

# The Critical Evaluation of Arguments in Favour of Shareholder Primacy

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**Abstract:** There is no doubt that the concept of shareholder first, as a system, has a long historical tradition. Under the shareholder primacy model of corporate governance, both the board and senior executives are required to devote themselves to the maximization of shareholders' interests. In reality, when confronting conflicts of interests, managers might have become accustomed to ensuring the achievement of shareholders' interests at the expense of other interested persons, which reflects the prevailing ideology of shareholder primacy. Moreover, facing challenges from some novel concepts, the advocates of shareholder primacy should also pay more attention to the research of a balance between egoism and altruism for the sustainable development of the company.

**Keywords:** Shareholder Primacy, Corporate Governance, Sustainable Development.

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## 1. Introduction

This legal essay aims to critically evaluate the arguments in favour of shareholder primacy. There has been a phenomenon that shareholders are the proprietors of the company and the financial capital that they have invested forms the property of the company. It is the shareholders who ultimately undertake the residual risk so that shareholders ought to naturally enjoy the residual right of control and right of earning of the company. The management objective of the company is to persist with shareholder primacy and the maximization of the benefits of shareholders. Only if managers and other interested persons exert the right of control and command in accordance with the shareholder primacy, could there be a guarantee of effective corporate governance and the win-win model between owners and managers of the company. Under this background, this essay attempts to research the merits of the shareholder-oriented business model and the reasons why the public ought to still be in favour of shareholder primacy, in order to defend the historical tradition of shareholder supremacy.

Following the introduction, in the main body of this essay, section one will focus on the advantageous factors and the inevitable reason that the point of shareholder primacy is still the mainstream in process of the development of corporate institutions. Then, section two will concentrate on challenges to shareholder primacy due to inevitable factors of that and attempted to find justifications for refutation and some methods to tackle problems. Finally, section three will be utilized to verify the feasible scheme to balance interests between shareholders and interested persons on the basis of shareholder primacy.

## 2. The Agreement of Shareholder Primacy Is the Crystallization of the Wisdom of Human Beings

Shareholder primacy is the mainstream view in academic and practical circles. As the main undertakers of economic activities of human beings, companies are still of significance at present, because of the fundamental role of creating social

wealth. Meanwhile, shareholder primacy has not only become the main source of corporate power, but also an important section of corporate structure. Under the regulations of articles of association, the separate legal personality, the freely transferable shares and the limited liabilities have become the soul of the modern company system, which makes the limited liability company and the incorporated company the most popular form of enterprises for investors. The importance of enterprises to the economic life of a country could not be overemphasized invariably. Nevertheless, the key factor is that the management right of the company has essentially originated from its investment basis, which makes the shareholders have become the most important interested group. Furthermore, their contribution is the basis of the formation of the company's economic strength, which provides a rationale for shareholder primacy. Notwithstanding there is a continuous legal limitation towards the absolute power and the actual ability of shareholders controlling over the company with the development of the company legal system, investors are still eager for proprietary rights of shares and the identity of shareholders.

It is a universal truth that, as an economic entity, the establishment and development of the company ought to aim to achieve the maximisation of shareholder interests and shareholder primacy, from the beginning to the end. The company law system of many countries in the world, to a large extent, is on the basis of shareholder primacy, which is an outstanding thought of company law, concentrating on bringing about a favourable circumstance for shareholders and maximizing the profits for themselves. For instance, in terms of the most powerful capitalist states, the UK and the USA, the shareholder primacy has always been the objective of the establishment and development of the company of the first importance, accompanied by supreme preference. Furthermore, shareholders are real owners of a company, so that the power of shareholders is the ultimate source of all other resulting powers of the company, resulting in the desire of shareholders to appoint employees who are always willing to insist on shareholder primacy, via actual control of affairs and operation regulations of the company. As the group most

closely to the core interests of the company, shareholder primacy is the concentrated expression of the legal status of shareholders. Shareholders enjoy the privileges and commit to the obligations on the basis of their own investment, which is the basis for the survival of the company.

