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UNIVERSITY OF TURKU

NAVIGATING AGENCY PROBLEMS IN CORPORATE LAW

A Comparative Study through the Lens of Law and Economics

Yasith Hirimburegama

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ABSTRACT

This interdisciplinary research explores agency problems within corporate law, through the lens of comparative law and law and economics. By expanding these distinctive yet complementary perspectives, this complex entity can be more easily understood. Here the approach departs from traditional company law strategies and instead unites an economic evaluation of legal norms with a comparative examination of various jurisdictions, thus offering a novel view on how to better solve agency problems. To discern and combine effective legal strategies from diverse jurisdictions, this research also capitalises on comparative law methodology. Based on the strengths of different legal cultures it creates a framework, grounded in law and economics – *tertium comparationis* –, that can be used to assess and address the second and third agency problems.

After analysing the second agency problem, this research proposes the integration of shareholder costs within transaction cost theory. It recommends enhancing cost-efficiency in corporate governance, facilitated by bolstering fiduciary duties, promoting transparency, and endorsing proactive dispute resolution. A proposal emerging from this research introduces a mechanism for prosocial investors to voice their interests in the company, safeguard economic rights and empower minority shareholders.

In addition to the second agency problem, the third agency problem is explored, redefining a company's purpose to mirror public interest and balance socio-economic prosperity with environmental sustainability. The research introduces stakeholder costs in transaction cost theory, underlining the long-term value increase of incorporating stakeholder rights as monitoring costs. Here, emphasis is placed on the importance of aligning businesses with the provisional nine planetary boundaries and establishing a robust social foundation, as inspired by the Doughnut Economics model. The research suggests regulatory mechanisms to categorise businesses based on their environmental impact and advocates for all companies, irrespective of their size or sector, to adhere to high sustainability standards.

In conclusion, the research combines comparative law methodology with law and economics, and proposes legal strategies that address agency problems, promote efficiency, and advocate for environmental sustainability. It exemplifies the potential of this combined approach to reshaping the corporate landscape to better reflect public interest while upholding the principles of the Doughnut Economics model.

KEYWORDS: Law and economics, agency problems, company law, planetary boundaries

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TIIVISTELMÄ

Tässä monitieteisessä tutkimuksessa tarkastellaan yhtiöoikeudessa esiintyviä agenttiongelmia vertailevan oikeuden ja oikeustaloustieteen näkökulmasta. Laajentamalla näitä toisistaan poikkeavia mutta toisiaan täydentäviä näkökulmia voidaan tätä monimutkaista kokonaisuutta ymmärtää helpommin. Tässä lähestymistavassa poiketaan perinteisistä yhtiöoikeudellisista strategioista ja sen sijaan yhdistetään oikeudellisten normien taloudellinen arviointi ja eri lainkäyttöalueiden vertaileva tarkastelu, mikä tarjoaa uudenlaisen näkemyksen siitä, miten agenttiongelmia voidaan ratkaista paremmin. Tässä tutkimuksessa hyödynnetään myös vertailevan oikeustieteen menetelmiä, jotta voidaan havaita ja yhdistää eri lainkäyttöalueiden tehokkaita oikeudellisia strategioita. Eri oikeuskulttuureiden vahvuuksien pohjalta luodaan oikeustieteeseen ja talouteen perustuva kehys (tertium comparationis), jota voidaan käyttää toisen ja kolmannen agentuuriongelman arvioimiseen ja ratkaisemiseen.

Toisen agenttiongelman analysoinnin jälkeen tässä tutkimuksessa ehdotetaan osakkeenomistajakustannusten sisällyttämistä transaktiokustannusteoriaan. Siinä suositellaan kustannustehokkuuden lisäämistä omistajaohjauksessa, jota helpotetaan vahvistamalla luottamusvelvollisuuksia, edistämällä avoimuutta ja tukemalla ennakoivaa riitojenratkaisua. Tutkimuksen tuloksena syntyneessä ehdotuksessa otetaan käyttöön mekanismi, jonka avulla sosiaalisesti aktiiviset sijoittajat voivat tuoda esiin etujaan yrityksessä, turvata taloudelliset oikeudet ja antaa vähemmistöosakkeenomistajille enemmän vaikutusvaltaa.

Toisen agenttiongelman lisäksi tutkitaan kolmatta agenttiongelmaa, jossa yrityksen tarkoitus määritellään uudelleen siten, että se heijastaa yleistä etua ja tasapainottaa sosioekonomista hyvinvointia ja ympäristön kestävyyttä. Tutkimuksessa esitellään sidosryhmäkustannukset transaktiokustannusteoriassa ja korostetaan, että sidosryhmien oikeuksien sisällyttäminen valvontakustannuksina kasvattaa arvoa pitkällä aikavälillä. Tässä yhteydessä korostetaan, että on tärkeää sovittaa yritystoiminta yhteen planetaaristen rajojen kanssa ja luoda vankka sosiaalinen perusta Doughnut Economics -mallin innoittamana. Tutkimuksessa ehdotetaan sääntelymekanismeja yritysten luokittelemiseksi niiden ympäristövaikutusten perusteella ja kannatetaan sitä, että kaikkien yritysten olisi niiden koosta tai toimialasta riippumatta noudatettava korkeita kestävyysstandardeja.

Lopuksi voidaan todeta, että tutkimuksessa yhdistetään vertailevan oikeustieteen metodologia sekä oikeustaloustiede ja ehdotetaan oikeudellisia strategioita, joilla puututaan agenttiongelmiin, edistetään tehokkuutta ja parannetaan ympäristön kestävyyttä. Se on esimerkki tämän yhdistetyn lähestymistavan mahdollisuuksista muuttaa yritysmaailmaa siten, että se heijastaisi paremmin yleistä etua ja noudattaisi samalla Doughnut Economics -mallin periaatteita.

AVAINSANAT: Oikeustaloustiede, agenttiongelmat, yhtiöoikeus, planetaariset rajat

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CHAPTER ONE – INTRODUCTION TO THE RESEARCH AND ITS OBJECTIVES

1.1 Chapter navigation: a thematic research roadmap

This research aims to develop a unique comparative methodology that utilises tools from both law and economics to devise legal strategies that reduce costs in the context of law and economics. In doing so, it argues that legal strategies informed by the goals of the Doughnut Economics model, as suggested by Kate Raworth,[1] would benefit the company in the long term. To achieve these goals, this research comprises six chapters.

Chapter one serves as an introduction to the research, providing a roadmap for the themes and topics that will be addressed throughout the study. It commences by outlining the background and motivation behind the research, identifying crucial gaps in the existing body of knowledge that this research seeks to fill. Following this, the chapter sets the course and establishes the primary research question and aims. Central to this chapter is a comprehensive overview of the comparative law methodological framework. The chapter delineates the historical context, relevant disciplines, and the pivotal role and objectives of comparative law, fostering an understanding of its methodology and application in the context of this study. Furthermore, the chapter defines the scope of the research and expounds upon key concepts fundamental to the study. The chapter concludes by contemplating the potential impact of the research, laying the groundwork for ensuing chapters and the study's overall contribution to the field of corporate law and governance. This chapter, therefore, functions as a gateway to the complex research journey that lies ahead.

Chapter two explores the 'economic approach to law', highlighting its importance in the realm of company law. The chapter emphasises the significance of this approach within the law-making process, tracing its historical development

[1] Kate Raworth, Doughnut Economics: Seven Ways to Think Like a 21st Century Economist (Random House Business Books 2017).

across various jurisdictions such as Finland, Sweden, the United States (US), the United Kingdom (UK), and German-speaking countries. At the heart of this examination lie the themes of ‘economic analysis of law’ and ‘law and economics’. These key aspects of the economic approach to law are analysed in depth, showcasing their considerable influence on legal interpretations and applications. The necessity and benefits of applying economic theories within the law-making process are thoroughly explored, emphasising their relevance to fundamental legal doctrines like ‘limited liability’, ‘separate legal personality’, ‘separation of ownership and control’, ‘control transactions’, and ‘related-party transactions’. Furthermore, the chapter critically examines recent developments and contentious elements within these themes. This entails carefully examining the distinct features, commonalities, and distinctions between ‘economic analysis of law’ and ‘law and economics’, along with a balanced evaluation of the critique commonly aimed at the economic approach to law. The chapter culminates in a comprehensive commentary that consolidates various perspectives, underscores the significance of the economic approach within the field of law, and elucidates its intricate ramifications within the broader legal system.

In chapter three, titled ‘The Theory of the Firm and Stakeholderism: A Way Forward in Policymaking?’, the theories of law and economics that underpin this research are explored, and several interconnected themes are presented. First, the evolution of the theory of the firm is considered, emphasising its significant role in corporate governance. In another theme, the merits of the agency cost theory and transaction cost theory are discussed, advocating for their utility in efficient law-making processes. These themes propose a case for long-term cost-efficiency in company law and suggest potential solutions derived from the principles of both agency cost theory and the stakeholder approach. The next theme provides a thorough analysis of the three agency problems in corporate governance. This research sheds particular light on the environment as a stakeholder, facilitating the promotion of prosocial investor rights and contributing to the discourse on the applications of agency theory in corporate governance. The theme of legal strategies utilised across jurisdictions to mitigate agency costs is analysed, offering insights into diverse regulatory approaches and their implications.

Another significant theme is the stakeholder theory, which frames the discourse around the merits and application of the stakeholder approach in corporate governance. The latter sections of the chapter present themes centred on the contentious debates between stakeholderists and contractarians, as well as the potential for future research. Taken together, these sections underline the importance of fully grasping these themes in the context of policymaking in corporate governance. In essence, chapter three provides an academically rigorous, thematic exploration of the theory of the firm, agency cost theory, transaction cost theory, and

stakeholder theory. The chapter highlights their central roles in shaping effective law-making processes. As such, this chapter lays the foundation for fashioning six law and economics questions as the *tertium comparationis* for the comparative chapter.

Chapter four embarks on a comparative study and analyses how the corporate laws of various jurisdictions approach the task of reducing agency costs. Here, six key questions, derived from an economic approach to law, examine how existing laws mitigate the agency costs associated with the second and third agency problems. The chapter begins with an introductory section, followed by a deeper analysis addressing corporate law in three jurisdictions, namely - Finland, Sri Lanka, and the UK. The motivation for choosing these countries can be attributed to the author's personal, professional, and educational background, as well as their familiarity with the specific legal remedies available in each jurisdiction. Finland is chosen primarily due to the author's residence, which facilitates easy access to legal resources. This jurisdiction provides an opportunity to explore the Nordic elements of company law, particularly the application of the equal treatment remedy. The Finnish context offers a compelling contrast to the common law traditions observed in Sri Lanka and the UK. Sri Lanka's inclusion stems from the author's professional and legal experiences within the country, ensuring a nuanced understanding and accessibility to pertinent legal resources. The focus here is on the remedies for oppression and mismanagement, traditional legal solutions deeply rooted in the nation's company law. The UK is selected based on the author's educational background and familiarity with the common law system. The evolution of UK company law is especially noteworthy; it has progressed from offering remedies for oppression and mismanagement to introducing the unfair prejudice remedy. This transition presents an area for analysis and comparison. Together, these jurisdictions offer a comprehensive overview of various legal remedies—from the equal treatment remedy in Finland, to the traditional oppression and mismanagement remedies in Sri Lanka, and finally, to the evolved concept of the unfair prejudice remedy in the UK. This selection enables an in-depth examination of the different legal frameworks and their practical implications in company law.

As part of the Sri Lankan comparative study, legal strategies from other common law jurisdictions such as India, Canada, Australia, New Zealand, and the US are also examined. For each jurisdiction, the chapter outlines general aspects of its corporate law before dissecting specific legal strategies related to the second and third agency problems. These strategies focus on shareholders' rights, cost-effective enforcement mechanisms, equal treatment remedies, and definitions of oppressive conduct, all within the context of the second agency problem. The third agency problem analysis explores the role of law in protecting non-shareholder stakeholders, particularly the environment, and seeks to generate new knowledge regarding the role of unfair

prejudice, oppression, and mismanagement remedies in achieving sustainability in corporate governance. In essence, Chapter four serves as a navigational tool, presenting a structured and in-depth exploration of how different legal systems utilise laws and legal strategies to reduce agency costs, thereby fostering a more sustainable and efficient corporate environment.

Chapter five embarks on a deep exploration of agency problems, and attempts to redefine a company's interests to align with a commitment to prioritising the public and subsequent shareholder interests. This undertaking provokes a scholarly debate centred on the critical need to ensure a safe and just space for humanity within the realm of corporate governance. This chapter thoroughly explores these debates and also introduces a global perspective on the subject. It critically analyses the historical emergence, current status, and future perspectives of shareholder primacy, and navigates through the complex terrain of the business judgment rule, shareholders versus stakeholders' debate, and the emergence of sustainable corporate governance initiatives. Moreover, the chapter paves the way for a paradigm shift, presenting innovative and transformative approaches to redefine corporate purpose through sustainable value creation and the Doughnut Economy Model, signalling a refreshing perspective on corporate sustainability.

Chapter five's findings offer a challenging discourse to traditional company law thinking, setting the stage for thought-provoking discussions. Furthermore, it provides a valuable foundation for Chapter six, which presents the culmination of the research, suggesting novel legal strategies to address the second and third agency problems. Hence, the findings of this chapter offer key insights into future research and policy-making, underlining the significance of this investigation in the broader landscape of corporate law and sustainability.

Chapter six synthesises the salient findings from the previous chapters and analyses the second and third agency problems from a corporate governance perspective. The chapter first clarifies the transformative potential of sustainable investments and shareholder remedies in altering the current trajectory of corporate governance, thereby tackling the second agency problem. Next, it assesses shareholder rights, viewed as proactive monitoring mechanisms, and evaluates procedures for resolving disputes cost-effectively. It further proposes a set of innovative legal strategies tailored to diminish the costs associated with the second agency problem.

Transitioning to the third agency problem, the chapter outlines cost implications for various stakeholders and offers a comparative overview of proactive environmental monitoring mechanisms. It highlights a range of legal strategies that aim to ameliorate agency problems between the firm and its creditors, employees, and the environment, all the while drawing on doctrines, corporate codes, and legislation from multiple jurisdictions. Moreover, the chapter examines the redefined

purpose of companies through the lens of sustainable corporate governance and articulates a series of proposed legal strategies intended to alleviate costs within the third agency problem, specifically those between the firm and the environment. Chapter six culminates in a rigorous synopsis of the findings, encapsulating the critical outcomes and intellectual contributions of the research to the broader discourse on sustainable corporate governance.

1.2 Background of the research

In any given country, the state is responsible for fashioning an effective legal and regulatory framework in which businesses may operate in order to promote enterprise, growth, and the right conditions for investments and employment to develop. Weaver and Rockman state that '*A state with more administrative ability has the means to establish itself as the legitimate authority to pursue new opportunities, innovate when old policies fail, identify and evaluate alternatives, and build coalitions in support of new policies'*.[2] This research supports state action towards achieving the stated goals by carrying out a comparative study of company law, specifically through the principles of law and economics. The seminal work, 'The Anatomy of Corporate Law' by Kraakman and others identifies three core agency problems in corporate law. The first is the classic agency dilemma between the company's owners and its appointed managers (the first agency problem). The second conflict arises between controlling and non-controlling shareholders (the second agency problem), also known as the majority-minority shareholder problem. The third issue identified by Kraakman and others is the agency problem between the firm itself—including, notably, its owners—and its contracting parties such as stakeholders (the third agency problem).[3] These agency problems will be discussed in greater detail in the subsequent chapter.

Company law set out the legal and economic basis on which the companies are formed, operated and managed. The regulative institutions underpinning shareholder capitalism and minority shareholder protections are mostly found in the domains of

2 Kent R Weaver and Bert A Rockman, *Do Institutions Matter? Government Capabilities in the United States and Abroad* (Brookings Institution Press 1993); also see Mauro F. Guillén, and Laurence Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (2016) 61 (1) Administrative Science Quarterly 125, 126.

3 Reinier Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford 2017) <https://doi.org/10.1093/acprof:oso/9780198739630.001.0001> accessed 11 July 2023, 37.

corporate law and supplemented by corporate governance.[4] For example, within these jurisdictions, governing regulations are established for various stakeholders within a company, encompassing shareholders, directors, and those in managerial roles, including board members and the general manager. It is pertinent to acknowledge that the nomenclature employed is often jurisdiction specific. For example, in the Nordic context, the term 'director' ('*johtajat*') pertains to an individual in a managerial position, a notion that diverges from its interpretation in common law jurisdictions. These regulatory frameworks play a crucial role in steering decisions pertinent to business growth and investments, whilst also instituting a system of accountability for the utilisation of the firm's economic prowess. The proposed Company Law Reform Bill for the 2006 amendment (the White Paper presented to the UK parliament) specifically stated, inter alia, '[...] *an effective framework of company law and corporate governance is a key building block of a modern economy. A genuinely modern and effective framework can promote enterprise, enhance, competitiveness and stimulate investment*'.[5] This research leverages law and economics theories to devise legal strategies for addressing legal issues outlined through the aforesaid agency principles in law and economics. Accordingly, the yardsticks or the Latin expression '*tertium comparationis*', as explained by Husa, are law and economics tools that focus on agency problems in law.[6] Chapters two and three provide an in-depth discussion on these yardsticks, which comprise the law and economics comparative framework.

This research presents a comparative study of the legal strategies currently used in both common law and civil law countries to address the aforesaid agency problems. The strategies analysed primarily come from the United Kingdom and Sri Lanka, which represent common law countries, with additional insights drawn from the United States, India, Australia, Canada, and Singapore. Civil law strategies are mainly derived from Finland, although Germany's approaches are also considered. This study leans more heavily towards common law strategies, as the author hails from a common law country, in an effort to minimise potential misinterpretations of legal concepts from civil law jurisdictions.

This research concentrates on two of the aforementioned agency problems: the second and the third. The aim is to develop a model of statutory provisions, also known as legal strategies, to increase economic efficiency in the operation of the

4 John Coffee, 'The mandatory/enabling balance in corporate law: An essay on the judicial role' (1989) 89 Columbia Law Review 1618.

5 Alan Dignam and Andrew Hicks, *Hicks and Goo's Cases and Materials on Company Law* (OUP 2011) 63-64; also see Kanaganayagam Kanag-Isvaran and Dilshani Wijesinghe, *Company Law* (Published by K. Kanag-Isvaran 2014) 294.

6 Jaakko Husa, *Introduction to Comparative Law* (2nd edn, Hart Publishing 2023) 148.

company by amending company law provisions. Specifically, this research seeks solutions to existing legal problems in the second and third agency problems, with a focus on creating an efficient shareholder remedy for the second agency problem and devising legal strategies to address the third agency problem, particularly in relation to the company's purpose. The ultimate goals of these aims are to secure long-term benefits for both the company and society at large.

Shareholders of a company have access to multiple legal remedies through company legislation in different countries, such as 'derivative action' and 'minority buy-out rights'. This research, however, specifically focuses on the legal remedies available to shareholders for acts of unfair prejudice, oppression, and mismanagement, collectively referred to as the 'unfair prejudice', 'oppression', and 'mismanagement' shareholder remedies.

