Arguments for and against shareholder democracy

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Company Law and Law of Corporate Governance Coursework

Lorraine Talbot argues that shareholders in large publicly-owned companies " shouldn't vote" and shareholder power should be reduced rather than enhanced. On the other hand, recent measures from the EU and the UK government have sought to improve shareholder democracy and to increase shareholder power over the company.

Evaluate the arguments for and against these two positions, drawing on evidence from recent changes to the law and evidence from corporate practice.

Table of Statutes

The Companies Act 2006	s. 21, s. 40, s. 84.
	s. 172 (1) (a), (b), (c), (d),

	(e), (f)
EU Shareholder Rights Directive II 2017/828/EU	Art. 3(a), 3(h), 3(g), 9(a)
The Insolvency Act 1986	s. 84

<u>Table of Cases</u>

Allen v Gold Reefs of West Africa Ltd [1900] 1 Ch 656

Automatic Self-Cleansing Filter

Syndicate Co

v Cuninghame

[1906] 2 Ch

34

Borland's

Trustee v

Steel Brothers

and Co Ltd

[1901] 1 Ch.

279

Dodge v. Ford

Motor Co.,

170 N. W. 668

(Mich. 1919)

Her Majesty's

Commissioner

s of Inland

Revenue v.

Laird Group

PLC [2003]

UKHL 54

Macaura v

Northern

Assurance Ltd

[1925] AC 619

(HL)

Re Welfab

Engineers Ltd

[1990] BCLC

833

Shlensky v

Wrigley 95 Ill.

App. 268, 237

N. E. 2d 776

(Ill. App. 1

Dist. 1968)

In the commonly-cited verbal debates between Merrick Dodd and Adolf Berle in the 1930s, Dodd cited that the utilisation of stakeholder theory, putting stakeholder interests at the forefront of business activity, was less abnormal than Berle's stakeholder primacy (Dodd, 1934: 199). With regards to the aforementioned theories and examination of the work of contemporary authors, such as Lorraine Talbot, this essay shall seek to evaluate the arguments for and against the further empowerment of shareholders. In addition to the use of theoretical literature, this essay shall draw upon recent EU and UK legislative advancements, soft law and recent cases to examine the above argument.

Firstly, it should seem pertinent to explore the definition of a ‘ share’. According to Farwell J in *Borland’s Trustee v Steel Brothers and Co Ltd* [1] *,* a share can be defined as: *“ not a sum of money … but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount”.* Thus, affording shareholders numerous personal rights – including that of the right to vote, the right to speak at meetings, the right to a dividend and the right to restrain *ultra vires* acts[2]. However, there are a number of collective rights which academics, such as Lorraine Talbot, oppose. Such rights include the right to remove directors from office[3], the right to enter the company into voluntary liquidation[4]and the right to alter the articles of association[5]. Conversely, the only obligation of shareholders in limited companies, is the payment of share capital. Thus, the legal rights and responsibilities of the share have evolved significantly since the end of the nineteenth century, where all shareholders were ‘ *bound capitalists’* (Talbot, 2013) and were assigned unlimited liability to the partnership’s debts.

Company law has seen a number of large-scale changes, including the introduction of the Companies Act 2006. The Company Law Review Steering Group’s Final Report set the basis for the Companies Act and as such, introduced the controversial concept of Enlightened Shareholder Value (Ajibo, 2014). The Company Law Review sought to determine whether the law should adopt the shareholder primacy approach – the view that shareholder value was the primary concern of directors (Grier, 2013) – or to adopt the pluralist or stakeholder approach, which puts stakeholders at the forefront.

S. 172(1) of the Companies Act (2006) was a direct result of this white paper. This statute provides that the directors must act in good faith to *" promote the success of the company for the benefit of its members as a whole"* [6]and that in doing so will have regard to; the long-term future of the company[7], the employees[8], suppliers, customers[9]and the environment[10], amongst the company's reputation[11]and the other members[12]. However, while these changes may be seen as a move towards the more European, pluralist approach, critics argue that Enlightened Shareholder Value is still synonymous with the common-law principle of shareholder primacy (Ajibo, 2014). Enlightened Shareholder Value approach does not attempt to balance the interests of shareholders and stakeholders, as it only provides directors with the ability to contribute to decision-making (Davies and Worthington, 2016).

