

## RESILIENCE: THE RESUMPTION OF SHAREHOLDER PRIMACY

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### Abstract

The once dominant and inconsiderate player in corporate governance, the shareholder, has faced increasing pressure from its rival stakeholders (creditors and the general public) and their agents (i.e. the management and directors) eager to unproportionately increase their stake. The idea of shareholder primacy in corporate governance is while previously was losing its dominance as corporate law versus stakeholder theory could be set for an even stronger come back.

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### Introduction

The former monopoly shareholder model has been eroded with the introduction of increased corporate governance regulations. But can shareholder primacy return, only time will tell whether stakeholders are able to maintain their increasing presence. The aim of this paper is to delve into the intricacies of corporate governance issues prevalent today and evaluate if the concept of shareholder primacy can regain its dominance despite the assertion that to hold shareholder primacy as the cardinal rule in corporate governance is outmoded, outdated and in the least, undesirable. Although, a model such as the stakeholder theory maybe more germane in the business world of today we give two examples whereby shareholders are beginning to flex their muscles.

Part one of this paper will introduce the two theories in corporate business and expound the essential bases of each theory; part two will explore the implications of each model to corporate governance issues; part three will evaluate if indeed shareholder primacy is a catalyst for “good” corporate governance and financial performance; and part four investigates two recent examples surrounding the relative re-emergence in the prevalence of shareholder primacy.

### 1. Fundamental Underpinnings of the Shareholder and Stakeholder Models

#### The Shareholder Model and the Notion of Shareholder Primacy

In its illustrious beginnings, shareholder primacy was seen as not only the essential rule of modern business corporations but it was also regarded as the golden safeguard to corporate governance problems. Shareholder primacy as an adjunct of shareholder

theory, views shareholder interests as exclusive and above all others and mandates that management devote its energies to the advancement of shareholder interests. If pursuit of this objective conflicts with the interests of one or more of the non-shareholder constituencies, management is to disregard such competing considerations.<sup>i</sup>

The shareholder was elevated to the pinnacle of the corporate hierarchy as a consequence of the characterization of the business form as a purely private enterprise. Under this classification, the business exists for the profit of its owners.<sup>ii</sup> Shareholders are owners of the firm as they solely provide the capital for the firm, and as shareholders are the primary source of equity for the business, managers must carry out the will and interests of shareholders. Shareholder interests are treated as pre-eminent on the basis that they are the residual claimants and bear the greatest risk. As they receive most of the marginal gains and costs, shareholders have the greatest incentive to maximize the firm’s value, thus, it is efficient for the managers to pursue shareholder interests.

The right to vote follows this residual claim and effectively gives the shareholder the power and discretion to make all decisions in a company; including instating directors and managers.<sup>iii</sup> The fact that shareholders vote managers and directors into office, leads to the proposition that managers have a duty to support the shareholders and their wishes. This right to vote exemplifies the notion of shareholders as ‘owners’ of the firm. Thus, as owners of the corporation, managers must act according to their wishes and only make decisions that align with the interests of the owners, that being those which increase the firm’s value.

The prioritization of shareholders has also been strengthened through the interpretation of the nature of the corporation in economic terms. This view was expounded by Fischel<sup>iv</sup>, who stated that the firm is a

legal fiction and merely a legal market, which serves as a nexus of contracts for mutual benefit of the people within the firm. Within this classification, corporations do not have any moral or social obligations and only operate to serve the market. Under this model, the shareholder is prime as all other constituencies in the firm are able to protect themselves through contract, bargaining for better positions. Management is seen to stand in a fiduciary relationship with the owners of the firm; thus, it is efficient for managers to pursue shareholder goals.

