SHAREHOLDER PRIMACY AND THE ADVENT OF ENLIGHTENED SHAREHOLDER VALUE IN THE REFORM OF DIRECTORS' DUTIES IN THE UNITED KINGDOM.

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I Introduction

The role and work of directors in managing their companies is a critical aspect of corporate law. One element of this role, and which has been the subject of robust debate for many years, is : for whom are they to manage the company? While this debate has been at its hottest in the United States, spawning a voluminous amount of impressive scholarly pieces, in recent years there has been greater consideration of the issue in the United Kingdom and in other common law jurisdictions, such as Australia. It is trite law that a director owes a duty to act bona fide in the best interests of the company in which he or she is involved.[1] But it has been a vexed question as to what is meant by "the interests of the company." The conventional view is that this means that the director must act in the best interests of the company's shareholders, present and future.[2] This view has often been taken-for-granted[3] and is articulated by most texts and commentaries[4] as well as being endorsed by the British Takeover Code.[5] The following exemplifies the position stated in much of the literature : "The modern conceptualisation of the corporation states that the shareholders…are entitled to assume that the company will be run in their interests."[6] The approach to which the quotation refers is often known variously as the shareholder primacy principle (or paradigm), shareholder value principle or the

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1 If authority is needed, see *Percival v Wright* [1902] 2 Ch 421; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258. In the United States of America, see, for example, *United States v Byrum* (1972) 408 US 125 (US Supreme Court), in New Zealand, see *Nicholson v Permakraft (NZ) Ltd* ((1985) 3 ACLC 453 (Court of Appeal), and in Australia, see *Grove v Flavel* (1986) 11 ACLR 161 (Full Court of the Supreme Court of South Australia).

2 The case that is often cited is *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, but it is arguable whether it does in fact stand for this approach. The case is considered later.

3 P. Ireland, "Property and contract in contemporary corporate theory" (2003) 23 LS 453 at 456.

4 Lord Wedderburn, 'The Legal Development of Corporate Responsibility' in K. Hopt and G. Teubner (eds), *Corporate Governance and Directors' Liabilities* (Berlin, Walter de Gruyter, 1985), 1 at 5; L S Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 *Monash University Law Review* 164 at 173, B. Hannigan, *Company Law*, London, LexisNexis, 2003 at 203; P. Davies, *Gower and Davies' Principles of Modern Company Law*, 7th ed, London, Sweet and Maxwell, 2003 at 372; H. Hirt, "The Company's Decision to Litigate Against its Directors : Legal Strategies to Deal with the Board of Directors' Conflict of Interest" [2005] JBL 159 at 164-165. The view was made more (in)famous by the comments of the Noble laureate economist, Milton Friedman, in "The Social Responsibility of Business is to Increase its Profits" New York Times, September 13, 1970, Section 6 (Magazine).

5 S. Deakin and G. Slinger, "Hostile Takeovers, Corporate Law and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124.

6 L. Roach, "The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection : Expanding the Pluralist Approach" (2001) 22 Co Law 9 at 9.

shareholder wealth maximisation norm.[7] It requires, inter alia, a company to be run in such a way as to maximise the interests of the shareholders ahead of any other interested parties who might have claims against the company.[8] The objective of the company is, under this principle, to maximise market value of the company "through allocative, productive and dynamic efficiency."[9] Generally the principle is said to be embraced by most scholars[10] and applies in the United Kingdom, the United States and in many other common law jurisdictions, such as Australia[11] and Canada.

The approach that should be adopted by directors in the UK was considered in recent years by the Company Law Review Steering Group (CLRSG), appointed in 1998 by the Department of Trade and Industry to undertake a comprehensive review of company law. It was of the view that shareholder primacy prevailed in the UK, but finally came to the conclusion that what it termed, "an enlightened shareholder value approach," should prevail in the future. This recommendation was accepted by the Government in two White Papers, in July 2002 and March 2005 and it found its way into the Company Law Reform Bill, introduced into the House of Lords on 1 November 2005.

The purpose of this paper is to examine the theoretical basis of the shareholder primacy principle, and in light of that examination, to assess the enlightened shareholder value concept as proposed by the CSRLG and encapsulated in the July 2002 and March 2005 White Papers and the Company Law Reform Bill, and to ascertain how different this concept is compared to shareholder primacy. The paper also aims to consider the application of the enlightened shareholder value concept if and when it becomes part of companies legislation in the UK.

The paper begins with an examination of the rationale for the shareholder primacy principle and the debate that has raged, principally in the United States, concerning the normative quality of the principle. Following this there is an examination of the positive law and then a particular focus on the UK case law that has considered the meaning of "the interests of the company." Next, the paper considers the enlightened shareholder value approach sanctioned by the CLRSG in its reports, and by the Government in its White Papers and the Company Law Reform Bill. Following this,

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[7] S. Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm : A Reply to Professor Green" (1993) 50 *Washington and Lee Law Review* 1423; M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) U Pa L Rev 2063; W. Allen, J. Jacobs and L Strine, "The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide" (2002) 69 U Chi L Rev 1067 at 1075; S. Bainbridge, "Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547 at 549, 552, 565. The Company Law Review Steering Group in the UK did in fact refer to the principle simply as "shareholder value" (Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at paras 5.1.12ff.

[8] Some would also see the principle as representing the idea that the shareholders are the ones who have ultimate control of a company.

[9] C. Mayer, "Corporate Governance, Competition and Performance" (1997) 24 *Journal of Law and Society* 152 at 155.

[10] H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439 at 440-441.

[11] See, R. Mitchell, A.O'Donnell and I.Ramsay, "Shareholder Value and Employee Interests : Intersections Between Corporate Governance, Corporate Law and Labour Law" a research report for the Centre for Corporate Law and Securities Regulation and the Centre for Employment and Labour Relations Law, 2005.

the CLRSG proposals and the provisions in the White Papers and the Company Law Reform Bill that cover the implementation of the enlightened shareholder value approach are evaluated in the context of assessing the application of this approach in future legislation. The final part consists of some concluding remarks.

II Theoretical Foundations of Shareholder Primacy

A. The Background

Shareholder primacy has been largely fostered as a leading principle of corporate law by the contractarian school in the US.[12] It was in the US in the early 1930s that we find the genesis of the debate concerning the objective of a company. It all really started in earnest with the debates between Professors Adolf Berle and E Merrick Dodd, and carried out in the literature published at the time.[13] Without going into great detail, Berle maintained, inter alia, that directors should not, as managers of companies, have any responsibilities other than to the shareholders of their companies, for whom money was to be made.[14] On the other hand, Dodd held that the public saw companies as economic institutions that have a social service role to play as well as making profits for shareholders, and that companies had responsibilities to the company's shareholders, employees, customers, and to the general public.[15] While the former conceded defeat eventually, the last half of the twentieth century has arguably been characterised as a time when many of Berle's views held sway, especially in the US. It might be said that this position has been attenuated somewhat by the introduction of constituency statutes in over half of the American states, an issue that is discussed later. These statutes permit directors to take into account the interests of constituencies, other than shareholders, in the actions that they take. If there has been a weakening, and many would argue against that, it has been minimal, certainly amongst academic commentators, as the number of learned articles arguing for a shareholder maximisation approach attests.

B. The Arguments in Favour

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[12] This is not to say that those who do not see themselves as contractarians do not agree with shareholder primacy. For some of the leading works on the principle, see J. Macey, "An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties" (1991) 21 *Stetson Law Review* 23; S. Bainbridge, "In Defense of the Shareholder Maximization Norm : A Reply to Professor Green" (1993) 50 *Washington and Lee Law Review* 1423; Bernard Black and Reiner Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 *Harvard Law Review* 1911; D. Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277. It must be noted that some contractarians do not accept shareholder primacy : D.D. Prentice, "The Contractual Theory of the Company and the Protection of Non-Shareholder Interests" in D. Feldman and F. Meisel, *Corporate and Commercial Law : Modern Developments* (London, Lloyds of London Press, 1996) at 121.

[13] See A. A. Berle, "Corporate Powers as Powers in Trust" (1931) 44 Harv L R 1049; E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932) 45 Harv L R 1145; A. A. Berle, "For Whom Managers are Trustees : A Note" (1932) 45 Harv L R 1365. Also, see A.A. Berle and G. Means, *The Modern Corporation and Private Property* MacMillan, New York, 1932; E.M. Dodd, "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" (1935) 2 *University of Chicago Law Review* 194.

[14] A. A. Berle, "Corporate Powers as Powers in Trust" (1931) 44 Harv L R 1049 at 1049. The view was put forward, in effect, in the earlier decision of *Dodge v Ford Motor Co* (1919) 170 NW 668 (Michigan).

[15] E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932) 45 Harv L R 1145 at 1148.

The contractarian theorists, many of whom advocate a law and economics approach to law, focus on the contractual relationships that exist between persons involved in the affairs of the company, and, accordingly, hold to the principle of the sanctity of contract. Many contractarians[16] regard the company as nothing more than a number of complex, private consensual contract-based relations,[17] either express or implied, and they consist of many different kinds of relations that are worked out by those voluntarily associating in a company.[18] The parties involved in these contracts are regarded as rational economic actors, and includes shareholders, managers, creditors and employees, and it is accepted that each of these constituencies endeavour in their contracting to maximise their own positions, with the intention of producing concomitant benefits for themselves.[19] This scheme is usually known by the shorthand expression of "a nexus of contracts."[20] The nexus of contracts theory in relation to the firm was devised by economists[21] and embraced by economically inclined law academics.[22] The contractarians generally[23] regard shareholder primacy as the focal point of their view of the public company.[24] The principle fills gaps in

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16 For example, Eugene Fama, "Agency Problems and the Theory of the Firm" (1990) 99 *Journal of Political Economics* 288 at 290.

17 Referring to the relations as contracts is probably incorrect. Some authors refer to the relations as bargains as some of the relations do not constitute contracts in a technical sense. See, Michael Klausner, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757, 759.

18 Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract" (1989) 89 Colum L Rev 1416, 1426. At p1428 the learned commentators give examples of some of the arrangements.

19 See, Henry N. Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99; Christopher A. Riley, 'Understanding and Regulating the Corporation' (1995) 58 MLR 595 at 598.

20 The literature considering the nexus of contracts is too voluminous to cite. But see, for example, Eugene E. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *Journal of Political Economy* 228, 290; Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract" (1989) 89 Colum L Rev 1416, 1426-1427. Professor Stephen Bainbridge has said that the nexus of contracts provides us with "an educated guess" about the rule that most parties would embrace if they could bargain *ex ante*. The nexus of contracts approach is critiqued by William W. Bratton Jr in 'The "Nexus of Contracts Corporation" : A Critical Appraisal' (1989) 74 Cornell L Rev 407 at 412, 446-465. The scheme has been referred to as 'a nexus of incomplete contracts.' For recent comments, see, for example, Simon Deakin and Alan Hughes, "Economic Efficiency and the Proceduralisation of Company Law"(1999) 3 *Company Financial and Insolvency Law Review* 169 at 176-180; Iain McNeil, 'Company Law Rules : An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 *Journal of Corporate Law Studies* 107 .

21 See R. Coase, "the Nature of the Firm" (1937) 4 *Economica* 386 at 390-392; A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 Am Econ Rev 777 at 794; M. Jensen and W. Meckling, "Theory of the Firm : Managerial Behaviour, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

22 See F Easterbrook and D Fischel 'The Corporate Contract' (1989) 89 Colum L Rev 1416; Easterbrook and Fischel *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 37-39; W Bratton Jr "The 'Nexus of Contracts' Corporation : A Critical Appraisal" (1989) 74 Cornell L Rev 407.

23 Not all contractarians might agree with this. For instance, Professor Stephen Bainbridge would appear to be an exception as he emphasises director primacy : "The Board of Directors as Nexus of Contracts" (2002) 88 *Iowa Law Review* 1; "Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547.

