

The shareholder primacy theory law company business partnership essay

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There is currently a level of uncertainty as to what the objectives of a company should be.[2]Should they be purely for making a quick profit? Or should they look at the longer term and the social impacts? Therefore, establishing an objective is crucial as it provides guidance for directors on how they should act and what they are aiming to achieve. In making this decision, it is important of consider what the interests of the members are. In statute,[3]members are considered to be the company's shareholders with their aim being to increase the value of their shareholding. This follows the shareholder primacy theory which has dominated since the early 1930's.

[4]However, Keay has suggested that there is another theory, which he calls the Entity Maximisation and Sustainability theory (EMS). This was devised as shareholder primacy has been criticised and has been seen to be unfair[5]in that it focuses solely on one interest, the shareholder. EMS differs as, instead of focusing on a particular group interests, it focuses on the company as a single legal entity, as an institution in its own right,[6]with its objective being to maximise the wealth of that entity whilst ensuring that the company is sustained financially.[7]This means 'fostering entity wealth to endeavour to increase the overall long term market value...taking into account the investment made by various people and groups.'[8]In essence, this model considers all company interests, such as employees, the local community and wider environment. Keay makes it clear that this theory is unlike the shareholder primacy theory, which only operates on the basis 'that directors will maximise the wealth of the shareholders'[9]with no other interest considered. It is therefore necessary to consider both to understand what each seeks to achieve and what the effect of S172 has had.

Shareholder Primacy Theory

This theory was first manifested by a mandate in Dodge v Ford^[10] and has been used since. It is generally seen as being the focal point of most public companies and has been fostered by many.^[11] It is based on the promise that the directors will maximise the wealth of its shareholders in the short term and this is their main objective. This means that those who manage the company should do so for the best outcome for its shareholders.^[12] It is therefore important to consider what a company's interests actually are as this will help to define what the company objective is. In common law, these are seen to be the interests of present and future shareholders. Essentially, companies are in the business of making profit and shareholders invest in the business to make a profit. This is what the objective of shareholder primacy is because it focuses only on increasing shareholder value^[13] and fails to consider other interests. A company which has adopted this approach is Fulham Football Club which used shareholder primacy as a means to enforce a commercial transaction involving the disposition of land.^[14] Berle endorses this stating ' a corporation is primarily responsible to its shareholders to maximise its profits and as a result social factors, which sacrifice shareholder wealth such as environmental factors and communities, should not be taken into account.'^[15] He argues that shareholders are owed a fiduciary duty by their directors to have profits.^[16] Therefore, social responsibility is not a concern of companies who adopt this approach. The rise of the culture of profit at any cost has been significant in shaping public opinion of big businesses, recently seen by Sunbeam's Al Dunlap which benefited from short term profits but in return drastically lowered public

confidence to deliver social wealth. In this case, Dunlap was ruthless in laying-off employees and fired 11, 200, which drove up the share price by 225% meaning a higher profit for its shareholders.[17] Another scandal was the National Australian Bank, where fraudulent claims were made of \$37 million to cover a loss of \$5 million, to keep shareholders happy and to avoid scrutiny from them.[18] Similarly, failures can be seen by Enron, Ansett, FAL, HIH, One Tel and World. com[19] who all failed in the long term. This ultimately led to their downfall as it will have impacted on their reputation, which increases a company's worth as customers will be more likely to shop there and employees will see that they will be treated well. If the reputation is considered bad, then this will not be the case. To achieve shareholder primacy, the directors will use a short-term objective. However, directors are required to believe that their actions will maximise the company's profits in the short term and long term, but there have been difficulties with such a vague time frame.[20] As described previously, a short term aim would mean that shareholders would receive an immediate return whereas a long term aim would mean basic profitability.[21] Directors can make decisions to enable fast returns for their shareholders.[22] For example, drastic cost-cutting measures such as those seen in Dunlap. However, this method lacks social responsibility as the company does not consider the interests of other parties such as the local community and employees and can cause serious long term affects, affecting possible future profits. Shareholder value would be increased momentarily, but the long term picture may not be the same if profits are affected. For example, Burberry; the directors decided to close down one of factories in Wales, with the aim of making a financial gain from

the sale and moving the location abroad to China, where labour cost were significantly lower; meaning that a profit could be made immediately. However, this led to a series of backlashes. In the local community, the closure meant that 300 jobs in a community of 8000 people were lost, which led to costs for job losses and also had a dyer effect on the community itself. It also meant that the UK economy was to be impacted resulting in the wider community being seriously affected by the move.[23]This affected the company's reputation and the costs exceeded any benefit there would have been. Similarly in the case of Nike, where the company attempted to maximise its profits by setting up manufacturing facilities in low wage countries. However, this again led to a backlash on the company as reports emerged that it was exploiting workers to make profits. These reports affected the brand reputation of Nike which led to reduced sales and less profits as the consumer boycotted their products. From these examples it can be seen that short-termism is not necessarily the best outcome, particularly in that it fails to consider the long term effects of other interests which will cause future failures for the company, although the objective to make money for shareholders is satisfied. Lord Goldsmith[24]has said that 'success' means 'long term value' which connotes that profit making should be made via a long term method. Long term allows for directors to make decisions based on future profits. This can lead to successes but means that shareholders will have to wait for the success to materialise into a decent return. In practice, a company may make less profit in the first year compared to the next, but it will still mean that shareholders wealth is being maximised for the future. To achieve this, they could consider reducing the

shareholder returns by reinvesting money back into the company or by creating a good reputation by being socially responsible. This has been seen by several companies, such as The Body Shop, Starbucks and Pedigree, all of which have invested back into society in order to improve their reputation and in the process creating long term value. This highlights that having an objective is necessary but it needs a suitable time frame to satisfy it.

