# SCROOGE – THE RELUCTANT STAKEHOLDER:

# THEORETICAL PROBLEMS

# IN THE

# SHAREHOLDER-STAKEHOLDER DEBATE

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## Introduction

The Christmas Carol is Charles Dickens' story about the spiritual conversion of Ebenezer Scrooge. The story begins with the miser Scrooge niggardly guarding his wealth; however, as the story develops he encounters a series of spirits who show him the impact of his approach. The happy ending results when Scrooge sees the harm of his wealth maximizing ways and broadens opening his range of concern to include a benefit to his clerk's crippled son, Tiny Tim. In its essence, The Christmas Carol is an illustration of the shareholder-stakeholder debate, and that debate is one of the debates at the heart of corporate governance.[1]

S. Bottomley observes "'Corporate Governance'…is a slippery term: it is used both in discussions about the role of companies in society … and also in discussion about the

[1] Farrar writes somewhat reflectively, "…corporate governance is about the legitimacy of corporate power, corporate accountability, and the standards by which the corporation is to be governed, and by who, it is obvious that the concept transcends legal standards and liability, perhaps reflecting the fact that the law deals with minimal morality of obligation rather than a morality of aspiration. Corporate governance is often about the method as opposed to the substance of corporate decision-making. Nevertheless it seems too narrow to limit it exclusively to questions of method and good house keeping." J. Farrar, Corporate Governance in Australia and New Zealand, Melbourne, Oxford University Press, (2002), at p. 431 (hereinafter CG). The complexity and broad scope of corporate governance is well canvassed in S. Turnbull, "Corporate Governance: Its Scope, concerns and theories." (October, 1997) 5 Corporate Governance, (4) pp. 193-196

organization of affairs within companies."[2] It is this author's position that answers to the latter depend on answers to the former and therefore corporate governance must include both. Essentially, corporate governance asks and attempts to answer four questions: what is the entity being governed?[3] By whom it should be governed? What is the best way to govern it? And in whose interests should the entity be governed? The shareholder-stakeholder debate is one way of framing these problems and providing a series answers.

The shareholder-stakeholder debate itself can be analyzed along a number of different lines. At a most basic level it can be analysed as a discussion between monotonic and pluralistic approaches to corporations—is the corporation a vehicle for shareholder wealth or an instrument of a broader societal constituency?[4] It can be analyzed along cultural lines as in Anglo vs. Continental vs. Asian models.[5] It can be analyzed along the

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[2] S. Bottomley "From Contractualism to Constitutionalism: A Framework for Corporate Governance" (1997) Sydney LR at p. 277 (hereinafter From Contractualism).

[3] Assuming for the moment, contrary to nexus of contract theorists, that there is an entity to be governed.

[4] T. Dunfee, "Corporate Governance in a Market with Morality," 62 Law and Contemporary Problems, Duke University Law School, 129-158, Summer, 1999.

[5] See for example, A. Kakabadse and N. Kakabadse, The Geopolitics of Governance: The Impact of Contrasting Philosophies. Basingstoke: Pagrave, 2001. Path dependence theories cited by J. Hill, "Introduction: Comparative Corporate Governance and Takeovers" Sydney LR Vol. 24:319, p. 320, n. 7. See L. Bebchuk and M. Roe "A Theory of Path Convergence in corporate ownership and governance" (Nov. 1999) 52 Stanford Law Review il, p. 127, Farrar, CG p. 7, n. 2 and Chap. 2 generally. A. Corfield, "The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis." (1998) 10 Bond LR at p. 232, A. Gamble and G. Kelly, "Stakeholder Capitalism: Limits and

lines of business management vs. legal obligations.[6] It can be analyzed with a number of insider and outsider models. One such model is as members of the corporate entity vs. non-members.[7] Another insider-outsider model sets the question as corporation vs. community.[8] Still further, the stakeholder debate can be analyzed along the lines of economic thinking.[9]

The shareholder-stakeholder debate in corporate governance has been going on for decades increasing in pitch as globalization has increased[10] and corporate scandals of

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Opportunities." At p. 7. For the contrary view, that corporate governance is converging and essentially over, see H. Hansmann and R. Kraakman "The End of History for Corporate Law", (2000) New York University Centre for Law and Business, Working Paper #CLB-99-013 and Farrar's second last line in CG "This is not the end of history of corporate governance." P. 472

[7] C. Mayer, "Stock Markets: Financial Institutions and Corporate Performance" , in N. Dimsdale and M. Preveser (eds). Capital Markets and Corporate "Governance. Clarendon Press, Oxford, (1994), p. 179 cited in Farrar, CG, p. 417.

[8] D. Korten. When Corporations Rule the World, 2 ed. New York: Kumarian Press. (2001), J. Dine, The Governance of Corporate Groups. Cambridge: Cambridge University Press, (2000) (hereinafter GCG) Chap. 4., C. Weir, D. Laing and P. McKnight. "Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies." (June/July 2002) Journal of Business Finance & Accounting 29(5) & (6).

[9] R. Coase, "The Nature of the Firm," (1937) 4 Economia (NS) 386.

[10] See for example, Korten op cit. n. 6.

ever increasing size rock the not only the investment community, but society at large.[11] For some it is the critical debate as will be seen below,[12] while others dismiss it a "bogus".[13] This paper will analyze the debate, particularly looking at the legal arguments and assumptions behind the positions taken by the two camps, the models of corporations involved, normative issues corporate law and the implications for corporate governance.

## HISTORY OF THE SHAREHOLDER-STAKEHOLDER DEBATE

The debate can be traced back to Berle and Dodd's articles in the *Harvard Law Review* of the 1930's. The debate took place against the backdrop of the 1929 stockmarket crash

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[11] "These reexaminations are usually triggered by a dramatic event or series of events and are initiated by some of those involved in the events whose interests in dealing with those events would be served by changing the rules. And generally others involved in those events see their interests served by preserving the rules that have historically guided people." A. Sommer, "Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later," (Winter 1991) 16 Del. J. Corp. L. 33, p. 33. See public calls for and efforts to improve corporate governance in post-Enron times such as Sorbanes-Oxley Act in the USA.

[12] Millon sees it as a "crisis" in corporate law. P. 1377 Dine citing Sullivan and Conlon who refer to a change from contract to constituency models—i.e. shareholder to stakeholder—of corporations as having "created a crisis in corporate governance." GCG, p. 35.

[13] P. Goldenberg, "Shareholders v Stakeholders: the Bogus Argument" (1998), 19 (2) Company Lawyer 34, p. 36 cited in A. Reynolds, "Do ESOPS Strengthen Employee Stakeholder Interests?" (2001) 13 Bond LR p. 97, n. 18.

which prompted a deep suspicion in Americans about the corporations in their midst.[14] Berle took the view that managers only need consider the views of shareholders. Dodd took the view that although the law supported Berle's view, the concerns of workers should be included.[15] The debate has gone in both directions at different times in the intervening years[16] and as will be seen below continues to the present.[17]

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[14] Sommer, op cit at p. 36.

[15] "Professor Dodd said that: [this writer] believes that public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit--making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future. In response, Professor Berle said: "Now I submit that you can not [sic] abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else." Professor Berle finished his analysis with this summary: Unchecked by present legal balances, a social--economic absolutism of corporate administrators, even if benevolent, might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require. Meanwhile, as lawyers, we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear." Quoted in ibid, p. 37.

Generally, see J. Weiner, "The Berle-Dodd Dialogue on the Concept of the Corporation" (1964) 64 Columbia Law Review 1458. cited in Reynolds, op cit at p. 96.

[16] Berle conceded that Dodd was gaining a greater following in his book, The 20th Century Capitalist Revolution, 1954, cited in L. Stout "Bad and not-so-bad Arguments for Shareholder Primacy" (2002) Southern Calif. LR (75) 1189, at p. 1193.; however, W. Beaver's article laments that it seems stakeholder theory is finished. "Is the Stakeholder model dead?" (March-Apr. 1999) Business Horizons, 42 (12) p. 8.

[17] Brief outline of the debate offered in D. Millon, "Communitarians, Contractarians, and the Crisis in Corporate Law," (1993) 50 Washington and Lee LR 1373 (hereinafter Communitarians). The triumphalist

One fundamental issue is who should be included as a stakeholder? At one end of the spectrum are some scholars (and investors) who argue that the only stakeholder to be considered is the shareholder. At the other end of the spectrum are those scholars who would include even the most inanimate objects in the physical environment.[18] One generally accepted definition of stakeholder is R. Freeman's who wrote: "A stakeholder is any group or individual who can affect or is affected by the achievement of the

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rhetoric of the shareholder primacy theorists is surprising. Consider, for example, the statement by commentators Hansmann and Kraakman:

> The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago. Logic alone did not establish the superiority of this standard model or of the prescriptive rules that it implies, which establish a strong corporate management with duties to serve the interests of shareholders alone, and strong minority shareholder protections. Rather, the standard model earned its position as the dominant model of the large corporation the hard way, by out-competing during the post-World-War-II period the three alternative models of corporate governance: the managerialist model, the labor-oriented model, and the state-oriented model.

This rhetoric is reiterated by Jensen and others and is hard to explain given the lack of consensus among economists, legal, and business scholars on the issue. By way of contrast note Millon's observation " The longstanding shareholder primacy norm is on very shaky ground, Communitarians, p. 1376. Probably the best analysis of the situation is Millon's comment "our society never has committed itself, and never will, to relentless shareholder wealth maximization and its attendant social costs" and that "neither position is on the verge of triumph." Ibid.

[18] E. Sternberg, "The Defects of Stakeholder Theory," Corp. Gov. Vol 5(1) p. 4.

organization's objectives."[19] In essence then the stakeholder model suggests that a corporation should be governed by the people affected by the acts and decisions of the corporation and this will be the meaning for proposes of this paper.

These positions of shareholder and stakeholder reflect a number of different concerns. Scholars and business interests who favour the shareholder to the exclusion of all other stakeholder are "minimalist pure stakeholder"[20] and whose belief in the Market and Adam Smith's[21] "Invisible Hand" is nearly religious.[22] At the other extreme are scholars probably merit the supposedly pejorative epithet the pure capitalists hurl: "communist".

The stakeholder debate is further complicated by the stake in question. Is it a matter of control, of voice, or merely being taken into consideration? As business professor Gerald Vinten notes: "There is no such thing as a tradeable stakeholding certificate, and neither is there any direct legal requirement [to consider stakeholders]."[23] Yet the lack of consensus on the stake in question certainly makes for a more muddled debate.

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[19] Ibid., p. 31.

[20] D. Wood, "Whom should business serve?" (2002) 14 Aust. J. of Corp. Law commenting on Bruce Langtry's theory.

[21] It is well known among scholars that Smith only refers to the invisible hand once in his The Wealth of Nations and it more moderate in his views than commonly presented by neoliberals. Wood, op cit p. 2, n. 3.

