

International Corporate Law and Financial Market Regulation

A Case for Shareholders' Fiduciary Duties in Common Law Asia

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An abstract, colorful explosion or burst of light, featuring vibrant shades of red, purple, blue, and green, radiating from a central point against a dark background.

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exercise them. These powers come mainly in two forms: formal ones, i.e. voting rights, and informal ones, i.e. exertion of influence on the company. Chapter 3A first analyses formal power, followed by informal power.

The fundamental question of why shareholders should be given voting powers is underexplored in the literature. But analysing this question is vital if we are to understand what the role of shareholders ought to be. If we do not understand why shareholders should be given voting powers, we will not know how they ought to vote, specifically for what purpose and for whose benefit.

The question of shareholders' powers is important in part because it lies at the heart of the debate on shareholder empowerment versus directorial primacy in the United States, and on shareholder stewardship and engagement in the UK, EU and common law Asia. A central assumption underlying the US debate on shareholder empowerment versus directorial primacy is that shareholders should be given voting powers in order to monitor and discipline the board so as to address the agency cost arising from the divergence of interests between board and shareholders, the goal of which is to maximise shareholder value.¹ On this view, shareholders should be given greater powers to better monitor and discipline the board. On another view, proponents of directorial primacy argue that boards should be insulated from shareholder activism because boards have sufficient incentives and superior expertise to act in the shareholders' interests, and there are adequate mechanisms to deter the board from doing otherwise.²

But the US debate has not gained traction in common law Asia for two main reasons. First, the principal concern in those jurisdictions is the extraction of private benefits of control by controlling shareholders; and second, shareholders already wield significant powers, which are amplified in concentrated ownership jurisdictions like common law Asia. More importantly, as I shall argue, the assumption underlying the debate is

¹ See e.g. Lucian A Bebchuk, 'The Myth that Insulating Boards Serves Long Term Value' (2013) 113 *Columbia Law Review* 1637; Lucian A Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675; Lucian A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 833; Lucian A Bebchuk, 'The Case for Shareholder Access to the Ballot' (2003) 59 *Business Lawyer* 43.

² See e.g. Leo E Strine, Jr., 'Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law' (2014) 114 *Columbia Law Review* 449 at 458-59; Stephen M Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 *Harvard Law Review* 1735 at 1750; Stephen M Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2006) 53 *UCLA Law Review* 601.

questionable in principle. This is because shareholders should be given (more) voting powers not in order to monitor and discipline the board for the purpose of maximising shareholder value. Rather, as I shall argue, they should be given voting powers in order to protect and promote the best interests of the company as a distinct and separate entity, given that the general meeting is an agent of the company and owes fiduciary duties to it. Protecting corporate interest is not synonymous with shareholders' interests. And protecting corporate interest is not equivalent to maximising share price.

A central objective of the UK stewardship code³ and the EU Shareholder Rights Directive⁴ is to promote shareholder engagement with their investee companies (through voting, private and public communications, etc.) in order to protect and advance the latter's long-term interests. The shareholder engagement debate has taken roots in common law Asia, engendering similar stewardship codes that exhort shareholders to act responsibly.⁵ However, such codes clash with a well-established common law rule in company law under which shareholders can generally vote as they please, even if doing so is against the company's interests. As long as this rule remains unchallenged, the codes remain a pious aspiration. It is therefore necessary to analyse a prior, fundamental question: why should shareholders be given voting powers in the first place? For what purposes and for whose benefit should they exercise these powers?

I. Formal Power: Voting

A. Why Should Shareholders Be Given Voting Powers?

There is little analysis of the justifications for giving voting powers to shareholders. The most detailed analysis to date has been provided by Grantham⁶ from a UK perspective, and Easterbrook and Fischel⁷ as well

³ UK Stewardship Code (Sep 2012), para 1 ('Stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper').

⁴ Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

⁵ 2016 Hong Kong Principles of Responsible Ownership (HKPRO); 2016 Singapore Stewardship Principles for Responsible Investors (SSP); 2014 Malaysian Code for Institutional Investors (MCII).

⁶ Ross Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders' (1998) 57 *Cambridge Law Journal* 554.