However, this is up to the discretion of the directors as to what they think is the best option to take, whether it is to increase profits quickly for shareholders or to consider long term profits and other interests, where shareholders will have to wait for a return but reputation may be improved which will benefit in the long term. This is essentially determined by whether the directors are to concern themselves in other interests of the company such as the effect decisions will have on their employees and the local and wider community, or purely on making a profit for their shareholders. It has been said that social responsibility has led to maximised shareholder value, as the company, acting as a legal person, has an obligation to act as a good citizen and be socially responsible.[25]An example of a company who have adopted this approach and has been very successful is Ben & Jerry's Ice Cream who gave back to their local community and has since become giants in the ice cream market.[26]In order for the shareholders to obtain profits, the company must be solvent.[27]Therefore, directors must make decisions that enable this to be possible. This was seen in *Regentcrest v Cohen*, [28]where the company was struggling financially. The directors decided that the best outcome for their shareholders was to waive a claim of £1.5 million as this would put them in future debt. It was concluded by Park J that in

similar circumstances ' a business man in the position of the Richardson brothers,[29]the directors of Regentcrest, would have done the same. This demonstrates that the directors must act in the company's best interest, in line with s172, and with shareholder primacy that is to enable the shareholder value to be maximised. There has been some debate about this theories workability[30]as many companies are now looking at more than just making short term profits for their shareholders and instead are looking at being more socially responsible, to ensure long term profits can be achieved. This is because people are generally more inclined to want to buy, sell or work for a reputable company. For example, companies like Nestle are incorporating Fairtrade to ensure that the wider community benefits. Companies like this are looking at creating long term objectives which will benefit more than one interest of their company, unlike shareholder primacy companies which is said to be outdated as it fails to acknowledge the adoption of socially responsible practices. However, there have been a few cases that show that directors need not treat shareholder wealth maximization as being their sole objective. In AP Smith Manufacturing Co. v Barlow[31]it was said that ' corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate.'However, S 172 was introduced to replace the common law duty for directors to act in good faith, which is a subjective standard. This means that directors are free to choose how they wish to apply the law. In shareholder primacy, this requires directors to treat shareholders' interests as paramount. However, the interests of employees or other stakeholders can be considered[32]in performing these duties but only when

this would be in the company's (i. e. the shareholders) best interests.'[33]This is because the Act has created a hierarchy where shareholders sit at the top and the other interests, such as employees, sit below.[34]S172 states that directors have the duty to ' promote the success of a business for the benefit of the members as a whole.'[35]This section adopts the enlightened shareholder value principle (ESV). This principle is an attempt to strike a balance between the different theories. However, it has been said that ESV is unlikely to be achieved if only shareholders' interests are considered. This new section has meant changes to the law where there is now no requirement for directors to act in the company's best interests to ' promote' the success of the business. However, it can be said that this is for the benefit of the shareholders as the duty establishes priority of ' member' interests.[36]This has always been the case as seen from Lord Greene's statement in *Smith v Fawcett*[37]that directors must make decisions in the best interests of the company and its members.

EMS theory

This is, as Keay states[38], unlike EMS, as EMS focuses on enhancing the company's wealth but not necessarily by maximising profits, instead it can be done by increasing a company's reputation by considering other interests and being socially responsible. EMS looks at the company as an ' entity'[39]and proposes that the objective of a company is to foster entity wealth, which will involve directors endeavouring to increase the overall long term market value of the company'[40]Keay argues that to do this, it is necessary to consider the company's reputation, especially when a decision may have an adverse effect on the local or wider community, for example by

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making short term decisions. This differs from shareholder primacy which is primarily responsible to maximise its shareholders wealth and as a result, social factors are not taken into account.[41]If Keay's argument that social responsibility does affect wealth is true, it is necessary to look at how they affect reputation and what reputation actually means as he believes that the EMS theory 'encompasses...reputation'[42]Reputation has been defined as a multi-faceted element'[43]It can be viewed as including a company operating within its 'social licence.'[44]This means that other aspects, known as 'the community of interest,'[45]are considered in the decision making process. This is one of the main objectives of the EMS theory as Keay submits 'EMS is justifiable on the basis of the values of fairness and efficiency.'[46]A recent example is Primark. In 2006, Primark was accused of using child labour in India to produce its clothing range. It followed this with a statement saying that this had occurred without their knowledge and to prevent any further bad publicity affecting their reputation they sought to be socially responsible. To do this they set up a charity to help young people where the factory operates. This dramatic turn around prevented the brand reputation from being affected as it showed that Primark was a socially responsible company and wasn't just thinking about making a profit for its shareholders.[47]It was therefore, delivering for all of its interests which would have a positive impact on the reputation of the company. However, a company's reputation can be dissolved quicker than it is gained particularly if a wrong decision is made. For example, Exxon Mobil, the oil company, lost 20% of its share value due to a bad decision made by its directors which had a detrimental effect for its shareholders and in *Shlensky v Wrigley*. [48]In this