[22] See Harvard theologian, H. Cox's article, "The Market as God", (March 1999) Atlantic Monthly, p. 18-23, J. Dine's discussion of Cooter's analysis of Coase Theorem, GCG, p. 111-113 and L. McQuaig. All You Can Eat, (2001) Toronto: Penguin Books, discussion of the new capitalists view of Smith's theories, pp. 241-2.

[23] Vinten, "The Stakeholder Manager," (2000) 38 Management Decision (6) 377.

Yet another dimension to the debate is introduced by economists who approach the debate from the perspective of efficiency some have challenged stakeholder theory on the basis that stakeholder laws or "constituency states" such as anti-takeover legislation and non-exclusive wealth maximizing create distortions in the market harming the efficiency of the market and reducing overall social wealth and hence the overall well-being of society.[24] Other economists claim that stakeholder theory more accurately reflects the situation by having internalized more costs which current accounting principles inappropriately externalize.[25]

Another aspect to the debate is introduced when one examines the nature of the corporation and its consequent role in society. Is the corporation merely a legal recognition afforded to a natural aggregation of business people, or is it a concession granted by government for the public good? The former position is advocated by economists who as we shall see discuss the corporation in a nexus-of-contracts model.[26] Lawyers, environmentalists and business ethicists among others looking at corporate legal history as a way of supporting broader social responsibility, advocate the latter

[24] See M. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function: (2001) 7 European Financial Management (3) 297, for example.

[25] B. Horrigan "Fault Lines in the Intersection between Corporate Governance and Social Responsibility," UNSW LJ Vol 25(2), p. 515 and D. Wood, "Whom Should Business Serve?" (2002) 14 Australian Journal of Corporate Law 1-20.

[26] This concept was pioneered by Coase "Nature of the Firm" (1937) 4 Economia NS 386 cited in Farrar CG p. 30, n. 69.

position.  The legal aspect of the debate becomes more complex as one examines various legal concepts of corporate law arising from rulings such as *Salomon v. Salomon & Co. Ltd.*[27] and even more so when one examines the normative issues of corporate law.

Still further, the discussion takes on a different dimension when one examines the views of management theorists and practitioners who are concerned about the practical matters of profitability, accountability, and control.  These interests and concerns are intertwined with some of the interests and concerns of corporate lawyers.  The discussion in this area considers among other things, the best way to control the corporation, and generally frames the discussion in terms of internal or external forms of regulation.[28]

In dealing with the shareholder- stakeholder debate, yet another discussion comes into play.  That is: what is the role of government in dealing with corporations and the various interests they represent?  Is it to facilitate the market and the Invisible Hand as shareholders advocate, or is it to regulate corporations to promote the common good as stakeholders would have it?

[27] [1897] AC 22, Farrar CG p. 28.

[28] See for example, J. Dine, GCG, Chap. 4 "Theories and models of the regulation of corporations and groups."

Clearly, the stakeholder debate is multi-faceted, multi-disciplinary, interconnected and in some aspects circular.[29] Government, as the ultimate external control, needs direction from the public and from scholars on the nature, purpose and functioning of the corporation in order to develop appropriate systems to do its job of governing the nation. The role of government is made more complex by the influence of corporations, and of course, the debate on the proper role of government in the first place.

# STAKEHOLDER THEORY

## *Stakeholder Theory-Origins and History*

As a previously noted, as a legal concern, stakeholder theory goes back to Dodd; however, stakeholder theory as a management concern can be traced back at least to 1963 where it was used by the Stanford Research Institute in an internal memorandum on management to signify "those groups without whose support the organization would cease to exist."[30]

Stakeholder theory answers the four questions as follows. (1) The corporation is a

[29] In this paper the author will not distinguish between the various particularities of corporate law in Anglo jurisdictions because the fundamental concerns and issues are the same: the nature of the corporation and its role in society.

[30] R.E Freeman, Strategic Planning: a Stakeholder Approach. New York, Pitman Publishing, (1984), p. 32.

concession from the government and an independent entity in itself. (2) It should be governed by those affected by the decisions and actions of the corporation. (3) The best way to govern the corporation is by having decision making structures in place that permit those effected by the decisions at least voice, if not some control on the decisions made. And (4) the corporation should be governed in a way that promotes overall social good.

## *Stakeholder Theory – Assumptions And Criticism*

### Assumptions

Stakeholder theory fundamentally holds that the corporation is an entity that has profound effects on society. On that basis those affected should have some confluence or control over the corporation. It is based on fundamental legal principles and beliefs such as that one must bear responsibility for consequences of action, that economics and efficiency are not ultimate values, and voice in the distribution of cost and benefits of society resources.[31]

### Criticism

Perhaps the champion of stakeholder critics is Elaine Sternberg.[32] As the leading spokesperson opposing stakeholder theory, her arguments merit analysis.

[31] Referred to by Stokes as the democratic ideal, cited in Bottomley, From Contractarian op cit, p. 290

[32] M. Jensen, at p. 298, n. 2. Sternberg is a former investment banker turned philosopher. She includes in her argument certain legal grounds for opposing stakeholder theory. That she views stakeholder theory as some type of heretical cult as can be seen from the title of her article “Stakeholder Theory Exposed”. It is interesting to note that few lawyers seem to oppose stakeholder theory—at least not on legal grounds.

Sternberg's criticism of stakeholder theory has four main thrusts.[33] She argues: stakeholder theory is incompatible with business, stakeholder theory is incompatible with corporate governance, stakeholder theory of accountability is unjustified, and stakeholder theory undermines private property, agency and wealth.

Sternberg holds "stakeholder theory… wholly precludes the activity of business." She argues that business requires maximizing long-term owner value. In contrast the balancing requirement of stakeholder theory precludes such favouritism that by definition obviates business. She furthers her argument by claiming stakeholder theory is unworkable because the number of stakeholders is infinite and given all the competing interests the identification of what should be counted as a benefit is not identifiable. She further argues that as stakeholder theory has no means of weighing or balancing the competing interests of various stakeholders this balancing task is impossible. In essence this argument challenges the nature and purpose of corporations.

Sternberg next argues that stakeholder theory is incompatible with corporate governance. In her view, accountability of directors to shareholders is the central issue in corporate

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Perhaps this reflects an understanding that the law does not exist a priori, but follows from determined policy decisions, or alternatively, that law does have an inherent obligation of social justice.

[33] E. Sternberg, op cit. Criticisms of stakeholder theory are generally variations on these same themes, whether the criticisms arise from legal scholars, economists, business theorists or others. See for example, the paper by finance professor A. Sundaram and professor of management and strategy, A. Inkpen, "The Corporate Objective Revisited", p. 20-21 unpublished paper available on Social Science Research Network at www.ssrn.com .

governance. In contrast she notes: “an essential principle of stakeholder theory [is] that corporations should be equally accountable to *all* their stakeholders. [italics in original]”[34] She attacks this position as “unjustified” and “unworkable.” Clearly, if one accepts her view of accountability and corporate governance, she is correct.

Concerning her third argument on accountability, Sternberg argues that stakeholder theory “gives full rein to arrogant and unresponsive management” and assists in exploitation of corporations by management by failing to provide a single clear criterion for judgment of performance. She claims it requires management to reject the obligations to owners that they accepted in accepting their management jobs. Sternberg argues: “As the property of its owners, a business is properly accountable only to them.”[35]

Finally, Sternberg claims that stakeholder theory undermines private property rights by denying owners of private property the right to deal with it as they choose. If corporations for any reason act in the interests of anyone but the shareholders, corporations are converting and/or curtailing the private property rights of the owners. As Millon observes:

> [stakeholder theorists] characterize the debate as a disagreement over whether it is appropriate to use mandatory rules to impeded shareholder wealth maximization in order to benefit other corporate constituent groups or other affected interests outside the corporate enterprise. For contractarians [shareholder theorists], such rules represent an unjust imposition on the liberty of shareholder to pursue their own interests. They have made this point by criticizing communitarian

[34] Ibid, p. 5.

[35] Ibid, p. 6. Sternberg also briefly addresses corporate performance, Kantian moral theory, parallels with government, and social contract arguments for extra-corporate accountability.

> [stakeholder] corporate law reform as the reallocation of wealth from shareholders to nonshareholders.[36]

Sternberg applies this same analysis to the law of principal and agent. Again, Sternberg holds that the directors and managers of corporations are agents of the shareholders. Accordingly, stakeholder theory, which allows the former to act independently of or contrary to the wishes of shareholders it undermines the duty of the agent to the principal.[37]

She argues that these two pillars of law underlie the success of western economies and political liberties and accordingly should be protected by rejecting absolutely stakeholder theory. Sternberg's argument is that the law as it stands in support of capitalist, free market economies is correct and should be carefully guarded.

Sternberg concludes her attack on stakeholder theory with *ad hominem* arguments that seem to characterize opponents of stakeholder theory.[38] She opines: "stakeholder theory

[36] Millon, Communitarians, at p. 1383-4.

[37] Indeed, as a Sommer observes: "it may be reasonably concluded that the legislature intended to do something common law did not do in affording directors flexibility in fending off a hostile tender offer – namely, favor non--shareholders over shareholders." Op cit p. 43

[38] See, for example, Jensen, op. cit. p. 306 who writes "Stakeholder theory gives them [socialists] the appearance of legitimate political access to the sources of decision making power." This personalizing of the debate is addressed by Millon who observes: "The ideology and psychological predispositions that turn many corporate law scholars away from these kinds of inquires explain the inability of at least some contractarians to acknowledge the crisis in corporate law," Communitarians at p. 1388, in reference to the need to address social concerns in corporate law.

seems to offer a free lunch; it attracts those would like to enjoy the benefits of business without the discipline… [and] those with most to gain from avoiding accountability: business managers…. [and] promoters of worthy 'causes', who believe they would be the beneficiaries."[39] Perhaps this type of personal and emotional attack reflects the very deep and personal ideologies that underlie the debate, which shall be addressed later in this paper.

Sternberg's argument is that stakeholder theory is fundamentally flawed because it does not make directors responsible to owners. This is the classic Berle and Means agency problem. Her concern is that the agents will act exclusively in their own self-interest. As Sternberg sees it, directors cannot be or have any true accountability unless it is directly and exclusively to shareholder. Empirical studies of self-interest in management action and decision making suggest that Sternberg is being driven by ideology more than evidence. Studies indicate that managerial motivation is far more complex including aspects of altruistically motivated behaviour along with self-interested behaviour.

Sternberg's criticisms are by no means an exhaustive list of the criticisms of stakeholder theory; however they are both representative of general issues and address the main concerns.[40]

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[39] Ibid. pp. 8-9.

