

Myth of Shareholder Primacy in English Law

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Abstract

This article assesses the validity of the shareholder primacy norm, with particular focus on the pre and post Companies Act 2006 implications of shareholder primacy in English company law. Prior to the Companies Act 2006, much was written about shareholder primacy, which assumed it to be the basis of corporate governance in English law. In testing the validity of that assumption, this article examines the historical application of partnership principles to corporate governance, the case law often called in aid of the shareholder primacy norm, and finds that shareholder primacy remains at odds with the tenet of corporate legal personality in English law. It concludes that the assumption that shareholder primacy was the basis of corporate governance in English law is a myth.

I. Introduction

This article is concerned with shareholder primacy in English company law. Shareholder primacy provides preeminence to shareholders over other corporate constituencies. It infers an obligation on directors to manage the corporation for the sole interest of shareholders. Critically the theory involves creating wealth for shareholders.¹ The theory means that the principal sphere of the activities of the managers is defined by the obligation to shareholders, such that all other responsibilities are very much secondary or derivative.² Critically, shareholder primacy equates the interests of a company with the interests of its shareholders.

The ultimate shareholder primacy norm is that directors are agents of shareholders, and that directors are under fundamental obligation to run the company in the interest of the shareholders. Prior to the Companies Act 2006 (hereinafter referred to as “CA 2006”), much was written about shareholder primacy,³ which assumed it to be the basis of corporate governance in English law. But what has rarely been discussed is the validity of that assumption. Was shareholder primacy a legal norm in English law prior to the CA 2006? Did the case law that are purported to have supported shareholder primacy really support it? In answering these questions, this article finds that the confusion was based on the historical application of partnership principles to company law, and that a contextual reading of case law reveals that shareholder primacy is at odds with the tenet of corporate legal personality.

By virtue of section 172 of the CA 2006, the concept of Enlightened Shareholder Value, which is an extension of Shareholder Primacy norm, appears to be enshrined into English law as the basis of corporate governance. Section 172 requires directors to act in the way that would be most likely to promote the success of the relevant company for the ‘benefit of its

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¹ A Keay, *Shareholder Primacy in Corporate Law. Can it Survive? Should it Survive?* ECFR 369, 376 (2010).

² J Brummer, *Corporate Responsibility and Legitimacy* 103 (Greenwood Press 1991), quoted in A Keay, *Shareholder Primacy in Corporate Law. Can it Survive? Should it Survive?* ECFR 369, 376 (2010).

³ For examples, see: DG Smith, *The Shareholder Primacy Norm* 23 *Journal of Corporate Law* 277 (1998); H Hansmann and R Kraakman, *The End of History for Corporate Law* 89 *Georgetown Law Journal* 439 (2001); L Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy* 75 *South California Law Review* 1189 (2002); J Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy* 31 *Journal of Corporate Law* 637 (2006).

members' as a whole, and to have regard to the interests of other stakeholders. The questions here are twofold. One, should we read into section 172 a strict shareholder primacy norm or should we read the phrase 'benefit of its members' as a mere yardstick for assessing the duty therein? Two, if we read into section 172 a strict shareholder primacy norm, does the tenets of company law as understood at common law enable the shareholders to enforce qua shareholders the duty therein? In answering those questions, this article finds that a reading of shareholder primacy into section 172 would be at odds with the legal personality tenet and would provide shareholders with a right without corresponding enforcement legal remedy.

The aims of this article are twofold: to examine the legal validity of the assumption of shareholder primacy in English law prior to the CA 2006, and to discuss the subsequent implications of shareholder primacy norm in English law in the context of section 172 of the CA 2006. As to the first aim, this article examines the purported legal sources for the assumption rather than its merits. This is on the premise that 'whether a given norm is legally valid, and hence whether it forms part of the law of that system, depends on its sources, not its merit.'⁴ As to the second aim, this article focuses on the right created and its enforcement by shareholders qua shareholders in relation to the elementary tenet of corporate legal personality. This is on the premise that 'a right without a remedy is worthless.'⁵

The article proceeds in the following way. First, it examines the confusion created by partnership principles, blaming this as one cause for the assumption of shareholder primacy as a legal norm in English law prior to the CA 2006. Secondly, it takes a contextual reading of English legal sources often purported to have supported shareholder primacy prior to the CA 2006. Thirdly, it discusses the extent to which shareholder primacy norm has been enshrined into section 172 of the CA 2006 as a concept of enlightened shareholder value. Fourthly, it discusses the enforcement implications, in relation to the tenet of corporate legal personality, of reading shareholder primacy or enlightened shareholder value into section 172 of the CA 2006. Fifthly, it suggests an alternative reading of section 172 in order to align it with the tenets of English company law. Lastly, it makes concluding remarks.

II. Assumption of Shareholder Primacy Pre-CA 2006

A. Partnership Law and Shareholder Primacy

The question to be answered here is whether shareholder primacy was a legal norm in English company law prior to the CA 2006. Answering in the negative, it is argued here that the confusion was based on the historical application of partnership principles to company law. The corollary of shareholder primacy is to treat directors as trustees of shareholders, accountable to shareholders as the real company. Such view is derived from nineteenth century partnership principles that treated shareholders as synonymous with the company. It is said that company law, 'of all branches of law, is perhaps the one least understood except in relation to its historical development.'⁶ It is in this context that to better understand the confusion that created the assumption of shareholder primacy prior to the CA 2006, an historical development of English company law needs to be noted.

English company law traces its roots from partnership law through the nineteenth century joint stock company law, and 'until the latter half of the century, it was considered and

⁴ J Gardner, *Legal Positivism: 5½ Myths* 46 *American Journal of Jurisprudence* 199, 201 (2001).

⁵ M McDaniel, *Bondholders and Stockholders*'13 *Journal of Corporation Law* 205, 309 (1988).

⁶ P Davies, *Gower and Davies' Principles of Modern Company Law* 31 (6th edn, Sweet & Maxwell 1997).

treated as an adjunct of the law of partnership.⁷ For early writers like Lindley, the title of their texts on company law merely appended company law to partnership law.⁸ Informed by these early texts, no wonder courts continued to apply partnership principles to companies until ‘when the idea of the legal personality of the company had permeated all the courts.’⁹ This development from partnership law, through the application of partnership principles to the joint stock companies, explains the origins of the myth of shareholder primacy prior to the CA 2006 in company law debates.

It is important to note that, in the nineteenth century, in treating joint stock companies as adjunct to partnership law, ‘the members, as partners, owned the assets, and their entitlement to the control and benefit of the company was, an incident of their legal ownership of the business.’¹⁰ But applying partnership law principles soon proved difficult. ‘For example, if a partnership was to be sued it was necessary to make all the partners party to the suit. While in a partnership of five or six this presented no difficulty, discovering the identity of all the members of a joint stock company, where the shares were freely transferable, posed an insuperable obstacle.’¹¹ Company law had to transition, and thus the courts developed one of the fundamental tenets of modern company law, the legal personality of the company.

Unfortunately, although company law did transition from partnership principles, with the fundamental tenet of separate corporate personality, the debates on shareholder primacy continued to be held in the shackles of partnership law. It was observed that, ‘fuelled by the ownership myth and the legal remnants which sustain it,’ the debate in company law continued ‘rather to treat company and shareholders as in crucial respects synonymous. As a result of this “anomalous hangover from earlier times,”’¹² shareholder primacy was still assumed to be the basis of corporate governance in English company law. Whereas English company law had since evolved from the shackles of partnership law, it seems that we had ‘yet to bring shareholders’ entitlements as to the way a company is managed into line with this modern view of the company.’¹³

It is said that, ‘the general idea of a corporation, a fictional legal person, distinct from the actual persons who compose it, is very old.’¹⁴ Indeed, as early as 1837, it was said that, ‘the individual members of a corporation are quite as distinct from the metaphysical body called “the corporation” as any others of his majesty’s subjects are.’¹⁵ The transition from partnership principles, from treating shareholders as synonymous with the company, was judicially settled by the seminal case of *Salomon*.¹⁶ From henceforth, it should have been difficult to advocate for shareholder primacy without offending the fundamental tenet of separate legal personality in *Salomon*. But a discussion that aligns shareholder primacy with the principle in *Salomon* has been rare in the literature. To fully extend this transition to the

⁷ P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 38 (1999).

