Varieties of Shareholders as a driver of Company Law Reform

Dr Georgina Tsagas

ABSTRACT

The UK Companies Act 2006 replaced the common law duty to act in good faith in the interests of the company, with the duty to promote the success of the company for the benefit of its members as a whole. Whether the adoption of the ‘Enlightened Shareholder Value’ norm of section 172 CA 2006 prompts directors to consider the interests of third parties forms only one aspect of the academic debate. Another question which deserves attention is ‘who the fictional shareholder to whom corporate managers owe a duty to’ is. Using section 172 CA 2006 as a point of reference, the paper analyses the investor horizons and incentives of different types of shareholders with an aim of creating a shareholder taxonomy that challenges the efficacy of the shareholder primacy norm prevalent in UK company law.

The fictional shareholder focuses our corporate managers' minds admirably. But sometimes we need a little less focus and a little more breadth. The old task of corporate law has been to tie the managers to the shareholders; the new task must be to align the fictional shareholder more closely with us.

Greenwood (1996)

I. Introduction

The newly codified duty of section 172 of the Companies Act 2006 (CA 2006) in the UK has been the subject of much controversy. The CA 2006 replaced the common law duty to act in good faith in the interests of the company, with the duty to promote the success of the company for the benefit of its members as a whole, now enacted in section 172 of the CA 2006. The academic discussion on the operation of this section has predominantly focused on a threefold set of questions, namely (i) whether the new section changes the pre-existing law, (ii) whether the adoption of the ‘Enlightened Shareholder Value’ norm prompts directors to consider the interests of third parties or other issues beyond shareholders' interests in their decision making process, and (iii) whether the duty should adopt a more pluralist approach and be subject to further reform in this respect.

Despite the “maximisation of shareholder wealth” being adopted as the norm in corporate decision-making in the Anglo-Saxon models of corporate governance, an important aspect of this norm which has been overlooked by policy makers and the legislator is “who exactly is the ‘shareholder’ to whom ... [directors] hold themselves accountable?” Although, public corporations comprise of a variety of types of investors, directors operate on the assumption that they serve the interests of “a

---

1 Submitted for the Best Paper Prize CLTA 2016 by 11 January 2016 Midnight AUS time (+11 GMT).
2 Lecturer in Law, University of Bristol Law School, United Kingdom. E-mail: g.tsagas@bristol.ac.uk. The author would like to thank Professor Rene Reich Graefe and Dr Donald Nordberg for useful comments received that have significantly improved the present version of this paper.
generic ‘fictional shareholder’ abstraction”. Shareholders are a far more problematic fiction than the corporation itself. As Crespi explains:

Moreover, the law does not impose any particular definition of this hypothetical shareholder, which leaves directors with the discretion to choose among a wide range of possible fictional shareholder characterizations to guide them in their investment decisions. The choice of characterization used may well have significant consequences for those decisions.

The present paper will reflect on the efficacy of section 172 CA 2006, neither by reference to whether the duty embodied in section 172 has transformed the pre-existing legal landscape, nor by reference to the classic debate between shareholders’ and stakeholders’ interests. The paper will rather refer to the interests of shareholders as a collective body and the inherent problems of that statement. Section II provides a short review of duty to promote the success of the company of section 172 of the Companies Act. Section III provides a brief overview of the historical evolution of the image of the shareholder to date. Section VI discusses the importance of shareholder identity for a firm’s governance and performance. Section V provides a basic taxonomy of different types of shareholders depending on their individual characteristics and distinctive features. Finally, section VI provides conclusive remarks on the problematic use of the term ‘shareholder interests’ in UK corporate law.

II. An overview of section 172 CA 2006

The reform process of the CA 2006 aimed to provide clarity and accessibility, align what is good for the company with what is good for society at large and keep legal regulation to the minimum necessary to safeguard stakeholders’ legitimate interests. One of the most important changes introduced by the CA 2006 is the codification of directors’ duties in Chapter 2 of Part 10 of the statute, namely sections 170-180 of the CA 2006. According to section 170(1) CA 2006, each individual director owes his duties to the company, so that any action for breach of duty is vested in the company and the director does not owe duties to any individual shareholder specifically or other stakeholders of the company.

The previous duty to act bona fide in the interests of the company has now been substituted by section 172 CA 2006, which imposes on a director the duty to ‘act in a 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’ and in doing so must have regard to a series of factors listed in the section. Section 172 CA 2006 appears to represent a compromise between two opposing positions adopted on the nature of the company. The question of ‘whose interests should the directors promote?’ is intricately linked with the question of ‘what is the purpose of the corporation or what should it be?’ On the reformulation of the duty to act in the interests of the company at common law the debate which arose was between whether a shareholder primacy model or a pluralist model should be adopted. The section ended up constituting a compromise between the two positions proposed, one could argue, although in fact it resonates closer to the shareholder primacy model. A more pluralist approach to the drafting of the section than currently exists failed on the grounds that it

5 Crespi (2007), at 383.
7 Crespi (2007), at 383–84.
8 Law Commission, Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties (Law Com no 261, 1999) and the Consultation Paper (LCCP 153, September 1999).
9 Foss v Harbottle (1843) 2 Hare 461
10 Percival v Wright (1902) 2 Ch 421
was difficult to provide a safe enforcement mechanism that is alternative to the safe shareholder control mechanism that was in place. The duty was reformulated on the basis that the duty should reflect modern business needs and wider expectations of responsible business behaviour. The “enlightened shareholder value” adopted in section 172 CA 2006 was seen as the approach “most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all.” The Rt Hon Margaret Hodge MP, Secretary of State for Trade and Industry, in her Ministerial Statement on the reforms to the duties of the company directors commented that directors’ duties can either be seen as a mere codification of the existing law or as a radical change insofar as the section links what is good for a company to what is good for a society at large.

