Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach'

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Abstract

Ascertaining the objective of public companies has been a matter of debate for many years in many countries, including the United Kingdom and Australia. This has partly been because there has been no definitive statutory pronouncement on the matter. In its new *Companies Act* 2006, the United Kingdom has included, in its statement on directors' duties, what, in effect, is to be the objective of companies. This statement is set out in s 172(1). After discussing the shareholder value principle, hitherto regarded as encapsulating the corporate objective in the UK, and the policy and legislative processes that led to the enactment of s 172(1), this article analyses the provision and argues that while the enlightened shareholder value approach provided for by s 172(1) is seen as providing a significant new development in UK law the approach is in fact little different from the shareholder value approach.

PART 1

1. Introduction

For many years there has been a continuing debate in corporate law circles regarding the precise objective of public companies. There have been two main theories put forward: the shareholder value principle (or paradigm), also known as the shareholder primacy principle or the shareholder wealth maximisation norm;[1] and the stakeholder theory. The former requires, inter alia, a company to be run in

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1 The UK's Company Law Review Steering Group did in fact refer to the principle simply as 'shareholder value': The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy*: *The Strategic Framework* (1999) at 37 <http://www.berr.gov.uk/files/file23279.pdf>. See also, Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547 at 549, 552,563; Stephen Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 *Washington and Lee Law Review* 1423; Mark Roe, 'The Shareholder Wealth Maximization Norm and Industrial Organization' (2001) 149 *University of Pennsylvania Law Review* 2063.

such a way as to maximise the interests of the shareholders ahead of any other interested parties who might have claims against the company.[2] The objective of the company, under this principle, is to maximise the market value of the company 'through allocative, productive and dynamic efficiency.'[3] It is said that this approach provides the best means of securing overall prosperity and welfare. The principle is generally regarded as applying in relation to companies located in Anglo-Saxon jurisdictions, such as the United Kingdom ('UK'), Australia, the United States, Canada and New Zealand. Alternatively, the stakeholder theory provides that the objective of the company is to benefit all those who can be identified as stakeholders. The directors are not only to manage the company for the betterment of shareholders, but also in the interests of a multitude of stakeholders (including the shareholders)[4] who can affect or be affected by the actions of a company.[5] This approach is 'premised on the theory that groups in addition to shareholders have claims on a company's assets and earnings because those groups contribute to a company's capital.'[6] It is embraced in many continental European jurisdictions, and most notably in Germany.

The shareholder value principle, as I will refer to the former of the two theories described above, is said to be embraced by most scholars,[7] a fact recognised by some advocates of stakeholder theory,[8] and applied by the courts and business alike.[9] Although the UK courts have not uniformly embraced the shareholder value principle,[10] it is generally perceived as the basis for corporate law in the UK. This is made clear by the statement of the Company Law Review Steering Group

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

3 Colin Mayer, 'Corporate Governance, Competition and Performance' (1997) 24 *Journal of Law and Society* 152 at 155.

4 It is usually accepted that directors will be obliged to balance the interests of the various stakeholders in deciding on what are appropriate courses of action.

5 R Edward Freeman, 'A Stakeholder Theory of the Modern Corporation' in Tom L Beauchamp and Norman E Bowie (eds), *Ethical Theory and Business* (5th ed, 1997) at 69. It should be noted that the meaning of 'stakeholder' is a matter of some debate. For instance it might be said to encompass groups vital to the success and survival of the company. See, for example, Freeman, 'A Stakeholder Theory of the Modern Corporation' at 31.

6 Roberta S Karmel, 'Implications of the Stakeholder Model' (1993) 61 *George Washington Law Review* 1156 at 1171.

7 Henry Hansmann & Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439 at 440–441; Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance', above n1 at 563. It must be noted that some leading writers, primarily in the management and ethics fields, have actually proclaimed boldly that stakeholder theory is generally so pre-eminent that shareholder primacy is in fact dead. See, for example, R Edward Freeman: 'The Politics of Stakeholder Theory: Some Future Directions' (1994) 4 *Business Ethics Quarterly* 409 at 413.

8 Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (December 2005) *Fordham Law Legal Studies Research Paper No 105* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878391>; Kent Greenfield, 'New Principles for Corporate Law' (2005) 1 *Hastings Business Law Journal* 89 at 89.

9 There are some who have taken issue with this last point. See, for example, Margaret Blair & Lynn Stout, 'A Team Production Theory to Corporate Law' (1999) 85 *Virginia Law Review* 247.

('CLRSG'), established in 1998 by the Department of Trade and Industry in order to review UK corporate law.[11] The CLRSG found that UK law reflected the fact that companies are managed for the benefit of the shareholders, and confers on the shareholders ultimate control of the undertaking, such that '[t]he directors are required to manage the business on their behalf…'[12] It went on to say that the ultimate objective of companies is to generate maximum wealth for shareholders.[13] Referring to the observations made by the CLRSG brings me to the central thrust of this article. In its substantial review of corporate law, and subsequent recommendations for reform, the CLRSG went on to advocate the embedding of a statement in legislation concerning the corporate objective and the principle that it proposed is known as the enlightened shareholder value principle. The UK Government accepted the wisdom of the enlightened shareholder value principle and in late 2005 included it in a huge Company Law Reform Bill that it introduced into Parliament. This Bill became the foundation for the *Companies Act* 2006 (UK) ('the Act'), which received Royal Assent on 8 November 2006. I should add that some portions of the Act will not become operative for some time due to the need to formulate regulations to support the implementation of the legislation. However, s 172, the primary focus of this article came into force on 1 October 2007.

The aim of this article is to explain the enlightened shareholder value principle that has been implemented in the UK, to evaluate it critically, and to argue that while the enlightened shareholder value approach is seen as providing a radical reform,[14] the approach is little different from the shareholder value approach. The article is structured as follows. In Part 2, I discuss the shareholder value principle, which is essential given that it formed the basis for the enlightened shareholder value principle. Part 3 provides an explanation of the genesis of the enlightened shareholder value approach in the UK. Part 4 of the article critically examines this approach in the context of the UK's corporate legislation. Finally, some concluding remarks are provided.

Consideration of the UK's approach of setting out in legislation the objective of companies is of particular interest in light of the recent investigation by the

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10 See, *Fulham Football Club Ltd v Cabra Estates plc* [1992] BCC 863 at 876 (Lord Justice Neill); Andrew Keay, 'Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective' (2006) *Lloyds Maritime and Commercial Law Quarterly* 335 at 341–346. It would appear that the US courts have also not been completely unequivocal in their acceptance of shareholder value. See, for example, Richard A Booth, 'Who Owns a Corporation and Who Cares?' (2001) 77 *Chicago-Kent Law Review* 147 at 147. It has been said that corporate law in Delaware remains ambivalent on whether shareholder primacy is the determining force: William T Allen, Jack B Jacobs & Leo E Strine, Jr, 'The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide' (2002) 69 *University of Chicago Law Review* 1067 at 1067.

11 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework,* above n1 at 34.

12 Id at 34–35.

13 Id at 37.

14 Lee Roach, 'The Legal Model of the Company and the Company Law Review' (2005) 26 *Company Lawyer* 98 at 103.

Australian Parliamentary Joint Committee on Corporations and Financial Services, and its subsequent report, 'Corporate Responsibility: Managing Risk and Creating Value',[15] and the even more recent report of Australia's Corporations and Markets Advisory Committee ('CAMAC')[16] on the same topic. Both reports contained a brief discussion of the enlightened shareholder value approach.[17] Also, the issue that the UK legislation seeks to address is one that confronts Australia (and other countries) as both the Australian Parliamentary Joint Committee and CAMAC recognised in their respective reports. In Australia, the issue has come to the fore as a result of, for example, the furore over the decision of the James Hardie Group to restructure its affairs in order to safeguard itself from liability for the injuries sustained by individuals as a consequence of the use and production of its asbestos products in Australia for over 70 years.[18] The restructuring included, it seems, the transfer of assets offshore with the result that Australian victims could not recover compensation for their suffering.[19]

PART 2

1. Shareholder Value Principle

A. The Background

Shareholder primacy has been largely fostered as a leading principle of corporate law by the contractarian school in the United States.[20] It was in the United States in the early 1930s that we find the genesis of the debate concerning the objective

15 Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth of Australia, *Corporate Responsibility: Managing Risk and Creating Value* (2006) <www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/report/report.pdf>

16 Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations,* (2006) at 111 <http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2006/$file/CSR_Report.pdf >

17 Parliamentary Joint Committee on Corporations and Financial Services, above n15 at 51–52; Id at 102–107.

18 Id at 47.

19 Peter Prince, Jerome Davidson & Susan Dudley**,** 'In the shadow of the corporate veil: James Hardie and asbestos compensation,' *Law and Bills Digest Section, Research Note No 12 of 2004-05*, Parliament of Australia, 10 August 2004, and accessible at <http://www.aph.gov.au/Library/pubs/rn/2004-05/05rn12.htm>. See also, E Dunn, 'James Hardie: No Soul to be Damned and No Body to be Kicked' (2005) 27 *Sydney Law Review* 339.

20 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; Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green', above n1; Bernard Black & 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 & F Meisel, *Corporate and Commercial Law: Modern Developments* (1996) at 121.

of a company. It began in earnest with the debates between Professors Adolf Berle and E Merrick Dodd, and carried out in the literature published at the time.[21] Without going into great detail, for the debate has been rehearsed on many occasions, 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.[22] 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.[23] 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 have been adopted, especially in the United States. It might be said that the pre-eminence of this position has been attenuated somewhat by the introduction of constituency statutes in most 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 that there has not been, it has been minimal, certainly amongst academic commentators, as the number of learned articles arguing for a shareholder maximisation approach attests.