⁸ Note for example, N Lindley, *A Treatise on the Law of Partnership, including its Application to Joint Stock Companies* (4th edn, Maxwell 1878) – first published in 1860.

⁹ G Hornsey, *Alterations to the “Constitution” of Companies* 61 Juridical Review 263, 270 (1949), quoted in P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 40 (1999).

¹⁰ R Grantham, *The Doctrinal Basis of the Rights of Company Shareholders* 57 CLJ 554, 558 (1998).

¹¹ P Davies, *Gower and Davies’ Principles of Modern Company Law* 31 (6th edn, Sweet & Maxwell 1997).

¹² P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 48 (1999).

¹³ S Worthington, *Shares and Shareholders: Property, Power and Entitlement (Part 1)* 22 Company Lawyer 258, 259 (2001).

¹⁴ S Williston, *History of the Law of Business Corporations before 1800* 2 Harvard Law Review 105, 106 (1888).

¹⁵ *Bligh v Brent* (1837) 2 Y & C Ex 268, 295 (Alderson B).

¹⁶ [1897] AC 22.

academic debates, it is here suggested that post *Salomon* cases ought to be interpreted in light of separate legal personality unless they unequivocally promote shareholder primacy.

B. Law and Economics and Shareholder Primacy

It is difficult to defend shareholder primacy in a legal system that does not recognise shareholders as owners of the company. The idea of shareholders as owners of the company is foreign to English company law.¹⁷ In *Bligh*,¹⁸ the court rejected the idea of shareholders as owners, and took the view that shareholders only had interests in the profits of the company and no interest whatsoever in the assets of the company. The same view was taken in *Watson*.¹⁹ In *Short*, Evershed LJ, denying that shareholders were owners of the company, said: 'shareholders are not, in the eye of the law, part owners of the undertaking. The undertaking is something different from the totality of the share-holdings.'²⁰ Moreover, directors have exclusive rights to manage the company and cannot be ordered by the shareholders.²¹ Thus, in English law, whilst shareholders have rights to dividend on shares and right to transfer their shares, they do not own the company; which makes shareholder primacy difficult to defend.

In defending shareholder primacy, 'economists argue that when corporations are run to maximise shareholder value, the performance of the economy as a whole, not just the interest of shareholders, can be enhanced.'²² The problem though, 'econometrics is frequently, and rather frustratingly, too clumsy a tool for the study of corporate law.'²³ It has been argued that, 'neither in theory nor in practice, is it true that maximising the value of equity shares is the equivalent of maximising the overall value created by the firm.'²⁴ Moreover, shareholder primacy is not a product of English law, but rather of the 'US academics who have been largely responsible for developing the theories which try to rationalise and legitimate both neo-liberalism and Anglo-American style shareholder primacy.'²⁵ Being largely a norm of law-and-economics, it is no wonder that there is no unequivocal thread in English legal sources entrenching shareholder primacy into English company law.

In their study, Lele and Siems,²⁶ the authors found that the UK corporate governance was neither clearly shareholder oriented nor stakeholder oriented. In fact, the result of their study raises doubts as to the validity of shareholder primacy in other countries besides the UK. The study looked at shareholder protection in five countries: the UK, the US, Germany, France, and India. In examining whether the boards in these countries always has to give priority to shareholders interests or to the interests of other stakeholders, the study found no clear

¹⁷ For a detailed position of English law on not recognising the idea of shareholders as owners of the company, see S Worthington, *Shares and Shareholders: Property, Power and Entitlement (Parts 1 and 2)* 22 Company Lawyer 258, 307 (2001).

¹⁸ *Bligh v Brent* (1837) 2 Y & C Ex 268.

¹⁹ *Watson v Spratley* (1854) 10 Ex 222.

²⁰ *Short v Treasury Commissioners* [1948] 1 KB 116, 122 (Evershed LJ).

²¹ *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34.

²² W Lazonick and M O'Sullivan, *Maximizing Shareholder Value: A New Ideology for Corporate Governance* in T Clarke (ed), *Theories of Corporate Governance* 290, 298 (Routledge 2007).

²³ K Panijpan, *Market Dynamics in Corporate Governance: Lessons from Recent Developments in English Law* (Law Department, London School of Economics, London 2007) 12.

²⁴ See M Blair, *Shareholder Value, Corporate Governance, and Corporate Performance* in P Cornelius and B Kogut (eds), *Corporate Governance and Capital Flow in a Global Economy* (OUP 2003)

²⁵ P Ireland, *Shareholder Primacy and the Distribution of Wealth* 68(1) MLR 49, 80 (2005).

²⁶ P Lele and M Siems, *Shareholder Protection Index for the UK, the US, Germany, France, and India* (Centre for Business Research, University of Cambridge, Cambridge 2007).

evidence of either. As Gelter observed, ‘shareholder primacy is not enforceable – it all depends on how incumbents rationalize their decision.’²⁷ In light of the *Foss v Harbottle* tenet, shareholder primacy can only create a legal right with no corresponding legal remedy.

The conclusion drawn by Hansmann and Kraakman that corporate governance is now settled in favour of shareholder primacy,²⁸ is mainly an academic perspective,²⁹ and has not support in English company law.³⁰ In their study of corporate governance in the UK, Armour, Deakin and Konzelmann, rejected Hansmann and Kraakman’s claim that corporate control is now settled in favour of the shareholder value model. Armour, Deakin and Konzelmann concluded that, the UK corporate governance system, ‘rather than stabilizing around a norm of shareholder primacy, is currently in a state of flux.’³¹ But were we to accept that shareholder primacy is now entrenched into English company law by section 172, there would still remain the question of aligning it with directors’ duties. It is difficult for the courts to assess whether directors have in fact maximised profits, so the idea that shareholder value allows for more assessment of what directors do is illusory.³²

III. Contextual Reading of pre-CA 2006 English Cases

A. Introduction to pre-CA 2006 Cases

The question here is whether pre-CA 2006 case law that are purported to have supported shareholder primacy really supported it. A closer look at the assumption of shareholder primacy in the literature, in the context of English law, reveals that shareholder primacy was only a theory and not a legal norm, it was sustained by academics and not by the courts, and its analysis was mainly not from a legal perspective, but from economics perspective. On the premise that ‘whether a given norm is legally valid, and hence whether it forms part of the law of that system, depends on its sources, not its merits,’³³ we now turn to the legal sources.

A number of pre-CA 2006 cases were often quoted in support of shareholder primacy. It is here observed that none of these cases provided an unequivocal support to shareholder primacy, in the sense that the interests of the company are equated absolutely with those of its shareholders. By proof text method, one can find cases that support shareholder primacy in English law. The preferred method in this article is a contextual reading of such cases. There is a dire need for exposition of these cases in company law texts, but unfortunately “the

²⁷ M Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light* NYU Journal of Law and Business 643, 674 (2011).

²⁸ H Hansmann and R Kraakman, *The End of History for Corporate Law* 89 Georgetown Law Journal 439 (2001).

²⁹ See DG Smith, *The Shareholder Primacy Norm* 23 Journal of Corporate Law 277 (1998); J Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties* 21 Stetson Law Review 23 (1991); J Matheson and B Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance* 76 Minnesota Law Review 1313 (1992), 1328; E Fama, *Agency Problems and the Theory of the Firm* 99 Journal of Political Economics 288, 290 (1990).