⁷ Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991).

as Thomas and Edelman⁸ from a US perspective. All these scholars have examined the question of why shareholders should vote, and Thomas and Edelman have also analysed why other stakeholders should not vote, as well as the matters on which shareholders should vote. Regarding the first question – why shareholders should vote – Thomas and Edelman rightfully debunked the reason given by Easterbrook and Fischel as to why shareholders should be given voting rights, i.e. because shareholders are the residual claimants. They also refuted two other fallacies: that shareholders are owners, and that they are principals.

But the difference between Grantham, and Thomas and Edelman lies in what they regard as the correct justification for giving voting powers to shareholders. To Grantham, given that the state's goal is to ensure that the company is managed efficiently and fairly, 'shareholders are particularly well-suited to serve as an agent of the state as their incentives largely coincide with the state'⁹ because they are residual claimants motivated by rational self-interest. But to Thomas and Edelman, shareholders should be given voting powers because 'they are the sole stakeholders whose sole certainty of returns on their investment is tied directly to changes in the stock price of the corporation'.¹⁰ Thus, 'it is in the interest of the shareholders ... to maximise stock price'. And voting powers give shareholders 'the ability to monitor the board to insure it protects their interests'.¹¹ Thus, 'boards that are derelict with respect to increasing share price are subject to removal by a shareholder vote in a contested election'.¹² It follows from this reasoning that the role of shareholders is to ensure that the board maximises share price.

As I shall argue subsequently, this is extremely problematic on multiple levels – legal, empirical and normative. Legally, directors are not required to maximise share price. Crucially, reducing the role of shareholders to that of ensuring that directors maximise share price contradicts a fundamental principle in company law i.e. the general meeting is an agent of the company and owes fiduciary duties to it. Empirically,

⁸ Randall S Thomas and Paul H Edelman, 'The Theory and Practice of Corporate Voting at US Public Companies' in Jennifer G Hill and Randall S Thomas (eds), *Research Handbook on Shareholder Power* (Edward Elgar 2015), ch 21.

⁹ Ross Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders' (1998) 57 *Cambridge Law Journal* 554 at 586.

¹⁰ Randall S Thomas and Paul H Edelman, 'The Theory and Practice of Corporate Voting at US Public Companies' in Jennifer G Hill and Randall S Thomas (eds), *Research Handbook on Shareholder Power* (Edward Elgar 2015) at 462.

¹¹ *ibid* at 463.

¹² *ibid*.

maximising share price has been demonstrated to be one of the key causes of the global financial crisis. Further, maximising share price is synonymous with short-termism, which is widely considered to be a malaise of corporate governance. Remarkably, as I shall demonstrate, the laws in Singapore, India and Malaysia do not mandate the promotion of shareholders' interests, let alone the maximisation of share price; instead, they recognise the distinct interests of the company. Further, companies that identify the promotion of shareholders' interests as their corporate objective are not in the majority. Normatively, giving shareholders voting powers so that they could ensure that the board maximises share price is an unattractive and unpersuasive justification. But before we elaborate on this critique, for the sake of completeness, we should look at the other fallacious reasons for giving voting rights to shareholders: that shareholders are the residual claimants, owners or principals.

1. Residual Claimants

The idea that shareholders are the residual claimants of the company was articulated by Easterbrook and Fischel.¹³ There is an important ambiguity in their argument: it is unclear whether they claim that shareholders are or should be the residual claimants. Their analysis seems to indicate both.

They argue that shareholders are the residual claimants because they are entitled to the company's net assets and earnings after the company has discharged its contractual obligations to the employees, suppliers and creditors; that is, after the company has paid them their salaries, principal and interest. However, under the law, they have no right to receive any dividends unless and until the board declares them, and the board is under no legal duty to declare dividends.¹⁴ Moreover, the board is permitted but not required to declare dividends when there are sufficient

¹³ Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) at 67–68. The most compelling criticisms of the argument that shareholders as residual claimants provide the basis for shareholder primacy can be found in Lynn A Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189; Lynn A Stout, 'The Mythical Benefits of Shareholder Control' (2007) 93 *Virginia Law Review* 789; Lynn A Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public* (Berrett-Koehler Press 2012); Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (University of Chicago Press 2010) at 41–72.

