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Original Paper

How Corporate Governance Focuses on Stakeholders: A Review of Practice in the UK

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Abstract

The traditional shareholder primacy approach has been challenged, and this thought has steered UK practice towards a more enlightened perspective. There are increasing calls for better information on how companies are having regard for their stakeholders and how key decisions take their perspectives into account. New regulatory requirements, including the introduction of the Section 172 statement and changes to the UK Corporate Governance Code and the Guidance on the Strategic Report in particular, have driven companies to increase reporting on their stakeholders. Nevertheless, in the absence of accountability mechanisms for directors, these rules have proved to play a limited role.

Keywords

corporate governance, stakeholders, Companies Act 2006

1. Introduction

The debate as to whether firms should take account of just shareholders' interests or of the interests of stakeholders more broadly has been a matter of discussion for many years in many countries, including the United Kingdom (UK). This debate emerges not just among economists but also in the courts because there has been no definitive statutory pronouncement on the matter. In the UK, a shift occurred in the Companies Act 2006 which, for the first time in UK company law, included a section on directors' duties that encompassed an acknowledgement of stakeholders' interests.

This article aims to present how stakeholders are considered in UK company law under the Enlightened Shareholder Value (ESV) approach, and to identify possible problems with this framework. The paper first describes how corporate governance in the UK has shifted from a "shareholder primacy" to an ESV approach. Then, it explores what kind of innovations might motivate directors to focus on stakeholders. Lastly, while it is true that some of the arguments in favour of the "shareholder primacy" principle are unpersuasive, the new ESV approach remains unchanged from the common law position. The core of the ESV approach is section 172 of the Companies Act 2006, with vague interpretations and a lack of remedies as its main concerns. The article states, that the reforms, first in 2006 and then in 2018, failed to strike an appropriate balance between shareholders and other stakeholders and that, even though the ESV concept encapsulated in section 172 appears to be a significant reform, it is in fact just a restatement and clarification of what the law was before.

2. From Shareholder Primacy to Stakeholder Primacy

Since 2006, the UK corporate law position has evolved into the ESV approach. This framework is somewhere between "shareholder primacy" and "stakeholder primacy". It is an intermediate mode. The "shareholder primacy" is rooted in the traditional U.S. public company context, where directors must act on behalf of shareholders as a whole. Shareholders are the only concern. "Stakeholder primacy" is practiced in Europe, and the board has a responsibility to defend the multiple interests of shareholders, creditors, employees, customers, society and the environment. Section 172 is in the middle ground between the American approach and the European approach. It affirms the priority of shareholders, but also lists other stakeholders. Prior to 2006, certain U.K. cases were more consistent with shareholder primacy. Chief Justice Ostrander highlighted the significance of shareholders in *Dodge v. Ford Motor Co.*: "The directors utilize their authority primarily to serve the shareholders, who are the only corporate members to whom the court has granted fiduciary protection". At the time, the focus on shareholders in corporate governance was the prevailing attitude. The shift in attitude in the UK was influenced by countries that originally adhered to a "shareholder first" approach. The shareholder primacy model was questioned in Canada following the bursting of the technology bubble in 2002 and the financial crisis in 2008. In the case of *Peoples Department Stores Inc. v. Wise*, the statement from the Supreme Court of Canada was significant. "Directors should not be restricted to the immediate interests of shareholders and may pay attention to the needs of a variety of parties". The development of corporate law principles in Canada was also a factor in the reform of English corporate law.

Based on the ESV pattern clarified in 2006, the UK's legislative and regulatory regime has been reformed accordingly. Back in June 2018, the Government published the Companies (Miscellaneous Reporting) Regulations 2018, which introduced a new requirement to include a section 172 statement in the strategic report. The requirement is to explain how directors' have considered wider stakeholders and the long-term in exercising their duty to promote the success of the company. The regulations also added new requirements for companies to discuss employee and wider stakeholder engagement in the directors' report, and added new remuneration reporting requirements. Almost at the same time, the Financial Reporting Council (FRC) followed this up by publishing the new Corporate Governance Code, which emphasises the need for the board to set the purpose, culture, and longer-term strategy of the company while also increasing the focus on section 172. The FRC's Guidance on the Strategic Report, which is expected later, is the latest element in a clear push to improve transparency around stakeholders and directors' duties. The Guidance will encourage directors to explain how their regard for the long-term and wider stakeholders has impacted their decision-making, and will also highlight additional areas of best practice for reporting.

These changes place greater emphasis on the board taking a longer-term perspective and a more holistic view of value creation. This expectation is grounded in a company's genuine consideration of its key stakeholders, which is particularly relevant in reflecting sound corporate governance and developing trust.