Whether the new section changes the pre-existing law a distinction can be made between aspects of the duty that remain unaltered and altered, as well as aspects of the codified duty which the interpretation of remains ambiguous. The duty at its core has remained unaltered. Section 172 CA 2006, similarly to the old common law duty, continues to impose a subjective test, so that the business decision is left to directors and courts will not interfere in the judgment made. The section states that directors must act in the way they think in good faith will promote the success of the company.

The fact that the test of s. 172 is subjective and not objective creates additional difficulties in assessing the duty and finding breach and enforcing. At common law directors were not prohibited from taking other factors into account when promoting the interests of the company. Similarly to section 172, directors could take into account stakeholder interests. In Hutton v West Cork Railway Co, it was held that a director must conduct himself in a way which benefits stakeholders other than shareholders, but only insofar as it will be in the interest of the shareholders as a whole. As Bowen J had famously stated: “The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale, except such as are required for the benefit of the company.” Gower and Davies explain that the ESV approach is a development of common law, albeit a modest one, as the new section merely adds a requirement for the directors to take account of stakeholder interests when it is in the interests of the success of the company to do so. It is important to clarify that despite the enactment of the enlightened shareholder value approach in section 172, distinct in wording and context to the old common law duty, shareholders retain their central role in the UK corporate governance system.

The statute is different to prior law insofar as it requires the promotion of the success of the company not on its own right as a separate legal person, but for the benefit of the shareholder constituency as a default priority. It explicitly requires that regard be had to other constituencies when considering what promotes shareholders’ interests, so that the standard of care by which appropriate regard is measured has been altered. At common law the duty expressed in the words of directors acting in ‘the interests of the company’ made clear that the duty of the director was owed to the company, mostly in the sense that the company or those acting on behalf of the

---

13 Duties of Company Directors (DTI, June 2007), Ministerial Statements, Introduction and Statement of Rt Hon Margaret Hodge.
14 See Re Smith & Fawcett Ltd [1942] Ch. 304 at 306 per Lord Greene MR.
15 See Re Smith & Fawcett Ltd [1942] Ch. 304; Regentcrest plc v Cohen [2002] 2 BCLC 80;
16 Hutton v West Cork Railway Co [1883] 23 Ch D 654.
17 Hutton v West Cork Railway (1883) 23 Ch. D. at 673, with “cakes and ale” in this case referring to the benefits given to the company’s employees.
company could bring a claim against the wrongdoer to enforce the duty. The importance of the reformed duty lies in the fact that it lists a number of factors which directors are prompted to take into account.\(^{20}\) Although section 172 does not create a fundamental change to the pre-existing duty, it does however introduce the concept of the ‘enlightened shareholder value’ approach to management duties. The impact of the non-exhaustive list of factors in corporate decision-making remains unclear. Safe practice followed by boards in order to avoid the potential of incurring liability due to a failure to abide by the requirements of the duty is to follow a ‘tick-the-box’ procedure and to minute that the matters listed in section 172 have been considered before entering into any major board decision. Courts however will consider the belief of the director at the time the decision was taken and not the quality of his business judgment.

Section 172 introduces new terms and concepts, which differ somewhat to the old common law duty. According to the guidance to the Companies Act 2006 provided by the Department of Trade and Industry, the term “success of the company” reflects what the shareholders of the particular company want to collectively achieve, whilst it is accepted that commercial companies will normally equate success with the company’s long-term increase in value.\(^{21}\) Furthermore, it is noted that the company’s constitution and the decisions made under it will ultimately reflect what the “success model” for the particular company is.\(^{22}\) Concerns were however expressed during the review process on the terms introduced in the section. In its response the Law Society expressed concerns with regard to the use of the term “success” as it being too imprecise a concept to be helpful.\(^{23}\) It usefully pointed out that unlike the phrase “in the interests of the company”, the term “success” was not supported by an existing body of case law and that coupled with the term “for the benefit of its members” was likely to raise new questions.\(^{24}\) The concern put forward was that under the previous law, the concept of the company as an entity separate from its members was a well understood concept whereas with the new terminology introduced would make it far from clear whether this would still continue to be the case.\(^{25}\)

Section 172 CA 2006 has often been discussed through the prism of ‘enforceability’ and accountability. Gower and Davies emphasise the subjective test inherent in section 172 CA 2006 which makes it difficult to find a breach of the duty except in egregious cases and emphasise that its value lies more in the extended reporting requirements to shareholders by directors.\(^{26}\) One could argue that s. 172 prescribes a change in mind-set and a change in the way in which boards should proceed with their decision-making as a matter of practice, rather than a change of liability. Winter and Van De Loo contrast the role or law to that of economics in relation to regulating the conduct of the board by finding that whereas law stays at the margins of what boards are doing by focusing on formalities, process and liability\(^{27}\), economists take a view on what boards should be doing, and also on how to regulate boards to ensure that they do it.\(^{28}\) One could therefore perhaps safely argue that section 172 CA 2006 adopts an approach which is closer to the law and