24 M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 38.

the corporate contract;[25] it establishes "the substance of the corporate fiduciary duty."[26]

The preference for shareholder primacy is not a consequence of a "philosophical predilection"[27] towards shareholders, but a concern that the business should be run for the benefit of the residual claimants, namely, the shareholders, while the company is solvent.[28] This is probably regarded as the primary argument in favour of the shareholder value approach. The residual claimants have the greatest stake in the outcome of the company,[29] as they will benefit if the company's fortunes increase, but they will lose out if the company hits hard times (with their claims being last in line if the company is liquidated), and they will value the right to control above any other stakeholders,[30] as they have an interest in every decision that is taken by a solvent firm.[31] It has been said that as shareholders are the owners of the company,[32] those who manage the company should do so for the benefit of the shareholders.[33] Of course, this does not mean that the shareholders are the only ones who value the right to be owed fiduciary duties. But it has been argued that fiduciary duties are not public goods and the enjoyment by one group of stakeholders reduces the ability of other

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[25] Frank Easterbrook and Daniel Fischel *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 90-93; J. Macey, and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 404.

[26] T. Smith, "The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty" (1999) 98 *Michigan Law Review* 214 at 217. A view with which Professor Smith disagrees (ibid).

[27] M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 37.

[28] F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 36-39. Professors Margaret Blair and Lynn Stout take issue with this : "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash U L Q 403 at 404. Also, see L. Stout, "Bad and Not-so-Bad Arguments for Shareholder Primacy" (2002) 75 *Southern California Law Review* 1189 at 1192-1193. The view is sometimes espoused that the shareholders own the company : M. Friedman, "The Social Responsibility of Business is to Increase its Profits" New York Times, September 13, 1970, Section 6 (Magazine) at 32, 33; R. Hessen, "A New concept of Corporations : A Contractual and Private Property Model" (1979) 30 *Hastings Law Journal* 1327 at 1330.

[29] J. Macey, "Fiduciary Duties as Residual Claims : Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective" (1999) 84 *Cornell Law Review* 1266 at 1267. This has been queried by several commentators, such as Professor Margaret Blair (*Ownership and Control* (Washington DC, The Brookings Institute, 1995) at 229).

[30] Mark E.Van der Weide, "Against Fiduciary Duties to Corporate Stakeholders" (1996) 21 *Delaware Journal of Corporate Law* 27 at 57; M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 38.

[31] J. Macey, and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 408.

[32] For example, see Committee on the Financial Aspects of Corporate Governance (Cadbury Report), London, Gee, 1992, at para 6.1; Confederation of British Industries, *Boards Without Tiers : A CBI Contribution to the Debate*, London, CBI, 1996 at 8.

[33] This view has been criticised by many. For example, Martin Lipton and Steven Rosenblum, "A New System of Corporate Governance : The Quinquenial Election of Directors" (1991) 58 U Chi L Rev 187 at 195; Paddy Ireland, "Capitalism without the capitalist : The joint stock company share and the emergence of the modern doctrine of separate corporate personality" (1996) 17 *Legal History* 40; S. Worthington, "Shares and shareholders : property, power and entitlement (Part 1) (2001) 22 Co Law 258 and Part 2 (2001) 22 Co Law 307. Also see, *Short v Treasury Commissioners* [1948] 1 KB 116 at 122 where Evershed LJ denied the fact that shareholders were the owners of a company.

groups to enjoy the benefits that the duties produce.[34] The bottom line is that contractarians have a shareholder-centric concept of the company.

There are other arguments that are propounded in favour of shareholder primacy. First, according to the prevailing agency theory,[35] directors are the agents of the shareholders and are employed to run the company's business for the shareholders who do not have the time or ability to do so, and it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.[36] It is said that if there is no shareholder primacy, the directors are able to engage in opportunistic behaviour, known as "shirking." Costs, known as "agency costs,"[37] will be incurred in monitoring the work of the directors, so as to reduce the incidence of shirking, and the existence of duties owed to shareholders reduces those costs and at the same time protects the shareholders. The upshot is that shareholder primacy means that directors are fully accountable for what they do in running the company's business.

Second, it is argued that the principle is based on efficiency. Shareholders have incentives to maximise profits and so they are likely to foster economic efficiency. It is more efficient if directors operate on the basis of maximising shareholder wealth, because the least cost is expended in doing this;[38] the directors can work more efficiently if they are focused only on one objective.

Third, and allied to the previous argument, if directors owe duties to various constituencies, then it would be impossible for directors to balance all of the divergent interests, with the result that directors will make poor decisions.[39] It is said that the principle is certain and easy to administer, especially when compared with the stakeholder theory,[40] under which directors are to act with all stakeholder interests in view. Shareholder primacy allows, so the argument goes, courts to review managerial conduct with some rationality.[41]

Fourth, it is argued that constituencies other than the shareholders are able to protect themselves by the terms of the contracts that they make, while shareholders do not

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[34] J. Macey, and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 410.

[35] This is based on a large number of works, but arguably the most influential are : Michael Jensen and William Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of the Corporate Law*, 1991.

[36] J. Matheson and B. Olson, "Corporate Law and the Longterm Shareholder Model of Corporate Governance" (1992) 76 *Minnesota Law Review* 1313 at 1328.

[37] These costs are those resulting from managers failing to act appropriately and the costs expended in monitoring and disciplining the managers in order to prevent them abusing their positions.

[38] M.van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 56-57.

[39] The Committee on Corporate Law, "Other Constituency Statutes : Potential for Confusion" (1990) 45 *Business Lawyer* 2253 at 2269. It is generally felt that life would be made somewhat easier for directors if shareholder primacy did not exist as they could more easily justify decisions that they make.

[40] M.van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 68.

[41] Ibid at 69.

have this kind of protection. The assertion is made that the shareholders are vulnerable[42] in that they are not, unlike say creditors, able to negotiate special terms by way of contract, and they are, in many ways, at the mercy of the directors, for they have difficulty in monitoring the work of directors. Fifth, unlike some groups, such as creditors, shareholders are not always able to diversify their exposure to losses sustained by their investments. Finally, shareholders are not, except in listed companies, always able to exit easily a company with which they are not happy.

C. The Critics

It has been asserted in recent times that corporate governance debates have now been resolved in favour of the shareholder primacy model. [43] However, the shareholder primacy principle has long had its critics and some theorists have questioned its normative value, [44] and others, principally those adopting a communitarian or pluralist approach to corporate law,[45] have argued that directors should be required to consider the interests of others besides shareholders, namely those whom we can call stakeholders. While shareholder primacy appears to hold sway in legal, accounting and finance circles, this is not the case in relation to other disciplines, such as management and business ethics, which have embraced a wider perspective than shareholder primacy. Clarkson illustrates this when he states that : "Managers are now accountable for fulfilling the firm's responsibility to its primary stakeholder groups."[46] Some leading writers have even proclaimed boldly that stakeholder theory is generally so pre-eminent that shareholder primacy is dead.[47]

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42 See Luigi Zingales, "Corporate Governance" in *The New Palgrave Dictionary of Economics and Law*, Basingstoke, MacMillan, 1997 at 501.

43 H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439.

44 For example, see David Millon, "New Game Plan or Business as Usual? A Critique of the Team Production Model of the Corporate Board" (2000) 86 *Virginia Law Review* 1001 at 1001-1004; Lynn Stout, "Bad and Not-So-Bad Arguments for Shareholder Primacy" (2002) 75 *South California Law Review* 1189 at 1191.

45 For discussions of this approach to corporate law, see, for example, Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995); William Bratton Jr, "The 'Nexus of Contracts Corporation' : A Critical Appraisal" (1989) 74 Cornell L Rev 407Lawrence Mitchell, "The Fairness Rights of Bondholders" (1990) 65 *New York University Law Review* 1165; David Millon, "Theories of the Corporation" [1990] Duke LJ 201; Lyman Johnson, "The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law" (1990) 68 *Texas Law Review* 865. Works in the UK that have advocated this approach are : Janet Dine, "Companies and Regulations : Theories, Justifications and Policing" in D Milman (ed), *Regulating Enterprise : Law and Business Organisations in the UK* (Hart Publishing, Oxford, 1999) at 295-296; Janet Dine, *Company Law* (Sweet and Maxwell, London, 2001), 27-30; John Parkinson, *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993); Gavin Kelly and John Parkinson, "The Conceptual Foundations of the Company : A Pluralist Approach" (1998) 2 *Company Financial and Insolvency Law Review* 174. Also, see W. Leung, The Inadequacy of Shareholder Primacy : A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 *Columbia Journal of Law and Social Problems* 589; G. Crespi, "Rethinking Corporate Fiduciary Duties : The Inefficiency of the Shareholder Primacy Norm" (2002) 55 SMU Law Rev 141.

46 M. Clarkson, "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance" (1995) 20 *Academy Management Review* 92 at 112.

47 For example, Professor R Edward Freeman : "The Politics of Stakeholder Theory : Some Future Directions" (1994) 4 *Business Ethics Quarterly* 409 at 413.

Those holding to a communitarian[48] view of the company object to the shareholder primacy principle on normative grounds,[49] arguing that directors should be obliged to run companies for the benefit of all potential stakeholders in companies, such as creditors, employees, suppliers, customers and the communities in which the company operates. This aligns with the view of communitarians that companies should serve broader social purposes than simply making money for shareholders.

Communitarian theorists seek to focus on the fact that those involved in, and dealing with, companies are humans and corporate law should not be de-personalised.[50] In the communitarian assessment a greater array of social and political values are considered, and communitarians opine that whether the company is useful is measured by evaluating how it assists society gain a richer understanding of community by respecting human dignity and overall welfare.[51] Communitarians embrace a normative world view that emphasises the fact that people are part of a shared community who inherit the benefits, values and goals of the community, thus the cultural milieu in which people find themselves cannot be ignored,[52] and the company is regarded as "a community of interdependence, mutual trust and reciprocal benefit."[53] A consequence of this view is that it is asserted that the interests of shareholders are not the only interests to be considered by directors when carrying out their functions, for there are other important constituencies that warrant consideration from directors.[54] The effect of invoking a shareholder primacy approach is, arguably, to damage the incentives of non-shareholder stakeholders to make firm-specific investments in companies as they are aware that their investments will be subordinated to shareholder interests at all times,[55] therefore, communitarians have criticised it, with Professor Lyman Johnson saying that "a radically proshareholder vision of corporate endeavour [is] substantially out of line with prevailing social

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48 Those arguing for a "team production" approach to corporate law (the main scholars adopting this view are Professors Margaret Blair and Lynn Stout in "A Team Production Theory of Corporate Law" (1999) 85 Va L R 247; "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash U L Q 403).

49 For instance, see David Millon, "Redefining Corporate Law" (1991) 24 *Indiana Law Review* 223 at 227ff.

50 For example, see Lawrence Mitchell, "Groundwork of the Metaphysics of Corporate Law" (1993) 50 *Washington and Lee Law Review* 1477 at 1479-1481. In another work ("The Death of Fiduciary Duty in Close Corporations" (1990) 138 U Pa LR 1675 at 1675), the learned commentator states that "The corporation is a human enterprise."

51 D. Sullivan and D. Conlon, "Crisis and Transition in Corporate Governance Paradigms : The Role of the Chancery Court of Delaware" [1997] *Law and Society Review* 713 and referred to by Janet Dine, "Companies and Regulations : Theories, Justifications and Policing" in D. Milman (ed), *Regulating Enterprise : Law and Business Organisations in the UK* (Hart Publishing, Oxford, 1999) at 295.

52 D. Millon, 'New Directions in Corporate Law : Communitarians, Contractarians and Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373 at 1382.

53 D. Millon, 'Communitarianism in Corporate Law : Foundations and Law Reform Strategies' in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (Boulder, Colorado, Westview Press, 1995) at 10.

54 For example, Professor Lawrence Mitchell criticises the whole notion of shareholder maximisation in corporate law ("A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes (1992) 70 *Texas Law Review* 579 at 640). See Millon, ibid at 7-9. Progressives differ among themselves concerning the strength of the claims of various non-shareholder constituencies to warrant legal intervention.

