Centre for Business Law and Practice
School of Law
University of Leeds

BUSINESS LAW & PRACTICE REVIEW

2006 – 2007

CONTENTS

1. ABOUT THE CENTRE, THE UNIVERSITY AND THE CITY OF LEEDS

The Centre

The Centre for Business Law and Practice is located in the School of Law at the University of Leeds (which is part of the Faculty of Social Sciences, Education and Law) and its aim is to promote the study of all areas of Business Law and Practice, understood as the legal rules which regulate any form of business activity. It seeks to promote all forms of research, including doctrinal, theoretical (including socio-legal) and empirical research and to develop contacts with other parts of the academic world, as well as the worlds of business and legal practice in order to enhance mutual understanding and awareness. The results of its work are disseminated as widely as possible by publishing monographs, articles, reports and pamphlets as well as by holding seminars and conferences with both in-house and outside speakers.

Staff members have acted as consultants to law firms, accounting bodies and international bodies such as the International Monetary Fund. Research has been undertaken in many areas of business law including banking and financial services, business confidentiality, corporate (general core company law as well as corporate governance and corporate finance), employment, financial institutions, foreign investment, insolvency, intellectual property, international trade, and corporate and economic crime (including money laundering and the financing of terrorism).

One of the primary functions of the Centre is to oversee the research undertaken at postgraduate level and to manage postgraduate taught programmes in International and European Business Law. In addition, the Centre offers several undergraduate business law modules to law and non-law students.

The University

The University of Leeds is among the United Kingdom's top universities, located close to the centre of one of the most progressive, cosmopolitan and student-friendly cities in the United Kingdom. One of the largest single site universities, Leeds is a hugely popular choice for students. With over 30,000 students living in the city, it regularly tops the national polls as a favourite destination for students.

Established in 1904, the University is a member of the Russell Group, which was formed by nineteen of the country's most prestigious universities. With a world class reputation for quality in research and teaching, a degree from the University of Leeds, both undergraduate and postgraduate, is highly regarded by employers and universities worldwide.

The University has over many years invested heavily in its infrastructure to provide students with first-class learning, development, support and leisure facilities, including modern well-equipped lecture theatres and seminar rooms, an internationally acclaimed University library, an enterprising careers service, a wide range of sporting amenities and one of the biggest and most active Students' Unions in the country.

The University is one of the main centres for postgraduate teaching in the country, with around 5,000 postgraduate students drawn from all over the UK and another 100 countries world-wide. As a University of Leeds postgraduate research student, you will have access to outstanding facilities including our major academic research library and excellent computing facilities.

The City

Only a short walk from the bustling shops, boutiques, art galleries, cinemas, bars, restaurants and cafes of the city centre, the University campus is a vibrant place in which to live and study. Leeds is one of the fastest growing cities in the United Kingdom. With its continued prosperity in law, finance, business and media, the city offers great employment potential. This is complemented by an exciting mix of culture, commerce and style, making Leeds the primary social hub of the North of England. Rich in history with a growing economy and cosmopolitan atmosphere, Leeds remains an affordable student-friendly city and the centre of a region of great cultural diversity.

Leeds is a '24 hour city' that is famous for the diversity and popularity of its nightlife. The city prides itself on the vitality of its 'independent' bar scene, whilst its nightclubs offer a sophisticated and relaxed clubbing experience with a wide range of music and ambiences to suit all tastes. It is home to a wide variety of theatre, music, film and music venues including the legendary University Refectory. The annual Leeds Film Festival is also one of the leading cinema events in the country.

2. INTRODUCTION BY CENTRE DIRECTOR

This report covers the activities of the Centre for Business Law and Practice ("the Centre") during the period from 1st September 2006 to 30th September 2007. The Centre has been gradually expanding the scope of its activities, and this has been very much in evidence during the past year. The Centre is now in a position to develop strongly as a result of the increased number of academics who are members and we look to the future with considerable confidence. In particular the Centre has continued to develop its research profile particularly in those areas where it already has considerable expertise:

- Corporate law - with special emphasis on corporate governance, corporate finance and corporate insolvency law.
- International financial law – banking and financial services and anti money laundering.
- Contract law – including consumer law.

The past year has been another very productive year for the Centre in terms of activity of staff, research, research outcomes and growth of its postgraduate taught programmes and postgraduate research students. The publications of members of the Centre once again manifest the completion of some very high quality and relevant research work which spans diverse parts of business law. The number of postgraduate students recruited, for both doctoral research and taught masters programmes, indicates the popularity and strength of the Centre's programmes and is testimony to the standing of the Centre's staff. One of our major aims is to further develop the postgraduate research culture within the Centre and the Law School and we are pleased to report that in this respect the Centre is growing in accordance with our plans and the number of full-time postgraduate research students has continued to increase.

In accordance with the aim of the Centre to broaden its activities, within its remit, two high profile lectures by experts from outside the University took place during the period under review and we intend to continue to do this again in future years. Both speakers are internationally renowned academics. Further information on these lectures is provided later in this Report. Plans have been put in place for the Centre to expand its visiting speaker programme and we will be inviting a number of internationally renowned speakers during the academic year 2007/2008.

The talks are designed to appeal to the legal profession, business professionals (including bankers and directors), academics and students, both undergraduate and postgraduate. The seminars attract large audiences and we were pleased at the response from the legal community in West Yorkshire and beyond. They were also popular with our own postgraduate and undergraduate students, whose learning experience was enriched by being able to hear, and ask questions of, internationally acclaimed speakers on the relevant matters addressed.

The Centre has enjoyed links with the Leeds University Business School, including the sharing of Academic Fellowships and discussions on research objectives. Two members of the Business School act as members of the Executive of the Centre. The

Centre has also been in dialogue with legal practitioners in Leeds in order to improve links between the Centre and practice and to establish how the Centre might serve the interests of those in the legal profession who practice in the business law field. There have been some discussions concerning the possibility of law firms sponsoring certain research projects.

During the past year I have enjoyed the support of Joan Loughrey as Deputy Director and my other colleagues and members of the Centre.

Full details of the Centre's activities can be found at www.law.leeds.ac.uk/leedslaw

Andrew Campbell
Director of the Centre for Business Law and Practice

November 2007

3. RESEARCH DEGREES AND TEACHING PROGRAMMES

A. Research Postgraduates

The Centre for Business Law and Practice has been expanding its research degrees programme. Each postgraduate student receives high quality supervision from two academics who are trained and experienced supervisors as well as being experts in the particular field of research. In addition students are provided with formal research methods training.

All research students are encouraged to take an active part in the activities of the Centre and this includes attending seminars and conferences. The Centre's research postgraduates are located in the Law Graduate Centre, which has excellent facilities. Each student is provided with access to desk space, lockable storage space, a good quality computer cluster with printing facilities and a very convivial and collegial environment (including a social room) in which to undertake their work. Additional facilities are provided at the University's central Graduate Centre, which also runs helpful training courses. The Law Graduate Centre is only a short walk from the University's main research library, which contains a well-stocked collection of relevant books, journals, materials and sources.

The Centre for Business Law and Practice welcomes applications from students wishing to pursue research into any aspect of business and commercial law. The Centre has particular expertise in the following areas: contract law; corporate law – especially corporate governance, the role and duties of company directors, corporate insolvency law, corporate rescue, corporate finance; insider dealing; banking and financial services law; economic crime including anti money-laundering and terrorist financing; Islamic banking law; law relating to security; intellectual property; international economic law; consumer law including consumer credit; employment law: environmental law.

All relevant proposals within the broad remit of business law will be considered and even if the proposed research topic is not listed above it may be worth contacting the Director to discuss whether research supervision would be available.

The degree schemes on offer by research and thesis only are as follows:

- Master of Laws (LL.M) – one year full-time or two years part-time
- Master of Philosophy (M.Phil) – two years full-time or four years part-time
- Doctor of Philosophy (Ph.D) – three years full-time or five years part-time
- Integrated Ph.D – four years full-time (not available part-time). This new degree combines taught classes and the traditional research thesis, with an exit award of LLM Legal Research the students complete the first two years.

The entrance requirements for all schemes are that applicants must normally possess an upper second class honours degree or equivalent. Applicants with professional qualifications or substantial professional experience are also encouraged to apply. In addition, MPhil and Ph.D applicants are usually required to hold a Masters level qualification.

Informal enquiries from applicants are welcome. Please contact the Director of the Centre, Andrew Campbell, at a.campbell@leeds.ac.uk

B. Taught Postgraduate Programmes

During the academic year 2006 – 2007 the Centre offered a range of taught postgraduate programmes in international business law.

The two programmes for law graduates only are:

1) LLM European and International Business Law
2) LLM International Business Law

Students on the LLM programmes will all have a bachelors degree in law (commonly an LLB or equivalent) and will take this course in order to develop specialist knowledge in the various aspects of business law.

The two programmes for non-law graduates only are:

3) MA European and International Business Law
4) MA International Business Law.

Traditionally those attracted to the two MA versions of the programmes tend to have a business, economics or Master of Business Administration (MBA) background. The factor they have in common is that they do not have a background in law. Such students are usually looking to acquire a significant degree of knowledge about business law without having the intention to practice law in any country.

In all the programmes, the modules are taught by seminars, and there are two 11 week semesters in each academic year. Assessments are by written work.

The numbers of people applying for entry into the LL.M and M.A. programmes has been increasing significantly over the past couple of years, as have the number of students actually registered. A high proportion of the students enrolled are from outside the United Kingdom and one of the strengths of our programmes is that students come to study at Leeds from a wide range of countries.

The LL.M. programmes involve the completion of taught modules totalling 120 credits that are taken Semester 1 and 2. Some modules are compulsory (this varies between programmes) and the others are optional modules chosen from a long list of available subjects. The final stage of the programme is a dissertation (worth 60 credits) being completed in the Summer following Semester 2. The programme consists of 180 credits in total.

The compulsory modules consist of modules which are believed to form a critical base for the study of business law, nationally and internationally. Students have a broad choice when it comes to the optional modules, and this reflects the breadth of expertise in the Centre.

The dissertation, constituting 60 credits, is compulsory and forms a major part of the programmes, and reflects one of the aims of the programme, namely to foster research capabilities. The dissertation requirement permits students to engage in some detailed research of a particular issue that warrants investigation. Research for, and the writing of, the dissertation is undertaken in conjunction with a supervisor, who is a member of the law staff. The members of the law staff have a wide range of research interests and are able to supervise a broad spectrum of topics in different areas of the law.

The overall objective of this programme is to provide students with a firm grounding in many of the basic principles and rules regulating business activity in the UK Europe and around the world. The programme also aims to enable students to develop the following: analytical legal skills, ability to work independently, writing skills, and ability to undertake research.

As part of the Centre's objective to continually keep programmes under review we introduced a new LLM programme in Insolvency Law which commenced in September 2006. We believe that there should be significant demand in Leeds, which is a major commercial centre, for a programme such as this. We are also in the process of designing two further programmes which will be introduced in September 2008. These are LLM programmes in Banking and Finance and in Corporate Law. The Centre is fortunate to have staff with international reputations for expertise in these areas and this is a particular strength which we wish to utilise. Our market research indicates that there is significant demand in these areas both from students in the United Kingdom and from overseas but at present there are few places which are able to offer such programmes.

C. Undergraduate Teaching

While the Centre does not directly run any undergraduate programmes, it makes a very important contribution to teaching of the Bachelor of Laws (LLB) degree, in particular. The Centre has developed modules that are taught to both law and non-law undergraduates. These modules have been very popular with students, and have attracted good enrolments. The modules that are taught in the Bachelor of Laws programme (although students from other programmes with the necessary prerequisites can enrol for them) are Business Law, Company Law, Banking and Financial Services Law, Intellectual Property Law, Employment Law, and Corporate Finance and Insolvency. Members of the Centre also either act as leaders, or contribute to the teaching, of the following modules : Law of Contract, International Law, Equity and Trusts, Constitutional Law and Jurisprudence. Offerings to non-law students include Introduction to Company Law and Introduction to Obligations.

4. GENERAL CENTRE ACTIVITY AND NEWS

There have been some notable achievements by members of the Centre in the past year, and not always reflected in a published piece, that are worthy of mention. What follows is a selection of some of the activities of the Centre and its members and it is not intended to be exhaustive. We are also pleased to welcome Gerard McCormack, formerly of the University of Manchester, as Professor of International Business Law.

Sarah Brown, who joined the staff as a lecturer after having been awarded her Ph.D in 2006, had an article published in the Conveyancer and Property Lawyer; '*The Consumer Credit Act 2006: Real Additional Mortgagor Protection?'*[2007] 71 Conv 316. **Andrew Campbell** has continued his research into banking law paying particular attention to international bank insolvency and the protection of bank depositors. He co-edited (with John Raymond LaBrosse, David Mayes and Dalvinder Singh) a book on entitled *Deposit Insurance* which was published by Palgrave Macmillan in June 2007. Chapter 2 *'Legal Aspects of the Interests of Depositor Creditors: The Case for Deposit Protection Systems'* (pages 40 – 70) was co-authored with Dalvinder Singh. The timing of the publication of this book was extremely fortuitous as the credit crunch was just beginning around that time with liquidity drying up on the international financial markets. He was also guest editor (with John Raymond LaBrosse) of a special issue of the *Journal of Banking Regulation* which was also on the subject of deposit insurance. In addition to co-editing he co-authored the Editorial *'Challenges for Deposit Insurers in Resolving Bank Failures'* (2006) Vol. 8, 1 -3. By September 2007 the subject of deposit insurance had become a matter of some significance with the crisis at Northern Rock Bank. He presented sessions on bank insolvency and depositor protection issues at the *Financial Transactions for Lawyers* seminars held at the Joint Vienna Institute in April 2007, organised by the Legal Department of the International Monetary Fund and the IMF Institute. He also participated in a Seminar on *Creditor Rights in Emerging Economies* at the IMF Regional Training Institute in Singapore in August 2007. The participants were officials of central banks and government departments from a number of developing countries (mainly from the republics of the former Soviet Union and from south-east Asia).

Judith Dahlgreen's extensive knowledge of corporate law and corporate finance has added considerably to our strength in this area and she has joined the teaching team for the undergraduate module in Banking and Financial Services Law. **Roger Halson** became Head of School on 1st August 2007 and reluctantly gave up the position of Deputy Director of the Centre. He specialises in the law of contract and during the year he undertook, together with **David Pearce**, research into damages for breach of contract focusing on compensation, restitution and vindication. This has resulted in an article which has been accepted for publication in the Oxford Journal of Legal Studies. Roger has also been researching the issue of damages and remoteness in relation to time charters. **Juliet Jenkins** continued her research into intellectual property law focusing on registered trade marks, copyright and database rights.

Andrew Keay had another extremely productive year which saw the publication of two books, *Company Directors' Responsibilities to Creditors*, Routledge-Cavendish, 2007 (393pp). (The book was an outcome from an AHRC Research Leave Grant) and *Insolvency Legislation : Annotations and Commentary*, 2nd ed, Jordans, 2006 (co – author Louis Doyle) (1711pp (including legislation). He also had a chapter entitled "Broadening Corporate Governance in the United Kingdom : How are Directors To Act When Owing Duties to Creditors?" in T.Kowalski and S.Letza (eds), *Corporate Governance and Institutions : A Pan-European Perspective*, Poznan University of Economics Publishing House, 2006, pp 21-41. The following articles were published: "Company Directors Behaving Poorly : Disciplinary Options for Shareholders" [2007] *Journal of Business Law* 656-682; "Section 172(1): An Interpretation and Assessment" (2007) 28 *Company Lawyer* 106-110 (A4 pages); "Enlightened shareholder value, the reform of the duties of company directors and the corporate objective" [2006] *Lloyds Maritime and Commercial Law Quarterly* 335-361; "Wrongful Trading and the Point of Liability" (2006) 19 *Insolvency Intelligence* 132-134 (A4 pages);"Fraudulent Trading : The Intent to Defraud Element" (2006) 35 *Common Law World Review* 121-134. He was awarded a British Academy Larger Research Grant in March 2007 (£19,098) to explore the formulation and development of a new theoretical framework for determining what the objective of a public company should be. He acted as a member of the Advisory Boards for the journals *Insolvency Intelligence* and the *QUT Law and Justice Journal*.