3. Directors Play a Role in ESV Framework

Innovations in corporate governance mechanisms can drive directors to value stakeholders' interests. Whilst the UK has traditionally valued shareholders, we need to emphasise the position of directors. Directors are empowered by shareholders to make business decisions, as required by law. The separation of ownership and management gives directors a great deal of power in practice. And in a decentralised, widely held shareholder structure, shareholders in the UK are very passive. The exercise of shareholders' rights to remove and appoint directors is restricted. It may also be argued that the rights actually enjoyed by shareholders are not as effective as those set out in the law. The key to considering stakeholders, therefore, lies with the directors. The duty of the directors under section 172 is to act in good faith and to exercise their powers diligently. This duty is owed to the company and not directly to its shareholders or other stakeholders. However, the law recognises that the factors listed above need to be part of the assessment when directors make decisions. The directors, in carrying out their role, must use their own skill and judgment and have regard to the likely long-term consequences of their decisions, in order to prioritise the long term success of the company. How the directors address the interests of shareholders and stakeholders is a matter for them, but they should make this assessment in good faith.

The first concern is the structure of the board of directors. The UK government has made several proposals. Establish an advisory group and appoint designated non-executive directors with formal responsibility for articulating the views of specific stakeholders. A balanced board is likely to establish a good corporate governance mechanism. A gender diverse board, or just a more broadly diverse board, could allow for a variety of views from stakeholders on the board. Next, think about corporate culture. The FRC has always taken corporate culture seriously. Sir Winfried Bischoff, former Chair of the FRC, notes that "a healthy culture protects value as well as creates value". By fostering a corporate culture that values its stakeholders, society as a whole can benefit. And finally, play the role of non-financial reporting. Originally, companies only disclosed financial issues. Now, companies should be required to disclose non-financial issues as well. For example, companies should report on to what extent they have listened to the views of business organisations and employee representatives.

Such concerns illustrate that compliance, culture and success are inextricably linked. It therefore follows that a company must have an effective board of directors who are dedicated to ensuring that the company maintains its culture and achieves its purpose. Collectively, the directors must provide entrepreneurial leadership and direction to the company. The "success" of a company is not defined in the Companies Act 2006, but the term is likely to be interpreted as meaning "increasing value for shareholders". The section 172 duty specifically mentions that directors must have regard to the company's employees, customers, suppliers and the community in particular. It appears that the promotion of the success of the company is a form of "enlightened shareholder" approach to corporate governance. A board that can demonstrate that it has suitable governance procedures or policies (such as policies in relation to environmental issues, sustainability, recruitment, pay, diversity, payment policies, risks or internal controls) would likely generate trust and support from its shareholders and other stakeholders.

4. Attacks on Shareholder Primacy and the Persistence of Traditional Position

Shareholder primacy is a fundamental attitude to corporate governance in the UK, but some of the arguments in favour of this pattern are not persuasive. This argument is not inconsistent with the introduction to the ESV approach, which does not essentially alter the common law viewpoint. For one thing, the expression “the company belongs to its shareholders” is often used to support the primacy of shareholders. Milton Friedman in the New York Times in 1970 referring to the company as “the owner of the business”. However, shareholders do not own the company, they own the stock. Furthermore, shareholders aren’t given the authority to manage the company’s assets. They authorise the board to exercise that right. It would appear that shareholder primacy has limited direct value in practice. For another, the argument that “shareholders are the only subjects entitled to the surplus value of the company” has also been used to support shareholder supremacy. And Frank Easterbrook has emphasised this point in his work. Nevertheless, this interest is only possible for shareholders in the event of the company’s insolvency. It is not a right that can be claimed at any time, but a possible benefit that is expected in specific circumstances. Section 172 recognises the discretion of the directors to take into account relevant interest groups. In other words, the common law can no longer restrict management from considering the interests of non-shareholder groups. The revenues are available to donate or spend on employee benefits and salary increases, as long as directors do not pocket them for themselves. Directors may also embrace low-profit programs that promote the region and environment. These actions make the “shareholder is the only entity entitled to the surplus value of the company” proposition even more tenuous. The argument in favour of shareholder primacy is not supported by rights that cannot actually be claimed. And section 172 contributes to the collapse of this theory.

The difficulties of applying Article 172 in practice outweigh the benefits, both due to the vague interpretation of the concept and the absence of remedies. In terms of conceptual interpretation, attention has shifted from “good faith” to “success”. The former reflects the famous “good faith” requirement in *Re Smith & Fawcett Ltd*. This is easy for judges to assess. But the interpretation of “success” depends on the directors’ business judgement. This subjectivity allows the discretion of the directors to expand. Directors can easily escape liability by arguing that they took these factors into account in good faith. For the fact that the directors’ good faith judgement will determine what will contribute to the company’s success. As previously stated, they may reasonably believe that certain low-margin items would promote the long-term financial growth of the company. Although shareholders who expect short-term benefits may challenge this. In terms of remedies, the law ignores stakeholders. In contrast to derivative actions involving shareholders, the remaining stakeholders have no recourse for any violations. Rather than resorting to the ESV approach, creditors may prefer to rely on the liquidator when the company becomes insolvent. From this perspective, while Section 172 should be recognised as a hard law obligation, it can in practice only have a soft law effect on corporate decision-making. This effect is due to the lack of accountability mechanisms for directors.

5. Conclusion

Companies should create shared value for all their stakeholders if they are to be sustainable. Section 172 clarifies the ESV approach, but it is really just a list of benefits that cannot be enforced in practice. Section 172 does not have ideal results, but altering it would be difficult. Therefore, the UK should probably try to find other mechanisms to protect stakeholders.

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