The traditional shareholder theory has measured efficiency as its main determinant that the shareholder is prime and absolute. The efficiency rationale states that shareholder's incentives to increase the firm's value is efficient as it utilizes the factors of production and strives to maximize the satisfaction of human wants.<sup>v</sup>

### **The Stakeholder Model and its Fight for Recognition**

In a world where morality and social ethicacy is becoming more accepted and desired, we are slowly seeing the fist of corporate law loosening its grip on the principle of shareholder primacy. As with any established conception, there is always another notion that is diametrically divergent. The hailed savior to grace the corporate plane in non-shareholder's eyes was the proposition of the stakeholder model. The fundamentals of this theory starkly challenge the underpinnings of the shareholder model by demanding that the interests of *all* not just shareholders be considered, even if it reduces company wealth and profitability. Therefore, the importance of the bottom line is not pursued nor recognized in the stakeholder model, as such a chase would demean the positions of all those who take part in the corporation. The stakeholder model was quite revolutionary, redefining the parameters and scope of manager's duties to people with contact with the corporation. Within this theory is the placing of all constituencies, including shareholders on a level playing field. Under this model, managers are constrained by two responsibilities- to ensure the ethical rights of no stakeholder are violated and to balance the legitimate interests of the stakeholders when making decisions.<sup>vi</sup>

Corporate governance is determined, executed and supported through the classification of the corporation as a public institution. Dodd<sup>vii</sup> identifies the classification of the corporation as a very important element as the classification goes towards what type of model the business adopts. He identifies that the assumption of shareholder primacy is reliant on the fact that the corporation is classified as purely private. Stakeholder advocates passionately frame the corporation as public, upholding the traditional view that business exists to provide a social service to the community. This view has stemmed from the early phases of the corporation when the state's

involvement was in granting corporate charters and encouraging the attitude that business existed to further society's needs and goals.<sup>viii</sup> What necessarily is derived from such a classification is the fact that companies are social entities, and are encouraged to instill a responsibility to society, thus elevating all interests alongside shareholder's interests.

Taking these notions further, the nature of the corporation has been characterized as a legal entity; a real being that is responsible for its actions and decisions. This concept has been depicted in Dallas's Power Model<sup>ix</sup>, which was propositioned as a new model of corporate governance to challenge the traditional shareholder model. This model interprets the firm as an organic institution with its own internal structure and processes that impact on control of the firm.<sup>x</sup> Firm behaviour is reliant on the fact that there are power coalitions that are comprised of groups of people in specific relationships to the firm and with each other.<sup>xi</sup>

As it was shown under the shareholder model, the shareholder is supreme due to the acknowledgement of their sole capital investment and contribution into the firm. In contrast, the stakeholder model rebuts this perception and implores that other constituencies have just a real and valuable investment in the firm. Flynn<sup>xii</sup> supports such a rebuttal stating that workers have more of an investment in the firm, as they have invested their entire productive career, it being valued higher than monetary contribution. Shareholders do not provide most of the risk capital, as there are abundant sources of capital available, such as debt and retained earnings as examples. Thus, workers have a greater and more moral claim to the firm's furtherance of their interests. He believes that shareholder's are merely investors and agrees with Berle and Means<sup>xiii</sup> that the corporation has a separation of ownership and control and that there is no secure democracy. Shareholders are no longer necessary and their interests are no longer paramount.

### **2. Ramifications of the Shareholder and Stakeholder Models on Corporate Governance**

Corporate governance is an amalgam of legal issues, theoretical concepts and key elements that dictate and define the boundaries of directors and managers duties and responsibilities within a company. The endeavor of corporate governance is to adhere to a balance between two competing aims; one is to allow managers and directors to run the company as they see fit and the other is to ensure their decision making is achieved within the framework of effective accountability to the company and its constituencies.<sup>xiv</sup> The study of corporate governance is complex and at times, not at all translucent and thus is a pressing issue for corporate law theorists to tackle. The consequences for corporate governance and its precincts are different when looked through the lens of the shareholder model or the stakeholder

model, as observed by Dallas<sup>xv</sup>. These ramifications will be looked at as follows.