On the issue of whether shareholder interests should be at the forefront of the minds of directors, there has been debate for many years in several jurisdictions, with the UK and Australia being prime examples, as to whether directors are actually permitted to take into account the interests of non-shareholders in the management of the company. The law appears to be such that directors are not obliged to manage their companies so as to produce exclusively short-term benefits, such as maximising immediate profits.[24] Courts have stated that directors may take into account the long-term well-being of a company;[25] and that it is really a matter of a commercial judgment on directors' part.[26] There is case law to the effect that while directors are to manage their companies with shareholders in mind, they do have a reasonably wide discretion in the factors which they may consider in deciding what is going to benefit the company.[27]

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21 See Adolf A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049; E Merrick Dodd, 'For Whom are Corporate Managers Trustees?' (1932) 45 *Harvard Law Review* 1145; Adolf A Berle, 'For Whom Managers are Trustees: A Note' (1932) 45 *Harvard Law Review* 1365. See also, Adolf A Berle & Gardiner Means, *The Modern Corporation and Private Property* (1932); E Merrick Dodd, 'Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?' (1935) 2 *University of Chicago Law Review* 194.

22 Berle, 'Corporate Powers as Powers in Trust', above n21 at 1049. The view was put forward, in effect, in the earlier decision of *Dodge v Ford Motor Co* 170 NW 668 (1919) (Michigan).

23 Dodd, 'For Whom are Corporate Managers Trustees?', above n21 at 1148.

24 Corporations and Markets Advisory Committee, above n16 at 84–89.

25 *Provident International Corporation v International Leasing Corp Ltd* [1969] 1 NSWR 424 at 440 (Helsham J); *Paramount Communications Inc v Time* Inc 571 A. 2d 1140 (Del, 1989).

26 Corporations and Markets Advisory Committee, above n16 at 84–89.

B. The Arguments in Favour

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[28] regard the company as nothing more than a number of complex, private, consensual contract-based relations,[29] either express or implied, and that they consist of many different kinds of relations that are worked out by those voluntarily associating in a company.[30] The contractarians generally[31] regard shareholder primacy as the focal point of their view of the public company.[32] The principle fills gaps in the corporate contract[33] and establishes 'the substance of the corporate fiduciary duty.'[34]

The preference for shareholder primacy is not a consequence of a 'philosophical predilection'[35] towards shareholders, but a concern that the business should be run for the benefit of the residual claimants, namely, the shareholders,[36] while the company is solvent.[37] This is regarded as the primary argument in favour of the shareholder value principle. The residual claimants have a claim to the company's surplus[38] and, therefore, the greatest stake in the outcome of the company;[39] they will benefit if the company's fortunes increase, but they bear a greater risk than fixed claimants, such as creditors, and will lose out if the company hits hard times (with their claims being last in line if the company is liquidated). As a result shareholders will value the right of control above any other stakeholders,[40] as they have an interest in every decision that is taken by a solvent firm.[41] It has been said that as shareholders are the owners of the company,[42] those

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27 For instance, *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil NL* (1968) 121 CLR 483 at [493] (Barwick CJ, McTiernan & Kitto JJ); *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288 (BCSC); *People's Department Stores Inc v Wise* [2004] SCC 68, 244 DLR (4th) 564 at [42] (Major, Deschamps JJ), all referred to in Corporations and Markets Advisory Committee, above n16 at 84–89. Also, see *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627 (HL).

28 See, for example, Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 99 *Journal of Political Economy* 288 at 290.

29 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 at 759.

30 This is the nexus of contract theory. See, Frank H Easterbrook & Daniel R Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416 at 1426. At p1428 the learned commentators give examples of some of the arrangements.

31 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; Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance', above n1.

32 M Bradley, C Schipani, A Sundaram & 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.

33 Frank Easterbrook & Daniel Fischel *The Economic Structure of Company Law* (1991) at 90–93; Jonathon R Macey & Geoffrey P Miller, 'Corporate Stakeholders: A Contractual Perspective' (1993) 43 *University of Toronto Law Review* 401 at 404.

who manage the company should do so for the benefit of the shareholders.[43] 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 groups to enjoy the benefits that the duties produce.[44] 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 value. First, according to the agency theory,[45] 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 thus it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.[46] It is said that without the shareholder value principle, the directors are able to engage in opportunistic behaviour, known as 'shirking.' Costs, known as 'agency costs',[47] 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 value means that directors are made 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 having this as the object rather than

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34 Thomas. 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).

35 Bradley et al, above n32 at 37.

36 Some scholars take issue with the statement that shareholders are residual claimants. For instance, see Lynn Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189 at 1193–1194. The Investment Management Association, the trade body representing the asset management industry in the UK, has clearly supported the view that the shareholders are the residual claimants and that other stakeholders are able to protect themselves through contract, something that shareholders cannot do. See the Association's response to the International Accounting Standards Board's discussion paper on the conceptual framework for financial reporting <http://www.investmentfunds.org.uk/news/research/2006/topic/corporate_governance/imaresponsetoiasbdponconceptualframework.pdf>

37 Easterbrook & Fischel, above n33 at 36–39. Professors Margaret Blair & Lynn Stout take issue with this: 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 *Washington University Law Quarterly* 403 at 404. Also, see Stout, id at 1192–1193.

38 It has been argued that shareholders are not the only stakeholders with a claim to the surplus. See, Henry Hu, 'New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare' (1991) 69 *Texas Law Review* 1273; Stout, above n36 at 1194; Fisch, above n8 at 28.

39 Jonathon R 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* (1995) at 229.

40 Mark E Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 57; Bradley et al, above n32 at 38.

41 Macey & Miller, above n33 at 408.

something else;[48] and 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.[49] It is said that the principle is certain and easy to administer, especially when compared with the stakeholder theory,[50] under which directors are to act with all stakeholder interests in view. Shareholder value allows, so the argument goes, courts to review managerial conduct with some rationality.[51]

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 have this kind of protection. The assertion is made that the shareholders are vulnerable[52] in that they are not, unlike creditors, able to negotiate special terms by way of contract, and are consequently, in many ways, at the mercy of the directors. This is due to the fact that there is an inherent difficulty in monitoring the work of directors.[53]

Finally, it is argued that shareholders are not able to exit a company without considerable sacrifice, because while they can sell their shares to another, the price obtained will take into account any shareholder exploitation. As Professor Jill Fisch has observed: '[T]hey [the shareholders] will bear the costs of misdeeds or self-dealing by other stakeholders even if they exit.'[54]

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42 This view is probably most associated with Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits', *New York Times, Section 6* (13 September 1970), at 32, 33. Adolph Berle and Gardiner Means referred to shareholders as owners in their seminal work: *The Modern Corporation and Private Property* (1932) at 9. See also, Robert Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model' (1979) 30 *Hastings Law Journal* 1327 at 1330; Oliver Hart, 'An Economist's Perspective on the Theory of the Firm' (1989) 89 *Columbia Law Review* 1757 at 1765; Melvin A. Eisenberg, 'The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm' (1999) 24 *Journal of Corporation Law* 819 at 825–826. The view has also been espoused in the UK: Sir Adrian Cadbury (Chairman), *Report of the Committee on the Financial Aspects of Corporate. Governance* (The Cadbury Report) (1992) at para 6.1 <http://www.ecgi.org/codes/documents/cadbury.pdf> (last visited 20 September 2007); Confederation of British Industries, *Boards Without Tiers: A CBI Contribution to the Debate* (1996) at 8.

43 This view has been criticised by many. For example, Martin Lipton & Steven Rosenblum, 'A New System of Corporate Governance: The Quinquenial Election of Directors' (1991) 58 *University of Chicago Law Review* 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* 41; Sarah Worthington, 'Shares and Shareholders: Property, Power and Entitlement' (Part 1) (2001) 22 *The Company Lawyer* 258 and 'Shares and Shareholders: Property, Power and Entitlement' (Part 2) (2001) 22 *The Company Lawyer* 307; Stout, above n36 at 1190. Also see, *Short v Treasury Commissioners* [1948] 1 KB 116 at 122 where Lord Justice Evershed of the English and Wales Court of Appeal denied the fact that shareholders were the owners of a company. Professor Jill Fisch has said that even if shareholders are characterised as owners this does not determine whether other stakeholders can claim an ownership interest in the corporation (Fisch, above n8 at p16).

44 Macey & Miller, above n33 at 410.

C. *The Critics*

It has been asserted in recent times that corporate governance debates have now been resolved in favour of the shareholder value model.[55] Professor Ronald Gilson has even said that corporate law's only distinctive feature is as a means to increase shareholder value.[56] However, the shareholder value principle has long had its critics. One commentator has argued that the 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.[57] Others have said that shareholder value produces a short-term focus and that short-term earnings performance overshadows all else,[58] and this fails to maximise social wealth.[59] Professor Larry Mitchell has argued that American corporations are so focused on turning over short-term profits in order to benefit their shareholders that the result can be deleterious for various groups, including employees and consumers, and even for the long-term well-being of the corporation itself.[60]

In addition, it might be said that the emphasis on the shareholders being residual risk-bearers is misplaced vis-à-vis other stakeholders. It is not only shareholders who make firm-specific investments that put them in a vulnerable position. For instance, employees might embark on certain training that can only be used in the company for which they are working, making their employment prospects limited as they are unable to move to another employer and gain from

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45 This is based on a large number of works, but arguably the most influential are: Michael Jensen & William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 99 *Journal of Political Economy* 288; Eugene Fama & Michael Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301; Easterbrook & Fischel, above n33.

46 John Matheson & Brent Olson, 'Corporate Law and the Longterm Shareholder Model of Corporate Governance' (1992) 76 *Minnesota Law Review* 1313 at 1328.

47 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.

48 Van der Weide, above n40 at 56–57.

49 The Committee on Corporate Law, 'Other Constituency Statutes: Potential for Confusion' (1990) 45 *The 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.

50 Van der Weide, above n40 at 68.

51 Id at 69.

52 See Luigi Zingales, 'Corporate Governance' in *The New Palgrave Dictionary of Economics and the Law* (1998) at 501.

53 Many scholars point out that this does not take into account that that stakeholder contracts are deficient in that they are not complete and are not priced perfectly. See Fisch, above n8 at 29–30: 'To the extent that stakeholder contracts are imperfect or incomplete, stakeholders may retain a residual interest as well as a fixed claim.' (Fisch at 30).

