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Is the Sole Aim of Corporate Law to Serve the Interests of its Shareholders? - A Comparative Analysis

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INTRODUCTION

The primary function of corporate law is to provide business enterprises with a legal form. The legal form has five core attributes of a company. These are Legal Personality, Limited Liability, Transferrable Shares, Delegated Management under a Board Structure (in some jurisdictions, a single tier board while in others a two tier board) and investor ownership. In addition to providing businesses with this legal form, Corporate Law strives to make this form user-friendly by containing the conflicts that may arise from users of this legal form[1].

Shareholders have been singled out as being important players in the business enterprise because they provide majority of the capital needed to run the business, hence it has been advocated by some academics that the interests should be given priority while other academics have attempted to establish a connection between shareholder profit maximization and corporate social responsibility which simply refers to a situation where the corporation serves the interest of the society.

There have been divergent views about the effect of one to another. Orlitzky[2] conclusively established that Corporate Social Responsibility affects positively shareholder value.

Unfortunately, his brilliant research is of limited value here because he tells of how advancing social welfare by companies can increase the company's shareholder value, but he does not tell whether increasing shareholder value is the best means by which corporate law can serve the goal of advancing social welfare. A second view which supports the theory that maximizing shareholder return is a means by which corporate law can serve the goal of advancing social welfare is approached from the 'contract theory' point of view which states that the stakeholders (creditors, customers, workers) will consent to enter into a contract with the company if the contract provides that they too will benefit there from. The benefits in this instance include, but not limited to the following where as a result of the profit made by Shell Petroleum, the company engage in awarding scholarships to Nigerian students, build schools and employ more Nigerians as its staff[3].So it becomes important to make sure that the corporations' transactions are beneficial to all that deal with the firm (Kraakman, 2009).

Up until November 30, 2011, this would have been the appropriate interpretation of the above claim and I would have been satisfied in ending my research here, but the events of that day opened the way for new debates on the claim that maximizing shareholder returns is the best means by which the corporate law can serve the broader goal of advancing social welfare. The members of the Labour Union that went on public strike are stakeholders of the institution of organized labour. They embarked on this strike because their pensions were being threatened. These are stakeholders who dealt with the corporation on the 'contract' that they would benefit from it but ended up being victims of the system. Furthermore, Brendan McSweeny[4] says that shareholders profit maximization does not serve the goal of

[1]Kraakman .R, 2009. The Anatomy of Corporate Law. A Comparative and Functional Approach. 2nd ed, Oxford University Press

[2]Marc Orlitzky, F. L. (2003). Corporate Social and financial Performances. A Meta-Analysis. London: Sage Publications.

[3]http://www.shell.com.ng/home/content/nga/environment_society/shell_in_the_society/

[4]McSweeny, B. (2008). Maximising shareholder value. A Panacea foe Economic growth of a recipe for economic and social disintegration. *Critical perspectives on interntional business* .

advancing social welfare and all it does is to enrich the financial standing of the shareholders. The studies done in 2001 showed that in jurisdictions such as America (that advocate shareholder profit maximization) the wealthiest One percent (1%) of Americans owned over one-third of total wealth and the next wealthiest Nine percent (9%) owned another third. That is, the wealthiest 10 percent owned two-thirds of total wealth[5].

The situation is not different in the United Kingdom. The nation's wealth is concentrated in the hands of an insignificant minority and this account for the vast social and financial inequalities inherent in the system. According to Banks[6] "The distribution of wealth in the UK is also highly skewed, with extreme concentrations once again in the wealthiest 5-10 percent of households . . . it is extremely unequal"[7].An attempt to remedy this maybe an unspoken reason for the wide constituency of stakeholders provided for in the 2006 Companies Act.

In spite of the diverging arguments for and against profit maximization of shareholder returns being the best means by which corporate law can serve the broader goal of advancing overall social welfare, I align myself with the fact that profit maximization does indeed advance overall social welfare. Goods and services are readily available and affordable to the society. This is true in varying degrees in various jurisdictions, but it is true,

As stated above, the objectives of Corporate Law is to provide business enterprises with a legal form which has five core attributes of a company. It strives to make this form user-friendly by containing the conflicts that may arise from its use due to the relationships formed and the duties created as a result of these relationships[8] (Cahn A, 2010).