¹⁴ *Burland v Earle* [1902] AC 83. But note that a persistent failure to declare dividends may provide grounds for an unfair prejudice/oppression action.

profits. The board can choose not to declare dividends but instead use the profits to invest in other business ventures, increase employees' salaries or simply retain them as profits. Shareholders cannot compel directors to declare dividends. Further, shareholders are not entitled to have the money (or other consideration) that they have paid for the shares returned to them, and they are well aware of this when they purchase the shares.

That said, the notion that shareholders are the residual claimants is true in the exceptional situation of voluntary winding up, where shareholders are entitled to the company's assets after the company has discharged its obligations to employees, suppliers, creditors and the state. An unusual example is the Royal Bank of Scotland (RBS).¹⁵ But the fact that shareholders are residual claimants in this unusual situation does not necessitate giving them voting powers. This is because it is unlikely that giving shareholders voting powers would necessarily protect their interests. To go back to the RBS example, its collapse was not due to inadequate shareholder rights or the failure to exercise them; nor was it due to a lack of shareholder engagement. Rather, the reasons given were poor management decisions, deficient regulation and the flawed supervisory approach of the Financial Services Authority.¹⁶ Ironically, giving shareholders powers (without imposing corresponding duties on how they should be exercised) has led to the undermining of the interests of shareholders as a whole.¹⁷

Even if shareholders are the residual claimants, the question is why they ought to be, which is to say why they ought to be entitled to the board of directors exclusively maximising the share price. In other words, why the interests of shareholders should be given priority ahead of those of other stakeholders. This is apparently because shareholders stand to benefit the most when the company is prospering, and they stand to lose the most when the company is making losses, and thus, they have more incentive than other constituencies to make sure that the company is run profitably, and therefore, they should be given voting powers to monitor and discipline directors. However, they do not necessarily benefit the

¹⁵ Financial Services Authority, *The Failure of the Royal Bank of Scotland* (December 2011) www.thegazette.co.uk/notice/2681505.

¹⁶ *ibid* at 21.

¹⁷ John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision-Making, Final Report* (London: Department of Business, Innovation and Skills, 2012) ('2012 Kay Review') at [1.16], [1.28].

most because, as examined earlier, directors are not required to declare any dividends. On the contrary, if a company chooses to use its profits to increase employees' benefits, increase its R&D expenditure to produce improved products for its consumers or increase its corporate social responsibility, it is the employees, customers and society at large that benefit.

And it is false that shareholders stand to lose the most when the company is making losses. A loss implies that shareholders have been deprived of something that they already have, are entitled to have or have a legitimate expectation to have. But shareholders are not deprived of their shares or the rights that come with shares such as voting powers. They are only deprived of streams of income in the form of declared dividend, which is anything but an entitlement or legitimate expectation, and which is not a legal right, unlike voting rights.

But it may be said that when a company is doing badly, shareholders may lose the money that they have invested or they may have to sell their shares at a loss. There are several responses to this. To begin, institutional shareholders (such as pension and mutual funds) are likely to hold a diversified portfolio of shares, which will offset the losses from one investment.¹⁸ As for controlling shareholders, they would wish to maintain control, and thus will hold their shares for the long-term and will be far less prone to selling their shares when the company is not doing well. Retail shareholders will be much more affected than institutional and controlling shareholders, and if this is the case, the law has to come up with mechanisms to protect them. So, we have come to the crux of the matter. The law has to protect shareholders, or else they may not invest (or they may invest but only if the shares are heavily discounted), to the detriment of the company and economy. And the law has already done so through mechanisms such as limited liability, directors' duties, unfair prejudice and derivative action. The basis for protecting shareholders is pragmatic and prosaic, which is that the absence of any legal protection will discourage investment. The basis is not because shareholders are the residual claimants. Further, in view of the legal protections that shareholders already enjoy (including but not restricted to limited liability, directors' duties and derivative/oppression action), the question is why shareholders should be given voting powers. It may be said that shareholders are in a position to monitor the directors. Now, monitoring the

¹⁸ McKinsey & Company, *From Big to Great: The World's Leading Institutional Investors Forge Ahead* (June 2016).

behaviour of directors is a different justification from that of residual claimants. Even if this is a valid basis for giving shareholders voting powers, the question is why stakeholders like employees should not be given voting powers, for they too can monitor the directors,¹⁹ and are likely to be better monitors than controlling shareholders who suffer from serious conflicts of interest and who can extract private benefits of control (as demonstrated in Chapter 2).

