into the diverse understandings of the purposes of a corporation. Corporations that operate in Anglo-American countries generally apply the shareholder value paradigm and recognise the maximisation of shareholders’ wealth as their fundamental corporate objective, whereas countries that have adopted the continental approach tend to focus more on the stakeholders, including employees, creditors, suppliers, customers, local communities and the environment (Wen, 2015). Corporate governance norms are critical for realising the macro-economic and social goals in an economy, and usually embrace both the internal governing structures of a corporation and the external forces affecting corporate practice (Cadbury, 2000). If we examine the concept of corporate governance from the perspective of the purpose of a corporation, the shareholder value orientation principle honoured by Anglo-American jurisdiction requires a company to maximise the interests of its shareholders ahead of any other interested party who might have claims against the company (Keay, 2004). As Shuangge Wen writes, corporate governance in the countries led by the United Kingdom is arranged to focus on “dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer and Vishny, 1997). In contrast, the principal objective of corporate governance in continental systems, exemplified by countries like Germany, is “to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)” (German Government Commission, 2010). The evolution of corporate governance in the United Kingdom has been premised on the shareholder-orientated pattern. The Cadbury Report, mentioned above, emphasised the shareholder primacy principle. The 1998 Hampel Report followed a similar line of thought and clarified that the single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment (Wen, 2015). The interests of non-shareholder constituencies are incorporated in the UK company law regime, but only as a means of achieving the maximisation of shareholder wealth.

WHAT IS SHAREHOLDER PRIMACY?

The shareholder primacy perspective states that the overriding goal of the corporation is to maximise shareholder value. To understand this idea that a corporation’s sole reason for existence is to make money for its shareholders, it will be relevant to look at the debate between two eminent academics published in the Harvard Law Review in 1932. Professor Berle argued that all powers granted to a corporation or to the management of a corporation are at all times exercisable only for the rateable benefit of all the shareholders as their interest appears (Berle, 1931). This view was supported by Professor Milton Friedman, who argued that “there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits” (Friedman, 1970).

Professor Merrick Dodd challenged Berle’s shareholder primacy thesis. He argued for “a view of the business corporation as an economic institution which has a social service as well as a profit-making function” (Dodd, 1932). Economists usually favour shareholder primacy, viewing it as the key to the capital system, and this view is deeply entrenched in markets worldwide, including in the United Kingdom (Governance Institute, 2014).

THE UK SHAREHOLDER-ORIENTATED CORPORATE GOVERNANCE MECHANISM

Certain essential components exist within the UK corporate governance framework, which can be said to be premised on the shareholder-orientated pattern. The UK follows the Anglo-American model and has a well-developed market-based system linked to the shareholder value paradigm. Some of the notable characteristics of the market-based economy in the UK include diffused shareholdings, liquidity equity trade, mature equity and security markets and stringent disclosure rules to efficiently inform the market (Hall and Soskice, 2001). It is very obvious to measure the corporate performance under the parameter of maximisation of shareholders' profits: earnings per share and returns on equity capital. As Shuangge Wen also writes, market control via equity is regarded as a fundamental governance means in the UK that facilitates its shareholder-orientated corporate governance practice.

A dispersed share ownership structure has been observed in the UK, with shares widely distributed between among individuals and investment institutions. The average of large shareholdings in the Anglo-American countries is also significantly lower than in continental-based countries. The UK has a significantly lower average shareholding than Germany. This diffused ownership has rendered shareholders passive in corporate governance; they tend to exercise their power via the "exit" choice and leave market forces. To ensure the interests of the shareholders, the ideology of shareholder value orientation has been established, given the relatively weaker shareholder control in the UK.

THE PREDOMINANCE OF SHAREHOLDER PRIMACY IN THE UK

Prior to the introduction of the Enlightened Shareholder Value (ESV) principle in 2006, UK corporate law comprised both common law and statutory provisions and was significantly characterised by the principle of shareholder value orientation, manifested in a variety of ways. The common law exhibited the paramount significance of shareholders' interests, palpable in the common law construction of directors' duty and the confined regard for the interests of non-shareholder constituencies within the realisation of shareholder primacy in the company law context (Wen, 2015).

Directors' fiduciary duty

As discussed by Shuangge Wen in her book on shareholder primacy, the common law is broadly understood to be shareholder-orientated, particularly in the formulation of the loyalty duty of directors (Davies, 2008). The principle of *cestui que trust* states that, although in principle a director only owes his duty to the company, it is widely accepted that a fiduciary director's inherent discretion to act in a way that he believes to be in the best interests of his shareholders is intrinsic to his power (*Boulting v. Association of Cinematography, Television and Allied Technicians* (1963)³). The English jurisprudence does suggest that the stakeholder consideration of directors has traditionally been expected, but the approach of the courts tells us that they have been prepared to support the consideration of stakeholders' interests only on the grounds that such a stakeholder consideration would be subordinate to and ultimately serve the interests of shareholders. This means that the interests of the stakeholders will be only taken into account if this course of action ultimately benefits the shareholders. For example, Bowen LJ in the case of *Hutton v. West Cork Railway Co.* explicitly confirmed the importance of employee consideration. Acting on behalf of their interests in corporate operations was strictly qualified: the only circumstances in which the directors might legitimately promote the interest of any other groups or entities were those where to do so ultimately advanced the interests of the shareholders.