Dr. Paul Lewis is a senior lecturer in Leeds University Business School who has been undertaking research into the difficulties faced by small firms with regard to contractual relationships. He has also been working on a study of human rights and the litigant in person in the county court as well as revisiting the theory of the small claims procedure. **Joan Loughrey** has been working on a major research project on privileged litigants and has had an article *Privileged Litigants: Shareholder Rights, Information Disclosure and Corporate Privilege* accepted for publication by the *Journal of Business Law*. (This was published in October 2007. (2007) *JBL* 777 – 805). She also continued her work on the interests of the client and the role of counsel in intra-corporate litigation as well as researching corporate lawyers and corporate warfare. She became Deputy Director of the Centre on the appointment of Roger Halson as Head of School.

John McMullen was a member of the Council of the Advisory Conciliation and Arbitration Service. He is Editor of the Oxford University Press' *Employment Practitioner Series.* **David Pearce** has been undertaking research into aspects of property and contract law and in particular has been undertaking research jointly with **Roger Halson** (see above). **Surya Subedi** continued to produce work for the Centre despite being otherwise occupied in the work of the Centre for International Governance. In particular he has been researching the question of balancing public interests with private interests in the settlement of investment disputes by the International Centre for Settlement of Investment Disputes (ICSID) and also the Doha Development Round of Multilateral Trade Negotiations and the Future of the World

Trade Organisation. **Peter Vincent-Jones** monograph *The New Public Contracting: Regulation, Responsiveness,Relationality* was published by Oxford University Press.

5. CONFERENCES AND PUBLIC LECTURES

Centre members were actively involved in giving papers at conferences in the United Kingdom and overseas. **Andrew Campbell** presented the following papers: 'Addressing the Problems of Non-Performing Loans' at the Annual Conference of the International Association of Deposit Insurers, Rio de Janeiro, Brazil (November 2006); 'Lawyers and Money Laundering' at the Symposium on Money Laundering, International Law Research Forum, Department of Law and Criminology, University of Wales, Aberystwyth (April 2007); 'The Threats Faced by Islamic Banks' at the Cambridge International Symposium on Economic Crime, Jesus College, Cambridge (September 2007). **Andrew Keay** presented a paper entitled ' Company Directors Behaving Poorly: Disciplinary Options for Shareholders' at the Annual Conference of the Society of Legal Scholars, Company Law Section, University of Keele (September 2006).

Joan Loughrey gave a paper entitled 'The Interests of the Client and the Role of Counsel in Intra-Corporate Litigation' at the Society of Legal Scholars Annual Conference, Company Law Section, at the University of Keele (September 2006). She also presented an invited paper entitled 'Corporate Lawyers and Corporate Warfare' at the Centre to Legal Research and Policy Studies, Oxford Brookes University (April 2007). **Surya Subedi** presented the following papers: 'Balancing Public Interests with Private Interests in the Settlement of Investment Disputes by the International Centre for the Settlement of Investment Disputes (ICSID) at the International Conference to mark the 20th anniversary of the Chinese Society of Private International Law on 'Global Forum on Private International Law' at the Faculty of Law, University of Wuhan, China (September 2007); 'Trade, Environment and Sustainable Development' at the International Trade Law Conference on the Doha Development Agenda and the Future of the Multilateral Trading System, organised jointly by the World Trade Organisation, Sri Lankan Ministry of Trade and the Sri Lanka Law College, Colombo, Sri Lanka (July 2007); 'The Principles of Fairness and Reciprocity in International Trade Law', public lecture delivered at Heilongjiang University, China (September 2007); 'The Doha Development Round of Multilateral Trade Negotiations and the Future of the World Trade Organisation', public lecture delivered at the Faculty of Law, Zhongnan University of Economics and Law, China (September 2007).

The Centre hosted two significant public lectures during the year. The first of these was by **Joshua Getzler,** Reader in Law, University of Oxford who gave an extremely interesting and informative paper entitled *'Are Floating Charges Bad for Industry?: A Fresh Look at the Legal and Financial Data'*. The second lecture was by **Professor**

John Birds of the School of Law, University of Manchester. This was entitled *'The Companies Act 2006 and Directors' Duties* and provided an excellent and detailed explanation of the changing nature of the law relating to directors' duties.

Both events were held in the evening to ensure that they would be available to legal practitioners as well as law students at both postgraduate and undergraduate level. They were both extremely well attended.

Due to the success of these public lectures we intend to expand these into a series during the next academic year.

6. EDITORIAL WORK

Many members of the Centre are actively involved as members of editorial boards and editorial activity includes:

Campbell, A., He continued to serve on the editorial boards of the *Journal of Financial Crime*, the *Journal of Money Laundering Control*, the *Journal of Banking Regulation* and the *Journal of Financial Regulation and Compliance.*

Keay, A. , Member of Editorial Boards of *International Insolvency Review* **(**Wiley), *Insolvency Law Journal* **(**Law Book Co)., *Insolvency Intelligence* **(**Sweet and Maxwell) and *QUT Journal of Law and Justice* (Queensland University of Technology)**.**

McMullen J., General Editor, *Employment Practitioner Series*, Oxford University Press.

Subedi, S., General Editor, *Asian Yearbook of International Law* (Martinus Nijhoff, the Netherlands).

Walker, C., Member of the board of editors, *International Journal of Risk Management* (Perpetuity Press).

WORKING PAPER AND CONFERENCE PRESENTATIONS

This year Andrew Keay has provided a Working Paper and Andrew Campbell has provided outlines of two conference papers he delivered.

ASCERTAINING THE CORPORATE OBJECTIVE: AN ENTITY MAXIMISATION AND SUSTAINABILITY MODEL[+]

[+] The research for this paper was made possible by a Larger Research Grant from the British Academy. The author would like to thank Harry Rajak, Chris Riley and Gerry McCormack for being

Andrew Keay*

A Introduction

It is trite to say that public companies play critical roles in the carrying on of commerce across the world. They conduct many businesses, some of them operating on a global basis and netting millions of pounds, dollars, euro, yen etc a year. They are so pervasive in the world that we can say that they feature in all aspects of social, political and economic life,[1] having important legal and economic functions; they 'accumulate, convert, produce and disperse economic resources.'[2] Notwithstanding the importance of public companies, there has been uncertainty for many years as to the actual objective of companies, because company law fails to articulate this in any clear way. Robert Clark, the renowned American law professor, said, in his influential work on corporate law, that the corporate purpose is an 'extremely varied, inclusive and open-ended' concept.[3]

All significant activity requires an objective, and the work of a company is no different. It has been said that a company is an entity whose 'defining characteristic is the attainment of a specific goal or purpose,'[4] but the problem is that there is little agreement on what that goal or purpose should be. As Jensen has said : 'Every organisation attempting to accomplish something has to ask and answer the following question : what are we trying to accomplish?'[5] Recently, an editor of the journal, *Organization Science,* said that ascertaining the corporate objective is the 'most important theoretical and practical issue confronting us today,'[6] and it is the subject, directly or indirectly of a substantial amount of literature in many disciplines, including law, finance, economics, organisational behaviour and ethics. The ascertainment of the objective is critical for a number of reasons. For example, it underpins the kind of corporate governance that needs to be implemented and determines what responsibilities are imposed on directors.

Debate as to what should be the goal or purpose of a company has gone on for years[7] and although it has been said that the issue has been debated 'ad nauseam,'[8] it is far

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kind enough to read and comment on an earlier version of the article. The author is solely responsible for any errors.

* Professor of Corporate and Commercial Law, Centre for Business Law and Practice, School of Law, University of Leeds.

1 S. Bottomley, *The Constitutional Corporation* (Aldershot, Ashgate, 2007), 3.

2 *Ibid*, 111. This has been acknowledged for many years. See the comments of Jackson J in *State Tax Commissioners v Aldrich* 316 US 174 at 192 (1942) and Bull JA in *Peso Silver Mines Ltd v Cropper* (1966) 56 DLR (2d) 117, 154-155.

3 R. Clark, *Corporate Law*, 1986, 17 and referred to in M. Blair and L. Stout, 'Specific Investments and Corporate Law' (2006) 7 *European Business Organization Law Review* 473.

4 T. Parsons, *Structure and Process in Modern Scientific Societies* (Glencoe, Free Press, 1960), 63.

5 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 *European Financial Management* 297, 298.

6 J. Walsh, 'Introduction to the 'Corporate Objective Revisited' Exchange' (2004) 15 *Organization Science* 349, 349.

7 As far as the US is concerned, it goes back certainly as far as the time of the decision of the Supreme Court of Michigan in *Dodge v Ford Motor Co* (1919) 170 NW 668.

from at an end[9] for it still exercises the minds of academics in many disciplines. This article is an attempt to provide some early thinking on a new approach to the corporate objective. The aims of the article are to examine the existing pre-eminent theories of the objective of companies and to argue for a new model for ascertaining the corporate objective,[10] namely an entity maximisation and sustainability model, and then to explain that model. I should add, by way of disclaimer, that the article does not seek to flesh out all aspects of the model, for to do so would not be possible in one article of limited length. At appropriate points the article identifies matters which require further treatment. Whilst the article considers the issue from a legal perspective, the discussion seeks to draw substantially on studies in various other disciplines, notably in the fields of management, finance, accounting, economics and ethics. The article argues, normatively (although it notes that there are indications of descriptive support for it), that the goal of a company is to maximise the company's total wealth and, importantly, at the same time to ensure the survival of the operation of the company. So, whilst referring to the theories of the nature of the company, the article does not purport to address the issue of the nature of the company in any detail. I should also add that the article is all about the general objective of a company. It is acknowledged that every company, through its board, will set its own goals and these will undoubtedly differ. But the argument of the article is that all companies should have the overall objective identified here.

As indicated above, the debate over the corporate objective, although not always articulated in these terms, has been with us for a long time. Certainly since the 1930s it has been dominated by two models, on the one hand the shareholder primacy principle (or paradigm), also known as the shareholder value principle or the shareholder wealth maximisation norm, and on the other hand, the stakeholder model (and its philosophical forebears).[11] This work does not argue for either of these two dominant theories. In fact it is contended that the shareholder primacy and stakeholder models are either not normatively desirable or workable, or both, and each suffers from several shortcomings. The article is structured as follows. First, there is a short explanation of why a new model is needed. Second, the article critically examines, albeit relatively briefly because of space constraints, the two primary models that have been developed to explain the corporate objective. Third, the main part of the article proposes and seeks to justify a new model. The article ends with some concluding remarks.

It must be emphasised that this study is focused on those jurisdictions that embrace the Anglo-American system of corporate law. Other countries which follow different systems may take a different approach, often based on cultural and/or historical grounds. While it has been argued that corporate law is converging in favour of the

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8 See H. N. Butler and F. S. McChesney, 'Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation' (1999) 84 Cornell L Rev 1195, 1195.

9 A. Sundram and A. Inkpen, 'The Corporate Objective Revisited' (2004) 15 *Organization Science* 350.

10 The assumption is that the company is solvent. If a company is insolvent then arguably a different approach must be invoked. See A. Keay, 'Formulating a Framework for Directors' Duties to Creditors : An Entity Maximisation Approach' (2005) 64 CLJ 614.

11 W. Allen, 'Our Schizophrenic Conception of the Business Corporation' (1992) 14 *Cardozo Law Review* 261, 264.

Anglo-American system,[12] it can be asserted with justification that there is no significant convergence occurring because of culture, social conditions and political imperatives, which keep countries separated, at least to some substantial degree.[13]

A The need for a new model

Establishing the objective of the company is critical. First, it provides some guidance for directors in the carrying out of their functions. Second, it enables us to assess whether directors have done what they should have done. Third, it helps us to formulate corporate governance mechanisms. This last point is made more pertinent by Jensen's assertion that at the very essence of the 'current global corporate governance debate is a remarkable division of opinion about the fundamental purpose of the corporation.'[14]

Historically there has been in most jurisdictions no legislative proclamation or unequivocal judicial statement[15] which provides directors with a clear answer as to what is the corporate objective. We have been left with essentially a debate based on lines of scholarly thought, and re-energised in light of the US corporate scandals of 2001 and 2002, namely between those scholars holding to shareholder primacy and those holding to stakeholder theory. The two approaches are based on radically different normative premises,[16] with little ground being given by the proponents of either theory.[17] Notwithstanding the significant amount of commentary written in relation to both of the major models, little progress has been made in securing any common ground.

Clearly, the modern public company is a complex undertaking that consists of intertwined human and economic relationships and far more complex than that posited by the traditional shareholder model.[18] The discovery of a new approach is justified by the fact, as we see shortly, that the prevailing paradigms have patent problems, and were devised in old societal contexts. It is also justified by the fact that firms are clearly changing as commerce changes.[19]

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

[13] See, M. Guillen, 'Corporate Governance and Globalisation' in T. Clarke (ed), *Theories of Corporate Governance* (Abingdon, Routledge, 2004), 226-228

[14] 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 14 *Journal of Applied Corporate Finance* 8, 8.

[15] A. Keay, 'Enlightened shareholder value, the reform of the duties of company directors and the corporate objective' [2006] LMCLQ 335, 341-346.

[16] D. Millon, 'New Game Plan or Business as Usual? A Critique of the Team Production Model of the Corporate Board' (2000) 86 Va L Rev 1001, 1040-1042.

[17] A good example of this is to be found in the series of articles published in volume 15 of *Organization Science* in 2004 where Anant Sundaram and Andrew Inkpen resolutely put forward the shareholder value approach, while R Edward Freeman, Andrew Wicks and Bidhan Parmar responded on behalf of stakeholder theory, and then Sundaram and Inkpen provided a rejoinder. See n 9 above; Freeman, Wicks and Parmar, 'Stakeholder Theory and 'The Corporate Objective Revisited' (2004) 15 *Organization Science* 364; Sundaram and Inkpen, 'Stakeholder Theory and 'The Corporate Objective Revisited' : A Reply' (2004) 15 *Organization Science* 370.

[18] L. Mitchell, 'A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes' (1992) 70 *Texas Law Review* 579, 630.

[19] L. Zingales, 'In Search of New Foundations' (2000) 55 *Journal of Finance* 1623.

There needs to be a consideration of the issue from a different perspective. It is submitted that what Daily, Dalton and Canella say in relation to corporate governance applies equally to determining the corporate objective:

> Researchers often embrace a research paradigm that fits a narrow conceptualisation of the entirety of corporate governance to the exclusion of alternative paradigms. Researchers are, on occasion, disinclined to embrace research that contradicts dominant governance models and theories (i.e. a preference for independent governance structures) or research that is critical of past research methodologies or findings. This will not move the field of corporate governance forward.[20]

The article now turns to a consideration of the two primary theories. I should say by way of disclaimer that the comments in the ensuing discussion are generalised.

A Shareholder primacy

B. The theory[21]

Contractarians generally[22] have fostered shareholder primacy and see it as the focal point of their view of the public company.[23] The theory[24] is predicated on the basis of a promise made by directors to shareholders that they will maximise the wealth of the shareholders. It has also been said in this context by some that as shareholders are the owners of the company,[25] those who manage the company should do so for the benefit

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[20] C.M. Daily, D.R. Dalton and A.C. Canella, 'Corporate Governance : Decades of Dialogue and Data' (2003) 28(3) *Academy of Management Review* 371, 379.

[21] While shareholder primacy takes different guises (eg, S. Bainbridge, 'Director Primacy in Corporate Takeovers : Preliminary Reflections' (2002) 55 Stanford L R 791, 794) what follows is a discussion of the theory that is generally adhered to.

[22] Not all contractarians might agree with this or even accept shareholder primacy in its general form.

[23] M. Bradley, C. Schipani, A. Sundaram and J. Walsh, 'The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads' (1999) 62 *Law and Contemporary Problems* 9, 38.