54 Fisch, above n8 at 26.

55 Hansmann & Kraakman, above n7.

the training that they have undertaken. Companies are, in such situations, able to hold employees virtually to ransom. In fact, shareholders are arguably able to diversify risk more easily than other stakeholders. Finally, the idea that the shareholders own the company does not sit well with the concept of the company being a separate legal entity. Shares are clearly the shareholders' property, but the company is not. Shareholders are unable, short of a solvent liquidation where property can be distributed in specie to shareholders, to point to any property held by the company and assert ownership rights over it.

Some theorists have questioned the normative value of shareholder value,[61] and those holding to a communitarian view of the company[62] object to the shareholder value principle on normative grounds,[63] 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.[64] 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.[65] In the communitarian assessment a greater array of social and political values are considered and communitarians take the view 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.[66] 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,[67] and the company is regarded as 'a community of interdependence, mutual trust and reciprocal benefit.'[68] 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 the consideration of directors.[69] The effect of invoking a shareholder value 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.[70] Therefore, communitarians have criticised it, with Professor Lyman

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56 Ronald J Gilson, 'Separation and the Function of Corporation Law' (January 2005) *Stanford Law and Economics Olin Working Paper No 307* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=732832>.

57 D Gordon Smith, 'The Shareholder Primacy Norm' (1998) 23 *Journal of Corporate Law* 277 at 279.

58 Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties' (1991) 21 *Stetson Law Review* 163 at 176–177; See also M Lipson & S Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors (1991) 58 *University of Chicago Law Review* 187 at 205–215; Van der Weide, above n40 at 61.

59 Wallman, id at 176–177; Lipson & Rosenblum, id at 203.

60 Larry Mitchell, 'Corporate Irresponsibility: America's Newest Export' (2001).

61 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; Stout, above, n36 at 1191.

Johnson saying that 'a radically pro-shareholder vision of corporate endeavour [is] substantially out of line with prevailing social norms,'[71] and that courts must acknowledge this and define 'the meaning of corporate endeavour'[72] by embracing norms 'wider than the thin thread of shareholder primacy.'[73]

Other commentators, who specialise in organisational behaviour and other management disciplines, have also challenged shareholder value theory, embracing a wider perspective. Such commentators propound what is called 'a stakeholder theory.'[74] They take the view that directors have to balance the interests of different constituencies that make up the company. Clarkson illustrates this when he states that: 'Managers are now accountable for fulfilling the firm's responsibility to its primary stakeholder groups.'[75] Theorists adhering to this approach see the company as a set of relationships in which managers adopt an inclusive concern for all stakeholders, both internal stakeholders, such as employees, and external stakeholders, such as consumers. The leading advocate of stakeholder theory, Professor R Edward Freeman, and his co-authors express the rationale behind the theory in this way:

> Business is about putting together a deal so that suppliers, customers, employees, communities, managers and shareholders all win continuously over time. In short, at some level, stakeholder interests have to be joint – they must be traveling in the same direction – or else there will be exit, and a new collaboration formed.[76]

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62 Many of the proponents prefer to call their approach, a 'progressive approach.' For discussions of this approach to corporate law, see, for example, Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995); William W Bratton Jr in 'The 'Nexus of Contracts Corporation': A Critical Appraisal' (1989) 74 *Cornell Law Review* 407; Lawrence Mitchell, 'The Fairness Rights of Bondholders' (1990) 65 *New York University Law Review* 1165; David Millon, 'Theories of the Corporation' [1990] *Duke Law Journal* 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 David Milman (ed), *Regulating Enterprise: Law and Business Organisations in the UK* (1999) at 295–296; Janet Dine, *Company Law* (2001) at 27–30; John Parkinson, *Corporate Power and Responsibility* (1993); Gavin Kelly & 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 Review* 141.

63 For instance, see David Millon, 'Redefining Corporate Law' (1991) 24 *Indiana Law Review* 223 at 227–229.

64 Those arguing for a 'team production' approach to corporate law (the main scholars adopting this view are Professors Margaret Blair & Lynn Stout (see above n9 and n37) take a similar approach although they focus on economic analysis while communitarians do not do so.

65 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 learned commentator states that 'the corporation is a human enterprise': Lawrence Mitchell, 'The Death of Fiduciary Duty in Close Corporations' (1990) 138 *University of Pennsylvania Law Review* 1675 at 1675.

Unlike many communitarians who eschew economics and focus solely on ethics and fairness, stakeholder theory seeks to combine economics and ethics, and in doing so it has been said that it 'tames the harsher aspects of capitalism.'[77]

Stakeholder theory has a lot of support and some leading writers have even proclaimed boldly that stakeholder theory is generally so pre-eminent that shareholder value is dead.[78]

PART 3

1. The Emergence of the Enlightened Shareholder Value Approach

The UK's company law legislation developed significantly in the mid-nineteenth century, and has been amended many times since then. Notwithstanding many changes to company legislation in the nineteenth and twentieth centuries, much of the framework and many of the rules found in the *Companies Act* 1862 remained in place at the end of the twentieth century. With this in mind, in March 1998 the UK's Department of Trade and Industry commissioned a review that was to formulate proposals for the reform of company law.[79] The review was to be overseen by a committee that became known as the Company Law Review Steering Group. The CLRSG published several substantive papers that set out its views and sought responses to questions posed. In July 2001 it submitted a Final

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66 Daniel. Sullivan & David 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 Dine, above n62 at 295.

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

68 David Millon, 'Communitarianism in Corporate Law: Foundations and Law Reform Strategies' in Lawrence E Mitchell (ed), *Progressive Corporate Law: New Perspectives on Law, Culture and Society* (1995) at 10.

69 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, Id at 7–9. Progressives differ among themselves concerning the strength of the claims of various non-shareholder constituencies to warrant legal intervention.

70 Gavin Kelly & John Parkinson, 'The Conceptual Foundations of the Company: A Pluralist Approach' in J Parkinson, A Gamble & G Kelly (eds), *The Political Economy of the Company*, (2000) at 131.

71 Lyman Johnson, 'The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law' (1990) 68 *Texas Law Review* 865 at 934.

72 Ibid.

73 Ibid.

74 For instance, see R E Freeman, *Strategic Management : A Stakeholder Approach* (1984); T Clarke & S Clegg, *Changing Paradigms : The Transformation of Management Knowledge for the 21st Century* (2000); T Donaldson & L Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, Implications' (1995) 20 *Academy of Management Review* 65.

75 Max Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance' (1995) 20 *Academy of Management Review* 92 at 112.

Report to the Secretary of State for Trade and Industry. Subsequently the UK government drafted two White Papers that provided its response to the CLRSG's Final Report.[80] After receiving feedback from the community, the Company Law Reform Bill 2005 was introduced into Parliament in November 2005. The Bill was subjected to considerable debate in both Houses of Parliament until it was finally passed. It became the *Companies Act* 2006 (UK)[81] on 8 November 2006, and when all of it is put into operation it will encompass most of the law that affects companies in the UK.

The CLRSG clearly saw the issue of, in whose interests company law should be formulated, as a critical one in its deliberations.[82] The CLRSG proceeded to identify two possible approaches to addressing the issue, namely either a shareholder value approach or a pluralist approach, the latter essentially providing for a stakeholder model, and it did this in connection with its recommendations to have the duties of directors, which were based on common law, codified, thereby bringing the UK in line with many other common law jurisdictions, such as Australia. The CLRSG noted that shareholder value has generally been implemented in the UK, and pointed up, in its discussion of the issue of for whose benefit a company should be managed, many of the arguments that have been used by those in favour and those against the implementation of the principle. The CLRSG stated that the law reflected the fact that companies were managed for the benefit of the shareholders,[83] and it conferred on the shareholders ultimate control of the undertaking, such that '[t]he directors are required to manage the business on their behalf …'[84] It went on to say that the ultimate objective of companies is to generate maximum wealth for shareholders.[85]

In considering the objective of companies in carrying on business, the CLRSG advocated an approach, which it referred to as 'enlightened shareholder value,'[86]

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76 R Edward Freeman, Andrew Wicks & Bidhan Parmar, 'Stakeholder Theory and "The Corporate Objective Revisited'"; (2004) 15 *Organization Science* 364 at 365 and referring to S Venkataraman, 'Stakeholder Value Equilibration and the Entrepreneurial Process' in R E Freeman & S Venkataraman (eds), *The Ruffin Series No 3: Ethics and Entrepreneurship* (2002) at 45.

77 John Plender, *The Stakeholding Solution*, 1997 and quoted in Janice Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (2001) at 117.

78 See, for example, Freeman, above n7 at 413.

79 The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy* (1998) at <http://www.berr.gov.uk/files/file23283.pdf>.

80 Department of Trade and Industry – Government White Paper, Modernising Company Law', *Command Paper* Cm 5553–1 (Comment) and 'Modernising Company Law: Draft Clauses', *Command Paper* 5553–11 (Draft Companies Bill), Her Majesty's Stationery Office (now Office of Public Sector Information) (2002) available at <http://www.dti.gov.uk/companiesbill/whitepaper.htm>.

81 The legislation is the longest in UK parliamentary history.

82 See, The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework,* above n1 at 34.

83 Ibid.

84 Id at 34.

85 Id at 37.

('ESV') and which it felt would better achieve wealth generation and competitiveness for the benefit of all. This approach was clearly based on shareholder value and involved directors having to act in the collective best interests of shareholders,[87] but it eschewed an 'exclusive focus on the short-term financial bottom line' and sought a more inclusive approach that valued the building of long-term relationships.[88] It involved 'striking a balance between the competing interests of different stakeholders in order to benefit the shareholders in the long run.'[89] 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.[90]

In the process of embracing the ESV approach, the CLRSG considered, and subsequently rejected,[91] 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.[92]

The CLRSG stated that adopting the pluralist approach (interestingly the CLRSG avoided the use of stakeholder nomenclature) would necessitate substantial reform of the law on directors' duties,[93] and later in another consultation paper, the CLRSG stated that it regarded the pluralist approach as neither workable nor desirable in the UK.[94] In a subsequent consultation paper, the CLRSG explained its approach further, stating that under the ESV 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.'[95]

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86 Ibid.

87 The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy: Developing the Framework* (2000) at 15 <http://www.berr.gov.uk/bbf/co-act-2006/clr-review/page25086.html>.