\(^{20}\) s. 172(1)(a),(b),(c),(d),(e),(f) CA 2006.
\(^{24}\) The Law Society (2005) at 6-7.
\(^{26}\) Gower and Davies Principles of Modern Company Law (2012) at 543.
\(^{28}\) Winter and Van De Loo (2014) at 228.
economics rationale, rather than the law. Section 172 CA 2006 becomes more relevant when considered with reference to sections 415-417 of the CA 2006 which impose a duty on directors to prepare a director’s report which includes a business review.\(^{29}\)

The problem in relation to the enforcement of this duty is not the fact that it leaves out stakeholders from the enforcement process, but that the shareholder body cannot easily enforce the duty. A judicial review of section 172 CA 2006 by Grier exemplifies the problems in bringing an action against the directors.\(^{30}\) Case law on section 172 CA 2006 evidences the difficulties in enforcing the duty, even in the case where a majority shareholder in the company may have legitimate preferences to do so. In R (People & Planet) v HM Treasury\(^{31}\) rejecting the claim that there was a misdirection by law by HM Treasury in the course of a Green Book exercise as to the effect of section 172 CA 2006, the Court founds that that officials conducting the Green Book Exercise had correctly identified the proper way in which social and environmental considerations are to be taken into account in accordance with the duty.\(^{32}\) The Court found that the HM Treasury should not have sought to go beyond that, so as to impose its own policy in relation to combatting climate change and promoting human rights on the Board of RBS, contrary to the judgment of the board, as this would not only conflict with the duties of the board of RBS as set out in section 172(1) CA 2006 but would also have given a real risk to litigation by minority shareholders complaining that the value of their shares had been affected by the Government seeking to impose its policy on RBS.\(^{33}\)

The common law provided that the interests of the company are those of its shareholders, specifically current and future ones.\(^{34}\) The term ‘the benefit of its shareholder as a whole’, further clarifies the position of the law and as made clear: “the duty is to promote the success for the benefit of the members as a whole—that is, for the members as a collective body—not only to benefit the majority shareholders, or any particular shareholder or selection of shareholders”.\(^{35}\) However, the term ‘for the benefit of its members as a whole’ raises new questions. Irrespective of whether the firm is considered a legal abstract or an artificial person, the duty owed to the company is nevertheless owed in substance to a specific group of natural persons.\(^{36}\) It is therefore important to clarify whether the interests of the shareholders, which at common law are seen to be as the future and present shareholders of a company, are those of a fictional shareholder or the actual shareholders of the company at each period in time. What consideration should be given in the former situation and what in the latter?

III. From past to present: a Historical Evolution of the Shareholder

The image of the shareholder has changed historically. To date one can witness the existence of a wide array of shareholders with different characteristics. Certain types of shareholders had

\(^{29}\) Section 417(2) CA 2006; See also s. 417(3) CA 2006 on the content of the business review.


\(^{31}\) R (People & Planet) v HM Treasury (2009) EWHC 3020, an application for permission to bring proceedings against HM Treasury relating to policy of HM Treasury concerning the government’s interest in Royal Bank of Scotland (RBS) for handing its investment in RBS, in which case the Government held an interest in RBS via a company UK Financial Ltd (‘UKFI’) in which HM Treasury was sole shareholder of, which company held a 70 per cent shareholding in RBS

\(^{32}\) R (People & Planet) v HM Treasury (2009), para 34.

\(^{33}\) R (People & Planet) v HM Treasury (2009), para 35.

\(^{34}\) Gaiman v National Association for Mental Health [1971] Ch. At p. 330 “both present and future members”.


\(^{36}\) See Nourse L.J. in Brady v Brady [1998] B.C.L.C. 20 at 40, CA, who stated that “The interests of the company, as an artificial person, cannot be distinguished from the interests of the persons who are interested in it.”
previously been completely unknown to financial markets and the corporate world. From the beginning of the 20th century to date discussions have moved away from addressing managerial accountability and shareholder passivity, to shareholder stewardship, shareholder short-termism and the fiduciary duties of intermediaries in investment chains.

The starting point of shareholding in the modern world began with the investment of millions of small investors willing to contribute to the finance capital required by the modern manufacturing process at the start of the 20th century. In the first half of the 20th century, equity in most corporations was held by a large number of individuals, leading to collective action problems and to the separation of ownership from control. The emergence of a growing number of large listed companies with dispersed ownership structures, or otherwise termed ‘the managerial corporations’, led to the adoption of the shareholder primacy view which focused on the ‘agency’ relationship between management and shareholders. In 1932 Berle and Means clearly identified the problematic issue of the separation of ownership from control which characterised large US corporations. The authors’ basic contention was that dispersed share ownership in the modern corporation equated the delegation of control to a large managerial hierarchy and that it was managers rather than shareholders who ultimately had control over the corporation. Jensen and Meckling, influenced by the prior research of Alchian and Demsetz, came to first identify the firm as a ‘nexus of contracts’. The ‘nexus of contracts’ refers to the nexus of contracts as between investors, management, employees, suppliers, clients, etc. Jensen and Meckling analysed the relationship between managers and owners and described it as one of agency, i.e. a contract under which the principal engages the agent to perform some service on their behalf by delegating to the principal a decision-making authority.