[24] The literature is extensive. For some of the leading works on the principle, see J. Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson Law Review* 23; S. Bainbridge, 'In Defense of the Shareholder Maximization Norm : A Reply to Professor Green' (1993) 50 *Washington and Lee Law Review* 1423; B. Black and R. Kraakman, 'A Self-Enforcing Model of Corporate Law' (1996) 109 Harv L R 1911; D. G. Smith, 'The Shareholder Primacy Norm' (1998) 23 *Journal of Corporate Law* 277.

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[25] This view is probably most associated with Milton Friedman ('The Social Responsibility of Business is to Increase its Profits' New York Times, September 13, 1970, Section 6 (Magazine), 32, 33. Also, see R. Hessen, "A New concept of Corporations : A Contractual and Private Property Model" (1979) 30 *Hastings Law Journal* 1327 at 1330; M. A. Eisenberg, 'The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm' (1999) 24 J Corp L 819, 825-826. The view has been espoused in the UK by : See Committee on the Financial Aspects of Corporate Governance (Cadbury Report), London, Gee, 1992, para 6.1; Confederation of British Industries, *Boards Without Tiers : A CBI Contribution to the Debate*, London, CBI, 1996, 8. This view has been criticised by many, eg, M. Lipton and S. Rosenblum, 'A New System of Corporate Governance : The Quinquenial Election of Directors' (1991) 58 U Chi L Rev 187, 195; P. Ireland, 'Capitalism without the capitalist : The joint stock company share and the emergence of the modern doctrine of separate

of the shareholders. But the focus on shareholder primacy is not a consequence of a 'philosophical predilection'[26] towards shareholders, but a concern that the business should be run for the benefit of the residual claimants, namely, the shareholders, while the company is solvent.[27] The residual claimants have the greatest stake in the outcome of the company,[28] as they will benefit if the company's fortunes increase, but they will lose out if the company strikes financial difficulties (with their claims being last in line if the company is liquidated), and they will value the right to control above any other stakeholders,[29] as they have an interest in every decision that is taken by a solvent firm.[30]

Other principal arguments in support of shareholder primacy follow. It is fair to say that most are, in some way, informed by the value of efficiency.[31] First, according to the agency theory,[32] a theory advocated by many scholars who favour shareholder primacy, directors are the agents of the shareholders and are employed to run the company's business for the shareholders who do not have the time or ability to do so, and it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.[33] It is said that without shareholder primacy, the directors are able to engage in opportunistic behaviour. Costs, known as 'agency costs,'[34] will be incurred in monitoring the work of the directors, so as to reduce the

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corporate personality' (1996) 17 *Legal History* 40; S. Worthington, 'Shares and shareholders : property, power and entitlement (Part 1) (2001) 22 Co Law 258 and Part 2 (2001) 22 Co Law 307; S. Deakin and G. Slinger, 'Hostile Takeover, Corporate Law and Theory of the Firm' (1997) 24 *Journal of Law and Society* 124 at 126; D. Wood, 'Whom should business serve?' (2002) 14 *Australian Journal of Corporate Law* 1 at 10. Also see, *Short v Treasury Commissioners* [1948] 1 KB 116, 122 where Evershed LJ rejected the notion that shareholders were the owners of a company.

26 n 23 above, 37.

27 F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991), 36-39. Margaret Blair and Lynn Stout take issue with this : 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 Wash U L Q 403, 404. Also, see L. Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189, 1192-1193. Arguably the shareholders are the only residual claimants if the theory adopted is the nexus of explicit contracts.

28 J. Macey, 'Fiduciary Duties as Residual Claims : Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 Cornell L Rev 1266, 1267. This has been queried by several commentators, such as Margaret Blair (*Ownership and Control* (Washington DC, The Brookings Institute, 1995), 229).

29 M. E.van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 Del J Corp L 27, 57; n 23 above, 38.

30 J. Macey, and G. Miller, 'Corporate Stakeholders : A Contractual Perspective' (1993) 43 *University of Toronto Law Review* 401, 408.

31 I am indebted to Chris Riley for this insightful observation.

32 This is based on a large number of works, with the most influential being : M. Jensen and W. Meckling, 'Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; E. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288; E. Fama and M. Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301; Easterbrook and Fischel, n 28 above. Also, see C. Perrow, 'Economic Theories of Organizations' (1986) 15 *Theory and Society* 11, for a discussion from a management perspective. It has been argued that the agency theory is not descriptive of companies : M. Blair and L. Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247, 258-259. It has been asserted that the theory has been abandoned by modern company theorists : G. Frug, 'The Ideology of Bureaucracy in American Law' (1984) 97 Harv L R 1276, 1307.

33 J. Matheson and B. Olson, 'Corporate Law and the Longterm Shareholder Model of Corporate Governance' (1992) 76 *Minnesota Law Review* 1313, 1328.

34 These costs are those resulting from managers failing to act appropriately and the costs expended in monitoring and disciplining the managers in order to prevent them abusing their positions.

incidence of opportunism. The upshot is that shareholder primacy means that directors are made fully accountable for what they do in running the company's business.

Second, it is argued that the principle is based on efficiency.[35] This argument has three parts to it. The first part is that shareholders have incentives to maximise profits and so they are likely to foster economic efficiency. The second part is that it is more efficient if directors operate on the basis of maximising shareholder wealth, because the least cost is expended in doing this;[36] the directors can work more efficiently if they are focused only on one objective and the interests of one investor. The third part is that that shareholder primacy increases social wealth in that many constituencies benefit from the directors being focused on maximising shareholder wealth.

The third argument to support shareholder primacy, and linked to the previous one, is that if directors owe duties to various constituencies, then it would be impossible for directors to balance all of the divergent interests, with the result that directors will make poor decisions.[37] It is said that shareholder primacy is certain and easy to administer,[38] and enables courts to review managerial conduct with some rationality,[39] because the managers only have to concentrate on one goal.[40] In a nutshell, the approach is workable.

Fourth, it is argued that constituencies other than the shareholders are able to protect themselves by the terms of the contracts that they make, while shareholders do not have this kind of protection. Hence, shareholders are vulnerable,[41] as they are at the mercy of the directors, because they have difficulty in monitoring the work of directors. Also, along similar lines, it is argued that non-shareholder stakeholders are protected by regulatory law, while shareholders are not.[42]

Fifth, unlike some groups, such as creditors, shareholders are not always able to diversify their exposure to losses sustained by their investments. Finally, shareholders are not, except in listed companies, always able to exit easily a company with which they are not happy.

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[35] Some empirical evidence suggests that shareholder wealth maximisation may not necessarily be efficient : J. Coffee, 'Shareholders Versus Managers : The Strain in the Corporate Web' (1986) 85 Mich L R 1, 91. Also, see E. Elhauge, 'Sacrificing Corporate Profits in the Public Interest' (2005) 80 NYULR 733, 776.

[36] n 29, above, 56-57. T. Smith, 'The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty' (1999) 98 Mich L Rev 214, 215 questions whether the goal of shareholder maximisation is efficient.

[37] The Committee on Corporate Law, 'Other Constituency Statutes : Potential for Confusion' (1990) 45 Bus Law 2253, 2269.

[38] This is especially when compared with the stakeholder theory under which directors are to act with all stakeholder interests in view : n 30 above, 68.

[39] n 29 above, 69.

[40] M. Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 *European Financial Management* 297, 301; n 9 above, 353-355.

[41] See L. Zingales, 'Corporate Governance' in *The New Palgrave Dictionary of Economics and Law* (Basingstoke, MacMillan, 1997), 501.

[42] n 9 above, 355; n 23 above, 24-29.

The theory is supported by many in the fields of finance and economics and also by many lawyers, particularly those advocating a law and economics approach. It has been said that there has been an ever-increasing focus on shareholder value since the mid-1980s.[43]

B. Criticisms

Notwithstanding the fact that it has been asserted in recent times that corporate governance debates have now been resolved in favour of the shareholder primacy model,[44] with Gilson even saying that corporate law's only distinctive feature is as a means to increase shareholder value,[45] the principle has its shortcomings and its normative value may be questioned.[46]

First, the objective of the theory is unclear, namely whether it involves the increase of shareholder value in the short or the long-term.[47] Clearly short-term and long-term strategies differ, so there is the problem of whether short-term or long-term horizons should be set.[48] Second, and allied to the first point, there are concerns about the theory because it does not really posit what shareholder value actually encompasses. It might mean 'immediate revenue or long range basic profitability of wealth-producing resources.'[49] One of the main criticisms that are espoused by advocates of shareholder value when it comes to a consideration of stakeholder theory is that the latter does not provide managers with any guidance as to how they should manage, with no aim being set, and in fact it could provide an opportunity for managers to shirk. Yet the shareholder value paradigm is itself criticised on the basis that the goal is ill-defined to start with.[50] The reason is that different shareholders will have different aims and so it is not clear what managers should actually be doing. Orts has said that 'shareholders have different time and risk preferences that managers must somehow factor together, if they are to represent fairly the artificially unified interest of "the shareholders" in general.'[51] Orts gives the example of drastic cost-cutting which might achieve short-term results by improving the bottom line for a short while, but in the long-run this might deleteriously affect the company's business.[52] Also, it is difficult for the courts to assess whether directors have in fact maximised

[43] M. Omran, P. Atrill and J. Pointon, 'Shareholders versus stakeholders : corporate mission statements and investor returns' (2002) 11 *Business Ethics : A European Review* 318, 319

[44] n 12 above.

[45] S. Gilson, 'Separation and the Function of Corporation Law' (January 2005) Stanford Law and Economics Olin Working Paper No.307 and available at : http://ssrn.com/abstract=732832

[46] Eg, see n 16 above, 1001-1004; Stout, n 27 above, 1191.

[47] H. Simon, 'Theories of Decision-Making in Economics and Behavioral Science' (1959) 49 *American Economic Review* 253, 262. Stephen Bainbridge favours the latter and would prefer to see it referred to as 'wealth optimization' : *Corporation Law and Economics* (New York, Foundation Press, 2002), 21.

[48] See H. Hu, 'Risk, Time and Fiduciary Principles in Corporate Investment' (1990) 38 UCLA L Rev 277.

[49] P. Drucker, 'Business Objectives and Survival Needs : Notes on a Discipline of Business Enterprise' (1958) 31 *The Journal of Business* 81, 82. For an instance of a court permitting a company to foster long term benefits, see *Shlensky v Wrigley* 237 NE 2d 776 (Ill App Ct, 1968).

[50] P. Joerg, C. Loderer, L. Roth and U. Waelchli, 'The Purpose of the Corporation : Shareholder-value Maximization?' European Corporate Governance Institute Finance Working Paper No. 95/2005, February 2006, 7, and available at http://ssrn.com/abstract=690044

[51] E. Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 *Washington and Lee Law Review* 1565, 1591.

[52] *Ibid*, 1592.

profits,[53] so the idea that shareholder value allows for more assessment of what directors do is illusory.[54]

Third, it is asserted that the theory is too narrow in two respects. First, it does not allow for the fact that many investors are diversified and will be both shareholders and bondholders in companies.[55] Those in this situation are not going to have the same goals as those who are purely shareholders, for the former will be looking for a more balanced approach to the making of investment decisions. In addition, the interests of shareholders are not the only interests that should be considered by directors when carrying out their functions, for there are other important constituencies that warrant consideration from directors.[56] The effect of invoking a shareholder primacy approach is, arguably, to damage the incentives of non-shareholder stakeholders to make firm-specific investments in companies[57] as they are aware that their investments will be subordinated to shareholder interests at all times.[58]

Fourth, while much is made of the fact that the shareholders will be motivated to monitor the managers, many accept that shareholders do not have effective control of managers and so directors cannot be seen as being accountable to them.[59] Admittedly, in recent time we have seen in the UK, but not in the US, a number of occasions where shareholders have organised themselves to have a director removed or, at least, place enough pressure on the board for the board to remove a director, in the broad scheme of things it can be said that the shareholders' power is not all that substantial. This means that the theory is not workable because directors are not always going to be held responsible if they act opportunistically and fail to foster shareholder maximisation.

Fifth, it has been argued that shareholder primacy does not really increase social wealth.[60] It merely benefits shareholders, and only, perhaps, some of the shareholders. For in seeking to pursue shareholder primacy, the company might fail to be able to meet its obligations and all stakeholders will suffer. Also, in focusing on shareholder primacy, a company might find that it is only able to enhance the benefits of shareholders through the transfer of value away from one or more stakeholders, e.g. closing down a factory and making some employees redundant.

[53] Elhauge, n 35 above, 739.

[54] It has been said that shareholder value entails companies focusing on high-value activities and diverse activities should be consolidated for divested : J. Bughlin and T. Copeland, 'The virtuous cycle of shareholder value creation' (1997) 2 *The McKinsey Quarterly* 156.

[55] Smith, n 36 above. Taking such action obviously reduces risk.

[56] Eg, Larry Mitchell criticises the whole notion of shareholder maximisation in corporate law (n 18 above, 640).

[57] These are investments which are difficult to recover once they have been committed to a particular venture.

[58] G. Kelly and J. Parkinson, 'The Conceptual Foundations of the Company : A Pluralist Approach' in J. Parkinson, A. Gamble and G. Kelly (eds), *The Political Economy of the Company*, (Oxford, Hart Publishing, 2000), 131.

[59] See, A. Keay, 'Company Directors Behaving Poorly : Disciplinary Options for Shareholders' [2007] JBL 656.

[60] n 50 above. Sarah Worthington points out that directors may simply act to maximise shareholder wealth (n 26 above, 266 (Part 1)).

Sixth, there are many persons, other than shareholders, who can be said to be residual claimants. The shareholders are not necessarily the ones always most affected by a company's decisions.[61] 'Creditors, managers, employees – even suppliers, customers, and communities – also make firm-specific investments that tie their economic fortunes to the firm's fate.'[62] For example, employees invest firm-specific human capital in the company and this places them in a position where they are vulnerable to management caprice.[63]

Seventh, according to several finance academics, shareholder primacy produces a short-term focus and short-term earnings performance overshadows all else,[64] and this fails to maximise social wealth.[65] While logically shareholder primacy should not necessarily lead to short-termism, with a concomitant fixation on the quarterly earnings of companies and their share value,[66] in practice this has often occurred. Recently, Henry Silverman, a chairman of a US public company, Realogy property services group, complained bitterly about shareholders being obsessed with the short term, so much that he advocated taking companies private.[67] Enron and the effects of its business approach are synonymous with short termism.

Eighth, shareholder primacy might be criticised on the basis that there is no moral reason for the theory's implementation. The shareholders are merely one group amongst many who are affected by the company's actions,[68] so why should they be benefited before others? Shareholder value is very narrow in focus and to such an extent that it is overly glib and fails to consider values other than efficiency. This means that it cannot 'do justice to the panoply of human activity that is value creation and trade, ie, business.'[69] The concern is that the approach tends to ignore reality because more than the interests of shareholders are at stake when we are considering how companies should be run.[70] While some have acknowledged the fact that shareholder primacy provides a convenient common metric, it is too simplistic to reduce everything to a matter of profit.[71] Many see the theory as cold and uncaring and totally omitting the human dimension that is critical to all facets of life, including business.

One of the problems that can result from a company adhering to shareholder primacy is that the directors might choose to follow wasteful investment policies where the company is close to defaulting on its debt obligations.[72] In such situations

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61 n 19 above, 1632; Blair and Stout, n 3 above.
62 Blair and Stout, n 27 above, 418.
63 See M. O'Connor, 'The Human Capital Era' (1993) 78 Cornell L Rev 899, 905-917.
64 S. Wallman, 'The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties' (1991) 21 *Stetson Law Review* 163, 176-177; Lipton and Rosenblum, n 25 above, 205-215; n 29 above, 61.
65 Wallman, *ibid*, 176-177; Lipton and Rosenblum, n 25 above, 203; n 51 above.
66 See, D. Millon, 'Why is Corporate Management Obsessed with Quarterly Earnings and What Should be Done About it?' (2002) 70 *George Washington Law Review* 890, especially, 902.
67 T. Bawden, 'Surge in buyouts of quoted companies as hassled bosses line up to go private' *The Times*, January 13, 2007.
68 Wood, n 25 above, 7.
69 Freeman, Wicks and Parmar, n 17 above, 364.
70 W. Allen, J. Jacobs and L. Strine, 'The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide' (2002) 69 U Chi L R 1067, 1083.
71 Wood, n 25 above, 13.
72 Jensen and Meckling, n 32 above.

shareholders will prefer that directors not invest in certain projects with positive net present value because the net present value generated by these projects, though positive, will not produce sufficient benefits that will go to shareholders, who are more junior to creditors.[73] In such a situation the shareholders might prefer 'a bet the business' type of approach for they have nothing to lose.