³⁰ See *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627, 634 (Lord Diplock); *Fulham Football Club Ltd v Cabra Estates plc* [1994] 1 BCLC 363, 379; *Dawson International plc v Coats Paton plc (No 1)* [1989] BCLC 233, 240.

³¹ J Armour, S Deakin and SJ Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance* British Journal of Industrial Relations 531, 532 (2003).

³² A Keay, *Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model* 71 MLR 663, 670(2008).

³³ J Gardner, *Legal Positivism: 5½ Myths* 46 American Journal of Jurisprudence 199, 201 (2001).

tendency among company lawyers is to deal with these problems by discrete omission.”³⁴ But were company lawyers to engage in a contextual analysis of the array of case law, most would accept that modern company law has long transitioned from partnership principles that equated shareholders with companies as synonymous, and hence post nineteenth century cases ought to be read in the context of such transition, in the light of the *Salomon* separate legal personality,³⁵ unless the cases in question unequivocally promotes shareholder primacy.

B. Hutton v West Cork Railway Company

The main case often quoted as supporting shareholder primacy is *Hutton*,³⁶ where Directors had set out to award a gratuity to corporate officers for their past service. In ruling this proposal as unlawful, because it did not benefit the company to do so, Bowen LJ observed: ‘the law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as required for the benefit of the company.’³⁷ Clearly, *Hutton* did not refer to the interests of shareholders but of the company, and hence did not equate the interests of the company with those of its shareholders. Confusingly, there are some company law textbooks that apply *Hutton* to shareholder primacy in the sense that ‘it is unlawful to give the workers anything unless it is good for the shareholders.’³⁸

A contextual reading of *Hutton* reveals that the case concerned an injunction by shareholders to restrain the company from entering an *ultra vires* act, and had nothing to do with shareholder primacy. Shareholders argued successfully that it was *ultra vires* for the company, by its directors, to award gratuitous wages to its former employees on cessation of business.³⁹ Shareholders in *Hutton* simply brought an action for the wrong on the company under one of the established exceptions to the rule in *Foss v Harbottle*, and were not asserting shareholder primacy.

In *Hutton* though, Bowen LJ referred to ‘benefit of the company,’ but did not say what that means. As this was a case where the company was insolvent, does it follow that shareholder primacy applied on grounds of residual rights, as to reduce ‘benefit of the company’ to the interests of actual humans who would survive the company’s demise? The answer is no. For a contrary reading of *Hutton* fails to identify *what* residual rights the shareholders have. If their residual rights are to have the company’s assets managed for their benefit, then all follows; but if their residual rights are to the residue after the assets have been managed in a different way, then the rights will not support the allegation that the assets must be managed in the interests of the shareholders.⁴⁰ Thus, residual rights do not assert shareholder primacy, for that comes too late when management of assets has ceased but the liquidating of assets in dissolution.

C. Gaiman v National Association for Mental Health

³⁴ P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 49 (1999).

³⁵ *Salomon v Salomon & Co* [1897] AC 22.

³⁶ *Hutton v West Cork Railway Company* (1883) LR 23 Ch D 654.

³⁷ (1883) LR 23 Ch D 654, 673.

³⁸ B Pettet, *Company Law* 63 (Longman 2001) – this confusing understanding of the *Hutton* case has continued in subsequent editions (in its third edition) of this excellent text without notice.

³⁹ This power is now contained in section 247 of the Companies Act 2006.

⁴⁰ S Worthington, *Shares and Shareholders: Property, Power and Entitlement (Part 1)* 22 *Company Lawyer* 258, 265 (2001).

In some cases, the courts have referred to shareholders as the human equivalent of the company. One such example is found in *Gaiman*.⁴¹ A contextual reading of *Gaiman* reveals that the use of shareholders as a human equivalent of the company was a matter of a pragmatic reckoning based on the social reality of the company as opposed to the legal acceptance of shareholder primacy, in assessing the nature of the interests of the company in that particular case. It would be out of context to suppose that *Gaiman* supports shareholder primacy.

In *Gaiman*, Megarry J, in holding that a company is ‘an artificial legal entity,’ observed that ‘it is not very easy to determine what is in the best interest of the association without paying due regard to the members of the association.’ It is to this difficulty, as a pragmatic reckoning, that Megarry J referred to ‘members of the association’ as ‘a helpful expression of a human equivalent’ of the company, in answering the question, did the directors ‘act as they did in the bona fide belief that it was in the best interest of the association?’ to which question he answered, ‘yes.’⁴² Megarry J’s remarks merely illustrate the difficulties one gets into if one strays from the simplicity of the entity principle of the company. But the existence of the corporate entity as a separate person from its shareholders cannot be denied merely because of the difficulties one encounters in determining what is in best interest of that entity.

Similarly, in assessing whether directors have discharged their duties to the company, when the company is insolvent, the courts have often referred to the benefit of creditors as interests of company.⁴³ For example, in *Re Pantone 485 Ltd*, Richard Reid QC referred to creditor’s interests in assessing the interests of the company, as follows:

In my view, where the company is insolvent, the human equivalent of the company for the purpose of the directors’ fiduciary duties is the company’s creditors as a whole, *ie* its general creditors. It follows that if the directors act consistently with the interests of the general creditors but inconsistently with the interest of a creditor or section of creditors with special rights in a winding-up, they do not act in breach of duty to the company.⁴⁴

Both Megarry J and Richard Reid QC were using shareholders and creditors, respectively, to assess the interests of the company. As the references to shareholders and creditors in these cases are only tools to aid the assessment of the company’s interests, we cannot draw from them a theory to support shareholder primacy.

D. Brady v Brady

The other case also often quoted in support of shareholder primacy is *Brady*.⁴⁵ The principal issue in this case was not about in whose interests should the directors run the company, and therefore did not set a precedent for shareholder primacy in English law. The issue in the case revolved around disposition of company assets to a major shareholder, and breach of section 151 CA 1985. The question was whether a trading company’s disposition of half its assets for the benefit of one of its two major shareholders was valid. If we take shareholder

⁴¹ *Gaiman v National Association for Mental Health* [1971] Ch 317.

⁴² *Gaiman v Association for Mental Health* [1971] Ch 317, 330-331.

⁴³ See *West Mercia Safetywear Ltd (in liquidation) v Dodd* [1988] BCLC 250; *Winkworth v Edward Baron Development Co Ltd* [1997] BCLC 193 (HL).

⁴⁴ [2002] 1 BCLC 266, 286-287 (Richard Reid QC) [sitting as judge in the case].

⁴⁵ *Brady v Brady* (1987) 3 BCC 535 (CA).

primacy to mean that the interests of the company equates to the interests of its shareholders, then the disposition in *Brady* was valid. Any reading of shareholder primacy in *Brady* would have to find the disposition therein valid or else the very essence of shareholder primacy is questionable.

There were two objections to the disposition of assets to the shareholder in *Brady*. First, that it was ultra vires the company. Secondly, that it involved the giving of unlawful financial assistance for the purposes of an acquisition of the company's shares. In answer to both objections, it was argued that the disposition was necessary in order to free the company from the deadlock which, if continued, would have brought it into liquidation.

The judgment of Nourse LJ in the Court of Appeal is relevant in this discussion.⁴⁶ Dealing with the first objection, Nourse LJ quoted a statement of principle by Pennycuick J in *Ridge Securities Ltd v Inland Revenue Commissioners*, as follows:

A company can only lawfully deal with its assets in furtherance of its objects. The corporators may take assets out of the company by way of dividend or, with leave of the court, by way of reduction of capital, or in a winding up. They may, of course, acquire them for full consideration. They cannot take assets out of the company by way of voluntary disposition, however described, and, if they attempt to do so, the disposition is ultra vires the company.⁴⁷

To Nourse LJ, the principle was clear: company assets belong to the company. He explained that the principle was a 'facet of the wider rule, the corollary of limited liability, that the integrity of a company's assets, except to the extent allowed by its constitution, must be preserved for the benefit of all those who are interested in them, most pertinently its creditors.' To that extent, he stated that, 'a unanimous resolution of all the shareholders authorising a company, however solvent, to perform an ultra vires act can no more withstand a liquidator's trumpet than the walls of Jericho.' That 'a unanimous' shareholder resolution would fall like Jericho at a liquidator's trumpet, hardly supports shareholder primacy.