[40] See for e.g. Sundaram and Inkfield who identify five and Corfield who identifies eight. These criticisms are broadly addressed by the four raised by Sternberg.

## *Replies To Stakeholder Criticism*[41]

Stakeholder critics have some trenchant criticisms of the theory. The strength of these criticisms revolves primarily around the above noted issues of accountability and currently existing legal norms. We shall now turn our attention to individual replies to each of these criticisms. First, is it correct to say that stakeholder theory is contrary to business?

For stakeholder theory to be against business, one must accept a certain definition of business, and more particularly, a certain theory of the corporation. If the corporation is, as economists argue, a nexus-of-contracts, then there may be some credence to the argument. But one must further accept that the appropriate and exclusive object of business is the increase of wealth for the owners of the business. In addition, one must also exclude the wealth of any other party including the general social benefit as being of interest or importance.[42] Furthermore, as will be discussed in greater depth, it is not at all clear that long-term stockholder interest should have priority over short-term stockholder

[41] For a business reply to Sternberg's four objections, see G. Vinten, op cit.

[42] Later in this paper we will take up the challenge that the increasingly unequal distribution of wealth creates for those who argue that overall wealth increases the social wealth of a country. See, for example, Jenson, p. 302-304, and the contrary views by S. Bottomley, "Taking Corporations Seriously: Some Considerations for Corporate Regulation" in (1990) 19 Federal Law Review, pl. 204, and R. Dworkin, "Is Wealth a Value?" in (1980) 9 Journal of Legal Studies, p. 191, cited by J. Dine "Risks and Systems: A New Approach to Corporate Governance and the European Employee Consultation Structures?" (2001) 3 International and Comp. Corp. LJ 2 p. 302, n. 11.

interest, nor yet that shareholder are "owners" and have a unique or special position in the corporation

Clearly, these assumptions are suspect. Farrar, for example, laments about "the unsatisfactory state of affairs" in his authoritative analysis of the corporation,[43] H.L.A. Hart observes that none of the theories of the corporation adequately explain the phenomenon.[44] Theories of the corporations include sociological, economic, and legal. One can further analyze the corporation in terms of culture, power, politics and cybernetics.[45] Farrar outlines the mutations of the idea of the corporation and its purposes over time and states that this too adds to the uncertainty in the proper identification of the nature and purposes of the corporation.[46] Accordingly, without any consensus concerning a foundational understanding of the corporation or its purpose, it is difficult to see how Sternberg's criticism can stand. Stakeholder theory is merely outside of Sternberg's paradigm for the corporation.

[43] J. Farrar, "Frankenstein Incorporated or Fool's Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (1998) 10 Bond LR at p. 161 (hereinafter Frankenstein).

[44] E. Orts **"**The Complexity And Legitimacy Of Corporate Law" (Fall, 1993) 50 Wash & Lee L. Rev. 1565 p. 1623 P. 3

[45] See for example the discussion in Turnbull, op cit, pp. 193-196

[46] Ibid, pp. 144-45.

Sternberg's next criticism, that stakeholder theory is contrary to corporate governance is based on the issue of accountability. [47] To be equally accountable to all she argues is to be accountable to none. This argument is a straw-man argument. Stakeholder theory, to the extent that one can speak of unanimity of views, does not advocate equality of all interests—or the view this extreme position implies: the rejection of the profit motive.[48] Judges daily and legislatures regularly balance conflicting interests examining by policy objectives among other things.[49]

In fact as noted by Prof. Henry Hu corporate directors already do just that.[50] These answers, however, are not to denigrate the seriousness of the criticism. Stakeholder theory does have a considerable challenge to address when it comes to the issues of how and to whom the corporation should be accountable. Alternative answers lie in corporate governance structures in non-Anglo corporations. For example, the German two tiered board that permits employees a strong voice in decision-making, or the Japanese model that permits a tripartite objective for the corporation.[51] Other more Anglo solutions lie as

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[47] Jensen ibid argues that from a management perspective, stakeholder theory is impossible because it requires management to consider more than one interest. P. 300 ff.

[48] Dunfee op. cit, n. 2 at p. 131.

[49] See, for example, Richard Posner's life work on economics as the policy driving law.

[50] H. Hu, "Risk, Time and Fiduciary Principles in Corporate Investment", (1994) 38 UCLA L. Rev. 277 cited in Orts, op cit.

[51] Noted in Horrigan, op cit at p. 542 writes "Japanese communitarian capitalism… [has] three intertwined strands of the common good—i.e. the pursuit of happiness and prosperity, the concern for justice and fairness, and the affirmation and importance of community."

Horrigan also notes in the "Triple Bottom Line" idea—i.e. profit, environmental protection and social good—which seems to be gaining some acceptance, at least in Australia.[52]

The must fundamental legal challenge to stakeholder theory comes from Sternberg's criticisms concerning of property and agency law.  This criticism goes back to the Berle and Dodd debate in which Berle cautioned against stakeholder view: "it requires little analysis to make place the fact that private property as understood in the capitalist system is rapidly losing its original characteristics."[53]  If one accepts, however, that all rights except the right to life,[54] are circumscribed, that no rights are absolute, then there is no reason the right to private property should be any different.  The law does in fact recognize many limitations on private property rights.  For example, the law recognizes the state's right to appropriate land, or to prohibit the ownership of another human being, and where and how one may drive one's car.  Furthermore, if one accepts that the corporation is not the property of stakeholder but an independent entity in which stakeholder have but three rights, voting, dividends and residue, the criticism from property and agency law do not stand.  Sternberg's view of law is a naïve view of law. She appears to presume that law in some manner is *a priori* and has followed a logical non-ideological path.  It is generally recognized that law is the product of its particular

[52] Ibid, pp. 543 ff.

[53] A. Berle and G. Means, The Modern Corporation and Private Property (1932)  Cited in D. Millon, "Frontiers of Legal Thought: Theories of the Corporation" (1990) Duke Law Journal, 201 at 222 (hereinafter Frontiers).

[54] USA capital punishment

times,[55] certain styles of thinking, by a limited group of people, usually a propertied, privileged class with less concern for those without.[56]

## SHAREHOLDER THEORY

To avoid a straw-man argument, as Sternberg created in her criticism of stakeholder theory, the discussion of "shareholder theory" must start with a caveat. In all but its most extreme versions, shareholder theory does not require that every other party be ignored and every possible action to advance profit be acted.[57] Rather, it requires that primacy be given to the shareholder, and accordingly in the USA legal literature at least, is referred to as "shareholder primacy." Shareholder primacy sees the corporation's objective as maximizing shareholder wealth. Business scholars refer to this wealth maximization as the "corporate objective function."[58] Although shareholders can be viewed or

[55] As Sommers observes: "the truth is that its content is constantly shifting, and notwithstanding the best efforts of justices to link their present decision making with the past in an effort to make it appear that nothing has changed, the truth is that change has occurred." Op cit p. 33.

[56] To demonstrate the equality of the law it has been said "The law equally prohibits the rich and the poor from sleeping under bridges."

[57] Shareholder theory does not, for example, require a corporation to hire "a hitman to murder the key witness against the firm in a major product liability case." Dunfee, op. cit. 10.

[58] See for example, the title of Jensen's article, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function", op cit.

characterized in a number of different ways,[59] for purposes of this debate, the view that most accurately represents the situation under discussion is the shareholder-as-investor view.

Shareholder theorists answer the four questions of corporate governance as follows. (1) There is no entity to be governed: it is a mere collection of contracts the terms of which govern the actions of the individuals involved. (2) Given the separation of owners from mangers, it should be governed by shareholder appointees—directors. (3) The best way to govern the corporation is by a board of directors elected by and accountable to the shareholders. And (4) the corporation should be governed for shareholder wealth maximization.

### *Shareholder Theory--Origins and History*

From the perspective of legal theory, one could argue that historically the primacy of shareholder rights arises from doctrines of private property. John Locke argued that private property is carved out of the common property by the labour a person puts into it:

[59] See J. Hill, "Visions and Revisions of the Shareholder" (Winter, 2000) 48 Am. J. Comp. L. 39 who identifies seven models or views of shareholders: owner/principal, beneficiary, bystander, participant in a political entity, investor, Cerberus, and managerial partners.

"It hath by this labour something annexed to it that excludes the common right."[60] In other words, by the direct connection of one's hands and the physical article one had an ownership right—the right to exclusive use.[61] As Mr. Justice Wilson wrote in the 1766 property case concerning landowners denial of gleaning rights to commoners: "the soil is his, the seed is his and in natural justice his also is the profit."[62] This view of private property rights lent credence to the argument that the rights of ownership of capital led to rights to manage the enterprise. This view provided a stronger argument at a time when capital and management were more closely linked.[63] In corporate law, one finds that the shareholders were historically those who invested their private property, money, into a common fund such as a joint stock company with a view to a profit.[64]

Changes in corporate law, however, increased the separation between owners of financial capital and in the income generating assets of the business. In the USA with *Santa Clara County vs. South Pacific Railroad* [65] and in the UK with *Salomon vs.*

[60] *Second Treatise on Government* II v. 33 general theory of private property discussed Uzgalis, William, "John Locke", *The Stanford Encyclopedia of Philosophy* (Summer 2003 Edition), Edward N. Zalta (ed.), forthcoming URL = http://plato.stanford.edu/archives/sum2003/entries/locke/

[61] Interestingly, Locke use the example of the activity of one's servant without explaining how that person become a servant in the first place.

[62] E.P Thompson, Customs in Common. New York: The Free Press, (1991), cited in McQuaig, p. 209.

[63] See discussion in J. Dine, GCG, p. 6. Note J. Hill, who suggests that such closeness of shareholder and management in earlier times could be "another myth of corporate law." See also Adam Smith's comments on passive, uninterested, uninvolved inventors, cited in Wood p.10

[64] Farrar CG, p. 158

[65] 118 U.S. 394 (1886)

*Salomon & Co. Ltd.*[66] the courts gave the corporation an independent personality. This personality existed and held property and liability in this own right with complete independence from the shareholders and other members of the corporate entity. This change in the law permitted management to ignore the broader concerns of the general commercial environment, which would include such parties as creditors and employees, and to the narrow focus on the interests of the "owner" shareholders.[67]

Prior to these court decisions, corporations did not have independent legal personality, and hence were not able to sustain a legal action independently of the shareholders. Nor was limited liability a feature of corporations until 1855.[68] With the combined benefits of independent legal personality and limited liability, it was no longer necessary for shareholders to consider any other interests. There was no greater personal financial risk in refusing to consider other interests than the risk already accepted by making the investment in the corporation in the first place. As a result, people could become investors, carefree of corporate action and its consequences, except for return on capital.[69] While this phenomena is neither new nor unexpected—it was anticipated by Smith and Marx[70]—it carries with it certain problems, and particularly the agency problem, and for some, a moral problem.[71] As Wood notes:

[66] [1897] AC 22

[67] Farrar, CG p. 22

[68] Dine, GCG p. 5 offers 1844 as the date of incorporation by registration and 1855 as the date of limited liability. Farrar CG p. 9 offers 1844 that the UK's Companies Act first conferred limited liability.