88 Ibid.

89 John Armour, Simon Deakin & Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531 at 537.

90 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework,* (1999), above n87 at 35.

91 This is developed in the Company Law Review Steering Group, *Modern Company Law for a Competitive Economy : The Strategic Framework,* above n1 at 33–36.

92 Id at 37–38.

93 Id at 45.

94 The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy: Completing the Structure* (2000) at 34 <http://www.berr.gov.uk/bbf/co-act-2006/clr-review/page25080.html>.

95 The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy: Developing the Framework,* above n87 at 12–14.

In addition, the CLRSG recommended that listed companies and certain other large companies with significant economic power should publish an operating and financial review as part of the company's annual report.[96] This review would be:

> 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.[97]

The concept of ESV appears to be similar to enlightened value maximisation that has been advocated in recent years 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.[98]

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

When the UK government came to responding to the recommendations of the CLRSG, first in White Papers and then in a Bill, it embraced the ESV concept, and it is now enshrined in s 172(1) of the *Companies Act* 2006 (UK), albeit a little differently drafted. That section states that:

> (1) A director of a company must act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —
>
> (a) the likely consequences of any decision in the long term,
> (b) the interests of the company's employees,
> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the environment,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly between the members of the company.

96 The Company Law Review Steering Group, Department of Trade and Industry, *Modern Company Law for a Competitive Economy*: *The Final Report, Volume 1* (2001) at 49–54.

97 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure,* above n94 at 34.

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

PART 4

1. An Assessment of Enlightened Shareholder Value

In considering the objective of the company, the CLRSG, and later the UK Government, seemed to wish to retain the idea of the shareholders being the ultimate focus of directors, but they wanted to have a greater emphasis placed on the company's long term future. Certainly the invoking of the description 'enlightened shareholder value' seems to suggest that it is a different concept from shareholder value in its basic form, with the distinguishing feature being that it is more enlightened and, ipso facto, more palatable than that which preceded it. That is, the approach is more enlightened as directors are required to take into account interests other than those of the shareholders. As we will see, this does not take the matter very far, for, as CAMAC has rightly noted:

> The section [s 172] makes clear that directors owe their fiduciary duty only to the shareholders generally, rather than a range of interest groups, but seeks to provide a broader context for fulfilling that duty.[99]

The obvious view of the UK government is that the fact that a director is required to have regard for the interests of non-shareholder stakeholders and the long-term interests of the company mean that corporate law is subject to an enlightened approach. Arguably, the only enlightened element seems to be found in the recognition that directors may take into account material interests, namely those enumerated in s 172(1), if they wish and not be sued for doing so, but this is only provided that the action that they take promotes the success of the company for the benefit of the members as a whole. It must be noted that directors cannot pursue a course of action that might be good for all material interests, unless it ultimately benefits the members. So, this would appear to rule out the possibility of actions such as directors declining to dismiss employees, unless that would ultimately benefit shareholders. It is submitted that the overall effect of s 172(1) is that ESV can be classified as a 'shareholders first interpretation.' This interpretation is explained as follows:

> The basic legal position is quite straightforward: the duty of directors to act in good faith and in the best interests of the company…requires directors to treat *shareholders'* interests as paramount. The interests of employees, or other stakeholders, can be considered in performing these duties – but only where this would be in the company's (ie the shareholders') interests.[100] [Emphasis in original].

99 Corporations and Markets Advisory Committee, above n16 at 103–107.

100 Parliamentary Joint Committee on Corporations and Financial Services, above n15 at 51. The submission came from Dr Anthony Forsyth, Department of Business Law and Taxation, Monash University, Submission 39 at [17].

A. The Prescribed Factors

Section 172(1) requires directors to have regard to several matters when considering what would be most likely to promote the success of the company for the benefit of its members as a whole. The first mentioned is the fact that directors are to have regard to the likely consequences of any decision in the long term. There have been significant comments over the years to the effect that companies should be required to think long term, or at least longer than many have in the past. So, there is little controversy concerning this particular factor. As with most aspects of s 172(1) there is no attempt to provide any explanation of the words, 'long term'.

Again, there is little controversy over the requirement to take account of employee interests. This is something that is regularly done in continental Europe, and under s 309 of the *Companies Act* 1985 (UK) directors were to have regard, in the performance of their functions, for the interests of employees, as well as the members.[101] However, this has always been regarded as a 'lame duck' provision, indicated partly by the fact there are no cases involving any breach of the provision. One of the primary problems is that the employees of companies have no right to bring any action to enforce a breach of the provision. The new *Companies Act* repeals s 309 and, seemingly, as consideration for this, includes employees as one of the groups for whose interests the directors must have regard.[102] However, the new provision is likely to be as (in)effective as the present one. There is no right given to employees to enforce any breach of the provision. Furthermore, even if there was, it might be extremely difficult to prove a breach. The issue of enforcement is discussed in much more detail, and in a wider context, later in the article.

As far as the other matters are concerned there are only two things that need to be said. First, there is no reference to creditors in s 172(1), although one potential category of creditor, suppliers, is mentioned. The creditor constituency might be covered by the catchall term, 'others', in s 172(1)(c), which states that directors are to have regard to the need to foster the company's 'business relationships with suppliers, customers *and others*' [my emphasis]. However, if that is envisaged then it is perhaps strange that creditors were not expressly mentioned as they are often regarded as an important constituency. It might be said that the reason that they are not mentioned is that they are protected to some degree by s 172(3) in the situations where they are most vulnerable. This subsection provides that the duty imposed by s 172(1) is subject to any rule of law requiring directors in certain circumstances to take into account the interests of creditors. This is a clear reference to the case law that has developed over the past 20 years in the UK,[103] Australia[104] and elsewhere and provides that if a company is in some form of financial difficulty the directors must consider the interests of creditors in the

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101 *Companies Act* 1985 (UK), s 309. This provisions was introduced in 1980 as a result of the recommendations made by Lord Bullock (Chairman) Committee of Inquiry on Industrial Democracy, ('*Bullock Report*') Cmnd 6706 (1977) at Chapter 7, paragraph 12 and Chapter 8, paragraph 38.

102 *Companies Act* 2006 (UK), s172(1)(b).

decisions which they make.[105] Creditors might respond that s 172(3) does not protect them sufficiently, but that is another issue.

Second, and in relation to the requirement to have regard for the impact on the community and the environment, the notion of the 'community' might be regarded as rather amorphous.[106] It is certainly a concept that is difficult to pin down for it is not easy to describe the idea of 'community' accurately. The expression encompasses notions of public interest and it is likely that it is intended to refer to the people, businesses and institutions (such as schools and national and local governments) located in the places from where the company operates. Governments are included as they are representative of the public interest and they invest funds in assets in reliance on the company's operations.[107] Such initiatives will be of diminished benefit usually if the company decides to re-locate or closes down a plant, and no other company comes into the area to replace it. If this occurs people living in the vicinity of the company's former operations are affected in that the value of their homes decreases and the general wealth of an area declines. Institutions like schools often suffer in such a situation as the company's former employees leave the area either to search for, or take up, work elsewhere and their children no longer attend the schools in the affected area.

B. The Constituency Statute Analogy

In a sense s 172(1) bears some similarities to statutes that apply in the majority of American States,[108] variously known as constituency statutes,[109] stakeholder statutes or non-shareholder statutes. The first of these alternative terms is employed here. The first constituency statute was enacted in Pennsylvania in 1983. These kinds of statutes have been introduced so as to ensure that the harshest application of the shareholder value principle does not prevail, certainly to the point of promoting short-termism.

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103 For example, see *Winkworth v Edward Baron Developments Co Ltd* [1986] 1 WLR 1512; [1987] 1 All ER 114; *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30; *Facia Footwear Ltd (In Administration) v Hinchliffe* [1998] 1 BCLC 218; *Re Pantone 485 Ltd* [2002] 1 BCLC 266; *Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153; [2002] EWHC 2748; *Re MDA Investment Management Ltd* [2004] BPIR 75; [2003] EWHC 227 (Ch).

104 For instance, see *Walker v Wimborne* (1976) 137 CLR 1; 3 ACLR 529; *Grove v Flavel* (1986) 4 ACLC 654; 11 ACLR 161; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215; 10 ACLR 395; *Jeffree v NCSC* (1989) 7 ACLC 556; 15 ACLR 217; *Galladin Pty Ltd v Aimnorth Pty Ltd (in liq)* (1993) 11 ACSR 23; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465; *Spies v The Queen* [2000] HCA 43; (2000) 201 CLR 603; (2000) 173 ALR 529.

105 See Andrew Keay, *Company Directors' Responsibilities to Creditors* (2007) at 151.

106 William Carney, 'Does Defining Constituencies Matter?' (1990) 59 *University of Cincinnati Law Review* 385 at 414.

107 Ibid.

108 For a list of the States and the statutes, see Kathleen Hale, 'Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes' (2003) 45 *Arizona Law Review* 823 at 833, footnote78.

109 The UK might be said to have quasi-constituency statutes, but they do not impinge on a director's discretion. They are statutes which mandate that certain constituencies are protected, eg, employees. But many would say that is as far as the law should go. Stakeholders have that protection and should not have directors having to consider their multifarious interests in running a company.

While the respective statutes differ from one another in some respects, each of them authorises the directors, when they discharge their duties, to consider the interests of corporate stakeholders other than shareholders, such as employees, suppliers, customers, creditors and the communities in which companies establish themselves. The statutes enacted in Indiana and Pennsylvania[110] expressly provided in their respective Codes that directors are not required to give dominant effect to any constituency, thereby ruling out mandatory adherence to the shareholder value approach.[111] Connecticut, Arizona and Idaho[112] went even further and required directors to consider long-term interests of the company. During the campaign that was instigated to have the legislation passed in Pennsylvania, the co-sponsor of the relevant Bill stated that it would: 'reaffirm and make more explicit the time-honoured (and current) principle that directors owe their duties to the company rather than to any specific group such as shareholders.[113] The statutes have been enacted because it was not clear as far as directors were concerned whether they were permitted to have regard for non-shareholder groups when making decisions.[114] It would seem that in some states, such as Ohio, constituency statutes were not actually introducing new law, but simply codifying the existing law, although in others, such as Indiana and Connecticut, a change was being made to common law.[115]

It has been argued in relation to constituency statutes that 'any consideration of or benefit for non-shareholder groups must be rationally related to the interests of stockholders.'[116] If that is the case then it would seem that constituency statutes are very similar in effect to s 172(1) for it would seem that this is the situation with the new UK provision. In many ways the UK provision is closest to the constituency statute of Connecticut[117] in that it obliges directors to take into account non-shareholder interests,[118] whereas the statutes in other American jurisdictions merely permit directors to consider the interests of non-shareholder stakeholders.