55 G.Kelly and J.Parkinson, "The Conceptual Foundations of the Company : A Pluralist Approach" in J.Parkinson, A.Gamble and G.Kelly (eds), *The Political Economy of the Company*, Oxford : Hart Publishing, 2000 at 131.

norms,"[56] and that courts must acknowledge this and define "the meaning of corporate endeavour"[57] by embracing norms "wider than the thin thread of shareholder primacy."[58]

Another commentator has argued that the shareholder primacy principle is not relevant to business decisions today and that it was introduced originally to resolve disputes among majority and minority shareholders in closely-held companies, and courts tended not to distinguish between closely-held and public companies until the middle of the last century.[59] Others have said that shareholder primacy produces a short-term focus and short term earnings performance overshadows all else,[60] and this fails to maximise social wealth.[61]

III Shareholder Primacy and Law and Practice

A. Support for Shareholder Primacy?

Clearly there are strong arguments that favour shareholder primacy as a normative principle, notwithstanding the communitarian critique. But is it descriptive of law and practice? In the US the Principles of Corporate Governance seem to provide for shareholder primacy.[62] In the UK there is some evidence of directors following a shareholder primacy approach. The 1999 survey of directors conducted by the Institute of Directors found that many directors believed that they were obliged to maximise short term shareholder benefits at the expense of long-term interests.[63] More pertinently, the UK's Company Law Review Steering Group ("CLRSG") stated that the directors are to manage the company's business for the benefit of the company, and this normally means that it is managed for the benefit of the shareholders as a whole.[64] Earlier the CLRSG had said that the legal framework essentially supported a shareholder primacy system.[65] Certainly there are aspects of corporate law that appear to support shareholder primacy. Three examples suffice. First, shareholders have voting rights which can determine who will be the directors and also the shareholders have the power to dismiss directors under s 303 of the

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[56] "The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law" (1990) 68 *Texas Law Review* 865 at 934.

[57] Ibid.

[58] Ibid.

[59] D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 279.

[60] S. Wallman, "The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties" (1991) 21 *Stetson Law Review* 163 at 176-177; M. Lipson and S. Rosenblum, "A New System of Corporate Governance : The Quinquennial Election of Directors (1991) 58 *University of Chicago Law Review* 187 at 205-215; Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 61.

[61] Wallman, ibid at 176-177; Lipson and Rosenblum, ibid at 203.

[62] *Principles of Corporate Governance : Analysis and Recommendations*, 1994, s.2.01(a) and referred to in Mark Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U Pa L Rev 2063 at 2072.

[63] *Good Boardroom*, London, Institute of Directors and referred to in Lee Roach, "The legal model of the company the Company Law Review" (2005) 26 Co Law 98 at 101.

[64] Company Law Review, *Modernising Company Law :* The Strategic Framework, London, DTI, 1999, at para 5.1.5.

[65] Ibid at para 5.1.4.

Companies Act 1985.[66] These rights give the shareholders, in limited situations, the right to decide on fundamental changes to the corporate constitution, such as alterations to the articles of association. But, when it comes to electing and possibly dismissing directors, we have to note that in public companies with a widely dispersed share ownership there are legal and practical hurdles that mean that voting rights will often make little or no difference.[67] The chairman of the board will often be empowered by absent shareholders to vote on their behalf through the use of proxies, and this frequently sees the incumbent directors retaining control. In closely-held companies it is usually the case that a shareholder or group of shareholders will control the voting at meetings and so the voting rights of individual shareholders are rendered close to otiose. As far as voting on changes to the life of the company are concerned, shareholders usually only get to vote on such issues when the board convenes the appropriate meeting. When the opportunity does arise then the points that have been made above apply just as they do with respect to voting for the election and/or removal of directors. It has been said that shareholder voting is "a fraud or a mere ceremony designed to give a veneer of legitimacy to managerial power."[68] Generally, shareholders do not have the power to tell the directors how to run the company, a function usually bestowed on the directors by the articles.[69] Consequently, describing the directors as the agents of the shareholders, as is often done, is debatable.

Second, s.459 of the Companies Act 1985 permits shareholders to present a petition against a company where the company is being run in a way that is unfairly prejudicial to his or her interests.[70] However, s.459 has been used overwhelmingly in relation to private companies where a member can establish that he or she had, when joining the company, certain legitimate expectations that have not been adhered to. With public companies, where people tend to become involved without being given any expectations by directors or managers, this sort of approach is generally not going to work.[71]

Third, in certain restricted cases, shareholders may take derivative proceedings against the directors on behalf of the company. This is permitted primarily where directors have committed a fraud on the minority, that is, their actions perhaps constitute a breach of duty and this prejudices the interests of the minority shareholders.[72] Certainly shareholders are exclusively granted special rights, but this is simply instrumental. As Professors Margaret Blair and Lynn Stout have said:

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[66] In Australia, the equivalent provision is s.203D of the Corporations Act 2001. Sections 203C and 135 entitle the shareholders of a proprietary company to remove only where the constitution applies replaceable rules.

[67] See, L. Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 Harv L R 833.

[68] R. Clark, *Corporate Law*, (Aspen Publishers, New York, 1986) at 781-782 and quoted by Margaret Blair and Lynn Stout in 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247 at 312.

[69] For example, see Art 70 of Table A of the Companies (Tables A-F) Regulations 1985.

[70] In Australia, s. 232 of the Corporations Act 2001 is the broadly equivalent provision, although it deals with oppression.

[71] See *Re Astec (BSR) plc* [1998] 2 BCLC 556.

[72] A classic case is *Cook v Deeks* [1916] 1 AC 554. Part 11 of the Company Law Reform Bill, which is presently before Parliament, entitles shareholders to initiate derivative actions. If this is passed then, like Australian shareholders, British shareholders will no longer have to rely solely on common law exceptions to the rule in Foss v Harbottle.

> "Shareholders enjoy special legal rights not because they have some unique claim on directors, but because they often are in the best position to represent the interests of the coalition that comprises the firm."[73]

So, if shareholders initiate derivative proceedings against errant directors, any benefits that result from that action will usually inure to the company as a whole, and not just to shareholders. In like manner, if shareholders use their voting rights to oust a director who has acted incompetently and/or improperly, that will benefit the company as a whole.[74]

Yet, notwithstanding the points that seem to favour shareholder primacy, it is possible to identify a number of aspects of law and practice that do not appear to support shareholder primacy.

B. The Position in the United States

Even in the US, where shareholder primacy has been advocated with the greatest force,[75] there are indications that while there is significant support for it, it is not a universally accepted principle, particularly amongst many of the judges.[76] In the most influential state, as far as corporate law goes, Delaware, the Court of Chancery has stated that directors owe duties to the corporate enterprise and have "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the long-term wealth creating capacity."[77] In *Revlon Inc v MacAndrews & Forbes Holdings Ltd*[78] it was said that duties are owed to the corporation and the shareholders. The actual reference both to the corporation and the shareholders suggests that any mention of acting in the best interests of "the corporation" does not automatically mean that the responsibility is only to the shareholders,[79] a point made more recently in the Massachusetts case of *In re Healthco International Inc*.[80] It has been said that corporate law in Delaware remains ambivalent on whether shareholder primacy is the determining force.[81] More recently, a federal court in the US has clearly stated that duties are owed by directors to the

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73 Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247 at 289.

74 Ibid at 289

75 The best known case might well be, *Dodge v Ford Motor Co* (1919) 170 NW 668 (Michigan). For a more recent decision that advocates it, see the Delaware case of *Simons v Cogan* (1988) 549 A 2d 300 at 304.

76 A point acknowledged in R. Booth, "Who Owns a Corporation and Who Cares?" (2001) 77 *Chicago-Kent Law Review* 147 at 147.

77 *Geyer v Ingersoll Publications Co* 621 A 2d 784 at 787-788 (1992).

78 506 A 2d 173 at 176-182 (1986) (Delaware). Also, see *Simons v Cogan* 549 A 2d 300 at 302-304 (1988) (Delaware).

79 Although some scholars interpret this to mean shareholder primacy : A. Chaver and J. Fried, "Managers' Fiduciary Duty Upon the Firm's Insolvency : Accounting for Performance Creditors" (2002) 55 *Vanderbilt Law Review* 1813 at 1814. It might be because the proviso laid down in Revlon was that action that is taken must ultimately provide some benefit for the shareholders (at 176).

80 208 BR 288 at 301 (1997).

81 W. Allen, J. Jacobs and L Strine, "The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide" (2002) 69 U Chi L Rev 1067 at 1067.

corporate entity and not to any person.[82] In another case, *Green v Hamilton International*,[83] duties were held to be owed to the community of interests in the corporation, and not solely to shareholders.[84] Chancellor Allen of the Delaware Chancery Court took a very similar approach in *Credit Lyonnais Bank Nederland N.V. v Pathe Communications Corp.,*[85] when he said that when a company that is in the vicinity of insolvency, the directors owe duties not simply to shareholders, but to the community of interests that the company represents. It is interesting that Chancellor Allen, when writing in an extra-curial context at close to the time of his judgment in *Credit Lyonnais,* took the view that essentially what can be seen as shareholder primacy held sway in the nineteenth century and co-existed with what the judge called, "the social entity view," namely directors have to consider stakeholders besides shareholders. The Chancellor's view was that now the social entity view prevails.[86] The result is that in the US Blair and Stout have queried whether courts in fact generally accept the shareholder primacy principle.[87]

While a significant number of jurisdictions require directors to act in the best interests of the corporation and the shareholders,[88] a majority of state legislatures,[89] the first being Pennsylvania (in 1983), have sought by way of legislation to ensure that shareholder primacy does not prevail, certainly to the point of promoting short-termism. These states have enacted what are referred to as "constituency statutes." While the respective statutes differ from one another in some respects, each of them authorises the directors to consider, when discharging their duties, the interests of other corporate stakeholders, such as employees, suppliers, customers, creditors and the communities in which companies establish themselves. The statutes enacted in Indiana and Pennsylvania expressly provide that directors are not required to give primacy to any constituency or interest.[90] Connecticut, Arizona and Idaho[91] went even further and required directors to consider the long term interests of the company. The Pennsylvania and Indiana legislatures provided in their respective Codes that directors are not required to give dominant effect to any constituency, thereby ruling out shareholder primacy.[92] During the campaign instigated to have the legislation

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82 *Official Committee of Unsecured Creditors v R F Lafferty & Co* (2001) 267 F 3d 340 at 348 (3rd Circuit).

83 (1977) 437 F Supp 723 (New York).

84 Ibid at 729, n.4.

85 1991 Del Ch WL 277613; LEXIS 215; (1992) 17 *Delaware Journal of Corporate Law* 1099.

86 William Allen, "Our Schizophrenic Conception of the Business Corporation" (1992) 14 *Cardozo Law Review* 261 at 276.

87 "Director Accountability and the Mediating Role of the Corporate Board" (2001) 78 Wash U L Q 403. This view has been echoed by Professor Richard Booth in "Who Owns A Corporation and Who Cares?" (2001) 77 *Chicago-Kent Law Review* 147 at 147, but Professor Stephen Bainbridge implicitly disagrees ("Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547 at 575-576).

88 For example, California (Corporations Code, s.309).

89 For a list of the States and the statutes, see L. Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 *Texas Law Review* 579 at n.1; R. Karmel, "Implications of the Stakeholder Model" (1993) 61 *George Washington Law Review* 1156 at n.42.