As put forward by Berle (1932: 1367), corporations exist for the primary reason to create profit. As such, Freidman's (1970) work maintained this view and averred that shareholders are owners of the company and without them it would not exist, therefore, the company should be run in their interests. As *Ostrander CJ* set out in *Dodge v Ford Motor Co.* [13] *,* directors should not take part in any activity that is not profitable and does not result in a direct increase in shareholders' dividends.

Furthermore, a company can be viewed as a *" nexus of contracts"* (Jensen and Meckling, 1976) and the relationship between the shareholders and directors is represented through the agency theory (Jensen and Meckling, 1976). The Agency theory finds that shareholders are the ' principal' and directors are the ' agent' (Collison et al., 2014) and that the company should

be ran according to the shareholders’ interests, thus consolidating the approaches found in s. 172[14].

Further, increasing shareholder power can also be likened to increased corporate governance. Examples of shareholder activism in corporate practice can be seen in the shareholder revolt at ExxonMobil over the company’s approach to climate change (Milman and Holden, 2018). In this case, a group of institutional investors brought the directors to account for alleged fraudulent claims made by ExxonMobil regarding the company’s risk exposure to environmental laws (Milman et al., 2018). Shareholders have also proven to be powerful actors in director remuneration. A 2017 report from KPMG found that the percentage of companies whose shareholders voted significantly against their renumeration report has almost doubled since 2014, including such votes at BT and Royal Mail.

The rise in shareholder dissent on remuneration has led to new legislation giving shareholders the ability to hold companies accountable. The Shareholder Rights Directive[15]gives shareholders the right to vote on the remuneration policy, a right which was previously only afforded when specifically outlined in the articles of association. In addition, the white paper on Corporate Governance Reform issued by the BEIS has resulted in a number of proposals to give shareholders increased power. The Department for Business, Energy and Industrial Strategy (BEIS) recommended giving the Financial Reporting Council the power to amend the Corporate Governance Code to show the recommended process companies should follow when more than 20% of shareholders dissent to executive pay proposals. These recommendations also include that the Investment Association should keep

note of what companies has significant dissent and what steps they are taking to address them.

However, much of the theory of shareholder primacy is built upon the false understanding that shareholders " own" the company. Numerous cases at common law have dispelled this theory. The judgement in *Macaura v Northern Assurance Ltd* [16]held that share ownership does not give rise to any rights or direct ownership in the company's assets, as reaffirmed by the House of Lords in 2003[17]. Furthermore, the Court of Appeal also found in the case of *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [18], found that the directors are in fact not agents of the shareholders, again, disproving Jensen and Meckling's (1976) theory.

Further, Davies and Worthington (2016) point out that shareholder activism is fundamentally flawed in that directors are able to vote in their own selfish interests in their capacity as shareholders, unless explicitly prohibited. Thus, Davies and Worthington (2016: 637) state that it is " *wrong"* to view shareholders' voting powers as fiduciary duties. In addition, shareholders are under no obligation to act within the best interests of the company and are only obligated to do so under common law when altering the articles of association[19], and such it can be argued that their powers should be constrained rather than extended.

As aforementioned, shareholders do not owe any fiduciary duties to act within the interests of the company and should therefore seem necessary to examine the reasons against shareholder empowerment. Davies and Worthington (2016: 636) liken a vote to a share, in that it is a proprietary

right, thereby giving the shareholder no duty to act within the company's interests. While shareholders are afforded a number of rights by way of share purchase, it can be argued that these are not utilised in a responsible way and that shareholder power should be decreased.