case, the directors made decisions which were negligent and were charged with acting for a reason unrelated to the business interests of the corporation which led to a waste of corporate assets.[49]Section 172 was created to clarify what directors should consider when making decisions and has been regarded as 'killing two birds with one stone' as it is supposed to deliver for both shareholders and non-shareholders. This has been shown where directors have decided to retain profits to reward hard-working employees, especially those who are skilled in a particular area that could be poached by competitors. Bowen LJ in *Hutton v West Cork Railway Company*[50]used the metaphor 'cakes and ale' to describe giving money to employees as a reward for their work, instead of to the shareholders. 'Directors are able to pay out additional non-contractual benefits to any investor, and no group can demand preferential treatment.'[51]These rewards, therefore, could be given to anyone who has an interest in the company such as donations to community projects, seen by Britvic, the maker of Tango, with their 'Transform Your Patch' campaign with a percentage of profits going towards local communities to improve parks and social centres.[52]However, what S172 actually does is segregate shareholders from non-shareholders as S172(1) directly applies to 'members' followed by a non-exhaustive list of stakeholders. This means that all other interests are put into a group that renders them of less importance than shareholders, so the decisions of directors are more likely to deliver for shareholders. Keay suggested that S172 should be amended to remove all words following 'the success of a company' as this would provide for a focus on the company as an entity and EMS could be applied.[53]This would then

enable companies to be socially responsible and boost their reputations. However, the Act does not recognise a company to be an independent entity and is worded to focus on the benefits given to shareholders and because of this it is not compatible with the EMS theory, instead suiting the shareholder primacy theory. Further application of S172 shows that ESV will benefit the other members indirectly in that it is a consequence of the successes of the company. This is because it will create wealthy individuals who will create a diverse society. Keay believes that under s172, the success and the benefit to members cannot be separated but the EMS theory purports to do so. This is because the theory makes directors apportion profits to permit the company to survive which will then ensure sustainability and will therefore maximise future wealth. This does require the directors to do some balancing, but the overall decision must be based on what will eventually maximise the entity and sustain it.[54]Keay believes that it is the 'balancing of factors to ascertain the overall benefit for the entity.'[55]These factors will be such as how the company affects the environment, the community and its employees to lead to a better reputation. There have also been concerns about the duty imposed by S172 in that there will be a negative impact the process of decision making. This is mainly that the decision process will be slowed down as directors will be too concerned to ensure that they have had adequate concern to all the listed interests. This may have an impact on the business as they may be slow to react to changes in the market and economy. This is not good in a competitive market and may affect future profits and reputation. To conclude, it can be seen that each theory has their core differences with shareholder primacy focusing purely on the

shareholder as its objective and the EMS theory looking at all interests as a single entity as its. Keay has suggested that shareholder primacy has its shortcomings if its aims are short term and only in order to make quick profits.[56] However, the EMS model is not fitting with the duties bestowed upon directors under S172, mainly as the law is aimed at the interests of the shareholders. Therefore, it cannot fulfil the needs of the EMS model.

Although Keay has suggested that the Act be modified to enable the EMS model to be a success, there is no doubt that this will not be the case.

Essentially, in both theories, it is the directors who play the crucial role of deciding what they think is the best decision to make. Lord Denning has suggested that 'as long as a director is left free to exercise his best judgement in the interests of the company which he serves'[57] he cannot do any wrong. This was reflected in the case of *Kuwait Asia Bank v National Mutual Life*. [58] Pennycuik J in *Charterbridge Corporation Ltd v Lloyds Bank* [59] devised a test that directors should follow in that 'if a reasonable, intelligent and honest man could believe that the decision was in the best interests of the company'[60] the decision is legitimate. S172 is complicated as its language seems to uphold shareholder primacy. This means that contrary to Keay's EMS theory, all interests can never be catered for as S172 upholds shareholder primacy as its wording allows for shareholders to be the main interest. However, directors must consider other interests of a company, even if they don't do anything for them, as otherwise long term profits will not be achieved and the company will become insolvent, but shareholders remain paramount. [61] In an ideal world the EMS theory would be a useful tool as it would consider every aspect of a company. This would

result in equality between all interests and each would be entitled to a reward as Keay suggests this would increase the company's reputation and be positive for doing so. However, the legislation does not allow this and can only deliver for shareholders. Therefore, Keay's argument that EMS looks at reputation and is not just about making a profit is true. However, in the light of the wording of section 172 it is not workable as the section advocates shareholder primacy.