[69] Farrar, CG, p. 11.

[70] Noted in Farrar, CG, p. 11 n. 40 and n. 37.

> Berle and Means point out that having ‘surrendered control and responsibility’ over corporate assets, shareholders had ‘surrendered the right that the corporation should be operated in their sole interest’ and ‘released the community from the obligation to protect them to the full extent implied in the strict doctrine of property rights’.[72]

Over time, corporate law came to reflect this single focal point[73] and increased the focus on director accountability to shareholders. Hill argues that the trade-off of control was made at the same time that the courts moved the focus of corporate law to the maximization of shareholder wealth.[74] In other words, the agency problem that was created by the separation of ownership and management was at the same time resolved by the fiduciary nature of the duties placed on management.[75]

Although shareholder primacy was developed by USA courts in the 1830’s in terms of receiving of dividends and voting,[76] the view of shareholder wealth being the focus of the

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[71] Indeed, passive investing may be looked upon as a morally questionable activity, dividends being quite undeserved. Adam Smith expressed very little concern for such an investor. He castigated what he referred to as ‘proprietors’ of joint stock companies, for they: “seldom pretend to understand any thing of the business of the company; and when the spirit of faction happens not to avail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make to them.” Wood, p. 11, quoting Adam Smith, Wealth of Nations.

[72] Wood, p. 12.

[73] See Millon detailed discussion of the history of corporate development, Frontiers pp. 205-240.

[74] Hill, Visions at p. 7

[75] Fiduciary duties are placed on directors not managers, but the term “management” is used to keep linguistic symmetry and emphasize the idea of operators versus owners.

[76] D. Smith. “The Shareholder Primacy Norm”, (Winter 1998) 23 The J. of Corp. L 2 p. 279 at p. 296.

corporate enterprise was pronounced by the courts in 1919 case of Dodge *v. Ford Motor Co.*[77] As stated in that case, "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end." Managers have followed that lead[78] and generally welcomed this focus as it simplified their responsibility and tied their success to clearly and easily measurable outcomes.[79] In regulating corporations more recently, however, some governments have opened the earlier narrow laws that precluded non-shareholder interests.[80] In doing so, the hope was that corporations and specifically directors would consider other interests of the broader community or social development concerns.[81]

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[77] 170 N.W. at 684 cited in Smith, op cit.

[78] S. Bainbidge, "Participatory Management Within a Theory of the Firm" (1996) 21 J. Corp. L 657-71 cited in D. Smith, ibid. Note that Smith argues the contrary: in his view, shareholder wealth maximization is not and has not been the norm in corporate law. Nevertheless, Smith acknowledges that the consensus is the shareholder primacy norm.

[79] Dean Clark describes the practical argument for this perspective: A single, objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests.... Better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do, and do it efficiently.
Quoted in Orts, n. 204.

[80] For example, in the USA 30 states have enacted laws permitting directors to consider stakeholders Millon, New Directions, p. 1375. E. Ortis "Beyond Shareholders: Interpreting Constituency Statutes," (1992) The George Wash. L R, 61,1 pp. 14- 135 (in Sternberg)

[81] It appears, however, that this broadened ambit has been used primarily, if not exclusively, in the development of anti-takeover strategies, and not the true interests of the community at large. Corfield, op cit p. 230.

As such, pursuit of non-shareholder interests—i.e. stakeholder interests—in the shareholder view amounts to a tax or misuse of the private property of the shareholders.[82] In summary the main idea here is that as the parties who put up the money for the enterprise, the shareholders should have the right to be the sole concern of and have the right to control the enterprise. From the management perspective, current proponents of shareholder primacy, such as Jensen, argue, "value maximization says that managers should make all decisions so as to increase the total long-run market value of the firm."[83]

The other main argument for shareholder primacy comes from the legal foundation of the corporation. Corporations are founded by one or more people contributing a fund of capital for the purpose of carrying on a business with a view to making a profit. These founding contributors are the shareholders. As founders of an entity, the corporation, shareholders have the right to control the entity.

## *Shareholder Theory – Assumptions And Criticism*

[82] M. Friedman, "The Social Responsibility of Business is to Increase Its Profits", Sept. 13, 1970, New York Times Magazine, at 32-33, 122, 124, 126 cited in Millon, Frontiers, p. 227-8.

[83] P. 299 Jensen adds that the long-term interests of the corporation include "equity, debt, preferred stock and warrants." Interestingly, for purposes of the legal debate on stakeholder theory, Jensen would be included with the stakeholders. Dunfee, p. 3 "stakeholders (variously, bondholders, suppliers, distributors, creditors, local communities, users….")

Most recently, shareholder primacy was brought into focus by the views of the economist, Milton Friedman. In his highly controversial article, "The Social Responsibility of Business is to Increase Its Profits"[84] Friedman argued that the social good achieved by a corporation is to producing a profit.[85] He wrote: "the one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it… engages in open and free competition, without deception or fraud."[86] And, "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[87] Friedman and other profit maximization theorists[88] make social welfare the ultimate justification for the exclusive focus on profit. In other words, the good end—social benefit—will be achieved by ignoring it and in fact focusing exclusively on another

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[84] Friedman, op cit.

[85] Millon points out that Friedman was well aware "that profit seeking can generate externalities, and that various members of the public may be affected adversely. The question for Friedman was how such problems ought to be addressed, and he took for granted that a government accountable to the public, rather than private initiatives undertaking in the boardroom, should make the necessary cost-benefit decisions." in "The Ambiguous Significance of Corporate Personhood", (Jan 2001) Wash & Lee Pub. Law and Legal Theory Research Paper Series, Working Paper No. 01-6. (hereinafter The Ambiguous) at p. 20.

[86] M. Friedman, Capitalism and Freedom, (1962) 133 showing the development of the view before become famous in the NY Times article.

[87] Ibid.,

[88] See for example, Jensen, p. 302 "value maximization is an important one because it leads… to the maximisation of social welfare."

end—shareholder wealth maximization.[89] As Hansmann and Kraakman, the authors of the influential "The End of History for Corporate Law" write:

> The point is simply that now, as a consequence of both logic and experience, there is a convergence on a consensus that the best means to this end—the pursuit of aggregate social welfare—is to make corporate mangers strongly accountable to shareholder interests, and… only to those interests.[90]

This social benefit therefore becomes the justification for shareholder primacy.

It should be asked, therefore, whether this has in fact occurred. Economic studies do not support this contention. What can be said is that in the United States as shareholder primacy has advanced over the last 30 years is that there has been an increased concentration of wealth. One finds a growing disparity between rich and poor and decline in the wealth of the middle class.[91] Indeed, World Bank and IMF[92] structural

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[89] This position shows either a remarkable faith in free market economics or a Zen approach to social justice.

[90] Op cit. n. 3 p. 10. View reflected in Jensen who writes that value maximization "has its roots in 200 years of research." P. 299.

[91] See for example, David Cay Johnston who reports "The 400 wealthiest taxpayers accounted for more than 1 percent of all the income in the United States in the year 2000, more than double their share just eight years earlier," in "Very Richest's Share of Income Grew Even Bigger, Data Show" New York Times article, June 26, 2003.

Clearly, there are many reasons for such disparities such as government policies, performance of the economy and changes in the labour force resulting from globalization, but the disparity noted parallels the shift away from stakeholder thinking and seems to suggest that shareholder primacy cannot be supported along these lines. See Millon, Frontiers, p.229-230 on the triumph of shareholder primacy in this era. And McQuaig, op cit, pp. 96-107.

adjustment programs, an integral part of which have been to open borders to shareholder primacy corporations, have been a failure in increasing general social wealth or widely distributing the benefits of corporate activity.[93] The activities of these transnational corporations seem to do the opposite: they increase the concentration of wealth and increase the disparity between the rich and the poor.[94] Accordingly, shareholder primacy as a general principal or a specific mechanism cannot be supported on the basis that it benefits society overall.

Four further reasons, however, are advocated by contemporary law and economics scholars. Hill notes that these scholars claim that shareholders should have primacy because: (1) they hold the residual claims, (2) have the greatest risk, (3) the greatest incentive to maximize firm value and (4) the least protection.[95] In her analysis of corporate finance, however, we find a very different reality to which we will now turn.

As to the first claim, concerning the residual claim, L. Stout observes that, the only time shareholders actually have the actual residual claim is when the corporation is in bankruptcy or being wound-up.[96] Accordingly, to argue that shareholders deserve to

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[92] See, for example, McQuaig's discussion of Joseph Stiglitz, former chief economist at the World Bank, in ibid pp. 82-92.

[93] See Dine, GCG, Chap. 5 and extensive notes therein.

[94] Ibid., p. 151 and Wood, p. 11 n. 46.

[95] Ibid.

[96] op cit at p. 1193.

have their interests as the foremost consideration on the basis of their right to the residual claim is hardly compelling.[97]

The second argument concerning risk is also challengeable. With respect to publicly traded corporations there is a highly liquid market for shares and at practically any point, should the shareholder deem the risk unacceptable, the shareholdings can easily be sold. Furthermore, in contrast to other stakeholders, such as employees who for example bear the risk of unemployment and who lack the their general in ability to "withdraw their investment", shareholders appear to have a lesser risk.[98]

Furthermore, shareholder primacy advocates argue the risk shareholders take as equity investors is significantly different and greater than other capital providers. This argument is premised on a clear distinction between debt and equity. Hill demonstrates, that this distinction in contemporary corporations is very hard to maintain. She writes: "with the rise of more complex funding instruments the traditional distinction between debt and equity fails to accord with economic reality and looks artificial, arbitrary and increasingly passé."[99] She notes that the disaggregation of equity investments, dividing the risk and control components, makes the notion of shareholder as risk bearer and residual claimant

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[97] Farrar suggests this residual claim is the basis of their right to vote. CG, p. 158, and citation in n. 6.