In the 1970s and 1980s individual ownership in the US started to decline and institutional ownership rose until by the 1990s it amounted to a significant proportion of companies, comprising of mutual funds, insurance companies and the various pension plans. These fiduciary institutions had started to become the real owners of companies in the US and took their ownership responsibilities seriously. As Hill identifies, in the post-Enron era, with the corporate and financial scandals which followed, commentators began to perceive shareholders with short term interests not as victims, but rather as a threat to the corporate enterprise. In the US in terms of policy, there began a move away from corporate law aiming to protect shareholders, to the need to

41 Jensen and Meckling (1976) at 308.
42 Hawley and A. T. Williams (2000) at 68.
protect corporations from its shareholders 44 and protect shareholders from other shareholders with divergent interests. 45

The matter of whether shareholders’ interests should be the exclusive focus of company law or whether a wider ‘stakeholder’ focus should be adopted is an old debate that can be traced back to the debate between Berle and Dodd in 1936. 46 Subsequent theories have attempted to address the problems deriving from the shareholder primacy norm. The team production view of the corporation by Blair and Stout introduced the ‘mediating hierarch’, who is viewed upon as a trustee and performs an additional function of “encouraging firm-specific investment in team production by mediating disputes among team members about the allocation of duties and rewards.” 47 In an attempt to address the problem of short-termism in corporate decision-making, Jensen puts forward the enlightened value maximisation theory. The theory accepts the maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders. 48 The theory basically advocates that in order to promote the long-term value of the corporation managers must have regard to other constituencies when maximizing shareholder value. 49 As Jensen provides, the issue which requires consideration is not which one group should be more privileged than the other, but rather what type of corporate behaviour will result in the least social waste. 50

In recent times the debates have come to focus on a different set of problems. The emergence of different types of shareholders with short-termist investment strategies and perverse incentives has placed emphasis on shareholders’ stewardship and the duties shareholders should owe as quasi-owners of the companies they invest in. The term ‘stewardship’ came into play following the latest events of the global financial crisis. Following the 2008 bank bailouts by the UK Government, the Walker Review 51 in 2009 assessed the role of banks and financial institutions in the current crisis. The Review recommended the adoption of a Stewardship Code, in order to increase shareholder engagement, which was seen as a solution to market failure. Indeed, in 2010 the Financial Reporting Council (FRC) published the Stewardship Code, 52 which comprises of a set of principles for institutional investors to assist them to better exercise their stewardship responsibilities. More recently, following the Kay Review on the UK Equity Markets and long-term Decision-making 53, the growth of intermediation was noted as a source of short-termism, which in turn prompted an investigation on how the law of fiduciary duties applies to investment intermediaries. 54 The Kay Review specifically highlighted that investment chains were too long with a growing number of intermediaries between an investor and the company in which they invest, which may lead to increased costs, misaligned incentives and reduced trust. 55 Strine has identified

44 Hill (2010) at 1013.
46 Berle and Means (1932).
47 Blair and Stout (1999) at 277.
50 Jensen (2001) at 12.
52 The UK Stewardship Code, Updated version September 2012.
54 In July 2014, the Law Commission produced its final report on the fiduciary duties of investment intermediaries.
the shift from the problem of a ‘separation of ownership from control’ to the problem of a ‘separation of ownership from ownership’. As he explains this separation arises, because of the existence of shareholders with indirect investments via the use of money managers, such as mutual funds or hedge funds, whose interests as agents are not necessarily aligned with the interests of long-term investors.\footnote{\textsuperscript{56}}

It is worth reflecting on the types of shareholder prevalent in UK companies at present times in order to appreciate the challenges of the varieties of shareholders norm which has come about. At the end of 2014, shares in quoted UK domiciled companies\footnote{\textsuperscript{57}} were valued at a total of £1.7 trillion. From the data provided by the office for UK national statistics, the beneficial ownership\footnote{\textsuperscript{58}} of quoted shares in UK domiciled companies at the end of 2014 comprised of rest of the world ownership at an estimated 54\% of the value of the UK stock market. UK individuals owned an estimated 12\% of quoted UK shares by value, unit trusts held an estimated 9\% by value, other financial institutions held an estimated 7\% by value at the end of 2014, insurance companies held an estimated 6\% and pension funds an estimated 3\% by value at the end of 2014, continuing the downward trends in these sectors seen in recent years. The largest sector was the rest of the world, with 54\% of the total at the end of 2014, similar to 2012 but higher than the 2010 level of 43\%. Individuals owned the next largest proportion of shares at the end of 2014, with 12\% of the total, higher than the estimated 10\% they held in 2010 and 2012.

Source: Office of National Statistics

**Figure: Beneficial ownership of quoted shares in UK domiciled companies at 31 December 2014**

\footnotetext[57]{Companies included are those which are listed on the London Stock Exchange and are domiciled in the United Kingdom; that is, their country of incorporation is the UK.}  
\footnotetext[58]{The beneficial owner is the underlying owner; the person or body who receives the benefits of holding the shares, for example income through dividends.}
IV. Why Shareholder Identity Matters

Empirical evidence shows that the identity of the shareholders of a company defines the company’s objectives, the type of monitoring management is subject to and the company’s market value. Despite the acknowledgment that the type of shareholder has an impact on corporate performance, the law tends to make no meaningful distinction between different types of shareholders.