### Shareholder Primacy and Corporate Governance

The shareholder theory has been the traditional view adopted by managers and corporations as the essential discipline for a successful company. Supporters of the shareholder theory believe there is no question as to how to better the firm under this model, as with shareholder primacy taking the corporate reigns, governance within the business is quite clear-cut. Advocates of the shareholder model, such as Fischel<sup>xvi</sup> believe that when classifying the corporation as a nexus of contracts, there is actually no apparent corporate governance question to be resolved. By defining the corporation under economic theory, shareholders interests will be executed by managers because of the nature of shareholders role as sole suppliers of capital within the corporation. Shareholders do not participate in the governance of the company, as it is not extremely beneficial to do so. The unique characteristic of the modern corporation is that it enables individuals who have wealth but lack managerial ability to invest while allowing managers with little personal wealth to run the business.<sup>xvii</sup> If managers fail to follow shareholder interests, the shareholder simply and easily succumbs to portfolio theory, selling their shares on the market. As in Fischel's words "Because of this free rider problem, most shareholders lack incentives to expend resources to become informed in elections or wage proxy contests. If a shareholder is dissatisfied, the more logical course in most cases is simply to sell one's shares. To sell shares is the shareholders guarantee/safeguard that managers will act in their best interests".<sup>xviii</sup> It can be said that Fischel's points are not as simple as what he puts forward and there are flaws to his contentions. The seemingly simple governance mechanism of share selling does not work in practice or reality. The proposition that managers will act in the shareholders interest merely due to a threat of share selling, is blatantly refuted by the attitude of an increasing number of high profile directors, whereby shareholders were objecting to various decisions made by the boards. Moreover, we see have seen directors stating obnoxiously in annual meetings that if investors were unhappy with the way the companies were run, they should simply sell their shares.<sup>xix</sup> Obviously, the directors least concerned with the possibility that shareholders will just sell their shares are the ones with a high concentration of power within the corporation. Ultimately, this can pose great governance problems, as shareholders (the minority that vote) do not get a voice in how actions should be done.

As managers are only responsible to one group, that is the shareholders, the only corporate governance issue evident under shareholder theory is when managers do not follow shareholder wealth

maximization goals (a failure of their fiduciary duty). The consequence of such derogation will result in managers being ousted and/or disciplinary action taken against breach of fiduciary duties. However, as it will be seen, managers can circumvent these shareholder protections by manipulating and finding loopholes that work in their favour. It is contended that shareholder primacy does not prevent nor rectify corporate governance issues and so, is untenable as the cardinal rule in corporate governance.

To reiterate, shareholders have the right to vote when shares are purchased enabling an ability to call elections on short notice and oust the directors or managers for any or no reason. The fear of the market for corporate control in theory, effectively works to ensure managers and directors act as faithful agents to residual claimants. However, in practice, crafty managers are able to circumvent this mechanism through clever manipulations of proxy.<sup>xx</sup> Managers rely on shareholder apathy and collective action problems to hold onto and keep themselves in office. Berle and Means have observed the watering down of shareholder voting rights and a diminishment of shareholder power as a result of this reliance on shareholder voting side effects.<sup>xxi</sup> Thus, coupled with the notion of dispersed owners, diminishing shareholder voting rights incur shareholders' positions within the corporation to one of 'impotence'.<sup>xxii</sup>

A strongly campaigned contestant to this collective action problem and dispersed ownership is the institutional investor. Rock's<sup>xxiii</sup> piece diligently examines the advancement of the theory that institutional investors have both the incentive and the ability to constrain managers. As institutional investors can concentrate their stock to override such shareholder weaknesses, they are the better fit for the mould to discipline managers. Bainbridge<sup>xxiv</sup> has highlighted the fact that institutional investors can remedy collective action problems and monitoring issues as they have more power to hold management accountable and to access information and they are more interested and likely to invest more resources into determining the value of management decisions. However, there are various criticisms with such a remedy of institutional investors that cannot be overlooked or accepted. Institutional investors are agents and logically, with agents come conflicts of interests and further agency costs. Rock notes that both money managers and outside directors lack significant economic incentives to protect shareholder's interests, with both facing significant disincentives.<sup>xxv</sup> Hence, we are back at square one.