90 Indiana, s.23-1-35-1(d)(f) and Pennsylvania, ss.515(a)-(b), 516(a).

91 Connecticut Corporations Code, s.33-313; Arizona Corporations Code, s.10-1202; Idaho Corporations Code, s.30-1602.

92 This is even acknowledged by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association ("Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus Law 2253 at 2262), which was essentially in favour of shareholder primacy.

passed in Pennsylvania, the co-sponsor of the Bill stated that the Bill would : "reaffirm and make more explicit the time-honoured (and current) principle that directors owe their duties to the corporation rather than to any specific group such as shareholders."[93] But too much cannot be made of these statutes as they only operate, for the most part, in the context of takeovers, and therefore they have a limited effect. By the end of the last century, only three of the statutes had been cited in court and only on one occasion, in *Georgia Pacific Corp v Great Northern Nakoosa Corp*,[94] had a statute been referred to in finding in favour of a decision by the managers.[95] Nevertheless, the statutes have had an effect on US corporate law and they can be added to the divergent case law to suggest that shareholder primacy is not as dominant in the US as we are often led to believe. This is consistent with the empirical evidence derived in relation to a study of negotiated mergers, which reported that directors, when left alone, tend to maximise firm value rather than shareholder wealth.[96]

IV "In the Interests of the Company"

As explained at the beginning of this paper, the UK courts[97] have said, as have the Australian courts,[98] that directors' powers are to be exercised in the interests of the company. But more often than not, the courts have not explained what they mean by the phrase, "the interests of the company." As pointed out by Nourse LJ in *Brady v Brady,*[99] this is an expression that is often used, but is rarely defined, and it is probably one of the most problematical expressions in company law. His Lordship opined that it was sometimes misunderstood. Professor Dan Prentice has referred to the phrase as being "indeterminate"[100] and another commentator has said that it was "unclear."[101]

The phrase has been employed by judges in several corporate law areas, besides when hearing cases that involve the exercise of directors' duties.[102] For instance, it is used when assessing whether an alteration to the articles of a company is permissible,[103] and some of those cases will be referred to below.

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93 Outrage of the Month, Issue Alert, Dec 1989 at 6 and quoted in N. Minow, "Shareholders, Stakeholders and Boards of Directors" (1991) 21 *Stetson Law Review* 197 at 220.

94 727 F Supp 31 (1989) (Maine).

95 Richard Marens and Andrew Wicks, "Getting Real : Stakeholder Theory, Managerial Practice, and the General Irrelevance of Fiduciary Duties Owed to Shareholders." (1999) 9 *Business Ethics Quarterly* 273 at 284.

96 Dennis and McConnell, "Corporate Mergers and Security Returns" (1986) 16 *Journal of Financial Economics* 143. While this study is not recent, it accords with empirical evidence discussed in L. Stout, "Bad and Not-so-Bad Arguments for Shareholder Primacy" (2002) 75 *Southern California Law Review* 1189 at 1201-1207.

97 For instance, see *Re Smith and Fawcett Ltd [1942] Ch 304 at 308; Mutual Life Insurance Co of New York v The Rank Organisation Ltd* [1985] BCLC 11 at 21; *Fulham Football Club Ltd v Cabra Estates plc* [1994] 1 BCLC 363 at 378.

98 For instance, *Brunninghausen v Glavanics* [1999] NSWCA 199; (1999) 17 ACLC 1247 at para 40.

99 (1987) 3 BCC 535 at 552.

100 D.D. Prentice, "Creditor's Interests and Director's Duties" (1990) 10 OJLS 265 at 273

101 J. Heydon, "Directors' Duties and the Company's Interests" in P. Finn (ed), *Equity and Commercial Relationships* (Law Book Co, Sydney, 1987) at 122.

102 For instance, see *In re Smith & Fawcett Ltd* [1942] Ch 304 at 306, 308 (CA).

103 For instance, see *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671.

One of the first indications that shareholder primacy held sway in English law came in the comments of Jessel MR in *In re Wincham Shipbuilding*[104] in 1878. His Lordship (with the concurrence of James and Bramwell LJJ) said, after asking the question, for whom are the directors trustee, that "the directors are trustees for the shareholders, that is, for the company."[105] Shortly after that case, *Hutton v West Cork Railway Co*[106] was decided (by a differently constituted Court of Appeal) and it is often cited as supporting shareholder primacy. It is also well known for the classic statement by Bowen LJ that : "The law does not say that there shall be no cake and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[107] The fact is that the Court did not make a specific statement concerning who are to be the beneficiaries of the directors' management efforts. The Court was concerned that any action was taken for the benefit of the company, and it did not, it appears, notwithstanding the assertions of a number of writers,[108] state that this meant benefiting the shareholders' interests.

As mentioned above, there are many cases that have considered the meaning of the expression in the context of dealing with whether an alteration of articles of association was in the best interests of the company as a whole.[109] In one of the strongest cases supporting a shareholder primacy interpretation, *Greenhalgh v Arderne Cinemas*,[110] Evershed MR, in whose judgment the other members of the Court of Appeal agreed, said that the phrase "interests of the company as a whole" did not mean the company as a commercial entity, but rather it meant the corporators as a general body.[111] This approach might be said to be consistent with what Dixon J said in the Australian High Court case of *Peters American Delicacy v Heath*,[112] where it was said that the company as a whole is a corporate entity consisting of all of the shareholders.[113] Yet, it must not be forgotten that these cases, and all the cases dealing with an alteration of the articles, are referring to how the members of the company are to act, and not the directors. Only the latter group is encumbered by the requirement to act subject to certain fiduciary duties. Furthermore, the cases dealing with the articles are not addressing the issue of for whose benefit is the company to be

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104 (1878) LR 9 Ch D 322.

105 Ibid at 328. Such a view was posited in New Zealand in *Re H Linney & Co Ltd* [1925] NZLR 907 at 922. In more recent times the idea that directors are trustees has been exploded. For instance, see L S Sealy, "The Director as Trustee" [1967] CLJ 83. However, even more recently reference has still been made to directors acting as trustees. For instance, see Lord Cullen in *Dawson International plc v Coats Paton plc (No1)* 1988 SLT 854 at 858; [1989] BCLC 233 at 237.

106 (1883) 23 Ch D 654.

107 Ibid at 673.

108 For instance, Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 452.

109 For example, see *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656; *Sidebottom v Kershaw Leese and Co Ltd* [1921] 1 Ch 154; *Shuttleworth v Cox Bros and Co (Maidenhead) Ltd* [1927] 2 KB 9.

110 [1951] Ch 286.

111 Ibid at 291. This is a position accepted in Australia in *Ngurli v McCann* (1953) 90 CLR 425 at 438.

112 (1939) 61 CLR 457.

113 The difficulties with the "benefit of the company as a whole" test caused the Australian High Court in *Gambotto v WCP Ltd* (19995) 182 CLR 432, to say that it was time that the test was dispensed with. But the Company Law Review Steering Group felt that that the test was too well-established in English law, and should be retained (*Modern Company Law for a Competitive Economy : Completing the Structure,* London, DTI, 2000 at paras 5.94-5.99; Company Law Review, *Modern Company Law for a Competitive Economy :*Final Report, vol 1, London, DTI, 2001, at paras 7.52-7.62).

managed. But, there is authority involving consideration of directors' duties, such as *Parke v Daily News Ltd*[114] where Plowman J said that the benefit of the company meant the benefit of the shareholders as a general body.[115] Later, in *Gainman v National Association for Mental Health,*[116] Megarry J said that "it is not very easy to determine what is in the best interests of the [company] without paying due regard to the members of the [company]. His Lordship went on to say that he regarded the expression to mean the interests of present and future shareholders as a whole.

Perhaps one of the clearest statements to favour shareholder primacy was emitted by Nourse LJ in *Brady v Brady*.[117] His Lordship said :

> "The interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent, *first and foremost* come the shareholders, present and no doubt future as well."[118](my emphasis)

However, the case was essentially dealing with whether there had been a breach of s.151 of the Companies Act 1985, the provision that prohibits the giving of financial assistance by companies for the acquisition of its shares, and not directors' duties.

Notwithstanding the comments supporting shareholder primacy, there are cases in which judges have played down the shareholders' interests. The paradigm was indirectly questioned by Lord Diplock in *Lonrho Ltd v Shell Petroleum Co Ltd,*[119] where he stated, by way of obiter, that :

> "[I]t is the duty of the board to consider whether to accede to the request [for inspection of documents] would be in the best interests of the company. These are not exclusively those of its shareholders but may include those of its creditors."[120]

The other four Law Lords concurred with his Lordship's judgment. There was no indication here that Lord Diplock had insolvency or near insolvency in view when he referred to consideration of the creditors' interests.

More recently the Court of Appeal in *Fulham Football Club Ltd v Cabra Estates plc*[121] stated that "the duties owed by the directors are to the company and the company is more than just the sum total of its members."

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114 [1962] Ch 927.
115 Ibid at 963.
116 [1971] Ch 317 at 330
117 (1987) 3 BCC 535
118 Ibid at 552
119 [1980] 1 WLR 627.
120 Ibid at 634.
121 [1994] 1 BCLC 363 at 379.

Many of the cases[122] that have been regarded as holding that directors must generally act for shareholders, do not in fact support that position. The courts in these cases have said that directors may owe fiduciary duties to the shareholders where special circumstances exist, such as when the company is the subject of a takeover offer.[123] Absent special circumstances, directors clearly do not owe such duties. Take the judgment in *Dawson International plc v Coats Paton plc (No1)*[124] for example. It was stated in that case that the directors were, in conducting the affairs of the company and discharging their duties, to consider the interests of the company.[125] The directors owed no general fiduciary duty to shareholders, although directors might become subject to a duty to shareholders if they were to make recommendations to the shareholders in light of a takeover offer, for if directors took the decision to recommend the acceptance of that offer they had a duty (which might he called a secondary fiduciary duty) to the shareholders.[126] This case suggests that the directors are to run the business of the company for the benefit of the company, and this involves considering the interests of constituents, such as shareholders. This is supported by the fact that the Court said that "the directors are under a fiduciary duty to the company to have regard to *inter alia* the interests of members and employees"[127] (my emphasis). The use of "inter alia" appears to indicate that the Court is saying that members and employees are only two of a number of interests to which the directors are to consider. Members are mentioned because the action involved a claim by members that the directors breached their duties to members. Employees are adverted to because the Court had referred, earlier in its judgment, specifically to s.309 of the Companies Act 1985, a provision requiring directors to consider the interests of employees.

The equivocal position that appears to exist in the UK, seems to reflect the experience in other parts of the Commonwealth. In the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd*[128] Cooke J indicated that the duties of creditors are owed to the company, and he went on to say unequivocally that directors had to act in the best interests of company as a whole.[129] His Lordship did not go on to say that this meant that consideration had to be given specifically to the interests of the shareholders. There are comments by Latham CJ and Dixon J in the Australian High Court case of *Richard Brady Franks Ltd v Price*[130] that support the notion that we are talking more about the shareholders when we say that directors are to act in the best interests of the company. In *Kinsela v Russell Kinsela Pty Ltd*,[131] Street CJ of the New South Wales Court of Appeal stated that when a company is solvent, "the proprietary interests of the shareholders entitle them as a general body to be regarded

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122 For instance, see *Heron International Ltd v Lord Grade* [1983] BCLC 244; *Peskin v Anderson* [2000] BCC 1110; [2000] 2 BCLC 1(and affirmed on appeal by the Court of Appeal [2001] BCC 874).

123 For instance, see *Gething v Kilner* [1972] 1 WLR 337; [1972] 1 All ER 1166; *Re a Company* [1986] BCLC 382; *Brunninghausen v Glavanics* [1999] NSWCA 199; (1999) 17 ACLC 1247.

124 1988 SLT 854; [1989] BCLC 233.

125 Ibid at 860; 241.

126 Ibid at 859; 240. This was acknowledged in *Prudential Assurance Co Ltd v Newman Industries Ltd* (*No 2*) [1982] Ch 204; *Gething v Kilner* [1972] 1 WLR 337; [1972] 1 All ER 1166.

127 Ibid.

128 (1985) 3 ACLC 453 at 459.

129 Ibid at 462.

130 [1937] HCA 42; (1937) 58 CLR 112.