A major argument that is mounted against stakeholder theory is that directors are required to balance many interests and that is impossible. Yet in many companies directors who practise shareholder primacy have to engage in balancing as there are different classes of shareholders and their respective interests have to be balanced against one another. Shares come in different shapes and sizes, such as ordinary and preference, and it is incumbent on directors to balance the interests of different kinds of shareholders, so that they act fairly between them[74] as, on occasions, these different classes of shareholders have opposing interests.[75] Macey and Miller point out[76] that some preferred shareholders may have interests that resemble those of fixed claimants, such as creditors, more than those associated with common shareholders. Some shareholders intend only to retain shares for a short term, while others are in for the long haul. Other shareholders hold a diversified portfolio, with their investment spread around a number of companies, and still others might have all their investment concentrated in the one company.

A. Stakeholder theory

B. The theory

While there clearly was some incipient form of stakeholder theory in company law evident in the work of E. Merrick Dodd in his verbal battles with Adolf Berle in the 1930s, where he said that the advancing of the interests of stakeholder groups such as employees and customers as well as the general community seemed to be less abnormal than shareholder primacy,[77] the development of the theory is usually traced to R. Edward Freeman, an organisational behaviour academic, and particularly to his book, *Strategic Management : a stakeholder approach*, published in 1984.[78] Freeman called for a re-think about business organisations, arguing that economic theories that had been pre-eminent were outdated.[79]

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[73] S. C. Myers 'Determinants of Corporate Borrowing' (1977) 5, *Journal of Financial Economics* 147. Also, see, R. Stulz and H. Johnson, 'An Analysis of Secured Debt' (1985) 14 *Journal of Financial Economics* 501; E. Berkovitch and E.H. Kim, 'Financial Contracting and Leverage-induced Over- and Underinvestment Incentives,' (1990) 45 *Journal of Finance* 765.

[74] *Mills v Mills* (1938) 60 CLR 150, 164; *Re BSB Holdings Ltd (No2)* [1996] 1 BCLC 155, 246-249.

[75] M. McDaniel,'Bondholders and Stockholders' (1988) 13 J Corp L 205, 273; R.B. Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561, 593; R. de R Barondes, 'Fiduciary Duties of Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45, 78.

[76] n 30 above, 433.

[77] E.M. Dodd, 'Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?' (1934) 2 U Chi L Rev 194, 199.

[78] Boston, Pitman/Ballinger, 1984.

[79] In broader social terms stakeholder theory has been invoked by several theorists for a great number of years, and one can trace it back to work of a German social theorist, Johannes Althusius, in

The view of stakeholder theory is premised on the idea that in addition to shareholders other groups have claims on the property of companies as they contribute to its capital.[80] It provides that the company is 'a constellation of cooperative and competitive interests possessing intrinsic value.'[81] Many of these contributors, usually referred to as stakeholders,[82] do not have contractual protection or the protection afforded by fiduciary duties and it is argued that their interests deserve consideration by directors as they manage the affairs of companies. The corporate application of the theory is based on the idea that there should be social and economic inclusion, and inclusion implies membership.[83] Under this theory it is advocated that corporate mangers' duty is to create optimal value for all social actors who might be regarded as parties affected by a company's decisions.[84] The argument is that all stakeholders have a right to be regarded as an end and not a means to an end (that is they are not used just to benefit the company in the long run, but their benefits are an end).[85] Stakeholder theory rejects the idea of maximising a single objective, such as efficiency. As a normative thesis the theory holds to the legitimacy of the claims on the company that many different groups have and this justifies its implementation.[86] Donaldson and Preston have said that 'each group of stakeholders merits consideration for its own sake and not merely because of its ability to further the interests of some group, such as shareowners.'[87] The adherents to this theory have advocated concepts of individual autonomy and fairness to all members of society.[88] The theory holds to equality of stakeholders in that they are entitled morally to be considered in the management of the company's affairs and to be considered simultaneously,[89] because corporate decisions affect their welfare. It has been asserted that 'The economic and social purpose of the corporation is to create and distribute wealth and value to all its primary stakeholder groups, without favoring one group at the expense of others.'[90]

Freeman and his co-authors express the rationale behind the theory in this way:

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the seventeenth century : E. Orts, 'A North American Legal Perspective on Stakeholder Management Theory' in F. MacMillan Patfield (ed), *Perspectives on Company Law : 2* (London, Kluwer, 1997), 170.

80 R. Karmel, 'Implications of the Stakeholder Model' (1993) 61 *George Washington Law Review* 1156, 1171.

81 T. Donaldson and L. Preston, 'The Stakeholder Theory for the Corporation : Concepts, Evidence, Implications' (1995) 20 *Academy Management Review* 65, 66

82 See text accompanying n 105 below.

83 W. Hutton, 'An Overview of Stakeholding' in G. Kelly, D. Kelly and A. Gamble (eds), *Stakeholder Capitalism*, (London, McMillan Press Ltd, 1997), 3.

84 R. E. Freeman, *Strategic Management : a stakeholder approach,* (Boston, Pitman/Ballinger, 1984).

85 *Ibid*, 97.

86 See, n 81 above, 66-67.

87 n 81 above, 67.

88 Eg, J. Boatright, 'Fiduciary Duties and the Shareholder-Management Relation : Or, What's So Special About Shareholders?' (1994) 4 *Business Ethics Quarterly* 393; see, A. Licht, 'The Maximands of Corporate Governance : A Theory of Values and Cognitive Style' (2004) 29 Del J Corp L 649, fn 287.

89 R. Mitchell, 'Toward a Theory of Stakeholder Identification and Salience : Defining the Principle of Who and What Really Counts' (1997) 22 *Academy Management Review* 853, 862.

90 M. Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance' (1995) 20 *Academy Management Review* 92, 112

> Business is about putting together a deal so that suppliers, customers, employees, communities, managers and shareholders all win continuously over time. In short, at some level, stakeholder interests have to be joint – they must be traveling in the same direction – or else there will be exit, and a new collaboration formed.[91]

In comparison with shareholder value, no grouping has prima facie priority over another.[92] Partly for that reason, and others, stakeholding is seen as attractive as it tames the 'harsher aspects of capitalism.'[93] It is argued that for a company to thrive it must do more than just produce competitive returns for shareholders. It must satisfy customers in order to produce profits, recruit and motivate excellent employees, and build successful relationships with suppliers.[94] In like manner, it has been asserted that stakeholding is the instrument through which efficiency, profitability, competition and economic success can be promoted on the basis that if one removed cohesion among stakeholders it would not be possible for companies to be competitive.[95]

Probably the attraction for many of this model is that it incorporates moral values as a critical aspect of the strategic management process and it emphasises trust and fairness, rather than efficiency, the latter if concentrated on as a value, or as an end, tends to produce overly harsh results. 'A world dominated by the pursuit of economic efficiency is often lacking in grace and kindness, those wonderful human qualities that society in its finer moments finds so attractive.'[96]

B. Criticisms

Some leading writers have even proclaimed boldly that stakeholder theory is generally so pre-eminent that shareholder primacy is dead.[97] Yet, again, there are many criticisms of the theory in the literature. One of the principal critics has said that the theory is 'deeply dangerous and wholly unjustified'[98] on the basis that it 'undermines private property, denies agents' duties to principals, and destroys wealth.'[99]

Notwithstanding the fact that many years have now passed since Freeman's book, we have yet to see a robust and workable theory formulated. Many proposals have been propounded but they have tended to rely on 'a serious mismatch of variables which are mixed and correlated almost indiscriminately with a set of stakeholder-related

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91 S. Venkataraman, 'Stakeholder Value Equilibration and the Entrepreneurial Process' in R. E. Freeman and S. Venkataraman (eds), *The Ruffin Series No 3 : Ethics and Entrepreneurship* (Charlottesville, Philosophy Documentation Center, 2002), 45.

92 n 81 above.

93 J. Plender, *The Stakeholding Solution*, (London, Nicholas Brealey, 1997) and referred to in J. Dean, *Directing Public Companies*, (London, Cavendish, 2001), 117.

94 Dean, *ibid*, 251.

95 A. Campbell, 'Stakeholders : The Case in Favour' (1997) 30 *Long Range Planning* 446, 446.

96 Campbell, n 75 above, 623.

97 Eg, R. E. Freeman : 'The Politics of Stakeholder Theory : Some Future Directions' (1994) 4 *Business Ethics Quarterly* 409, 413.

98 E. Sternberg, 'The Defects of Stakeholder Theory' (1997) 5 *Corporate Governance* 3, 6.

99 *Ibid*, 9.

performance variables that are not theoretically linked.'[100] The theory has been a difficult concept to define,[101] perhaps because it is 'a slippery creature…used by different people to mean widely different things which happen to suit their arguments.'[102] In addition the theory is explained and justified on the basis of divergent arguments.[103]

One of the main difficulties has been to settle on what is meant by a 'stakeholder.'[104] Probably the first articulation of the concept of stakeholders was provided in an internal memorandum at the Stanford Research Institute in 1963,[105] which said that stakeholders were 'Those groups without whose support the organization would cease to exist.' Freeman built on this and in 1984 defined them as 'any group or individual who can affect or is affected by the achievement of the organization's objectives.'[106] The stakeholder case has probably been harmed by the fact that Freeman included terrorist groups as stakeholders in some companies.[107] Many have sought to distance the theory from this approach. Definitions have varied from the narrow to the very broad. The criticism is that managers are given no basis for identifying who are stakeholders, and the number of people whose interests need to be taken into account is infinite.[108] Furthermore, some stakeholders are more important than others, but there is no guidance to determine who are the more important.[109]

Another major problem is enforcing any breach. Do you give the power to anyone who is a stakeholder to bring proceedings? The availability of statutory derivative proceedings under the Companies Act 2006 will not help most stakeholders as the shareholders, who are the only ones permitted by the Act to initiate derivative claims, will not feel inclined to take action (which opens them up to a costs order) as they will not be benefiting save where they are members of other stakeholder groups.

While often not appreciated, Berle was of the view that running companies for many constituencies was attractive, but his concern was to determine how it could be done.[110] Even Dodd acknowledged[111] that there were significant problems in implementation. Berle observed that if one abandons the focus on shareholder primacy there needs to be a clear and reasonably enforceable scheme of responsibilities to someone else.[112] He felt that this was not possible, and that shareholder primacy was the way forward as it could help to control managers. In

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[100] D.J. Wood and R.E. Jones, 'Stakeholder Mismatching : a theoretical problem in empirical research on corporate social performance' (1995) 3(3) *The International Journal of Organizational Analysis* 229, 231.
[101] n 43 above, 318.
[102] M. V. Weyer, 'Ideal World' (1996) *Management Today*, September, 35, 35.
[103] n 81 above, 66.
[104] See, n 90 above, 858 which identifies 27 definitions for stakeholders.
[105] R E. Freeman and D. Reed, 'Stockholders and Stakeholders : A New Perspective on Corporate Governance' (1983) 25 *California Management Review* 88, 89.
[106] n 84 above, 246.
[107] n 84 above, 52-53.
[108] n 98 above, 4.
[109] n 9 above, 352.
[110] A. Berle, 'For Whom Corporate Managers Are Trustees : A Note' (1932) 45 Harv L R 1365.
[111] E.M. Dodd, 'Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?' (1934) 2 U Chi L Rev 194, 199.
[112] n 110 above, 1367.

more recent times Dean has acknowledged that if stakeholding is to be implemented then there has to be a power to protect stakeholder expectations.[113]

A critical aspect of the theory is that stakeholder management involves 'a never-ending task of balancing and integrating multiple relationships and multiple objectives.'[114] So, directors are required, in making decisions, to engage in balancing the interests of all stakeholders, and that might be seen as an impossible task.[115] There are a huge number of potential stakeholders and the problem for a board is to determine how they are to address the needs of divergent groups.[116] This is exacerbated by the fact that in practice even within a stakeholder group there may well be different views and attitudes.[117]

A concern for directors is to know the basis on which they are to balance interests. There is no guidance for managers in identifying the values relied on in stakeholding and there is no indication how they are they to inform decision-making?[118] It is argued that arriving at a set of values that accounts for the concerns across a heterogeneous group of stakeholders requires managers to fulfil unrealistic expectations.[119] Furthermore, it is argued by many scholars that it is not in fact possible to advance the interests of non-shareholder stakeholders in conjunction with those of the shareholders.[120] Jensen states that '[i]t is logically impossible to maximise in more than one dimension at the same time.'[121] Balancing is made difficult by the fact that as contracts are incomplete it means that the constituencies of a company will usually have conflicting claims and each constituency will be subject to the opportunistic actions of other constituencies.[122] Finally, on balancing, directors are not always aware as to what stakeholders will consider benefits, and it is glib to say that all members of a particular grouping will value the same benefits.

Certainly, as Blair and Stout point out, there is ample evidence from behavioural theory of people acting altruistically and sacrificing selfish interests to achieve a result that benefits others and is consistent with ethical behaviour. Nevertheless, that does not solve the problem of addressing the conflicting interests of constituencies. For example, how do directors deal with the case where several constituencies are deserving, but it is impossible to favour them all, certainly equally.

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113 Dean n 93 above, 176. The learned commentator appears to think that the unfair prejudice ground under s.994 of the Act (formerly, s.459 of the Companies Act 1985) is the most promising for stakeholders (*ibid*, 177).

114 R. E. Freeman and J. McVea, 'A stakeholder approach to strategic management' in M. Hitt, R. E. Freeman and J. Harrison (eds), *Handbook of Strategic Management*, (Oxford, Blackwell Publishing, 2001), 194.

115 The difficulty of doing so is demonstrated in B. Shenfield, *Company Boards*, (London, George Allen and Unwin, 1971), Chapter 7.

116 W. Leung, The Inadequacy of Shareholder Primacy : A Proposed Corporate Regime that Recognizes Non-Shareholder Interests' (1997) 30 *Columbia Journal of Law and Social Problems* 589, 621.

117 S. Letza, X. Sun and J. Kirkbride, 'Shareholding and Stakeholding : a critical review of corporate governance' (2004) 12 *Corporate Governance* 242, 255.

118 n 9 above, 353.

119 n 9 above, 353.

120 Licht n 88 above, 686ff

121 Jensen, n 40 above, 300-301.

122 Blair and Stout, n 32 above, 276-287. The answer according to the learned commentators (pursuant to what they call 'the team production theory') is that the board must make the ultimate decisions in reconciling competing interests and disputes (*ibid*, 276-277).

It is particularly notable that stakeholder theory has failed to devise a framework, which is sufficiently robust and analytical, particularly where there is conflict between the interests of stakeholders. Besides failing to provide too little guidance, the theory also grants too much discretion to directors. According to some, this leads to the potential for directors to engage in opportunistic behaviour, namely taking the opportunity to benefit themselves at the expense of others, because directors end up accountable to no one (known as the 'too many masters' problem). 'A manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither…Agency costs rise and social wealth falls.'[123] Directors can therefore play off one group against another; they can say that after balancing interests they made a decision to benefit stakeholders X and Y, and this decision just happened to benefit or protect themselves. In such a case it is difficult to impugn the directors' decision. In such a system the directors are arguably given too much of an unfettered discretion that cannot be monitored. The response from the stakeholder adherents is that you have to rely upon the professionalism and trustworthiness of the directors. This really then comes down to a philosophical debate. The shareholder primacy school says that you cannot trust directors because human nature is such that it will want to seek benefits at every possible turn (and you must have tight monitoring measures in place), whereas stakeholder theory states that while there will be some improper actions by directors, generally they will be fair and can be trusted.