### **3. Challenges to Shareholder Primacy Due to Inevitable Factors of That**

In reality, there are also some counterarguments against the institution of the shareholder primacy due to some shortcomings and exaggerations of that, so it is necessary for the arguments in favour of shareholder primacy to be rationally taken into account. The source of enterprise capital accumulation is not only the capital chain initially invested by shareholders and the dispersion of stock rights has declined the risk of shareholders. Human capital has become a crucial source of increment of a company. Hence, equal risks are undertaken by shareholders and other interested persons in one company related to the operating efficiency. As a result, enterprises are becoming "social enterprises". Some scholars have pointed out that whether in western or eastern states, companies shall all not shareholder-oriented because companies are usually regarded as tools to undertake social functions for public service, which is to say that they mainly serve the social public benefits. Typically, the scholar Friedman argues that an enterprise is a pure entity that offers service to related interested persons and the range of the relevant interested persons ought to be broader including directors, middle and senior management, and total social members. The scholar Koutsias points out that it is reasonable to admit the shareholder primacy under the background of the early corporate form rather than modern listed companies because great changes have taken place on the structure, nature and function of modern listed companies so that the shareholder primacy has been out of date. Furthermore, directors and managers should have possessed the primacy because the reasonable relations between labours and capital directors, the long-term interests and the sustainable development factors could be better taken into consideration by directors and senior management instead of shareholders. Generally, shareholders tend to become obsessed with attempting to gain absolute power in order to increase their own wealth rather than considering the valid corporate power structure and benefits of interested persons. Shareholders might have excessive interference in company affairs or blind pursuit of the maximization of profits. When a company pursues profit maximization and shareholder primacy unilaterally regardless of benefits of other interested persons, the business model of corporate governance is going to be rigid, which really do harm to the generation and implementation policies of advantageous policies within a company.

The more shares shareholders possess, the more rights and interests they enjoy, and the greater risks they have to bear. The argument of shareholder primacy has to face challenges due to the train of thoughts mentioned above because the domination of shareholders to the company might generate a negative impact on the enterprise itself, the employees and other interested persons. Those who opposed shareholder primacy points out that the policy of shareholder primacy must lead to the excessive interference of shareholders to the company and the rampant abuse of power by controlling. Whereas, those are not the actual state of affairs. In terms of

the combination and operation system of a company, the existence of the hierarchy is inevitable. Therefore, concerning the distribution of interests, rights and obligations could not be exactly equivalent towards every corporate member, which does not mean that lawful rights and interests of other interested persons must be naturally damaged because of the perseverance of the legal principle of shareholder supremacy. In accordance with the manager-oriented theory, modern companies could operate and manage effectively only in the situation that all shareholders would like to abandon the shareholder primacy and transfer the right of control to the intern selected group. However, this business model about the independent care manager model for directors primacy is being fiercely challenged by proposals of the arguments in favour of shareholder primacy to expand shareholders' decision-making power, including more controversial proposals, that is, shareholders ought to possess the privilege to make proposals on items affecting the company's management, not only be limited in the initial stage of the foundation of a company. Compared with the business model of shareholder primacy, the manager-oriented theory has the disposition to limit the power of shareholders as much as possible in order to protect other interested persons. However, it has been proved that, although the manager-oriented theory is more attractive to the public, it, to a large extent, leads to a more serious problem of manager opportunism while this theory focusing on some drawbacks of shareholder primacy.

The concept of "enlightened shareholder value" still perseveres in the shareholder primacy and requires directors to submit to the interests of shareholders. The court of appeal in the UK has also provided protection and control mechanism for shareholders in order to keep the powers of directors within bounds and ensure that the concept of shareholder primacy could still be given adequate attention. The Companies Act of 2006 in the UK still points out that corporate executives and managers are supposed to balance competing interests of shareholders under the principle of shareholder primacy. The board of directors often deliberately abuse their power in the process of managing companies as well. Due to the concern to directors about the mismanagement of the acquisition by undervaluing the share price, the UK government has authorized the Bank of England to find remedies. Thereafter, the Bank of England has co-operated with interested investors in London in order to develop an agreement on the "merger statement for UK businesses", which is known as the initial approach of restricting the power of directors in order to maintain shareholder primacy and prevent directors from becoming dictators of the company. Therefore, shareholder primacy is still the main focus of shareholder power in British companies. In order to maximize the long-term interests of shareholders, the company should take into account the benefits of other interested persons while focusing on shareholder primacy. Confronting the benefits between shareholders and other interested persons, if the former and the latter are treated by corporate legal provisions in the same superior position, it might inevitably cause damages of the investment enthusiasm of shareholders, and then shake the modern company law system on the basis of private property rights.