While on the face of it constituency statutes appear to have the capacity to make a significant impact on corporate law in the United States, in fact

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110 Indiana: IND. CODE §23–1–35–1 (d)(f) (1995) and Pennsylvania: 15 PA. CONS. STAT §§515(a)–(b), 516(a) (2002).

111 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 *The Business Lawyer* 2253 at 2262, which was essentially in favour of shareholder primacy.

112 Connecticut: CONN. GEN. STAT §33–313 (2003); Arizona: ARIZ. REV. STAT §10–1202 (2002); Idaho: IDAHO CODE §30–1602 (2002).

113 'Outrage of the Month', *ISSue Alert* (December 1989) at 6 and quoted in N Minnow, 'Shareholders, Stakeholders and Boards of Directors' (1991) 21 *Stetson Law Review* 197 at 220.

114 Jonathan D Springer, 'Corporate Constituency Statutes: Hollow Hopes and False Fears' (1999) *Annual Survey of American Law* 85 at 105.

115 Committee on Corporate Laws of the Section of Business Law of the American Bar Association, above n111 at 2263–2264

116 James J Hanks Jr, 'Playing With Fire: Nonshareholder Constituency Statues in the 1990s' (1991) 21 *Stetson Law Review* 97 at 102.

117 CONN. GEN. STAT §33–313(e) (2003)

consideration of these statutes has been primarily in the area of takeovers,[119] particularly regarding the kind of interests directors have taken into account in considering whether to recommend the acceptance of takeover proposals. It is fair to say that there has been little judicial consideration of these statutes as, 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*,[120] had a statute been referred to in finding in favour of a decision by the managers.[121]

It has been argued that the existence of constituency statutes 'provides an obfuscation opportunity that facilitates [managerial opportunism],'[122] that is, directors can assert that they adopted a particular course of conduct to benefit a specific constituency and this statement cannot be contradicted. The end result, so the argument goes, is that board accountability is attenuated and directors have the chance to foster self-interest by hiding behind the statutes. Can the same be said about the new UK provision? Whether directors will do so is, ultimately, an empirical question, but it is submitted that the answer is likely to be in the negative as it is expressly mandated in the UK statute that directors, while they are to consider other interests, still have to be judged as to whether their decision(s) promoted the success of the company for the benefit of shareholders, whereas there is no such mandate in the US statutes. Constituency statutes can protect directors from shareholder retribution, where directors do consider non-shareholder constituencies, but the UK provision cannot do so except where the action taken by directors promotes the success of the company so as to enhance shareholder interests. Nevertheless, the UK provision will be susceptible to some of the same criticisms as constituency statutes, such as lack of certainty and guidance, which will be examined in the next part of the article.

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118 There is a significant amount of legal literature on the topic. For example, see Mitchell, above n69; Carney, above n106; Steven M H Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties' (1991) 21 *Stetson Law Review* 163; Springer, above n114; Committee on Corporate Laws, 'Other Constituencies Statutes: Potential for Confusion' (1990) *Business Lawyer* 2253; Hanks, above n116; Eric W Orts, 'Beyond Shareholders: Interpreting Corporate Constituency Statutes' (1993) 61 *George Washington Law Review* 14; Edward S Adams & John H. Matheson, 'A Statutory Model for Corporate Constituency Concerns' (2000) 49 *Emory Law Journal* 1085; Hale, above n108.

119 A major reason for the introduction of the statutes was because of the takeover frenzy of the 1980's: Springer, above n114 at 102. This rationale is accepted by Professor Lawrence Mitchell who takes a different view on these statutes compared with Hanks (Mitchell, above n69).

120 727 F Supp 31 (1989) (Maine).

121 Richard Marens & 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.

122 Rutheford B Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561 at 622. See also Macey, above n20 at 36. Macey sees the statutes as providing directors with meaningful job security no matter at what level they perform (at 33).

C. Guidance on the Application of ESV

As mentioned in the previous section of the article, s 172(1) is weakened by the fact that there is little guidance as to how directors are to act in practice. The provision sets out a menu of non-shareholder interests to which directors are to have regard, but fails to give any guidance as to the form this 'regard' should take and as a consequence gives no indication for directors as to what they must do in order to comply with the provision.[123]

An issue that is critical in relation to the issue of guidance is whether ESV means that directors are merely to take other constituencies into account insofar as this promotes shareholder value — a purely instrumental concern with constituency interests — or whether it enables or even requires directors to be concerned with such interests as ends in themselves. The background to the provision together with the way that it is drafted suggests that the former interpretation is probably correct. If so, then what relevance do other interests have? The phrase, 'have regard to' suggests, according to the *New Oxford Dictionary of English*, that one pays attention to or is concerned about something.[124] It is unclear what this actually means in the context of s 172(1). It seems simply to mean that where there are two routes that a company's management could take, 'A' and 'B', with both benefiting the company equally, but where A will also benefit one or more constituency interests and B will not, then A could be adopted. Also, it appears clear that if a course of action, which might benefit a number of constituencies, will not produce any benefit for shareholders, it should not be embraced. The situation is complicated where, say, action A is a marginally better option than B, as far as shareholders are concerned, but B provides benefits for one or more of the constituencies mentioned in the subsection. It might be argued that directors are entitled to follow B, because while A is going to benefit shareholders more, undertaking B will still promote the success of the company for the benefit of shareholders and the directors will have demonstrated their regard to the interests mentioned in s 172(1). The provision does not say that directors must necessarily follow that action which will benefit the shareholders the most. However, there are the statements of the CLRSG, and which might be considered by a court, that emphasise the fact that ESV is shareholder-centred, and it might be said that the directors in adopting B were not fulfilling the intention behind s 172(1). This certainly seems to be the opinion of one member of the CLRSG, Professor Paul Davies, who has said that:

> The interests of non-shareholder groups thus need to be considered by the directors, but, of course, in this shareholder-centred approach, only to the extent that the protection of those other interests promotes the interests of the shareholders.[125]

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123 Parliamentary Joint Committee on Corporations and Financial Services, above n15 at 55.

124 J Pearsall (ed), *New Oxford Dictionary of English,* Oxford University Press (2001) at 1561

125 Professor Paul L Davies, 'Enlightened Shareholder Value and the New Responsibilities of Directors', Lecture at University of Melbourne Law School (inaugural W E Hearn Lecture), 4 October 2005.

There is another important aspect that flows from the fact that there is uncertainty in relation to ESV. The only element that delimits what directors can or cannot do is their good faith, and this seems to be a significant departure from the terms of the draft Bill annexed to the 2002 White Paper, particularly 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.' Then '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…

The Bill, and later the Act, both omitted 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 to the Companies Bill' states that in having regard to the factors in what is now s 172(1), directors must comply with their duty to exercise reasonable care, skill and diligence.[126] If that is the case why were the words that were included in the draft Bill in the 2002 White Paper (set out above), 'as a person of care and skill would consider them relevant' removed? It is submitted that all that directors have to do, given s 172(1), in carrying out their decision-making, is to assert that they acted in good faith. The Guidance on Key Clauses seems to confirm this when it states that 'the decision as to what will promote success [of the company], 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.'[127] The difficulty with this is that there is no objective assessment of the actions of the directors, and 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 is virtually unassailable.[128] The Guidance on Key Clauses 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 does not seem to be consistent with that interpretation.

The Australian Parliamentary Joint Committee on Corporations and Financial Services, in its recent report, 'Corporate Responsibility: Managing Risk and Creating Value,'[129] considered ESV and stated that it did not support it as it felt that the approach introduced significant uncertainty into the area of directors' duties.[130] This is a conclusion to which the Senate's Standing Committee on Legal

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126 This document was drafted by officers of the Department of Trade and Industry when the Bill was introduced into Parliament. See 'Guidance on Key Clauses to the Companies Bill' at 17.

127 Ibid.

128 However, it is probable that directors could be held liable for a breach of s174, which codifies the duty of care and skill, if they can be found to have acted negligently.

129 Parliamentary Joint Committee on Corporations and Financial Services, above n15.

130 Id at 55–6.

and Constitutional Affairs came to when considering a similar type of approach, as far back as 1989 when it produced its report *Company Directors' Duties*.[131] The Australian Parliamentary Joint Committee favoured the 'enlightened self-interest' interpretation of directors' duties over an ESV approach,[132] which effectively means that directors may consider and act on the legitimate interests of stakeholders other than shareholders to the extent that these interests are relevant to the company,[133] and will enhance the long-term growth of the enterprise.[134]

A final issue in relation to lack of guidance, and one that is readily apparent to anyone that has followed the debate about what is the corporate objective, is how do directors have regard to the interests set out in s172(1) where there is conflict between the various interests?[135] Even the CLRSG recognised the fact that where the long-term interests of the company are in view, there will be a clash between the interests of those mentioned in s172(1), on the one hand, and those of the shareholders, on the other.[136] Examples given by the CLRSG include the closing down of a plant or the termination of a long-term supply contract when the continuation of either will impact adversely on shareholder returns.[137] The Government has promised to publish guidance explaining what directors must to do to comply with the new codified duties,[138] and it is hoped that this covers s172(1).

D. The Benefits of ESV

It is difficult to find the benefits that the ESV approach brings to UK corporate law. Perhaps three can be identified, although it is arguable whether they do in fact benefit the legal or commercial system in any way. The main, and perhaps even the only, benefit is that it would seem to give legislative permission to directors to look at interests other than short-term shareholder interests, and this would alleviate the concerns of some directors who, as reported by Dr Janice Dean in relation to an empirical study she conducted amongst directors of UK public companies, feel that they must operate in a way that is acceptable to society in a 'common sense' way and take into account the interests of the primary stakeholders.[139] This is consistent with the view that managers do not always act

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131 Commonwealth of Australia, *Company Director's Duties: Report by the Senate Standing Committee on Legal and Constitutional Affairs* (1989) at 91.