The oppression remedy, for instance, is a statutory measure available to shareholders when the company's affairs are conducted in a manner prejudicial or oppressive to the minority shareholders, usually by the controlling (majority) shareholders. Such oppressive acts can be characterised as 'burdensome', 'harsh', or 'wrongful' conduct.[7]

This remedy has its roots in the English Act of 1948.[8] Due to its effectiveness and economic benefits, it has been broadened and adopted by other common law countries, including Australia, New Zealand, Canada, Sri Lanka, and India. Empirical research conducted by Guillén and Capron suggests that minority shareholder remedies, such as the oppression remedy, have bolstered markets through higher capitalisation in countries like the UK and the US.[9] This is achieved by strengthening the rights of small-scale investors in the company (minority shareholders), attracting diversified investments to expand, grow, or scale the business.[10] However, it should be noted that other research has not yet confirmed Guillén and Capron's findings. This may be because Guillén and Capron's findings are supported by comprehensive real-world data. Over time, the oppression remedy has evolved into the unfair prejudice remedy in the UK and India, providing wider protection to shareholders.

7 KR Chandratre, Law & Practice Relating to Oppression & Mismanagement – Minority Shareholders' Remedies (S Balasubramanian ed, 2nd edn, Bharat Law House 2016) 143.

8 Section 210 of the UK Companies Act 1948.

9 Guillén and Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (n 2) 135.

10 ibid 135; also see Rafael La Porta, and others, 'Law and finance' (1998) 106 Journal of Political Economy 1113; Rafael La Porta and others, 'Investor protection and corporate governance' (2000) 58 (3) Journal of Financial Economics 27; Mary O'Sullivan, 'The political economy of comparative corporate governance' (2003) 10 (23) Review of International Political Economy 73.

The mismanagement remedy originated from the Indian Companies Act of 1956 and has no counterpart in the English Act. The context for the introduction of the mismanagement remedy in India was to provide relief against the mismanagement of company affairs that could not otherwise be suitably addressed under the oppression remedy. The Indian Companies Act of 2013 merged oppression and mismanagement into a single section, eg Sec. 241 and further, broadening minority shareholder protection by incorporating the UK concept of 'prejudicial' and thus securing investment diversification in entrepreneurial companies seeking to grow. Guillén and Capron found that since the year 2000, common-law countries have had the highest degree of protection of minority shareholder rights owing to such remedies.[11] Furthermore, several scholars have argued that widely dispersed share ownership is a catalyst for developing a given country's stock market and even its economic growth.[12]

Unfair prejudice, oppression and mismanagement shareholder remedies are not present in the Nordic corporate governance models, which is based on the 'majority rule' principle that confers higher controlling power of the company to the shareholders with a higher percentage of shares (majority shareholders).[13] However, the *Finnish Limited Liability Companies Act* (*Osakeyhtiölaki*, 624/2006)[14] (hereinafter referred to as 'FCA') has recently deviated from the traditional Nordic CG model by adopting several concepts and provisions from the Anglo-American CG model.[15] That said, the FCA has not adopted the concept of affording non-controlling shareholders protection through the unfair prejudice/oppression shareholder remedy. The main non-controlling (minority) shareholder protection provided to Finnish companies comes through the principle of equal treatment of shareholders (equal treatment).[16]

It should be noted that there are distinctions in the protection afforded by the aforementioned 'equal treatment' remedy and the 'oppression/unfair prejudice' remedy for non-controlling shareholders. The reasons for these differences include, but are not limited to, the scope of redress available under the 'equal treatment' remedy. In this context, minority shareholders can initiate actions solely based on

11 ibid 138.

12 Gerald Davis, Managed by the Markets: How Finance Re-shaped America (Oxford University Press 2009).

13 Per Lekvall (ed), *Nordic Corporate Governance Model* (SNS förlag 2014) 17.

14 Finnish Limited Liability Companies Act (624/2006, as amended).

15 Ville Pönkä and Matti Sillanpää, 'Finland' in Carsten Gerner-Beuerle and others (eds), *The Private International Law of Companies in Europe* (Hart 2018) 364.

16 See Section 5 of the Limited Liability Company Act of Finland 2006 (624/2006; *osakeyhtiölaki*) - The 'equal treatment' remedy prohibits the general meeting, the board or the executive management from taking decisions that unduly favour one group of shareholders at the expense of the company or other shareholders.

decisions by shareholders or management that unduly favour one group of shareholders to the detriment of either the company or other shareholders. Conversely, with the ‘oppression’ remedy, an aggrieved shareholder has the recourse to pursue additional actions against conduct that could be construed as ‘burdensome’, ‘harsh’, or ‘wrongful’. For instance, this could encompass actions that involve treating individuals cruelly and unfairly, particularly by denying them equal freedom, rights, or opportunities, including the inequitable treatment of a group of people. Consequently, the ‘oppression’ remedy offers supplementary safeguards to shareholders, extending beyond the acts covered by the ‘equal treatment’ remedy.

Based on Guillén and Capron’s empirical findings, one could argue that strengthening minority shareholder remedies, such as adopting unfair prejudice/oppression remedies, can instil confidence and provide security to foreign mutual funds/investors seeking to diversify investments in jurisdictions that currently provide lesser protection to minority shareholders. Consequently, companies in these jurisdictions—particularly private ones—could readily increase their capital when necessary.

The goal of this research is to compare various statutory provisions of unfair prejudice and oppression remedies in several jurisdictions, gather knowledge, and propose a model shareholder remedy. This remedy could be adopted in jurisdictions that currently lack such comprehensive protections, like the unfair prejudice/oppression remedy, but with special protective mechanisms for green investors to promote environmental sustainability.

As Husa notes, ‘Comparison is the engine of knowledge without which we cannot obtain knowledge that actually surpasses the knowledge of our limited cultural sphere’.[17] Thus, country specialists with specific language skills could utilise the model discussed in the concluding chapter, adapting it to their local company law according to its unique legal culture. Husa further agrees with Watson in stating that ‘Law develops mainly by borrowing’.[18]

In the contemporary landscape, safeguarding minority shareholders has become increasingly significant due to digital advancements that offer diversified methods of attracting investments in a company. Equity crowdfunding, for example, provides promising opportunities for startups and businesses to augment their capital through venture capitalism, thus facilitating their growth, diversification, and competitiveness. AngelList, established in 2010, has gained prominence as a US-based equity crowdfunding platform for raising capital. On a similar note, Invesdor, a Finnish equity crowdfunding platform founded in 2019 and based in Helsinki, has

17 Husa (n 6) 69.

18 Husa (n 6) 185; also see Alan Watson, *The Making of the Civil Law* (Harvard University Press 1981) 181.

also been recognised.[19] These platforms enable members of the public to invest in listed private companies, thereby purchasing equity shares.[20] This process aids in fund diversification and risk mitigation. It is notable that these fund investments often manifest as small-scale share purchases.

As asserted by La Porta, O'Sullivan, and Guillén and Capron, the expansion of the stock market and the encouragement of small-scale investments hinge on the availability of adequate legislative measures protecting minority shareholders.[21] Particularly, small-scale investors are reticent to take risks if their rights are not robustly safeguarded. Thus, legal remedies that protect against unfair prejudice, oppression, and mismanagement serve as essential shields for minority shareholders. An effective legal framework promotes investor confidence, inspiring them to diversify their investments via equity crowdfunding platforms and, in turn, enabling entrepreneurs to increase their capital with relative ease.

However, within the realm of shareholder remedies in listed companies, it is crucial to highlight that Esser and Loughrey observed a complete lack of inter-corporate litigation by shareholders in the UK. This suggests that the unfair prejudice remedy is underutilised in public companies.[22] Hannigan reinforces this viewpoint, noting that shareholders often opt to sell their shares at reduced prices to circumvent the expense of inter-corporate litigation.[23] This brings to light a weakness in the UK's enforcement of shareholder remedies addressing the second agency problem in public companies. In response to this, the present research introduces cost-effective strategies for shareholders, even in public companies, to invoke these remedies without unnecessary financial strain. In this context, the research explores cost-effective shareholder dispute arbitration methods specifically available through the International Chamber of Commerce and other internal mechanisms.

Drawing from a comparative study, this research puts forth a model shareholder remedy aimed at attracting global mutual funds, including green funds, to diversify their investments in companies listed on stock markets such as the Nasdaq First

[19] See Invesdor -<https://www.invesdor.com/en-gb/about-us/> accessed on 4th September 2021.

[20] **Note -** Senior advisor for legislative affairs of the Ministry of Finance highlighted the importance of crowdfunding and equity crowdfunding at the seminar on 'Digitalisation and Law' organised by Aalto University, Business School which was held on 28th of August 2019.

[21] Guillén and Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (n 2) 126; also see La Porta, 'Law and finance' (n 10).

[22] Irene-Marie Esser and Joan Loughrey, 'Stock corporations: corporate governance and external and internal controls' in Andrea Vicari and Alexander Schall (eds), *Company Laws of the EU: A Handbook* (Beck/Hart 2020) 1534.

[23] Brenda Hannigan, *Company Law* (6th edn, Oxford University Press 2021) 432.

North Growth Market. This model can prevent minority shareholders from having to sell their shares at a loss and exit the company due to unfairly prejudicial actions.

This comparative research enhances our understanding of functional comparisons within the field of law and economics. By scrutinising diverse provisions, or normative practices across selected jurisdictions, we underscore their similar functions in reducing agency costs. This examination brings to light the economic benefits of the aforementioned shareholder remedies and explores their potential to attract investments, particularly from pro-social or green investors, to private companies. Given the growing popularity of sustainable funds and the recent implementation of EU Directives such as the Corporate Sustainability Reporting Directive (CSRD)[24] and the Corporate Sustainability Due Diligence Directive (CSDD),[25] we believe the findings of this study will be beneficial for policymakers. These general insights could inform the crafting of an efficient legal framework for private companies, fostering their development and growth.

The study is particularly useful for policymakers seeking to shape company law to draw investment into private companies, especially to attract venture capitalists through equity crowdfunding platforms. It is also believed that these remedies can be highly effective in countries that encourage entrepreneurship. This is because entrepreneurs can attract small-scale investments and raise capital more easily, thanks to the protection provided by these statutory remedies. As pointed out by Esser and Loughrey, and Hannigan, these remedies are primarily utilised by shareholders in private companies (closed companies) in the UK during shareholder disputes.[26] Similarly, it is believed that these remedies can provide security to small-scale investors by strengthening minority shareholder protection, thus attracting small-scale investments to private entrepreneurial businesses.

This study thus aims to fill the research gap regarding the economic benefits of the aforementioned remedies. It embarks on a novel approach, leveraging economic theories such as the theory of the firm and the stakeholder approach found in management theories. The objective is to develop the aforementioned model shareholder remedy designed to enhance the efficiency of a firm (or company) via legal instruments.

[24] See CSRD - Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Text with EEA relevance) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464> accessed on 27 June 2023.

[25] See Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071> accessed on 30 June 2023.

[26] Esser and Loughrey (n 22); Hannigan (n 23).

It is recognised that corporate governance has been significantly influenced by economic theories, particularly in the US. The inception of the economic approach to law traces back to the early 1940s at the University of Chicago. In the 1960s, the mantle was carried forward by prominent figures like Ronald Coase[27] and Guido Calabresi,[28] who are credited as the founding fathers of the economic approach to the law movement. Despite these developments, the economic analysis of law has yet to gain substantial traction in Nordic countries, even as Finland shifts toward the Anglo-American company law model, which is rooted in economic theories. This deficiency in law and economics research within Nordic countries underscores the necessity for further research to bolster knowledge in the field.

Changes to government regulations in the US during the late 1960s and 1970s had a positive impact on the economic movement within corporate law, the success of which had far-reaching influences on global corporate governance. This period saw the birth of market or contract theories in corporate governance, including the nexus of contract theory, agency theory, and transaction cost analysis, all of which fall under the umbrella of the theory of the firm. These theories, despite their shared principles like the maximisation of shareholder profits, continue to guide corporate governance policymaking.

In 1984, Freeman introduced his stakeholder theory, proposing that corporate decision-making should account for non-shareholder interests, including environmental considerations, alongside the maximisation of shareholder profits, as part of the long-term success strategy of a company.[29] This idea offered a contrasting viewpoint to the existing theories of the firm. However, the stakeholder approach did not gain significant traction until the financial recession in 2008 and the COVID-19 pandemic in 2020.

Today, a global academic debate continues over which perspective is better suited to contemporary corporate governance policymaking – should the focus be purely on the maximisation of profits for shareholders, or should it consider the interests of all stakeholders in corporate decision-making?

In this research, a different approach is explored. Drawing on the SMART project led by Sjåfjell and Mähönen,[30] the Doughnut Economics model advocated

27 Richard A Posner, 'Economic Approach to Law' (1975) 53 Tex. L. Rev. 757.

28 Guido Calabresi, The Future of Law and Economics: Essays in Reform and Recollection 2 (1st edn, Yale University Press 2016).

29 Edward R Freeman, Strategic management: A stakeholder approach (Pitman 1984).

30 Beate Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (2019) University of Oslo Faculty of Law Research Paper No 2019-63, Nordic & European Company Law Working Paper No 20-05 <https://ssrn.com/abstract=3503310> accessed on 11 October 2023.

by Raworth,[31] and a specific consideration of the provisional planetary boundaries[32] (herein after referred to as the planetary boundaries), we argue that in terms of the third agency problem, to support the business judgment of directors, the company's interest should be aligned with the public interest, considering society at large.

It should be noted, however, that this comparative research offers solutions and ideas that depart from traditional company law, attempting to produce as coherent a study as possible. Nevertheless, it is important to acknowledge the inherent challenges of such a task, given that current legal systems are not inherently coherent or logical but are rather organic amalgams developed over time. As Husa observes, 'Comparatists are severely mistaken if they imagine that present-day legal systems are coherent and logical instead of being organic amalgams that have developed overtime'.[33]

The Agency Theory, which I consider as an offshoot of the Theory of the Firm, was conceived from the Nexus of Contract Theory and offers explanations for the costs borne from agency relationships within a firm. The concept of agency cost was initially formulated by Jensen and Meckling, focusing on the owner-manager agency relationship, termed as the first agency problem.[34] This research argues for addressing environmental sustainability through corporate legal provisions, with an aim to minimise company costs while achieving long-term profit maximisation. Eric Orts, recognising the importance of this economic approach to law, has lauded it as a highly successful legal ideology, even dubbing it the most successful intellectual movement in law over the past 30 years.[35] Furthermore, Michaels accentuates the significance of this renewed interest in law among economists. He states that 'as comparative lawyers, we should cherish and support this development, not dismiss it'.[36]

[31] Raworth (n 1).

[32] Johan Rockström and others, 'Planetary Boundaries: Exploring the Safe Operating Space for Humanity' (2009) 14 Ecology and Society <https://www.researchgate.net/publication/284146060_Planetary_Boundaries_Exploring_the_Safe_Operating_Space_for_Humanity_Internet> 4th June 2023; Will Steffen and others, 'Planetary boundaries: Guiding human development on a changing planet' (2015) 347 Science <https://www.researchgate.net/publication/270898819_%27Planetary_Boundaries_Guiding_Human_Development_on_a_Changing_Planet%27> 4th June 2023; Katherine Richardson and others, 'Earth beyond six of nine planetary boundaries' (2023) 9 (37) Sci. Adv. <https://www.science.org/doi/10.1126/sciadv.adh2458> accessed on 11 October 2023.

[33] Husa (n 6) 27.

[34] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J. Fin. Econ. 305.

[35] Eric W Orts, Business Persons: A Legal Theory of the Firm (OUP 2013) 13.

[36] Ralf Michaels, 'Comparative Law by Numbers?' (2009) 57 American journal of Comparative Law 765, 792.

Legal economics scholars have identified several agency costs arising out of agency opportunism in the theory of the firm, monitoring costs, agency costs, bonding costs and transaction costs such as shirking costs.[37] This research highlights the additional transaction costs that emerge from these two agency problems. They are termed 'shareholder costs' and 'stakeholder costs'. Thus, this research makes an addition to the cost analysis of the theory of the firm by identifying the novel shareholder and stakeholder costs, and its findings will facilitate the drafting of company law provisions to reduce agency opportunism in agency relationships between 'controlling and non-controlling shareholders' and 'the firm and the non-shareholder constituencies'. Accordingly, this research contributes to the search for solutions intended to increase the firm's cost-efficiency by identifying proactive legal measures against said agency opportunism.

1.3 Identifying research gaps

Existing research in company law has traditionally focused on the economic and corporate governance aspects, often overlooking the broader socio-environmental implications that companies have on society and the planet. While corporate law and economics have been extensively studied in isolation, the integration of these two disciplines in the context of comparative law methodology presents a significant gap in the literature. This research, with its interdisciplinary approach, fills this gap by applying a combined lens of comparative law methodology and law and economics to the examination of agency problems in corporate law.

Further, the current literature inadequately addresses the dynamics of shareholder costs within the framework of transaction cost theory. Incorporating these costs into transaction cost theory and the subsequent development of mechanisms to enhance cost-efficiency in corporate governance are relatively unexplored areas, creating another gap that this research seeks to fill.

In addition, according to the third agency problem, the introduction of a framework that integrates stakeholder rights as monitoring costs, hypothesising that this could lead to an increase in long-term shareholder value, presents a novel approach. The existing research is yet to sufficiently explore such a proposition, another research gap addressed by this study. Moreover, supporting directors to further environmental sustainability in corporate decision-making, ie through the business judgment rule by aligning a company's purpose with public and environmental interests has received insufficient attention. Redefining the

[37] Ralph K Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation' in Donald A Wittman (ed) Economic Analysis of the Law (John Wiley & Sons 2002) 177, 178.

company's purpose to balance socio-economic prosperity with environmental sustainability, particularly in line with the Doughnut Economics model, is an innovative perspective that can address this research gap. It should be noted that the SMART project has considered amending the director's duties to achieve this goal.[38]

Lastly, while discourse has increasingly centred on corporate sustainability and the need for policy reforms, the research is still sparse regarding how knowledge from law and economics, coupled with comparative law methodologies, can be leveraged to advocate for policy reform. Specifically, there is a scarcity of research on how such an integrated approach can contribute to regulatory changes in company law or business practices that enforce adherence to planetary boundaries, specifically for non-listed companies. This research addresses this gap by using its findings to inspire policy reform and encourage decision-makers to include environmental considerations in their strategic planning and legal frameworks.

In summary, this research aims to fill several gaps in existing company law research by proposing innovative legal strategies and frameworks that not only enhance cost-efficiency and resolve agency problems but also align corporate actions with public and environmental interests, thereby fostering a safe and just space for humanity.

1.4 Research question and aims

Q. How can corporate law be refashioned using insights from comparative law methodology and law and economics theories to address agency issues, enhance cost-efficiency for shareholders, empower prosocial investors, and align company interests with public and environmental interests in adherence to the Doughnut Economics model?

This research is driven by several pivotal objectives, all under the umbrella of a multidisciplinary approach that combines the principles of comparative law methodology and law and economics. The first objective is to utilise this approach to thoroughly explore agency problems within corporate law across selected jurisdictions. The second objective introduces the concept of shareholder costs within transaction cost theory and aims to devise mechanisms that boost cost-efficiency in corporate governance. The third objective addresses the third agency problem by redefining a company's purpose to harmonise with the public interest, balancing socio-economic prosperity with environmental sustainability. The fourth objective proposes a framework that integrates stakeholder rights as monitoring

[38] Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (n 30).

costs, guided by the premise that this incorporation could result in an increase in long-term shareholder value. The final objective utilises the knowledge acquired from both law and economics and comparative law methodologies to push for policy reform. This includes inspiring changes in company law and enforcing regulations that ensure all businesses adhere to the planetary boundaries, thereby raising awareness and encouraging policy and decision-makers to include environmental considerations into their strategic planning and legal frameworks, ultimately nurturing a more sustainable corporate sector.