The decreasing importance of shareholders is further exemplified in Gordon's<sup>xxvi</sup> piece where he notes the effect that dual class common stock has on the behaviour and actions of managers. Dual class stock effectively allows managers to gain voting power disproportionate to their investment or what they are entitled to. This aims to destroy shareholder-voting power and with the added results of shareholder apathy, collective action problems and the

free rider issue, managers are able to increase their ability to stay in office. This exploitation also decreases the risk of a hostile takeover, as the board would hold the majority of the votes needed to challenge such a bid. This effectively gives them a permanent and secure tenure of office and greater power in making decisions and keeping them alive in the company. The concept of shareholder primacy in the corporation is thus a fallacy, if existing in reality at all. It does not deter or control managers deviating from their duties, if anything; it enables greater scope for managers to revolt.

The shareholder primacy principle is actually a means of tug of war between shareholders and the directors and managers within the firm. It is a fracas between two groups vying to gain control of the corporation and in a corporate governance context, this is an undesirable process. This process of constant conflict creates intrigue about how business efficiency prevails within the corporation.

### Stakeholder Protection and Corporate Governance

Next we investigate stakeholder theory juxtaposed against the shareholder model to exemplify the inadequacies of the notion of shareholder primacy and its place in corporate governance.

The stakeholder model purports to rectify and avoid corporate governance issues that the shareholder primacy principle creates, by taking into account all players within the firm and not elevating one group as supreme. Advocates of such a regime do not discount the value of shareholders at all; they simply bring them down to the same level playing field as all other constituencies. This enables a fairer, more equitable and efficient corporate model. The stakeholder model does not discount the shareholder as an important interest; rather it includes their interests in the communal, all encompassing ambit of the stakeholder model's arms. Authors such as Dodd support such an embrace, stating that if managers take into consideration the welfare of stakeholders, this will in the long run increase the profits of shareholders, thus shareholders should really promote stakeholder theory.<sup>xxvii</sup>

The most acclaimed counterpoint to the remedy of managerial opportunism and in general, corporate governance is the communitarian movement illustrated by Millon<sup>xxviii</sup>. Communitarians have challenged the shareholder primacy principle quite vehemently, their work focusing on the sociological and moral phenomenon of the corporation as a community. Communitarians view the corporation as adhering to the Gierken<sup>xxix</sup> theory of fellowship rather than a legal fiction. This vision presents a new-grounded perception by establishing a rich foundation of mutual trust and interdependence rather than limiting it to the bare bones of actual contractual terms. Communitarians are concerned about the harm to non-shareholders that occurs due to managerial

adherence to shareholder primacy and believe that the inherent unequal bargaining power between constituencies within the firm leads to parties being manipulated and taken advantage of through managerial gain from information knowledge, greater capital acquisition and unforeseeable harm, i.e.- technology and innovation. Communitarians believe the answer to all of these issues requires an extension of the fiduciary duties of the board to all stakeholders, effectively creating managers duties as 'multi-fiduciary'.

However, Millon does find some criticism in this creation. By enabling managers to be accountable to all stakeholders, there will be conflicts with not only shareholders and non-shareholders but also between groups of non-shareholders. Also by increasing the number of constituencies the manager is accountable to, this approach increases agency costs, which will not be efficient or beneficial to the corporation as a whole. The greatest criticisms of the stakeholder theory are accountability issues. By blurring the beneficiaries of managerial responsibilities, management will be accountable to no one.<sup>xxx</sup> Thus, instead of manipulating systems to advance shareholder interests as in the shareholder model, under this model, managers will look to dishonest means to further their *own* interests. Too much power invested in management will see managerial opportunism emerging to greater heights. This falls into line with Dallas' power model where the managers emerge as the dominant party in the coalition. Stakeholders would effectively have to petition managers to act in their favour. Nonetheless, the communitarian movement has aimed to cure this denigration by praising state intervention to enforce non-shareholder rights. Bainbridge<sup>xxxi</sup> sees this as diluting personal liberties and autonomy.

Whatever the criticisms, the fundamentals of the communitarian movement are to be applauded. Albeit, the model does need reworking to apply in practice, it adequately addresses the need for a more specific examination of stakeholder protectionism and awareness.