[98] Hill, Public Beginnings, Private Ends—should Corporate Law Privilege the Interests of Shareholders?" (1998) 9 Aust. J Corp. L no. 1 (hereinafter Public), p. 7. Note that employees lose a 10% job specific premium when the lose their jobs. M. Blair, "Wealth Creation and Wealth Sharing" (1996) Brookings Institution, noted in Corfield, p. 216, n. 15

[99] Public P. 4

much less compelling. In fact, Hill argues, at times the courts are more likely to consider the interests of other financiers ahead of shareholders—the corporation's success or failure being a thing independent of any particular interest group.[100]

Hill also notes the long term involvement of some lenders who end up having much more at stake than shareholders who can easily exit a precarious financial situation. She notes the controlling positions some of these lenders take, not only in securing their funds, but also in the operations of the corporations becoming more like insiders than the traditional outsider role of creditors. This situation, which she argues is the corporate reality, does not jibe with the shareholder primacy model advocated by shareholder primacy theorists.[101] The point is pressed further by Stout who notes that even in a closely held corporation, once the corporation has assumed debt, the creditor has a greater right of "ownership" to the cash flow of the corporation than the shareholder.[102] It is fair to say therefore, shareholders are merely one group of financiers whose characteristics do not fit the description set out by the law and economics scholars.[103]

[100] In such instances the courts turn to the notion of the best interest of the corporation. See discussion of this concept in Sommer pp. 46-51 and mentioned by Bottomley, From Contract p. 284

[101] Ibid. p. 5

[102] She notes that shareholders have a first claim on profits. They only have a claim on profits when the corporation is (a) profitable and (b) the directors declare a dividend. Op. cit p. 1192.

[103] In his criticism of Salomon, Farrar notes: "[It] tipped the balance too far in favour of the equity investor at the expense of general and in particular involuntary creditors." Frankenstein, p. 144.

The third argument supporting shareholder primacy on the basis that they have the greatest incentive to see the corporation profit suffers its own weakness. While shareholders may be eager to see the value of the corporation maximized there are certainly others with the same interest. These would include such groups as employees seeking job security, directors and managers whose income may be directly tried to this measure, (and who lack the diversified portfolio common to shareholders) have a grater interest in seeing maximization than shareholders. Further, this position ignores the diversity among shareholder interest, and in particular such parties as those parties taking a short position on the shares.

Furthermore, profit and wealth are arbitrary abstractions that hold no innate value commanding a privileged position. As Wood observes:

> there is no 'prima facie' moral, as opposed to prudential, reason, why profit should be promoted, let alone maximized. Profit is a mere accounting concept, and profit-maximisation is at most a highly artificial goal. Profit is certainly not in its own right a 'morally important social value' such as: 'the protection of the environment, the advancement of knowledge, the development of culture, the promotion of social prosperity, the fostering of community, and the protection of public health.'

Again, one is turned to the objective of shareholder wealth maximization as the objective of corporate activity, and when contrasted with other valuable objectives, the shareholder primacy model comes up lacking.[104]

[104] Wood, p. 10. P. Dalley supports the shareholder primacy argument from a sociological analysis of groups. She argues that corporations as purposive groups can include only shareholders because only their interests conform with those of the corporate group, with each shareholder determined to increase corporate profitability. This conclusion seems odd because not only do shareholders doing nothing to increase

Further, this argument assumes an alignment of corporate interests and shareholder interests, as well as identifying corporate profit with shareholder wealth. As will be seen later in the discussion, neither of these assumptions is tenable.

The fourth argument put forward for shareholder primacy is that they are in the most vulnerable, least protected position. In addition to the replies to the previous three arguments, which equally apply to this contention, it is simply not the case. Shareholders have the option of choosing to invest in whichever form of contract they believe suits their specific acceptable combination of risk and reward. In addition, shareholders are granted several special remedies at law, such as derivative actions and winding-up the company on just and equitable grounds, denied to other stakeholders.[105] Finally, as a previously noted, in a stock market with much liquidity, there is always the exit option.

The shareholder primacy model has a number of other fundamental problems to which we will now turn. Shareholder primacy focuses on wealth maximization. This leads to the question, what is wealth maximization? Is it shareholder wealth, or is it corporate profit? In a groundbreaking study, Professor Hu has identified a significant difference between shareholder gain and corporate profit and particularly, that the one does not

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corporate profitability other than wish for it. "To Whom it May Concern: Fiduciary Duties and Business Associations," (2001) 26 Del. J. Corp. L 515.

[105] There is discussion in both Canadian and Ontario corporate law concerning the meaning and applicability of oppression remedies which may be available to non-shareholders.

necessarily lead to the other.[106] This fact creates a problem for managers who on the one hand seek job security by having employment with a wealthy corporation while on the other hand remaining answerable to shareholders seeking their own wealth.[107]

In addition, Hu has identified and analysed the myth of the common shareholder interest. He notes a number of conflicts existing as between shareholders. For example, shareholders disagree concerning the nature and amount of risk each wants the management to take, they have different time lines—whether long term capital gain, or speculators trying to take advantage of an acquisition announcement.[108] This critique leaves shareholder theorists subject to the same attack they level at stakeholders: there is evidently more than one objective and managers cannot focus on more than one objective. In this instance the objectives include corporate profit, shareholder wealth, short-term shareholder interests, long term shareholder interests, high-risk shareholder interests, and low risk shareholder interests, among others. Worse yet, the law has neither denied nor validated one shareholder over the other.[109] At this point, the law

[106] H. Hu, op cit, discussed in Orts 1588-91.

[107] Various commentators have noted the undercapitalization of USA corporations where directors under pressure from shareholders have taken too much money out of the corporation harming its long term viability and competitiveness in order to put money into shareholder hands. See, W. Hutton, cited in Corfield, p. 215, n. 8.

[108] Noted also in Sommer op cit, p. 40

[109] Ibid. Note Jensen above who argues for the long term as bringing together shareholder, creditor and warrant interests, challenged by Dunfee and Hu's theorem..

introduces yet another guidepost, namely, "the best interests of the corporation"[110] which tends to further confound the discussion.

But this brings us to the more fundamental question of why shareholders should have their privileged position in the first place. Dine raises the question from the dynamic aspect of the corporation. As noted previously, while shareholders are necessary to start up or found the corporation and claim primacy on that basis, from an operational perspective once the corporation is up and running, their role as founders loses significance. This foundational argument is even more seriously challenged by the practice among lawyers of having "shelf-companies", companies organized and registered for the purpose of rapid and easy deployment of a corporate vehicle in a commercial transaction. Once the business corporation is operational, shareholders are but one more source of capital, and in truth, the least preferred source of capital.[111] From an operational perspective therefore, shareholders really have no privileged position or interest.[112] In fact, were it not for their voting power, their existence would be but of marginal interest.[113] In a related vein, shareholder primacy theorists argue that because shareholders are true insiders because they are founders. Hill's study of corporations raises serious questions about the insider-outsider model of the corporation, and particularly, shareholder claims to primacy based on their special role as the ultimate

[110] Sommer op cit p. 51at pp. 46-51.

[111] Hill, Public, p. 4, n. 37, 38, & 39.

[112] Dine, GCG p.1

[113] Wood, op cit p. 7 It is interesting to note that non-profit corporations exist without difficulty regardless of the fact that they are incorporated without shareholders.

insider. As previously noted from the perspective of corporate finance, Hill's analysis suggests that other traditional outsider financiers often play a much greater insider role than shareholders.[114] In addition, as we have seen the demarcation lines between debt and equity have been sufficiently eroded to make it nearly impossible to ascribe one party "insider rights" to denied to the other "outsiders " on the basis of this debt-equity distinction. Further on this insider-outsider theme it is difficult to see how such employees should be outsiders without some determinative power over the direction of the corporation while day-trading shareholders should be considered insiders with such power. [115]

Horrigan criticizes the shareholder primacy approach to capital. He observes that this definition of capital in this model is too narrow or "monodimensional." Corporate enterprise as a type of human enterprise relies on "economic capital, human capital, intellectual capital, social capital and environmental capital."[116] In reality, shareholders are just one type of capital provider among a vast collection of providers including

[114] Ibid. p. 2

[115] Summers, "Codetermination in the United States: A Projection of Problems and Potentials" (1982) 4 J Comp. Corp L & Sec Reg 155. cited in Hill, Public. Shareholder theory relies on strong sense of private property as opposed to public, which distinction has it own set of distinctive and fundamental problems. See discussion in M. Ignatieff , The Rights Revolution. Toronto: Wiley & Sons, 2000.

[116] Horrigan, p. 517.

employees who provide human capital, creditors who provide debt capital, suppliers and society that provides educated, assimilated workers.[117]

Returning to the property rights argument for shareholder primacy, Hill points out that the early aggregate or partnership model of the corporation supported the view of shareholders as “owners” of the enterprise, and hence their importance rested on the idea that their interests are “distinct and inherently different” from other parties. But as we have seen, the history of the corporation has moved it and the associated rights a considerable distance from these roots. From a legal perspective [118] shareholders are not “owners” of the corporation and accordingly, this argument fails. Further, as Stout observes, options theory undermines at a most fundamental level the notion of shareholder ownership.[119]

## ***Replies to Shareholder Primacy Criticism and Further Criticism***

[117] Ibid, at p. 535 and 540. Further criticism of shareholder primacy arises from the effects of a single focus on wealth maximization. Presumably, somewhere down the line, the shareholders are ultimately controlled by or at least for the benefit of humans, and surely humans have interests in more than wealth maximization. Humans are interested in clean air and water, and a just society, and unless shareholder primacy wealth maximization is restricted to preserve these goods, there will be no point to wealth maximization. We will discuss the role of government and corporate law norms later in this paper.

[118] A mistake made by the economist Milton Friedman, noted in L. Stout, p. 4 and the management theorist Jensen, noted in Orts, p. 1575.

[119] P. 1191

If, then, shareholders are not dominant in management, control or in terms of providing finance, why should they continue to have the level of control they do? Why should they have the vote?[120]

In essence, the shareholder primacy theory is based on assumptions of efficiency. With one goal—wealth generation—managers will be clear on their objective and do what they are able to do, best—generate wealth. It is less efficient to have the corporation involved such other social concerns such as the just distribution of wealth, a takes for which it was not designed. General social welfare is outside the scope of corporate concern. Externalised costs are acceptable in the creation of wealth as they are of minimal concern to non-shareholders, and where they do become of concern, it is the role and responsibility of other societal organizations, such as government, to address them, or these non-shareholders to contract for those harms.

The argument has been advanced that perhaps shareholders should enjoy these rights to cause some general harm in the process of their wealth maximization on the basis that they value them more than non-shareholders value the right not to be harmed. Millon observes that at a factual level, non-shareholders tend to suffer more from shareholder exploitation than shareholders would if they were not permitted the right.[121] Further,

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[120] As noted earlier, Wood argues shareholders gave up these rights when they surrendered responsibility for the corporation.

[121] Millon, New Directions, p. 1384.