³ (1963) 2 QB 606.

Protection of the interests of non-shareholder groups in UK company law

As already mentioned, UK companies are managed for the ultimate interest of the shareholders. However, before the introduction of the ESV principle in the Companies Act 2006, in which directors' consideration of various stakeholders' interests is stated as a part of their statutory duty, only two non-shareholder groups' interests (the interests of creditors and employees) were specified in the UK company law regime for directors' consideration and prescribed in such a manner that shareholders' paramount interests would not be infringed (Wen, 2010). Earlier, the statutory protection for the creditors' interests had mainly been provided for in two legal instruments: the Companies Disqualification Act 1986 and the Insolvency Act 1986, both concerned with the performance of delinquent directors in a company approaching insolvency. Under the Companies Disqualification Act 1986, a director could be disqualified if his conduct as a director of an insolvent company made him unfit to be concerned in the management of a company, for instance, by trading to the detriment of creditors' interests (Farrar, 1998).

Traditionally, in English Law, directors owe no duty to any individual member of the company or any other corporate constituencies, including creditors. As stipulated by Dillon LJ, *"A company as it seems to me, likewise owes no duty of care to future creditors. The directors indeed stand in a fiduciary relationship to the company and they owe fiduciary duties to the company though not to the creditors, present or future or to individual shareholders."* Under the premise of shareholder value orientation, there is a high risk that directors might be held to be in breach of their fiduciary duty if they act for the benefit of creditors' interests instead of those of shareholders. This was succinctly stated by Buckley LJ in *Re Horseley and Weight Ltd*: *"It is a misapprehension to suppose that the directors of a company owe a duty to the companies' creditors to keep the contributed capital of the company intact"* (Wen, 2015; Riley, 1989). However, one can see the utility of creditors' interests being taken into account by directors in appropriate circumstances, such as in situations of actual or imminent corporate solvency.

Company law protection for employees before the 2006 framework

Before 2006, the interests of employees in the UK were mainly protected under the Employment Rights Act 1996 (ERA 1996) and the Employment Regulations Act 1999 (ERA 1999). The first company statute to acknowledge the interest of employees was the Companies Act 1985, which stated that *"the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general as well as the interests of its members"* (Companies Act 1985, s. 309). Two implementing methods were proposed for employee consideration pursuant to s. 309 of the CA 1985. One was based on the stakeholder argument, and suggested a balancing of employee and shareholder interests, including recognition that shareholders' interests could be overridden by employees' interests where appropriate. The other, in stark contrast, suggested that the consideration of employees' interests should be subordinate to the consideration of shareholders' interests. Shuangge Wen has shown that, since its introduction, there has been no judicial decision demonstrating its positive impact in terms of employee protection. If directors chose to act in the interests of employees rather than in the interests of shareholders, they could be held liable for not acting in good faith to promote the success of the company for the benefit of its members (Birds, 2007). The effectiveness and implications of s. 309 were spotlighted by a company law review in 1999. In the view of CLRSG, the interpretation of s.309 as entitling directors to prefer employees' interests over those of shareholders threatened shareholder primary – the cornerstone of company law – and thus was not feasible in the UK context (French, 2007). To avoid any confusion, this section was repealed by the Companies Act 2006 and the consideration of employee's interests is now explicitly confined to situations when such a consideration would be beneficial to the collective interests of shareholders (Companies Act 2006. s. 172(1)).

The Government's White Paper, which had set the tone for CA 2006, stated that "shareholders are the lifeblood of a company, whatever its size". The pre-2006 company law had suggested the inclusion of stakeholder-friendly attributes within the confines of shareholder primacy. This common law path of "*inclusive shareholder value*" was substantiated into the 2006 regime, and it still directs today's practice.

STAKEHOLDER DIRECTION IN UK CORPORATE GOVERNANCE

As the academics have argued, the stakeholder school of thought has presented both theoretical and practical difficulties. Although British law makers have taken the importance of this model into consideration, the stakeholder model has been perceived as losing out to shareholder primacy in the UK company law reform process. This is because of the given flaws of the stakeholder model and its incompatibility within the UK context. However, it might be of interest to look at the degree of stakeholder consideration within shareholder primacy. In fact, the introduction of the Enlightened Shareholder Value (ESV) principle in CA 2006 has pushed the UK in the stakeholder direction.