131 (1986) 4 ACLC 215; (1986) 10 ACLR 395.

as the company when questions of the duty of directors arise."[132] According to his Honour this is why shareholders are able to authorise actions of directors such that the latter's actions cannot be challenged. But, in a later New South Wales Court of Appeal case, *Brunninghausen v Glavanics,*[133] Handley JA said that : "The general principle that a director's fiduciary duties are owed to the company and not to shareholders is undoubtedly correct…" More recently, in *Peoples' Department Stores v Wise*[134] Canada's highest court, the Supreme Court of Canada, said that directors had a duty to act in the best interests of the corporation and that "the best interests of the corporation" meant acting to maximise the value of the corporation. Major and Deschamps JJ, in delivering the judgment of the Court, specifically stated that the expression acting in the "best interests of the corporation" does not mean acting in the best interests of the shareholders or any one stakeholder's interests.[135] The judges went on to say that :

> "But if they [the directors] observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not…leave directors open to the charge that they have failed in their fiduciary duty to the company…We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia,* the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment…At all time, directors and officers owe their fiduciary duties to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders."[136]

In sum, there is not a clear strain of authority running through UK case law supporting shareholder primacy, and, as the paper has already mentioned, this is similar to the US where the position of the courts on the subject is equivocal. Undoubtedly some cases suggest that the focus should be on shareholders, while others either merely blandly state that the directors are to act in the interests of the company, or indicate that more than the interests of shareholders make up the interests of the company.

This accords with the view propounded recently by John Armour, Simon Deakin, and Suzanne Konzelmann that corporate governance has not stabilised around a norm of shareholder primacy, but is in "a state of flux."[137] There are clear instances where a strict shareholder primacy approach has not been adhered to. A good example is the transfer by BMW to the Phoenix consortium of the Rover car factory and operation at Longbridge in the West Midlands of England in 2000. The concerns and interests of

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132 Ibid at 221; 395

133 [1999] NSWCA 199; (1999) 17 ACLC 1247 at para 43.

134 [2004] SCC 68. The case can be accessed through the Canadian Legal Information Institute. See < www.canlii.org/ca >

135 Ibid at para 42.

136 Ibid at paras 42-43.

137 "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531 at 531.

the workforce and the local community were key factors in the decision to transfer the business to Phoenix rather than another consortium which would have conducted an asset-stripping exercise.[138]

It is respectfully submitted that John Lowry and Alan Dignam are correct when they assert that in dealing with the question of what is meant by acting in the company's interests, "The courts have cleverly fudged the answer."[139] This conclusion is consistent with Professor Simon Deakin's recent statement that "It is surprisingly difficult to find support within company law for the notion of shareholder primacy."[140] Nevertheless, the Company Law Review Steering Group (CLRSG) found little difficulty in asserting that the positive law favoured shareholder primacy.

V. Policy Developments

A The Company Law Review

In March 1998 the Department of Trade and Industry commissioned a review that was to include proposals for the reform of UK company law in order to address a modern world.[141] This review was to be the most wide-ranging since the middle of the nineteenth century and was established to formulate a framework of company law which "facilitates enterprise and promotes transparency and fair-dealing;"[142] it was to be overseen by a Steering Group that become known as the Company Law Review Steering Group (CLRSG). The CLRSG published several consultation papers, and, in July 2001, it delivered a final report to the Department of Trade and Industry. The CLRSG clearly saw the issue of in whose interests company law should be formulated as a critical one in its deliberations.[143] The CLRSG proceeded to identify two possible approaches that can be used in addressing the issue, namely either a shareholder value approach or a pluralist approach, and it did this in connection with its recommendations to have the duties of directors, which presently are based on common law, codified. The CLRSG asserted that shareholder primacy has generally been implemented in the UK, and pointed up, in its discussion of for whose benefit a company should be managed, many of the arguments that have been tossed to and fro by law and economics scholars on the one side and communitarian and pluralist scholars on the other. The CLRSG stated[144] that the present law reflects the fact that companies are managed for the benefit of the shareholders, and it confers on the shareholders ultimate control of the undertaking, such that "[t]he directors are required to manage the business on their behalf…"[145] It went on to say that the ultimate objective of companies is to generate maximum wealth for shareholders.[146]

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[138] For a detailed discussion of the transfer, see ibid. Of course, with the wonders of hindsight, the subsequent collapse of Rover in April 2005 causes one to question the wisdom of the rescue of the company in 2000, or at least the strategy employed to engineer the rescue. But that is another issue.

[139] *Company Law*, 2nd ed, (LexisNexis, London, 2003) at 292.

[140] "The Coming Transformation of Shareholder Value" (2005) 13 *Corporate Governance* 11.

[141] Company Law Review, *Modern Company Law For a Competitive Economy*, DTI, 1998, at 1.

[142] Company Law Review, *Modern Company Law for a Competitive Economy*, London, DTI, 1998, Foreword.

[143] See, Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.1.

[144] Ibid at para 5.1.4.

[145] Ibid at para 5.1.5.

[146] Ibid at para 5.1.12.

In considering the objective of companies carrying on business, the CLRSG advocated an approach which it referred to as, "enlightened shareholder value,"[147] and which it was felt would better achieve wealth generation and competitiveness for the benefit of all. This approach is clearly based on shareholder primacy and involves directors having to act in the collective best interests of shareholders,[148] but it eschews "exclusive focus on the short-term financial bottom line" and seeks a more inclusive approach that values the building of long-term relationships.[149] It involves "striking a balance between the competing interests of different stakeholders in order to benefit the shareholders in the long run."[150] The CLRSG emphasised in one of its consultation papers, that this did not mean disregarding the short term interests of shareholders, but it in fact envisaged directors taking a balanced approach and that the long term view should not be paramount over the short-term or vice versa.[151] The concept of the enlightened shareholder value approach found its way into the Government's White Papers of July 2002 and March 2005, and the Company Law Reform Bill, to which we will refer shortly.

In the process of embracing the enlightened shareholder value approach, the CLRSG rejected the pluralist theory which would require the law being :

> "modified to include other objectives [besides maximising shareholder value] so that a company is required to serve a wider range of interests, not subordinate to, or as a means of achieving shareholder value (as envisaged in the enlightened shareholder value view), but as valid in their own right."[152]

The CLRSG said that adopting the pluralist approach would necessitate substantial reform of the law on directors' duties,[153] and later it said that it regarded the pluralist approach as neither workable nor desirable in the UK.[154] In a subsequent consultation paper, the CLRSG explained its approach further, stating that under the enlightened shareholder value directors were obliged to "achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose" and this involved taking "a proper balanced view of the short and long term; the need to sustain effective ongoing relationships with employees, customers, suppliers and others" as well as to "consider the impact of its operations on the community and the environment."[155] In addition, the CLRSG recommended that listed companies and certain other large companies with significant

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147 Ibid

148 Company Law Review, *Modern Company Law for a Competitive Economy,* : Developing the Framework, 2000, London, DTI at para 2.22

149 Ibid.

150 J. Armour, S. Deakin, and S. Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531 at 537.

151 Company Law Review, *Modern Company Law for a Competitive Economy,* : Developing the Framework, 2000, London, DTI at para 3.54.

152 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.13.

153 Ibid at para 5.1.30

154 Company Law Review, *Modern Company Law for a Competitive Economy,* : Completing the Structure, 2000, London, DTI at para 3.5.

155 Company Law Review, *Modern Company Law for a Competitive Economy,* : Developing the Framework, 2000, London, DTI at para 2.19

economic power should publish an operating and financial review as part of the company's annual report.[156] This review is :

> "designed to address the need in a modern economy to account for and demonstrating stewardship of a wide range of relationships and resources, which are of vital significance to the success of modern business, but often do not register effectively, or at all, in traditional financial accounts."[157]

The CLRSG viewed s.309 of the Companies Act 1985 as providing a statutory declaration of enlightened shareholder value, because it requires directors to consider the interests of employees in determining what is in the best interests of the company.[158]

The concept of enlightened shareholder value is similar to enlightened value maximisation that is advocated by Professor Michael Jensen, who states that :

> "it is obvious that we cannot maximise the long-term market value of an organisation if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, communities, and so on."[159]

The sentiments expressed by the learned commentator were effectively acknowledged by the CLRSG in its various reports.

B Company Law Reform : the First Government White Paper

The Government published its first White Paper on company law reform in July 2002,[160] a year after the CLRSG delivered its final report. Amongst its proposals was an acceptance of the general approach to the issue of the objective of the company recommended by the CLRSG, as well as expressly endorsing many of the statements of the CLRSG.[161] Furthermore, the Government accepted the need for an operating and financial review in order to require companies to address concerns that are broader than shareholder issues.[162]

The draft Companies Bill that was part of the White Paper provided for the codification of the duties of directors. Clause 19 stated that Schedule 2 to the draft

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156 Company Law Review, *Modern Company Law for a Competitive Economy* : The Final Report, vol 1, 2001, DTI, London, at paras 3.33-3.45.

157 Company Law Review, *Modern Company Law for a Competitive Economy*, : Completing the Structure, 2000, London, DTI at para 3.4.

158 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21.

159 Michael Jensen, "Value Maximisation, Stakeholder Theory and the Corporate Objective Function" (2001) 7(3) *European Financial Management* 297 at 309.

160 *Modernising Company Law*, Cm 5553, DTI. For a discussion of the White Paper, see R. Goddard, 'Modernising Company Law : The Government's White Paper' (2003) 66 MLR 402 at 407.

161 For example, *Modernising Company Law*, Cm 5553-I, DTI at para 3.6.

162 Ibid at para 4.28. See, B. Hannigan, *Company Law*, (LexisNexis, London, 2003) at 214.

Bill set out the general principles by which directors were to be bound. Paragraph 2 of the Schedule stated that:

> "A director of a company must in a given case –
> (a) act in the way he decides, in good faith, would be the most likely to promote the success of the company for the benefit of its members as a whole; and
> (b) in deciding what would be most likely to promote that success, take account in good faith of all the *material factors* that it is practicable in the circumstances for him to identify" (my emphasis)

The paragraph then went on to enumerate the "material factors." We will return to this in the next section of the paper, when considering the second White Paper.

Importantly, the draft clauses in the Bill included provision for the operating and financial review (OFR) that had been proposed by the CLRSG. Preparation of one was to be limited to certain companies, namely those with economic power and referred to in the draft Bill as major companies.[163] The OFR provides that companies are to publish material information pertaining to the activities of the company and this is to include details concerning future plans, opportunities and risks. The Government sees the OFR as providing a major benefit to a "wider cross-section of a company's stakeholders."[164] Clause 73(2) of the draft Bill stated that directors are obliged to ensure that the information contained in the OFR is such as to achieve the review objective, and the review objective was explained in clause 73(3), namely to allow shareholders to make an informed assessment of the company's operations, financial position and its future business strategies and prospects. The material that directors must consider including in the review is relevant to the interests of stakeholders other than shareholders, such as the company's policies in relation to : employment; environmental issues relevant to the company's business; and the company's policies on social and community issues relevant to the company's business.[165]

C. Company Law Reform : the Second Government White Paper

Nothing further was published until March 2005 when a second White Paper titled "Company Law Reform"[166] appeared. This second White Paper encompassed many of the points raised in the earlier White Paper, but there were some interesting changes in how the approaches advocated in the CLRSG's Final Report and the first White Paper would be implemented.

Importantly, for the purposes of this paper, the second White Paper is said by the explanatory notes to :

> "embed in statute the concept of Enlightened Shareholder Value by making clear that shareholders must promote the

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[163] Clauses 77 and 78 (of *Modernising Company Law*, Cm 5553-II, DTI) set out the criteria for companies that fall into this category.
[164] *Modernising Company Law*, Cm 5553-I, DTI at para 4.32.
[165] Clause 75(2).
[166] Cm 6456, DTI.