To return to the earlier contention that shareholders as residual claimants are likely to lose the most when the company is doing badly, the rebuttal is that employees are likely to be retrenched, and suppliers and creditors are unlikely to be repaid. Employees are generally less diversified than shareholders; most do not hold multiple jobs. It is generally more difficult and costly for retrenched employees to find new jobs (especially in an economic downturn) than for shareholders to find new companies to invest in. The problem is exacerbated when employees have developed company-specific skills which are not easily transferable to a different company.²⁰ These employees are thus vulnerable to exploitation by employers. Knowing that it is harder for them to find jobs in different companies, employers may cut their salary, reduce their benefits or make working conditions tougher. Employees' interests may arguably be more adversely affected than shareholders' interests. In response, it may be said that employment law has already taken care of employees' interests, and if that is not the case, employment law should be reformed. This assumes that corporate law should not and could not be reformed to protect the interests of constituencies other than those of shareholders. But this tendentious assumption has been vigorously contested.²¹

The final argument that can be used to support the claim that shareholders ought to be the residual claimants is that shareholders in listed companies do not have the protection of contracts, unlike employees and creditors. This is highly doubtful. Although certain types of employees, particularly those in senior management, can protect

¹⁹ One possible model as to how this can play out is the German co-determination in which employee-directors (who are appointed by employees and act in their interests) account for 50% of the supervisory board: s 1 and 7 Mitbestimmungsgesetz.

²⁰ Margaret M Blair and Lynn A Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

²¹ The literature on stakeholder theory is voluminous. The most recent and trenchant argument showing why and how corporate law could and should be used to protect stakeholders' interests can be found in Iris Chiu, 'Operationalising a Stakeholder Conception in Company Law' (2016) 10 *Law and Financial Markets Review* 173.

themselves using contracts, they are in the minority. Employment contracts do not provide adequate protection for the vast majority of employees, largely due to the inequality of bargaining power between the employer and the vast majority of employees. The majority of employment contracts are incomplete in the sense that commitments to salary increase or promotion, the responsibilities and tasks that are required to be performed by employees, and the criteria by which employees' performance will be evaluated, are rarely spelled out in detail in the contract (if at all), whereas the grounds on which employees can be terminated are broadly and vaguely worded,²² all of which give employers the upper hand at the expense of employees. Further, the argument that shareholders ought to be the residual claimants because they do not have the protection of contracts unlike employees suggests that they are in a vulnerable position. But this is not true. As mentioned earlier, the law already has well-developed mechanisms to protect shareholders, including limited liability, directors' duties, unfair prejudice/oppression and derivative actions, rights to acquire information, and board representations where their nominee directors keep a close lookout for their interests. These powers are amplified in the case of controlling shareholders.

To conclude, shareholders are not the residual claimants when the company is solvent (except in the exceptional situation of voluntary winding up); more importantly, they should not be treated as such. And even if they should be, it does not necessitate giving them voting powers. We now turn to the second justification for giving shareholders voting powers: they are the owners of the company.

2. Owners

The second argument that can be used to justify shareholders' voting powers is that they are the owners. But there is no doubt that under the law, shareholders do not own the company any more than directors or employees do. To state the obvious, shareholders only own shares. They do not own the assets of the company. Yet, the myth that shareholders are the owners has persisted.²³ There two main reasons for this. The first is the historical origin of English

²² Paul Davies, 'Efficiency Arguments for the Collective Representation of Workers' in Alan Bogg, Cathryn Costello, ACL Davies, Jeremias Prassl (eds), *The Autonomy of Labour Law* (Hart Publishing 2015) at 375.

²³ Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62 *Modern Law Review* 32.

company law, which has its roots in partnership law. And the second and more important one is the disregard for, or opportunistic use of, the fundamental legal rule in company law: the separate legal personality doctrine.