The basic rules of UK company law were laid down 150 years ago, and the courts have since been insisting on long-term attributes of corporate conduct in line with most stakeholders' interests. It should be made clear that, while emphasising the interests of shareholders, it does not necessarily imply short-term gains, but broadly embraces the benefits that may accrue to "*the shareholders present and future*". This in no way implicates the interests of shareholders at a particular point of time in the future, but extends to cover the collective interests of shareholders over time (Ferran, 1999). As Shuangge Wen also argues, the logic lies in that the goal of long-term shareholder value can only be successfully pursued by developing sustaining relationships with stakeholders (Miles, 2012). Cases like *Hutton v. West Cork Railway Co.* and *Parke v. Daily News Ltd.* support the promotion of stakeholders' interests under the rubric of shareholder primacy (Wen, 2015). When the CLRSG observed "*we do not accept that there is anything in the present law of directors' duties which requires them to take an unduly narrow or short-term view of their functions. Indeed they are obliged honestly to take account of all the considerations which contribute to the success of the enterprise*", it was logically inferring that shareholder value maximisation in UK company law was in keeping with, rather than in conflict with, the interests of stakeholders and wider interests such as the environment and local community, insofar as such considerations are relevant to the maximisation of shareholders' interests (Armour, 2009).

RECENT CHANGES IN UK COMPANY LAW AND CORPORATE GOVERNANCE

The UK has recently been cited as a pioneer in drifting from the shareholder-orientated position towards the continental direction. There have been two significant changes in the landscape of company law and corporate governance in the UK: the introduction of the ESV principle, and the increase in the practice of responsible ownership. Both these changes can be attributed to the integration of stakeholder considerations into the narrowly defined objective of shareholder value. Under the newly enacted Companies Act, 2006, the fresh objective of the company was set out in the new Companies Act as the ESV approach also stipulated in s. 172(1). Stakeholder consideration by directors is now explicitly emphasised, interpreted as a conscious effort to enhance the long-term interests of the company and its members. The recently enacted Companies Act of 2006 is one of the largest piece of legislation ever enacted in the British history. The ESV principle was included in the Act with the intention of bringing about a clear corporate objective for UK directors to aim for in corporate governance, in particular to promote "*a cultural change in which companies conduct their business*". S. 172(1) reads:

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.

This section suggests the way a director should operate while running a company. The director should take into account the non-shareholder groups' interests if they are to discharge their general duty under S. 172(1). For the first time in the history of UK law, a wider range of interests additional to those of shareholders (particularly in respect to the long-term well-being of the corporation) has been statutorily recognised. Further, the wording "*promoting the success of the company for the benefit of its members as a whole*" suggests that the stakeholder consideration and the long-term concern required by this provision have the aim of maximising shareholders' benefits. The explicit recognition of non-shareholder groups' interests in s. 172(1) seems to have the ultimate objective of maximising the wealth of the shareholders. This particular provision has been debated by academics. Some have argued that the shift towards the ESV principle is a testimony to the erosion of the Anglo-American shareholder value. However, some have argued in contrast that the newly enacted statutory directors' duty offers little to non-shareholder interest groups over the traditional common law, and that the shareholder perspective remains intact under the new ESV approach (Birds, 2007).

The ESV approach, however, preserves rather than adjusts the overriding objective of UK corporations: the pursuit of shareholder primacy. The enlightened shareholder value approach does not depend on any change in the ultimate objective of companies: shareholder wealth maximisation (CLRSG, 2009).

CONCLUSION

This paper has asked a deceptively simple question: whose interests should corporations serve? It has thrown light on the existing debate between shareholder value maximisation and stakeholder consideration. It has explored the genesis, recent changes and development of the corporate objective in the UK, i.e. shareholder value maximisation. The first part of the paper has thrown light on the rationale and scope of shareholder primacy in the UK while also discussing the different schools of thought. Some of the essential elements of the UK corporate governance framework are shareholder orientated, for example the market-orientated economy and the strong reliance on takeovers. In the current scenario, a focus on the maximisation of shareholder returns is still considered to be the best possible means by which corporate law can be used as a tool to advance social welfare. The second half of the paper discussed the recent change in UK corporate law: the introduction of the ESV principle. If we look into the pre-2006 common law heritage regarding the scope of the shareholder primacy principle and the current ESV principle enshrined in s. 172 (1) of CA 2006, both suggest that the codified approach is in keeping with, rather than in conflict with, the traditional common law understanding of shareholder primacy (Wen, 2015). It can be deduced that the new statutory formulation rejects the stakeholder approach and has reaffirmed the accommodating and inclusive nature of shareholder primacy in the UK. However, the significance of the stakeholder consideration in corporate governance, and the increasing Anglo-American awareness of the long-term effects of corporate conduct, cannot be denied. Recent legal and policy changes in keeping with the traditional common law framework make explicit the inclusive nature of shareholder value rather than threatening its primacy (Wen, 2015). The welfare priority of shareholders will always remain sacrosanct in the corporate governance