The purpose of this research is to utilise an interdisciplinary approach, combining comparative law methodology with law and economics, to identify and propose solutions to agency problems within corporate law. The research seeks to provide innovative legal strategies that uphold both company interests and public interest while accentuating the critical need to safeguard humanity by not transgressing planetary boundaries and not falling beneath the social foundation, as articulated by the Doughnut Economics model. This dual focus on environmental sustainability and socio-economic equity is seen as vital in modern corporate governance. By integrating considerations of shareholder and stakeholder costs, noncontrolling shareholders' rights, and environmental sustainability into a comprehensive framework, the research aims to enrich the understanding and strategies of corporate governance. Ultimately, the research seeks to contribute to the field by demonstrating the potential of these combined approaches to reshape corporate governance and support a more sustainable, equitable, and resilient future.

1.5 Research limitations

This research encountered significant linguistic challenges, most notably when interpreting Finnish sources. These difficulties were compounded when assimilating data from other civil law territories, such as Germany and Sweden. While the study is deeply entrenched in the nitty-gritties of common law, spotlighting jurisdictions including Sri Lanka, the United Kingdom, Australia, Singapore, the United States, India, and Canada, it also explores civil law jurisdictions. Within this exploration, there is a distinct emphasis on sources translated into English from Finnish, though these are complemented by valuable insights from Germany.

From a theoretical standpoint, this research adopts the lenses of the stakeholder approach and shareholder primacy, with a specific focus on the economic principles related to cost efficiency. This research's perspective deserves mention: it encapsulates a legal scholar's integration of economic views, seamlessly merging legal principles with economic paradigms, all in a quest to enhance the efficiency of legal provisions. A key suggestion emerging from this study is to modify company law provisions to align with insights on planetary boundaries. This multidisciplinary

endeavour relies on an in-depth comparative analysis. The intricacies and limitations of this methodological approach will be comprehensively addressed in the subsequent section dedicated to the comparative law framework.

1.6 Comparative law Methodological Framework

1.6.1 Introduction

Legal scholars globally acknowledge the indispensable role that a robust methodology plays in ensuring the success of research. Consequently, this study is underpinned by a carefully designed, comprehensive, methodological framework. This section discusses various methods available in legal research, and substantiates the selection of the comparative law methodology. Comparative law is a diverse method that has evolved since the times of ancient Greece.[39] Scholars worldwide have contributed to its development, although, as Husa noted, there is no 'generally accepted theoretical framework, established terminology or aims set in comparative law'.[40]

The comparative law methodological framework for this study was carefully crafted based on guidelines from eminent comparative law scholars, which will be discussed below. This framework, while not limited to, aligns with the functionalist approach in comparative law methodology. The rationale and background for this methodological framework are provided, with the framework itself presented at the conclusion of this chapter.

The purpose of this comparative section is to first offer a clear understanding of the discourses in comparative law relevant to this research and to clearly delineate the research's methodological framework. Thus, the history of legal methodology, the various disciplines incorporated in legal research, and the relevant discourses are explored. Next, the relevance of these disciplines to comparative law, specifically concerning the research's methodological framework, is considered. Finally, the relevant core methodological elements of comparative law and the study's methodological framework are discussed to fashion a model for the existing remedies for oppression, unfair prejudicial, and mismanagement.

39 Blerton Sinani and Klodi Shanto, 'Methods and Functions of Comparative Law' (2013) Acta U. Danubius Jur. 25, 26.

40 Husa (n 6) 1.

1.6.2 History of legal methodology

Since the Roman Legal Doctrines of the 2nd century,[41] legal doctrine has been rediscovered and renewed. During the Middle Ages, it was elevated as a 'scientific discipline' at a time when 'authoritative interpretation' and not 'empirical research' was the main criterion for the scientific status of a discipline.[42] However, during the 17th and 19th centuries, legal doctrine as a scientific discipline changed dramatically. Physics became the model for science, and unlike legal scholarship, the theories and hypotheses of physics and mathematics were without geographical limitations. Hoecke explains that this kind of reaction gave birth to 'legal theory' in the sense of a 'positive science of law', a kind of empirical 'natural law' – a search for legal concepts, legal rules and legal principles that the whole of humanity would share.[43]

In turn, during the 20th century, other social sciences developed with a focus on law, such as legal sociology, legal psychology and law and economics.[44] Despite this, the geographical limitations continue to-date as a barrier to legal doctrines being considered as a scientific discipline. Language differences in law are another hindrance for legal doctrines to be considered a scientific discipline. For example, the Finnish translation of the International Covenant on Civil and Political Rights[45] provides two words – '*pidättämällä'* and '*vangitsemalla'* to mean '*arrest'* and '*detention'* – whereas the word '*säilöönotto'* has not been taken into consideration, even though 'arrest' also means 'take into custody' in the English language. However, contemporaneously, the comparative law and legal linguistics branches of law act as facilitators to eliminate these differences, thereby strengthening legal doctrine as a scientific discipline.

1.6.3 Disciplines in legal doctrine

Various discourses exist regarding disciplines in legal doctrine. In his article entitled 'Legal Doctrine: Which Method(s) for What Kind of Discipline?', Hoecke focuses

41 Mark Van Hoecke, 'Legal Doctrine: Which Method(s) for What Kind of Discipline?' in Mark Van Hoeck (ed), *Methodology of Legal Research* (Hart Publishing 2013) 1.

42 ibid.

43 ibid 2.

44 ibid.

45 Article 9.4 of the International Covenant on Civil and Political Rights: Adopted and opened for signature, ratification and accession by General Assembly resolution 2200A (XXI) of 16 December 1966 entry into force 23 March 1976, in accordance with Article 49 – 'United Nations Human Rights Office of the High Commissioner' <https://www.ohchr.org/en/professionalinterest/pages/ccpr.aspx> accessed 10th May 2019.

on several disciplines that have existed since the Roman Empire.[46] They are, inter alia, the 'hermeneutic', 'argumentative', 'empirical', 'explanatory', 'logical', and 'normative' disciplines.

It can be argued that the hermeneutic and argumentative disciplines are instilled in legal doctrine; as Hoecke writes in respect to the former:

> It can hardly be denied that legal scholars are often interpreting texts and arguing about a choice among diverging interpretations. In this way, legal doctrine is a Hermeneutic discipline, in the same way as is, for example, the study of literature, or to a somewhat lesser extent, history. Interpreting texts has been the core business of legal doctrine since it started in the Roman Empire.[47]

Hoecke further states that the main research objects of the hermeneutic discipline are text and documents, and that interpretation is the main activity of the researcher. The main research objectives of this research are the same. For example, the evaluation of the oppression and mismanagement remedies in different jurisdictions is based on legal statutes, case law, and scholarly texts. In addition, the argumentative nature of legal research is important to support legal interpretations or solutions that are emphasised in legal statues, cases and legal documents. Thus, both the interpretative and argumentative disciplines are important in legal research.

It is important to note that interpretation in relation to legal science can be divided into two categories. First is the 'legal interpretation', which has an internal standpoint owing to the fact that interpretation is based on binding legal sources, eg the juridical legal research or the doctrinal legal method.[48] The second category comprises fields of legal sciences, such as the 'socio-legal method', which are not based on binding legal sources but on other elements in a society, ie an external perspective of the law. In comparative law research, both the 'internal standpoint' and the 'external perspective of law' have been used by comparative lawyers in their interpretation. It can be stated that the distinction between these two types of interpretation is of paramount importance in a comparative law research study.

The 'explanatory' and 'logical' nature of legal doctrines are also important in legal research. According to the former, legal doctrine explains why a rule is a valid legal rule in a given society. Hoecke states that this explanation may be historical, sociological, psychological, economical and the like, but it may also be based on an

46 Hoecke (n 41) 4.
47 ibid 4.
48 Lainopillinen/oikeusdogmaattinen in Finnish.

internal logic.[49] Thus, it can be argued that legal research should be based on logical legal reasoning with proper explanation.

The 'normative' nature of legal research is also the subject of critical discourses among several eminent scholars. According to Bratman, legal scholars have a wide range of ideas with respect to normativity in law.[50] In response, HLA Hart observes – in a fundamental advancement from Austin's appeal solely to habitants of obedience – that '*law essentially involves legal norm guidance – that is, guiding one's activities by appeal to legal norms/standards – at least on the part of legal officials*'.[51]

Bratman states that HLA Hart's normative nature of law emphasises the internal acceptance of relevant social rules, including rules of recognition.[52] Thus, Bratman's interpretation of Hart's basic point of view highlights the importance of considering the relevant social rules, including those of recognition, in legal research. It can be stated that if a legal scientist is researching a specific part of law from a specific jurisdiction, it is prudent to research all the relevant social rules and similar rules related to that specific part of law; in doing so, the researcher can obtain knowledge on the application and effectiveness of that specific law.

Furthermore, Bratman provides a stronger idea of the normative nature of law: 'Law, quite generally and by its nature, induces normative /justifying reasons for legal officials to act in ways mandated by the law'.[53] Bratman, building on Hart's foundational concept of normativity, presents a more nuanced view of the law's normative nature. He posits that the law, inclusive of both statutory provisions and social regulations, furnishes normative or justifying grounds for legal officials' actions as dictated by legal mandates. This expanded interpretation not only broadens the scope of legal normativity but also underscores the imperative of examining social norms and akin rules in legal scholarship. Such scrutiny is pivotal in grasping the justifying rationales that underpin the actions of legal officials within the juridical system of a nation. Accordingly, it is important to consider the normative nature of law in comparative legal research, as discussed in relation to the methodological framework of this study in Section 1.6.

As mentioned above, during the 19th century, legal doctrine was not considered a 'scientific discipline', since empirical research did not fit into the framework of

[49] Hoecke (n 41) 8.

[50] Michael E Bratman, 'Reflections on Law, Normativity and Plans' in Stefano Bertea and George Pavlakos (eds), *Law and practical reason: new essays on the Normativity of law* (Hart Publishing 2011) 73.

[51] ibid; also see Herbert L A Hart, *The Concept of Law* (2nd edn, Oxford University Press 1994).

[52] ibid.

[53] ibid 75.

legal doctrine. As a result, during the 19th and 20th centuries, successful attempts have been made to develop legal scholarship as an empirical discipline. Legal scholars (including Hoecke) have since identified and categorised empirical data used in legal doctrine into two categories:

(a.) Normative sources, such as statutory text, treaties, general principles of law, customary law, binding precedents, and the like; and

(b.) Authoritative sources, such as case law, if they are not binding precedents, and scholarly legal writings.[54]

This comparative study, investigates the application and effectiveness of remedies for unfair prejudice, oppression, and mismanagement in the UK, India, and Sri Lanka. The UK was selected because it is the jurisdiction where the oppression remedy evolved into the unfair prejudice remedy, a legal concept that India and Sri Lanka have since adopted and adapted in their own unique ways. The said countries are Commonwealth countries with a common law legal system. Thus, case law as a legal source is categorised under normative sources in this research.

Hoecke states that the authoritative sources category has a somewhat ambivalent position, as it is not external to legal doctrine.[55] However, Aarnio has indicated that the Doctrine of Sources of law, including sources mentioned as authoritative sources by Hoecke, is normative and not authoritative, further arguing that doctrine dictates the criteria of first, what is *law*, and second, what is a *good* (correct) law. Aarnio states that '*the degree to which the single sources are binding is the key issue*'.[56] Aarnio categorises the doctrine of sources of law as follows:

1. Strongly binding sources of law as: Norms external top national law, Norms of national law;

2. Weakly binding sources of law as: The intention of legislator and Precedents;

3. Permitted sources of law as: Practical arguments (economics, historical, social, etc.), Ethical and moral arguments, General legal principles,

[54] ibid 11.
[55] ibid.
[56] Aulis Aarnio, *Essays on the Doctrinal Study of Law* (Springer 2011) 150.

Standpoints presented by the doctrinal study of law (prevailing opinion), Comparative arguments, Others;

4. Forbidden sources of law: reasons that can be held forbidden are only arguments that are against the law or good practice and those that are openly political.[57]

According to Aarnio, while all law sources are normative, their binding force is categorised into four distinct levels. This perspective on the normative essence of law sources, as described by Aarnio, is agreeable.Thus, for the purpose of this research, which is from a common law country perspective, strongly binding sources of law are statutes, treaties, case law, general principles of law and customary law. Weakly binding sources of law are the intentions of the legislator. Permitted sources of law are scholarly legal writing, practical arguments in economics, politics, history and society, and ethical and moral arguments.

It can be stated that strongly binding sources of law vary from country to country. For example, laws enacted by the European Parliament do not bind Canada, Australia, India or Sri Lanka, but they used to bind the UK. However, special emphasis should be given to the UK pursuant to Brexit and the terms entered therein.

Accordingly, it can be argued that the hermeneutic, argumentative, empirical, explanatory, logical and normative disciplines are instilled in legal doctrine, and they are also relevant to the comparative law methodology applied in this research. The importance of these disciplines to comparative law methodology is discussed in more detail in the following section.

1.6.4 Disciplines salient to comparative law methodology

Legal scholars have attempted to provide a definition of comparative law; to date, several definitions have been brought to light due to its broad application. Zweigert and Kötz have stated that the words 'comparative law' suggest '*an intellectual activity with law as its object and comparison as its process'*. Further, they state that '*the extra dimension is that of internationalism'* and thus, comparative law reflects the comparison of the different legal systems of the world.[58] Such comparison of legal systems is an integral part of considering and knowing foreign and national legal systems. As such, comparative law provides an application of comparative techniques to the field of law to improve existing laws and/or adapt foreign laws to

[57] ibid 150-151.

[58] Konrad Zweigert and Hein Kötz, *An introduction to comparative law* (Tony Weir tr, 3rd edn, OUP 1998) 2.

the national legal system in order to have a *sui generis* law adaptable to the national system. Kamba states that the comparative law method involves the study of law through the systematic comparison of two or more legal systems, or of parts, branches or aspects of two or more legal systems.[59]

However, as Kahn-Freund has said, '*The trouble is that the subject he (ie a professor of comparative law) professes has by common consent the somewhat unusual characteristic that it does not exist*'.[60] Likewise, comparative law has no hard and fast rules or principles. That said, it does have a scientific characteristic, the claims to which have been strengthened from the times of ancient Greece to the present day.[61] Indeed, the knowledge and information gained by comparing legal systems or their components have aided legislators and judges to fashion rules or principles of positive law.[62]

Bell further explains that comparative law is one form of legal research, and it shares three central characteristics of legal research. The first is that comparative law is hermeneutic in the way that 'it takes the insider's view on all the legal systems studied'.[63] The second is that it is institutional, meaning that the 'knowledge of the law is embedded in the institutional structure of concepts, structures of thinking (especially mental maps) and organisations of the systems in question'.[64] The third is the interpretative nature of comparative law, which means that 'the comparative lawyer has to interpret both the target legal system and his or her own'.[65]

However, it can be stated that the argumentative, empirical, explanatory, logical and normative natures of legal research are also crucial elements that are instilled in comparative law methodology. Hoecke states that through the argumentative discipline, a concrete legal question can be answered, or a case can be solved, on the basis of generally accepted, or at least acceptable, views.[66] This emphasises the importance of the argumentative discipline in legal doctrine, specifically in

[59] Walter J Kamba, 'Comparative Law - A Theoretical Framework' (1974) 23 Int'l & Comp. L.Q. 485-519, 486.

[60] ibid 486; Otto Kahn-Freund, 'Comparative Law as an Academic Subject' (1966) 82 L.Q.R. 40, 41; also Harold C Gutteridge, *Comparative Law* (2nd edn, Cambridge 1949) 2.

[61] Several other legal scholars such as Levy-Ullman, Kohler, Arminjon, Nolde, Wolff, Rabel and Brutau on the Continent, and Yntema, Rheinstem and Hall in the United States also associate with the view that comparative law is a 'science'.

[62] Kamba (n 59) 487.

[63] John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in Mark Van Hoeck (ed), Methodology of Legal Research (Hart Publishing 2013) 167.

[64] ibid.

[65] ibid.

[66] ibid 4.

comparative law where two or more laws are compared based on the functions of 'similarities and differences'.

The empirical nature of legal research is a central characteristic in comparative law, and its importance in legal research has been highlighted above (see section 1.6.3.). Empirical data are an important element in comparative law: the quality of comparative legal research depends on the legal binding effect of the sources researched by the comparatist. As Aarnio states, the degree to which the source is binding is important.[67] Thus, this should be carefully and meticulously researched in the first instance to identify the degree to which the foreign source is binding. It can be argued that the initial starting point of the research of a foreign legal system should be to identify the binding effect of its sources. For example, in the German legal system, scholarly texts are not 'permitted sources of law'; they are 'weak binding sources of law'. Moreover, German judges apply the oppression remedy through the textbooks and not from the statutes.[68] Thus, it can be stated that the empirical nature of legal research is also a central characteristic of comparative law.

One of the main responsibilities of a comparative lawyer is to meticulously compare two or more legal systems and explain the 'similarities and differences' using logical reasoning.[69] Plainly explaining and intelligibly rendering the foreign legal system is important for helping the reader understand that legal system or its components.[70] Accordingly, the historical, sociological, psychological, economical and other relevant aspects of the foreign legal system should be thoroughly researched and explained. These explanations should be logically connected with these reasons to enable foreign legal systems to be clearly understood.

For example, the historical development of oppression and mismanagement remedies including unfair prejudicial remedy has been discussed in depth in this research. Oppression, which evolved into unfair prejudicial remedy, was born in the UK and thereafter adapted by many other common law countries. However, many 'similarities and differences' are evident in the application of the oppression remedy in each jurisdiction. In addition, India has created its own mismanagement remedy to provide wider protection to minority shareholders, while its neighbour Sri Lanka has also borrowed the mismanagement remedy in its Companies Act, No.7 of 2007 for the same reason.

As noted above, the explanatory and logical nature of legal research is paramount if comparative law is to achieve its objectives. Having given a general description of

[67] Aarnio (n 56) 150.

[68] Paul Pieter De Vries, Exit rights of minority shareholders in a private limited company (KLUWER 2010) 157.

[69] Husa (n 6) 147.

[70] ibid 154.

the normative nature of legal research above, hereafter, its importance in comparative law in the context of this research is highlighted. In his 1982 essay, Postema considers normativity in law as follows: '*we understand law only if we understand how it is that laws give members of a community, officials and law-subjects alike, reasons for acting. Thus, any adequate general theory of law must give a satisfactory account of the normative (reason-giving) character of law*'.[71] Both Postema's meaning of the normativity of law and Bratman's definition discussed above provide the same basis for the normativity of law. The key term in both ideas is 'reason'. According to Postema, members of a community understand the law if reasons are given for acting. It can be argued that these reasons may vary from country to country depending on culture, society, economy and so on. Further, it can be argued that a nexus exists between the explanatory nature and the normative nature of law. Here, the key term 'reason' in normativity is the foundation of this nexus in legal research, thus foregrounding the importance of both disciplines in comparative law.