Ownership duration, as well as ownership type affect corporate performance. Bøhren, Priestley and Ødegaard (2009) examine the impact of ownership duration and investor type on corporate performance and focus on how investor short-termism interacts with the value of the firm.59 The investor types examined are individuals, industrial owners, financial institutions and foreign investors. It is found that investors with indirect ownership, such as industrial owners and financial institutions have an aim of short-term profits and lead managers in destroying firm value. The negative impact is found to increase the longer this type of investor stays on in the company. Personal investors with extended ownership duration in the firm have an aim of long-term profits and have the adverse effect on firm performance.

Other research of Thompsen and Pedersen (2000a) confirms their assumption that the type of shareholder has an impact on the way in which managers exercise their power and determine the company’s objectives.60 Their research is based on the use of data on 100 of the largest non-financial companies in 1990 of each of 12 European nations with a method of equations of economic variables that can measure company performance. It is found that changes in ownership structure and in the identity of the company’s shareholders affect company performance. The types of investors examined by the study are institutional investors, banks, corporations and governments as shareholders of listed companies. Whereas institutional shareholders are clearly interested in shareholder value, other types of investors give priority to other business expectations from their investment in the company, such as control for families, network relations for business groups, social goals for governments and credit risk for banks. In another study, Thomson and Pedersen (2000b) find that investors such as financial institutions and non-financial corporations exert a positive influence on market valuation, whereas family ownership, as well as government ownership have an insignificant and low market valuation over the company respectively.61

V. Building a Shareholder Taxonomy

A basic taxonomy of the different types of shareholders sheds some light on the similarities and differences that may exist between them. It should be noted that the taxonomy is by no means exhaustive and that there exist overlaps between different distinctive features and characteristics. Table 1 below provides a basic overview of criteria of distinction with corresponding distinctive features.

---

Table 1: Basic Shareholder Taxonomy Table

<table>
<thead>
<tr>
<th>Criteria of Distinction</th>
<th>Distinctive Features</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Engagement</td>
<td>Passive vs Active</td>
</tr>
<tr>
<td>B. Investor Horizons</td>
<td>Long term vs Short term</td>
</tr>
<tr>
<td>C. Incentives</td>
<td>Corporate interest aligned vs not aligned</td>
</tr>
<tr>
<td>D. Diversification</td>
<td>Diverse portfolio vs targeted investment</td>
</tr>
<tr>
<td>E. Objectives</td>
<td>Shareholder value vs control vs network building vs social goals vs credit risk vs risk averse</td>
</tr>
<tr>
<td>G. Location</td>
<td>Global vs Local shareholders</td>
</tr>
<tr>
<td>H. Investment Chain</td>
<td>Institutional vs Individual Shareholders</td>
</tr>
</tbody>
</table>

A. Engagement

The distinction between passive and active shareholders is determined by the level of shareholder engagement. The Law Commission has defined shareholder engagement as ‘an approach to investment which emphasises the importance of effective dialogue between investors and investee companies. Engagement may involve an exchange of views on issues such as strategy, performance, board membership and quality of management’.\(^{62}\) Following evidence from the financial crisis, Cheffins explains how institutional shareholders have been identified as one of the culprits, in the sense that they allegedly did nothing meaningful to prevent bank executives from failure.\(^{63}\) The Stewardship Code in 2009 came as a solution to the problem of lack of engagement of institutional shareholders with the companies they invest in. However, as Cheffins further explains, the Stewardship Code is likely to have little positive impact on engagement, considering that the target audience of the Code, i.e. UK-based fund managers, pension funds and insurance companies, which dominated share registers of quoted UK companies twenty years ago, are a matter of the past.\(^{64}\) Overseas investors, hedge funds and private individuals now collectively dominate share registers.\(^{65}\) The current debates on the efficacy of the Stewardship Code\(^{66}\), as well as on merits and detriments of shareholder activism\(^{67}\) fail to take into account the divergence which exists between different types of engagement and activism. The promotion of shareholder engagement

---

\(^{62}\) Law Commission Law Com No 350 Fiduciary Duties of Investment Intermediaries, Definitions, page xiv


\(^{64}\) Cheffins (2010) at 1006.

\(^{65}\) Cheffins (2010) at 1006.


activism is based on the myth that the shareholder, irrespective of the shareholders’ individual characteristics, serves the shareholders' interests for the benefit of all the shareholders’ “common interests” and subsequently the interests of the company.

Hedge-fund activism has attracted special attention over recent years. It has been found that hedge funds increasingly engage in a new form of shareholder activism and monitoring that differs fundamentally from previous activist efforts by other institutional investor. Brav et al. first documented hedge fund activism using a large-scale sample over the time period 2001 through 2006, documenting heterogeneity in hedge fund objectives and tactics and showing that there is a positive market reaction to hedge fund intervention with the improved post-intervention target performance, the effect of the interventions on CEO pay/turnover, and changes in payout policy. As explained, “unlike traditional institutional investors, hedge fund managers have very strong personal financial incentives to increase the value of their portfolio firms, and do not face the regulatory or political barriers that limit the effectiveness of these other investors.” A series of commentators have however claimed that hedge fund activist intervention is value decreasing in the long term, even when they are profitable in the short term. The claim has been tested by Bebchuk et al. who examine the operational performance and stock performance relative to the benchmark evolve during the five year period following activist interventions finding that the empirical evidence does not support the claim. In fact, they find that interventions of the sort are followed by long-term improvements rather than declines in performance. Hence, shareholders do not only differ in terms of the type of engagement they perform, but it is also the case that the empirical evidence on the effectiveness of the engagement is mixed and dependent on the type of shareholder in terms of its identity, as well as its location and its incentives.