> success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers."[167]

The White Paper provides, as with the earlier one, that there are two elements to the way in which directors are to run the company.[168] First, they are to do that which they consider, in good faith, is most likely to promote the success of the company for the benefit of the members as a whole. Second, in carrying out the first element, the directors are to take into account, where relevant, and as far as is reasonably practicable, several factors (in order to reflect wider consideration of responsible business behaviour) that are listed, but not intended to be exhaustive. The factors enumerated in clause B3 of the draft Company Law Reform Bill that was part of the White Paper, which was very similar to the notes relating to paragraph 2 of Schedule 2 of the first White Paper, were set out in clause B3(3) and are:

> "(a)The likely consequences of any decision in both the long and the short term
>
> (b) any need of the company –
>
> (i)to have regard to the interests of its employees
> (ii)to foster its business relationships with suppliers, customers and others
> (iii)to consider the impact of its operations on the community and the environment, and
> (iv)to maintain a reputation for high standards of business conduct."

The directors also have to consider the need to act fairly as between members of the company who have different interests. In addition, the draft Bill recognised that the directors have to take into account creditors' interests in certain circumstances. These circumstances are, according to the explanatory notes, when the company is insolvent or near to insolvent.[169]

Clause B3 encompassed two ideas. First, the long term performance of the company has to be considered by directors. It has been a frequent criticism of directors that they overly focus on the short term benefits for companies as this pleases shareholders. Second, the approach takes into account an array of interests of those who might be categorised loosely as stakeholders. So, while the clause ensures the maintaining of the shareholder-centred paradigm, at the same time it permits, in appropriate circumstances, consideration being given to a wider range of interests. However, although not overtly stated, it is likely that the duty to foster the success of

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167 Ibid at 5.

168 *Company Law Reform*, DTI, 2005, Explanatory notes, para B17.

169 Ibid at B19. For a discussion of this issue, see, for example, A. Keay, "The Director's Duty to Take into Account the Interests of Company Creditors : When is it Triggered?" (2001) 25 *Melbourne University Law Review* 315.

the company for the benefit of the members and the duty to take into account other interests can be seen in a hierarchal way, with the former being regarded more highly than the latter. This is because the CLRSG advocated a hierarchy of obligations when it proposed a similar approach,[170] and this involved the promotion of the benefit of the members' interests above those of the broader interests set out in B3(3) of the draft Bill. A director only has an obligation to take account of B3(3) matters where he or she believes that it is relevant and reasonably practicable to do so. But once he or she has reached the view that it is relevant and reasonably practicable to consider wider interests, it is not permissible for them to be disregarded. There is, however, no indication as to the extent to which directors are to have regard for wider interests, an issue that is discussed later.

D. The Company Law Reform Bill

On 1 November 2005, the Company Law Reform Bill was introduced into the House of Lords. The Guidance to the Key Clauses, and published by the Government at the same time as the Bill was introduced, states that the Bill enshrines the enlightened shareholder value principle.[171] Clause B3 in the draft Bill in the Second White Paper has now become clause 156. Clause 156 is essentially the same as clause B3, although there is one interesting change from the draft Bill in that there is no reference to the need to consider both short-term and long-term consequences; reference is made only to long-term consequences. This is possibly an admission that directors already focus on short-term results and that their responsibility to promote the success of the company for the benefit of the members implicitly demands that they always consider the short-term results of any action.

Prima facie, clause 156 might be regarded as virtually embedding a form of shareholder value in company law when it had not previously been so embedded. Doubts have been expressed on occasions that UK law has not unequivocally adopted shareholder value as the main concern for directors in managing the company.[172] But clause 156 will make it clear that the focus is to be on shareholder interests, and for that reason alone it constitutes a critical development.

The Bill also, importantly for our purposes, addressed the issue of the OFR, but this is done in only three clauses (393-395). Unlike with the draft Bill in the 2002 White Paper there is no statement about what matters or interests directors have to consider in formulating the OFR. However, clause 394 states that the Secretary of State may make provision by way of regulations as far as the objective and content of the OFR are concerned. The Bill limits the need for an OFR to quoted companies.[173]

IV. An Assessment of the Proposed Reforms

The main issue that emanates from the aspect of the company law reform process that we have been focusing on is : with whose interests are directors to be concerned in the

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[170] Company Law Review, *Modern Company Law for a Competitive Economy* : *Completing the Structure*, 2000, London, DTI at para 3.19.

[171] Clause 62. The Guidance can be found at http://www.dti.gov.uk/cld/guidancekey.doc

[172] For instance, see S. Deakin, "The Coming Transformation of Shareholder Value" (2005) 13 *Corporate Governance* 11.

[173] Clause 393.

process of running the business of the company. This Part of the paper explores how the provisions considered in the last Part might work and the issues which they appear to raise. References to clauses are to clauses in the Company Law Reform Bill unless the contrary is indicated.

A. Balancing Constituent Interests in the Modern Company

The first point to note is that clause 156 appears to give the directors a completely unfettered discretion in the actions which they take provided that they are acting in a way that they consider would most likely promote the success of the company for the benefit of the members. Yet the CLRSG, whose basic recommendations are implemented in the White Papers and the Bill, stated that the reason that the pluralist position was to be rejected was, primarily, that it would grant an unpoliced discretion to directors.[174] Second, the Company Law Reform Bill does not explain, and neither does the Guidance to Key Clauses, or the explanatory notes issued with the draft Bill in the March 2005 White Paper, how directors are to consider interests other than those of the members, in the decisions that they are making. This is particularly pertinent where there are competing interests, that is, where a course of action would benefit one constituency and prejudice another. Are directors to engage in a balancing exercise in such circumstances? Clearly, the balancing of stakeholder interests is, of itself, a tricky issue, and it means that directors have to solve what some commentators see as impossible conflicts of interests.[175] According to Jay Lorsch and Elizabeth MacIver, who studied directorial behaviour, only a minority of the directors interviewed refused to acknowledge that there was a conflict between holding strictly to shareholder primacy and the interests of other stakeholders. The learned commentators found that the majority of directors regarded themselves as accountable to more than one constituency and this led to a complicated decision-making process.[176] The problem that really exists with balancing in a stakeholder context is that there is no object stated for the balancing exercise, that is, to what end is the balancing to be conducted. Hence, balancing involves an "inherently subjective process."[177] It has been the subject of significant criticism over the years,[178] particularly on the basis that directors are unable to balance the interests of constituencies. For instance, in its response to the second White Paper and the draft Bill included with it, the Law Society for England and Wales indicated significant

174 Company Law Review, *Modern Company Law for a Competitive Economy,* : *Developing the Framework,* 2000, London, DTI at para 3.24.

175 There are many American commentators who take this view. For example, J. Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson Law Review* 23 at 31; V. Jelisavcic, 'A Safe Harbour Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the 'Vicinity of Insolvency' [1992] *Journal of Corporation Law* 145 at 148; N. Beveridge, 'Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?' (1994) 25 *St Mary's Law Journal* 589 at 621. This view gains some support from the Ontario High Court of Justice in *Royal Bank of Canada v First Pioneer Investments Ltd* (1980) 20 OR (2d) 352.

176 *Pawns or Potentates : The Reality of America's Corporate Boards*, 1989 at 50 and referred to in D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 291.

177 J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 498.

178 For instance, see T. Hurst and L. McGuiness, 'The Corporation, The Bondholder and Fiduciary Duties' (1991) 10 *Journal of Law and Commerce* 187 at 205; M. Siems, "Shareholders, Stakeholders and the 'Ordoliberalism"(2002) 13 EBLR 139 at 141.

concern in relation to directors having to weigh up the list of factors contained in clause 156(3) when making decisions, fearing that it will lead to practical problems. The Law Society stated that the issue of balancing was one of their main concerns.[179] It might be argued that directors will not understand the interests of non-shareholder groups as directors are usually involved in exercising entrepreneurial skills.[180] Allied to this is the fact that directors' thinking is, generally, too centred on shareholder benefits to be able to focus on what are the interests of others. This is accentuated by the existence of shareholder power. Are directors going to take into account other interests in light of the power that shareholders have? It might be argued that the directors will only practise shareholder maximisation because it is the shareholders who have power over the directors. The shareholders have voting rights which can determine whether directors are re-elected. Furthermore, as mentioned earlier, the shareholders have the right under s.303 of the Companies Act 1985[181] to set in motion a process which can lead to a vote to have directors dismissed. As far as legal proceedings are concerned shareholders might be able to initiate either action against directors under s.459 of the Companies Act or derivative proceedings where directors have breached their duties.

The agency theory,[182] a popular way of explaining the relationship between directors and shareholders, has, as one of its elements the notion that directors will be opportunistic and engage in self-serving activity, known as shirking. Consistent with that, it might well be that directors will use the requirement to balance between conflicting interests, and their apparent freedom in doing this, as an opportunity to foster their own self-interest.[183] Certainly Professors Lyn Lo Pucki and William Whitford found in an empirical study that this occurs with respect to US companies that are subject to Chapter 11 bankruptcy.[184] With directors having greater discretion in deciding what interests to take into account, it might be thought that shareholders will have more difficulty in monitoring the performance of directors, and directors might resist claims of breach of duty on the basis that what they did was based on a consideration of the interests of one or more parties mentioned in clause 156(3)(b). This might, for instance, enable them to thwart hostile takeovers on the basis that a takeover would not benefit one or more constituencies.[185]

Some adherents to stakeholder theory, although not accepting the agency theory would also question whether the company managers are in a position to carry out a

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179 June 2005 at p35. The reply can be accessed at the Society's Website – www.lawsociety.org.uk

180 Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 60.

181 This provision is effectively reproduced in clause 152 of the Company Law Reform Bill.

182 This is based on a large number of works, but the most influential are : Michael Jensen and William Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of the Corporate Law,* 1991

183 M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U Pa L Rev 2063 at 2065.

184 See, L. LoPucki and W. Whitford, "Corporate Governance in the Bankruptcy Reorganization of Large Publicly Held Companies" (1993) 141 U Pa L Rev 669 at 710.

185 This issue was a concern of the CLRSG in Company Law Review, *Modern Company Law for a Competitive Economy*, : *Developing the Framework,* 2000, London, DTI at para 3.24.

fair and efficient balancing of the interests on the basis that they will take into account their own interests, often at odds with those of many constituencies.[186] For instance, the directors might consider that if they favour the shareholders, their position might be enhanced, especially if they own shares in the company, or if their compensation packages are tied to share prices.[187]

It is likely that in large companies that have different kinds of shareholders, the balancing exercise will be made more complicated, for while directors might be accustomed to having to balance the interests of such persons, the fact that there are multiple types of shares is likely to exacerbate the difficulty of the directors' task of balancing when the interests of other constituencies are also taken into account.

Notwithstanding all of this, there are points that favour directors being able to balance. First, it has been argued that resolving conflicts is part and parcel of being a director. Some management specialists have even said that managing competing interests is a primary function of management.[188] The fact that the balancing of diverse interests is within directors' abilities and skills is something that has been recognised as far back as 1973 by a UK Department of Trade and Industry Report,[189] and by some American courts.[190] Directors have been classified as fiduciaries and society regularly requires those who are fiduciaries to make balanced decisions that can be quite difficult.[191] Proponents of the view might point to another kind of fiduciary, the trustee. Trustees have to make investment decisions sometimes with various categories of beneficiaries in mind. Second, while it is argued that it is easier to police how directors are acting when directors are only to act for shareholders and no one else,[192] it must not be forgotten that once all is said and done, that it is not always easy to perceive what is in the best interests of the shareholders, and directors have to balance various elements when deciding what is the best for shareholders. For example, directors might have to consider whether to take a particular action which, although it might boost the share prices of a company, it will also reduce the likelihood of dividends for a period.

Third, as adverted to above, shares come in different shapes and sizes and it is incumbent on directors to balance the interests of different kinds of shareholders, so

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[186] J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 495.

[187] D. Tauke, 'Should Bondholders Have More Fun? A Reexamination of the Debate Over Corporate Bondholder's Rights' (1989) Colum Bus L Rev 1 at 65.