In addition, Hoecke states that '*legal doctrine is often called a normative discipline, which is not only describing and systematising norms (a discipline about norms), but also and to a large extend, a discipline which takes normative positions and make choices among values and interests*'.[72] Thus, it can also be stated that the values and interests instilled in a legal system provide reasons for legal officials and members of a community to act in ways mandated by the law. Likewise, the normative nature of legal doctrine depends on different values and interests. Bell observes two normative elements in comparative law.

The first is that 'the statement of the foreign law are not simply the description of beliefs of actions of foreign lawyers; as we shall see, they are statements of what the subjects of foreign law should do from the legal point of view'.[73] Here, Bell contends that the comparative lawyer should not observe the foreign law at face value so as to realise the belief of action of foreign lawyers, but to identify the legal point of view, ie to identify the functionality of the foreign law. This has been highlighted by many other comparatists as well. The second element is that 'comparative legal research demonstrates that the goals of law can be achieved by different rules and institutions in different social context'.[74] As different legal systems are based on their own social contexts, comparatists investigate the

71 Gerald J Postema, 'Coordination and Convention at the Foundation of Law' (1982) 11 Journal of Legal Studies, 165, 165.
72 Hoeck (n 41) 10.
73 Bell (n 63) 158.
74 ibid.

justifiability of differences and whether the laws embedded in these different legal systems achieve the purpose of the law equally and effectively.

Since this research focuses on company law, particularly the effectiveness of shareholder remedies for oppression and mismanagement, it is prudent to examine the values and interests of companies in each selected jurisdiction. For instance, in Sri Lanka, the primary interest of a company is 'to gain profit'. To support this, the economic efficiency of company law should be considered, and it is thus prudent to research the aspect of the 'economic efficiency of company law' in the application of the remedies proposed in this research. In other jurisdictions, company interests may be similar or different depending on various economic, historical, cultural or societal factors. For example, in some countries, 'corporate social responsibility' (CSR) is also of interest to the company. Thus, it can be argued that the normative nature of comparative law is also important in comparative law methodology.

In sum, it can be argued that Hoecke's argumentative, empirical, explanatory, logical and normative natures of legal research are important considerations in comparative legal research, as are Bell's three characteristics of legal research: hermeneutic, institutional and interpretative. Accordingly, the methodological framework of this comparative research encompasses these crucial elements of legal research.

1.6.5 Role and objectives of comparative law

The contemporary world is rapidly globalising, with the internet acting as its catalyst. As a result of globalisation, world trade possibilities are also rapidly growing. Today, ordering an item manufactured in countries located on the other side of the world is just a smartphone click away. For example, through e-commerce markets such as Alibaba, eBay and Amazon, such items can easily be ordered straight to one's home. However, the differences in laws enacted in different countries pose a hindrance to this development of world trade. In response, the use of an appropriate comparative law methodological framework could support the mitigation of these differences in laws, ultimately facilitating the harmonisation of laws and unlocking world trade. Eberle states that the 'gathering of knowledge obtained through comparative law can be a vital portal to a foreign culture',[75] which can be considered helpful in the harmonisation of laws. Eberle states further that '*The insights gathered can usefully illuminate the inner workings of a foreign legal system. And these insights can be*

[75] Edward J Eberle, 'The Method and Role of Comparative Law' (2009) 8 Wash. U. Global Stud. L. Rev. 451, 452.

applied to our own legal culture, helping illuminate different perspectives that may yield a deeper understanding of our legal order'.[76]

Zweigert and Kötz have stated that the primary aim of comparative law, as of all science, is knowledge and that good laws cannot be produced without the assistance of comparative law.[77] The authors also highlight four practical benefits of comparative law: it aids the legislator in drafting good laws; it acts as a tool of construction; it can be taught in law schools; and it serves the purpose of the systematic unification of law and the development of private law common to the whole of Europe.[78] Furthermore, Kamba has noted that by using comparative law, the international community would be able to understand foreign law, and judges would be able to fill gaps in their respective national laws.[79]

The objective of this research is also for the international community to gain an understanding of oppression, unfair prejudicial and mismanagement shareholder remedies, and the unification and harmonisation of these remedies in the global context. These remedies are alien to most civil law legal cultures, thus highlighting the importance of their harmonisation through a comparative law framework.

1.6.6 Insights into comparative law methodology and its application

Zweigert and Kötz state that comparatists consider the basic rule of comparative law so that 'different legal systems give the same or very similar solutions, even as to detail, to the same problems of life, despite the great differences in their historical development, conceptual structure, and style of operation'.[80] Taking this basic rule into consideration, Husa states that 'the differences arise from the dissimilarity of interest of knowledge'.[81] The comparatists search for 'similarities and differences' by comparing functions adopted in different legal systems to solve the same legal problem. They also seek solutions to the causes of these 'similarities and differences' through logical explanations based on history, economy, politics, culture and geography.

Zweigert and Kötz suggest that the pivotal question in comparative law methodology is 'why different countries use divergent approaches to resolve same

76 ibid.
77 Zweigert and Kötz (n 58) 16.
78 ibid 16.
79 Kamba (n 59) 504.
80 Zweigert and Kötz (n 58) 39.
81 Jaakko Husa, 'Comparative Law, Legal Linguistics and Methodology of Legal Doctrine' in Mark Van Hoeck (ed), *Methodology of Legal Research* (Hart Publishing 2013) 224.

disputes'.[82] This research provides a comparative analysis of the application of oppression, unfair prejudicial, and mismanagement shareholder remedies across selected jurisdictions. While examining these areas, it is important to consider the history of company law, economic efficiency, government influence, corporate culture, and geography.

Furthermore, Zweigert and Kötz propose that 'separate reports should be offered for each legal systems, and they should be objective, that is, free from any critical evaluation, though containing all significant qualifications or modifications'.[83] They suggest that after each legal system has been studied, the comparatist must critically evaluate the findings, discern the most effective solution, and thereby formulate a superior alternative. In alignment with this approach, this research conducts a comprehensive comparative study incorporating significant insights pertinent to company law. Moreover, relevant environmental legislation and other protective mechanisms are discussed to underscore the existing external mechanisms that could escalate company costs.

Husa asserts that 'the comparatist has to themselves build the conceptual–analytic framework by means of which comparison can be carried out in a balanced way'.[84] The common feature or characteristic forming the basis for comparison is termed the '*tertium comparationis*'. According to Husa, the *tertium comparationis* is a conceptual context (framework), constructed by the scholar, and its existence is based on the assumption that the system-specific solutions are commensurable to the extent that it makes sense to compare them'.[85] It is crucial that the yardstick, or *tertium comparationis*, treats the objects of study impartially, despite their inherent differences.[86]

Finally, Husa introduces the concept of micro-comparison, which is 'aimed at legal rules (also individual legal concepts), which regulate broadly the same thing and are compared with each other'.[87] He states further that 'in micro-comparison, provisions or judgments are legal solutions of a concrete nature to legal problems'.[88] This comparison can answer questions about commonalities and differences among legal systems, and the reasons behind these similarities and differences. He notes that 'most micro-studies to date have focused on different sectors of private law'.[89] For instance, this research centres around the specific rules of company law, using

[82] Zweigert and Kötz (n 58) 44.
[83] ibid 43.
[84] Husa (n 6) 120.
[85] ibid 150.
[86] ibid.
[87] ibid 101.
[88] ibid.
[89] ibid 102.

law and economics as the yardstick to focus on agency problems. The goal is to enhance efficiency in company law, specifically addressing issues further discussed in chapters two and three. Accordingly, this research has built its own conceptual-analytic framework, grounded in law and economics, for the micro-comparison of company law.

1.6.7 Concluding remarks: methodology and applications

The comparative law methodology employed in this research is built on the aforementioned principles, incorporating the hermeneutic, institutional, interpretative, argumentative, empirical, explanatory, logical, and normative aspects of legal research as the core characteristics of this functional comparative law methodological framework.

The purpose of this research method is to explore the different approaches employed by various jurisdictions in addressing six identified economic issues related to non-controlling shareholder protection and environmental sustainability. The long-term success of a business is evaluated in relation to environmental sustainability and the aforementioned remedies. The six economic problems have been outlined in accordance with law and economics theories to answer the research question, as follows:

In relation to the second agency problem:

1. What are the rights vested in shareholders to proactively reduce agency costs in the second agency problem?
2. What is the function of corporate law in avoiding litigation and ensuring cost-effectiveness in enforcement mechanisms?
3. What is the function of the equal treatment remedy?
4. What is the function of corporate law in defining oppressive conduct?

In relation to the third agency problem:

5. What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?
6. What is the role of unfair prejudice, oppression, and mismanagement remedies in achieving sustainability in corporate governance?

The findings are critically analysed based on the comparative law principles of 'functionality' and 'similarities and differences'.[90] Moreover, the analysis is conducted from an economic perspective using economic theories such as 'the theory of the firm' and the 'stakeholder approach'. This research's findings could assist jurisdictions in drafting economically efficient company laws within their unique legal frameworks on their own language.

The comparative law method is excellent for identifying divergent legal approaches adopted in countries with different legal traditions (civil and common law) for the same legal problem.[91] Furthermore, when combined with the two aforementioned economic theories, this method is suitable for amending existing legal provisions from a fresh perspective, thereby ultimately strengthening the economy.[92] The six economic problems listed above are based on these two economic theories, and each comparative study examines how jurisdictions have approached resolving these problems through legal measures.[93]

Currently, the majority of company laws around the world are primarily based on these theories, especially the classic theory of the firm, which asserts that a firm's primary responsibility is to maximise its shareholders' wealth.[94] However, following the 2008 global financial crisis, many economic scholars criticised the theory of the firm.[95] After the crisis, the stakeholder approach gained prominence, suggesting that managers should make decisions considering all of the company's stakeholders.[96]

The comparative study primarily focuses on common law countries such as the UK and Sri Lanka, but aspects from India, Australia, Canada, and Singapore are also considered. Legislative measures, case decisions, and expert reports are discussed in

90 Husa (n 81) 224.
91 Bell (n 63) 158.
92 Zweigert and Kötz (n 58) 15, 16, and 31.
93 Andrew Johnston, 'Corporate Governance for Sustainability Statement' (Harvard Law School Forum on Corporate Governance, 7th January 2020) <https://corpgov.law.harvard.edu/2020/01/07/corporate-governance-for-sustainability-statement/> accessed on 23rd February 2020.
94 Milton Friedman, *Capitalism and Freedom* (University of Chicago Press 1962).
95 Terence Tse, 'Shareholder and stakeholder theory: after the financial crisis' (2011) 3 Qualitative Research in Financial Markets 51, 53.
96 Wenzhi Ding, and others, 'Corporate Immunity to the COVID-19 Pandemic' (NBER Working Paper No. 27055, issued in April 2020) <https://www.nber.org/papers/w27055.pdf> accessed 23 May 2020.; also see Klaus Schwab, 'Covid-19 is a litmus test for stakeholder capitalism' (Financial Times, 25th March 2020) <https://www.ft.com/content/234d8fd6-6e29-11ea-89df-41bea055720b> accessed 23 May 2020; Jaepil Choi and Heli Wang, 'Stakeholder relations and the persistence of corporate financial performance' (2009) 39 Strategic Management Journal 895 (the stakeholder approach is positively associated with the persistence of superior financial performance).

the comparative study. The results of this research will provide valuable insights for integrating these remedies into national legal systems. As Husa notes, comparatists 'learn by doing, and it is essential in comparative law to give foreign law fair treatment and conduct the study as honestly and accurately as possible'.[97] Empirical data in this study was collected from expert opinions and reports from countries with diverse economic and legal backgrounds, ie Finland, the UK, Germany, India, Singapore, the US, Canada, New Zealand, and Sri Lanka. The comparative law methodology and the two economic theories will be utilised to comparatively analyse and find improved solutions for current social and economic issues.

1.7 Research scope and key concepts

This section defines the key concepts used in this research, providing the reader with a clear understanding of its scope. However, giving precise definitions can be challenging due to the differing legal definitions across different legal cultures. For example, terms like 'share', 'shareholder', 'unfair prejudice remedy' and 'private company' may have different meanings in different legal cultures. These terms will be further discussed in the comparative chapter (chapter four), and this section provides a general definition for the reader to understand the research content and arguments.

The principal aim of this research is to enhance company law provisions to better facilitate non-listed private companies, helping them promote environmental sustainability and increase efficiency in alignment with the goals set out in the Doughnut Economics model (discussed in chapters five and six). The term 'private companies' can have different interpretations and identities in different legal systems. For instance, non-listed private companies might also be termed as 'closed companies' or 'closed corporations'. Black's Law Dictionary defines a 'close corporation' as a corporation whose stock is not freely traded and is held by a few shareholders, often within the same family. This is also known as a 'closely held corporation', 'closed corporation', or (when family-owned) 'family corporation'.[98]

Easterbrook and Fischel note a fundamental difference between closely held and publicly held corporations. The separation of risk-bearing and management in publicly held corporations, a feature absent in closely held corporations, has led to divergent governance mechanisms in the two types of firms.[99] In this research, 'company law' is defined, according to Black's Law Dictionary, as 'the collective

[97] Husa (n 6) 142.
[98] Bryan A Garner (ed), *Black's Law Dictionary* (11th edn, Thomson Reuters 2019) 429.
[99] Frank H Easterbrook and Daniel R Fischel, 'Close Corporations and Agency Costs', (1986) 38 Stan. L. Rev. 271, 271.

statutes, rules, regulations, and legal doctrines relating to the operations of corporations'.[100] 'Company law' and 'corporate law' are interchangeably referred to in this research and carry the same meaning. 'Corporate governance', on the other hand, refers to the system of rules and standards that governs the management, control, and accountability of a company, especially pertaining to the integrity, transparency, and responsibility upheld by the management and the board of directors.[101] It is worth noting that depending on the context of the discussion, the term 'corporate governance' may include company law or, in certain circumstances, may only refer to the system of rules and standards that supplement company law.

A 'shareholder', as defined by Black's Law Dictionary, is 'someone who owns or holds a share or shares in a company, esp. a corporation. – also termed shareowner; (in corporation) stockholder'. This research also uses 'majority' and 'minority' interchangeably with 'controlling' and 'non-controlling' shareholders, respectively. A controlling shareholder is one who can influence the corporation's activities due to ownership of a majority of outstanding shares or a significant proportion of the remaining shares, widely distributed among many other shareholders.[102] Conversely, a non-controlling shareholder cannot influence the corporation's activities.

'Shareholder protection' refers to company law mechanisms protecting the rights and privileges of investors who acquire shares. As discussed, shareholders can be categorised into controlling and non-controlling based on their capacity to influence corporate activities. This research focuses on non-controlling shareholders, who lack access to corporate activities and may therefore be susceptible to oppression. Oppression, as defined by Black's Law Dictionary, is 'the act or an instance of unjustly exercising authority or power so that one or more people are unfairly or cruelly prevented from enjoying the same rights that other people have'.[103] The residual rights of shareholders refer to the shareholders' right to the company's profit and, in the instance of insolvency, the right to the remaining assets of the company after the priority claims of other stakeholders, such as creditors, have been settled.

This research also discusses redefining the company's interest to prioritise the public interest over that of the shareholders. Public interest is defined as 'the general welfare of a populace considered as warranting recognition and protection. Also, it provides a second meaning to mean 'something in which the public as a whole has a stake…'.[104] 'Environment' refers to the 'the natural world in which living things dwell and grow; the conditions affecting the development, growth, or performance

[100] Garner (n 98) 428.
[101] ibid.
[102] ibid 1654.
[103] ibid 1318.
[104] ibid 1486.

of a person or company; the physical conditions of a particular place where a living person or a company exists'. This definition provided in the Black's law dictionary is adjusted to incorporate the term 'company'.

'Sustainable development' means the 'use of natural resources in a manner that can be maintained and supported over time, taking into account the needs of future generation'.[105] This research uses the Doughnut Economics model proposed by Raworth,[106] which incorporates the recent findings on planetary boundaries by Rockström and others, Steffen and others and Richardson and others.[107] 'Environmental sustainability' is thus defined as human activities not exceeding these planetary boundaries. Corporate sustainability, in turn, means aligning a company's activities and goals with the Doughnut Economics model.

Lastly, it is essential to acknowledge the limitations and difficulties posed by the comparative study itself, some of which have been discussed earlier. Comparative legal scholar Husa remarks that presenting a precise methodology with strict boundaries is challenging in comparative law, as scholars' subjects of study and areas of interest vary significantly.[108] To navigate this challenge, this research has developed its own comparative law methodology, discussed later in this chapter.

A notable limitation of this research is the language barrier. Husa highlights the significance of linguistic competence, contending that a comparatist exploring, for example, Finnish law could potentially misinterpret certain elements if their reliance is placed solely on materials in languages other than Finnish. While the formal depiction might be accurate, the depth of comprehension regarding legal-cultural nuances could remain cursory.[109] Nonetheless, Husa also maintains that 'nothing precludes the use of, for instance, English translations if the scholar intends to engage with Russian law for a purpose that is less demanding'.[110] However, inherent challenges arise when referring to an English translation of national language, as the translation can be misleading if not executed accurately.

In this vein, the comparative study of Finnish company law encountered difficulties due to the reliance on English translations. These challenges were amplified by certain resemblances between Finnish and Anglo-American laws, despite the former's firm roots in Nordic-Germanic legal tradition. It is imperative to exercise caution with direct comparisons; for example, the concept of 'directors' in Finnish law does not correspond precisely with its Anglo-American counterpart.

105 ibid 1749.
106 Raworth (n 1).
107 Rockström and others (n 32); Steffen and others (n 32); Richardson and others (n 32).
108 Husa (n 6) 98.
109 ibid 115.
110 ibid 141.

Further, it would be incorrect to equate the Finnish business judgement rule and that of Delaware, or to presume that Finnish enlightened value maximisation is identical to the UK's approach. To avoid any potential misunderstandings due to language barriers, this study opts not to delve deeply into these concepts, instead choosing to present the perspectives of Finnish scholars on these topics. The author's background, steeped in common law jurisdictions, have influenced the comparative perspectives employed in this research. Nonetheless, the study benefitted immensely from the expertise of the supervisor and examiners, specialists in Finnish company law, which enhanced the author's grasp of Finland's unique legal idiosyncrasies. Additionally, Husa stresses the need for full disclosure regarding the limitations and potential misconceptions in comparative studies of foreign legal systems. This practice ensures valuable results for the reader and future research, promoting good research habits.[111]

1.8 Impact of the research

The primary impact of this research lies in its innovative approach to synthesising new knowledge from law and economics, with the aim of developing more effective legal strategies to reform corporate law. By employing a comparative study methodology, the research not only formulates these strategies but also exemplifies how they can be effectively integrated into diverse legal systems to address agency problems.

A significant result of the research is the construction of a model consisting of legal strategies that are tailored to safeguard the rights of prosocial investors through company law, inspired by the 'think small first' ideology. Moreover, it introduces an efficient arbitration-based dispute resolution mechanism, offering a progressive solution to potential conflicts within corporate governance.