### 3. Should Shareholder Primacy Be the Cardinal Rule?

So what is the answer? It has been established that shareholder primacy is undesirable in the business world of today. Shareholder primacy ignores the inherent problems of the separation of ownership and control within modern business and allows gateways for managers to manipulate their positions.<sup>xxxii</sup> Managers will embrace whatever illegal and dishonest means to achieve the goal of maximising shareholder value and shareholder theory will support this as long as it maximises their value and profit. We are increasingly becoming more ethically aware and morally sensitive. What was once viewed as competitive business strategy, the facets of shareholder primacy is now seen as morally

reprehensible. Even shareholders are becoming aware of the dangers of giving too much power to directors and managers<sup>xxxiii</sup>.

What is proposed in this paper is that corporations should consider the interests of all groups, as this leads to the ultimate corporate governance faux par-managerial opportunism. The principle of managers bowing to shareholder primacy has been established as a fallacy. It not only creates disarray between shareholders and managers but can also facilitate bad corporate practice. The stakeholder model has numerous proponents that are seen as not only desirable but workable in the modern business world of today. Consequently the corporation has a responsibility to address the needs of stakeholders juxtaposed to the requirements of shareholders. Nonetheless, while in theory the stakeholder model is highly worthy, in the reality of the modern business world, the shareholder's demise to obscurity is far from near, if anything it will demand and gain further intensity.

#### 4. The Reemergence of Shareholder Primacy

Undoubtedly shareholders are ever striving for a bigger slice of corporate action. Research from the Economic Policy Institute finds that despite the continual news about fast rates of economic growth millions of workers are still struggling live within there means. They find that a disconnect between what aggregate gross domestic product (GDP) numbers are worker incomes as corporate profits soar while the growth in labor compensation (the paychecks that families live on) has been historically sluggish. For example, the labor compensation's share of total income growth previously averaged 75% now it only accounts for 40% of total income growth. Conversely, profits' share of total income growth that averaged 25% now accounts for 60% of income growth<sup>xxxiv</sup>. Ultimately this is an example shareholder profits at the expense of other stakeholders.

Next we find a strong voice for restraint and control on management remuneration as the shareholders and the public are outraged over the

enormous paychecks that are now standard for people who run large corporations. With compensation packages routinely running into the tens of millions of dollars, and it has become common practice for a top executive to walk away with hundreds of millions of dollars for their service and often *bad* service at that. Consequently, there have been calls for the rules of corporate governance to be altered to require that compensation packages of top executives get the approval of shareholders at regular intervals. Also, unlike the standard practice for shareholder votes, in which management gets to count unreturned proxies as supporting their position, the vote on CEO pay should only count ballots that are actually returned - as in a real election<sup>xxxv</sup>. These could assist in protecting (empowering) shareholders against abuses by insiders - the sort of abuses that we witness when incompetent CEOs get hundred-million-dollar compensation packages - and increasing corporate governance by requiring more accountability of the board of directors.

Finally, we find evidence from Australia that shareholders may be alongside creditors in deciding a failing company's fate following a decision by the High Court. In the High Court's *Sons of Gwalia* decision this year the court held that former shareholders of collapsed companies are given the same status as unsecured creditors if they successfully claim losses for shares bought on the basis of misleading or deceptive conduct by the company directors or management. Consequently, the expectation is that shareholders will become poised to flex their right to vote in creditors' meetings to block plans for company restructuring (and re-listing) in accordance with certain cash. At the end of the day, this new shareholder power comes at the expense of other stakeholders, namely the creditors who otherwise would get a return on the future company's profits once operations resume<sup>xxxvi</sup>.

From history and the recent occurrences it appears evident that the resilience of the shareholder primacy has not yet met its match.

#### Endnotes

<sup>i</sup> D. Millon, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in Lawrence E Mitchell, Ed, *Progressive Corporate Law* (Boulder: Westview, 1995).

<sup>ii</sup> E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932), 25, *Harvard Law Review*, pg. 1145.

<sup>iii</sup> I. Ramsay (Ed), "Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford", LexisNexis Butterworths: Australia, 2002 pg.105.

<sup>iv</sup> D.R Fischel, "The Corporate Governance Movement" (1982) 35 *Vanderbilt Law Review* pg.1259

<sup>v</sup> L.L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 *University of Michigan Journal of Law Reform* pg.19

<sup>vi</sup> H.J Smith, *The Shareholders vs. Stakeholder Debate*, 44 *Sloan Management Review* 85 (2003), pg. 86.