#### **4. Pursuit of Balance on Profits Between Shareholders and Other Interested Persons under the Principle of Persistence of Shareholder Primacy**

In essence, it is profound that both shareholders and other interested persons have common benefits in the end. The investment of financial capital of shareholders is the foundation and guarantee for other corporate members to obtain opportunities to be employed for their daily expense and realize their values of life. Furthermore, "owners manage and managers also own" could be regarded as a fabulous approach to combine the proprietary rights and management rights. Notwithstanding there could be witnessing a gradual separation between the proprietary rights and the management rights, the divergence of interests into the open between the superintendent and shareholders with the power of controlling could also gather the former and the latter to strive for the common interests of the company, rather than just focus on the interests of the owners or the operators themselves. For instance, the parliament and the UK government have realized the positive influence in the divergence of interests and a series of legal and regulatory measures have been formulated to ensure that the directors and managers of a company could co-operate effectively within their authority and manage the company fairly. There should not be a fierce opposition between directors and shareholders and there is a contractual relationship between them so that after the establishment of the company, the legal responsibilities could not only shared by the shareholders but also should be undertaken by the directors. Essentially, directors are not only active participants in company affairs but also good assistants to shareholders who ought to consider both the shareholder primacy and the benefits of other interested persons. Directors should constantly handle matters in accordance with the optimum, in order to preserve the company's assets, develop the company's business, and achieve the purpose of the company's establishment.

The concept of "enlightened shareholder value" has found the third way between the shareholder primacy and the orientation of other interested persons. It is a very crucial issue that, owners of a company need to find a balance between egoism and altruism. In other words, they need to realize that to what extent, the operation and development of a company could take into account the rights and benefits of other social members who do not possess any shares, on the basis of the adherence to shareholder primacy. The adherence to shareholder primacy could also be the best implementation choice for the well-being of other interested persons. The company should not only insist on shareholder primacy but also attach importance to social public benefits such as social welfare and environmental protection. In detail, owners of a company could choose to abandon exploitative labour mode and prevent managers and other employees from harmful production and working environment. Some suggestions for improvement of the shareholder primacy could be put forward in a further step in order to balance the efficiency demonstration and accountability system. In terms of the procedure of draft resolutions for internal decision-making in a company, the following measures can be used to prevent low efficiency caused by duplicate proposals, such as to innovate a new form named the calm period of the proposals before the

resubmission, as well as setting a higher threshold for resubmitting rejected proposals. In addition, with regard to the approach of solving the corporate governance problems caused by the concentration of ownership structure, we are supposed to also take into account adopting other measures, such as adjusting the percentage structure of the equity, removing the pre-emptive right rules and retaining the institution of one share one vote.

#### **5. Conclusion**

This legal essay has demonstrated the values of the arguments in favour of shareholder primacy with critical analysis in order to defend the historical tradition of shareholder supremacy. There is no doubt that the concept of shareholder primacy is the mainstream view in academic and practical circles, which has not only become the main source of corporate power, but also an important section of corporate structure. The establishment and development of the company ought to aim to achieve the maximisation of shareholder interests and shareholder primacy, from the beginning to the end. Notwithstanding that the concept of shareholder primacy has been commonly accepted, it is still affected by some challenges. The source of enterprise capital accumulation is not only the capital chain initially invested by shareholders and the dispersion of stock rights has declined the risk of shareholders. Furthermore, shareholders may have excessive interference in company affairs or blind pursuit of the maximization of profits. Future research should consider the balance on profits between shareholders and other interested persons of the shareholder primacy more carefully since both shareholders and other interested persons have common benefits in the end. The third way to cope with the relationship between shareholders and other interested persons has been found via the concept "enlightened shareholder value" so that owners of a company need to find a balance between egoism and altruism.

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