Considering growing awareness about environmental sustainability and the imminent risks associated with climate change, this research's relevance becomes even more pronounced. By addressing these urgent issues within the context of corporate law, it allows for jurisdictions adopting these changes to be potentially more attractive to investments. This could label these regions as prosocial jurisdictions, encouraging investment flow, fostering stock market development, and ultimately, contributing to job creation.

Further, by endorsing a stakeholder approach, the legal provisions developed through this research can promote the long-term success of companies, thereby enhancing societal welfare. The insights generated from this study could prove

[111] ibid 143.

invaluable in informing and shaping policy decisions, thereby amplifying its impact beyond academia.

Moreover, the research lends support to the UN Sustainable Development Goals 8 and 9 – ‘Decent work and economic growth’ and ‘Industry, innovation and infrastructure’. It advances the cost analysis theory of firms by identifying and incorporating ‘shareholder costs’ and ‘stakeholder costs’ within the transaction cost theory framework, thereby enhancing our understanding of agency opportunism.

The research also significantly contributes to the development of ‘law and economics’ as the *tertium comparationis* in comparative law methodology within the company law context, illustrating its potential as a multidisciplinary tool. Lastly, it opens up new avenues for further research into the third agency relationship within the agency cost theory, as well as sustainability through the Doughnut Economics model.

By taking these actions, this research not only shapes our understanding of company law but also underscores the critical importance of aligning company interests with those of society and the environment, thereby cultivating a safe and just space for humanity.

CHAPTER TWO – ECONOMIC APPROACH TO LAW AND ITS APPLICATION IN THE CONTEXT OF COMPANY LAW

2.1 Introduction

This chapter explains the importance of the economic approach to law. The first part addresses the historical developments in this approach as a foundation for readers to understand law and economic interdisciplinarity. It also discusses the developments in several countries and highlights the difficulties faced when adopting this approach. Likewise, the differences in economic application in a country depend on each country's political and economic background. The second part of this chapter explains the benefits and disadvantages of applying 'theories' that are alien to law compared to legal 'doctrinarism'. The third part explains the characteristics of the economic approach to law and the reasons for its importance in policymaking and the implementation of legal rules. The fourth part discusses the importance of the economic approach in business law, specifically in corporate governance. This section considers doctrines in corporate law in connection with the economic implications of economic theories. Economic analysis of limited liability, separate legal personality, separation of ownership and control, control transactions and related-party transactions are also generally discussed. The fifth part of this chapter explores the more recent developments in the economic approach to law. This section outlines the theory of the firm and the stakeholder approach in connection with the economic analysis of law and Calabresi's law and economics. The sixth part addresses criticisms of the economic approach to law contended by scholars from its inception, along with responses to said critiques. The seventh part closes with the findings and their relevance to this study overall.

Special attention should first be given to the differences between similar terms used in 'law' and 'economics' while reviewing the interdisciplinary research. For example, Bratton argues that lawyers and economists understand key terms such as 'contract' and 'agency' differently: while the lawyer understands 'contract' as a set of legal rules by which the agreeing parties should act accordingly, the economist

thinks more broadly in terms of voluntary exchanges and other relations among free agents.[112] Brian Cheffins also argues that economists use the term more broadly so that it encompasses arrangements to which parties will tend to adhere, regardless of legal enforceability.[113]

2.2 Historical developments in the economic approach to law

A brief discussion of the historical developments of the economic approach to law is important to obtain an overall understanding of this interdisciplinary subject. Historical antecedents, such as Becarria's writings on crime, show that this perspective originated in or around 1767. In 1789, Jeremy Bentham developed the idea that legal sanctions could discourage bad conduct and thus could be adopted in law if they effectively deterred the actions of bad conduct.[114]

The initial steps of the economic approach to law began in the early 1940s at the University of Chicago in the US. In the 1960s, economics as a tool for legal scholarship started to develop; thereafter, it became an open source of debate among legal scholars. During this time, the work was mostly done by Ronald Coase and Guido Calabresi, known as the founding fathers of the economic approach to law movement.[115] Coase's article on 'The Problem of Social Cost'[116] and Calabresi's article on 'torts' were the first attempts to apply economic analysis in a systematic way in relation to law.[117] Calabresi has since worked on several important articles promoting this approach. These include, but are not limited to, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral',[118] 'Transaction

[112] William W Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (1988-1989) 74 Cornell L Rev 407, 446.

[113] Brian R Cheffins, 'Corporations' in Mark Tushnet and Peter Cane (eds) *The Oxford Handbook of Legal Studies* (OUP 2018) 6.

[114] Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press 2004) 4.

[115] Kristoffel Grechenig and Martin Gelter, 'The Transatlantic Divergence in Legal Thought: American Law and Economics vs. German Doctrinarism' (2008) 31 Hastings Int'l & Comp. L. Rev. 295, 327 <https://repository.uchastings.edu/hastings_international_comparative_law_review/vol31/iss1/7> accessed on 30th April 2021.

[116] Ronald H Coase, 'The Problem of Social Cost' (1960) 3 The Journal of Law & Economics 1. <https://www.jstor.org/stable/724810?seq=1> accessed on 10th October 2020.

[117] Richard A Posner, 'Economic Approach to Law' (1975) 53 Tex. L. Rev. 757, 759.

[118] Guido Calabresi and Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 HARV. L. REV. 1089.

Costs, Resource Allocation and Liability Rules – A Comment'[119] and a recent article on economics and law entitled 'The Future of Law and Economics: Essays in Reform and Recollection 2'.[120]

The year 1960 was revolutionary for the legal literature, as legal scholars (especially in the US) began to import conceptual approaches from the social sciences and humanities into law and made them the basis of legal analysis.[121] The arrival of new concepts from these disciplines added theories to the legal field, in contrast to the doctrinal approach. Accordingly, legal academics began to view law from two perspectives: externally from a theoretical perspective and internally from a doctrinal perspective. Theorising law thus became an important part of the legal literature, and legal scholars from all over the world joined the economic approach to law movement. During the 1990s, legal scholars such as Gary Backer promoted economic analysis in criminal law, racial discrimination and family life.[122] This expanded the application of economic analysis beyond business law, eg Calabresi and Coase's early economic approach work on property rights and liability rules.[123] Henry Manne was another important proponent of the economic approach to law movement, mainly in the fields of corporate law and securities law. Other scholars from all over the world, such as, inter alia, Shavell Steven, Robert Cooter, Brian Cheffins, Stephen Bainbridge, Keith Hyöton, William Bratton, Morton Horwitz, Armen Alchian, Harold Demsetz, Frank Easterbrook, Daniel R. Fischel, Mark Casson, Henry Butler, Jules Coleman and Jeffrey Lange have all contributed to the economic approach in legal scholarship. These scholars have developed various methods for analysing the law using the tools of economics.[124]

Changes in U.S. government regulations during the late 1960s and 1970s positively impacted the economic movement in corporate law, eg the market/contract theories in corporate governance. These theories included the 'nexus of contract theory', the 'agency theory' and 'transaction cost analysis', all of which fell under the 'theory of the firm'. These theories – combined with capital market computerisation, the rise of institutional investment and junk bonds, increased foreign investment and competition, and revised campaign financing tactics –

[119] Guido Calabresi, 'Transaction Costs, Resource Allocation and Liability Rules – A Comment [article]' (1968) 11 (1) Journal of Law & Economics 67.

[120] Guido Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (1st edn, Yale University Press 2016).

[121] Brian R Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (1999) 58 The Cambridge Law Journal 197, 202; also see Marc Galanter, 'Law Abounding: Legalisation Around the North Atlantic' (1992) 55 19 M.L.R. 15.

[122] Gary S Becker, 'The economics of crime' (1995) 12 (Fall) Cross Sections, Federal Reserve Bank of Richmond, 8.

[123] Posner, 'Economic Approach to Law' (n 27) 760.

[124] Grechenig and Gelter (n 115) 327.

resulted in the promotion of deregulation in corporate governance.[125] This Anglo-American CG model has since been adopted by many (mainly common law) countries owing to its benefits towards the success of businesses. The Finnish Company Act 2006 has borrowed several characteristics from the said Anglo-American CG model.[126] However, in most countries that have adopted this model, only limited research has been conducted with respect to its national economic implications. As a result, economic scholarship is needed to apply the economic approach to corporate law in line with the specific economic backgrounds of these countries. By doing so, a country-specific *sui generis corporate law* model can be fashioned to suit each respective economy and social context. To this end, the comparative part of this research focuses on comparatively analysing how different countries are addressing six different agency problems, with special emphasis given to the oppression, mismanagement and unfair prejudice remedies. The objective of this analysis is to devise comprehensive dispute resolution provisions that take into account pertinent economic factors. This entails a succinct exploration of both the historical evolution and the current status of the 'economic approach to law' within specific jurisdictions, with a focus on Anglo-American jurisdictions, particularly the UK and the USA, as well as an examination of developments in a Nordic country like Finland and in German-speaking nations. The rationale for selecting these countries stems from the USA's notable influence in propagating the law and economics discipline to other jurisdictions, including the UK. Furthermore, it is intriguing to investigate the trajectory of law and economics within the unique socio-legal frameworks of Finland and the German-speaking territories.

2.2.1 Developments in the 'economic approach to law' in Anglo-American jurisdictions

The 'economic approach to law', an interdisciplinary movement melding legal principles with economic reasoning, first gained prominence in the United States in the 1960s, subsequently permeating other common law jurisdictions, notably the United Kingdom. This evolution within the Anglo-American legal sphere highlights the nuanced interplay of historical, cultural, and academic influences, shaping the approach's reception and integration differently in each context.

In the US, the movement's emergence was catalysed by several factors. Until the 1960s, American legal scholarship primarily steered judges and lawyers through

[125] Lawrence S Zacharias, 'The Economic Structure of Corporate Law by Frank H Easterbrook and Daniel R Fischel' (1993) 67 (3) The Business History Review 472, 474.

[126] Per Lekvall (ed), *Nordic Corporate Governance Model* (SNS förlag 2014) 17.

doctrinal pathways.[127] Proponents of legal realism (in a political context) advocated, inter alia, that judgments in common law countries were not primarily based on legal precedents and other legal materials, but also on the judge's personal views. Grechenig and Gelter argue that these events led academics to work on new approaches to implement legal rules combined with other disciplines, such as sociology and economics, through judges.[128] In addition to the influence of legal realism, utilitarianism had gained considerable attention in American society during the 1960s as a motivation for the economic approach to law movement. These two reasons provided fertile ground for the emerging economic approach to law movement in the US and have influenced the global academic work on the subject to date. Grechenig and Gelter further argue that current policymakers and judges in the US utilise economics tools to *achieve specific goals instead of value in itself.*[129]

A landmark in the approach's US trajectory was Easterbrook and Fischel's 1991 work, 'The Economic Structure of Corporate Law'. This scholarly work provided a systematic application of the economic approach to law as a scientific method in the context of US company law.[130] In the contemporary world, this interdisciplinary subject has become an integral part of the US legal system, as well as those in several common law countries, including the UK, Australia and Canada. In other words. the judgments, judicial opinions and Bar journals consist of majority writings from the economic approach to law in the US. Furthermore, Grechenig and Gelter state that European scholars were surprised by the external approach adopted by US scholars compared to the European literature, which mainly focuses on the internal perspective of law.[131]

Conversely, the UK exhibited initial reluctance towards this interdisciplinary nexus. The economic approach first garnered governmental acknowledgment in a 1993 report on financially distressed companies restructuring, published by the UK government's Insolvency Service.[132] The UK Law Commission, in 1998, solicited expertise from law and economics scholars for an examination into company directors' duties.[133] However, legal academics criticised these attempts, claiming that the use of economic theoretical analysis was insufficient to address company law

127 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 202.
128 Grechenig and Gelter (n 115) 296 and 325.
129 ibid 325.
130 Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1st edn, Harvard University Press 1991).
131 Grechenig and Gelter (n 115) 297.
132 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 214.
133 ibid.

issues.[134] Nevertheless, other British academics have stressed that interdisciplinary approaches improve general understanding of the law,[135] and British law teachers have highlighted the usefulness of the interdisciplinary study of the economic approach to law, stating that 'good theory makes good practise' – meaning that the quality of legal practise may increase if students inject other theoretical studies therein.[136]

From the late 1990s onwards, the economic approach to law has gradually gained traction in the UK. Anecdotal evidence suggests a shift in British legal scholarship, moving beyond a strictly doctrinal approach to embrace insights from the social sciences and humanities. This transition is particularly evident in corporate governance discourse, with the UK Companies Act stipulating that directors consider all stakeholders' interests in corporate decision-making, reflecting an economic 'stakeholder approach'.[137] Despite these inroads, the doctrinal perspective maintains its primacy in UK legal thought, mirroring broader European trends.[138]

In summary, the 'economic approach to law' within the Anglo-American domain illustrates a dynamic academic and practical evolution, marked by distinct national trajectories within a shared legal heritage. While the US embraced this interdisciplinary juncture relatively early, integrating it deeply into legal education and practice, the UK's journey reflects a more cautious, incremental assimilation, highlighting the diverse influences and considerations shaping each country's legal scholarship and jurisprudence.

2.2.2 Developments in the 'economic approach to law' in Finland

Interdisciplinary research in law and economics arrived late to Finland in the middle of the 1990s, owing to several interlinked reasons, four of which are noted by Nuolimaa and Timonen in their article 'Law and Economics in Finland'.[139] The first is that jurisprudence in Finland has been influenced by Scandinavian realism since the 1940s, as well as German doctrinarism. The second is that the economic approach to law is mainly connected with the Anglo-American common law system and is

[134] D Sugarman, 'Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies: Part 2' (1997) 18 Company Lawyer 277, 274.
[135] Brian R Cheffins, *Company Law: Theory, Structure and Operation* (OUP 1997) 197.
[136] Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121).
[137] See Section 172 of the United Kingdom Companies Act 2006.
[138] Grechenig and Gelter (n 115) 303.
[139] Risto Nuolimaa and Pekka Timonen, 'Law and economics in Finland' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics* Vol 1 (Edward Elgar 1999).

thus alien to civil law legal system countries such as Finland. The third is that the legal debate between the US's economic approach to law and German legal doctrinarism linked to Scandinavian legal realism has affected the economic approach to law research in Finland. The fourth is that, during the 1990s, Finnish scholars were occupied with new legislation relating to the EEA agreement and EU membership, resulting in less focus on economic analysis in Finnish law. Furthermore, during this period, the Finnish domestic market was in severe depression; hence, scholars were more focused on working on decisions to reform or dismantle the Nordic welfare state. Indeed, it was only after European economic integration that the approach gained attention, as Finnish scholars were forced to seek out new analytical methods as a result of the amendments proposed to Finnish business law, specifically corporate law.[140]

Legal scholars who have contributed to the economic approach to law in Finland can be identified as, inter alia, Matti J. Sillanpää,[141] Veikko Vahtera,[142] Oker-Blom,[143] Timo Rapakko,[144] Kenneth Högholm,[145] Stefan Sundgren,[146] Kanniainen,[147] Kalle Määttä,[148] and Pekka Timonen.[149] The first doctoral theses on the economic approach to law were published in Finland by Timonene and Määttä, both in 1997.[150]

140 ibid 147.

141 Matti J Sillanpää, Pauli Koski and Veikko Vahtera, *Yhtiöoikeus* (WSOYpro 2021).

142 Veikko Vahtera, *Osakeomistuksen riski ja sääntely* (Kauppakamari 2011).

143 Max Oker-Blom, 'Jurionomi eller rätten i ekonomiskt perspektiv (Law and Economics or Law from the Economic Percpective)' (1980) Tidskrift utgiven av Juridiska Föreningen i Finland 245.

144 Timo Rapakko, *Corporate Control and Parent Firms' Liability for their Controlled Subsidiaries: A Study on the Regulation of Corporate Conduct* (Helsinki School of Economics 1980).

145 Kenneth Högholm, *Essays in the Market for Corporate Control* (Swedish School of Economics and Business Administration 1994).

146 Stefan Sundgren, *Bankruptcy Costs and Bankruptcy Code* (Swedish School of Economics and Business Administration 1995).

147 Vesa Kanniainen and Kalle Määttä (eds) *Näkökulmia oikeustaloustieteeseen (Perspectives on Law and Economics)* (Helsinki, Gaudeamus, 1996); also see Vesa Kanniainen, Kalle Määttä, and Matti Heimonen, 'Oikeustaloustiede - law and economics (Law and Economics)' (1995) Oikeus, 107-124.

148 Kalle Määttä, *Environmental Taxes. From an Economic Idea to a Legal Institution* (Finnish Lawyers' Publishing 1997).

149 Pekka Timonen, *Määräysvalta, hinta ja markkinavoima - Julkisesti noteeratun yrityksen määräysvallan siirtymisen oikeudellinen sääntely (Control, Price and Market Power - The judicial regulation of transfers of control in quoted companies)* (Finnish Lawyers' Publishing 1997); Pekka Timonen, 'Oikeustaloustiede - mitä se on? (Law and Economics - What is it About?)' (1998) Lakimies 100.

150 Pekka Timonen, *Määräysvalta, hinta ja markkinavoima - Julkisesti noteeratun yrityksen määräysvallan siirtymisen oikeudellinen sääntely (Control, Price and Market*

Although these two theses were more or less based on a legal perspective rather than an economic perspective, the economic approach to law movement in Finland has now started to accelerate, specifically in Finnish corporate governance, ie the incorporation of aspects of the theory of the firm into the Finnish Companies Act 2006, which is based on the Anglo-American CG model. Indeed, it is specifically mentioned in FCA 1:5 that the purpose of a company is to make profits for its shareholders unless otherwise stated in the articles of association, which mirrors the primary assumption of the theory of the firm (shareholder profit maximisation).[151] Sillanpää has been continuously contributing to the law and economics literature in Finland for many years.[152] Alongside the work of other young Finnish scholars, the economic approach to corporate law continues to grow in the country.

2.2.3 Developments in the 'economic approach to law' in German-speaking countries

Evidence of the economic approach to law can be traced back to the 19th century in German-speaking countries in Europe, specifically in Vienna, the capital of the Habsburg Empire. The interdisciplinary subject was well advanced there, including debates on private law, eg 'freedom of contract'. Law and economics disciplines were combined and taught at the University of Vienna during 1848.[153] In 1888, Victor Mataja published an important work in the interdisciplinary subjects of the economic approach to political economy, tort law and contractual liability entitled '*Das Recht des Schadensersatzes vom Standpunkte der Nationalokonomie'* ('The law of torts and contractual liability from the political economy point of view').[154] Mataja was one of the main proponents of the economic approach to law movement in German-speaking countries. Mataja's central ideas, specifically on economics in

Power - The judicial regulation of transfers of control in quoted companies) (Finnish Lawyers' Publishing 1997); Määttä (n 148).

151 Chapter 1, Section 5 of the Limited Liability Company Act of Finland 2006 (624/2006; *osakeyhtiölaki*).

152 See Raimo Immonen and others, *Juhlakirja Matti J. Sillanpää 60* vuotta (2016).

153 ibid 337; also see Thomas Olechowski, 'Law and economics, part 1: From the beginnings to the end of the 19th century', University of Vienna (edn, 20th April 2017) <https://geschichte.univie.ac.at/en/articles/law-and-economics-part-i> accessed on 5th October 2022.