The shareholders in *Brady* had clearly misunderstood English company law. The company carried on a family business and the two major shareholders were brothers. The brothers got into dispute, and a scheme was devised to divide the assets in two while keeping the company in being. The perception of company law to the brothers was that of shareholder primacy, in the sense of equating the interests of the company to their own interests as shareholders, and thus could justify the proposition to divide the assets between themselves instead of seeking a remedy under section 122 of the Insolvency Act 1986. In answer to the brothers' perception, and contrary to shareholder primacy, Nourse LJ observed that 'the fallacy in the proposition lies in its assumption that it is in the interests of a company to survive at any cost,' on the contrary, he stated, 'in some circumstances it must be in the interests of a company that it should be put into liquidation.'

As to the second objection in *Brady*, Nourse LJ observed that the question was whether the financial assistance was an incidental part of Brady's larger purpose of keeping itself alive and was given in good faith in the interests of Brady, within section 153 CA 1985. Assessing whether the disposition was in the interest of the company, Nourse LJ made several

⁴⁶ (1987) 3 BCC 535, 549-554 (Nourse LJ).

⁴⁷ [1964] 1 WLR 479, 495 (Pennycuick J).

observations before making the following dicta statement, which is often quoted supposedly in support of shareholder primacy:

The interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent, first and foremost come the shareholders, present and no doubt future as well. How material are the interests of creditors in such a case? Admittedly existing creditors are interested in the assets of the company as the only source for the satisfaction of their debts. But in a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much. Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone.⁴⁸

Ostensibly, one can derive a shareholder primacy from the judgment of Nourse LJ in *Brady*. But it is difficult to derive a shareholder primacy from the quoted statement if understood from the larger context of the judgment as a whole. A careful reading of the several observations made by Nourse LJ before making the quoted statement, clearly reveals that he did not promote the shareholder primacy.

First, Nourse LJ observed that the expression ‘the interests of the company’ is one which is often used but rarely defined. If rarely defined, it is hard to see how Nourse LJ would have concluded that English company law is based on shareholder primacy in the sense that those interests of the company meant the interests of shareholders. He would have had to first define the expression to settle the question of shareholder primacy. That shareholder primacy was not an issue he considered in his judgment, Nourse LJ left the expression undefined.

Second, Nourse LJ observed that the expression ‘the interests of the company’ is sometimes misunderstood and it is possible that it has slightly different meanings in different contexts. If Nourse LJ meant to address the concept of shareholder primacy in the quoted statement, it would have necessitated him to first clear the misunderstandings and give the different meanings of the expression. Nourse LJ neither attempted to clear the misunderstandings nor attempted to give the various possible meanings of the expression.

Third, Nourse LJ categorically stated, in regard to the expression ‘the interests of the company,’ that ‘here I confine myself to a consideration of its meaning in a statutory provision whose object is to make a particular exception to the general prohibition against a company’s giving financial assistance for the purposes of an acquisition of its own shares.’ If so confined himself to the assessment of section 151 CA 1985, then we should be careful not to apply his statement to the general support of shareholder primacy in English company law.

Contrary to supporting shareholder primacy, in *Brady*, Nourse LJ was of the view that the interests of the company included creditors and could be distinguished from its shareholders. In finding that ‘the directors never asked themselves whether *half the* assets would *in all eventualities* be sufficient to discharge *all* the existing debts,’ he said that it could not be said, ‘for the purposes of an exception to the provisions of section 151, that the directors considered that the dispositions were in the interests of the two companies,’ and such, he concluded that ‘the most which can be said is that they considered that they were in the

⁴⁸ (1987) 3 BCC 535, 552 (Nourse LJ).

interests of the shareholders.⁴⁹ As such, it is argued, Nourse LJ distinguished the interests of the company from those of the shareholders, and hardly promoted shareholder primacy.

E. Greenhalgh v Arderne Cinemas

Another proof text often quoted for shareholder primacy is from *Greenhalgh*, where Evershed MR stated that “the company as a whole,” does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the incorporators: it means the incorporators as a general body.⁵⁰

Firstly, ‘the company as a whole’ is Delphic term employed by different judges in different circumstances to signify different things.⁵¹ In the context of the various cases using the term differently,⁵² it is not safe to draw from such inconsistency a conclusion of shareholder primacy.

Secondly, *Greenhalgh* concerned a sale of personal property (shares), and therefore directly affected the interests of shareholders. The dispute was inter-shareholders. ‘In such context, it is hardly surprising that the interests of shareholders should be to the fore and, arguably, the interests of other corporate constituencies and the company as a commercial entity were simply not at stake.’⁵³

As such, the contextual reading of *Greenhalgh* reveals that Evershed MR was simply assessing whether a special resolution had been passed in the interest of the company on particular facts of a case that alleged that the resolution discriminated between the majority and the minority shareholders. It is in that confinement of the case that ‘the company as a whole’ had to be assessed against the interests of all shareholders whose shares were affected by the special resolution. Nothing in *Greenhalgh* sustains a shareholder primacy.

Some cases that are often quoted in favour of shareholder primacy are, on contextual reading, cases dealing with acquisition of shares in takeovers, where special factual relationships place directors in a fiduciary capacity vis-à-vis the shareholders. For example, in *Heron*,⁵⁴ the case dealt with transfer of *personal property* (shares), in a takeover situation, an issue that directly affected the interests of shareholders. It was to that effect, contrary to general shareholder primacy, that it was said that directors, when exercising their power under the articles to register a proposed transfer, ‘were under a fiduciary obligation to exercise the power in the interests of both the company and the shareholders,’ as it was in ‘the interests of all shareholders that they should not be deprived of an opportunity to sell their shares to the highest bidder.’⁵⁵ Thus, in *Peskin*, it was said that, ‘fiduciary duties owed by directors to shareholders only arise if there is a special factual relationship between the directors and the shareholders.’⁵⁶ In *Dawson*, it was stated that directors owed no general duty to shareholders,

⁴⁹ (1987) 3 BCC 535, 552 (Nourse LJ).

⁵⁰ *Greenhalgh v Arderne Cinemas* [1951] Ch 286, 291 (Evershed MR).

⁵¹ FG Rixon, *Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association* 49 MLR 446, 454 (1986).

⁵² To name but a few cases: *Re Halt Garage Ltd* [1982] 3 All ER 1016; *British Equitable Assurance Company v Baily* [1906] AC 35; *Brown v British Abrasive Wheel Co* [1919] 1 Ch 290; *Sidebottom v Kershaw* [1920] 1 Ch 154; *Allen v Gold Reefs of West Africa* [1900] 1 Ch 656.

⁵³ R Grantham, *The Doctrinal Basis of the Rights of Company Shareholders* 57 CLJ 554, 568 (1998).

⁵⁴ *Heron International Ltd v Lord Grade* [1983] BCLC 244.

⁵⁵ [1983] BCLC 244, 264-265 (Lawton LJ).

⁵⁶ *Peskin v Anderson* [2001] 1 BCLC 372, 379 (Mummery LJ).

except where a special case applied as in light of a takeover offer.⁵⁷ Cases dealing with takeovers are therefore not cases that support shareholder primacy per se.

