

The Myth of Shareholder Primacy

If repetition were the font of truth, nothing would be truer than the mantra that company directors have a duty to maximise shareholder profits. This characterisation of directors' duties is so firmly ensconced that even the most trenchant critics of the modern corporation do not question it as a statement of legal fact. The popular documentary *The Corporation*, for example, proceeds from the notion that corporations are legally constrained to act only to maximise profits.

The doctrine of shareholder primacy is pushed by investor advocacy groups, accepted without question by most company directors, and taken as the basis for critique by community groups and theorists. The Australian Shareholders' Association's recent draft "Shareholders' Expectations" policy asserts that the primary purpose of a corporation is to "generate value for shareholders". Similarly, the Board of James Hardie cited their "duty to shareholders" in initially refusing to cover a shortfall in the asbestos compensation fund to meet the obligations of its subsidiaries.

As a matter of law, however, the idea that directors must act to maximise shareholder returns is a simplistic and inaccurate caricature of the law. With the prominence of directors' duties in the news recently, and the recent announcement of a review of directors' duties by the Companies and Markets Advisory Committee, we ought to remind ourselves of some basic legal principles.

First, under the Corporations Act the director's general duty is to act "in the best interests of the corporation", not the best interests of the shareholders. But what does it mean to act in the best interests of a corporation? That very much depends on one's view of what a corporation is. One point of view is that the corporation is no more than property of the shareholders. A more sophisticated view is that the corporation is a web of relationships, contractual and otherwise, among investors, workers, customers, suppliers, communities, and ecosystems. If one takes this view of a corporation, then the legal duty is more nuanced and entails acting in the collective best interests of all these groups.

This view has received the blessing of the Supreme Court of Delaware (the temple of U.S. corporate law) in *Paramount Communications v. Time, Inc.*, where the court upheld the decision of the Board of Time, Inc., to reject a bid by Paramount Communications in favour of a less attractive bid (from the shareholders' financial perspective) that would better preserve the "culture" of the organisation. Australian law does not prescribe which view is the better one, and Australian courts have never squarely endorsed either perspective.

Second, directors in fulfilling their duty to the company must consider the interests of both present and future shareholders. This requires directors to balance the short-term and long-term interests of the corporation, and puts to rest any notion that there is a duty to "maximise profits" over any particular period of time.

Third, directors are duty-bound to consider the interests of creditors, at least when a company is nearing insolvency. The Supreme Court of Western Australia has even gone so far as to endorse *Winkworth v. Edward Baron Development*, a U.K. case holding that directors should consider the interests even of future creditors. The duty

to consider creditors' interests stands on equal footing with the duty to consider shareholders' interests, although obviously creditors interests are more likely to come to the fore as a company approaches insolvency. On the strength of this case, it is at least arguable that under Australian law James Hardie's Board was bound to consider the interests of future creditors, including future claimants for asbestos-related illnesses (even if they could not be individually identified), on par with the interests of its shareholders.

What follows from these principles? For one, we should not let company directors off the hook for pursuing unethical or socially and environmentally harmful company policies on the basis that they are legally constrained to maximise shareholder profits. Their hands are not so fettered as is often claimed, and we should not blame the law when it affords ample latitude for directors to act responsibly vis-à-vis the environment and society generally. The positive corollary is that directors should be encouraged to act in the broad interests of all contributors to the success of the venture without fear of retribution by profit-maximising shareholders.

This is not to say that clarification of directors' duties is undesirable. Under U.K. company law, directors are explicitly instructed to consider the interests of the company's employees, as well as its members. Most European jurisdictions either have similar requirements, or have employee representatives on the Board. In the U.S., thirty-one states have passed "non-shareholder constituency" laws in the past two decades, which either permit or require consideration of a range of non-shareholder interests in the exercise of directors' duties.

In this regard, the upcoming review by the Companies and Markets Advisory Committee is welcome. Australia should follow these international developments and clarify that directors should consider the interests of all contributors to the success of the corporation, including voluntary and involuntary creditors, communities, employees and the environment. In the meantime, however, we should recognise the myth of shareholder primacy for what it is – a statement of economic theory with little foundation in modern law.

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