English company law, which the company laws in the four common law Asian countries are based on or derived from, originated from joint stock company law.²⁴ The latter in turn was treated as an aspect of partnership law (until around the middle of the nineteenth century). Under ordinary partnership law, all partners share equally in the profits and must contribute equally to the losses of the business; every partner can take part in the management of the business; partners owe fiduciary duties to one another; and the partnership property is owned by all the partners, and thus profits and losses from the sale of the property will be shared by all the partners. Partnership law (subject to some modifications) applied to joint stock companies (incorporated and unincorporated). Joint stock companies were treated like large partnerships, but the main difference was that the former had large number of passive investors and ownership and management were separated. Incorporation did not render the company a separate legal personality distinct from its shareholders; under the 1856 Joint Stock Companies Act, shareholders were allowed to 'form themselves'²⁵ into a company. Thus, shareholders were still treated as though they were the company. Crucially, owners of shares in the joint stock company were considered as having an equitable interest in the company's assets. Shareholders were therefore legally treated as being owners of the company's property.

However, in view of doctrinal developments²⁶ which held that shareholders had neither legal nor equitable interests in the company's property, and in light of a developed stock market in which shares became more transferrable and tradeable, shares were no longer considered as part of company's assets by 1860. Further, unlike the 1856 Joint Stock Companies Act, the 1862 Joint Stock Companies Act allowed persons to 'form a company';²⁷ this suggests that the company is a separate and

²⁴ Paddy Ireland, 'Capitalism without the Capitalists: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Legal Personality' (1996) 17 *Legal History* 41.

²⁵ Paddy Ireland, 'Finance and the Origins of Modern Company Law' in Grietje Baars and Andre Spicer (eds), *The Corporation: A Critical, Multi-Disciplinary Handbook* (Cambridge University Press 2017) at 241.

²⁶ *Bligh v Brent* (1837) 2 Y & C 268.

²⁷ Paddy Ireland, 'Finance and the Origins of Modern Company Law' in Grietje Baars and Andre Spicer (eds), *The Corporation: A Critical, Multi-Disciplinary Handbook* (Cambridge University Press 2017) at 241.

distinct entity. The legal separation between the company and its shareholders was reiterated and firmly established in the 1897 seminal decision of the House of Lords in *Salomon v. Salomon & Co Ltd.*²⁸ This critical decision affirmed the fundamental and most vital legal rule in company law, i.e. the company is a real entity that is separate and distinct from its members and directors. The rule is taken so seriously that even in a one-man company (i.e. there is only one shareholder who is the only director and employee), the law has affirmed the separate legal personality doctrine.²⁹

However, an important reason why shareholders are still considered owners by some is the failure to give effect to, or the opportunistic use of, the separate legal personality rule. There are at least three manifestations of this problem. The first is that the connection between ownership of shares and ownership of the company's assets has never been neatly and unequivocally severed.³⁰ Although commentators have recognised that ownership of shares is not legally the same as ownership of the company's property, the legal nature and boundary of shares remain fuzzy. On one view, a share gives the holder contractual and statutory rights in and against the company. Taken to its logical conclusion, shareholders are materially no different from debenture holders from a practical, economic perspective. On another view, a share is more than just contractual and statutory rights. A share has been said to be 'objects of property which are bought, sold, mortgaged and bequeathed'.³¹ To add to the confusion, it has been asserted that shares 'confer proprietary rights in the company though not in its property'.³² This view suggests in a contradictory fashion that shareholders are owners of the company, but they do not own its assets.

The second manifestation of the disregard for the separate legal personality rule is that the interests of the company have been equated with those of the shareholders as a whole.³³ If the company is a real entity that

²⁸ [1897] AC 22.

²⁹ *Lee & Lee's Air Farming* [1961] AC 12.

³⁰ Paddy Ireland, 'Corporate Schizophrenia: The Institutional Origins of Corporate Social Irresponsibility' in Nina Boeger and Charlotte Villiers (eds), *Shaping the Corporate Landscape* (Hart 2018) at ch 1.

³¹ Paul Davies and Sarah Worthington, *Gower Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) at [23-3] 789.

³² *HM Commissioners of Inland Revenue v Laird Group plc* [2003] UKHL 54 at [35] (Lord Millet).