IV. Section 172 CA 2006 and Shareholder Primacy

Prior to the CA 2006, the debate espousing shareholder primacy, later developed by the Department of Trade and Industry (hereinafter referred to as 'DTI') into the concept of Enlightened Shareholder Value (hereinafter referred to as 'ESV'), was based on a mistaken idea that shareholders are owners of the company. 'Despite the recognition of the company's status as a distinct entity and the consequential displacement of shareholders as legal owners of the company's assets,'⁵⁸ the law reform bodies were still advocating for shareholder primacy based on the nineteenth century notion of shareholder ownership.

The Cadbury Report observed: 'Thus the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress.'⁵⁹ The CLRSG was of the view that, 'companies are formed and managed for the benefit of shareholders,' and that 'directors are required to manage the business on their behalf.'⁶⁰ But the CLRSG did not derive this view from English decisions, but rather from academic debates on efficiency. Quoting Easterbrook and Fischel, the CLRSG observed that, 'the main economic justification offered for this approach is that members have greatest exposure to residual risk as a result of mismanagement of these resources and are therefore best qualified to ensure proper stewardship.'⁶¹ Based on this premise, the CLRSG advocated for the ESV concept,⁶² which was ostensibly enshrined in section 172. But the apparent ESV in section 172 is hence not based on any English legal source but on economics merits.

ESV is an elevated notion of shareholder primacy, which seeks to strike a balance between the competing interests of different stakeholders in order to benefit the shareholders in the long run.⁶³ At the root of both, the shareholders are the subjects in whose interests the company is to be run. In both ESV and shareholder primacy, the directors are to discharge their duties by acting in good faith. Applying section 172 CA 2006 to both, would require directors to act in the way they think would be most likely to promote the success of the company for the benefit of its members. In both, a subjective test, what the director thinks as opposed to what the court thinks, would be applied to assess whether the directors have discharged their fiduciary duties.⁶⁴ The discharge and assessment of this duty, whether under shareholder primacy or ESV, would be the same. It is to this extent that, in this article, ESV and shareholder primacy are treated as synonymous.

In 2005, the DTI saw the introduction of ESV into English law as one of the objectives of the legislative reform. In reaching this objective, the Government set out to

⁵⁷ *Dawson International plc v Coats Paton plc (No 1)* [1989] BCLC 233, 240.

⁵⁸ R Grantham, *The Doctrinal Basis of the Rights of Company Shareholders* 57 CLJ 554, 555 (1998).

⁵⁹ Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* [6.1] (London, Gee & Co Ltd 1992).

⁶⁰ Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* [5.1.4-5] (London, DTI 1999).

⁶¹ Easterbrook and Fischel, *Economic Structure of Corporate Law* Harvard Law Review, 11, 28-39 (1991), quoted by the Company Law Review, [5.1.5, footnote 23] (1999).

⁶² Company Law Review (n60) [5.1.12].

⁶³ See Company Law Review (n60) [5.1.12-13].

⁶⁴ See *Re Smith & Fawcett Ltd* [1942] Ch 304; *Regentcrest plc v Cohen* [2001] BCC 494.

embed in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers.⁶⁵

To the DTI, enshrining in statute a concept called “Enlightened Shareholder Value” meant that

directors will be more likely to achieve long-term sustainable success for the benefit of their shareholders if their companies behave responsibly. Directors will therefore be required to promote the success of the company in the collective best interests of shareholders, but must in doing so have regard to wider factors such as the interests of employees and the environment.⁶⁶

In this regard, ESV was seen as ‘a new approach’ of pursuing ‘the interests of shareholders’ in corporate governance.⁶⁷

What this ‘new approach’ really entailed was to equate the interests of the company with the interests of the shareholders albeit coached as ESV. In answer to the elementary question, in whose interests should companies be run, the then UK Chancellor of Exchequer referred to the ‘enlightened shareholder value.’⁶⁸ Taking ESV as synonymous with shareholder primacy, given that shareholder primacy was not a legal norm in English law prior to CA 2006, section 172 not only introduced a ‘new approach’ to corporate governance, but also radically changed common law in that regard. Section 172 (1) provides as follows:

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company’s employees,
- (c) the need to foster the company’s business relationships with suppliers, customers and others,
- (d) the impact of the company’s operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.

Ostensibly, section 172 provides a reformulation of the common law duty to act in ‘the best interests of the company’ as a separate legal person from its shareholders. It is said that section 172 ‘requires the promotion of the success of the company but not in its own right as a separate legal person but for the benefit of the shareholder constituency.’⁶⁹ It is also said, of section 172, that ‘the rule of shareholder primacy is reiterated in the section.’⁷⁰

⁶⁵ Department of Trade and Industry, *Company Law Reform 5* (London, DTI 2005).

⁶⁶ HC Deb 11 July 2006, col 545.

⁶⁷ Department of Trade and Industry, *Companies Act 2006: Duties of Directors: Ministerial Statements 3* (London, DTI 2007).

⁶⁸ A Darling, ‘Reforms in Pursuit of Enlightened Shareholder Value’ *Financial Times* (London, 4 June 2006).

⁶⁹ D Kershaw, *Company Law in Context: Text and Materials* 349 (OUP 2009);

⁷⁰ P Davies, *Gower and Davies Principles of Modern Company Law* 508 (8th edn, Sweet & Maxwell 2008).

But a strict reading of shareholder primacy into section 172 is problematic. It would mean that the law, by embedding shareholder primacy into section 172, has taken a retrograde step. It would require a radical reformulation of common law. It would require unsettling the settled tenets of English company law, namely, separate legal personality,⁷¹ and to whom directors owe their duties,⁷² and aligning them with the ‘new approach’ in section 172. The alternative to such a radical reformulation is to read less of shareholder primacy into section 172, and to align the section with the settled tenets at common law.

It is here argued that section 172 does not, as a matter of law, promote shareholder primacy, despite its ostensible reading. At common law, the duty now in section 172, was to act in the interests of the company as a commercial entity separate from its shareholders. The ‘new approach’ in section 172 abandoned the phrase for ‘in the interests of the company’ and adopted the phrase ‘the success of the company for the benefit of its members.’ The Law Society, opining that ‘the concept of the company as a legal entity separate from its members, and in whose interests the directors must act, is well understood,’ warned as follows:

We remain concerned that “success” is too imprecise a concept to be helpful. Unlike the phrase “in the interests of the company”, it is not supported by an existing body of case law. Similarly, the fact that directors will be required to promote the company’s success “for the benefit of its members” raises new questions. Under the existing law, the concept of the company as an entity separate from its members, and in whose interests the directors must act, is well understood. It is far from clear that this will continue to be the case.⁷³

In section 172 drafters seem to have chosen ‘benefit of its members’ as the criterion by which the court should assess whether the directors have promoted the ‘success’ of the company. But from the legislative history, it would appear that the drafters chose this criterion on the basis of the confusion in the literature,⁷⁴ and case law,⁷⁵ as to the objective of the company. This confusion ignored the fact that the cases relied upon either concerned alteration of Articles affecting shareholding,⁷⁶ or concerned breach of share purchase rules rather than breach of directors’ duties.⁷⁷

In answering the question in whose interests are companies run, the majority of case law prior to section 172 consistently required directors to manage company business, not for the

⁷¹ *Salomon v Salomon* [1897] AC 22.

⁷² *Percival v Wright* [1902] 2 Ch 421.

⁷³ The Law Society, *Company Law Reform White Paper* para 3.3 (Cm 6456, 2005)– this paper was a response of the British legal profession: the Law Society’s Company Law Committee, the Company Law Sub-Committee of the City of London Law Society and the Law Reform Committee of the General Council of the Bar.

⁷⁴ For example, see Clive M Schmitthoff and James H Thompson (eds), *Palmer’s Company Law* 531 (21st edn, Stevens & Sons Ltd 1968).

⁷⁵ For example, in *Re Wincham Shipbuilding* (1878) LR 9 Ch D 322, 328 Jessel MR who treated shareholders as being the same as the company when he stated that, ‘the directors are trustees for the shareholders, that is, for the company.’