The problems surrounding the discretion given to directors was highlighted by the Company Law Review Steering Group ('CLRSG'),[124] when it said that it was against stakeholder theory (it referred to it as 'pluralism') because :

> in particular that this would impose a distributive economic role on directors in allocating the benefits and burdens of management of the company's resources; that this role would be uncontrolled if left to directors in the form of a power or discretion; and that a similarly broad role would be imposed on the judges if the new arrangement took the form of an enforceable obligation conferring rights on all the interested parties to argue for their interests in court.[125]

Finally, the Hampel Report explained its concern over the theory when it stated that having directors' duties defined in :

> terms of the stakeholders would mean identifying all the various stakeholder groups; and deciding the extent and nature of the directors' responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would no clear yardstick by which to judge their performance. This is a recipe neither for good governance nor for corporate success.[126]

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123 Easterbrook and Fischel, n 27 above, 38.

124 The Group that was commissioned in 1998 to engage in a comprehensive review of company law. See, Company Law Review, *Modern Company Law for a Competitive Economy*, (London, DTI, 1998), Foreword.

125 Company Law Review, *Modern Company Law For a Competitive Economy* : *Developing the Framework*, (London, DTI, 2000), para 2.12.

126 Final Report of the Committee on Corporate Governance, January 1998, para 1.17 and accessible at http://www.ecgi.org/codes/documents/hampel_index.htm Nevertheless, the Hampel

To sum up the criticisms of many : in seeking the balancing of the interests of all stakeholders, the theory is unworkable.

A A new model : The entity maximisation and sustainability model

B. Introduction

The two primary theories that have just been discussed undoubtedly suffer from shortcomings. Macey has said[127] that no company can sustain the abstract goal of shareholder wealth maximisation or the broad stakeholder model. The former is unachievable given management's control, power and relationship to constituents other than shareholders. Similarly, given the fact that shareholders provide the capital required to keep the company going, the sustained application of the stakeholder model is precluded. Arguably, shareholder value is not attractive from a normative perspective, although it might be regarded as pragmatic and workable. It provides for more certainty than stakeholder theory, but, although often overlooked, it does suffer from some uncertainties, as outlined above. While stakeholder theory has attractions, normatively speaking, because, *inter alia*, it embraces values of trust and fairness, it is not practical.

Consideration of a new model is warranted. This part of the article seeks to do that by proceeding to explain the Entity Maximisation and Sustainability Model ('EMS').

To ensure there is no confusion with stakeholder theory in this part of the article, those people and groups who have interests in the company will be referred to as investors. This is appropriate as people other than shareholders invest capital in companies. Creditors invest their money when they give credit, employees their skill and time, local governments invest in services, and so on. More will be said about these investors later.

Generally the emphasis of the literature has been on the issue : for whom should managers run the business or in whose interests should directors act? The approaches, which have been discussed have said that the business is to be managed either for the shareholders in particular or for the stakeholders in general. However, this suggests a focus on people or groups rather than on an objective. It is too loaded a question to ask for whom the business should be run. Once we focus on groups, partisan interests come to the fore. Of course, one cannot dismiss concern for such groups, but once one begins to ask the question posed above, it becomes difficult for a model outside of the ones discussed already to emerge.

The model that is being proposed here has two elements to it. First, there is a commitment to maximise the entity. This involves, *inter alia*, enhancing the company's wealth, but unlike with profit maximisation this is not always measured by how much profit has been made. The second part is to sustain the company as a going concern, that is, to ensure its survival. An important aspect of the model is that there is focus on the company as an entity or enterprise, that is the company is an

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Committee did acknowledge the fact that to ensure that there is long-term shareholder wealth, directors have to develop and sustain relationships with stakeholders (para 1.18).

127 J. Macey, 'Convergence in Corporate Governance' (1999) 84 Cornell LR 1166, 1172.

institution in its own right. The fact of the matter is that the entity exists separately from those who invest in it, and continues to exist notwithstanding changes in the identity of the investors.[128] It is appropriate to consider the concept of the entity before explaining the model.

B. The Concept of the Entity

EMS turns on the company being regarded as a distinct legal entity. It is not possible to refrain from some consideration of the nature of the company, an issue over which there has been and still is significant debate and uncertainty, although we do not have adequate space to indulge in a sustained consideration of the issue. The first point to note is the fact that EMS treats the entity as an actor, which is responsible for what is done in its name. In this interpretation the company can lead a life of its own.[129] A company is :

> a legal concept which, through the conferment of separate legal personality, provides legal recognition of bodies of persons as distinctive holders of rights under a collective name, having distinct legal consequences. This is not simply a matter of form and fiction.[130] (footnote omitted)

The entity is an organisation that is separate from all those associated with it, including the members, and has legal standing and personality. The company is not a fiction, for the law, in recognising the existence of a company, is simply recognising an objective fact.[131] Under this approach the organisation is very much the key to our experience of the company.[132] The life of the organisation is not simply the sum of all of the actions of the individuals who are involved in the company.[133] It is submitted that Machen is correct when he states 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.'[134]

The corporate form developed because of its unique ability to promote and protect interests not only of shareholders but all kinds of investors whose investment was predicated on the continued existence and financial survival of the company, and all of this was possible because a separate entity was created that was separate from all

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[128] W. Suojanen, 'Accounting Theory and the Large Corporation' (1954) 29 *The Accounting Review* 391, 393.

[129] Blair and Stout. n 27 above, 277.

[130] J. Farrar, 'Frankenstein Incorporated or Fools Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 142 and referring to *The Case of Sutton Hospital* (1613) 10 Coke Rep 1, 32.

[131] A. W. Machen Jr, 'Corporate Personality' (1910-11) 24 Harv L R 253, 260. Also, see W. J. Brown, 'The Personality of the Corporation and the State' (1905) 21 LQR 365 and especially, 370.

[132] W. Bratton, 'The Economic Structure of the Post-Contractual Corporation' (1992) 87 *Northwestern University Law Review* 180, 209. Also, see M. Blair, 'The Neglected Benefits of the Corporate Form : Entity Status and the Separation of Asset Ownership from Control' in A. Grandori (ed), *Corporate Governance and Firm Organization : Microfoundations and Structural Forms* (New York, OUP, 2004), 45.

[133] P. Selznick, 'The Moral Commonwealth : Social Theory and the Promise of Community' (1992), 242 and referred to in n 4 above, 31.

[134] Machen, n 131 above, 363. In a similar vein, see, H. Laski, 'The Personality of Associations' (1915-16) 29 Harv L R 404, 424.

investors.[135] It is able to be asserted that the personality of the company is a key aspect of the corporate form.[136]

Critics might say that it is only incorporation that causes one to assert that a company is an entity. But that is not so. It is possible to argue that one can have an entity outside of incorporation. Clearly, historically, unincorporated bodies have been regarded as entities as a matter of nature. Dicey stated that : '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.'[137] Nevertheless, the concept of the entity has undoubtedly developed from the early days of the modern company law era. This is well articulated by Ireland, Grigg-Spall and Kelly.[138] They explain that there was in the UK a subtle, but critical, distinction made in the Companies Act 1862, when compared with its 1856 successor. The earlier piece of legislation provided in section 3 that 'Seven or more persons…may…form *themselves into* an incorporated company.' This suggested that the newly formed company, while an entity, was made up of the creators. Yet, the corresponding provision in the 1862 Act omitted the words 'themselves into.' So, the indication is that people no longer formed themselves into companies. Rather 'a company was made *by* them but not of them.'[139] This suggests that companies are separate from the members.[140] The learned commentators point out that today a company is normally referred to by the use of the pronoun, 'it,' thus 'confirming its depersonalised, reified status.'[141]

While this is primarily a normative study, it is important to note that there is descriptive support for the entity concept. We have seen in the courts in the UK, the US and other jurisdictions references to companies as entities.[142] The entity theory better fits the law to the facts of the corporate world.[143] It also explains why shareholders can be members of the company, on the one hand, and yet bring legal proceedings against it, on the other. The company remains the same even when the identity of the shareholders and managers changes completely. A company established in the early twentieth century and still existing today has a completely different group of managers and shareholders, yet in a legal sense it is the same company. The decision of the Privy Council in *Lee v Lee's Air Farming Ltd*[144] is pertinent. In this case there was a company, the archetypal 'one man company,'

[135] Blair, n 132 above, 45
[136] Blair and Stout, n 3 above.
[137] *Law and Concern*, 105 and quoted by Laski, n 134 above, 404.
[138] P. Ireland, I. Grigg-Spall and D. Kelly, 'The Conceptual Foundations of Modern Company Law' (1987) 14 *Journal of Law and Society* 149, 150. Also, see L.S. Sealy, 'The Director as Trustee'[1967] CLJ 83, 89-90; D. Millon, "The Ambiguous Significance of Corporate Personhood" Working Paper No 01-6, Washington and Lee University School of Law, January 2001, and accessible at http://papers.srn.com/paper.taf?abstract_id=264141.
[139] Ireland et al *ibid*, 150.
[140] As Ireland et al note (*ibid*, 151), before the 1862 there were indications of companies being regarded as separate from the members. For example, see *Bligh v Brent* (1837) 14 LJCP 193. The learned authors take the view that incorporation was not the source of the separation. Rather it was the changing economic and legal nature of the share (*ibid*, 150).
[141] Ireland et al, n 138, 150.
[142] See, G. Mark, 'The Personification of the Business Corporation in American Law' (1987) 54 U Chi L R 1441, 1465.
[143] *Ibid*, 1470.
[144] [1961] AC 12.

where Lee was the governing director and controlling shareholder as well as being appointed by the company (a crop-dusting contractor) as its chief pilot (and, therefore, an employee). Lee was killed while flying for the company and his wife claimed workers' compensation from the company's insurer. Importantly, the Judicial Committee said that Lee was, in his pilot capacity, contracted to the company. It went on to say : 'That relationship 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.'[145]

In the classic case of *Salomon v Salomon and Co Ltd* [146] Lord Halsbury LC said 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.[147]

His Lordship went on to say that the judges in the lower courts were not certain whether to treat the company as a real thing. His Lordship said that 'If it was a real thing; if it had a legal existence, and if consequently the law attributed to it certain rights and liabilities…it is impossible to deny the validity of the transaction into which it has entered.'[148] In the same case, Lord MacNaughton said that the company is at law a different person altogether from the subscribers to the memorandum.[149]

More recent case law acknowledges the entity principle. The Supreme Court of New South Wales in *Darvall v North Sydney Brick & Tile Co Ltd*[150] said that it was quite proper to have regard to the interests of the company as a commercial entity, separate from the members. The Court of Appeal in *Fulham Football Club Ltd v Cabra Estates plc*[151] appeared to adopt a similar approach when it stated that 'the duties owed by the directors are to the company and the company is more than just the sum total of its members.' In *Peoples' Department Stores v Wise*[152] the Supreme Court of Canada, said that directors had a duty to act in the best interests of the corporation and that 'the best interests of the corporation' meant acting to maximise the value of the corporation. In the US, *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp*[153] also accepted the notion of the entity, referring to it as 'the corporate enterprise.' In that case, Chancellor Allen said that the board 'had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.'[154]

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145 *Ibid*, 25.
146 [1897] AC 22.
147 *Ibid*, 30.
148 *Ibid*, 33.
149 *Ibid*, 51
150 (1988) 6 ACLC 154, 176.
151 [1994] 1 BCLC 363, 379.
152 [2004] SCC 68; (2004) 244 DLR (4th) 564.
153 1991 WL 277613; 1991 Del Ch LEXIS 215 (Delaware Chancery Court).
154 *Ibid*, n 55 (of the case report).

A specific instance demonstrates the approach taken here. It is trite law that no one but the company is entitled to initiate proceedings to right a wrong done to it.[155] Even though derivative actions can now be brought by shareholders,[156] with court approval, the law regards the company as the victim. Such proceedings may be brought to serve the interests of the company as a whole, and not the shareholders' interests (at least not directly). Any financial benefits from the action go into the company's coffers. The existence of derivative actions might be said to be consistent with the acceptance of the entity theory and, even, entity maximisation.[157] Writers like Whincop, who endorse the economic theory of the company to which we will refer shortly, have to go to extreme lengths to repudiate this, and do so by interpreting the exceptions to the rule in Foss v Harbottle as limits on majority rule.[158]

Besides the case law, one can find recognition of the corporate entity, in the way we have been considering it, in the comments of the CLRSG which, interestingly, said that shareholder wealth maximisation was the objective of the company.[159] The CLRSG talked about the business relationships which companies have as important intangible assets of *the company* (my emphasis).[160] It then went on to say that the state of directors' duties at common law are often regarded as leading to directors having 'an undue focus on the short term and the narrow interests of members at the expense of what is in a broader and a longer term sense the best interests of *the enterprise*…' (my emphasis).[161]

In the modern world where the idea of ownership without control prevails in large public companies, where the group of shareholders has become an anonymous mass, the notion of entity sits better with the fact that shareholders of large companies do not effectively control directors[162] as the former are not actively involved in the company's business – they are merely investors,[163] as are others, such as creditors.

Finally, accountants employ the entity concept. They utilise what is known as the entity theory of accounting, the essence of which involves recognising that creditors as well as shareholders contribute resources to the company and the company exists as a separate entity apart from those groups. Assets and liabilities belong to the company.[164]

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155 *Foss v Harbottle* (1843) 2 Hare 461.
156 See Part 11 of the Companies Act 2006.
157 Campbell, n 75 above, 589.
158 M. J. Whincop, 'Overcoming Corporate Law : Instrumentalism, Pragmatism and the Separate Legal Entity Concept' (1997) 15 *Company & Securities Law Journal* 411, 424. This article pre-dated the emergence of a statutory derivative proceedings scheme in Australia.
159 Company Law Review, *Modern Company Law For a Competitive Economy* : *Strategic Framework*, (London, DTI, 1999), para 5.1.17.
160 *Ibid,* para 5.1.10.
161 *Ibid*, para 5.1.17.
162 *Automatic Self-Cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34 (CA); *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614 at 620 (Aust HC).
163 Millon, n 138 above, 8-9.
164 R. Schroeder, M. Clark and J. McCathey, *Accounting Theory and Analysis* 7th ed (New York, John Wiley, 2001), 444.

Notwithstanding the above, there has been a significant amount of criticism of the entity concept of the company,[165] principally by those who are corporate nominalists. Those favouring economic analysis of law tend to assert that the company is an aggregation of persons and the company is an abstraction; Whincop regarded the company as 'a pragmatic compromise.'[166] Easterbrook and Fischel scoffed at the notion that the company is an entity in its own right.[167] They see the concept of 'the personhood of the company as a matter of convenience rather than a reality.'[168] Jensen and Meckling deny that a company has its own goals and intentions.[169] On this view the company is merely regarded as involving actions by individuals and the only aim is to maximise the benefits of the shareholders. Advocates of this approach generally subscribe to the view that the company is a nexus of contracts,[170] whereby the company is seen in economic terms.[171] The firm is not regarded as existing as a separate entity – it is just a shorthand notation for a set of contracts.[172] The firm, as it is often referred to, is merely the sum of the contracts that constitute it and the firm cannot be worth more than the sum of the contracts.[173] The nexus of contracts paradigm asserts that the idea of the company being a person is an empty fiction and is to be rejected.[174] The problem with this view is that if the company is merely a matter of convenience for arranging the affairs of individuals, how can a shareholder sue the company or even be said to own it? 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.

The objection that is sometimes voiced is that the entity concept requires the company to be reified.[175] But the law does not appear to have a problem with reification. Companies legislation in the UK, and many other jurisdictions inheriting UK law, has

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165 Eg, see F. Cohen, 'Transcendental Nonsense and the Functional Approach' (1935) 35 Col LR 809.

166 M. J. Whincop, 'The Political Economy of Corporate Law Reform in Australia' (1999) 27 *Federal Law Review* 77. But see, J. Armour and M. Whincop, 'The Proprietary Foundations of Corporate Law' (2007) 27 OJLS 429, 461.