³³ Paddy Ireland, 'Limited Liability, Shareholder Rights and Corporate Irresponsibility' (2010) 34 *Cambridge Journal of Economics* 837.

is separate and distinct from its shareholders, directors and stakeholders, it follows that the company ought to have interests that are distinct from those of these people.³⁴ It is incoherent to claim that on the one hand, regarding the issue of in whose interests or for whose benefit the company should be run, the company and shareholders' interests are effectively one and the same. But on the other hand, regarding the issue of corporate liability, the company and shareholders are separate and distinct entities with separate and distinct obligations and interests.

English law (both common law and statutory law), however, still regards the company's interests and shareholders' interests as largely synonymous. This is evidenced in the common law that directors have to act bona fide in the company's best interests³⁵ and in s 172 of the UK Companies Act (2006) which states that directors have to promote the success of the company for the shareholders' benefit.

However, as I will show in the subsequent section of this chapter, the courts in most of the common law countries in Asia (i.e. Singapore, Malaysia and India) have taken a position that is different from that in the English courts in that they give effect to the separate legal personality doctrine by recognising that the interests of the company are separate and distinct from its shareholders and stakeholders. Of no less importance is that from an empirical perspective, the majority of the listed companies in common law Asia (and the UK) do not equate the interests of the company exclusively or primarily with those of shareholders. On the contrary, the pursuit of the interests of the company as a separate commercial entity, and the promotion of the interests of stakeholders constitute key objectives for many of these companies.

The myth that shareholders are the owners is reinforced by the responsibility imposed by English common and statutory law on directors to act for the benefit of shareholders, and shareholders' ability to control the directors by appointing and dismissing them. This perpetuates a circular form of reasoning. Shareholders are the owners of the company because they have voting powers and are entitled to have directors run the company for their benefit. Shareholders have these powers and entitlement because they are the owners. Neither the former nor the latter is true. The former is false because shareholders do not possess a key incident of legal ownership, that is, the right to exclusive use of the company's assets and to

³⁴ Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Theory' (2008) 71 *Modern Law Review* 663.

³⁵ *Re Smith & Fawcett* [1942] Ch 304.

prevent others from using them. The latter is not true because there could be other reasons, not based on ownership, for giving voting powers to shareholders: they can monitor and discipline directors more efficiently, or because of the historical legacy of partnership. Therefore, shareholders are not the owners because of their voting powers. Rather, proponents of shareholders as owners ought to assert that because shareholders are owners, they are entitled to voting powers. But this assertion is indefensible because shareholders are not the company's owners.

The third and last manifestation of the disregard for the separate legal personality rule stems from the nexus of contract theory developed by US financial economists whereby a company, i.e. a firm, is a 'legal fiction which serves as a nexus for contracting relationships'³⁶ among different parties including investors (shareholders and debenture holders), workers (directors, managers and employees), creditors and customers. The company is merely reduced to a nexus or platform for different parties to exchange their input (such as equity or labour) for output (such as dividends or salaries). Fama asserts that the firm is 'just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs'.³⁷

There are numerous criticisms of this theory, including the fact that it is empirically inaccurate (because companies' constitutions do not reflect arrangements that maximise share price; nor do they adopt innovative arrangements); it fails to account for mandatory rules in company law; and it excludes other values that motivate or underpin company law.³⁸ For present purposes, what is particularly problematic is the implication of the reduction of the company to a mere nexus. Once the company as a separate and distinct legal personality has been eviscerated as result of its reduction to a mere nexus, and once shareholders are characterised as suppliers of

³⁶ Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305 at 311.

³⁷ Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288; Frank H Easterbrook and Daniel R Fischel, 'Voting in Corporate Law' (1983) 26 *Journal of Law and Economics* 395 at 396.

³⁸ Michael Klausner, 'The "Corporate Contract" Today' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2018), ch 4; Marc Moore, 'Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism' (2014) 34 *Oxford Journal of Legal Studies* 693; Paddy Ireland, 'Property and Contract in Contemporary Corporate Theory' (2003) 23 *Legal Studies* 453.

capital (a term that is not clearly defined),³⁹ a fundamental corollary of the separate legal personality rule – the company is the owner of its assets – correspondingly disappears. Although Fama asserts that ‘ownership of capital should not be confused with ownership of the firm’,⁴⁰ the nexus of contract theory may give the misleading impression that because shareholders supply the assets of or to the firm, they are the firm’s owners. And thus, as the argument goes, shareholders should have voting powers and directors should run the company for their benefit.