154 Victor Mataja, *Das Recht des Schadensersatzes vom Standpunkte der Nationalokonomie* (Leipzig: Duncker & Humblot, 1888) <https://play.google.com/books/reader?id=8y_ES1XcLgUC&pg=GBS.PA14&hl=en> accessed on 14th October 2020. For further work on law and economics by Mataja on liability which he has discussed about upcoming reforms see Victor Mataja, 'Das Schadenersatzrechtim Entwurf eines BOrgerlichen Geselzbuches fur das Deutsche Reich' (1889) 1 ARCHIV FOR BORGERLICHES.

tort law, influenced the American economic approach to law movement. However, Mataja's work failed to influence legal scholarship and practise in German-speaking countries due to the prevalent legal realism based on doctrinarism, unlike the American movement that emerged in the 1960s. During that time specifically, the doctrinal method was strongly defended in German-speaking countries, and the proponents of doctrinarism strongly advocated against the economic approach to law. Instead, German scholars were committed to the systematization and coherence of legal norms. As a result, the economic approach to law was seen as an external concept to legal norms, and it was unfamiliar to the 19th-century conceptual formalism in German legal thought.

Grechenig and Gelter state that despite several attempts to promote law and economics disciplines in German-speaking countries,[155] economic concepts such as economic efficiency were seen as external and subjected to criticism in the German legal scholarship.[156] Conversely, the authors also state that Erwin Steinitzer published an interesting work in 1908 named '*Okonomische Theorie der Aktiengesellschaft*' ('Economic Theory of the Public Corporation') and other economic analyses that anticipated several contemporary concepts, such as the 'principal-agent problem' and the 'perspective of the corporation as a nexus of contracts theory'.[157] However, due to the strong opposition to the economic approach movement, these works gained only minor influence. Grechenig and Gelter also argue that the strong German anti-utilitarian attitude was another reason why the political background was hostile to the economic approach to law movement and that the strong protest against utilitarianism in German philosophy was due to German idealism and materialistic concerns.[158] Thus, German legal thinking has historically been stubborn and dominated by the doctrinal approach and has mainly focused on the systematisation and coherence of legal norms. However, in the contemporary world, German scholars have shown increasing interest in the economic approach to law. This can be seen in the annual conferences organised by the German Law and Economics Association.[159]

[155] Jurists such as Carl Menger and Bohm-Bawerk were appointed professors of economics and further, Free Law Schools in German had the same agenda **of** integrating interdisciplinary approaches by displacing doctrinal approaches, but all these attempts failed. See Grechenig and Gelter (n 115).

[156] Grechenig and Gelter (n 115) 339 and 359.

[157] ibid 38.

[158] ibid 360.

[159] See German Law and Economics Association <https://glea.hypotheses.org/previous-conferences> accessed on 14th October 2023.

2.3 'Doctrinarism' and 'theory' in legal scholarship

Most legal scholarship is doctrinal, meaning that lawyers and legal academics apply interpretative methods to systematically examine the law and predict the outcome, specifically in courts.[160] Van Hoeck and Ost argue that legal scholarship cannot be qualified as theory because it is characterised as doctrinal or descriptive.[161] However, laws drafted according to the aforementioned normative economic analysis can be organised and categorised using a systematic method. The systemisation of legal rules can improve the certainty and trust in the legal system vested in it by society. Doctrinal legal academic literatures are mainly addressed to judges, lawyers and law students who are mainly engaged in the practical interpretation and application of law. Doctrinal legal research assists the practical needs of the legal profession, specifically those lawyers and judges who find and apply accurate law to a legal dispute. Legal doctrine is also useful to law students who are studying to be lawyers. On the other hand, the interdisciplinary legal literature that examines the application of law is mostly useful for policymaking individuals and legal academics. Interdisciplinary scholars examine legal principles and their effects through other metaphysical elements such as society, politics or the economy.[162] Hence, interdisciplinary scholars view law mostly from a theoretical standpoint and seek to debate the relationship between law and said external elements.[163]

Cheffins argues that the interdisciplinary aspects of the law provide analytical and conceptual techniques to *broaden perspectives on experience through systematic observation and theoretical reflection.*[164] Similarly, Bratton argues that interdisciplinary theory legitimates the existence of a systematic legal regulatory framework.[165] Thus, interdisciplinary aspects of the law are important to identifying those areas of law (wasteful laws) that require amendments. Interdisciplinary aspects consider the characteristics of a society in examining its legal systems. Aristotle argued that different types of societies would adopt different distributive principles. In other words, 'democracies' would adopt the principle of equal share among everyone, and 'aristocracies' would adopt the principle that the best gets more.[166] Accordingly, societies incorporate legislation depending on their economic, political

[160] ibid 295.
[161] Mark Van Hoecke and François Ost, 'Legal Doctrine in Crisis: Towards a European Legal Science' (1998) 18 Legal Studies 197, 197.
[162] Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121)199.
[163] ibid.
[164] ibid 201.
[165] William W Bratton, 'An anatomy of Corporate Legal Theory' in Dana Gold (ed), *Law & Economics: Towards Social Justice* (Vol 24, Emerald Publishing 2009) 23.
[166] Robert D Cooter, 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (1989) 64 Notre Dame L Rev 817, 823.

and historical backgrounds. As shown in the previous section, the economic approach to law is increasingly gaining attention in the contemporary world. Economic concepts such as 'Pareto efficiency' are utilised to solve legal disputes efficiently. Yet, until the 20th century, both American and German scholars focused on doctrinism. These historical antecedents meant that even during the 20th century, German scholars mainly focused on developing doctrinal aspects of the law, whereas their US counterparts mostly focused on the economic approach to law. This is because both countries promoted their respective legal systems, ie civil law and common law. Doctrinal legal research mostly favoured civil law legal systems like those in German-speaking countries, while American scholars believed that interdisciplinary aspects of the law were beneficial to common law systems. Thus, the deviation from doctrinarism by American scholars was allied to the prevailing political developments of the 20th century.[167] As a result, contemporary economic analysis of law was developed by American scholars, and common law countries such as the United Kingdom, Australia and Canada have drafted and incorporated laws into their legal systems by utilising the corresponding economic theories. In other words, the economic analysis of law has become prevalent in many developed common law countries.

Doctrinal study is part and parcel of studying law. Doctrinal scholarship provides necessary information to lawyers and judges engaged in examining the law from an internal point of view. In this sense, the law is an autonomous discipline, independent from other social sciences and generally viewed from inside.[168] However, the doctrinal study of law is not solely sufficient in delivering justice, because it ignores the social consequences of law in its application to disputes.[169] For instance, in a shareholder dispute, if an interim injunction is issued by the court halting the functions of a company that supplies essential goods and services, all the stakeholders (including consumers) will be affected, and consumers' quality of life and/or business activities can be hampered drastically, resulting in economic losses. In addition to these economic consequences, court orders can result in a negative impact on the wellbeing of societies. For instance, if an interim injunction is issued to a company delivering goods to a village located from a major city, the villagers may not receive essential items such as food. Thus, it is important to ex ante and ex post examine the consequences of laws incorporated in the relevant legislation.

Interdisciplinary scholars borrow techniques and methods from other disciplines, including economics, to analyse the law. Legal economics scholars have done so to examine the law only from an external perspective, which has enabled them to shape

[167] Grechenig and Gelter (n 115) 309.
[168] ibid 295.
[169] Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 201.

the law to bring outcomes having a sense of efficiency in justice through drafting laws according to economic principles, ie instilling economic principles in the legal system to ex post examine the economic consequences of its legislations.[170] Thus, the use of intellectual disciplines outside the legal scholarship can be helpful in bringing utilitarian results – politically, socially and economically. As a result of utilising techniques and approaches from the social sciences and humanities,[171] legal scholars are able to secure a deeper understanding of legal systems as a means to develop and enhance their legal rules for the practical benefit of society. Equally, interdisciplinary study is relevant to university students because it empowers them to understand the legal system more deeply and broadly from different perspectives. From the economic perspective, Robert Cooter argues that the goal of the economic analysis of law is to *increase the Nation's wealth as measured by the market value of what it produces.*[172] Grechenig and Gelter argue that concepts in economics such as 'economic efficiency' could be implemented through statutory law, eg as a method of interpretation or as an element of generally accepted legal principles.[173] In common law countries, a judge has the legal capability to interpret statutory law in accordance with economic efficiency. However, judges should be well-educated in economic principles relevant to the law. For instance, most judges in the US are knowledgeable of economic principles, especially in the commercial and tort courts.

The economic approach to law plays a major role in delivering justice efficiently in the US. Economists have been appointed to academic positions in many US law schools, and economic theories have been integrated by these economists in connection with teaching traditional law school courses, such as torts, property and procedure.[174] Moreover, and reminiscent of the common saying that 'justice delayed is justice denied', economists have been appointed to sit as judges in US federal courts. For instance, Guido Calabresi is a judge with a degree in economics. Priest states that analysing law by utilising other disciplines in American law schools has increased and refined the understanding of law far beyond what generations of doctrinalists have achieved.[175]

[170] Richard A Posner, 'The Decline of Law as an Autonomous Discipline' (1987) 100 Harv. L.Rev. 761, 779; Graham C Lilly, 'Law Schools Without Lawyers? Winds of Change in Legal Education' (1995) 81 Virginia L.Rev. 1421, 1431.

[171] Cheffins (n 121) 198.

[172] Cooter, 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (n 166) 827; also see Richard A Posner, 'The Economics of Justice' (Revised ed, HUP 1981) 13-118.

[173] Grechenig and Gelter (n 115) 304.

[174] Posner, 'Economic Approach to Law' (n 27) 757.

[175] George L Priest, 'The Growth of Interdisciplinary Research and the Industrial Structure of the Production of Legal Ideas: A Reply to Judge Edwards' (1993) 91 (8) Michigan Law Review 1929, 1934; Cheffins (n 121) 203.

Similarly, economic analysis of the law has recently gained attention in the European context as an analytical methodology because it has been legitimised in European private law as a mechanism for both positive analysis and normative purposes.[176] However, incorporation of the economic approach to law into the British legal system has been comparatively slower than its European counterparts. Atiyah states that this is because British lawyers and judges are more inclined to the pragmatic theoretical approach.[177] In turn, American academics have criticised the legal literature in the UK, arguing that it is descriptive and thus *arid, uncreative, tedious and lacking in 'vision'*.[178] However, since the year 2000, there has been a positive response and growing interest in economic analysis of the law in the UK and in how the law works in practise more than on paper.[179]

2.4 Characteristics of the economic approach to law

Proponents of the economic approach to law have championed several qualities and characteristics that are beneficial to legal and economic professionals. Richard Posner has advocated, inter alia, that the economic approach to law allows the user to *analyse decision making by 'rational maximisers' under conditions of uncertainty*; it *enables legal scholars to explain a realistic behaviour*, specifically in business law to *reform existing legislations*; and *quantitative study of the legal system is fruitful.*[180] Posner also states that many of the legal doctrines and legal systems are best understood and explained as efforts to promote '*efficiency*'.[181] In other words, elements of the legal system – such as the *procedures for resolving legal disputes*, *the rules assigning property rights and determining liability*, *methods of computing damages and determining the availability of injunctive relief* – can be understood as attempts to promote *the efficient allocation of resources.*[182] Indeed, the 'theory of the firm' in corporate governance comprises most of the characteristics advocated by Posner, especially efficient resource allocation. Furthermore, Posner argues that the second meaning of justice itself is 'efficiency',[183] and that the economic approach to

[176] Stefano Lombardo, 'The Comparative, Law and Economics Analysis of Company Law, Reflection on the Second Edition of the Anatomy of Corporate Law – A Comparative and Functional Approach' (2011) 8 ECFR 47, 63.

[177] P S Atiyah, *Pragmatism and Theory in English Law* (Stevens & Sons 1987) 3-4,35-36 and 39-40.

[178] Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 200.

[179] ibid 201.

[180] See Posner, 'Economic Approach to Law' (n 27) 761,762,764, and 765.

[181] ibid 760.

[182] ibid 764.

[183] ibid 777.

law has enormous potential to increase our knowledge about the legal system.[184] This has become a valid statement today, as countries around the world have adopted the economic approach to law. Thus, it is beneficial here to utilise the economic approach to law to analyse the economic benefits of oppression, mismanagement and unfair prejudice remedies and to deepen understanding of the said remedies.

Cooter advocates the 'efficiency and waste' theory within the context of the economic approach to law. Central to this is the 'theory of the firm', which endeavours to minimise waste and augment efficiency in corporate governance. This theory recognises several costs, including 'agency costs' and 'transaction costs', the reduction of which is proposed to enhance efficiency in corporate governance. Cooter contends that economic models strive for the judicious allocation of legal resources by supplanting wasteful laws with efficient ones. The consequent savings can then be redistributed to those affected by the change, thereby achieving a state where some individuals are better off, but none are worse off,[185] as per the Pareto improvement principle derived from economics. In other words, the implementation of efficient legal rules in place of wasteful ones can diminish agency costs and allocate the advantages to stakeholders without detriment to the shareholders. To this end, both the theory of the firm and stakeholder theory can be instrumental in devising Pareto efficient laws, ensuring no stakeholders are disadvantaged. This research seeks to contribute to the development of Pareto efficient laws, supplanting current inefficient statutes, with particular regard to environmental considerations.

Efficiency is the most important characteristic of the economic approach to law, specifically regarding corporate governance. Cooter explains that *'efficiency' is a desirable property of law as 'nutritious' is to property of food*. Judgments and legislations can be analysed ex ante using economic principles to predict how the decision will affect future behaviours. Cooter states that the *redistribution of resources through courts is costly*, meaning that court litigation is always costly.[186] This is because numerous costs are inevitably involved, such as lawyer fee costs, transaction costs of trials, and the uncertainty of results specific to common law countries. This research attempts to minimise these costs by replacing wasteful laws with efficient laws according to economic theories, eg the agency problems. In other words, existing oppression, mismanagement and unfair prejudice remedies in several jurisdictions are examined to fashion an efficient dispute resolution method to mitigate court litigation.

[184] ibid 778.
[185] Cooter, 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (n 166) 822.
[186] See ibid 830, 824, and 834.

Cooter also argues that 'self-interest' is a common characteristic shared between utilitarianism and economics. Certain economic theories have indeed influenced corporate law, resulting in regulations that both favour and challenge 'self-interest'.[187] Shareholder wealth maximisation and majority rule, for example, promote 'self-interest' in favour of investors. On the other hand, corporate law concerning directors' duties introduces regulations against 'self-interest,' aiming to prevent managerial opportunism. Similarly, the stakeholder approach challenges the 'self-interest' inherent in shareholder profit maximisation, advocating instead for the consideration of all stakeholders. In this context, the economic approach to law becomes a valuable tool, allowing for the analysis of the economic impacts of both regulating and deregulating 'self-interest' in connection with oppression, mismanagement, and unfair prejudice remedies. For instance, the mismanagement remedy could function as a general monitoring device, encouraging managers to act responsibly towards all stakeholders and potentially reducing the need for specific regulations on managerial duties. In turn, deregulations will enhance the business judgment rule, allowing managers to take *bona fide* decisions fearlessly in the best interests of the company.

Keith Hyöton states that the economic analysis of law can be separated into two categories: 'positive economic analysis', which aims to explain '*causes' and 'likely welfare'*, and 'normative economic analysis', which attempts to reform *existing institutions towards optimality or to design optimal institutions defined by an analyst.*[188] In this context, the objective function will be set out by utilising economic tools and attempting to draft legal rules that can optimise said objective function. For instance, if the objective function is to reduce costs and increase efficiency in corporate law, a legal rule should be fashioned to optimise this objective function. In this thesis, the comparative part examines the function of oppression, mismanagement and unfair prejudice remedies in the selected jurisdictions with the aim of optimising the objective function of reducing agency costs and increasing efficiency. As Posner argues, '*where the legal system systematically and effectively designed to maximise economic efficiency, the role of normative economic analysis would be very small*'.[189]

In sum, the main aim of the economic approach to law is to analyse the efficiency of the legal rules and to reduce wasteful laws by replacing them. The above-discussed characteristics are important in justifying this application of the economic approach to law.

[187] ibid, 825.

[188] Keith N Hylton, 'Law and economics versus economic analysis of law' (2019) 48 Eur J Law Econ 77, 79.

[189] Posner, 'Economic Approach to Law' (n 27) 765.

2.5 Importance of the economic approach to law, specifically in business law

Economic influence in the legal field has steadily grown in recent times, to the point that economic analysis is currently the most important theoretical approach to corporate law.[190] Business entities are governed by corporate laws, and such laws are interlinked with many fields, eg economics, management theories, accountancy, sociology, and natural sciences (including biological processes in the environment).[191] In this context, stakeholder scholars consider the environment as an important stakeholder in the corporate decision-making process as a means to achieve sustainability. Further, Cheffins argues that the methods of enquiry into corporate governance need to be interdisciplinary with *political theory, studies of managerial behaviour, economics and history owing to the reason that the rules governing corporate activity are inclined to be in a state of flux.*[192] Cheffins further argues that the primary role of corporate law is to facilitate the '*contracting process*' from an economic perspective,[193] and that the interdisciplinary methodology can be utilised to gain a sense of how legal rules affect corporate activity.[194] This allows academics to evaluate existing and proposed legislation in terms of economic analysis. In this way, Cheffins highlights the importance of examining corporate governance through economic principles.

Posner has stated that economic theories and the characteristic empirical methods of economics have been used by both economists and academic lawyers to understand how the law works.[195] Similarly, Cooter states that economic tools are highly useful in predicting *the way alternative courses of action impinge upon important values that are operationally defined and built into the core of the predictive models.*[196] Thus, the economic approach to law assists the user to predict an economic outcome of the application of legal rules. In other words, economists draw assertions based on the application of legal rules. In other words, microeconomics and macroeconomic principles *ex ante* and *ex post* make it possible in the legal world to predict the economic results of the application of legal rules. These two economic principles are often used in the academic and practical legal

190 Brian R Cheffins, 'An Economic Analysis of the Oppression Remedy: Working Towards a More Coherent Picture of Corporate Law' (1990) 40 U Toronto LJ 775, 775.
191 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 276.
192 ibid 216.
193 Cheffins, 'An Economic Analysis of the Oppression Remedy: Working Towards a More Coherent Picture of Corporate Law' (n 190) 784.
194 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 218.
195 Posner, 'The Decline of Law as an Autonomous Discipline' (n 170) 757.
196 Cooter, 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (n 166) 830.

world; Ohlin's seminal articles from the Stockholm school (1937)[197] made them generally accepted all over the world.[198]

The concept of efficiency is central to economics and closely related to business law in delivering justice. As discussed above, Cooter states that efficiency in law means 'without waste', and in economic terms it means 'without wasting money'.[199] Further, Cooter argues that the Pareto efficiency concept is vital to efficiency: economists apply it to law because *Pareto efficient laws satisfy individual preferences over feasible alternatives.*[200] Thus, the economic approach to law provides practical directions for policymaking.[201] The importance of efficiency is reiterated in this thesis, owing to its benefits to business law in particular. In corporate governance, the economic concept of the 'theory of the firm' has contributed to instilling efficiency in governing companies for their economic benefit. Likewise, the agency principle that forms part of this theory has contributed to the drafting of corporate laws to increase the efficiency between managers and owners in a company. Meanwhile, the recently debated stakeholder theory in economics provides sustainable solutions in terms of corporate governance and societal wellbeing. These two economic theories are utilised in this research to provide sustainable and efficient solutions to modern business requirements through the regulation of corporate law.