<sup>vii</sup> E.M. Dodd, "For Whom are Corporate Managers Trustees?" (1932), 25, *Harvard Law Review*, pg. 1145.

<sup>viii</sup> J. Hill, *Public Beginnings, Private Ends- Should Corporate Law Privilege the Interests of shareholders?* 9, *AJCL* 1 (1998), pg.1.

<sup>ix</sup> L.L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 *University of Michigan Journal of Law Reform* pg.20

- <sup>x</sup> *ibid* at p.20
- <sup>xi</sup> *ibid* at p.21.
- <sup>xii</sup> J.L. Flynn, "Corporate Democracy: Nice Work If You Can Get It" in Ralph Nader and Mark J Green, eds, *Corporate Power in America* (Harmondsworth: Penguin, 1977)
- <sup>xiii</sup> A.A. Berle, Jr and G.C Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933).
- <sup>xiv</sup> I. Ramsay, *op cit* at fn 3, pg. 133.
- <sup>xv</sup> L.L. Dallas, at pg 21.
- <sup>xvi</sup> *Op cit* at fn 4.
- <sup>xvii</sup> D. R. Fischel, *op cit* at fn 4, pg 18.
- <sup>xviii</sup> *Ibid* at pg. 19.
- <sup>xix</sup> Mr Murdoch's statement is featured in an article by J. Synnott, *Like it or sell shares, rules Murdoch*, *The Sun Herald*, 16 November 2003 at pg 24. Mr Mansfield's statement is featured in a report by K. Nicholas, *Long, Angry Grilling for Directors*, Business section: *The Weekend Australian Financial Review*, 15-16 November 2003 at pg 10.
- <sup>xx</sup> Berle and Means, *op cit* at fn 13, pg 35.
- <sup>xxi</sup> *ibid*
- <sup>xxii</sup> *ibid*
- <sup>xxiii</sup> E.B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown Law Journal* pg.445.
- <sup>xxiv</sup> S. M. Bainbridge, "The Politics of Corporate Governance" (1995) 18 *Harvard Journal of Law and Public Policy* pg.671.
- <sup>xxv</sup> E.B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown Law Journal* pg.445.
- <sup>xxvi</sup> J. N Gordon, "Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice" (1988) 76 *California Law Review* pg.1.
- <sup>xxvii</sup> A. B. Berle, "Corporate Powers as Powers in Trust" (1931) 44 *Harvard Law Review* pg.1049.
- <sup>xxviii</sup> D. Millon, *op cit* at fn 1.
- <sup>xxix</sup> A. Black, "Editor's Introduction" in Otto von Gierke, *Community in Historical Perspective* (Cambridge: Cambridge University Press, 1990)
- <sup>xxx</sup> P. Ireland, "Corporate Governance, Stakeholding and the Company: Towards a Less Degenerate Capitalism?"
- <sup>xxxi</sup> S.M Bainbridge, "Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship" (1997) 82 *Cornell Law Review* pg. 856.
- <sup>xxxii</sup> J.J. Flynn, "Corporate Democracy: Nice Work If You Can Get It" in Ralph Nader and Mark J Green, eds, *Corporate Power in America* (Harmondsworth: Penguin, 1977)
- <sup>xxxiii</sup> As seen from the articles by J. Synnott, and K. Nicholas, *op cit* at fn 19.
- <sup>xxxiv</sup> [http://www.epinet.org/content.cfm/webfeatures\\_snapshots\\_archive\\_12032003](http://www.epinet.org/content.cfm/webfeatures_snapshots_archive_12032003) (Accessed April 2nd 2007)
- <sup>xxxv</sup> [http://www.truthout.org/docs\\_2006/041707C.shtml](http://www.truthout.org/docs_2006/041707C.shtml) (Accessed April 2nd 2007)
- <sup>xxxvi</sup> The Sons of Gwalia decision is currently under review by the Corporations and Markets Advisory Body which is the Australian Government Advisory Body.