B. Investment Horizon

Depending on their investment horizon shareholders are often categorized in long-term and short-term investors based on a simple criterion of the time frame within which they aspire to see a return on their investment. The trading volume and the rate that investors sell and buy on the stock exchange are also often used as parameters in this respect. Such criteria, although well warranted, do not in fact offer an accurate picture of what factors determine the differences in investment horizon. Long-term characterised investors may also act in dissimilar ways. Venture capital funds, albeit long-term investors, are interested in selling their stake soon and use their seat on the board to encourage maximising cash flows and short-term performance. The pension

69 Brav, Jiang, Partnoy and Thomas (2008) at 1773.
70 Brav, Jiang, Partnoy and (2008), at 1773.
73 Bebchuk, Brav and Jiang (2015) at 1155.
74 Nordberg (2010) at 420.
fund, although a long-term investor as well, takes a passive approach to engagement, encouraging policies such as research and development aimed at providing sustainable profits.  

An insightful review of long-term investment and what determines investor horizon is offered by Warren, who examines the influences of long-term investing of institutional investors and finds that discretion over trading and how investment decisions are made are the two main indicators that influence investment horizon.  

He defines long-term investors to be best characterised as those who set their sights on the generation of value and returns over the passage of time, backed by considerable discretion over when they trade.  

As explained, with regard to discretion over trading, investors with longer horizons have discretion in deciding when they buy or sell, whereas investors without such discretion tend to adopt a short-term view when investing. With regard to how decisions are made, a variable which he argues affects investment horizon, specifically relates to the information used and whether it focuses on near-term price changes or long-term ones.  

Cash flow generation over time, future investment opportunities and the implied long-term expected return given the price paid are all information that long-term investors will focus on. Despite the distinction on the issue of characteristics however, as Warren observes, there exist rare examples where investment horizon is well defined, with positions being reviewed and adjusted along the way.

The Kay Review identified short-termism as a “tendency to make decisions in search of immediate gratification at the expense of future returns: decisions we subsequently regret.” Kay drew a distinction between investors ‘whose primary focus is on activities of the company, its business, its strategy, and its likely future earnings and cash flow – and those primary focus is on the market for shares of the company – the flow of buy and sell orders, momentum in the share price, and short-term correlations between the prices of different stocks’. Kay also distinguishes between those who trade and those who invest. Whether short-term or long-term investing should take preference falls outside the ambit of this discussion. Warren identifies that in light of the fact that there is too much short-term behaviour in markets, which does have some adverse effects, suggests that from a policy perspective, shifting the balance towards more long-term investing should be beneficial.

C. Perverse, divergent or aligned incentives

Shareholders may also have a wide range of incentives, depending on their affiliation to the company or its management, and depending on their individual strategies. Shareholders may retain certain links to the firm, such as being at the same time of their shareholding employees of the firm, which can in turn be contrasted with shareholders that are purely seen as outsider
investors. A relationship to the firm of this sort can also relate to the characteristic of being risk prone or averse.\textsuperscript{83}

In terms of other incentives a distinction can be drawn along these lines between hedged and unhedged shareholders, as the purchase of equity derivatives equates that the shareholder will have different economic interests to that of a pure shareholder.\textsuperscript{84} Martin and Partoy draw a distinction between “economically encumbered” shares that are held by stockholders who may lack the otherwise homogeneous incentives generated by “pure” share ownership (e.g., who hold both a share and a short or other derivative position) and the “legally encumbered” shares that are held by stockholders who may have a legal impediment to voting such shares (e.g., who have loaned out such shares to a broker or short-seller, or who maintain a synthetic position that mimics a share but does not create the right to vote).\textsuperscript{85} Martin and Partoy further explain that economically or legally encumbered shareholders, do not due to their type of shareholding have appropriate incentives to make discretionary decisions and might even be indifferent or hostile to gains of the company and instead embrace losses.\textsuperscript{86} One can also refer to a perverse orientation towards investment, usually characteristic of short-term investors, which may involve buying and selling simultaneously with deferring time horizons for the two actions.\textsuperscript{87} Different types of investment practices, including short-selling and the use of derivative instruments, may well facilitate perverse incentives on the shareholder’s part, which may have significant governance implications.\textsuperscript{88} The perverse incentives of hedge funds, pension and insurance funds using empty voting encourage decision-making that would damage the economic interests of the company and perhaps the sustainability of the business.\textsuperscript{89}