Millon questions why bargaining and bargaining power should be the basis of protection from the harmful effects of shareholder wealth maximization.[122]

A further criticism of shareholder primacy comes from the nature of shareholders themselves. Shareholders are by and large passive. As Hill observes, "[shareholders] invest in the investment, not in the corporation."[123] They are not interested in building, operating, or controlling the corporation. When problems in the corporation become evident, shareholders prefer to exercise exit rights—the Wall Street walk—over working to resolving the situation.[124]

There are as well some obvious factual arguments against shareholder primacy. Contrary to their claim that the stakeholder corporations cannot function because of diverse objectives, in many places the law has successfully and without undue diminution of

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[122] As Millon puts it, "one might argue that shareholders should enjoy this right because they value it more highly than nonshareholders would value a property right not to be harmed". One response is to question the validity of the factual assertion. Many nonshareholders lose far more from shareholder exploitation of nonshareholder vulnerability than would shareholders if such opportunities were impeded. If an entitlement were with nonshareholders, shareholders would presumably sustain a somewhat lower rate of return on their investments (unless job security and other protections actually resulted in heightened productivity). In contrast, as long as the entitlement is with the shareholders, workers, for example…" Frontiers p. 1380.

[123] Hill. Visions, quoting Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective," 57 Brooklyn LR 1 28-29

[124] Farrar CG, 13. but note also that shareholders are unlikely to expend the effort to get involved to resolve these problems as management per se is not likely to be their area of expertise and furthermore, there is the disincentive of the free-rider problem. CG, p. 325.

wealth—shareholder or societal—integrated stakeholder theory. Whether one chooses to look at European corporations with their two tiered boards, or employee, creditor, environmental liabilities placed on directors in Anglo modelled corporations, one finds that directors have successfully incorporated the conflicting concerns of their various constituent stakeholders in the supposedly exclusive shareholder model.[125] One study indicates that managers understand the different objectives demanded by the difference between shareholder value and traditional accounting have adapted their behaviour accordingly.[126]

Further, shareholder primacy theorist tends to ignore empirical studies demonstrating the success of stakeholder oriented corporations.[127] In reality, even in the USA, arguably the most shareholder primacy jurisdiction, the law permits considerable latitude to management to deviate from shareholder primacy.[128] Even among shareholder primacy advocates themselves, one notes levels of deviation from shareholder primacy. Whether one notes Friedman's caveat restricting shareholder wealth maximization to "conforming

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[125] See Wood op cit for his interesting explanation of Langtry's "Tinged Stakeholder theory".

[126] See, M. Useem, "Executive Defence: Shareholder Power and Corporate Reorganization" 4-5, 10-11 (1993) cited in Orts, p. 1589-90.

[127] See for example, M. Omran and J. Pointon, "Shareholders versus Stakeholders: Corporate Mission Statements and Investor Returns." (Oct. 2002), 11 Business Ethics: A European Review, 4, p. 318. and a 5 year longitudinal study of companies on the FTSE unpublished presented at EBEN conference Cambridge, England, April 6-8, 2003.

[128] Dunfee, p. 8. contested by Sommer who views the latitude to be limited to long-term shareholder interest. Blumberg "The American Law of Corporate Groups" argues contrary cited in Dine GCG p. 59

to the basic rules of society"[129], Jensen's concern for "equity, creditors, warrant holders," or Hansmann and Kraakman, move away from pure shareholder interests granting "creditors, to be sure, are to some degree an exception"[130] (with no reason for the exception), it suggests that shareholder supremacy is in some way unsatisfactory even to its most outspoken advocates. It suggests that these advocates recognize, as others have noted, that the corporation exists within society and relies on the social goods or capital supplied by society.[131]

From the above discussion, it is clear that the debate is complex and difficult, if not impossible, to resolve within the parameters of the debate itself. If one is to move forward one must step outside the narrow confines of the debate and address directly the ideological and technical considerations underlying the tensions. From an ideological perspective, one compares the neoliberal economics focus on private property, anti-regulatory stance with the social justice concerns of more socialist oriented scholars.[132]

[129] Dunfee observes that Friedman's meaning is ambiguous and the statement open to both broad and narrow interpretation pp. 9-10

[130] Op. cit. p. 10

[131] This idea of the necessity of society for the existence of the market goes back at least to Adam Smith *Theory of Moral Sentiments* noted in Farrar, CG, 409

[132] To avoid a digression into this complex discussion, I will simply note the comment of R. Malloy concerning the relationship and roles of law and economics: "To the traditional law and economics scholar the relationship is positive, efficient and wealth maximizing. It is a relationship that inherently promotes autonomy, prosperity and social justice. To others the relationship may seem exploitative, chaotic and oppressive. It is a relationship that fosters self-interested behaviour and institutions of greed and profit.", Law and the Market Economy: Reinterpreting the Values of Law and Economics, 2001, Cambridge:

These two opposing stances translate into the discussion of nature and purpose of the corporation and from whence, the nature and purpose of corporate law. It is from such an understanding that the four questions of corporate governance can be answered.

## MODELS OF THE CORPORATION AND THE DEBATE[133]

Models of the corporation are intimately connected to the debate. As we shall see, one level the whole shareholder-stakeholder debate hinges on what one's theory of the corporation is. Models are both a starting point and a conclusion for the various positions. Briefly, if one adopts the model of the corporation as a series of private contracts between individuals, there can be no discussion about any interest but shareholder interests. If, however, one adopts the model of the corporation as a concession from society, then one may rightly claim corporate obligations back to society. In this section we will briefly examine the various models of the corporation and the significance of models for the debate.[134] Broadly speaking, there are three main

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Cambridge University Press. P.1 Malloy views the issue not as a tension between efficiency and social justice. Rather, on the basis of the application of semiotic theory to the problem, Malloy frames the issues as a dynamic between creativity and efficiency. Unfortunately, his set of solutions are beyond the scope of this paper's analysis of the traditional stakeholder-shareholder debate.

[133] This analysis relies heavily on Dine GCG, pp. 3-28, and Bottomley, From Contractualism.

[134] Millon, writes, "A standard argumentative move in these debates has been the effort to justify a position for or against legal reform by reference to some kind of characterization of the corporate person. A descriptive assertion ("the corporation is x") is advanced on behalf of a normative claim ("therefore y

models of the corporation. These are: concessionaire and contractarian which roughly approximate the entity, social models for the former and the aggregational, property models for the latter and—the third model of the corporation, the communitarian model, will not be dealt with because it has largely been abandoned with the decline of state-run corporations.[135]

## *Contractarian Theories*[136]

In essence, contractarians view the corporation as a form of contract between shareholders. This theory posits the corporation as a private matter between individuals thus placing no additional duty on the corporation than that which exists on the separate individuals involved in the corporation. The corporation as a private matter should be subject to the least possible government interference. There are two types of contractarians—legal and economic.[137]

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should follow"). In this way, what might otherwise appear to be abstract, purely academic debates about corporate legal theory in fact support controversial political agendas." The Ambiguous, p. 2.

[135] Some Authors see the debate as communitarians versus contractarians. Se for example, Millon, New Directions in which, he loosely ties communitarians to concessionaire views. Other, describes the models in terms of property versus entity. See for example, W. Allen. "Our Schizophrenic Conception of the Business Corporation" 14 Cardozo L.R. 261, noted in Stout p. 1190 n. 6

[136] There are other approaches to the analysis of corporations as voluntary collectives. See for example P. Dalley op cit p. 45.

[137] Bottomley, From Contractualism p. 277-287

**Legal Contractarian Model**

Legal contractarianism is the view that corporations arise when two or more people come together, to form a legal contract to carry on commercial activity. From Bottomley's discussion, we may note three aspects of legal contractualism, relevant to this discussion. First, it creates a legal entity in which directors and members are bound together in the corporation's articles of incorporation. Second, it defines the boundaries and membership of the corporation.[138] And third, it favours the overall interest of the members over the interest of any individual.[139] It is, to say the least an "unusual type" of contract.[140]

The model's weakness lies in interpretation of the corporation's founding articles or constitution. The "founding contract" is only enforceable by shareholders despite the fact that other parties may be party to the contract and even then, shareholder legal remedies are greatly restricted.

A further problem is that the model posits the interests of the founding contractors as being identical to the corporate enterprise itself. As seen in the above discussion of the theories of Professor Hu, this is simply not the case. Corporate interests differ from shareholders' as do shareholders among themselves.

[138] p.283

[139] p.284

[140] p.281

As previously noted, Dine identifies the difficulty in applying this foundational model to an operating company: once up and running, the rights and duties of the parties in a corporation change—the shareholders no longer have the absolute rights they had when founding the corporation, and in particular, their rights vis-à-vis directors are weakened. As demonstrated in *Foss v. Harbottle*,[141] the directors have independence from the shareholders and a level of immunity from shareholders even should the directors take an action contrary to the wishes of some shareholders. This suggests that the corporation is more than a mere contract between shareholders.

**Economic Contractarian Model**

This model finds its origins with the economist Ronald Coase. Coase first proposed that the corporation is a type of firm.[142] By this Coase means that the firm operates as a more efficient means of production by grouping people and inputs together, combining tasks in one enterprise thereby lowering transaction costs.[143] In this model, there is a direct connection and related accountability between the capital provider-shareholders and the managers. As Friedman puts it "He [an executive] has a direct responsibility to his

[141] (1843) 2 Hare 461 in which case the court in its examination of minority shareholder rights determined that the appropriate party to take action against directors is the corporation itself. Farrar CG, p. 171.

[142] Op cit n. 9.

[143] Coase op. cit discussed as the source of the 1980's nexus of contracts theorists in Millon, New Frontiers, pp. 229-232. This issue for economic contractarians is: How the owner-shareholder principal can control and limit the manager-agent sufficiently to minimize "managerial opportunism" or "agency costs". They find answers in the markets for capital, corporate control and management skill, and secondarily in the body of corporate law. Bottomley, From Contractualism pp. 285-287

employers. That responsibility is to conduct the business in accordance to their desire, which generally will be to make as much money as possible."[144]

Contractarians reject the notion of the corporation being a body independent of the shareholders and in fact reject the very idea of corporation. It is merely a nexus of contracts. Logically, it cannot have obligations distinct from the obligations of its individual members. Therefore, the notion of corporate social responsibility as distinct from the responsibilities of the individual shareholders, is a non-sequitor. It is simply a logical contradiction.

Clearly, as Millon observes, the contractarians model favour shareholder primacy. In his words, contractarians

> state corporate law provides the terms of the contract by which shareholders purchase management's undivided loyalty to their welfare… to the extent that management's pursuit of shareholder welfare threatens nonshareholder interests, workers, creditors, and other affected nonshareholders are free to bargain with shareholders (through their agents) for whatever protections they are willing to pay for. This view assumes that feasible (that is, not excessively costly) contracting strategies exist for correction of the harmful external effects of shareholder/management activity and, perhaps, that such effects are relatively uncommon.[145]

The contractarian model has number of shortcomings. Critically, it fails to explain the most significant feature of the corporation: that is to say it does not account for limited

[144] Cited in Dunfee, p. 3.

[145] ibid 1379

liability.[146] Nor do contractarian models adequately address other corporate rights such as the right to hold property and the right to freedom of expression, which rights are held independently of its members.