⁷⁶ For example, *Greenhalgh v Ardene Cinemas Ltd* [1951] Ch 286, 291 (Evershed MR), when dealing with alteration of Articles affecting share as personal interests of shareholders, to aid the assessment, he stated that the ‘phrase interest of the company as a whole’ did not mean the company as a commercial entity, but rather it meant the incorporators as a general body.

⁷⁷ For example, *Brady v Brady* (1987) 3 BCC 535, 552 (Nourse LJ), when dealing with the purchase of shares from shareholder by the company, to aid the assessment of breach of section 151 Companies Act 1985, stated that ‘the interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it.’

benefit of its members per se, but in the interest of the company. In *Re Smith & Fawcett Ltd* Lord Greene MR said that directors should exercise their powers bona fide in what they consider to be ‘in the best interest of the company.’⁷⁸ In *Dorchester* Foster J said that a director must exercise powers vested in him in good faith ‘in the interest of the company.’⁷⁹

It is argued here that a better reading of section 172 is to apply an economic concept to the phrase ‘success.’ Section 172 requires the directors to promote the ‘success’ of the company for the ‘benefit’ of its shareholders. It is in this economic context that, as a minimum, directors’ achievement of that ‘success’ is to be measured by the ‘benefit’ to shareholders as the core constituency of the company. The phrases ‘success’ and ‘benefit’ in section 172 should be read in light of the separate legal personality, with the later reduced to a mere economic tool for measuring the former. A reading of shareholder primacy into section 172 fails to distinguish between legal entitlements and economic expectations of success. The law should not, and cannot, insist on success.⁸⁰ If a strict shareholder primacy were intended by section 172, it is here argued, section 170(1) would be of no effect.

That the usage of the phrase ‘benefit of its members’ was intended only as a tool to aid the assessment of the duty is clear from section 170(1). Section 170(1) unequivocally states that: ‘The general duties specified in sections 171 to 177 are owed by a director of a company to the company.’ Moreover, section 170(4) provides: ‘The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.’ Applying those rules and principles to section 172 suggests that the directors are under a fiduciary duty to the company to have regard to the interests of its members and other stakeholders such as employees,⁸¹ and the duty to have regard to the interests of its members is owed to the company rather than to the shareholders themselves individually or collectively.⁸²

Most company law textbooks are still grappling with the proper reading of section 172. The proper reading of section 172 as been well stated in the textbook by Brenda Hannigan as follows:

The position on these matters has not been altered by CA 2006, s 172. The phrase ‘to promote the success of the company for the benefit of the members as a whole’ would appear to give greater weight to the interests of the current shareholders than to the commercial entity, but directors must also have regard to the consequences of any decision in the long term which suggests the interests of the commercial entity are as relevant now as they have always been. The need to act fairly between members is also a specific factor to which the directors must have regard (s 172(1)(f)). Overall, there is nothing to suggest that s 172 is intended to alter the balance between the

⁷⁸ [1942] Ch 304, 306.

⁷⁹ *Dorchester Finance v Stebbing* [1989] BCLC 498, 501-502.

⁸⁰ S Worthington, *Shares and Shareholders: Property, Power and Entitlement (Part 1)* 22 *Company Lawyer* 258, 259 (2001)..

⁸¹ *Dawson International Plc v Coats Paton Plc (No 1)* [1989] BCLC 233, 240.

⁸² *Percival v Wright* [1902] Ch 421; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258; *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627; *Scottish Co-operative Wholesale Society Ltd v Meyer* [1958] 3 All ER 66 (HL); *Boulting v ACTT* [1963] 1 All ER 716 (CA); see also B Hannigan, *Company Law* (2nd edn, OUP 2009) 175; A Reisberg and J Lowry (eds), *Pettet’s Company Law* 155 (3rd edn, Pearson 2009).

competing “entity” and “membership” interests which has already been established at common law.⁸³

V. Section 172 and Enforcement Remedy

There are two possibilities to the requirements of section 172. First, that the directors run the business in the interest of the company as a detached legal entity separate from its members,⁸⁴ the implication being that directors’ duties are enforced by the company as a commercial entity. Second, that the directors run the business in the interests of the members as the human equivalent of the company,⁸⁵ the implication being that directors’ duties are enforced by shareholders as the company equivalent. The DTI seem to have taken the second concept in developing the ESV. If we accept a reading of shareholder primacy into section 172, we would remain with the problem of enforcement by shareholders qua shareholders.

To overcome the problem of enforcement, should we read section 172 as making a distinction between the *identity* of the person to whom the duties are owed (the company), and the question of the *content* of the duty as in whose interest the duty requires to be promoted (the shareholders)? The answer is no. It is trite law that directors owe their duties to the company.⁸⁶ If that duty is breached, the company is the victim, and only the company can sue to right a wrong done to it.⁸⁷ Yes, the shareholders can enforce the duties, collectively, under the derivative action, but that would in no way explain the distinction between the *identity* and *content* of the duty in answer to shareholder primacy.

To equate the collective derivative action to promoting shareholder primacy is only a symptom of ‘anomalous hangover from earlier times,’⁸⁸ which can only confine modern company law into the shackles of the nineteenth partnership principles. If we were to apply a distinction between the *identity* and *content* of the duty in section 172, that would create a duty in favour of shareholders who cannot enforce it qua shareholders. Even with derivative actions, the proceedings are brought on behalf of the company and not qua shareholders; and ‘any financial benefits from the action go into the company’s coffers,’⁸⁹ and not into shareholders’ coffers. Further, shareholder primacy is not a prerequisite for derivative action.

That shareholder primacy is not the basis of English company law, explains why courts would not hear a suit to right a wrong on the company if brought other than by or on behalf of the company even if all the shareholders (100 per cent) were in favour of the lawsuit. An English judge is very likely to say to the shareholders’ advocate: ‘You have the wrong Plaintiff here – the Plaintiff must be the company.’⁹⁰ To read shareholder primacy into section 172 would be to presuppose that English law allows for a legal declaration without any relief. Section 172 would then confer rights on shareholders in the face of legal

⁸³ B Hannigan, *Company Law* 201-211 (2nd edn, OUP 2009).

⁸⁴ *Salomon v Salomon & Co Ltd* [1897] AC 22.

⁸⁵ *Gaiman v Association for Mental Health* [1971] Ch 317, 330 (Megarry J) – ‘I would accept the interests of both present and future members of the company as a whole, as being a helpful expression of a human equivalent.’

⁸⁶ *Percival v Wright* [1902] 2 Ch 421.

⁸⁷ *Foss v Harbottle* (1843) 2 Hare 461.

⁸⁸ P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 48 (1999).

⁸⁹ A Keay, *Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model* 71 MLR 663, 682 (2008).

⁹⁰ *Macdougall v Gardiner* (1876) LR 1 Ch D 13, 23 (Lord James) – quoting the words used by the Master of the Rolls in the lower court.

principles that provide no enforcement of such right. As directors' duties would still be owed to the company, such conferment of rights would lead to no practical benefit to shareholders. As such, the lack of direct shareholder enforcement further undermines shareholder primacy.