[188] H. Ansoff, *Strategic Management* (Englewood Cliffs, Prentice-Hall, 1984) and referred to in J. Harrison and R. Freeman, "Stakeholders, Social Responsibility and Performance : Empirical Evidence and Theoretical Perspectives" (1999) 42 *Academy of Management Journal* 479 at 479. Management commentators have asserted that directors are in effect to act as referees between two stakeholder groups (M. Aoki, The co-operative game theory of the firm (Oxford, Clarendon Press, 1984) and referred to in T. Donaldson and L. Preston, "The Stakeholder Theory of the Corporation Concepts, Evidence, and Implications" (1995) 20 *The Academy of Management Review* 65 at 86).

[189] *Company Law Reform*, Cmnd 5391 at paras 55-59.

[190] For example, *Unocal Corporation v Mesa Petroleum Corporation* (1985) 493 A 2d 946.

[191] R. Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561 at 593.

[192] For example, R. Clark, *Corporate Law* (1986) at 20 and referred to in Committee on Corporate Laws, "Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus Law 2253 at 2270.

that they act fairly between them[193] for, on occasions, these different classes of shareholders have opposing interests.[194] Some shareholders intend only to retain shares for a short term, while others are in for the long haul. Other shareholders hold a diversified portfolio, with their investment spread around a number of companies, and still others might have all their investment concentrated in the one company. In companies that are closely-held, one might have the problem of the conflicting interests of controlling and minority shareholders. Notwithstanding this, no concerns are voiced about the stresses of decision-making for directors, nor is it argued that directors, in balancing interests, are too burdened.

Finally, it has been found empirically, in a study of UK private water companies, that the requirement that directors must consider customer interests as well as that of shareholders, can result in "mutual benefits for different stakeholder groups with apparently conflicting economic interests."[195] Therefore, this suggests that balancing can be achieved, and can be beneficial.

How have directors conducted themselves in the past? Have they engaged in balancing? There is evidence that directors are often seeking to balance interests in the decisions which they make.[196] The chairman of the US company, Standard Oil, stated, in 1946, that the business of companies should be carried on "in such a way as to maintain an equitable and working balance among the claims of the various directly interested groups – stockholders, employees, customers and the public at large."[197] More recently, a corporate reputation survey of Fortune 500 companies (the largest listed companies in the United States) found that satisfying the interests of one stakeholder does not automatically mean that this is at the expense of other stakeholders.[198] This is supported by empirical evidence, obtained in a study of Europe's most respected companies by the Financial Times, finding that chief executive officers were of the view that one of the features of a good company was the ability to ensure that there was a balancing of the interests of stakeholder groups.[199] Lorsch and MacIver, in their empirical study found that "directors usually don't share a consensus about their accountability to various constituencies and, therefore, about their purposes in serving. Further, the norm in most boardrooms is to

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193 *Mills v Mills* (1938) 60 CLR 150 at 164; *Re BSB Holdings Ltd (No2)* [1996] 1 BCLC 155 at 246-249.

194 M. McDaniel, 'Bondholders and Stockholders' (1988) 13 *Journal of Corporation Law* 205 at 273; R. Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561 at 593; R de R Barondes, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45 at 78.

195 S. Ogden and R. Watson, "Corporate Performance and Stakeholder Management : Balancing Shareholder and Customer Interests in the UK Privatized Water Industry" (1999) 42 *Academy of Management Journal* 526 at 536.

196 It has been noted that directors do already consider the interests of various constituents : *Report of the Committee on Corporate Governance* (chair, Sir Ronald Hampel) (1998) and referred to by J. Dine, 'Implementation of European Initiatives in the UK : The Role of Fiduciary Duties' (1999) 3 *Company Financial and Insolvency Law Review* 218 at 223.

197 Quoted in M. Blair, *Ownership and Control* (Washington DC, The Brookings Institute, 1995) at 212. It is also quoted in N. Craig Smith, *Morality and the Market*, London, Routledge, 1990, at 65 and referred to in J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 494, although the date given in the latter is 1950.

198 L. Preston and H. Sapienza, "Stakeholder Management and Corporate Performance" (1990) 19 *Journal of Behavioral Economics* 361.

199 Referred to in Eileen Scholes and David Clutterbuck, "Communication with Stakeholders : An Integrated Approach" (1998) 31 *Long Range Planning* 227 at 230.

avoid discussing such matters."[200] Yet, the learned authors found that while shareholders are regarded as the most important constituencies, directors do take into account the other constituencies in their decision-making.[201] In very recent times Tom Watson, the chief executive of Hermes, a British fund manager, said that British directors were managing for the short-term and this seemed to suggest that boards were focusing solely on shareholder interests and not balancing interests.[202] A recent paper has asserted that shareholder interests are in a paramount position in the attitudes of directors due to :

> "the rise of the hostile takeover and increased institutional activism, which have the effect of putting managers under greater pressure to maximize 'shareholder value,' plus remuneration schemes that link management pay to shareholder returns and heightened competition resulting from the trend towards globalization."[203]

The Confederation of British Industries has emitted mixed message. In 1973 it opined that boards should take note of obligations "arising from the company's relationships with creditors, suppliers, customers, suppliers and society at large" and to balance them and their responsibilities to shareholders.[204] But in 1996, in its submission to the Hampel Committee, it rejected the idea that directors should be responsible to non-shareholder stakeholders.[205] This latter view accords with the assertion of Deakin that "[m]anagers are encouraged to pursue strategies for share price maximisation which depend upon the externalisation of costs on to other stakeholder groups."[206] So, in sum the evidence on what directors do is somewhat equivocal.

Clearly, an issue that has emanated from the above discussion is that it is difficult to assess whether directors have undertaken appropriate balancing. It has been argued that an independent process of review is needed,[207] and Professor John Parkinson suggested a supervisory board or an independent and diversified set of non-executive directors in a single board set up.[208] But, neither the CLRSG nor the White Papers have advocated such an approach.

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[200] *Pawns or Potentates : The Reality of America's Corporate Boards*, 1989 at 38 and referred to in D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 290.

[201] Ibid

[202] P. Hosking, "Blue-chip bosses 'are too focused on short-termism" *The Times*, June 29, 2005.

[203] J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 494 and referring to J. Armour, S. Deakin, and S. Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531.

[204] *Responsibilities of the British Public Company*, London, CBI, 1973 at para 61 and referred to in J. Parkinson, ibid at 494.

[205] Confederation of British Industries, *Boards Without Tiers : A CBI Contribution to the Debate*, London, CBI, 1996 at 8.

[206] "The Coming Transformation of Shareholder Value" (2005) 13 *Corporate Governance* 11 at 16.

[207] J. Kay and A. Silberston, "Corporate Governance" [1995] *National Institute Economic Review,* August, 84 at 93-95.

[208] J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 499.

The clear benefit of the Bill is that there is an object to the balancing in which directors might have to engage, namely the promotion of the success of the company for the benefit of the members. But, arguably certainty could be achieved by simply providing that the interests are to be taken into account so as to ensure the success of the company, as an entity. In adding the proviso that the success must be for the benefit of the members, with the members' interests therefore being the primary focus, "it will never be clear whether the directors ought to favour members' short or long-term interests, or their interests in income or capital generation,"[209] and it is arguable that we do not have an approach that is much different from shareholder primacy.

B. Enforcement

If directors fail to take into account the interests enumerated in clause 156(3) of the Bill in circumstances where the company needed to do so, it causes one to ask, what penalty will ensue for the directors who are in breach of duty? The answer appears to be : none. The reason is that no one, other than the board itself or shareholders (under a derivative action), has the right to initiate proceedings against the directors. Even if action against directors is taken later, perhaps following the company's entering into administration or liquidation, it is likely to be difficult to establish that the directors should not have done what they did. First, any administrator or liquidator would have to impugn successfully any claim on the part of the directors that they had acted in good faith in a way that was most likely to promote the success of the company for the benefit of members. Second, the courts have made it plain that they will not use hindsight in making their decision when assessing the actions of directors,[210] and it might be argued, certainly when one studies the cases involving claims of wrongful trading under s.214 of the Insolvency Act 1986, the UK's equivalent of insolvent trading (under s.588G), that courts have tended to place a benevolent interpretation on what directors have done, and they have not found them liable save where they have acted in a completely irresponsible manner.[211]

The CLRSG has stated that it sees s.309 as a declaration of an enlightened shareholder value approach,[212] in that directors must have regard for the interests of the employees of the company while deciding what in the best interests of the company. However, most, if not all, are agreed that the provision is something of a lame duck,[213] and, therefore, not a particularly good example. The provision has not been used and there is very little case law on the section.[214] No one has known what to do with the provision and it is likely that that will be the case with clause 156(3) of the Bill. One of the primary problems with s.309 is that the constituent group affected, in this case the employees, has no right to bring an action against the

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209 Sarah Worthington, "Reforming Directors' Duties" (2001) 64 MLR 439 at 447.

210 For instance, see *Re Welfab Engineers Ltd* [1990] BCC 600; *Re Sherborne Associates Ltd* [1995] BCC 40.

211 For example, see *Re Continental Assurance Co Ltd* [2001] BPIR 733; *The Liquidator of Marini Ltd v Dickensen* [2003] EWHC 334 (Ch); [2004] BCC 172.

212 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21

213 See criticism of it in L. Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 Mon U LR 164 at 177.

214 Cases that refer to it, do so in passing. For instance, see *Dawson International plc v Coats Paton plc (No1)* 1988 SLT 854 at 860.

directors if they contravened the section, a point acknowledged by the CLRSG.[215] The same thing can be said for clause 156 as far as the constituencies mentioned there are concerned. The CLRSG says that the benefit of a provision like s.309 is that it will "confer an immunity on the directors, who would be able to resist legal actions by the shareholders based on the ground that the directors had neglected their normal fiduciary duty to them…"[216] That might be true, but the problem is not usually that directors considered the interests of non-shareholder interests and need protection; rather it is that the directors in fact failed to consider non-shareholder interests.

One avenue available to disenchanted shareholders is to initiate derivative proceedings, but these proceedings are not available to non-shareholder stakeholders. While the Bill provides for the introduction of derivative proceedings for shareholders, it is highly unlikely that the UK would introduce derivative actions for non-shareholders.[217] The only possible action might be to allow proceedings for injunctive relief, stopping directors from doing something that manifests a lack of regard for the interests of stakeholders. Even here it is questionable whether a court would accede to the prayers of non-shareholders, for the courts would have to consider evidence in order to make a decision as to whether directors did intend to act appropriately. Deciding this issue would not be easy even for a judge at the actual trial dealing with alleged breaches of duty, let alone on an application for an injunction, where often fewer details are available and, certainly, evidence is usually only by affidavit. Yet, if we accept that the Bill grants directors greater power and discretion there must be some framework in place to ensure that they are held accountable. As it is there are likely to be few occasions, if any, where a director is going to have to justify what he or she did. Of course, very often, and especially with what might be regarded as the day-to-day affairs of the company, constituencies will not know what the directors have done. In many situations they might not know what has been done for some appreciable time, and by then it might be too late to do anything that is effective.

The CLRSG rejected the pluralist position, *inter alia*, because it would involve directors having to consider the interests of all constituencies, and it would give no formal remedy for abuse by the directors.[218] But, that is exactly what we have with clause 156. The framework proposed by the CLRSG, and adopted by the Government, seems to have the same failings that the CLRSG identified with the pluralist theory – how to choose between a number of competing and inconsistent constituent interests? We could end up with what has been said to be wrong with stakeholder theory, namely directors are left in a position of not being accountable for their stewardship of their company's resources.[219]

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[215] Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21.

[216] Ibid.

[217] Unlike Canada, where creditors can initiate derivative proceedings if they can convince a court that they are a proper person to make an application (Business Corporations Act 1985, s.238).

[218] Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.30.

[219] Michael Jensen, "Value Maximisation, Stakeholder Theory and the Corporate Objective Function" (2001) 7(3) *European Financial Management* 297 at 305.

It has been suggested, with some significant justification, it is respectfully submitted, that while the enlightened shareholder approach is traditional[220] in substance, its objective is pluralist, with the OFR facilitating this objective.[221] Yet there is simply no meaningful mechanism by which directors can be called to account, and any breach remedied. Perhaps the real problem is that unlike in the past where the law has sought to require directors to meet acceptable standards of behaviour, such as not acting in self-interest, it is now seeking to compel directors to act in a particular manner,[222] and this is far harder to regulate.