Further, another problem lies with how contractarian theorists justify voting rights for shareholders. Under the nexus of contract theory, shareholders will enter into an ‘incomplete’ contract. As a result of shareholders supplying their input (capital), they are at risk of losing their capital if the company makes losses. Thus, shareholders will bargain for the right to control the managers (who are in charge of using their capital) in the form of voting rights and fiduciary duties. Employees do not and need not bargain for these rights because they enter into ‘complete’ contracts which adequately protect them. As discussed above, the notion that employees can adequately protect themselves using contracts is misguided. The notion that shareholders ‘bargain’ for fiduciary duties is incorrect as directors cannot be exempted from fiduciary duties (although shareholders can ratify breaches of duties or authorise the transaction).⁴¹

A critical implication of the nexus of contract theory is that as a result of the undermining of the doctrine of the company as a separate and distinct legal personality, the only proper relationship lies between shareholders and the managers, or that between the shareholders themselves

(the controllers and minorities). In short, what truly matters is how the agency cost arising from the relationship between the principal (the shareholders) and the agent (the board) is to be controlled. This brings us to the next fallacious justification for shareholders’ voting powers: shareholders are principals.

3. Principals

The notion that shareholders are principals and directors their agents has been subject to trenchant criticisms. This notion, like the one that shareholders are owners of the company, should be completely buried, but because it still seems to have wide currency, it is imperative to debunk it once more. This claim, like the one that shareholders are the owners, has no legal basis for two main reasons. First, if directors are shareholders’ agents, the former would owe the latter duties and the latter would be able to enforce them directly against the former. But it is trite law that directors do not owe duties to shareholders except in exceptional circumstances. It is equally trite law that directors owe duties to the company, and only the company acting through its board or the shareholders in a derivative action can enforce the duty owed by directors to the company. Second, if directors are the shareholders’ agents, then they are obligated to act on the principal’s behalf. And shareholders would be able to dictate to the directors. But once directors are properly appointed, and absent alteration of the company’s constitution by a special resolution, shareholders cannot interfere with the board’s decision-making process or its outcome.⁴²

It might be said, however, that these legal criticisms miss the point. Financial economists have understood the ‘agency problem’⁴³ in the ‘most general sense of the term’,⁴⁴ not in the legal sense. It ‘arises whenever the welfare of one party, the “principal”, depends upon actions taken by another party termed the “agent”. The problem lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest.’ But a highly effective way of ensuring that the agent (i.e. director) acts for the benefit of the principal (i.e. shareholder) is to

³⁹ In any event, the contractarian theorists’ assertion that shareholders supply the assets of or capital to the company is not correct in the context of listed companies (except occasionally in follow-on offering, rights issue or when they act as creditors, which is a separate issue). Thus, the claim that shareholders in listed companies should have voting powers because they are the suppliers of capital is unpersuasive. This is because shareholders supply the money to the company when they purchase shares in a private company, and in the context of a pre-listed company, when they purchase shares in an IPO. But once the company is listed, shareholders do not generally provide funds except where there is a follow-on offering. In the context of most listed companies, shareholders generally do not provide any funds as shareholders. Rather, shareholders trade on the secondary market by buying pre-existing shares from other shareholders. The former pays the money to the latter, not to the company. While shareholders may provide funds to the company as creditors or debt holders, this is a separate matter.

⁴⁰ Eugene Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88 *Journal of Political Economy* 288 at 290.

⁴¹ Section 172(1) SG CA; s 468(2) HK CO; s 288 MY CA.

⁴² *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34.

⁴³ John Armour, Henry Hansmann and Reiner Kraakman, ‘Agency Problems and Legal Strategies’ in Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law* (3rd edn, Oxford University Press 2017) at 29.

⁴⁴ *ibid.*

impose a duty on the agent to do so. It is therefore remarkable that under this economic understanding of agency, the agent does not owe any enforceable duties to the principal. If the agents (directors) act in a self-interested way or engage in acts that harm the interests of the principals (shareholders), the latter has no right to enforce the duties breached by their 'agents'.