132 Parliamentary Joint Committee on Corporations and Financial Services, above n15, at xiii.

133 Ibid.

134 Id at 53.

135 The same concern that was expressed in regard to the US constituency statutes. It has been said that these statutes place burdens on directors to consider a wide range of interests that might well conflict without 'establishing sufficient standards by which directors may evaluate them' (Springer, above n114 at 107).

136 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework,* above n1 at 38–39.

137 Ibid.

138 Robin Hollington, Tim Akkouh & Emily Gillett, 'Companies Act 2006 (1)' (2007) 151 *Solicitors Journal* 12.

139 Janice Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (2001) at 251.

only in the interests of shareholders, even in the United States.[140] 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.'[141] More recently, a corporate reputation survey of Fortune 500 companies found that satisfying the interests of one stakeholder does not automatically mean that this is at the expense of other stakeholders.[142] The Australian Parliamentary Joint Committee on Corporations and Financial Services, in its 2006 report, *Corporate Responsibility: Managing Risk and Creating Value*,[143] observed that many directors of Australian companies make decisions founded on social responsibility as well as the interests of shareholders. The Committee went on to say later in its report that:

> Progressive, innovative directors, in seeking to add value for their shareholders will engage with and take account of the interests of stakeholders other than shareholders.[144]

Ultimately, directors will value protection when they act in such a way as to consider non-shareholder interests for fear of being pursued by shareholders. In Australia the Chairwoman of the substantive James Hardie Group, Ms Meredith Hellicar, indicated that directors are aware of the possibility of being the objects of shareholder suits, even where the majority of shareholders might be in agreement with what is done.[145]

It is possible that ESV will legitimise what is already occurring in the UK, Australia, and even the US, namely far-sighted managers considering the interests of non-shareholder stakeholders so far as it fosters corporate profits. Certainly it would appear that the CLRSG felt that the ESV concept would provide protection for directors. It said that the benefit of a provision in the mould of s 172 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…'.[146]

But the benefit identified above might well be illusory, for s 172(1) might not assist directors, for if they fail to comply with the ultimate aim of s 172(1), that is to promote the success of the company for the benefit of the members as a whole, then derivative proceedings could be initiated by members for breach of duty. Even if the directors secured the agreement of the majority of members for a

140 G Garvey & P Swan, 'The Economics of Corporate Governance: Beyond the Marshallian Firm' (1994) 1 *Journal of Corporate Finance* 139 at 148.

141 Quoted in Blair, above n39 at 212. It is also quoted in N. Craig Smith, *Morality and the Market*(1990) at 65, although the date given in the latter is 1950.

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

143 Parliamentary Joint Committee on Corporations and Financial Services, above n15 at 48–49.

144 Id at 59.

145 Fiona Buffini, 'Calls to Protect Corporate Conscience' *Australian Financial Review* (23 November 2005) at 4.

146 Above n1 at 41.

particular course of action that took into account the interests of one or more constituencies, but did not benefit members as much as an alternative course, a minority shareholder might be successful in any derivative proceedings brought against the directors for breach of s 172. What is not clear, as indicated earlier, is whether directors can be held liable if they have regard for the interests of one or more constituencies and the result is that the success of the company is promoted for the benefit of members, but not as much as another course of action that would not have involved taking into account constituency interests.

A further problem exists for directors. It must be remembered that the decision-making of directors is ultimately to benefit the members *as a whole* [My emphasis]. The expression 'members as a whole' has been used on several occasions in UK company law, as it has in Australia, and, consequently, one would assume that the judicial comments on the meaning of the expression would be pressed into service here. The courts have tended to hold that it means the present and future shareholders.[147] Consequently, it makes the assessment of the decisions of directors difficult, for some actions can be more beneficial for the present shareholders than future ones because a long-term view is not taken.[148] Does that mean that the requirement that regard has to be made to long-term interests requires directors to be more concerned about future shareholders? If so, it might be argued that directors could say that they have taken into account employees' interests in a certain area of company activity so as to produce benefits in the future, thereby benefiting future shareholders.

A second benefit of ESV, and one that might appeal to some shareholders, is that it permits directors to focus on long-term interests. Not all shareholders necessarily want directors to focus on short-term benefits. When the International Accounting Standards Board stated in a discussion paper that 'to an equity investor, an entity is a source of cash in the form of dividends (or other cash distribution) and increase in the prices of shares or other ownership interests,'[149] the Investment Management Association, the trade body representing the asset management industry in the UK, indicated that it disagreed and it asserted that

147 For instance, *Gaiman v National Association for Mental Health* [1971] Ch 317 at 330 (Nourse J); *Brady v Brady* (1987) 3 BCC 535 at 552 (Megarry J). *Provident International Corporation v International Leasing Corp Ltd* [1969] 1 NSWR 424 at 440 (Helsham J); *Darvall v North Brick & Tile Co Ltd* (1987) 12 ACLR 537 at 554 (Hodgson J).

148 In *Provident International Corp v International Leasing Corp Ltd* [1969] NSWR 424 at 440 Helsham J stated that directors should consider the interests of future members although in Robert Austin, Harold Ford & Ian Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2004) at 275, the learned commentators take the view that this is rather odd given the fact that the present members could have the company wound up and the assets distributed to themselves.

149 Investment Management Association, 'IMA Response to Discussion Paper on an Improved Conceptual Framework for Financial Reporting' (2006) at 4, referring to International Accounting Standards Board, 'Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information' (2006) <http://www.investmentfunds.org.uk/news/research/2006/topic/corporate_governance/imaresponsetoiasbdponconceptualframework.pdf>

members want financial reports to enable them to carry out a stewardship role, as part of their role of assessing management and corporate strategy for the long-term benefit of the business. The Association states that 'financial reports should focus on providing them with historic and governance information to enable them to discharge this stewardship role.'[150] Along similar lines, the Australian Parliamentary Joint Committee on Corporations and Financial Services was of the view that most shareholders were happy to support corporate responsibility as that will lead to shareholder gains, either in the short or long-term. [151]

Concern for long-term wealth is something that has been advocated even by those who have been the most fervent supporters of shareholder value. In their well-known article, 'The End of History for Corporate Law,' Professors Henry Hansmann and Reiner Kraakman said that there was 'no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.'[152] Professor Michael Jensen, a long-time advocate of shareholder value, agrees.[153] However the focus of these and other commentators is on long-term shareholder value, while the ESV talks rather vaguely about the fact that directors are to have regard for the likely consequences of any decision in the long term. In this regard it has been asserted that meeting the fair expectations of stakeholder groups is necessary for long-term profitability.[154] Yet that is not necessarily consistent with long-term shareholder value.

So, it might be argued that the directors are now able to consider a long-term strategy provided that it can be said that it will promote the success of the company for the benefit of the members, even if a more short-term strategy would produce greater benefits for the members.

Some shareholders might take the view, adroitly, it is suggested, that if there is not a concern for wider interests demonstrated by the company then when the time comes for them to exit, it is quite possible that new investors might not view the company as an attractive investment proposition.

A possible third benefit is that because ESV does not embrace the requirement that directors are to balance the interests of a wide range of constituents, it ensures that UK law prevents director opportunism. It is often argued that if it was mandatory for directors to balance the interests of those involved with companies, directors could use this to mask their making of decisions which are to their advantage. Directors merely have to state that what they did was a result of balancing interests, and no one could challenge the conclusion at which they arrived.

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150 Id at 4.
151 Parliamentary Joint Committee on Corporations and Financial Services, above n15 at 50.
152 Hansmann & Kraakman, above n7 at 439.
153 See, for example, Jensen, above n98.
154 Karmel, above n6 at 1169.

E. The Side-lining of the Operating and Financial Review

The CLRSG and the first White Paper in 2002 focused on the fact that large companies would be required to file an operating and financial review ('OFR') when the ESV approach became law. This requirement was clearly attractive to some who had argued for a pluralist emphasis to defining the corporate objective. The view was put by the CLRSG that demanding an OFR would mean that directors would have to give an account of their stewardship of a wide range of relationships and resources.[155] The UK government weighed in with similar comments saying that it would 'be a major benefit for a wider cross-section of a company's stakeholders.'[156] Importantly, the draft clauses in the Bill included provision for the 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[157] The OFR provided that companies were to publish material information pertaining to the activities of the company and this was to include details concerning future plans, opportunities and risks. Clause 73(2) of the draft Bill stated that directors were obliged to ensure that the information contained in the OFR was 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 had to 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[158]

However, while the Companies Bill was being debated in Parliament, the Government decided not to require an OFR from companies, but to rely on a Business Review that would have to be part of the Directors' Report. Under s 417 of the new Act directors are obliged to include in the Business Review a fair review of the company's business and a description of the principal risks and uncertainties facing the company. The purpose of the Business Review is, according to s 417(2), 'to inform members of the company and help them assess how the directors have performed their duty under s 172.' The obligation imposed on companies whose shares are quoted on a stock exchange is more onerous. Such companies must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include factors likely to affect the future development, performance or position of the business of the company analysis

155 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure,* above n94 at 34.

156 Department of Trade and Industry, 'Modernising Company Law', *Command Paper Cm 5553-I*, above n 80 at 38.

157 Id at clauses 77 and 78 sets out the criteria for companies that fall into this category. Department of Trade and Industry, 'Modernising Company Law: Draft Clauses', *Command Paper Cm 5553-II*, above n 80 at 150–151.

158 Id at 149.

using financial key performance indicators, and information about environmental matters, the employees of the company and social and community matters.[159] However, information about environmental, employee and community matters does not have to be provided if it does not assist in understanding the development, performance or position of the business of the company. There is no requirement for directors to state why these matters will not affect the business, and there is no indication as to what weight they are to give to any material relating to these matters, if they do include it. Hence, it is highly debatable whether the Review will produce a true account of the stewardship of all relationships in which the company is involved.