\textbf{D. Diversification}

The rise of fiduciary capitalism and universal owners has been well identified by Hawley and Williams.\textsuperscript{90} They define the universal owner as an institutional owner whose holdings are highly diversified and typically held long term. The holdings of these institutions are small but significant cross section of publicly traded stock in the economy and have the characteristic of representing the entire economy.\textsuperscript{91} Greenwood emphasises the point that unlike the corporate law shareholder, the portfolio shareholder does not take seriously the distinction among companies, as its main concern is the total value of the portfolio and the particular security’s contribution to that value, and similarly prevailing against a publicly traded competitor may not be in the portfolio shareholder’s objectives.\textsuperscript{92}

A general distinction can therefore be made between institutional shareholders that adopt a diversified portfolio investment strategy as opposed to those that target a particular investment. Norway’s investment fund for example constitutes the most extreme example of the former, as investing in Norway’s oil revenue is close to all publicly listed companies in the world.\textsuperscript{93} Crespi

\begin{thebibliography}{99}
\bibitem{83} Anabtawi ‘Some Scepticism about Increasing Shareholder Power’ Journal of Scholarly Perspectives (2007) 3(01), at 10.
\bibitem{84} Anabtawi (2007) at 13.
\bibitem{86} Martin and Partnoy (2005) at 813.
\bibitem{88} Nordberg (2010) at 416.
\bibitem{89} Nordberg (2010) at 420.
\bibitem{90} Hawley and Williams (2000).
\bibitem{91} Hawley and Williams (2000) at 3.
\bibitem{92} Greenwood (1996) at 1099.
\bibitem{93} The Economist, Norway’s Investment Fund-Passive Aggressive (Feb 4, 2010) Berlin.
\end{thebibliography}
creates a sub taxonomy of shareholder types depending on their diversification.\textsuperscript{94} The \textit{Fictional Undiversified Shareholder} has, according to Crespi, been the widely accepted by directors type of shareholder and simply constitutes the personification of the corporation’s common stock.\textsuperscript{95} Reference to this type of shareholder allows for the maximization of the value of the corporation’s common stock disregarding the existence of other impacts of share price maximization efforts in a real-life circumstances, as would be the case for example if the shareholders were operating in another capacity, such as corporate officers or employees, corporate bondholders or other creditors, or as corporate pension recipients.\textsuperscript{96} The \textit{Fictional Diversified Shareholder}, follows a diverse portfolio investment strategy and its aim is to diversify away the “unsystematic” risk associated with holding individual risky assets by combining them into a portfolio of assets.\textsuperscript{97} An assessment of the interests of this type of shareholder will take into account the impacts of corporate actions on the value of their entire portfolio, rather than only on the value of their subject corporation common share holdings.\textsuperscript{98} The final distinction made is that of the \textit{Fictional Equity-Only Diversified Shareholder} and the \textit{Fictional Corporation-Specific Diversified Shareholder}. The former is the personification of an investment portfolio that is fully diversified across all common share equity claims available in the capital markets, but which is not fully diversified in that it does not include any preferred stock or debt securities or other non-corporate financial assets, whilst the latter is the personification of an investment portfolio that is diversified across the common stock, preferred stock, and bonds of the subject corporation, holding each of these securities in proportion to its share of the corporation’s overall debt and equity capitalization, without including any other risky assets.\textsuperscript{99}

\textbf{E. Objectives}

Shareholder objectives may also vary. Despite the common interest on receiving returns on their investment, there is a wide array of objectives beyond this, such as creating shareholder value, control objectives, network building, social goals, credit risk and being risk averse. Anabtawi draws a distinction between public and union pension funds versus economic shareholders, so as to explain that certain shareholders may well have targeted non-economic interests. Examples of such shareholders are public pension funds and labor-union pension funds, which may well pursue socially targeted objectives depending on their mandates at the expense of shareholder wealth.\textsuperscript{100}

\textbf{F. Global and Local Shareholders}

Shareholders operating from afar or locally to the companies they invest in are likely to have a different outlook on their investment. A distinction can be drawn between large, globally operating money managers and large strategic shareholders that often protect the ‘national interest’ in certain companies. An example of the former is Blackrock investments, which moves money around the globe chasing the best returns. An example of the latter the French or German governments, that are locked into certain ‘local’ investments irrespective of the financial gains or losses that occur.

\textsuperscript{94} Crespi (2007) at 381.
\textsuperscript{95} Crespi (2007), at 388.
\textsuperscript{96} Crespi (2007), at 388-389.
\textsuperscript{97} Crespi (2007), at 389.
\textsuperscript{98} Crespi (2007), at 390.
\textsuperscript{99} Crespi (2007) at 391.
\textsuperscript{100} Anabtawi (2007) at 11
H. Investment Chain

Outside the remit of shareholder identification, it is important to note that in many cases, so called “fund-managers” are responsible for the day-to-day management of a scheme’s assets acting on the basis of instructions given to them by an investment mandate.\(^\text{101}\) The investment mandate constitutes the agreement between the investment manager and their client and outlines how the assets of the scheme are to be managed, and may contain performance targets by reference to a benchmark, or may contain restrictions on which investments the investment manager can make.\(^\text{102}\) Institutional shareholders consist of large institutions such as insurance companies, pension funds, hedge funds and mutual funds. These investors act on behalf of others and are assumed to be more sophisticated and have superior financial capabilities in comparison to regular individual investors. Institutional shareholders can be further distinguished between financial institutional (pension fund – only strategy is to make financial gain) and operational institutional, when their investment is part of strategic alliances, as build up to eventual consolidation, meaning that their strategy is driven by operational concerns. As Greenwood identifies, the characteristic of institutional shareholders is that they invest on behalf of the interests of their own fictional corporate law shareholders and act as if they were agents of an undiversified investor with no interests beyond the portfolio held by the institution and without offering any mechanism by which their own investors could indicate any divergent interests.\(^\text{103}\)