framework. The post-financial crisis scenario has witnessed intensified calls for directors to be more pro-active and accountable in future corporate governance across the Anglo-American regime. Even in the near future, an emphasis on stakeholder consideration in the context of promoting member benefit is likely to remain. The shareholder value is deeply ingrained in the UK both in theory and case law practice. As discussed above, some of the essential characteristics of the UK corporate governance system (dispersed ownership, ultimate shareholder decision rights and a liquid market) are all necessary concomitants to attain the objective of maximising shareholder wealth. It will be difficult to change the duties of directors and introduce additional rights to redress in favour of a particular class of stakeholders, as this does not seem to be a viable framework in the UK context. As also stipulated by Lord Goldsmith, “*We want the director to give such consideration to the (stakeholder-related) factors identified as is necessary for the decision that he has to take, and no more than that*” (Hansard HL, 2006).

REFERENCES

- Aguilera, R. et al. (2007) Putting the S Back in Corporate Social Responsibility. *Academy of Management Review*, 32(3), 836-863.
- Armour, J., Hansmann, H. and Kraakman, R. (2009) What is Corporate Law? In: R. Kraakman et al. (eds.). *The Anatomy of Corporate Law: A Comparative and Functional Approach*. 2nd ed., Oxford: Oxford University Press, 1-34.
- Berle, A. (1931) Corporate Powers as Powers in Trust. *Harvard Law Review*, 44(7), 1049.
- Birds, J. (2007) The Companies Act 2006: Revolution or Evolution? *Managerial Law*, 49(1/2), 13-15.
- Birds, J. et al. (2014) *Boyle and Birds Company Law*. 9th ed., Jordan: Jordan Publishing.
- Cadbury, A. (2000) Foreword. In: M. R. Iskander and N. Chamlou (ed.). *Corporate Governance: A Framework for implementation*. Washington, D.C.: The World Bank Group
- CLRS (2009) *Modern Company Law for a Competitive Economy: The Strategic Framework*. [Online]. Developing the Framework, URN 000/656. Available from: <http://webarchive.nationalarchives.gov.uk/20121029131934/http://www.berr.gov.uk/whatawedo/businesslaw/co-act-2006/clr-review/page25086.html> [Accessed 2 April 2017].
- Davies, P., Worthington, S. and Micheler, E. (2008) *Gower and Davies: Principles of Modern Company Law*. 8th ed., London: Sweet and Maxwell.
- Dodd, E.M. (1932) For Whom Are Corporate Manager Trustees? *Harvard Law Review*, 45(7), 1145, 1148.
- Farrar, J. and Hannigan, B. (1998) *Farrar's Company Law*. 4th ed., London: Butterworths.
- Ferran, E. (1999) *Company Law and Corporate Finance*. Oxford: Oxford University Press.
- French, D., Mayson, S. and Ryan, C. (2007) *Mayson, French and Ryan on Company Law*. 24th ed., Oxford: Oxford University Press.
- Friedman, M. (1970) The Social Responsibility of Business is to Increase its Profits. *New York Times*, 13 September.
- German Government Commission (2010) *German Corporate Governance Code* (amended 26 May 2010).
- Governance Institute of Australia (2014) Shareholder Primacy: Is there a need for change? [Online]. A Discussion Paper. Available from: file:///C:/Users/FLE%20Learning%20UK/Downloads/govinst_shareholder_primacy_disc_paper_feb2017_web.pdf [Accessed 2 April 2017].
- Hall, P. and Soskice, D. (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press.

- Iskander, M. R. and Chamlou, N. (ed.). *Corporate Governance: A Framework for implementation*. Washington, D.C.: The World Bank Group
- Keay, A. (2004) Tackling the Issue of the Corporate Objective. *Sydney Law Review*, 29, 577-612.
- Miles, L. (2012) A Philosophical Basis for the Enlightened Shareholder Value Approach. *Company Law Newsletter*, 308, 1.
- Riley, C. (1989) Directors' Duties and the Interests of Creditors. *Company Lawyer*, 10, 87.
- Shleifer and Vishny, R. (1997) A Survey of Corporate Governance. *The Journal of Finance*, 52(2), 737-783.
- Tricker, B. (2012) *Corporate Governance: Principles, Policies and Practices*. 2nd ed., Oxford: Oxford University Press.
- Wen, S. (2013) *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Directions*. Abingdon: Routledge.