The univocal focus on efficiency[147] supported by contractarian models brings the question of why efficiency should be set as the prime value. As Millon observes: "References to efficiency simply beg the underlying question of why efficiency should provide the sole normative criterion. As a society we have not embraced the market as a totalizing model for the definition of rights and responsibilities."[148] Furthermore, this

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[146] Dine notes the state involvement in creating the limited liability aspect of corporations. This grant of limited liability is what made corporations such an attractive option for conducting business (Eley v. Positive Government Life Assurance (1876) 1 ExD 88,) and essentially what gave rise to their dominance in commerce. GCG p. 4. The explanation that this would eventually have been contracted for, according to Dine, is not supported by the facts.

[147] Contractarians' efficiency focus follows closely on the economists' view that creating wealth is the sole objective of corporate activity. Any increase in wealth is a social benefit, and permits turning a blind eye to the distribution of that wealth or the costs of producing that wealth. As Malloy points out, Kaldor-Hicks theorem suggests that as long as there is an overall net gain in a transaction, regardless of the size of the loss sustained by any party, the parties should be coerced into the transaction for the benefit of the overall gain. This position seems to undermine some of the fundamentals of property rights on which contractarians base their arguments. Dine observes that in the contractarians model, the role of government is to correct market failure, to create a more perfect market. The idea of the economic contractualists is that allocation efficiency will be best achieved by permitting the market to adjust supply, demand and costs with the least interference.

[148] New Directions, p. 1386.

focus on the bottom line always creates a strong incentive to externalize costs, increase production, and thereby increase profit.[149] As Horrigan observes:

> financially based shareholder focus… allows corporations to externalize the costs of maximizing stock prices onto everyone except the stockholders' the includes employees, the environment, consumers, suppliers and the community at large.[150]

Contractarians are focused on internal corporate activity and apply a cost--benefit analysis to a relatively narrow range of items that are more easily subject to numeric measurement.

A further criticism of this view is how it explains the one-person corporation where the shareholder is also the director. How can one contract with oneself? The legal answer to this question, of course, comes from the case of *Salomon* mentioned previously.[151]

Thus, generally it may be stated that shareholder primacy advocates support and argue from a contractarian model.[152]

## *Concession Theories*

Concession theorists note that corporate existence owes its origins to a governmental concession. In the beginning, governments delegated and granted trading rights to

[149] See Kaldor-Hicks theory discussed op cit. Also, Kaldor-Hicks as discussed in Dine, p. 9 and Malloy p. 154-155.

[150] Horrigan, p. 550.

[151] I have not been able to locate a contractarian response to *Salomon.*

[152] Interestingly, Rawls uses a contractarian model to argue for a different result. Noted in Millon, New Directions, n. 19.

corporations.[153] Corporations were permitted to carry on only those activities authorized in the concession granted by the government. The limits of the concession were set out in the articles of incorporation or constitution of the corporation. Given this concessionary nature of the corporation, the government retained certain rights concerning the governance and operation of the corporation. Further, as Bottomley argues, "[corporations] themselves are systems in which power and authority, rights and obligations, duties and expectation, benefits and disadvantages, are allocated and exercised…. Each company is a body politic…"[154] If one accepts this view of the corporation, its is easier to see the argument for stakeholder involvement or are least for government regulation. As a governmental concession, it owes duties back to the government. This obligation, however, does not extend automatically, to society.[155]

Dine observes that the concessionaire view is susceptible to the criticism that the corporation is no more than a mere fiction.[156] If it is not made up of the solid, physical shareholders, acting in concert to create a common enterprise, the corporation has no more substance than a mere idea. Further, while it may explain the foundation of the corporation, concession theory fails as an operational theory. It does not explain by whom or how the corporation is to be run. Nor yet does it set any limits on state

[153] Dine, GCG, p. 21

[154] S. Bottomley, From Contractualism.

[155] Dine, GCG, p. 21

[156] Ibid p. 24

involvement. Indeed a pure concession view allows the corporation to be a mere instrument of the state. [157]

Models by definition are inadequate representations of the thing they attempt to represent. In the context of corporate law, this limitation of models is exacerbated by the complexity of the subject. He goes on to observe:

> To say "corporation" is not like saying "chair" or "dog." The reality to which "corporation" refers is more complex than an easily identifiable material thing or animal, and any attempt to force a preconceived theory on a complex legal reality results in what Hart calls "contrivances varying with tastes." The idea of the corporation is complex precisely because it involves various relationships that presuppose the rules and principles, and methods of enforcement and compliance that compose a legal system.[158]

In fact, as Hart, notes: “a survey of competing theories of ‘the corporation’ leaves one to conclude that none has survived intact.”[159]

## *History and the Development of Models*

These models follow an historical development. At the time of monarchical domination of trade, the concession theory most accurately reflected the state of affairs. As well, the state’s involvement in the creation of corporations through such things as acts of legislature also lent weight to the argument for state involvement and enforcement of broader social interests. With the development of the discipline of economics, the application of economic theory to law and the increasing interest in efficiency and its

[157] Ibid

[158] P. 1572

[159] Quoted in Orts, at p. 1570.

relation to wealth creation, the contractarian models began to take shape and move into a position of prominence. As the consequence of following this model of the corporation became clearer, the appropriateness of the model came into question and the theories of private property and the role of government in the market began to be re-examined. This re-examination is particularly evident in legislation designed to mitigate costs to non-shareholders in the market for corporate control.[160] An understanding of the historical development of the corporation cannot lead one to any conclusion as to the correct or appropriate model of the corporation.

## *The Ideological Divide*

Underlying this war of models is a much deeper ideological conflict. Shareholder advocates start from the idea that people should be free to decide how to live including how they should dispose of their property. As Millon puts it: "[they focus] on the individual as an autonomous being…. [and] human liberty as freedom from external, unconsented-to restraint." Stakeholder advocates, by contrast, view the individual as set in a context, and that context is a social context. They view liberty as having positive duties. From their perspective: "Liberty is empty without taking into account those

[160] Summaries of the history of the corporation are readily available from a number of sources. The above summary is based primarily on Millon, New Frontiers, pp. 205-220. The history of corporate law follows more or less the same path in Anglo jurisdictions.

primary needs upon which adequate conceptions of individual dignity and human flourishing depend."[161]

There are those who view the corporation as a social body. These scholars view the corporation as a member of society, and a significant member at that. They emphasize the power and effects of corporations in society. In addition, they are, in Millon's words, "skeptical about the practical efficacy of contract as a mechanism by which nonshareholders can protect themselves ex ante from… harmful effects."[162] There are those who view the corporation as a nexus of contracts between private individuals in which the government has no business and by which the greatest efficiency can be achieved.

As Millon frames the debate "what does set communitarians apart from contractarians is the communitarians' strong skepticism toward the baseline presumption that contract alone should specify the terms of corporate governance relationships."[163] At a fundamental ideological level, contractarians and communitarians are divided. While contractarians believe that justice is manifest in the status quo and the only legitimate interests are those bargained for, as Millon puts it:

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[161] Ibid, p. 1382-3.

[162] ibid 1380

[163] ibid 1381

> For communitarians, justice does not require endorsement of the existing distribution of wealth and bargaining capability. They seek instead to reform corporate law so as to foster individual dignity and promote societal welfare.[164]

Such deep ideological debates are not about to be settled on the basis of superiority of models.[165]

## A NORMATIVE COMMENT ON NATURE OF THE CORPORATION AND CORPORATE LAW

From the foregoing discourse it is evident that the shareholder-stakeholder debate cannot be resolved by looking at models nor the history of the corporation, or yet by looking at economics. The economics focus on efficiency is fundamentally at odds with certain legal principles such as non-oppression of minorities, human rights and social justice.

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[164] ibid 1386. In Millon's review of Chayes's theories, he summarises the issue at a personal level: "Having induced nonshareholders to rely on legitimate expectations of fair dealing, shareholders therefore may forfeit the right to insist on contract terms guaranteeing profits at the expense of others." The Ambiguous, p. 23.

[165] Dine's suggestion, following Wolff, is an organic view, separating founding theories from operational theories where the former deal with the creating of the entity and the latter with the actual activities of the entity once it has been founded. In this view, the corporation becomes the concern of those most intimately connected and affected by its operations and actions. While this view certainly helps address the conflict between shareholder and stakeholder interest arguments, it does not resolve the conflict as to how to weigh different interests. It does have the benefit, however, of keeping the corporation focused on commercial ends and not making it merely a state instrument and still permitting it to be responsive to broader societal concerns on which it undeniably has a significant effect.

To the extent that the shareholder-stakeholder debate can be resolved, at least for westerners, it may be by returning to first principles. As Wood puts it: "In short, it [the duties of business] is a moral question—or more precisely an extra- or pre-legal question which typically involves complex practical and moral factors."[166] The eighteenth century British philosopher Edmund Burke observed: "The nature of man is intricate: the objects of society are of the greatest possible complexity; therefore no simple disposition or direction of power can be suitable, either to man's nature, or the quality of his affairs."[167]

In essence then, we must ask, what are the objectives of law in general, and of corporate law in particular. This question needs to be answered as it is asked—in the two parts as to general and specifics. From the general perspective, Justinian offers that the law ought to cause a man "to live honesty, not to harm another, and give each his due."[168] Reinterpreted by the modern legal philosopher, John Rawls,[169] it can be said that justice in the distribution of society's goods is fundamental to a just society. Rawls observes "Society is a cooperative venture for mutual advantage." He argues that we live in a world of limited resources, and that a just resolution to the conflicts concerning society's distribution and use of resources is necessary to have a society in the first place. This he states is society's enabling condition.

[166] Wood, op. cit. p. 6

[167] Reflections on the Revolution in France 74 (1790) quoted in Sommer, p. 1.

[168] Institutes, Book I I 3. cited in Farrar, Frankenstein op cit. n. 30 p. 148.

[169] J. Rawls, A Theory of Justice, Cambridge, Ma.: Harvard University Press, (1971).

This view is reflected even in management literature. As Vinten notes: “to have any defensible property rights at all, one must recognise a fundamental commitment to helping those in need.”[170] Law’s proper role as concerning justice then is to support such a distribution. Rawls suggests that equality of opportunity in that he sees the only way to prevent the stronger (or richer) in his just state from overpowering the weaker (or poorer) in enforcing the maxim.

This power of corporations has long been recognized: as to financial power in society, by Dodds, and as to more general influence on society at least since the 1950’s. As noted by a legal scholar of that era: “‘the corporate organization of business have long ceased to be private phenomena. That they have a direct impact on the social, economic, and political life of the nation is no longer a matter of argument.’”[171] The current state of the law in Anglo countries, while permitting shareholder concerns to be overridden in certain circumstances, through constituency legislation and the business judgment rule, still places a heavy emphasis on shareholder primacy.[172] In fact, directors who wish to include other stakeholders do so at their peril, both at law and in business.[173] Judging by Rawls principles, this state of the law cannot be correct.