The decision not to require an OFR is a huge blow to those advocating stakeholder interests. It was the feature that led members of the CLRSG who favoured pluralist theories, to agreeing to the ESV. It also was one of the major elements that led Professors Cynthia Williams and John Conley to the view that the UK was moving towards stakeholder theory.[160] The commentators were moved to say that 'the social and environmental transparency newly required by the OFR may become the global gold standard of corporate governance.'[161] The fact that the OFR concept has been swept away causes one to question to what extent is the Government committed to any consideration of stakeholder interests.

F. How New and Radical is ESV?

How far does ESV take UK corporate law? One commentator stated, when the provision was merely a recommendation of the CLRSG that, '[s]uch changes in UK company law would reflect the fundamental assumptions and often long-established principles in company law and practice in Europe, which have yet survived the onslaught of shareholder value ideology.'[162] This suggests that ESV has taken the UK a significant way from shareholder value. I cannot agree. Whilst it appears that the ESV is taking a different approach and directors have a different role to play when compared with the past, there does not appear to be a great movement away from the shareholder value principle, notwithstanding the fact that on occasions UK courts have emitted dicta that suggest a broader approach.[163] For the CLRSG, after stating that the proposals for ESV reflect its opinion that 'companies should be run in a way which maximises overall competitiveness and wealth and welfare for all,'[164] added a note that:

159 *Companies Act* 2006 (UK), section 417(5).

160 Cynthia Williams & John Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct' *University of Carolina Legal Studies Research Paper No 04-09* at 8, accessible at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=632347 >.

161 Id at 9.

162 J Clarke, 'Introduction' in *Theories of Corporate Governance* (2004) at 13–14.

163 For instance, see, *Fulham Football Club Ltd v Cabra Estates plc* [1992] BCC 863 at 876 (Lord Justice Neill).

164 See the Company Law Review Steering Group, Department of Trade and Industry, '*Modern Company Law for a Competitive Economy: Developing the Framework,* above n87 at 14.

> the means which company law deploys for achieving this objective must take account of the realities and dynamics which operate in the running of commercial enterprise. It should not be done at the expense of turning company directors from business decision makers into moral, political or economic arbitrators.[165]

This places severe limitations on what directors can do when they are to have regard to the interests set out in s 172(1).

It has been suggested by Williams and Conley that the UK 'appears to be setting out on a 'third way' that merges elements of the shareholder and stakeholder approaches.'[166] The learned commentators go on to say that the UK is developing a long-term enlightened shareholder value approach with 'strong elements of European stakeholder thinking' and that UK institutions are being encouraged to think more broadly about stakeholder interests.[167] The suggestion here is, it appears, that some form of convergence is occurring. Convergence in this context essentially means that the corporate governance systems applying in nations are changing so as to move closer to those systems operating elsewhere. There has been significant argument in corporate governance circles about whether in fact there is any substantial global convergence.[168] The major ongoing debate is whether there is, in fact, global convergence towards the Anglo-American market-based approach. Any movement by the UK to a more stakeholder approach would be notable, given its past adherence to shareholder value. If there is some convergence occurring as a result of the advent of the UK legislation, then the thesis of Hansmann and Kraakman that the debate concerning the direction of corporate law has been resolved in favour of shareholder primacy,[169] is wrong, as is the view of Professor Douglas Branson that convergence is a very limited phenomenon.[170] While, undoubtedly, s 172 does give the appearance of embracing aspects of stakeholder theory, with the requirement that directors are to have regard for wide-ranging interests, ESV is not to be taken as an exemplar of convergence. The bottom-line is that unlike in Germany and other European jurisdictions stakeholders under ESV have no control over, or input to, company affairs. As will be demonstrated shortly, non-shareholders have little or no power to influence the directions that the directors take in their decision-making. This is not to say that directors will refrain, certainly in some circumstances, from making decisions that are based on the interests of non-shareholder stakeholders.

'There are interests in the UK, as there are in Australia and the United States, which favour shareholder value and these have influenced the development of ESV in the terms in which it is drafted. Williams and Conley, speaking in an

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165 Ibid.

166 Williams & Conley, above n160 at 4.

167 Id at 7.

168 See S Nestor & J K Thompson, 'Corporate Governance in OECD Economies: Is Convergence Under Way?' (2000) *Directorate for Financial, Fiscal and Enterprise Affairs*,Organisation for Economic Co-operation and Development; D. Branson, 'The Very Uncertain Prospect of Global Convergence in Corporate Governance' (2001) 34 *Cornell International Law Journal* 321.

169 Hansmann & Kraakman, above n7.

170 Branson, above n168 at 325.

American context, point to the mergers and acquisitions culture, the financial press, financial globalization and managerial self-interest as those influences that cause a focus on short-term stock valuations.[171] It is submitted that these are important influences in the UK and Australia, and they do affect the make-up of company law.

It has been asserted that 'ESV kills two birds with one stone since stakeholders get more consideration and shareholders maintain the profit maximisation goal and remain to hold directors accountable.'[172] It is highly debatable whether directors, on many occasions, will be held accountable for their consideration (if any) of the interests enumerated in s 172. Accountability is of little use unless the person who is accountable can be forced to account. It is likely, as discussed shortly, that the only situation that will require directors to be accountable is where shareholders, who are allied to groups covered by s 172(1), are ready to take proceedings against directors.

While suggesting that ESV brings something new and exciting to the corporate governance table, Williams and Conley acknowledge that like the traditional shareholder value model, ESV 'assumes that making profits for shareholders is the primary corporate purpose.'[173] This was acknowledged by the CLRSG when it first developed the idea of ESV. It said in one consultation document that 'the enlightened shareholder value approach is not dependent on any change in the ultimate objective of companies, shareholder wealth maximisation…'[174] So, the question remains, how is the ESV approach so different and innovative?

G. Enforcement

According to the Department of Trade and Industry's Guidance to the Company Law Reform Bill, the second part of s 172(1), namely the part that requires the directors to have regard to the matters listed in the provision, is the enlightened part of ESV. The Guidance stated that:[175]

> Directors are required to 'have regard to' the factors listed… In doing so, their duty to exercise reasonable care, skill and diligence will apply. It will not be sufficient to pay lip service to the factors. In many cases they will need to take action to comply with this aspect of the duty.

The problem is: what happens if directors do just pay lip service to the factors? If 'X', a member of one of those constituents that are referred to in s 172(1)(a)-(f), is of the view that directors have breached the provision in that the directors failed to have regard to the interests of X's constituency, is X able to take any legal action against the directors? The plain answer appears to be 'no', certainly under the Act

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171 Williams & Conley, above n160 at 10.

172 S Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value : Which Road Should the United Kingdom Take?' (2006) 17 *International Company and Commercial Law Review* 329 at 342.

173 See, for example, Williams & Conley, above n160.

174 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy*: *The Strategic Framework,* above n1 at 39

175 Department of Trade and Industry, *Guidance to the Company Law Reform Bill* at 17.

(or any other corporate law provision). This has been one of the problems with s 309 of the 1985 legislation, as acknowledged by the CLRSG in its deliberations.[176] As mentioned earlier, this section requires directors to consider the interests of employees in determining what is in the best interests of the company. Yet it has been next to useless. The provision has hardly been used and there is very little case law on the section. It has been said that 'a right without a remedy is worthless,'[177] so this causes one to ask: has s 172(1) any teeth?

The only stakeholders in the company who are able to take action under the Act appear to be the shareholders. Shareholders are, under s 260(1) of the Act,[178] given the right, for the first time under statute in the UK, to bring derivative proceedings[179] in respect of a cause of action vested in the company, and to seek relief on behalf of the company.[180] The new provisions are similar in effect to those already extant in Australia under the *Corporations Act* 2001 (Cth),[181] and it is submitted that there is likely to be some reliance on Australian decisions by UK courts. The UK legislation provides that a claim may only be commenced in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.[182] So a derivative claim can only be brought for a breach of duty by a director,[183] and this is in comparison with the *Corporations Act* 2001 (Cth), which imposes no such limitations on the cause of action, nor the identity of the defendant.[184] Any claimant must obtain the permission of the court to continue the claim[185] (as a claimant must under the Australian legislation).[186] The court will grant permission where a prima facie case is made out.[187] Permission has to be

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176 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework,* above at 1 at 41–42.

177 Morey McDaniel, 'Bondholders and Stockholders' (1988) 13 *Journal of Corporation Law* 205 at 309.

178 This section is in Chapter 1 of Part 11 of the Act and it covers the jurisdictions of England and Wales on the one hand and Northern Ireland on the other. Scotland is covered by Chapter 2. For the purposes of this article discussion is limited to provisions in Chapter 1.

179 Members have always been able to bring proceedings at common law provided that they could establish an exception to the rule in *Foss v Harbottle* (1843) 2 Hare 461 which provided, in essence, that if the directors breached their duties to the company or hurt the company in some way, it was the company and the company alone that could bring proceedings against the directors. The problem was that the articles of association (the company charter) empowered the directors with the management of the company and the right to litigate was part of this management and the directors would be reluctant to sanction the bringing of proceedings against one of their number (or against themselves). The provisions addressing derivate claims have not come into force as yet. They will do so from 1 October 2007: Department of Trade and Industry, 'Margaret Hodge announces Companies Act Implementation Timetable,' (Press Release, 28 February 2007).

180 So, if the members had a personal right against the directors, emanating from a breach of their duties, the members could not use the derivative claim process in order to take proceedings against the directors.

181 See Part 2F.1A. This Part was introduced on 13 March 2000. Unlike the Australian provisions, the UK provisions do not entitle officers of the company (unless they are also members) to bring proceedings.

182 *Companies Act* 2006 (UK), s 260(3).