One may rebut this criticism by saying that the principal, i.e. shareholders, do have powers to ensure that directors do not act in their self-interest in view of their voting powers, particularly the voting power to dismiss and appoint them. But this rebuttal is question-begging. Why should shareholders be given voting powers unless they are the principals and directors their agents? Therefore, it is essential that we first determine whether the principal-agent relationship holds true in the case of shareholders and directors. We cannot avoid the legal analysis of agency.

One counterargument may be that because shareholders delegate their decision-making power to the directors through the company's constitution, directors must be held accountable to shareholders for the exercise of their powers. This explains why shareholders ought to have voting powers in order to monitor and discipline the directors. But it does not follow that accountability necessitates giving voting powers to shareholders. And there is no *a priori* reason why shareholders should have voting powers for the purposes of making directors accountable to them or for the purposes of deterring negligent or self-serving behaviour by directors. Even without giving voting powers to shareholders, directors can be held accountable through different mechanisms such as disclosure (through the reports they are required to produce such as audit reports, financial reports, directors' reports, strategic reports), directorial fiduciary duties, reputational constraints, and the market for corporate control (for dispersed ownership companies). Each of these mechanisms has its pros and cons. The point is not that, for the purposes of promoting directorial accountability, disclosure, suing for breach of directors' duties, reputational damage or the threat of takeovers is more effective than giving voting powers to shareholders. Rather, the point is that those who claim that accountability necessitates giving shareholders voting powers have not adequately discharged the burden of proof.

Finally, of equal or even greater importance is the fact that thousands of listed companies across different industries have adopted dual-class

share structures⁴⁵ under which, although shareholders have voting rights, they are practically deprived of control of the companies, and denuded of the power to appoint and dismiss directors. This demonstrates that voting powers are not a necessary feature of ownership of shares and undermines the claim that shareholders ought to have voting powers in order to monitor and discipline directors. It is telling that investors are willing to buy shares in dual-class structure companies despite the fact they are not guaranteed dividends and do not have effective control over the company. This strongly suggests that shareholders recognise there are other mechanisms in place for deterring directorial shirking and opportunism other than giving them voting rights. At the very least, it demonstrates that voting powers are not a necessary part of share ownership.

4. Shareholders' Returns Depend on Maximising Share Price

Thomas and Edelman argue that because shareholders 'are the sole stakeholders whose sole certainty of returns on their investments is tied directly to changes in the stock price of the corporation',⁴⁶ they will be incentivised to 'maximise stock price',⁴⁷ and thus they should be given voting powers. They assert that 'the vote is almost uniquely useful in providing the shareholders with the ability to monitor the board to insure it protects their interests'.⁴⁸ In short, shareholders should be given voting powers to make sure that directors pursue their interests by maximising share price. Their justification for giving shareholders voting powers is problematic. First, maximising share price has led to short-termism, which is bad for companies, the economy and society. Second, because their argument requires boards and management to manage the company according to stock price movement, they assume that the stock price is fully informed and reflects the fundamental value of the

⁴⁵ The prominent ones include but are not limited to Facebook, Alibaba, Google, Viacom, Dell, Expedia, Ralph Lauren, Estee Lauder, New York Times, TripAdvisor and Visa: see Council of Institutional Investors, Dual Class Companies List (March 2017) [www.cii.org/files/3_17_17_List_of_DC_for_Website\(1\).pdf](http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf). Hong Kong and Singapore have approved dual class shares, see Emma Dunkley, 'Lure of Tech IPOs Spurs Asian Exchanges to Seek Dual-Class Listings' *Financial Times* (23 January 2018) www.ft.com/content/8403cd18-ffea-11e7-9650-9c0ad2d7c5b5.

⁴⁶ Randall S Thomas and Paul H Edelman, 'The Theory and Practice of Corporate Voting at US Public Companies' in Jennifer G Hill and Randall S Thomas (eds), *Research Handbook on Shareholder Power* (Edward Elgar 2015) at 462.

⁴⁷ *ibid* at 463.

⁴⁸ *ibid*.