167 Easterbrook and Fischel, n 27 above, 12.

168 Easterbrook and Fischel, n 27 above, 12

169 n 32 above.

170 This idea is that the parties involved in these contracts are regarded as rational economic actors, and includes shareholders, managers, creditors and employees, and it is accepted that each of these constituencies endeavour in their contracting to maximise their own positions, with the intention of producing concomitant benefits for themselves. The literature considering the nexus of contracts is too voluminous to cite. But see, eg, Fama, n 32 above, 290; F. H. Easterbrook and D. R. Fischel, 'The Corporate Contract' (1989) 89 Colum L Rev 1416, 1426-1427; S. Deakin and A. Hughes, 'Economic Efficiency and the Proceduralisation of Company Law'(1999) 3 *Company Financial and Insolvency Law Review* 169, 176-180; I. McNeil, 'Company Law Rules : An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 *Journal of Corporate Law Studies* 107.

171 S. Bainbridge, 'Director Primacy in Corporate Takeovers : Preliminary Reflections' (2002) 55 Stanford L R 791, 799.

172 n 19 above, 1631.

173 According to Luigi Zingales, some definitions of the nexus only include explicit contracts, while others embrace implicit contracts as well : n 19 above, 1634

174 Although, often law and economics scholars do accept the entity concept when explaining the company in legal terms. For example, see S. Bainbridge, *Corporation Law and Economics*, (New York, Foundation Press, 2002) 7.

175 For example, see Easterbrook and Fischel n 27 above, 11-12; n 51 above, 1578-1579.

contained, for many years, provision for a 'statutory contract.' The section in the Companies Act 2006 which provides for this is section 33. The section states that members are bound to each other and to the company. For the first time in the long history of this statutory contract, it is made clear in section 33 that the company itself is bound by this contract. How can it be if it is not an entity?

Moreover, some writers seem happy to refer to the entity, and say that the entity created by the act of incorporation has the power to make contracts, hold property[176] and to take legal action, but then, in another context, they seek to vilify the concept on the basis of reification. If we can talk about companies owning property, why cannot we talk about them maximising wealth?

B. Maximisation

Entity maximisation involves the fostering of entity wealth, which will involve directors endeavouring to increase the overall long-run market value of the company as a whole, taking into account the investment made by various people and groups. In other words, directors should do that which value maximises the corporate entity, so that the net present value to the company as a whole is enhanced, and so is its strategic importance. In doing this directors should have concern for 'the community of interest.'[177] This means that the common interest of all who have invested in the company is to be fostered, but it does not mean that at some point one group will not benefit at the expense of another.[178]

Maximisation may, in concrete terms, lead to, *inter alia*, improved dividends for shareholders, timely repayment of, and reduction of risk for, creditors, improved working conditions, greater job security and bonuses for employees and a contribution to a stable living environment in which the company operates, and so on. But, rather than the focus being on the investors and their interests, as stakeholder theory requires, the focus is on the entity and what will enhance its position. Any benefits for investors flow from that very object. The entity's interests are to be maximised for the long term – this might entail making less profit one year compared with a previous one, but still maximising the entity for the future. Unlike shareholder primacy, the maximisation process does not focus solely on profit maximisation, for it encompasses such things as augmenting reputation, which can be seen as the most important intangible asset of a company.[179] Firms have economic incentives to have a good reputation in communities where they have offices and factories – they might be

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176 Even law and economics scholars Hansmann and Kraakman ('The Essential Role of Organizational Law' (2000) 110 Yale L J 387) accept that the entity holds assets. This is a key point in their argument that the entity permits asset partitioning, namely providing a separate pool of assets associated with the entity, but separate from those of the shareholders ('owners' according to Hansmann and Kraakman) and managers.

177 In *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* 1991 WL 277613; 1991 Del Ch LEXIS 215; LEXIS 215; (Delaware Chancery Court), at [34] per Chancellor Allen. This might be said to overlap with the argument posited by some, namely that directors act as stewards who identify with their company and its aspirations : J. Davis, F.D. Schoorman and L. Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22 *The Academy of Management Review* 20.

178 This is accepted even by some advocates of stakeholder theory. See n 91 above, 103.

179 Dean n 93 above, 107. Also, see n 119 above, 255; R. Woolley, 'Shareholder Analysis' 31 *Company Secretary's Review* 62, 8 August 2007.

subject to higher taxes or find it hard to recruit workers if their reputation suffers.[180] A company might decline to take on a project that despite being potentially profitable, might alienate the local or wider community and lead to the entity being derided and see its reputation diminish, something that has happened to large well-known companies in recent years. For instance, Nike attempted to maximise profit by setting up manufacturing facilities in low-wage countries, and the reporting of its alleged exploitation of third-world workers, resulted in significant brand damage.[181] Reputation is a multi-faceted element that relies on a great number of issues. The fostering of reputation does not always easily translate into profits. But whilst difficult to measure,[182] an enhancement of it is likely to increase entity wealth in due course.

The vision for the long-term and the maximising of entity wealth means eschewing actions such as trimming labour costs, scrimping on health and safety matters that can put the workforce and the community in danger, the delaying of the payment of creditors and embracing risky ventures, which can produce future credit problems, just to increase revenue growth. Invoking EMS means that directors will not be moved to act in order to justify a high share price, or to 'cook the books,' acquire unprofitable assets or firms or undertake investment projects with negative net present value.[183] It permits managers to invest more in research and development, the training of employees, and to make investments in the local and broader community because it intends to be located there for the long haul. The creation of value does not mean that one has to succumb 'to the vagaries of the movements in a firm's value from day to day.'[184]

It might be argued, in the language of hypothetical bargain theory,[185] that as entity maximisation endeavours to increase the value of all investors' interests *ex post*, the investors would bargain for it *ex ante* if they could have done so.[186] Hypothetical bargain analysis (asking what parties would have agreed to *ex ante*) is just as applicable to contracts between the company and fixed claimants and others as it is to the contract between the firm and the shareholders. For example, if asked, before entering into a contract, creditors would expect there to be an implicit term that directors would not act in a way that would undermine the possibility of repayment. Employees and suppliers would expect something similar. Local government might be willing to provide certain services, but on the implicit basis that the company would retain its factory in the same locality for a reasonable period of time.[187]

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180 L. Ribstein, 'Accountability and Responsibility in Corporate Governance' (2006) 81 Notre Dame L Rev 1431, 1457-1458.

181 Australian Parliamentary Joint Committee on Corporations and Financial Services, 'Corporate Responsibility : Managing Risk and Creating Value,' 21 June 2006, Canberra, para 3.6 and accessible at www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/report/report.pdf

182 *Ibid*, para 4.28.

183 n 50 above, 13.

184 n 40 above, 309

185 Sometimes referred to as 'hypothetical perfect contract.' See C. Rose, 'Stakeholder Orientation versus Shareholder Value – A Matter of Contractual failures' (2004) 18 *European Journal of Law and Economics* 77, 79.

186 Smith n 36, 244; A. Chaver and J. Fried, 'Managers' Fiduciary Duty Upon the Firm's Insolvency : Accounting for Performance Creditors' (2002) 55 *Vanderbilt Law Review* 1813, 1825.

187 This approach is used in relation to companies that are undergoing Chapter 11 bankruptcy in the United States. See *In re Johns-Manville Corp* (1985) 52 Bankr 879 (NY); *Official Committee of Unsecured Creditors v R F Lafferty & Co* (2001) 267 F 3d 340 at 348 (3rd Circuit). See, R. Nimmer

Some, such as Jensen, argue that the corporate objective must be one that has a single value, and in his view this should be the maximisation of shareholder value.[188] Jensen states that one cannot tell a manager to maximise current profits, market share, future growth in profits etc as that leaves the manager with no objective. There is much to commend having one main objective. In fact EMS has one overall goal (it is argued later that maximisation and sustainability are complementary), but how that is implemented will, obviously, depend on a number of issues including the company's circumstances and business strategy, and market conditions. So how companies actually achieve the objective of maximisation is a matter for them given their business aims, and the market in which they operate.

One of the concerns that we identified with stakeholder theory was that the balancing of the interests of investors is difficult to implement. Is entity maximisation approach any different? With EMS directors do not have to engage in active balancing between investors' interests as their aim is to maximise entity wealth. To be sure, the directors will inevitably have to undertake some balancing, as is necessary in applying most principles, including shareholder primacy. But the balancing, unlike that in stakeholder theory, is not of interests, but of courses of action, and it has a clear goal, namely the maximisation and sustainability of the entity. The problem with balancing, as it exists in the context of stakeholder theory, is that there is no goal to the balancing; balancing is an end. But with EMS it is only part of the process, in attaining the purpose. EMS does not force directors to weigh up the benefits and harm accruing to different stakeholders as a result of a particular action. Their remit is to act to enhance the wealth of the entity, and any balancing must seek to achieve this. The directors have to be the ones who decide what will maximise entity wealth, based on the circumstances and advice they take. Of course, they are accountable for their decisions, and this issue is discussed later.

It is submitted that EMS is justifiable on basis of the values of fairness and efficiency. The former because those investing in the company have its affairs run so as to enhance the company's wealth and not ultimately for a particular group. Fairness is, of course, incapable of precise definition. There are potentially many dimensions to the value of fairness and it is not possible to provide an exposition of all of them here. Fairness in our legal tradition assumes support for those who are vulnerable and the meeting of people's reasonable and legitimate expectations. Many investors are vulnerable *ex ante* because they often do not have the necessary information, knowledge or bargaining position that enables them to either protect themselves adequately or to charge a price for their investment. Furthermore, most investors are vulnerable after having contributed to the company for there few or no ways of securing information and they have little or no influence on the company's management. Fairness dictates that the actions of management do not directly or indirectly transfer wealth from one set of investors to another.

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and R. Feinberg, 'Chapter 11 Business Governance : Fiduciary Duties, Business Judgment, Trustees and Exclusivity' (1989) 6 *Bankruptcy Developments Journal* 1, 33. Also, see, eg, *In re Central Ice Cream* 836 F 2d 1068 at 1072 (7th Circuit, 1988). Although what is meant by this is not articulated clearly : Nimmer and Feinberg refer to the need for the debtor in possession (the company's management) to balance the competing interests present : *ibid*, 34

188 n 40 above, 300.

The concept of reasonable and legitimate expectations in essence is a contract-based idea, the object of which is to fill in the gaps in a contractual relationship. It involves asking what reasonable parties would have wanted to have included in their contract had they thought about the issue.[189] It is fair that an investors' reasonable expectations at the time of contributing to the company are fulfilled. This will obviously mean different things for different investors.

EMS is efficient as fewer transaction costs might result. First, investors are not likely to be so concerned about negotiating such complicated contracts so as to include, *inter alia*, provision for wide-ranging protection measures. Second, it will mean that existing employees, creditors and others want to continue to invest in the company, thus reducing the cost of finding, and contracting with, new investors. Keeping investors contented will enhance and sustain the company, for, when compared with shareholder primacy, it is more likely to precipitate loyalty from the investors. Arguably without loyalty the future of a company is limited. Loyalty is engendered because the directorial focus is on maximising the entity's wealth and not benefiting a single group. There will, in some situations, need to be a balance struck between !

C. Investors

The EMS approach recognises that corporate wealth is not generated solely by the shareholders' input, for it is also fostered by other investors who make 'firm-specific' investments. The entity needs : investment capital; to borrow money; products and services on credit; employees to contribute their skill and labour; services supplied by local government and utility suppliers, and so on. The people and groups providing these benefits can be said to have made an investment in the company. It has been asserted that no business can run without opportunity capital, namely making use of 'a pre-existing knowledge base, (subsidized) education system, police function, and infrastructure (roads, water mains, sewage systems etc).'[190] The point is that companies do draw on the work of many people over a long period of time to provide certain facilities and circumstances, and this is as important to companies as shareholder funding. There is, to a degree, an interdependence of investors and EMS recognises that fact. The rights of all investors are not to take precedence over those of the entity (the community of interest), but those who invest in the company have a legitimate expectation to a return on that investment. Such investors' incentive to do so will be greatly reduced[191] if they believe that receipt of any benefits will always depend on what advantages shareholders in any given situation. Moreover, it has been suggested that any perceived distinction between the shareholders and outsiders are, for the most part, artificial.[192] While shareholders undoubtedly assume significant economic risk, so do other investors, eg, the employee who moves half-way across the country to take up a position with a company. Unlike the shareholder, the employee who makes such a move also takes social and emotional risks.

189 L. Mitchell, ' The Fairness Rights of Bondholders' (1990) 65 NYULR 1165, 1225.
190 E. Schlossberger, 'A New Model of Business : Dual-Investor Theory' (1994) 4 *Business Ethics Quarterly* 459, 461.
191 n 70 above, 1077.
192 n 180 above, 1442.

Shareholders often hold diversified portfolios, investing as lenders in companies as well as in equities.[193] They are also consumers and employees of companies as well as having other interests in companies. So shareholders are more likely to benefit overall if EMS is the objective of companies for it is the best way of satisfying their interests, as it would mean that the entity would develop and survive and would ensure that they benefit in all their various roles. It is important to emphasise that shareholders are investors and not owners, as sometimes they are so described. They only own the capital which they have invested and the share of the company that that investment reflects.

The point has been made by several commentators that human capital invested by employees in businesses has, in particular, become very important, while there has been a commensurate reduction in the importance of physical assets.[194] In knowledge-based economies, intangible assets, such as human capital are emerging as the most crucial assets for companies,[195] because, *inter alia*, there is increased demand for innovation.[196] More and more of business is dependent on human know-how, so that : 'Employees are not merely automata in charge of operating valuable assets but valuable assets themselves, operating with commodity-like physical assets.'[197] Drucker refers to such persons as 'knowledge workers.'[198] Employees make an investment in the company and like money investors in the company, trust the directors to manage the company well. Employees are, in many companies, viewed as the company's main assets e.g., football clubs. This means that the approach of shareholder primacy, with only shareholders getting the surplus, is no longer tenable.[199] Power and rents are no longer restricted to the top of the management structure, but they are distributed among other employees and those outside of the traditional boundaries of the firm, such as critical suppliers.[200] Redundancy of employees has often been seen as a way to reduce costs, but it may not enhance entity wealth because the company loses skills, and, perhaps, even more importantly it creates morale problems in relation to employees that remain,[201] with the possible result that the company will not be able to attract new, or at least the best, workers from the community in the future when they are needed.[202]

For the most part EMS will, indirectly, benefit the investors. But benefits cannot be guaranteed. Sometimes one investor, A, will benefit over another, B, and at other times B might benefit over A, and, at other times all will benefit. To create entity value it will be necessary for managers to make decisions that might well affect the

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193 R. Gordon. 'Do Publicly Traded Corporations Act in the Public Interest?' (2003) 3 *Advances in Economic Analysis and Policy* 1, 1. Also, see Smith n 36 above.

194 n 19 above, 1643

195 n 19 above, 1624. Also, see M. O'Connor, 'The Human Capital Era' (1993) 78 Cornell L Rev 899; J. Singer, 'The Reliance Interest in Property' (1988) 40 Stanford L R 611, 621; D. Millon, 'Redefining Corporate Law' (1991) 24 Indiana L R 223, 234-235.

196 n 19 above, 1642; Blair and Stout n 33 above, 261.

197 n 19 above, 1641.

198 *Post-Capitalist Society*, (New York, Harper Collins, 1993) and referred to in T. Clarke, 'Introduction' in n 13 above, 23.

199 n 19 above, 1645

200 n 19 above, 1647-1648.

201 C. Bull, 'The Existence of Self-Enforcing Implicit Contracts' (1987) 102 *Quantitative Journal of Economics* 147, 149-154.

202 J. Macey, 'Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes' (1989) Duke L J 173, 192.

position of investors, but all investors must be persuaded that they will, at some point, benefit from entity maximisation or else they will withdraw that investment. If EMS is the focus then they should not want to do so; they will remain loyal. As, under EMS, all investors will not be totally satisfied all of the time, it is necessary that directors provide proper explanations for their decisions so as to prevent unnecessary disaffection, untimely withdrawal, and damage to the company's reputation.