Of course, it might be argued that some, if not all stakeholders, are protected by legislation outside of company law, so they are not relying on the directors' discretion to provide them with protection, and the CLRSG certainly thought that non-Companies Act legislation could be used to provide safeguards for stakeholders.[223] As far as creditors of the company are concerned, they are protected if directors engage in wrongful trading, in breach of s.214 of the Insolvency Act. The environment is safeguarded by the provisions of the Environment Protection Act 1990. Employees are protected by the Health and Safety Executive and employment statutes. But, these give partial and imperfect cover to stakeholders and only allow for some sort of remedy or relief *ex post*, while protection *ex ante* is often needed in order for it to be truly effective.

The fact of the matter is that protection of the interests of stakeholders is left not to any specific rights, such as the right to be heard or represented, but to the discretion of the directors, which is effectively unpoliced.

C. Good Faith

The Bill provides that directors must act in good faith in a way that is most likely to promote the success of the company for the benefit of members. This seems to be a significant departure from the terms of the 2002 draft Bill, which contained a clause, clause 2(b) of Schedule 2, that said that "in deciding what would be most likely to promote that success [of the company], [a director must] take account in good faith of all the material factors that it is practicable in the circumstances for him to identify." "Material factors" were defined as :

> "(a)The likely consequences (short and long term) of the actions open to the director, *so far as a person of care and skill would consider* them relevant; and
> (b)All such factors as a person of care and skill would consider them relevant…" (my emphasis)

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220 That is in the mould of shareholder primacy. This is regarded as the traditional approach : Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 451.

221 Sarah Worthington, "Reforming Directors' Duties" (2001) 64 MLR 439 at 440. See Company Law Review, *Modern Company Law for a Competitive Economy* : Completing the Structure, 2000, London, DTI at para 2.21.

222 Worthington, ibid at 448.

223 Company Law Review, *Modern Company Law for a Competitive Economy* : Developing the Framework, 2000, London, DTI at para 2.12.

The Bill omits any reference to the fact that the directors are to consider the factors that a person of care and skill would consider relevant. Yet, the Guidance on Key Clauses states that in having regard for the factors in clause 156 directors must comply with their duty to exercise reasonable care, skill and diligence.[224] If that is the case why did the Government remove the words, "so far as a person of care and skill would consider them relevant," that were included in the draft Bill in the 2002 White Paper. It is submitted that all that directors have to do, in carrying out their decision-making, is to act in good faith. The Guidance seems to confirm this when it states that "the decision as to what will promote success, and what constitutes such success, is one for the directors' good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith."[225] The difficulty with this is that there are no definite standards against which the actions of directors can be assessed. Directors can merely say that they acted in good faith, and their position then becomes virtually unassailable. The Guidance states that "it will not be sufficient to pay lip service to the factors." Yet, the omission of the wording that was contained in clause 2(b) of the draft Bill in the 2002 White Paper tells against this interpretation.

In the past, the courts found, in considering claims made against directors that they acted in breach of their duty to act bona fide in the best interests of the company, that it was a problem merely having a subjective test for determining whether a director had breached the duty, so objective considerations were introduced by courts to supplement the subjective test. In *Charterbridge Corp Ltd v Lloyds Bank Ltd*[226] Pennycuick J said that the court had to ask whether an intelligent and honest man in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the transaction was for the benefit of the company.[227] Unless the present law on how directors are judged is applied to the reforms, what is to prevent directors saying that they considered, in good faith, the interests of non-shareholders, but thought that what was done was appropriate? Prima facie it would seem that any grounds that are given by a director are not able to be assessed from an objective standpoint. The famous comment of Bowen LJ in *Hutton v West Cork Railway Co*[228] that:

> "Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide, yet perfectly irrational."[229]

is apposite. While the comment might be using hyperbole, the principle rings true. One can have a director doing something which he or she thinks is perfectly proper, yet it is so radical that no one else might agree with it. The question that all of this

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224 Paragraph 63.

225 Ibid at para 64.

226 [1970] Ch 62; [1969] 3 All ER 1185.

227 Ibid at 75; 1194. See *Shuttleworth v Cox Bros (Maidenhead) Ltd* [1927] 2 KB 9 at 23. The view expressed in *Charterbridge Corp* was accepted in Australia in *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386 at 402; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465; 17 ACLC 619. Also, see *Wayde v New South Wales Rugby League Ltd* (1985) 180 CLR 459.

228 (1883) 23 Ch D 654.

229 Ibid at 671.

poses is whether the courts will, in interpreting any provision based on the Bill, apply the common law rules that have been applied in the interpretation of the duty to act in good faith. With respect, I believe that Professor Sarah Worthington is correct when she says that "it is unlikely that the old cases will lose their force as illustrations of the proper application of the law."[230] Sub-clauses 154(4)(5) of the Bill do state that the in considering the general duties of directors the common law rules and equitable principles are to be taken into account, but will courts be able to use objective considerations when the legislation unequivocally refers only to a subjective test? It is submitted that the answer should be in the positive, particularly when one considers the fact that the Privy Council and the House of Lords in two notable cases, *Royal Brunei Airlines Snd Bhd v Tan*[231] and *Twinsectra Ltd v. Yardley,*[232] were of the view that in determining something as grave as dishonesty (in the context of a claim that person dishonestly assisted in a breach of trust) the test was a combined test involving both subjective and objective considerations. Nevertheless, it is likely that any attempt to argue that objective considerations warrant being taken into account will be met, on the part of directors, with the argument that Parliament did not believe that objective considerations were warranted as it decided to approve changes to the wording of the 2002 draft Bill.

D. The Operating and Financial Review

The CLRSG and the first White Paper made a lot of the fact that large companies will be required to file an OFR. The view was put by the CLRSG that demanding this review will lead to an account of stewardship of a wide range of relationships and resources.[233] The Government weighed in with similar comments saying that it would "be a major benefit for a wider cross-section of a company's stakeholders."[234] But, while directors are required to consider whether the inclusion of information about wide-ranging matters (including stakeholder interests) is necessary in the OFR,[235] the directors have no obligation to include any material in the review, to give reasons for not including material, and there is no indication as to what weight they are to give to any material, if they do include it. Furthermore, the OFR is said to hold directors more accountable to members,[236] and it is presented to the shareholders. However, it is not likely that the shareholders will be concerned that the directors have failed to take into account the interests of other constituencies. Hence, it is highly debatable whether the OFR will produce a true account of the stewardship of all relationships in which the company is involved. The Company Law Reform Bill includes very little on this subject, and critically fails to indicate what interests are to be considered in the compilation of the Review, but there is power for the Secretary of State to make provision by way of regulations as far as the objective and content of the OFR are concerned.

E. Summary

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[230] Sarah Worthington, "Reforming Directors' Duties" (2001) 64 MLR 439 at 456.
[231] [1995] 2 AC 378.
[232] [2002] UKHL 12; [2002] 2 AC 164.
[233] Company Law Review, *Modern Company Law for a Competitive Economy,* : Completing the Structure, 2000, London, DTI at para 3.4.
[234] *Modernising Company Law*, Cm 5553-I, DTI at para 4.32.
[235] *Modernising Company Law*, Cm 5553-II, DTI, clause 75(2).
[236] *Modernising Company Law*, Cm 5553-I, DTI at para 4.31.

It has been said by some advocates of shareholder primacy that directors need to pay attention to other constituencies, but only insofar as such action contributes to maximising shareholder wealth.[237] It might be argued that this is what clause 156 of the Company Law Reform Bill provides for in stating that directors are to do that which they consider, in good faith, is most likely to promote the success of the company for the benefit of the members as a whole. Therefore, one must query how enlightened is the approach being advocated by the Bill. Decisions that take into account the interests of those non-shareholders mentioned in clause 156 must ultimately serve the interests of the members of the company, and while that might well maximise the aggregate value of all those with claims on the company, some constituencies might well lose out. It would seem that the approach taken by the CRLSG, the White Papers and the Bill is to subordinate the interests of non-shareholders to those of the shareholders, just as it is with shareholder primacy. The fact is that shareholder primacy appears to be pre-eminent under the Bill, just as it is now according to some commentators.[238]

Arguably, the benefit of the enlightened shareholder value model is that it enables directors to take into account non-shareholder interests when making decisions, without being in breach of their duties, always providing that their ultimate decisions do in fact promote the success of the company for the benefit of its members as a whole. Of course, if the actions of the directors do achieve this objective it is unlikely that shareholders would be complaining about the fact that directors have considered the interests of other stakeholders. The only scenario where shareholders might take umbrage at what the directors have done is where the company would have been more successful had the directors not taken into account non-shareholder interests.

VII Conclusion

Undoubtedly, there is room for debate as to whether shareholder primacy has normative value. This paper has not sought to address that issue. What it has done is to explain the shareholder primacy principle and to identify the arguments that have been mounted both for and against the implementation of the principle, as well as considering whether it is part of positive law. It has been concluded that it is questionable whether the principle applies unequivocally in either the US, where one American commentator has said that the shareholder primacy norm "may be one of the most overrated doctrines in corporate law,"[239] or the UK, and there does not seem to be a clear strain of authority, certainly in the UK, that supports its use. The law has been that directors are to act in the best interests of the company, and it would appear that all too often the assumption has been made that the interests of the company accord with profit maximisation for shareholders. Certainly, the CLRSG assertion that shareholder primacy is descriptive of the law of companies in the UK is questionable, but, while acknowledging the need to take into account other interests, it

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[237] For instance, Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 451.

[238] This might well illustrate the point that Professors Lucian Bebchuk and Mark Roe have argued for, namely that corporate rules are path dependent : "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford Law Review* 127.

[239] D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 322.

accepted it as the basis for the company law reform process. The Government agreed with this in the first two White Papers that have been published.

The paper has also examined the enlightened shareholder value principle that was favoured initially by the CLRSG, and latterly by the Government in its White Papers and Company Law Reform Bill. The enlightened shareholder value principle is clearly based on shareholder primacy and involves directors having to act in the collective best interests of shareholders,[240] but it does not demand exclusive concern for short-term gains, rather it seeks an approach that values the building of long-term relationships.[241] It has been noted in the paper that the provisions in the Company Law Reform Bill effectively require directors to engage in a balancing of the interests of various constituencies, but with little or no guidance, other than that they are to be concerned about benefiting the members' interests; the directors are given virtually an unfettered discretion as to what interests, if any, they take into account. The paper has asserted that if any constituent is unhappy with the way that directors have acted, they have no power to bring proceedings to have the directors' acts reviewed. Even shareholders, who can utilise the derivative suit, might find it difficult to establish that a director has failed to do that which the legislation requires him or her to do. The clauses in the Bill provide that the directors must act in good faith, but this involves a subjective test and means, unless the courts employ objective considerations as a counterweight, as they have done in the past when assessing the good faith of a director, that the decisions of directors will be able to be challenged in few cases.

The enlightened shareholder value approach is seen as providing a radical reform.[242] While some might argue that directors have been doing what the Bill aims to require them to do, to place this in statutory form is certainly able to be classified as radical. How different the enlightened shareholder value approach will be, when compared with the shareholder primacy principle, will largely depend on how the provision will be interpreted and applied, first by directors and, more importantly, by the courts. It appears that in practice the approach is likely to be little different from the shareholder primacy approach. It would mean that shareholder primacy, the pre-eminence of which has been subject to no little doubt, would clearly be paramount. Arguably, non-shareholder constituents will be less advantaged under a provision in the mould of clause 156 of the Bill as directors will no longer be subject to common law guidelines, but statutory directives, and those directives support, in essence, a shareholder-centric approach to management of companies.

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[240] Company Law Review, *Modern Company Law for a Competitive Economy*, : Developing the Framework, 2000, London, DTI at para 2.22

[241] Ibid.

[242] Lee Roach, "The legal model of the company : the Company Law Review" (2005) 26 Co Law 98 at 103.