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[170] Op cit. p. 380

[171] Friedmann, “Corporate Power, Governance by Private Groups, and the Law” (1957) 57 Columbia L. R. 155, p. 176 noted in Millon, Frontiers, p. 226.

[172] See Sommer’s discussion pp. 39-46.

[173] Sommer, for example, comments: “only a reckless corporate advisor would permit board minutes, or an accurate rendering of the advice given a board to suggest that the board had put non-shareholder interests before those of shareholders.” Ibid.,

On the level of the particular, one must ask and attempt to answer the question: What is the purpose of corporate law? The contractarian answer, that corporate law provides a set of off the shelf rules for the corporation can hardly be correct. Nor yet can shareholder primacy theorists' position of wealth maximization. As Millon observes, "Neither in practice nor in law has society ever accepted the ruthless, single-minded pursuit of shareholder wealth maximization as a justified end in itself."[174]

As seen from the previous discussion concerning the nature and models of the corporation, it is not a simple matter. Indeed, as Professor Orts observes, reductionistic modelling is "not only unhelpful, but destructive."[175] The problem resulting from such simplification can be seen in the economic argument for shareholder primacy, namely, the betterment of society. The argument runs as follows: By permitting the market to operate with the least restrictions, there will be the greatest possible efficiency, creating the most possible wealth, creating the greatest quantity of goods possible available to

[174] Millon notes: "For much of this century, at least since the publication of Berle and Means' classic in 1932, the orthodox assumption has been that corporate law's objective is to develop legal structures that will maximize shareholder wealth. This shareholder primacy vision of corporate law therefore disregards claims of various nonshareholder constituencies (including employees, creditors, customers, suppliers, and communities in which firms operate) whose interests may be adversely affected by managerial pursuit of shareholder welfare. Managerial accountability to shareholders is corporate law's central problem. Nonshareholder interests, if entitled to any legal protection at all, are for other, noncorporate law legal regimes." New Directions, at p. 1374

Ibid., p. 1374.

[175] op cit p. 1565.

society.  In other words, by permitting the markets to operate with the highest level of efficiency—corporations focused exclusively on wealth production—the greatest social good will be achieved.[176]

Taking Hart's rule based analysis Orts identify complexity results from corporate law's normative conflicts.  He discusses the following conflicting norms. The divided economic object: profit vs. wealth, short vs. long term, central management vs. dispersed capital providers, capital accumulation, protection of investors, and the protection of other interests.  He then notes that following the law serves as an objective in itself referring to the thinking and terminology of Dean Clark who describes this as "modest idealism." In such instances managers may cause a corporation to take a course of action that produces a lesser profit but complies with the law when non-compliance would be more profitable for the purpose of honouring the social-moral ideal of following the law.[177]  Finally, Orts notes the ethical dimension of corporate law that allows for the noneconomic considerations of ethics and justice.[178]  As Orts observes:  "policies underlying corporate law cannot be reduced to a unidimensional value, such as the economic objective of 'maximizing shareholders' wealth' or even, more generally,

[176] But there are some fundamental flaws with this argument brought out by Dworkin, discussed in Dine GCG, p. 112-4. This view of the corporation's role and participation in society is certainly Panglossian (referring to Diderot's character Pangloss whose constant justification for the state of affairs was that he was living in the best of all possible worlds.).

[177] R. Clark, Agency Costs versus Fiduciary Duties , in Principals and Agents: The Structure of Business, 55-79 (J. Pratt and R. Zeckhauser eds., 1984) cited in Orts, p. 1602.

[178] This is a summary of Orts extensive arguments on pp.  1587-1612.

'economic efficiency.'" [179] But a discussion of normative corporate law should go beyond a mere distillation of principles and objects in the particular area of law.

Millon posits four norms for corporate law. He suggests that it should (1) promote stable relations between certain non-shareholder constituencies and the corporation, (2) adjust the gains between shareholders and non-shareholders, (3) address the fairness in allocation of transaction costs, and (4) look for ways to include in decision making those most directly effected by such decisions.[180] Orts adds, "Corporate law, like most law, is primarily about the rule--oriented structuring of social power, and it is specifically about the rules that structure the organization of economic power."[181] Following Rawls, therefore, a strong argument can be made that corporate law should include access to power by non-shareholders.[182] By such standards, Australia's CLERP objectives: Market Freedom, Investor Protection, Information Transparency, Cost Effectiveness, Regulatory Neutrality and flexibility, Business Ethics and Compliance appear inadequate.[183]

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[179] Ibid, p. 1612

[180] New Directions, p. 1388. Interestingly, this fourth suggestion aligns with the fundamental ideology of shareholder advocates whose emphasis on individual freedom requires consent by the individual effected.

[181] P. 1577.

[182] See suggestion by W. Wilson Leung "The Inadequacy Of Shareholder Primacy: A Proposed Corporate Regime That Recognizes Non-Shareholder Interests" (Summer 1997) 30 Columbia J. Law and Social Problems (4), p. 587.

[183] Farrar, CG, p. 16. See Horrigan whose opinion it is that law is going in the opposite direction. P. 516.

Corporate law, like all law, should have as its purpose the betterment of society. Farrar takes the position that the fundamental tenet of corporate law, the independent legal entity doctrine, is fundamentally flawed and fails to meet or promote any of the three criteria advocated by Justinian.[184] Wood notes that the effect of limited liability is to pass on the costs of business failure to others, and in the collapse of a big firm, a multitude of smaller victims or involuntary stakeholders.[185] Corporate law that permits and promotes the on-going externalisation of business costs is contrary to the fundamental principles of justice.[186] Shareholder primacy creates another problem in situations where hyper norms are involved. Such norms, argues Dunfee, "serve to judge, and if necessary to invalidate, local laws and local morality…. [they] entail principles… fundamental to human existence".[187]

The effect of current corporate law emphasizing shareholder interests is just the opposite. Recent computer modelling of the current free market economic model suggests that this concentration will increase, not decrease.[188] This trend of increasing concentration of wealth suggests that a more fundamental modification to corporate law is called for.

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184 Farrar, Frankenstein, p. 148.

185 Op cit p. 8 noted also by Farrar, Frankenstien.

186 R. Green "Shareholders as Stakeholders: Changing Metaphors of Corporate Governance," (1993) 50 Wash. & Lee LR 1409 and reply by S. Bainbidge "In Defense of the Shareholder Wealth Maximization Norm" , (1993) 50 Wash & Lee LR.

187 Dunfee, p. 24

188 B. Hayes, "Follow the Money", (Sept-Oct. 2002) 90 American Science, p. 400-405.

Corporate law that permits and promotes increased inequalities between members of society too is fundamentally flawed for the reason that it contradicts the basic principles of justice.  Admittedly, the distributive aspect could be dealt with through tax law; however, the fact that current Anglo corporate law with its heavy shareholder focus tends to exacerbate social inequalities, both political and economic suggests that a profound re-examination of corporate law and corporate law reform is well overdue.

It is unsupportable that corporations which, as Dine points out,

> account for most of the world's industrial capacity, technological knowledge and international financial transactions… mine, refine and distribute most of the world's oil,… extract most of the world's minerals… harvest much of the world's wood… grow many of the world's agricultural crops, while processing and distributing much of its food… hold 90 per cent of all technology and product patents worldwide and are involved in 70 percent of world trade[189]

should be only answerable to those relatively few who have the wealth to be shareholders.[190]

## CONCLUSION

The shareholder-stakeholder debate is a highly complex, multi-faceted, interdisciplinary debate.  As such it cannot be answered easily or completely.  As Wood observes

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[189] Karliner, The Corporate Planet, 5, quoted in Dine, GCG, p. 152, and n. 7 referring to UNCTAD, World Investment Report 1995.

[190] Taking the lead from Hardens' "The Tragedy of the Commons", property rights help people to be concerned about and take better care of a thing.  Applying this theory to corporate law, we could ask, why not give those to community and or employees?

> Concerning the shareholder conception, the weakness is moral and the strength practical; in the case of the stakeholder conception, the position is reversed. The shareholder conception therefore stands… in need of moral rehabilitation, and the stakeholder conception in need of practical rehabilitation.[191]

From the perspective of this author the broader perspective of the role of the corporation in society seems to be the more realistic, logical perspective. If one takes that to be the better position, let us briefly put the four answers to the four questions of corporate governance.

What is the entity being governed? A combined answer looking at legal, economic, social and dynamic aspects may serve us best. One such definition is offered by Clarkson who writes: '''The Firm' is a system of stake holders operating within the larger system of the host society that provides the necessary legal an market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stake holders by converting their stake into goods and services."[192]

By whom it should be governed? I would suggest that it be governed by a multi-tiered board including other stakeholders. This suggestion is not impractical as can be seen by the relative efficacy of other stakeholder models of boards, such as the German model.

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[191] p. 6

[192] M. Clarkson, A Risk Based Model of Stakeholder Theory, The Centre for Corporate Social Performance & Ethics, University of Toronto, (1994) cited in Turnbull.

What is the best way to govern it? By permitting the corporation to pursue its commercial ends within more broadly drafted corporate statutes mandating a broader range of interests and integrating into the governance structure people whose interests more broadly represent the community of stakeholders effected by the corporation a corporation can be well governed. The disclosure requirements of shareholder theory should be kept, but the accounting amplified to include “triple bottom line” or “quadruple bottom line” regimes.

And finally, in whose interests should the entity be governed? Given the great impact of corporations on society, the narrow shareholder primacy view advocating the operation of corporations for the exclusive interests of people with sufficient wealth to be shareholders can no longer be supported. Corporations must be run for the benefit of society. While not supporting a model where corporations are merely instruments of the state, these entities must be run for the broader interests of society.

Horrigan offers an interesting criticism of the whole shareholder-stakeholder debate. He focuses on what he believes is the falsely dichotomous structure of the debate and suggests that a reframing of the issue, as the effective functioning of different elements of society would serve all interests best.[193]

Perhaps the best way to express this view as an aspiration for corporate law can be found in the words of Orts:

[193] Op cit., p. 551.

> Wise policy makers… should not convert the framework of corporate law into either an unfeeling gauntlet of economic madness nor an overly sanguine vision of do--good business. New directions in corporate law should instead take society on a course that is morally and politically uplifting, as well as economically productive.[194]

The current growing stakeholder views may permit us to limit the externalising of social and environmental costs done in favour of maximizing shareholder wealth and ultimately save our planet from destruction, permitting us to say with Scrooge, the reluctant stakeholder: “the shadows of the things that would have been, may be dispelled.”[195]

[194] Op cit p. 1623

[195] C. Dickens, The Christmas Carol, Stave 5.