In economic terms, it would be efficient if directors promoted the success of the company by focusing on the 'benefit of shareholders' instead of the interests of the company. Even then, it would require restating company law to have directors' duties owed to shareholders, who in turn would hold directors accountable for breaches of their duties. But to read this economic concept into section 172 would only create a legal right with no corresponding legal remedy. For in company law, ordinarily, until a company is in liquidation, or a successful takeover bid ensues, it is almost impossible for shareholders to bring an action and obtain a legal remedy for breach of duty against directors. Even then, either the liquidator is interested in bringing an action against the directors, or the majority, having elected a new board of directors after a successful takeover, are willing to maintain an action against the old board.⁹¹

In understanding the notion of 'benefit to members' in section 172, one ought to keep in mind that English company law is inclined to the interests of the company and not benefit of shareholders. To start with, initial appointment of directors is usually on the formation of the company,⁹² and the law requires every company to have directors;⁹³ shareholders have little choice in this process. Once the company is formed, the general and day-to-day management of affairs of the company is vested in the directors;⁹⁴ shareholders begin losing control. The shareholders in a general meeting have no power to give instructions to the directors on matters of day-to-day management, and nor can the shareholders overrule the business decisions of directors, unless the directors are acting contrary to the constitution.⁹⁵

However, the shareholders in a general meeting can remove directors by an ordinary resolution,⁹⁶ and they retain ultimate strategic control by virtue of their ability to alter the articles by which mechanism they can (for example) restrict the future powers of the directors.⁹⁷ In theory, shareholders may remove and replace directors who fail their duty to promote the success of the company in a manner that adds value to shares. In practice, the cost of removing directors and replacing them may not serve the collective interests of shareholders.⁹⁸

There is the impediment to shareholders' litigation under the rule in *Foss v Harbottle*.⁹⁹ But does lack of direct enforcement say anything about whether the corporate objective is or should be one aimed at shareholders? The affirmative answer here is debatable. The case law in this regard has historically been confusing. It was said in *Normandy* that, 'the

⁹¹ See *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

⁹² See CA 2006, s 12.

⁹³ See CA 2006, s 154.

⁹⁴ *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34; Regulation 70 of Table A of 1985 Model Articles of Association, as amended by Statutory Instruments 2007/2541 and 2007/2826 The Companies (Table A to F) (Amendment) Regulations 2007 – Minor amendments were made to bring the 1985 version of Model Articles in line with provisions of the Companies Act 2006.

⁹⁵ See *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34; *Salmon v Quin and Axtens Ltd* [1909] AC 442; *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* [1989] BCLC 100; *Rose v McGivern* [1998] 2 BCLC 593.

⁹⁶ See CA 2006, s 168.

⁹⁷ See CA 2006, s 21.

⁹⁸ See CA 2006, 168(5) – removal of a director does not deprive him compensation or damages against the company.

⁹⁹ (1843) 2 Hare 461.

language by which [rule in *Foss v Harbottle*] is expressed varies so much that it is by no means easy to reconcile the whole of any one judgment with every other.¹⁰⁰ The rule in *Foss v Harbottle* is said to have its roots partly in the law relating to corporations and partly in partnership principles.¹⁰¹ But whether or not the lack of direct enforcement by shareholders explains the problem of reading shareholder primacy into section 172, ‘the mechanism employed nevertheless reflects a conception of the company that does not rest on shareholder proprietorship.’¹⁰²

The complexity of ownership in a company further makes it difficult for shareholders to maintain an action against directors. Shareholders own the shares in a company, but do not own the company itself.¹⁰³ Directors are appointed by shareholders, but owe their duties only to the company and not to shareholders individually or collectively.¹⁰⁴ If there is any breach of duty by the directors, shareholders may have no personal cause of action against directors. In investing into company shares, a shareholder ‘takes the risk that management may prove not to be of the highest quality,’ and ‘there is prima facie no unfairness to a shareholder in the quality of the management turning out to be poor.’¹⁰⁵ With all these impediments and corporate structures, it is little addition to English company law to read into section 172 a shareholder primacy.

VI. Entity Principle as Alternative to Shareholder Primacy

So far in this article, the argument is made that ‘there is nothing to suggest that s 172 is intended to alter the balance between the competing “entity” and “membership” interests which has already been established at common law.’¹⁰⁶ With the shareholder primacy divorced from section 172, the answer to the elementary question in whose interests are companies run in the UK and to whom do directors owe their duties, is to be found in the analysis of the entity principle. The simplicity of this principle is that it compares a company to a natural person – a judicial analogy that ‘a company is a legal person whose existence is bounded by events analogous to the birth and death of a natural person.’¹⁰⁷ It is argued here that English law treats the company as an entity in its own right and not as an aggregate of shareholders.

Lord Hoffmann’s analogy of a company to a natural person is helpful here. We know that a natural person is one body with many parts. What would happen to the body if the foot or the eye or the ear shall say, because I am not the hand, I am not part of the body? Many parts with different functions makes up the body of a natural person, and the eye cannot say unto the hand, I have no need of you: nor again the head to the feet, I have no need of you, for the body would soon cease to function as the body. The same applies to the company, with the shareholders and other stakeholders being the many parts of the body corporate with different functions. None of these parts need take prominence over another, lest there be schism in the body corporate to its demise. It is these many parts that directors ought to consider when discharging their duty owed to the company.

¹⁰⁰ *Normandy v Ind Coope & Co Ltd* [1908] 1 Ch 84, 106 (Kekewich J).

¹⁰¹ KW Wedderburn, *Shareholders’ Rights and the Rule in Foss v Harbottle* 16 CLJ 194, 196 (1957).

¹⁰² R Grantham, *The Doctrinal Basis of the Rights of Company Shareholders* 57 CLJ 554, 575 (1998).

¹⁰³ See *Salomon v Salomon* [1897] AC 22; *Borland’s Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279, 288 (Farwell).

¹⁰⁴ *Percival v Wright* [1902] 2 Ch 421; *Scottish Co-operative Wholesale Society Ltd v Meyer* [1958] 3 All ER 66 (HL); *Boulting v ACTT* [1963] 1 All ER 716 (CA).

¹⁰⁵ *Re Elgindata Ltd* [1991] BCLC 959, 994 (Warner J).

¹⁰⁶ B Hannigan, *Company Law* 211 (2nd edn, OUP 2009).

¹⁰⁷ *Stanhope Pension Trust Ltd v Registrar of Companies* [1994] BCC 84, 85 (Hoffmann LJ).

The notion that a company is an entity separate from its incorporators goes beyond mere incorporation and legal fiction. It was said by Dicey, “whenever men act in concert for a common purpose, they tend to create a body which, from no fiction of law but from the very nature of things, differs from the individual of whom it is constituted.”¹⁰⁸ But far from being a legal fiction, the company is a real legal person, for the law, in recognising the existence of a company, is simply recognising an objective fact.¹⁰⁹ Indeed, the personality of the company is a key aspect of the corporate form.¹¹⁰ It is therefore not controversial that “we do not need to be instructed to regard a corporation as an entity and to regard that entity as a person: our minds are so constituted that we cannot help taking that view.”¹¹¹

Although incorporation gives birth to a corporation, once the incorporators duly comply with the formalities of incorporation, the company thereafter has a life distinct and independent of its incorporators. Historically though, the separation of company and members was not, as company lawyers tend to assume, inherent in the legal act of incorporation, but rather, the legal meaning of incorporation in a business context was reinterpreted in the latter half of the nineteenth century to accommodate the radical *economic* separation of joint stock companies from their shareholders.¹¹² Moreover, the entity principle, that the company is ‘distinct from the actual persons who compose it, is very old.’¹¹³ Indeed, as early as 1837, it was said that, ‘the individual members of a corporation are quite as distinct from the metaphysical body called “the corporation” as any others of his majesty’s subjects are.’¹¹⁴ In the context of incorporation, the entity principle was settled in *Salomon*, that

once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.¹¹⁵

The House of Lords maintained the same approach in *Regal*, where it was stated that ‘the company is at law a different person altogether from the subscribers to the memorandum.’¹¹⁶

We can take further Lord Hoffmann’s analogy of a company to a natural person to aid in our understanding of the entity principle. Man and woman decide to have a child. Once the child is born, the child thereafter has a life distinct from the parents. The motives of the parents in having a child are absolutely irrelevant in discussing the separate personality of the child. If the parents intended the child look after them in their old age, if the child does not, the failure does not form any factor to consider in discussing the separate personality, rights and liabilities of the child.

¹⁰⁸ A Dicey, *Law and Concern*, 105, as quoted by H Laski, *The Personality of Associations* 29 Harvard Law Review 404 (1916).