Cooter advocates that the economic analysis of law could be categorised as a 'policy science' because of its increased breadth and sophisticated legal models.[202] In other words, the 'theory of the firm' continues to integrate models of increased sophistication and breadth into corporate law, resulting in continuous economic developments. Scholars from common law countries such as Australia, Canada, New Zealand, the UK and the US continue to dominate the interdisciplinary works on corporate governance using this economic approach to law.[203] In contrast, the

197 Bertil Ohlin, 'Some Notes on the Stockholm Theory of Savings and Investment I' (1937) 185 The Economic Journal 47, 53. <https://doi.org/10.2307/2225278> accessed on 12 January 2020.

198 Tord Palander, 'On the concepts and methods of the Stockholm School: some methodological reflections on Myrdal's 'Monetary Equilibrium' (1953) International Economic Papers no. 3, 5, 34 - quoted and translated from Palander, 'Om 'Stockholmsskolans' begrepp och metoder: Metodologiska reflexioner kring Myrdals 'Monetary Equilibrium'' (1941) 43(1) Ekonomisk Tidskrift 88.

199 Cooter 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (n 166) 817.

200 ibid.

201 ibid 817-818.

202 ibid 837.

203 Theresa A Gabaldon, 'The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders' (1992) 45 Vanderbilt L.Rev. 1387, 1402;

integration of economic concepts into company law in Europe has been comparatively slow. The reason for this slow integration can be traced to the popularity of the doctrinal, dogmatic or systematic approach to the law in some European countries. However, recent scholarly works on the economic approach to law reveal that some European countries are increasingly incorporating economic principles into corporate law. For instance, 'Anatomy of Corporate Law: A Comparative and Functional Approach'[204] explains how Germany and Italy have utilised economic tools together with the doctrinal approach as an analytical method in corporate law.[205] Furthermore, higher education institutes in Germany, such as the University of Hamburg, offer master's and doctoral programmes in the economic approach to corporate law.

However, the economic approach to law is not yet as developed as a source of law in European jurisdictions compared to their American counterpart, where the US judiciary utilises the approach in judgments that are later integrated into the legal system through the principle of *stare decisis*. Nonetheless, the German judiciary has the judicial authority to apply economic principles in court by utilising the legal scholarship of prominent legal scholars as a source of law. Moreover, considering the increasing amount of legal scholarship on the economic approach to law, it is possible that the approach will fall under the category of source of law in Germany in the future. Currently, many young scholars are utilising the economic approach to law as a theoretical method in corporate law in their monographs and articles.[206] For instance., Stefano Lombardo argues that analytical tools from the economic approach to law are useful as an interpretation method for European corporate law contexts in light of the importance of economics in securities regulations.[207] In turn, member EU countries can utilise this approach as an analytical tool to interpret the Directives issued by the EU Commission when integrating Directives at the national level.

Interdisciplinary scholars have utilised economic tools to analyse and predict the *ex ante* outcomes of corporate law and doctrines. As a result, interdisciplinary scholars have been able to identify the economic implications of corporate law and doctrines. For instance, the theory of the firm and the stakeholder approach in general

William T Allen, 'Contracts and Communities in Corporation Law' (1993) 50 Washington and Lee L.Rev. 1395, 1399.

204 Reinier Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford 2017) <https://doi.org/10.1093/acprof:oso/9780198739630.001.0001> accessed 11 July 2023.

205 Lombardo (n 176) 62.

206 See footnote no. 50 in Lombardo (n 176).

207 Lombardo (n 176) 63.

company law, economic analysis of limited liability, economic analysis of the separation of ownership and control, economic analysis of the market for corporate control (takeovers), economic analysis of insider trading, economic analysis of regulation in the securities market, and economic analysis of insurance regulation.[208] The contemporary and prominent economic theories in corporate governance that cover these legal doctrines are the 'theory of the firm' and 'stakeholderism'. 'Stakeholderism' is used synonymously with the 'stakeholder approach' in this research. The classic theory of the firm is the dominant economic theory in contemporary corporate governance. This theory mostly favours individualism, promoting the principles of freedom of contract, freedom of association and the protection of private property of the participants in business rather than depending on strict government-imposed regulations.[209] However, stakeholderism is becoming increasingly popular.

William Klein suggests that business organisations should be analysed through the connected economic arrangements as *a series of bargains subject to constraints and made in contemplation of a long-term relationship.*[210] 'Business organisations; are referred to as partnerships, corporations and cooperatives in the legal world. Similarly, 'connected economic arrangements' are referred to as, inter alia, shareholder agreements, loan agreements and employment contracts.[211] Accordingly, these connected economic arrangements are important to further the profit maximisation of the business organisation, specifically in companies. They can be created according to economic theories to increase efficiency and replace existing wasteful economic arrangements. This research focuses on replacing such existing wasteful economic arrangements with efficient economic arrangements. For instance, scholars have argued that it is more economically efficient for the business organisation to increase capital through equity investors than finding capital through creditors or lenders.[212] Thus, replacing existing economic arrangements with efficient laws to facilitate the attraction of investments from equity investors is efficient in the economic sense. In this research, legal instruments like the oppression, mismanagement and unfair prejudice shareholder remedies are analysed to redefine the corporate purpose.

208 See Risto Nuolimaa and Pekka Timonen, 'Law and economics in Finland' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics* (Volume 1, The history and methodology of law and economics, Edward Elgar 1999).

209 Eric W Orts, *Business Persons: A Legal Theory of the Firm* (OUP 2013) 13.

210 William A Klein, 'The Modern Business Organization: Bargaining under Constraints' (1982) 91 Yale LJ 1521, 1521.

211 ibid.

212 Orts, *Business Persons: A Legal Theory of the Firm* Persons' (n 35) 14.

2.5.1 Economic analysis of 'limited liability' doctrine

Economists have identified the economic benefits/implications of doctrines established through corporate law statutes. For instance, *limited liability distributes the risks associated with business failures which is mutually advantageous for shareholders and creditors.*[213] Investors can thus diversify their returns on investment in large corporations while at the same time being immune from adverse effects resulting from misconduct by their corporate agents.[214] Ronald Green argues that limited lability is an unpaid insurance policy enjoyed by investors who are protected against the bottomless liability arising from corporate misconduct.[215] Likewise, Susan Woodward states that limited liability reduces certain costs, such as 'transaction costs', allowing corporations to exist.[216]

Limited liability is an important doctrine in corporate law and for minority shareholders in limiting their liability. In other words, minority shareholders are only liable to the extent of their shares. Furthermore, oppression, mismanagement and unfair prejudice remedies provide stronger rights for minority shareholders to influence the decision-making of the company in certain circumstances. Thus, these remedies benefit investors seeking to diversify their investments by enabling them to influence decisions-making safe in the knowledge of their limited liability.

2.5.2 Economic analysis of the 'separate legal personality' doctrine

The legal principle of separate legal personality in company law is an important doctrine for economists to consider in economic theories. Cheffins argues that economists should pay more attention to this legal doctrine and consider the company as a separate entity. Cheffins states that economists identify the business organisation as a focal point for *voluntarily bargaining relationships which result in the business organisation operating as a 'nexus of contracts'.* This view neglects the doctrine of separate legal personality and portrays the company as a *market as a medium where buyers and sellers engage in free and willing exchange.*[217] Accordingly, it can be said that business arrangements in the economic sense lack

213 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 209.

214 Ronald M Green, 'Shareholders as Stakeholders: Changing Metaphors of Corporate Governance' (1993) 50 Wash & Lee L Rev 1409, 1414.

215 ibid.

216 Susan E Woodward, 'Limited Liability in the Theory of the Firm' in Donald A Wittman (ed) *Economic Analysis of the Law* (John Wiley & Sons 2002) 153, 153.

217 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 209; also see Easterbrook and Fischel (n 130) 8-22 and Cheffins, *Company Law: Theory, Structure and Operation* (n 135) 38-41.

the legal reality of being separated from other actors through their economic arrangements because legal personality is not recognised in economic theories. However, this gap is filled in the economic approach to law because legal norms are interlinked with economic principles. I believe that this provides realistic results compared to pure economic theories. Accordingly, scholars should pay more attention to the existing legal norms over and above economic assumptions.

Together, the separate legal personality and limited liability doctrines have contributed to creating the separation between ownership and control in the company. This structure in corporate governance facilitates an efficient framework for the business to function. Thus, investors who invest in the company will act as company shareholders (residual claimants), and the directors/managers (hereafter referred to as 'managers') act as the deciding body of the company in the conduct of its daily affairs. Corporate law has vested powers on directors to control the company on behalf of the shareholders to support its maximisation of profits for the shareholders. Generally, corporate law allows managers to be appointed by controlling shareholders as their agents. However, certain jurisdictions provide that managers must additionally represent minority shareholders and non-shareholder stakeholders, such as employees. For instance, corporate law and codetermination law provide worker representation at board level of between 33.3% and 50% in Germany[218] and between 33.3% and 66.6% in Denmark.[219] Economists have drawn theoretical assertions based on the separation of ownership and control created through these legal doctrines. For instance, Berle and Means argue that the separation of ownership and control has resulted in economic benefits for investors in terms of liquidity. On the other hand, investors may lose controlling power of the company to a controlling group of managers in a diverse ownership structure.[220]

Generally, corporate law provides two methods for shareholders to intervene in the directors' decision-making powers: at the AGM and by passing a special/ordinary resolution.[221] However, oppression, mismanagement and unfair prejudice statutory provisions provide shareholders – specifically, minority shareholders – with the opportunity to influence this director-level decision-making process. It is an established company law principle that managers run the business on behalf of shareholders. In turn, the separate legal personality has made it possible

[218] Codetermination Act of 1976.

[219] Section 140 of the Denmark Companies Act of 2010.

[220] Carl Landauer, 'Beyond the Law and Economics Style: Advancing Corporate Law in an Era of Downsizing and Corporate Reengineering' (1996) 84 Cal L. Rev. 1693, 1699.

[221] Depending on the company law of a country a special resolution is a resolution of the Corporation's shareholders which requires at least 75% of the votes cast by shareholders (2/3rd majority) in favour of it in order to pass. An ordinary resolution may be passed by shareholders with a simple majority of the votes cast (50% or more).

for non-controlling shareholders to make the company a party to an oppression, mismanagement or unfair prejudice action in certain jurisdictions and to seek damages from the company itself for being negligent, inter alia, in conducting its affairs and violating shareholder rights.

2.5.3 Economic analysis of the 'separation of ownership and control' doctrine

Separate legal personality has resulted in the separation of company ownership and control. Stephen Marks states that the economic benefits of this separation arise from the interaction of three economic factors. First, *in certain circumstances hierarchical decision making may be more efficient than market allocation.*[222] As a result, investors can appoint experts in the field to take efficient decisions depending on the market conditions. This allows investors to invest in more businesses and their agents to look after the businesses on their behalf. However, economists argue that this separation has created 'agency cost', which is a 'sunk cost' in transaction cost theory, meaning that investors must bear certain costs in their investments that cannot be recovered. Nevertheless, economists argue that the benefits outweigh the costs associated with the separation of ownership and control. The second factor is that *optimal firm size could be large* due to *economies of scale in both production and decision making*. This allows businesses to expand and grow within a simple governance structure. The third factor is akin to the aforesaid liquidity of investments, which provides an optimal investment strategy for investors to diversify their investments and the ability to change their allocations in changing market situations.[223]

Furthermore, oppression, mismanagement and unfair prejudice remedies contribute additional economic benefits to the three factors listed above. In relation to the first factor, this research examines the aspects of the said remedies' role in reducing agency costs and transaction costs and argues that the said remedies facilitate the reduction of agency costs in corporate governance. In relation to the second factor, the said remedies provide shareholders with urgent interventional ability (with good reasons) in the decision-making of the company, even in a large conglomerate. In relation to the third factor, the said remedies grant stronger rights for investors to diversify their investments and small-scale invest in companies and even exit the company, seeking redress through minority shareholder buyout rights

[222] Stephen G Marks, 'The Separation of Ownership and Control' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics,* Vol 1 (Edward Elgar1999) 694.

[223] ibid.

provisions. Examples of said legal provisions are further discussed in the comparative parts of the research.

2.5.4 Economic analysis of 'control transactions'

Control transactions in a company can occur through mergers, acquisitions and takeovers. Acquisitions or takeovers can be 'hostile', meaning that the management of the target company opposes the offer made by the acquirer.[224] Control transactions can bring dramatic changes to the company's stakeholders, eg the employees. More specifically, the various types of control transactions include, inter alia, open market purchases, block purchases, tender offers, negotiated purchases and proxy contests.[225] Furthermore, these control transactions can occur owing to transactions between the company and its shareholders or when a company issues new shares or re-purchases shares or engages in a statutory merger.[226] Research has shown that takeovers are generally profitable for the target company's shareholders[227] and they appear to bring[228] Henry Manne has advocated that control transactions impose responsibility on managers to perform efficiently in managing the daily affairs of the company; otherwise, the market price of its shares would drop, and it would attract takeovers resulting in their replacement by the new owners of the company. Accordingly, Manne advanced the idea of a 'positive correlation between corporate managerial efficiency and the market price of shares'[229]. This position is supported by a study conducted by Palepu in the US.[230] However, a study in the UK by Franks

[224] George Bittlingmayer, 'The Market for Corporate Control' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics,*Volume 1 (Edward Elgar 1999) 727.

[225] ibid 728.

[226] Paul Davies, Klaus Hopt and Wolf-Georg Ringe, 'Control Transactions' in Reinier Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 205.

[227] See Roberta Romano, 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 Yale Journal on Regulation 119, 122; Marina Martynova and Luc Renneboog, 'A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?' (2008) 32 Journal of Banking & Finance 2148, 2153; Klaus J. Hopt, 'Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis' (2014) 20 Columbia Journal of European Law 249, 252.

[228] See Espen B Eckbo, 'Corporate Takeovers and Economic Efficiency' (2014) 6 Annual Review of Financial Economics 51, 67. See also Marina Martynova and Luc Renneboog, 'A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?' (2008) 32 Journal of Banking & Finance 2148, note 12, 2164.

[229] Henry G Mann, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political Economy 112.

[230] See Krishna G Palepu, 'Predicting Takeover Targets: A Methodological and Empirical Analysis' (1986) Journal of Accounting and Economics 3-35.

and Mayer found little evidence that target companies performed poorly before hostile takeover.[231] Nonetheless, several studies have found that control transactions have brought numerous economic benefits such as, inter alia, improved performance and productivity.[232] Thus, control transactions can bring economic benefits to a company. However, due to the sudden changes in the target company ownership structure, it can also affect (minority) shareholders' rights. Here, the 'minority buyout right' remedy has addressed several issues arising out of control transactions, allowing minority shareholders to remain in the company with a reasonable value for their shares. Likewise, the oppression, mismanagement and unfair prejudice remedies can proactively operate as a monitoring and protective mechanism to safeguard minority shareholders from any oppressive acts on the part of the new management.

The above-mentioned types of control transactions can create agency problems within the target company as well as coordination problems among the target company shareholders.[233] These problems may depend on the ownership structure of the company, ie whether the company has a dispersed or block holder ownership structure. For instance, new shareholders may have disagreements with the group of existing minority shareholders, resulting in agency problems between the controlling shareholders and the minority shareholders. In response, this research examines potential solutions for reducing said agency costs by utilising oppression, mismanagement and unfair prejudice remedies to replace wasteful laws with efficient laws.

2.6 Developments in the economic approach to law – 'economic analysis of law' and 'law and economics'

Recently, legal economics scholars have worked on two approaches concerning the interaction between law and economics: 'economic analysis of law' and 'law and economics'. Steven advocates that the economic analysis of law addresses two basic types of questions about legal rules.[234] The first concerns the 'effects of legal rules', which are described as *descriptive.*[235] In this context, in a legal context, how do the existing legal rules affect the occurrence of misconduct in the business world? For

[231] See Julian Franks and Colin Mayer, 'Hostile Takeovers and the Correction of Managerial Failure' (1996) Journal of Industrial Economics 229-259.

[232] Bittlingmayer (n 224) 746.

[233] Davies Hopt and Ringe (n 226) 207.

[234] Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press 2004) 1.

[235] ibid.

instance, effective prevention of syphoning company money and litigation. The second type of question pertains to the 'social desirability of legal rules', which Steven describes as *normative.*[236] In other words, are the aforesaid existing legal rules that prevent the occurrence of misconduct in the business world socially good? In response, I believe that the theory of the firm is useful in fashioning efficient legal rules to prevent the occurrence of misconduct in the business world. Similarly, the stakeholder approach is useful in fashioning said effective legal rules in a socially good manner, eg by furthering environmental sustainability. The stakeholder approach promotes consideration of all stakeholders, including local communities and environments in corporate decision-making. Thus, stakeholderism promotes socially desirable legal rules. On the other hand, the theory of the firm focuses on increasing the profits of its shareholders. Theorists argue that this benefits the public, ie shareholder wealth maximisation will promote business growth, resulting in more job opportunities.

From the early 19th century until recently, 'economic analysis of law' has been the dominant economic approach to law. However, American judge Calabresi recently highlighted a different perspective through his writings on 'The Future of Law and Economics',[237] which explains the differences between 'economic analysis of law' and 'law and economics'. Calabresi concurs with Bentham in advocating that '*Economic Analysis of Law, uses economic theory to analyse the legal world […] and, as a result of that examination, confirms, casts doubt upon, and often seeks reform of legal reality'*.[238] According to this explanation, the method of economic analysis of law utilises economic theories to critically evaluate the legal reality within its own fit to utilitarianism from an Archimedean point of view of the economic theory. If a legal reality does not fit from said perspective, such law is said to be 'irrational'; accordingly, economic analysis of law highlights the need for reforms.[239] Additionally, economic analysis of law focuses on efficiency and sees human beings as the rational maximisers of their own preferences.[240]

236 ibid.

237 Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (n 28).

238 Keith N Hylton, 'Law and economics versus economic analysis of law' (2019) 48 Eur J Law Econ 77; also see Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (n 28).

239 Ofer Malcai, 'The Alternative Futures of Law and Economics: Comments on Guido Calabresi's The Future of Law and Economics' (2017) 16 (1) Jerusalem Review of Legal Studies 83, 83.

240 Brian H Bix, 'Law and economics and the role of explanation: A comment of Guido Calabresi, The Future of Law and Economics' (2019) 48 European Journal of Law and Economics 113, 114.

Judge Posner has linked the common law tendency towards wealth maximisation with 19th-century 'laissez-faire ideology', which resembles the wealth maximisation norm of 'law and economics'.[241] Posner has contributed to the theoretical aspect of 'economic analysis of law' that has led economics scholars such as Calabresi to expand the topic and develop 'law and economics'. Bainbridge has argued that a legal system that facilitates wealth maximisation has provided freedom for individuals to pursue and accumulate wealth.[242] This is the basic presumption in the 'theory of the firm': that economic man's rational choice is to maximise profits.[243] In other words, the main duty of directors and management is to act in the best interests of the company to maximise the wealth of its shareholders.[244] Bainbridge supports this presumption by stating that shareholder wealth maximisation reflects a *more pragmatic and realistic view* of human nature,[245] specifically in the commercial world. Investors invest in a business with a specific focus on its return of profits in an attempt to maximize their own wealth. To this day, shareholder wealth maximisation remains the dominant corporate governance norm worldwide, and it is part and parcel of corporate law in the majority of jurisdictions.[246] In the FCA, it is specifically stated that the purpose of a company is to make profits for its shareholders.[247]

However, different schools of thought have recently emerged among legal economics scholars, who have advocated for economic theories such as the stakeholder approach to corporate governance to promote economic welfare and sustainability. This approach does not promote profit maximisation solely for company shareholders but economic welfare for all the corporate stakeholders. Ralph Winter has argued in favour of stakeholderism theory, stating that *'lax'*

241 See footnote 121 in Stephen M Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (1997) 82 Cornell L. Rev. 856, 882; Richard A Posner, *The Problems of Jurisprudence* (Revised edn, Harvard University Press 1993) 353.