C. Hard Decisions

There are obviously hard decisions that have to be made with any model that is applied, and it is no different under EMS. The most difficult decisions that are likely to have to be made are those where a course of action will deleteriously affect one or more investors. There are countless fact situations that could present directors with hard decisions, and, of course, much will turn on the actual circumstances, the position of the company and the nature of the market. Here are a couple of instances. First, a company is clearly profitable, but it has ascertained that it might be able to make more profit in another location. This would involve closing down the factory in the original location. Re-location will obviously affect both employees and the community, with possible effects on the company's reputation. The directors might reason that the re-location might not be sensible taking into account the effect, certainly in the short-medium term, on reputation. However, on the other hand, if the closing down might be good for the long-term benefit of the company, then the directors might take the view that the entity is best maximised if it were to re-locate. The decision would depend, to a large degree, on directors balancing the benefits against the drawbacks. But, unlike under stakeholder theory there would not be a balancing of stakeholder interests, but a balancing of factors to ascertain the overall benefit for the entity.

Second, what if a company devises a way of producing products for their customers so that the products are as good as they have always been, but the process is less costly. Should the company charge customers the same price and make more profit, or should they pass the benefit on to customers? One might be of the view that the company is entitled to greater profit because it has implemented efficient processes. Perhaps the latter option is better for the long-term, as it might well enhance goodwill and loyalty, but the directors have to take into account any adverse responses from investors, particularly the shareholders.

How does EMS deal with the facts of the well known US case of *Shlensky v Wrigley*.[203] In this case the directors of the company that ran the Chicago Cubs baseball team refused to erect lights at the team's stadium to permit night games to be played because they were concerned that it would have a deleterious effect on the lives of people living in the surrounding community. The shareholders brought an action against the directors for failing to pursue shareholder primacy. The decision of the directors could very well be justified under EMS on the basis that any ill-will created in the community would not be good for the reputation and, ultimately, company wealth in the long-term.

B. Sustainability

203 237 NE 2d 776 (Illinois, 1968).

A word about the term 'sustainability' is appropriate. The term has in many ways become 'a mantra for the 21st century.'[204] Yet it does not have a consistent meaning. It is a 'contested concept'[205] and deciding on a meaning is a vexed problem.[206] It has been defined as 'the activities, demonstrating the inclusion of social and environmental aspects in the normal business operations of a company and its interaction with its stakeholders.'[207] Some might say that it is inextricably linked to stakeholder theory as it might be defined as meeting the needs of a firm's stakeholders without compromising the ability of the company to meet the needs of future stakeholders as well.[208] The concept is seen by some as having three dimensions – the economic, the social and the environmental, and often known as the triple bottom line of corporate sustainability.[209] It involves growing the economic, social and environmental capital base, with rejection of simply focusing on economic sustainability.[210] However, entity sustainability in this article simply means the survival of the company, namely the company does not fall into an insolvent position from which it cannot escape. But, sustaining a company could well involve, as a matter of necessity, having concern for social and environmental sustainability, and the extent of concern will depend on the nature of the company's business. Keeping a workforce satisfied, and refraining from abusing the environment could set the scene for wealth maximisation, as there is evidence that there is congruence of social and financial performance.[211]

Maximisation of entity value is designed to lead to growth, but it is only half of the story. It is also necessary for the company to aim for long-term survival. 'Growth and survival are two sides of the same coin,'[212] and the focus on only one of these aims does not necessarily mean either or both can be achieved. In fact achieving sustainability over a period of time, is an indication that the company is maximising the long-term market value or the wealth of the entity and that any risks that are inherent in the company business activity are being minimised.

The aspect of the model that is discussed in this section is designed to foster the existence of the entity as a going concern. It is critical that the company does not become insolvent, or if it does, it is only a very temporary phenomenon. The merit of seeking to ensure survival should be self-evident,[213] for if a company does not sustain

204 T. Dyllick and K. Hockerts, K, 'Beyond the Business Case for Corporate Sustainability' (2002) 11 *Business Strategy and the Environment* 130, 130.

205 D. Dunphy, 'Corporate Sustainability : Challenge to Managerial Orthodoxies' (2003) 9 *Journal of the Australian and New Zealand Academy of Management* 2, 3.

206 Jeremy Cooper, Deputy Chairman of Australian Securities and Investments Commission in a submission to the Australian Parliament's Joint Committee on Corporations and Financial Services and referred to in its report, n 182 above, para 2.3.

207 A. Caldelli and M. L. Parmigiani, 'Management Information System – A Tool for Corporate Sustainability' (2004) 55 *Journal of Business Ethics* 159, 159.

208 n 205 above, 131.

209 n 205 above, 132. The triple considerations are sometimes known as 'People, planet and profit.' See, T. Hardjono and P. de Klein, 'Introduction on the European Sustainability Framework (ECSF)' (2004) 55 *Journal of Business Ethics* 99, 99.

210 n 205 above, 132.

211 R. Aguilera et al, 'Putting the S Back in Corporate Social Responsibility : A Multi-Level Theory of Social Change in Organizations' (2007) 32 *Academy of Management Review* 836.

212 M. J. Gordon, *Finance, Investment and Macroeconomics : The Neoclassical and a Post-Keynesian Solution* (Aldershot, Edward Elgar, 1994), 94.

213 *Ibid*, 93.

itself, it cannot make wealth for anyone. When investors sign up to be involved with a company they envisage that the focus will not only be on maximisation, but also on survival (so that capital is safe, loans are repaid, wages are satisfied etc).

It has been asserted that all approaches to business enterprise begin with asking what are the survival needs of a business? That is, 'what …does it have to be, to do, to achieve – to exist at all?'[214] Companies have to ask : on what does our survival depend? The fact of the matter is that to seek profit maximisation without consideration of survival misses the point for the company might well fail to survive.[215]

It might be argued that if one focuses on maximisation, then survival is taken care of and the issue of survival does not need to be broached. Yet, survival is something that has to be aimed for and not something that can be expected.[216] In seeking to maximise, the company must maintain economic (efficient rendering of services) and financial (maintaining an atmosphere conducive to attracting further business capital) competence.[217] It cannot expect to survive or else complacency sets in. Companies, even the most solvent ones, might well be only one decision away from insolvency.[218] All it takes is one risk that goes wrong for a company to find itself in an insolvent state. A prime example is Barings Bank, which was once highly solvent, but which became insolvent as a consequence of huge losses on derivatives.[219] A trader, Nick Leeson, was left in control of both the dealing and settlement functions (a very powerful position) at the bank's Singapore office. If the actions of Leeson, which can be referred to as 'bets,' succeeded, the shareholders of Barings would have benefited substantially.[220] The risks did not work out, and they precipitated the collapse of the bank. Even a company that is delivering high shareholder value might well be on the brink of financial collapse in the near future.[221]

While the directors are seeking to maximise, the company must sustain itself – it is no good if the strategies will bring benefits down the track if the company is not able to meet financial demands in the short-medium term. Managers must develop a strategy that combines the maximisation of long-term value, and survival, particularly in the short term for creditors are not necessarily going to wait for any master plan to unfold – they will have to be convinced that the company will be able to sustain itself. The need to ensure survival will prevent short termism, for the company must ensure that its value will continue to develop and that wringing out profits today does not mean insolvency tomorrow. There is a need to achieve a balance so as to ensure both survival and growth.[222]

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214 Drucker, n 49 above, 84.

215 A recent example is Enron Inc.

216 D. Li, 'The Nature of Corporate Residual Equity Under the Equity Concept' (1960) 35 *The Accounting Review* 258, 259.

217 *Ibid,* 259, 262.

218 Smith n 36 above, 223 and referring to C. Loomis, 'A House Built on Sand : John Meriwether's Once Mighty Long-Term Capital Has All But Crumbled' *Fortune*, Oct 26, 1998, 110.

219 N. Denton, 'The Barings Crisis : Disaster, Just When Most Things Were Going Right' *The Financial Times*, Feb 27, 1995, 3.

220 Smith n 36 above, 225.

221 n 95 above, 449.

222 Drucker, n 49 above, 88. Of course, these objectives may pull in different directions.

Survival is the necessary precursor of all of a company's specific goals.[223] Without survival a company, naturally, cannot achieve anything. This is why it is argued that it must be factored into any formulation of the corporate objective. But, it cannot be regarded as the only objective as it does not provide sufficient direction and aspiration needed for a corporate objective. Survival entails ascertaining the minimum profit that is required to meet the risks that are assumed,[224] but it is only a minimum point. Seeking merely to survive means there is a lack of ambition. More importantly, firms cannot in fact survive without making profits.[225] A company has to grow as it cannot just standstill. Where, for instance, a company is in a market where there are a large number of competitors, over a period of time the only strategy that will ensure survival is the one that maximises company wealth.[226] Companies should be making as much as it can, whilst taking into account the need to retain economic and financial stability that will ensure survival. Maximising wealth is to be aspired to while keeping a watchful eye on the survival of the company.

Sustainability will mean managing carefully the company's various types of capital/assets, namely financial capital (equity and debt) tangible capital such as plant, land, stock and intangible capital, such as reputation, intellectual property, and know-how. If a company is sustained economically then it will guarantee a cash flow sufficient to ensure liquidity. To survive a company must do certain things.[227] First, it has to have a human resource structure that is effective in that people work for a common cause and are organised for joint performance. This human resource must be able to perpetuate itself. Second, the company must be able to adapt to the society and economy in which it operates. Third, there is the need to attain a minimum profitability that is adequate to the risks which are assumed.

To be sustainable a company must be able to pay its business expenses. They are often referred to as 'overheads,' and feature the costs associated with borrowing money, payment of employees, purchasing materials needed for the business etc.

Arguably, directors have an interest in sustainability as it enables them to keep their jobs, and it enhances their reputation as far as the labour market is concerned; the reputation of executive directors is likely to plummet if they oversee a company's slide into insolvency. There is evidence from the US that suggests directors who resign, or are retrenched, from financially distressed companies will experience difficulties in finding a similar post in the labour market.[228]

Aiming to sustain can have a beneficial effect generally, because if a company suffers financial distress and its survival is in the balance, even if it is quite temporary, it

[223] D. Li, "The Objectives of the Corporation under the Entity Concept" (1961) 39 *The Accounting Review* 946, 948.

[224] Drucker, n 49 above, 86.

[225] R. Eels and C. Watson, *Conceptual Foundations of Business* (Homewood, Richard D Irwin, 1969), 535. See D. Rose, 'Teams, Firms and the Evolution of Profit seeking Behavior' (1999) and accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=224438

[226] S. Enke, 'On maximizing profits : a distinction between Chamberlain and Robinson' (1951) 41 *American Economic Review* 566.

[227] The following are adapted from Drucker n 49 above, 85-87.

[228] S. Gilson, 'Management Turnover and Financial Distress' (1989) 25 *Journal of Financial Economics* 241, 254.

might well have very long-term consequences on the value of the firm.[229] Evidence indicates that financial distress of a company can lead to underinvestment in valuable projects.[230] So, a company that focuses on sustaining itself might well reduce the chances of it experiencing distress and, therefore, detrimental effects in terms of value.

The sustainability over time of sound economic and financial conditions is the necessary requirement for the company to remain a 'going concern.' Development of the business activity under sound economic and financial conditions when resulting in the survival and development of the business satisfies all investor interests.

B. Distinguishing the Model

It is important to identify how the model posited here is different from others. First, EMS is clearly different from shareholder primacy because with the latter there is the temptation to subtract from other investors in order to boost shareholder benefits, that is, a company might find that it is appropriate to transfer value away from one or more investors to ensure that shareholders benefit. For example, the management lays-off workers, or embraces a high risk strategy that might jeopardise the payment of creditors, so that the shareholders can be paid a larger dividend and/or the share price increases. EMS seeks to take the course of action that will enhance entity wealth, and not only the wealth of shareholders.

Unlike with stakeholder theory, in EMS the directors are not required to balance all investors' interests or resolve conflicts per se, but merely to ascertain what action will maximise the wealth of the entity. Directors might have to take action which damages one investor because that is best for the entity as a whole, eg, the closing of a plant. The managers are seen as representatives and guardians of all stakeholder interests in stakeholder theory,[231] whilst under EMS the emphasis is on the directors acting as agents for the corporate entity. Directors are not referees; they will take the action that serves the continuing prosperity and development of the company as an entity.

An interesting theory, known as 'team production' (TP), was formulated in 1999 by Blair and Stout[232] and warrants some consideration. In a nutshell the main thrust of this approach is to say that the company is a team to which different persons contribute, and from which they can expect returns. The theory sees an independent board of directors as mediating hierarchs in monitoring inputs and outputs, with shareholders not having control rights. The directors have ultimate power in both determining how company assets are to be used and in reconciling conflicts between the various interests of team members. The problem with this approach, as with the stakeholder approach, appears to be that it does not indicate how directors are to reconcile conflicting interests. EMS differs from TP in that it sets an objective for a

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229 n 19 above, 1633.

230 n 19 above, 1636

231 K.L. Hall, *The Magic Mirror : Law in American History*, New York, OUP, 1989) and referred to in n 125 above, 250.

232 Blair and Stout, n 32 above. The theory built on the work of others, such as A. Alchian and H. Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777.

company that is not directly related to the investors (who are the team under TP), while the team approach requires, without any guidance, directors to look after the team members' interests. Also, and importantly, TP does not formulate a corporate objective; rather it is a theory of the firm (the authors seek to depose the agency theory) and seeks to describe what actually happens in the company (and answers the question : why are directors given so much discretion in public companies?), while EMS seeks to provide a normative objective of the company.

B. Directorial Discretion and Accountability

While the steps in the previous sections of the article delineate what directors can do, directors will retain under EMS an extensive amount of discretion in what they do and how they do it. This is not a perfect solution, but undoubtedly, and most would agree, the placing of significant discretion upon the directors is largely unavoidable, for even under shareholder primacy, directors have broad discretion. It is clear that the 'core of management decision-making is centered on discretion rather than an application of preset formulas.'[233] To perform efficiently directors have to be granted open-ended discretions.[234] We have to accept that it is a company's management, with its organisational skills, that is able to decide how to maximise the entity's wealth so as to make a large-scale enterprise productive in the long-run. This comes down partly to trust and dependence on their professionalism.[235]

Having said that, we must not forget that that there is a mixture of contractual, regulatory, market and fiduciary constraints on the choices which directors can make. For instance, managers remain subject to the financial markets, the market for control and the product markets[236] and these provide highly objective and demanding guidelines.[237] While directors do enjoy significant discretion they will be discouraged from shirking and failing to maximise the entity because they are likely to be subject to discipline in one form or another. Their discretion is, practically, limited to some extent by economic pressures, such as the cost of capital, the availability of employees who are sufficiently skilled, the demand for the company's goods and whether creditors feel disposed to lend.[238] To a degree directors have an incentive to exercise their discretion fairly for if they do not then certain investors might exit, necessary finance might not be attracted or key employees might become disenchanted and resign, and that could lead to the end of the business, leaving directors without a job.[239] Also, directors must always have in their mind that they might be held accountable for their actions at some stage, such as if there is a takeover (and new management installed) or liquidation.

Undoubtedly, there is room for directors to act opportunistically, but this is the case with companies operating under shareholder primacy (and stakeholder theory).

233 Nimmer, n 187 above, 36.
234 M. J. Whincop, 'A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care' (1996) 6 *Australian Journal of Corporate Law* 72, 83.
235 The issue of trust is too immense to discuss here. But see, Blair and Stout, n 33 above, 316. Also, see M. Blair and L. Stout, 'Trust, Trustworthiness and the Behavioral Foundations of Corporate Law' (2001) 149 U Pa L R 1735 where the authors consider trust in the wider corporate setting.
236 See, eg, the works cited at n 32 above.
237 n 95 above, 448.
238 Blair and Stout, n 27 above, 438.
239 Blair and Stout, n 32 above, 283.