¹⁰⁹ WJ Brown, *The Personality of the Corporation and the State* 21 LQR 365, 370 (1905).

¹¹⁰ M Blair, and L Stout, *Specific Investments and Corporate Law* 7 European Business Organisation Law Review 473 (2006).

¹¹¹ AW Machen Jr, *Corporate Personality* 24 Harvard Law Review 253, 363 (1911).

¹¹² P Ireland, *Company Law and the Myth of Shareholder Ownership* 62 MLR 32, 43 (1999).

¹¹³ S Williston, *History of the Law of Business Corporations before 1800* 2 Harvard Law Review 105, 106 (1888).

¹¹⁴ *Bligh v Brent* (1837) 2 Y & C Ex 268, 295 (Alderson B).

¹¹⁵ *Salomon v Salomon & Co Ltd* [1897] AC 22, 30 (Lord Halsbury LC).

¹¹⁶ *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, 157 (Lord MacNaughton).

What benefits the parents obtain from the child are a matter of relationship that may be based on contract. As a matter of efficiency and morals, a child who has been educated by the parents and fortunate to have a good job, may find it wise to look after the parents in their old age. The needs of the parents then become part of the interest of that working child. But to insist, as a matter of duty, that the working child must exist for the purpose of serving the parents based on the fact that the parents gave birth to that working child, would be a claim society would find objectionable. It is the interests of that working child and the relationship with the parents that determines whether the parents benefit from the working child's wealth.

In the same vein, what benefits shareholders obtain from the company are a matter of relationship that may be based on contract. This was the case in *Lee*, where the widow of Lee who until his death had been the sole shareholder-director and employee of the company, successfully claimed worker's compensation from the company's insurer based on the contract her late husband, Lee, had with the company. The court found that the relationship between Lee and the company 'came about because the deceased as one legal person was willing to work for and to make a contract with the company which was another legal entity.'¹¹⁷

The relationship between shareholders and the company is not one of ownership, but of contract. 'In order to understand shareholder rights in a British company, therefore, it is necessary to look first at the company's articles of association and see what rights are established there.'¹¹⁸ To that end, section 33 of CA 2006 provides that, 'the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.' Section 33 CA 2006 is to be interpreted as its predecessor, section 14 Companies Act 1985, which Astbury J in *Hickman* held that the section required the company to be 'treated in law as a party to its own' constitution.¹¹⁹ Indeed, the courts have always held that shareholders can sue the company based on the contractual relationship,¹²⁰ and the company likewise could sue the shareholders.¹²¹ That the company can sue and be sued by its shareholders is based on the entity principle. The company in English law is entirely separate from its shareholders, and the interests of shareholders cannot therefore validate the company's existence.

But shareholders cannot sue the directors qua shareholders if the company also suffers the wrong in question. In *Macdougall*, the Articles provided power to the chairman to take a poll if demanded by five shareholders. At the meeting, on proposing to adjourn, five shareholders demanded a poll, but the chairman refused and adjourned without a poll. The shareholders sued the directors qua shareholders. Following the rule in *Foss v Harbottle*, James LJ held that shareholders ought to have sued 'in the name of the company' in regard to the meeting in question, for he observed that 'every meeting that is called must be for the purpose of doing or undoing something which is supposed to accrue for the benefit of the company' and the suit, 'if it was to be sustained at all, could only be sustained by the company.'¹²² Thus, the entity principle governed the litigation process.

¹¹⁷ *Lee v Lee's Air Farming Ltd* [1961] AC 12, 25.

¹¹⁸ R Nolan, *Shareholder Rights in Britain* 7 *European Business Organisation Law Review* 549, 566 (2006).

¹¹⁹ *Hickman v Kent or Romney Marsh Sheepbreeders Association* [1915] 1 Ch 881, 897.

¹²⁰ *Wood v Odessa Waterworks Co* (1889) 42 Ch D 636.

¹²¹ *Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279.

¹²² *Macdougall v Gardiner* (1875) 1 Ch D 13, 22-23.

On the other hand, the contractual relationship, on the basis of section 33 and the Articles of the company, is not an absolute contract in the strictest sense of a contract. It is arguable, as observed in *Swabey*, between the company and its members, that ‘the Articles do not themselves constitute a contract, they are merely the regulations by which provision is made for the way the business of the company is to be carried on.’¹²³ That is why it is better to explain the relationship between the company and the shareholders in terms of the entity principle. The principle treats shareholders as one of the many parts of the body corporate without according them prominence as to confer special rights on them that would essentially amount to ownership claims upon the company.

Once we stray away from the simplicity of the entity principle, underpinned by the legal personhood of the company, and thereby fail to treat shareholders as distinct from the company, then we cannot be consistent in explaining the rights of shareholders to sue the company under section 33 of CA 2006. Both the shareholder primacy and stakeholder theory are economic endeavours of explaining the legal personhood of the company. The problem here is that

those arguing for an explanation of the company in economic terms tend to want to “have their cake and eat it.” They wish to deny the personhood of the company and see the company as merely an aggregation of individuals in some circumstances, and at other times, particularly when it comes to liability issues and in other situations where it is pragmatically attractive, to invoke the separate personhood of the company.¹²⁴

English law does not buy into these economic explanations, but rather provide under section 33 CA 2006 that the company and its shareholders are bound to each other in contractual relationship – treating both as distinctly separate personhoods.

Long-term wealth need not focus on shareholder interest, but the entity in general, of which the shareholders are only one part of many constituencies. It can be argued that corporate governance in dispersed share ownership structure of English public companies is based on the entity principle. For shareholders will buy and sell shares based on the value of the corporate shares and not individual shares on the market. In focusing on the interests of the entity, with “success” measured against entity objectives or purpose, the directors will of course often take into account the various constituencies, but only to the extent of achieving entity interests. It is the business judgement of the directors here that matter in determining what is in the best interest of the company.¹²⁵ Where the directors fail in promoting the success of the company, it is for the company, not the shareholders, to hold the directors accountable. This is why reading shareholder primacy into section 172, based on the phrase ‘for the benefit of shareholders,’ is merely an economics and efficiency concept or creates a legal right with no corresponding enforcement legal remedy in English law.

VII. Conclusion

This article proceeded on the basis that prior to the CA 2006, the validity of shareholder primacy in English law was merely assumed. The article examined the historical context of shareholder primacy and noted that the assumption was based on partnership principles that

¹²³ *Swabey v Port Darwin Gold Mining Co* (1889) 1 Megone’s Company Cases 385, 386.

¹²⁴ A Keay, A Keay, *Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model* 71 MLR 663, 684 (2008).

¹²⁵ See *Re Smith & Fawcett Ltd* [1942] Ch 304; *Regentcrest plc v Cohen* [2001] BCC 494.

treated shareholders as synonymous with the company. Applying a contextual review of case law revealed no support for the conclusion that English law required directors to run the business in the interest of shareholders. Pre-CA 2006 cases where the human equivalent of the company has been referred to, have always been a matter of a pragmatic reckoning based on the social reality of the company as opposed to the legal acceptance, in assessing the nature of the interests of the company. Whereas arguments based on law and economics provides the merits of shareholder primacy, these do not validate the assumption of shareholder primacy as a legal norm. As such, this article has drawn a conclusion that shareholder primacy in English company law pre-CA 2006 was a myth.

This article noted that section 172 CA 2006 appear to introduce shareholder primacy into English law. However, it is difficult to read shareholder primacy into section 172 without undermining the elementary tenets of English company law – the separate legal personality of the company and to whom directors owe their duties. A reading of shareholder primacy into section 172 would create a legal right in favour of shareholders with no corresponding legal remedy in English law for shareholders to enforce qua shareholders. Examining the historical context of and applying a contextual reading of section 172 CA 2006, this article found that English company law is based on the entity principle, which best explains the basis of corporate governance in modern English company law.