These relationships are created because it has been said and I agree that the company operates the contractual theory[9]. Here, the company is a form of contract created by the free agreement of its shareholders. This form of contract creates an agency relationship that imposes on the agent a fiduciary duty to act in good faith and in the best interests of the principal. Stokes, suggests that the contractual theory of Company Law is the theory in existence, because the contract entered into by the company and the shareholders is clearly seen in the exchange of money for shares in the company. In order to define in clear terms the rules governing the "contract", the company's Articles of Association (Companies Act , 2006) was put in place. This document is aimed at allocating powers, duties and responsibilities to parties in the contract.

In effect, a board of directors was created to manage the activities of the company, with directors elected by the shareholders. This contractual analysis formed the foundation of the early theory that the relationship between the shareholders and the company was that of principal and agent. This form of relationship posed its own set of problems; problems which corporate law aims to provide solutions for.

The problem with agency arises whenever the welfare of the principal depends on the actions taken by the agent[10]. This problem lies in enforcing the agent's acts in the best interests of the principal rather than in its own interest. Here, the principal is the shareholder, who by electing the board of directors as its agents, have delegated to them the actual and/or ostensible authority necessary in managing the company. This problem with agency, more specifically, the relationship between directors and shareholders can be classified broadly into two categories: Accountability and Enforcement.

In an agency relationship, it is necessary to keep the agent accountable to the principal. This, Corporate Law does by providing its checks and balances in the form of lifting and/or piercing the veil in certain circumstances thereby ensuring accountability of the agent to the principal.

Lifting and/or piercing the company veil in certain circumstances is a form of accountability and it is an exception to one of the foundational characteristics of corporate law, namely, legal personality. Simply put, a company upon incorporation becomes a legal personality which

[5]Kennickel, A. B. (2001). A rolling tide changes in the distribution of walth in the US 1989-2001. *The Federal Reserve Board Finance and Economics Discussion Series* .

[6]Banks, J. S. (2002). The distribution of financial wealth in the UK: Evidence from BHPS Data, IFS Working Paper 02/21. *Institute of Financial Studieds*

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[8]Cahn A, D. D. (2010). *Comparative Company Law.* Cambridge University Press.

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is separate and distinct from its owners[11]. It acquires a 'separate patrimony'. This means the separation of a pool of assets that are distinct from the assets owned by the shareholders which is the company's own. In effect, a separate legal personality is a way to shield the personal assets of shareholders from debts acquired by the company.

A court will lift or pierce the corporate veil where it is discovered that a company was just a sham or fraud, "mere adjunct, agent, alias, alter ego, alter idem, arm, blind, branch, buffer, cloak, coat, corporate double, cover, creature, curious reminiscence, delusion, department, dry shell, dummy, fiction, form, formality, fraud on the law, instrumentality, mouthpiece, name, phrase, puppet, screen, sham, simulacrum, snare, stooge, subterfuge, tool"[12]

It should be noted that the courts are very reluctant to pierce and/or lift the corporate veil. This is because the concept of a separate legal personality is the foundation on which Company Law is built. In Germany, the corporate veil is pierced where there is strong evidence of domination by a parent company over a subsidiary. In the United Kingdom, the corporate veil is rarely ever pierced. It has however been established in the case of Adams v. Cape Industries plc[13]amongst others that the courts will consider piercing the corporate veil when the company is set up for fraudulent purposes. In the United States, as with the other above jurisdictions, the courts are hesitant to pierce the corporate veil. The litigant in most cases has to prove that the incorporation of the company was merely a formality. There is also the issue of jurisdiction to be taken into consideration in the United States.

Every jurisdiction has a home and that is the state in which the company was incorporated and if they have to operate in other states, they would need authority to do so. As such, in considering whether the corporate veil should be pierced, the courts would apply the laws of the home states.

Notably, the laws of some states are more relaxed than others. Hence, the companies will be subject to different guidelines in situations where the corporate veil will be pierced.

