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Financialization and company law: A study of the UK Company Law Review

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ABSTRACT

This paper considers the role of company law in the context of financialization, with a focus on shareholder primacy. After a detailed review of the provenance of the putative shareholder primacy rationale, the study provides an analysis of relevant aspects of the Company Law Review (CLR) process in the UK. This ultimately led to the Companies Act 2006 (CA 2006) which determined that shareholder primacy would be maintained as a key principle of UK company law. The CLR had raised the central question: 'in whose interests should companies be run?' and put forward two alternatives: one based on shareholder primacy, and the other based on balancing the interests of a range of stakeholders. The two alternatives were described as 'enlightened shareholder value' and 'pluralism'. Drawing on interviews with key participants in the CLR process, findings from this study suggest that: the breadth of expertise and opinion represented on the CLR was rather narrow; there was a presumption in favour of the status quo of shareholder primacy; there was a lack of any meaningful discussion of the alternatives and that little or no consideration was given to comparative international evidence. In fact, some key participants expressed a great deal of scepticism about the value of the process. The new form of words governing directors' duties, which finally emerged in legislation, was thought by some to embed the concept of shareholder primacy more firmly than before – arguably reflecting the process of financialization.

1. Introduction

This paper examines the widespread acceptance of the maximization of shareholder value (MSV) as the fundamental objective of business activity. In the UK context, this subject was explicitly considered during the Company Law Review (CLR) that began in March 1998 and whose *Final Report* was issued in June 2001.[1] The CLR explicitly addressed what it termed 'the question of 'scope' – i.e. in whose interests should companies be run' (Company Law Review Steering Group (CLRSG), 2001, p. 41). Two possibilities were initially considered: (i) directors should run the company in the interest of shareholders and (ii) directors should adopt a stakeholder perspective – the so-called 'pluralist approach'. The outcome of the Review was clear

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[1] This process culminated in the introduction of the Companies Act 2006 (CA 2006) which became law in November 2006. However, many of the provisions in this Act such as those relating to directors' duties – which are the main areas of interest of this study – came into force on 1 October 2007.

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support for shareholder primacy with 'the basic goal for directors' being 'the success of the company in the collective best interests of shareholders' (CLRSG, 2001, p. 41). The resultant Companies Act (CA) 2006 requires a director to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole' though directors must also 'have regard to' a range of other interests including employees, the community and the environment (Ch. 2, Pt 10, 172 (1)). The previous wording in S309 of the CA 1985 had simply stated that the matters to which the directors of a company had to have regard to when performing their functions included 'the interests of the company's employees in general, as well as the interests of its members'; thus the duty of directors in the previous legislation was 'to the company (and the company alone)'.[2]

The current paper examines the process which led to the CLR's preference for MSV in its *Final Report*. The methods used include a review of relevant documentation and interviews with a range of interested parties including members of the CLR Steering Group (CLRSG), members of other CLR Working Groups, and individuals with board level experience of listed companies. While the main empirical focus is therefore the UK, our analysis is informed by research in the political economy tradition concerned with the phenomenon of 'financialization' – 'the ascendancy of finance capital over industrial capital, and . . . profitability based on financial returns from credit markets and speculation' (Arnold, 2009, p. 58). As Krippner (2005, p. 181) points out, 'in a world where accumulation occurs predominantly through financial activities, one would expect systems of corporate governance to reflect the imperatives of financial markets'. In this respect, our paper is concerned with a particular aspect of financialization – i.e. 'the ascendancy of 'shareholder value' as a mode of corporate governance' (Krippner, 2005, p. 181; see also Dore, 2000; Epstein, 2005).[3] Within a wider international context, the findings of the current analysis highlight how evaluations of alternative approaches to the conduct of business were quickly curtailed and the primacy of shareholder value maximization accepted.[4]

The study was motivated by an interest in the extent to which the case for or against MSV was considered during the CLR process; this motivation recognizes that the fundamental legal objectives which guide business strategy and operations can have both economic and social impacts and that evidence about the latter in particular could play some role in assessing the regulatory framework within which business operates. There is, of course, a lively political and media debate about the interests which business should serve that arguably reflects the perceived significance of the issue for wider society. The central dispute concerns the right of one particular stakeholder group in business, the shareholder group, to have its interests maximized. This debate is of course deeply political although within the practices of accounting and finance it scarcely seems to take place at all, at least within Anglo-American culture (Collison, 2003).

The rest of this paper is organized as follows. Section 2 reviews the literature concerning the emergence of, and the rationales for and against, shareholder primacy in the context of financialization. Section 3 presents a brief overview of relevant aspects of the CLR process and the subsequent events which led up to CA 2006. Section 4 contains the main empirical contribution of this paper; it reports on a series of in-depth interviews with a range of interested parties, the majority of whom were directly involved in the CLR itself. Section 5 concludes; it provides a summary and discussion of the findings.

2. The rationale for shareholder primacy

2.1. Maximization of shareholder value: intellectual roots and critique

In their overview of the debates surrounding the intellectual underpinnings of shareholder value, leading authors distinguish between two traditions: (i) the 'reformist liberal collectivist critique of the rentier and the financier from the 1920s and 1930s' and (ii) the emergence of agency theory in the 1980s (Erturk et al., 2008, p. 30; see also Aglietta and Reberioux, 2005). The former primarily considers the legal position of the shareholder resulting from the separation of ownership and control and whether the rights of property should extend to passive owners. Berle and Means' (1932), *The Modern Corporation and Private Property*, is often identified as the seminal text in this tradition; although, their contribution did not emerge in isolation (see Dodd, 1932). The agency theory perspective seeks to re-establish the primacy of the shareholder. While associated, in particular, with the work of Jensen and Meckling (1976) and Fama (1970, 1980), the earlier contributions of Coase (1937, 1960), Demsetz (1967), Alchian (1965, 1969) and Manne (1962, 1965) were pivotal to the development of this tradition.

Jensen and Meckling (1976) and Fama (1980) emphasized the disciplinary role of the market and asserted that 'discretionary management objectives [were] not in the (financial) interests of owner-shareholders' (Erturk et al., 2008, p. 30; see also, Aglietta and Reberioux, 2005). Agency theory represented a more radical opposition to the popular liberal

[2] Of course, Section 309 of the CA 1985 was only one of several sources regarding the duties of directors. The common law fiduciary duty and the duty of skill and care were more commonly recognized duties not derived from legislation.

[3] Armour et al. (2009) state that 'Core institutions of UK corporate governance, in particular those relating to takeovers, board structure and directors' duties, are strongly orientated towards a norm of shareholder primacy'.

[4] A very important implicit restriction in both the empirical and literature based components of this research should be made explicit here. Our interest is in 'large companies with real economic power' (to borrow a form of words from CLRSG, 2000a, p. 13) not in smaller private companies which happen to share a similar legal status but which are, in substance, very different entities. It should be noted that the CLR explicitly identified this difference and sought also to recognize the needs of small companies in their deliberations.