183 *Companies Act* 2006 (UK), s 260(2).

refused where one of the following situations occurs: the court is satisfied that a person acting in accordance with s 172 would not seek to continue the claim; the cause of action arises from an act or omission that is yet to occur and the act or omission has been authorised by the company; or the cause of action arises from an act or omission that has already occurred and the act or omission either was authorised by the company before it occurred or has been ratified by the company since it occurred.[188] In weighing up its decision in relation to permission a court must consider, inter alia: whether the applicant member is acting in good faith; the importance a person acting in accordance with s 172 would attach to continuing the claim; whether the company has decided not to pursue a claim; and any evidence of the views of members of the company who have no personal interest, direct or indirect, in the matter.[189]

So, if directors fail to comply with s 172(1) in some way, does that lead to a claim that is vested in the company so that the members could initiate derivative proceedings? It would appear that the answer is in the affirmative given the fact that s 178 of the Act retains in relation to any breaches of ss 171–177 the common law rules or equitable principles that have applied in the past. Under these latter rules and principles a right of action would redound to the company where directors breached one of their duties. Also, s 260(3) provides that a derivative claim may be brought only in respect of a cause of action arising from an actual or proposed act involving, inter alia, a breach of duty by a director of the company. Hence, it would seem that a cause of action would vest in the company, within the meaning of s 260, and members would be entitled to commence derivative proceedings (subject to court permission). This is confirmed by s 178(2) when it states that:

> The duties in those sections [171–177] … are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.

Therefore, if directors breach s 172(1) the members could seek to take action on behalf of the company. One could envisage them doing so if the directors either fail to act so as to promote the success of the company for the benefit of the members or fail to have regard for the need to act fairly as between members (s 172(1)(f)), but this is not so likely to occur, if at all, in circumstances where the directors fail to have regard for the other interests adumbrated in s 172(1)(a)–(e), especially when one takes into account the fact that there is likely to be a cost element in any derivative claim brought by a shareholder.

184 Though it is more difficult to bring a claim against third parties: see *Corporations Act* 2001 (Cth), ss 237(3) and (4).

185 *Companies Act* 2006 (UK), s 261.

186 See *Corporations Act* 2001 (Cth), section 237 where the legislation refers to 'leave' rather than 'permission.'

187 *Companies Act* 2006 (UK), s 261(2).

188 *Companies Act* 2006 (UK), s 263(2).

189 *Companies Act* 2006 (UK), ss 263(3)(4).

There are only a few situations where one could envisage an action being brought by a member other than in the cases mentioned above. First, where a member invested in the company for the long term, and he or she feels that the action of the directors does not have regard for the long term. The member might feel that the directors are overly myopic and that could well mean that the member will receive less in the long run. Second, and where a member has become a member for the long term, a member is concerned that the directors have not had regard for the need to promote business relationships with suppliers, customers or others and it is likely to damage the company in the future. Third, a member is also an employee of the company and is concerned that the directors did not have regard to the interests of the employees. Fourth, there are members of the company living in the community in which the company operates, and they believe that the community will be adversely affected by the actions of the directors, and that will, as a consequence, affect the lives of those members. An example might be where a company, which operates several factories, decides to close one that is in the community where a member resides or has business interests. Fifth, a member has concerns wider than his or her own interests and feels obliged to take proceedings because of a heightened sense of community interest. The upshot is that except where one has a member with a social conscience, the only likely derivative proceedings are those brought by members whose self-interest in another capacity will be affected deleteriously in some way. This is not likely to occur frequently.

Even if derivative proceedings are commenced, directors might well argue that, in good faith, they did have regard for all of the matters mentioned in s 172(1)(a)-(f) and simply believed that what they did promoted the success of the company for the benefit of the members. If so, it might well be difficult for a member to impugn such an assertion successfully, and to establish that the directors did not have regard for the relevant matters.

All of this means that directors are more likely to ensure, in order to protect themselves from the real threat, that they get the best possible deal for shareholders, even if it means disregarding the interests of others (and possibly breaching s 172(1) in a technical sense), because if they do not then the shareholders are the only ones who can pursue them in the courts for breach. Additionally, shareholders are the only stakeholders who can dismiss a director, under s 303 of the *Companies Act* 1985 (UK),[190] or ensure he or she is not re-elected.

Of course, the company might end up in administration (similar in many ways to voluntary administration in Australia) or liquidation, and the person appointed as administrator or liquidator will be able to take action against the directors for a breach of s 172(1), but it is likely at this stage (and it might depend on the period of time between the controversial decision of the directors and the entry into administration or liquidation) to be difficult to establish that the directors should

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190 The equivalent provision under the *Companies Act* 2006 (UK) t is s 168. The section is not in force as yet. See *Corporations Act* 2001 (Cth) s 203C (proprietary companies) and s 203D (public companies) for Australia's equivalent provisions..

not have done what they in fact did. First, any administrator or liquidator would have to impugn successfully any claim by 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 as a whole. Second, the courts have made it plain that they will not use hindsight in making their decision when assessing the actions of directors,[191] and it might be argued, certainly when one studies the cases involving claims of wrongful trading under s 214 of the *Insolvency Act* 1986 (UK),[192] 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.[193]

Perhaps the only possible action available to those who make up the constituencies covered in s 172(1) might be to seek injunctive relief, in an attempt to prevent directors from doing something where the directors have failed to have regard to the matters set out in the subsection. It is questionable whether a court would accede to the application of a non-member, and even if they did, the courts would have to consider evidence in order to make a decision as to whether directors did intend to act appropriately and this would be far from easy at an interlocutory stage. It is more likely that non-member stakeholders will have to rely on rights that are provided for outside of company law, and certainly this is where the CLRSG thought that stakeholders' safeguards lay.[194] For instance, creditors are protected if directors engage in wrongful trading. But, as argued elsewhere,[195] 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.

PART 5

Conclusion

For the first time the UK, in effect, has embedded in statute the objective of companies. This objective is set out in s 172(1) of the Act. At first blush s 172(1) appears to move the UK a significant distance away from the shareholder value principle and closer to a stakeholder approach, but on more intense scrutiny this is

191 See, for example, *Re Welfab Engineers Ltd* [1990] BCC 600; *Re Sherborne Associates Ltd* [1995] BCC 40.

192 This provision states that directors of a company that entered insolvent liquidation may be held liable for the debts of their company if at some time before the commencement of the liquidation of the company, they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The Australian equivalent is insolvent trading under ss 588G-588Y.

193 See, for example, *Re Continental Assurance Co Ltd* [2001] *Bankruptcy and Personal Insolvency Reports* 733; *The Liquidator of Marini Ltd v Dickensen* [2003] EWHC 334 (Ch); [2004] BCC 172.

194 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework,* above n87 at 10–11.

195 See, Keay, above n10.

not the case. It is arguable that the legislation does not really change the law, because provided that the action of directors is designed ultimately to foster shareholder benefits, it is not going to be impugned, even if the directors did not, in their decision-making process, consider the interests of other constituents.

Stakeholder value has been criticised on a number of bases over the years, perhaps the primary one being that it lacks precision as it fails to provide a way of balancing the conflicting interests of different stakeholders, and stakeholders have no way of enforcing any failure on the part of the directors to consider constituency interests appropriately. But that is what one ends up with in relation to ESV. There is a lack of precision in setting out how ESV is to work, and added to that, stakeholders have no right of enforcement if s 172(1) is breached. Besides the legal problem of having no right to take legal proceedings, a stakeholder has the practical problems of establishing the fact that his or her interests were not taken into account by directors and that his or her interests should have prevailed.[196]

During the evolution of ESV, much was made of the fact that there was an intention to create something that might make the decision-making of directors more enlightened in the sense that they are to take into account a greater range of interests. But one is moved to question how enlightened ESV is. The CLRSG itself even suggested in one of its consultation papers that having regard for the interests in s 172(1) is not based on fairness, but on efficiency and seeing shareholders get more overall.[197]

Because ESV does not make directors accountable to non-shareholder stakeholders, and there are likely to be few occasions when any breach against the interests of non-shareholders will be enforced, the ESV cannot be regarded as an example of a shareholder value jurisdiction moving towards the continental European approach as far as corporate objective is concerned. In practice it is likely that the Anglo-American position that advocates shareholder value remains quite strong.[198]

Perhaps the best that stakeholder advocates can hope for is that s 172 will, as some have hoped in relation to US constituency statutes, point 'the way towards a change in corporate law that will account actively for [stakeholder] interests.'[199] While those who favour a stakeholder approach to corporate law will not be satisfied by s 172(1) because of many of the points made in this article, it is likely that the shareholder value school will also have some concerns. It might argue, and in this it would be employing similar arguments used in relation to constituency statutes, that the discretion given to directors in their consideration of interests of groups other than shareholders might disrupt the traditional emphasis placed on the maximisation of shareholder wealth.[200] It might provide opportunities for directors to further their own interests on the basis that they have had regard for

196 Kiarie, above n172 at 338.

197 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework,* above n1 at 36–37.

198 Contrary to the conjecture of Williams & Conley, above n160 at 3.

199 Springer, above n114 at 104–105 and quoted in above n108 at 840.

the interests of others. In fact shareholder value advocates might say that the UK position is even more of a concern than constituency statutes for, Connecticut apart, American directors are merely permitted to consider non-shareholder interests while British directors are required to have regard to non-shareholder interests. If this is the case the danger is that the UK provision could end up pleasing no one.

In completing this article it is poignant to note that the UK approach has been roundly rejected in Australia, a country with a similar corporate law system and values. As mentioned earlier, the Parliamentary Joint Committee on Corporations and Financial Services[201] rejected the approach, and CAMAC shortly followed suit. The latter took the view that:

> a non-exhaustive catalogue of interests to be taken into account serves little useful purpose for directors and affords them no guidance on how various interests are to be weighed, prioritised and reconciled ... The Committee considers that…to require or permit directors to have regard to certain matters or the interests of certain classes of stakeholders, could in fact be counterproductive. There is a real danger that such a provision would blur rather than clarify the purpose that directors are to serve. In so doing, it could make directors less accountable to shareholders without significantly enhancing the rights of other parties.[202]

This might well be prophetic as far as UK developments are concerned.

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200 Note the argument of Kathleen Hale that as directors are generally not obliged to consider nonshareholder interests there should not, necessarily, lead to a disruption of the shareholder value approach (Hale, above n108 at 840).

201 Parliamentary Joint Committee on Corporations and Financial Services, above n15.

202 Corporations and Markets Advisory Committee, above n16 at 111–112.