Variances exist even between institutional investors. Mutual funds and insurance companies are subject to constant rating and comparison and are concerned with maximising their investment returns to offer competitive insurance rates respectively.\(^\text{104}\) Pension funds are less subject to competitive markets and are in theory more concerned with complying with acting in the interests of the participants and beneficiaries of the fund.\(^\text{105}\) However, as Greenwood rightly points out, despite the fact that pension plans are required by law to reduce the plan participants to fictional persons who are interested only in the benefits from the plan, regardless of any other considerations, the truth of the matter is that the fund’s aim of maximising the benefits of the fictional beneficiaries of those funds without recourse to employees’ interests, may be contrary to the interests of the actual beneficiaries of the fund, who are both employees and pension beneficiaries, and perhaps long-term residents of a local economy with few alternative job opportunities.\(^\text{106}\) Individual shareholders also constitute a significant proportion of investors in UK companies and can be distinguished between high-net worth individuals and individuals that make investments for an increase of their income. Individuals can also be distinguished between those which allocate an excess of their funds in an investment for better returns and retirement income independent individuals.

VI. Conclusion

The ‘varieties of shareholders’ argument put forward by the present paper casts serious doubt on the shareholder primacy position adopted by various legal jurisdictions across the globe, including the UK. The ‘varieties of shareholders’ suggests that there is no monolithic realm of “shareholders’ interests” that directors can give priority to.\(^\text{107}\) Shareholders’ interests are too fragmented, too conflicted and potentially at times at odds with each other. It is recommended that guidelines

\(^{101}\) Law Commission Law Com No 350 Fiduciary Duties of Investment Intermediaries, Definitions, page xii.
\(^{102}\) Law Commission Law Com No 350 Fiduciary Duties of Investment Intermediaries, Definitions, page xii.
\(^{103}\) Greenwood (1996) at 1066.
\(^{104}\) Greenwood (1996) at 1067.
\(^{105}\) Greenwood (1996) at 1067-1070.
\(^{106}\) Greenwood (1996) at 1067-1070.
\(^{107}\) Anabtawi (2007) at 7, who arrives at a similar conclusion.
should be provided with reference to which shareholder interests are legitimate interests and which
not. The broad term ‘shareholder’ is outdated. Legislators and policy makers must acknowledge
the existence of profound differences between shareholders, which need be reflected in policy
making and law making respectively. A formal acknowledgment of the varieties of shareholders
that exist is necessary in order to have a clear view of the different types of opportunistic
incentives and agency/social costs that companies may face and should avoid. How can the
legislator guarantee that the company’s interests are indeed aligned with the correct set of
shareholders’ interests that can facilitate the long-term growth of companies that create and add
value in a society in which they operates?

As Nordberg argues, within the shareholder primacy context and specifically within the context of
increasing shareholder power, it is necessary to consider what the bases for legitimacy of this
power is.\textsuperscript{108} Especially at this current stage in time, with diverging interests ranging between long-
term, activist asset management firms and perverse activist shareholders, it is questionable which
type of interests managers should aspire to serve. As Nordberg identifies, the question to consider
is whose rights are more legitimate and on what basis? The majority rule is a well-known common
law principle established in Foss v Harbottle.\textsuperscript{109} The time has come however to consider whether
this rule needs to be complemented by guidance on the set of interests of shareholders, majority
or not, that managers should aspire to serve. It is indeed questionable whether companies perform
“well” by acting in the interests of majority shareholders, when the interests of those shareholders
are perverse.\textsuperscript{110}

Nordberg argues that the way forward is the need for the government or another authority with
political legitimacy to set in place a framework that will hold the asset management industry to
account by regulating their voting practices. The present paper argues however that trading
practices, voting practices and investment strategies cannot easily be regulated. The way forward
necessarily lies with the board of directors and better regulating the practice followed in board
decision making. From an overview of section 172 CA 206 it becomes apparent that the section
aims to change or rather better articulate what good practice in corporate decision-making is. The
section does not seek to alter the standard or content of accountability. It has left many questions
unanswered but addresses an important point with regard to the interests of shareholders and
what those are. In publicly traded companies shareholders will exercise their power and influence
on an informal level, outside courts and outside the General Meeting of shareholders. Directors
however are entrusted to manage the corporation in the interests of shareholders, on a condition.
The condition is or should be that the interests that are served are supported by a legitimate basis.

The fictional shareholder ultimately fails to represent the reality that the law needs to take account
of. Using shareholders’ interests as guidance for board decision-making and beyond misses the
point, as its use may be more appropriate for the interests of some shareholders and less or not at
all for the interests of others. There is a need to break up the monolithic corporate governance
construction of “shareholder” into something more meaningful based on the common knowledge
that the shareholder body of large publicly listed companies is heterogeneous by nature
encompassing a series of interests and incentives.

\textsuperscript{108} Nordberg (2010) at 422.
\textsuperscript{109} Foss v Harbottle (1843) 67 ER 189.
\textsuperscript{110} Nordberg (2010) at 422.