Firstly, there has been criticisms of the short-term interests of investors and Bernstein (2015) proposes that they fundamentally conflict with the long-term goals of the corporation. Kahan and Rock (2007) identify short term investors as *" arbitrageurs"* , whom are individuals who seek to purchase shares in companies, to allow for takeovers and profit for shareholders. Lord Mandelson (2010) heavily criticised short-termism, and particularly institutional investors. A consultation paper issued by the Panel of Takeovers and Mergers in 2010 identified concern about shareholders' ability to obtain over 50% of a company's voting rights and the influence of short-term investors on hostile takeovers. A recent example of the consequences of arbitrageurs can found in the hostile takeover of Cadbury by Kraft, whereby Lord Mandelson (2010) critiqued that the company's future was decided by a group of investors *" who had not owned the company a few weeks earlier, and probably had no intention of owning it a few weeks later".*

Keay (2008) maintains that by focusing on creating profits for shareholders, capital which could overwise be reinvested into the company's long-term future is divested in dividends and is ultimately not in the company's ultimate best interests.

A further issue with issuing additional powers to shareholders is that of passive investors. Berle and Means' (1968) work argued that the

shareholding in public companies has become too widely dispersed, thereby widening the gap between ownership and control. This is particularly applicable to publicly-listed companies, due to the recent increase in institutional shareholders (Appel et al., 2016). Thus, this gap between ownership and control, only reduces the level of accountability that directors must show to shareholders (Keay, 2008). Berle and Means (1968) attribute this lack of interest in control to the fact that shareholders have limited liability and thereby may not act in the best interests of the company, when compared with the older partnership models which made shareholders unlimitedly liable for the company's debts.

The ' dispersion' referred to by Berle and Means (1968) can also have a literal application in modern times. The geographical dispersion of shareholders also highlights issues in activism – according to the Office for National Statistics, 54% of shares in UK public companies are held by overseas institutional investors, 63% of which are held in pooled accounts (ONS, 2016). Therefore, backing up the claims of Berle and Means (1968) that shareholders are unlikely to devote *" time, effort or resources"* (Davies and Worthington, 2016: 413) to seeking management changes in large companies, where co-ordinated shareholder action is near impossible. Davies and Worthington (2016) identify that institutional shareholders in public companies are far more likely to take the cost-effective measures of accepting a takeover bid or selling shares, if unhappy with the company's management, than exercise their rights at general meetings.

However, new Shareholder Rights Directive[20]aims to regulate much of the irresponsibility of shareholders mentioned above. The directive aims to

increase shareholder transparency, firstly by bestowing the right to identify shareholders upon the company[21], thereby, attempting to decrease the risk of arbitrageurs and passive shareholders. Short-termism is further addressed in Article 3(h)[22], providing that institutional investors shall disclose how their investment strategy benefits the long-term success of the company. The Directive also sets out to reduce passive shareholders. Article 3(g)[23]provides that institutional investors shall be required to produce an engagement policy on an annual basis and thereby describe how they engage the shareholder in their investments.

Perhaps the most commonly-cited argument in favour of decreased shareholder power and increased stakeholder power is the Stakeholder theory, also known as the pluralist approach (Gower and Davies, 2016). Merrick Dodd (1934) and Edward Freeman (1984) are responsible for bringing this theory to popularisation. According to Karmel (1993: 61), stakeholder theory can be defined as the idea that *" in addition to shareholders, other groups have claims on the property of companies as they contribute to its capital".* Talbot (2013) echoes this view, as she argues the Kantian view that employees are merely utilised as a means to an end. Despite employees' significant investment to the company in the form of human capital (Blair and Stout, 2001), they and other stakeholders are vulnerable to the decisions of the board (Keay, 2008).

Donaldson and Preston (1995) argue that stakeholders' interests should be promoted in their own right, not solely because of their ability to further the interests of shareholders. The courts took this approach in *Re Welfab Engineers Ltd* (1990)[24], where Hoffmann J. held that directors were right in

their decision to sell the company to a party whom would guarantee the current staff employment, rather than favouring the interests of shareholders and accepting the highest bid. This approach can be increasingly seen in new legislation - the Companies Act[25]now outlines the directors' duty to act with regards to stakeholders' interests. In order to enforce this regulation even further, the BEIS' White Paper outlines proposals to further guidance on how to comply with s. 172, in addition to requiring directors to outline what measures were undertaken in order to comply.