In Nigeria, the Companies and Allied Matters Act herein after referred to as CAMA[14] provides for situations where legislation "…can forge a sledgehammer capable of cracking open the corporate shell". In Section 93 of CAMA, the veil may be lifted or pierced where such company carries on business without having at least two members and does so for more than six months; in Section 246 (3), where a member or director of such company knowingly carries on business when the numbers of directors have fallen below two for more than sixty days; in Section 290, where a company receives money by way of advance payment for the execution of a contract and with intent to defraud, fails to apply the money for the purpose for which it was received and; in Section 506(1), where in the course of winding up a company, it appears that any business of the company has been carried on in a reckless manner or with intent to defraud creditors of the company.

From the above, it can be seen that even though all jurisdictions have the ability to pierce the corporate veil, they rarely do because as said earlier, the concept of the Separate Legal personality is one of the foundations of Corporate Law and when a foundation is open to attack the whole structure will collapse.

However, while the concept of piercing the corporate veil is rarely used, it is neither sidelined nor believed to be inexistent. This knowledge of its possibility helps keep directors accountable to the company.

Another way that Corporate Law maintains the relationship between all the users of the business enterprise is by keeping agents accountable to their principal. This it does by clearly stating their duties. These are generally the same in most jurisdictions. They are generally described as the duty of care and the duty of loyalty. These duties come into force after the shareholders have appointed directors.

Director's duties in the United Kingdom are provided for in Section 172-177 of the Companies Act 2006 (Companies Act , 2006). This is the most comprehensive provision on directors' duties in all jurisdictions as listed above and the duties provided include the duty to promote the success of the company[15], duty to exercise independent judgment[16], duty to

[11] Salomon v. Salomon Co. Ltd. (1897)
[12]HG Henn, J. A. (1983). *Corporations.* Hornbrooks.
[13] 1990 Ch 433

[14] Companies and Allied Matters Act, Cap C20 Laws of the Federation of Nigeria, 2004
[15] Sec 172 CA 2006
[16] Sec 173 CA 2006

exercise reasonable care, skill and diligence,[17] duty to avoid conflicts of interest,[18] with a very extensive provision of rules in Sections 177-231 of the Companies Act 2006. These rules deal with all the situations in which there could be conflict of interest. A look at the Rules shows that it focuses mainly on disclosure and approval. This provision has been cited as being a replacement of the Common Law duty to act in good faith in the best interests of the company. This is not totally a replacement of the Common Law rule but in some cases, a slight deviation from the Common Law rule. The duty to promote the success of the company is the codification of the duty to act in the best interests of the company. This has slightly changed the duty because with the codification, there is no longer a duty to act in the best interests of the company but a duty to promote the success of the company for the benefit of the shareholder constituency. Could this be translated to mean a duty to maximize shareholder value?[19]

In the United States, the Delaware law provides that a director must act in "good faith[20]... belief that her actions are in the corporations' interest" (Stone ex rel. AMSouth Bancorporation v. Ritter, 2006). This law was laid down in the locus classic us case of Guth v. Loft[21]. Delaware Company Law provides just one rule; that a "contract or transaction between a corporation and one or more of its directors or officers is against challenge if the material facts regarding the interest are disclosed and the transaction is either approved by the majority of disinterested directors or the majority of the shareholders in good faith or fair to the corporation as of the time it is authorized, approved or ratified.[22]

The Aktiengesetz of Germany in Sec 93 and 116[23] provides that directors have a duty of care and loyalty to the company. This is peculiar because of its board structures. Germany operates a two tier board structure with two different kinds of directors, the supervisory directors and the managing directors, and they are to comport themselves as "proper and prudent managers"[24]. The Aktiengesetz further regulates conflict situations by providing that the directors are subject to a duty of confidentiality and that they may not compete with the company.

In Nigeria, Sections 279-283 of the CAMA spells out the duty of directors. It emphasizes that a director of a company shall "…observe the utmost good faith towards the company in any transaction with it or on its behalf"[25]; that he shall at all times act in what he believes to be in the best interests of the company in a faithful and diligent manner as ordinarily expected of a skilled director[26]; that he shall exercise his powers and discharge the duties of his office with honesty, intelligence, degree of care, diligence and skill which a reasonable prudent director would exercise in comparable circumstances[27].