Shareholder primacy prides itself as providing the best answers to the agency problem, yet there are spectacular examples, such as Enron and WorldCom in the US, Maxwell Communications in the UK and HIH Insurance and One.Tel in Australia, of the failure to monitor and rein in directors. Clearly, managers have, under shareholder primacy, plenty of scope for self-serving activity.[240]

In managing the business the board would have to ensure that it is not unduly influenced by political power so as to favour a particular investor. Examples of political power in this context are the formation of coalitions of shareholders, publicity campaigns, employee action etc. In the framework suggested, it is critical that directors remember that they are not to act either as advocates of any investor group or as part of one. Although not a primary role of directors, it might be necessary for directors, at times, to mediate where there is an apparent conflict between interests,[241] so that the most efficient outcome can be achieved for the benefit of the entity.[242]

It is simply not possible to formulate a single overarching principle or test to guide directors how to act, as circumstances will be so varied and the issues that directors encounter are often complex and multifaceted. That is why it is necessary to have flexibility, and to have a model that embraces broad principles rather than specific rules.

B. Profits and Distribution

If the goal of a company is to maximise the total value created by the entity, that is produce as much wealth as possible for the entity, and at the same time ensure the survival of the operation of the company, one then has to consider what directors are to do with the wealth generated. Directors are able to pay-out additional non-contractual benefits to any investor – no group can demand preferential treatment.[243] There are many options, such as the payment of dividends, investment in new plant and equipment, bonuses to employees, donations to local community projects and so on. This issue is not directly part of the objective, although of crucial importance. Enlightened shareholder value, the concept introduced by section 172 of the Companies Act 2006, captures this to some degree in saying that the directors are to manage so as to promote the success of the company, but it then qualifies this by stating 'for the benefit of the members as a whole.'[244] Under section 172, the success of the company and the benefit of the members cannot be separated, whereas EMS purports to do so. Maximising entity wealth should benefit the members, but indirectly in that it is a consequence of success of the company. One can distribute on the basis of people get what they deserve – using the concept of distributional justice. The problem is that it is often impossible to determine what are in fact an investor's just desserts in a corporate situation.[245] Rather, EMS provides that directors should apportion profits in such a manner that will permit the company to survive and to go

[240] n 81 above, 87.
[241] n 116 above, 590.
[242] n 116 above, 605; n 18 above, 633.
[243] Worthington n 26 above, 312 (Part 2).
[244] The CLRSG accepted shareholder primacy as the objective of the company, so one assumes that this involves direct benefits for members.
[245] See n 16 above, 1025. In this respect the situation under TP might be no different than under shareholder primacy theory *(ibid*, 1026-1027).

on and maximise its wealth in the future. For example, the company might decide at a particular point of time not to pay as high a dividend as it could because it wishes, perhaps, to pay a bonus to employees and secure employee loyalty. All of this can be assessed on the basis of ensuring the company remains economically and financially sound. This will involve some balancing, but that must be based on what will eventually maximise the entity and sustain it. What is done as far as distribution is concerned is likely to affect, in a not insubstantial way, the future of the company.

There are obviously market-driven baselines that may well dictate how the board distributes funds. For instance, dividends will usually have to be paid out both to ensure retention of shareholders and a keenness amongst shareholders to take up any new share issue. There might be a need to pay a bonus to certain skilled workers who might be head-hunted by other companies. At this time Blair and Stout indicate, it is the task of the directors to balance competing interests in such a way as to keep everyone happy,[246] but unlike Blair and Stout who see the divvying up of the profits as dependent somewhat on political power,[247] rather than any principle, EMS lays down the principle for any distribution, namely that it must be done so as to produce entity enhancement. EMS is not primarily concerned about keeping everyone happy, although that is preferable, if possible, but rather it is focused on a distribution strategy that will maximise the company's long-term wealth creating capacity.

The concept of profit needs to be examined more closely. If the shareholders are seen as the owners of a company, then it is an easy step to regard what remains after discharging outgoings, such as buying goods and employing people etc, as the profits, and they are to go to the shareholders. But the concept of profits is more than the sums that are paid to shareholders as dividends each year or is reinvested in the company. Profit can be seen as the portion of the income of the company less that which has to be used to pay overheads, namely the costs associated with borrowing money, payment of employees, purchasing materials needed to pursue the development of the business etc. On the basis the shareholder is merely one investor, albeit an important one, and it is appropriate to see dividends as business expenses (needed to be paid to satisfy shareholders and retain them) rather than to be perceived as something that is paid after the meeting of business expenses,[248] or as returns on their ownership of the company.

Intuitively the above system would be fairer as investors are benefited to the extent that they can enrich the company entity; that is, if they are critical to the entity surviving and developing then they should be rewarded.

A Conclusion

This article proceeded on the basis that ascertaining the objective of the company is an important assignment. There is no legislation or case law that unequivocally sets out in Anglo-American law what it is to be, although there are two dominant theories, the shareholder primacy and stakeholder theories that have been argued for on many occasions in the literature of various academic disciplines. The article examined the two theories and argued that both have significant shortcomings and neither is to be

246 Blair and Stout, n 32 above, 281.
247 *Ibid*, 323-326.
248 D. Schrader, 'The Corporation and Profits' (1987) 6 *Journal of Business Ethics* 589, 599.

commended, for different reasons. Both are either normatively and/or practically flawed.

Rather than relying on either of the dominant theories, the article has advocated another approach, namely the entity maximisation and sustainability theory. This focuses on the company as a separate legal entity and maintains that the objective of the company is to maximise the wealth of the entity as an entity and, at the same time, to ensure that the company is sustained financially. The theory involve directors endeavouring to increase the overall long-run market value of the company as a whole, taking into account the investment made by various people and groups. But it maintains that maximisation must be combined with aiming to ensure entity survival. The theory values the broad range of people and groups who invest in the company and maintains that they should benefit from their investment. Undoubtedly, the directors, as in all models, play a critical role in this system, for they are to be seen as the guardians of the enterprise objectives, which are survival and growth; they have to determine what action is required to ensure that the company's wealth is maximised at the same time as securing the company remains a going concern.

Because of space constraints this article has only been able to outline the EMS model and provide some explanation and justification for it. Clearly more needs to be said about it, including how it could be enforced in practice.

Paper presented by Andrew Campbell at the Annual Conference of the International Association of Deposit Insurers, Rio de Janeiro, Brazil November 2006

Maximising Recoveries: How to Deal with Non-Performing Loans

Notes from PowerPoint Presentation

As noted in the Claims and Recoveries paper banks can and do fail. Although the main function of a deposit insurance system is to ensure that depositors receive compensation in accordance with the rules of the system it is vitally important to understand and recognise their part in the liquidation proceedings of the failed bank.

It has already been seen in the Claims and Recoveries paper that deposit insurance systems vary from being simply a "paybox" to being a regulator and a receiver of the failed bank. The nature of the role given to the deposit insurance agency, from the legal perspective has important consequences.

Paybox -from a legal perspective will be required to pay out the appropriate amount of compensation and to then stand in the shoes of those depositors as an unsecured creditor in the liquidation proceedings. This is done by way of the legal process known as subrogation. Here the deposit insurance agency may, although unsecured, have priority over other types of creditors. This is the legal position in a number of countries eg United States, Switzerland, Canada -any others?

In this type of system it will be the receiver or liquidator who will be responsible for gathering in the estate of the failed bank and ultimately making distributions to creditors. Such a deposit insurance agency has little power to become involved in maximising recoveries of assets. This has to be left to the liquidator.

The “ broad” function deposit insurance agency. Models for this type of approach, such as the Federal Deposit Insurance Corporation in the United States and the Canadian Deposit Insurance Corporation in Canada, provide an opportunity and agency with a tripartite mandate to attempt to maximise asset values both in the pre-closure and post-closure phases. One particular barrier to the introduction of such an agency in many jurisdictions is the fundamental conflict of interest which is thought to exist in allowing a creditor, and in the case of the deposit insurance agency probably the major creditor, to act as a receiver or liquidator. Indeed this is the principle of insolvency laws in many jurisdictions.

In many situations however a deposit insurance agency which has information in their period leading up to the closure of the bank which it has obtained in its role as regulator is in a much stronger position to be able to influence the outcome of the subsequent liquidation and to take steps to maximise the amount of assets available the distribution to the creditors of the failed bank.

As has been demonstrated by the FDIC in the United States the ability of the agency to act swiftly has proved to be very effective on many occasions.

Studying the position in Canada, the Philippines, the Russian Federation and the United States provides an opportunity to consider a number of issues relating to a defective maximisation of assets on a bank failure.

The corporate insolvency law of the jurisdiction will set out the powers, responsibilities and duties of a liquidator. One of the main functions will be to gather in assets and dispose of them to turn them into cash and therefore be available distribution to creditors.

Non-performing loans. In this part of this paper the focus will be on one particular asset class which has proved problematic in banking crises in many jurisdictions. This is what has become generally referred to as “non-performing loans” - how to deal with non-performing loans has proved to be a major problem in many jurisdictions. Where there is a failure at a single bank the problem is unlikely to require specific action to be taken but where there is a systemic crisis, or where the bank in trouble has a significant market share, there are many other issues that have to be brought into play.

Options - to dispose of immediately? To hold on in the hope that their value can be increased?

In many countries the law will not provide any framework for liquidators to retain assets in this way. Assets must be sold as soon as possible in order to complete the liquidation process expeditiously.

How to decide what to do with impaired loans?

Asset management corporations - have they been successful or have they only moved a problem from one place to another?

Conclusions

It is very difficult to come up with satisfactory proposals for dealing with non-performing loans. On the one hand a liquidator will often lack legal powers to do so and in any event will be required to wind up the bankrupt bank without delay. Some would argue that it is not the job of a liquidator to try and nurse assets back to health but it is hard to escape the conclusion that a quick disposal of such loans is economically inefficient in many cases. It is undoubtedly the case that in a systemic banking crisis it becomes necessary to move bad assets to another place to allow for the sale of the good assets, especially when these can be sold as part of a going concern.

Threats Facing Islamic Banks: Some Thoughts

Andrew Campbell
Cambridge International Symposium on Economic Crime
Jesus College
September 2007

Outline:

1. **Why might Islamic banks be at risk?**
2. **What risks do they face?**
3. **Risks to the banks**
4. **Risks to the customers**
5. **Risk minimisation**
6. **Regulation/Supervision**
7. **Management culture**
8. **Action to take**

Part One: Why might Islamic Banks be at risk?
Newly or recently established

- May lack experienced staff
- May be operating in countries where supervisory standards are less strict or less developed

- Bank supervisor may itself lack experience
- Supervisor may also lack resources
- Newly, or recently established, banks may be viewed by criminals as an easy target.
- This could lead to either fraudulent activity to defraud the bank and/or its customers OR to an attempt to gain ownership/control of the bank.
- Where ownership/control is the aim it is then likely that the bank will be used for fraudulent purposes including money laundering.

Part Two: What type of risks?
- Large scale eg Barings, BCCI etc
- Fraud –customers account eg cheques, cards etc
- Identity fraud
- Lending and credit fraud
- International fraud
- Computer systems – vulnerabilities?

Part Three: Risks to the banks
- Ownership/control risks
- Why?
- How?
- What?

Part Four: Risks to the customers
- Account fraud
- Identity theft
- Card/cheque fraud
- Loss of deposits if bank fails

Part Five: Risk minimisation
- Understanding the risks
- Establishing a strategy
- The role of the regulator/supervisor

- International cooperation
- Creating a fraud-averse culture

Part Six: Regulation/supervision

- Basel Core Principles (CBP) for Effective Banking Supervision as a starting point
- Also the CBP Methodology

Some examples:

- Principle 3 – licensing requirements
- Principle 4 – transfer of significant ownership
- Principle 5 – major acquisitions
- Principle 17 – internal audit and control
- Principle 18 – abuse of financial services
- In the UK the Financial Services Authority provides a detailed set of rules
- See, for example, Systems and Control 3.2R

"A firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements under the regulatory system and for countering the risk that it might be used to further financial crime"

Part Seven: Management culture

- Establishing, and maintaining, an anti-fraud culture.
- How can this be done?
- Danger signs can include poor levels of pay, lack of job security, lack of disciplinary rules and procedures.

Part Eight: Action to take

- Need to ensure a strong regulatory framework including clear legal rules
- Regulator/supervisor must have adequate resources both in terms of (1) number of staff and (2) that they are suitably qualified and experienced.
- Strict licensing requirements

APPENDIX 1

Constitution of the Centre for Business Law and Practice

1. Objectives
The objectives of the Centre are the promotion of research and teaching in all aspects of business law and practice, including but not limited to the interaction between legal rules and business practice. These objectives may, where appropriate, be pursued through links with other constituent parts of Leeds University or departments or centres within other Higher Education Institutions, as weII as through links with businesses and professions in Leeds and elsewhere.

2. Membership
2.1 Any member of the academic or research staff of the Department of Law or the Leeds University Business School may be a member of the Centre.

2.2. Other individuals, whether members of the University or not, may be appointed to membership of the Centre by the University Council on the nomination of the Executive Committee.

2.3 Institutions or firms may become associate members of the Centre if they fulfil the conditions established in by-laws made from time to time by the Executive Committee of the Centre.

3. Administration
3.1 The Centre shall be administered by a Director and an Executive Committee.

3.2 The Director shall be appointed by the University Council on the nomination of the Head of the Department of Law after consultation with the members of the Centre. S/he shall hold office normally for a period of three years and shall be eligible for immediate re-appointment.

3.3 The Director shall be responsible to the Executive Committee for the running of the Centre and the representation of its interests. The Director shall have regard to the views and recommendations of the Executive Committee and the Advisory Committee. The Director may be assisted by a Deputy Director or Directors appointed by the Executive Committee normally for a period of three years. Any Deputy Director so appointed shall be a member ex officio of the Executive Committee.

3.4 The Executive Committee shall consist of the Director and any Deputy Director together with the Head of the Department of Law, two representatives of the Leeds University Business School and up to three nominated members of whom not more than two may be members of the teaching staff of the Department of Law. The Executive Committee shall have power to co-opt up to two) additional members. Nominated and co-opted members shall be appointed normally for two years and shall be eligible for immediate re-appointment.

3.5 The Executive Committee shall meet as often as necessary to carry on the work of the Centre, but in any event at least twice a year, the Director acting as convenor. Any member of the Executive Committee shall have the right to require the holding of a meeting of the Committee.

3.6. Minutes of the meetings of the Executive Committee shall be presented to the following Staff Meeting of the Department of Law.

3.7 There shall be an advisory Committee appointed by the Executive Committee which shall formulate advice and recommendations concerning any aspect of the administration or activities of the Centre. The Advisory Committee shall consist of:
(a) all members of the Executive Committee;
(b) up to three members of the teaching staff of the University of Leeds in departments other than Law, being individuals 'those activities or interests have relevance to the objectives and work of the Centre;
(c) up to fifteen persons from outside the University of Leeds with experience in the fields of activity covered by the objectives and work of the Centre.

3.8 The Executive Committee may also nominate up to ten persons to act as Advisers to the Centre. Advisers shall be persons who agree to offer advice on the work of the Centre at the invitation of the Executive Committee

3.9 The Advisory Committee shall meet once a year with the Director acting as convenor. Special Meetings may be held at the request of the Executive Committee.

4. Amendment to the Constitution

This constitution may be amended by the University Council (or any committee acting with authority delegated by the Council) on the recommendation of the Department of Law and the Executive Committee of the Centre.

APPENDIX 2

OFFICERS OF THE CENTRE

Director :

Andrew Campbell (appointed 1st August 2005)

Deputy Director :

Joan Loughrey (appointed 1st August 2007) (Formerly Professor Roger Halson - appointed 1st August 2005)

Executive Committee:

Sarah Brown

Judith Dahlgreen

Jane Frecknall-Hughes (Leeds University Business School)

Oliver Gerstenberg

Juliet Jenkins

Andrew Keay

Paul Lewis (Leeds University Business School)

Joan Loughrey

Professor Surya Subedi