The stakeholder theory can be further expanded into the theory that the company is a for social good. Berle and Means (1968) identified that the company should be thought of as a *" major social institution".* As with the stakeholder theory, companies are said to have a much wider reach than just serving the interests of shareholders. In the US case of *Schlensky v Wrigley* [26], the plaintiff, a minority shareholder, averred that the board were not acting within the interests of the company by refusing to install floodlights at the company's baseball field as the board felt it would have a negative effect on the neighbours, despite having the fact that having floodlights would result in increased revenue. The court held that the directors were entitled to make business decisions which had a social benefit and that were not primarily focused on increasing shareholder value. The Government's adoption of the pluralist approach is also prevalent within the proposals for greater employee participation at senior levels, as outlined within the White Paper.

However, it should also seem necessary to examine the criticisms of the stakeholder approach. Firstly, critics have drawn attention to the vague

wording of the term ‘ stakeholders’. Freeman (1984), for example, defines stakeholders as *“ any group or individual who can affect or is affected by the achievement of the organisation’s objectives”* . Thus, according to Keay (2008), the stakeholder theory fails to address exactly who is and is not constituted a stakeholder. The Final Report from the Company Law Steering Group identified that by having no criteria as to who is and isn’t a stakeholder, results in a lack of clarity as to who directors should be accountable to. To conclude, the UK’s attitude towards shareholder primacy does appear to be moving towards a more pluralist-model in some respects – such as the call for greater involvement of employees and stakeholders in company matters. Following on from the hostile takeovers of traditionally-British companies, such as Cadbury, it is not surprising that authors such as Talbot postulate that shareholder power should be diminished.

However, it should be recognised that the active shareholder is a useful means of corporate governance, in their capacity as being moderators of executive remuneration and to a degree, the company’s existence may be futile without them. The primary legislation still finds that the company should be ran in the interests of its members, and so, shareholder primacy remains a cornerstone of company law.

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[1] *Borland’s Trustee v Steel Brothers and Co Ltd* [1901] 1 Ch. 279 at 288.

[2]S. 40(4) - Companies Act 2006

[3]S. 168-9 – Companies Act 2006

[4]S. 84 – Insolvency Act 1986

[5]S. 21 – Companies Act 2006

[6]S. 172(1) – Companies Act 2006

[7]S. 172(1)(a) – Companies Act 2006

[8]S. 172(1)(b) – Companies Act 2006

[9]S. 172(1)(c) – Companies Act 2006

[10]S. 172(1)(d) – Companies Act 2006

[11]S. 172(1)(e) – Companies Act 2006

[12]S. 172(1)(f) – Companies Act 2006

[13]In *Dodge v. Ford Motor Co., 170 N. W. 668 (Mich. 1919)*

[14]S. 172(1) Companies Act 2006

[15]Article 9(a) EU Shareholder Rights Directive (SRD II) 2017/828/EU

[16] *Macaura v Northern Assurance Ltd* [1925] AC 619 (HL)

[17] *Her Majesty's Commissioners of Inland Revenue v. Laird Group PLC* [2003] UKHL 54

[18] *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch 34

[19] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656

[20]EU Shareholder Rights Directive (SRD II) 2017/828/EU

[21]Art. 3(a) SRD II 2017/828/EU

[22]Art. 3(h) SRD II 2017/828/EU

[23]Art. 3(g) SRD II 2017/828/EU

[24] *Re Welfab Engineers Ltd* [1990] BCLC 833

[25]The Companies Act 2006 s. 172(1)(b)

[26] *Shlensky v Wrigley* 95 Ill. App. 268, 237 N. E. 2d 776 (Ill. App. 1 Dist. 1968)