Of all jurisdictions, the English and Nigerian laws provide that the directors exercise skill and competence, while Germany though it bears resemblance to the English provision, provides for a duty of confidentiality. The American provision on the duty owed by directors is not as developed as that of the other countries, but is developing through judicial rulings. The common denominator in the four jurisdictions is that they all provide whether statutorily or judicially that directors should exercise a duty of care and loyalty to the company.

Furthermore, all jurisdictions in an attempt to manage the conflict that arises from the users of the business enterprise provide rules and regulations that compel the directors to disclose any business with the company that conflicts with the interest of the company. This rule to disclose is also strengthened by the market regulations in all the jurisdictions.

These market regulations in the United Kingdom (FSA Listing Rules), the Transparency Directive, the Market Abuse Directive and the Takeover Directive; and in Germany, the (Kodex)Securities Trading Act (WpHG), the Exchange Act (BorsenG) and the Takeover Act (WpUG) apply to companies listed on the Stock Exchange market. While in the United States it applies to companies with total assets of at least

[17] Sec 173 CA 2006
[18] Sec 175 CA 2006
[19] Kershaw, D. (2009). *Company Law in Context, Text and Materials.* New York: Oxford University Press.
[20] Delaware General Corporation Law
[21] Guth v. Loft, Inc., 5 A 2d 503, 510 (Del. 1939)
[22] Sec 144(a) DGCL; see Cahn A. 2010
[23] Chan A., 2010
[24] Ibid
[25] Section 279(1) CAMA
[26] Section 279(3) CAMA
[27] Section 282(1) CAMA

$10 million and at least 500 shareholders[28] (Securities and Exchange Act, 1934).

In the United Kingdom, the extensive body of rules provided by the Company Act 2006 has been built upon to regulate strictly the director's relationships with the company. In the wake of various financial scandals such as the fall of Enron, directors are to obtain approval for any dealing with the company and the company is to keep records of all such dealings[29]. Germany does not have the extensive codification found in the United Kingdom; it only builds on what is provided by the Aktiengesetz that directors must not compete with the company and that supervisory directors must act in the best interest of the company[30].

The Kodex requires two boards to act as checks and balances. The Vorstand should disclose conflict transactions to the supervisory board and important conflicted transactions must be approved by the Aufsichtrat[31]. The directors are to notify the company within five days of their transaction in the Company's shares. While in the United States, the rules place heavy reliance on disclosure. Companies registered with SEC are notto provide any form of loans to its directors. The companies are required to disclose any transaction between the director and the company exceeding $120,000 in value and also disclose its policy and procedures for approving the consummation of such transaction[32]. Every listed company is also required to have an audit committee composed of independent directors. In Nigeria, the CAMA in S. 280 states that the personal interests of a director shall not conflict with any of his duties[33]; He shall be accountable for any secret profit or unnecessary benefit made by him while in the management of the company affairs or by utilization of the company's property[34]; He shall disclose his interest before the commencement of any transaction to escape liability for secret profits. He shall not escape liability if he discloses his interests after such secret profits have been made and he shall account for such profits[35].

The above listed legislations of different jurisdictions have, by the peculiar ways in which their laws are coined, shown that the corporate law is interested in maintaining stakeholders' interests as priority. Whether this is done by making the directors accountable to the shareholders or by engaging in social welfare, the role of corporate law has been as stated in the excerpt that opened this paper, the difference as pointed out in the paper is the varying degree of such.

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[28] Sec. 12(g) Exchange Act. In connection wih Exchange Act Rule 12g-1, 17 CFR Sec. 240.12g-1.
[29] FSA Listing Rules, Rule 9 Model Code 6
[30] Paras. 4.3.1 and 5.5.1 Kodex Respectively
[31] Cahn, A., 2010
[32] Ibid
[33] Section 280(1) CAMA
[34] Section 280(3) CAMA
[35] Section 280(6) CAMA

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[26] Salomon v. Salomon Co Ltd, 22 (AC 1897).

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