242 Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 898.

243 ibid 872.

244 Green (n 214) 1410.

245 Stephen M Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 Wash & Lee L Rev 1423, 1444.

246 See footnote 222 in Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 900.

247 Section 5 of the Limited Liability Company Act of Finland 2006 (624/2006; *osakeyhtiölaki*).

controls may be profit maximizing.[248] The theory of the firm and stakeholderism as theoretical approaches are further discussed in Chapter three.

The stakeholderism approach can be better explained in light of the law and economics approach advocated by Calabresi (over economic analysis of law). Law and economics, on which Calabresi agrees with Stewart Mill,[249] begins with an *agnostic acceptance of the legal world as it is and examines whether it can be explained by economic theory.*[250] If it is unable to explain through the economic analysis of law, Calabresi argues that it should then be asked whether economic analysis has 'mischaracterized that reality'.[251] Calabresi further contends that if it is not mischaracterized, the 'law and economics' approach forwards the following question: '*Can economic theory be amplified? […] can it be made broader or more subtle […] so that it can explain why the real world of law is as it is?*'[252] Calabresi and Melamed provide a good example of this in their seminal paper, 'Property rules, liability rules, and inalienability: One view of the cathedral'[253] liability rules[254] in economics permit the individual to obtain an entitlement by paying a price set by the court rather than transferring the entitlement by way of pure market interaction or direct collective decision.[255] For instance, under certain circumstances, a person may be able to commit a nuisance while allowing the victim to abate the nuisance by paying damages to the person who is causing the nuisance. However, in tort law, 'reversed damage' is not possible.[256] In such a situation, economic analysis of law may reject the legal reality, but law and economics may ask the question 'can economic theory be expanded and explain as to why the legal world is as it is?' Such

248 Ralph K Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation' in Donald A Wittman (ed), *Economic Analysis of the Law* (John Wiley & Sons 2002) 178.

249 See John Stuart Mill, *Mill on Bentham and Coleridge* (F R Leavis ed, CUP 2010).

250 Hylton (n 238) 78.

251 Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (n 28) 3.

252 Brian H Bix, 'Law and economics and the role of explanation: A comment of Guido Calabresi, The Future of Law and Economics' (2019) 48 European Journal of Law and Economics 113, 115. Also see Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (n 28) 4.

253 Calabresi and Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (n 118) 1128.

254 Liability rule: an external, objective standard of value is used to facilitate the transfer of the entitlement from the holder to the nuisance. See Calabresi and Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (n 118) 1106 and also Boomer v Atlantic Cement Co., 26 N.Y 219, 309 N.Y.S.2d 312, 257 N.E.2d 870 (1970) (avoidance of injunction conditioned on payment of permanent damages to the Plaintiff).

255 Malcai (n 239) 84.

256 ibid.

an explanation through an expansion of economic theory would facilitate the fashioning of economically efficient laws, eg incorporating laws on 'reverse damage'.

Similarly, company law can empower the company to abate self-interest actions performed by the management based on economic principles. In other words, the company law can allow the company to compensate management to hinder from engaging in self-interest actions, if such compensation is in the best interest of the company. In the economic sense, this may be able to reduce 'costs' in terms of the theory of the firm and the agency principle, which will ultimately benefit the company economically. For instance, a director appointed by minority shareholders may attempt to block a merger that would benefit the company but dilute the minority shareholders' shareholdings. In such a scenario, corporate law may empower the company to abate such actions by compensating and paying damages to the director or minority shareholders. This may also facilitate the avoidance of future court litigation, thereby preventing unnecessary costs. This is not yet possible in corporate governance, as such rules do not yet exist. Economic analysis of law may render such legal rules, but Calabresi's law and economics approach may provide a solution by taking 'real-world' data into account and fashioning laws accordingly.[257] This research has examined this type of real-world data – ie legislation and case law from different jurisdictions – to fashion efficient laws according to expanded economic theories of the theory of the firm and the stakeholder approach. This method is supported by the law and economics approach advocated by Calabresi, ie economic theory can provide an economic view of the legal world and assist in its sharpening in terms of economics by fashioning laws accordingly, specifically in business law. Additionally, the practical nature of the legal world facilitates the development of economic theory itself.[258] As a result, Orts advocates that 'law and economics' is a leading example of highly successful legal ideology specifically influencing business-related fields, including laws relating to corporations, and further argues that law and economics is the most successful intellectual movement in the legal academy in recent years.[259]

Furthermore, Calabresi argues that owing to the dominance of the economic analysis of law (theory over practise) over the law and economics approach (in Calabresi's words, '*the bilateral relationship between Theory and Practise*'), possible developments in economic theory that may be suggested by legal reality

257 Hylton (n 238) 78.
258 Malcai (n 239) 84.
259 Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 13.

may have been missed.[260] For instance, developments in stakeholder theory in corporate governance may have been adversely affected by the dominance of the economic analysis of law (theory over practise) over the last decade. However, the law and economics approach advocated by Calabresi may positively influence the stakeholder approach in corporate governance in the future. For instance, stakeholderism, which promotes the interests of all stakeholders, is considered 'irrational' by several scholars in the eyes of the economic analysis of law approach. Instead, the law and economics approach – by looking at the real-world data and *explaining why the real world of law as it is* – may support the stakeholder approach over the presumptions of theory. For instance, the COVID-19 crisis has strengthened arguments for stakeholder capitalism over shareholder wealth maximisation.[261] Currently, proponents of stakeholderism criticise the presumption of wealth maximisation in the theory of the firm by highlighting real-world data, arguing that presumption creates inequalities between the stakeholders of the company, which results in long-term losses to the company. As discussed previously, the stakeholder approach in corporate governance takes non-monetary values such as the environment into account, while wealth maximisation has been criticised as an approach that runs counter to the economic goals of maximising total social welfare.[262]

Keith Hyöton advocates that the law and economics approach is inherently institutionalist and advantageous in providing better solutions and advancing the current legal system in terms of economic benefits.[263] Stefano Lombardo advocates that the economic analysis of law is a useful mechanism to interpret legal norms and interrogate markets in the EU.[264] This thesis does not intend to focus on the argument between the economic analysis of law and law and economics but to utilise both to advance economic theories to find solutions by fashioning efficient laws for the current necessities of the world, eg environmental sustainability, investor attraction and efficient governance mechanisms. Ultimately, economics in law allows lawyers to understand corporate law more broadly, and these arguments in the field of

260 Calabresi, *The Future of Law and Economics: Essays in Reform and Recollection 2* (n 28) 169.

261 Wenzhi Ding, and others, 'Corporate Immunity to the COVID-19 Pandemic' (NBER Working Paper No. 27055, issued in April 2020) <https://www.nber.org/papers/w27055.pdf> accessed 23 May 2020.; also see Klaus Schwab, 'Covid-19 is a litmus test for stakeholder capitalism' (Financial Times, 25th March 2020) <https://www.ft.com/content/234d8fd6-6e29-11ea-89df-41bea055720b> accessed 23 May 2020.

262 Grechenig and Gelter (n 115) 301.

263 Hylton (n 238) 88.

264 Lombardo (n 176) 63.

economics facilitate the advancement of legislation to provide efficient solutions to society.

2.7 Criticisms of the economic approach to law

Constructive criticism is vital in legal drafting and policymaking. In the field of business law, economics plays a major part in achieving the best 'commercial interest'. Posner has stated that one of the criticisms levelled against the economic analysis of law is that it ignores 'justice', which is a central concern of the legal world.[265] However, in Calabresi's law and economics, this can be viewed from a different perspective. In other words, the legal outcome according to the stakeholder approach and 'considering the real-world data' does not ignore justice. Instead, long-term economic justice can be delivered according to the presumption of the stakeholder approach whereby the social welfare of all stakeholders in a company is considered. In other words, the court can deliver an 'economic judgment' by considering the economic and social impact to all stakeholders (by utilising economic theories and real-world data) in respect of a disputed decision by majority shareholders. Accordingly, economic aspects can be integrated into corporate law for judiciary officials to consider when delivering judgments. For instance, Section 172 of the UK Companies Act 2006.

In his seminal paper 'Economic Approach to Law' in 1975, Posner stated that economic theory is an alien concept to an intelligent lawyer and, owing to its counterintuitive nature and complexity, important and useful parts of economic theory can be missed by lawyers and judges.[266] However, it is almost 47 years since this criticism, and economic theory has changed greatly in the contemporary world. Economics has been taught as a subject in law schools, economic professors are frequently employed in law schools, and American judges such as Calabresi are delivering their judgments by utilising techniques and approaches taken from economics. Economic analysis of law has influenced several countries, including the UK. Indeed, in the modern world, where information technology is highly advanced, judges and lawyers can easily and freely gain knowledge of economic approaches to law. Likewise, governments can provide workshops and training programmes for judges. The growing interest in scientific research on economic approaches to law will further promote the adopting of economic theories in the practical legal world. Additionally, well-drafted legislation according to economic principles will facilitate lawyers and judges to apply law without missing useful parts of economic theory. The aim of this research is to fashion such legislation.

[265] Posner, 'Economic Approach to Law' (n 27) 777.
[266] ibid 762.

In 1992, Judge Edward heavily criticised the adoption of economic approaches in the legal profession, highlighting that 'a regrettable disjunction was growing between law schools and the legal profession'.[267] The main criticism against the economic approach to law was that the law professors were busy focusing on economic theories rather than focusing on cases, statutes and related sources of law. As a result, legal professions (including judges) were receiving less help from legal scholarship to interpret the law. What Judge Edward highlighted is that legal scholarship was focusing less on doctrinal analysis, and that theory, which is wholly divorced from cases, has no use in practical implementation.[268] Judge Edward's criticisms have since been addressed by pro-economic approach scholars, arguing that Judge Edward overstated his criticisms of theory in law. For instance, Cheffins has highlighted four arguments forwarded by pro-economic approach scholars. First and second are that the legal services industry is increasingly being commercialised owing to its competitive nature. As a result, theoretical advances from other disciplines are useful in creating commercial value for clients. Third is that, although interdisciplinary research is growing in law faculties, there has been no indication that doctrinal legal scholarship is declining. Fourth is that theory can still play a valuable role in legal education, because theory helps to understand the law more deeply. Moreover, theory can help judges to examine ex ante the consequences of an application of a legal rule; American judges are already increasingly applying such techniques and approaches in their judgments. This shows that interdisciplinary approaches can help judges to deliver judgments with a strong sense of 'justice' compared to those delivered without considering interdisciplinary approaches.

Other recent criticisms of the economic approach to law can be found in the German-language literature. Grechenig and Gelter note several criticisms in their seminal article 'The Transatlantic Divergence in Legal Thought: American Economic Approach to Law vs. German Doctrinarism'.[269] Their criticisms are that, inter alia, economic analysis of law mainly focuses on efficiency and neglects the distribution of goods and income. Economic approaches focusing on efficiency aim to create an optimal allocation of resources with minimal transaction costs, which

267 Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (n 121) 203; also see Harry T Edwards, 'The Growing Disjunction Between Legal Education and the Legal Profession' (1992) 91 Michigan L. Rev. 34; Harry T Edwards, 'The Growing Disjunction Between Legal Education and the Legal Profession: A Postscript' (1993) 91 Michigan L.Rev. 2191; Harry T Edwards, 'Another Postscript to The Growing Disjunction Between Legal Education and the Legal Profession' (1994) 69 Washington *L.Rev.* 561.

268 Edwards 'The Growing Disjunction Between Legal Education and the Legal Profession' (n 267) 46.

269 Grechenig and Gelter (n 115).

ultimately leads to the widening of existing inequalities, specifically between the poor and the rich. Thus, it is argued that non-monetary values warrant consideration. However, economists have already done so through the stakeholder approach. Another of the main criticisms is that social science generally cannot bring precise results, meaning that the economic consequences of legal rules are purely speculative.[270] In response, answers to the majority of these criticisms can be found in Calabresi's law and economics approach, which also takes the doctrinal aspect of law into consideration in addition to the economic theories. As well as the US, several advanced economies, such as the UK, Canada, New Zealand and Australia have incorporated economic elements into their laws. This would indicate that the benefits of bringing economics into law outweigh the negative effects.[271]

Developments in the economic approach to law have mostly taken place in common law countries, as common law judges can incorporate economic principles into their judgments more easily compared to civil law countries. Furthermore, it is difficult to incorporate economic principles into legal statutes compared to applying them in court judgments by judicial officials. Thus, scholars have a heavier burden in facilitating the integration of economic aspects in civil law legislation.

2.8 Comments

The findings in this chapter clearly show that the economic approach to law has spread across the contemporary world and specifically in developed countries. This approach cannot be avoided in legal research, particularly in this modern era where geoeconomics play a major part in business survival. Hyöton's findings on 'positive economic analysis' and 'normative economic analysis', Steven's questions on the 'effects of legal rules' and the 'social desirability of legal rules', and Calabresi's recent findings on law and economics have advanced the application of the economic approach to law as a method to deliver efficient justice.

Hyöton argues that 'positive economic analysis' aims to explain 'causes' and 'likely welfare', while 'normative economic analysis' attempts to reform existing legal rules to optimise the objective function. Steven argues that economic analysis should address the questions of the 'effects of legal rules' and the 'social desirability of legal rules'. Both authors argue that the economic analysis of law serve a similar function: to resolve societal issues efficiently. In turn, Calabresi's findings support that economic analysis should not only focus on theory itself, but also data taken from the real world. Accordingly, Calabresi argues that theory should be amplified to explain why the real work of law is as it is. In other words, environmental law,

270 ibid 299.
271 Cheffins, 'Corporations' (n 113).

consumer protection laws and employee protection laws provide strict protection to stakeholders, and economic theory in relation to corporate governance should thus be amplified by taking those interests into account. For instance, the stakeholder approach in economics considers all the stakeholders involved, including those who are protected by strict legislations that are external to corporate law.

While the theory of the firm is currently dominant in terms of the economic analysis of law, the stakeholder approach can be considered vital in corporate governance in line with Calabresi's findings on law and economics. In this way, this research amplifies these two economic theories to find efficient solutions to issues in corporate governance. Thus, the findings of this research suggest that it is beneficial to reform legal rules by considering perspectives taken from both the theory of the firm and the stakeholder approach to promote long-term benefits to the company. For instance, this research amplifies previous findings on a third type of agency relationship existing between the firm itself – including its owners (agent) – and its stakeholders (principal). This agency relationship can be further supported on the basis of the third agency problem that exists due to the 'social desirability of legal rules'. Additionally, this research amplifies Orts' findings on horizontal (mutual) agency relationships among the firm's stakeholders. Indeed, it further amplifies transaction costs theory by identifying 'shareholder costs' and 'stakeholder costs'. The economic approach to law is utilised to fashion laws based on optimising objective functions of, inter alia, reducing costs, protecting the environment and social welfare. The theory of the firm and stakeholder theory are utilised in fashioning laws on the said objective functions. The following chapter three includes a detailed examination and analysis of economic theories and these crucial amplifications.

This chapter emphasises the significance of adopting an economic perspective in company law. Additionally, the research highlights the urgent need for further studies that apply this economic approach within the legal domain, particularly in fields such as tax and social welfare laws. For instance, it is arguable that the 'stakeholder approach', which considers a variety of stakeholders (including society at large), stands as a relevant economic theory for enhancing a country's welfare. This comparative study contributes to the field of corporate governance, as the stakeholder approach can be used to shape company laws. However, its principles have been neglected in the legislative processes of numerous countries. While some might argue that incorporating stakeholder principles into company law is unnecessary in countries with strong social welfare systems, this research reveals the commercial benefits of adopting the stakeholder perspective. Consequently, this study opens up new possibilities for further research into the application of the economic approach within company law.

CHAPTER THREE – THE THEORY OF THE FIRM AND STAKEHOLDERISM: A WAY FORWARD IN POLICYMAKING?

3.1 Introduction

The theory of the firm is a vast and diverse topic on which new perspectives are being continually developed by scholars. This research mainly focuses on the legal perspectives of the economic theories of corporate governance. For instance, the theory of the firm attempts to predict and explain the nature, existence, behaviour, structure, and market relationship of the business enterprise. Economists mainly refer to such business enterprises as the ‘firm’ and/or ‘organisation’. However, the concept of the firm has different meanings in different jurisdictions, as defined by corporate law statutes. For instance, depending on the legal culture partnerships may not have a separate legal personality to sue or be sued,[272] but companies and corporations do. The legal terminology used to define a firm may differ depending on the jurisdiction and on the size and capacity of the business entity. In other words, the term ‘company’ is mainly used for small and medium-sized enterprises (SMEs), and the term ‘corporation’ largely refers to large business entities such as conglomerates. In this research, the business entity is interchangeably referred to as the ‘firm’ and ‘company’, specifically when it is discussed in an economic context. In turn, the theory of the firm and stakeholder theory primarily refer to corporate governance in business entities that have a separate legal personality.

The theory of the firm is a microeconomic concept based on the assumption that the firm makes decisions to maximise profits. It concerns all ‘producing units’, and legal theories of the firm tend to focus mainly on the internal governance of the

[272] It should be noted that in Finland a Partnership and a limited Partnership are in the eyes of the law, incorporated organisations (ie legal person, distinct from the Partners behind the company). See the Partnership Act 1:3 <https://www.finlex.fi/fi/laki/kaannokset/1988/en19880389_20151444.pdf> accessed on 18 July 2023; Heikki Toiviainen, *An Introduction to Finnish Business Law: A Comprehensive Survey of the Foundations and Main Rules of Finnish Corporate Law* (Edita 2008) 413.

firm.[273] In fact, the theory of the firm consists of several economic theories. This research mainly focuses on the general aspects of the 'neoclassical theory of the firm', the 'principal-agent theory of the firm' and the 'transaction cost theory of the firm'. First, however, it is important to revisit the historical developments of these theories to attain a suitable level of understanding.

Prior to the emergence of new economic theory, the corporate law discourse was dominated by the managerialist conception of the corporation. However, the 1970s witnessed a major change from 'economics with firm' to 'economics of firm'. The development and expansion of companies in this period led to economists addressing economic theories regarding internal issues of the firm and Adam Smith's concept of the 'economic man'.[274] Smith argued that if the organisation was controlled by a person or group of persons who are not the real owners, then they may not work in the owners' interest.[275] This highlights the core issue in principal-agent relationships. As industries needed to be expanded and companies needed to grow into conglomerates and multinationals, the internal issues of a business entity became more complex These conglomerates made a significant contribution to economic activities, employment, growth, income and wellbeing, and the expansion of businesses significantly impacted society at large and increased competition globally. This resulted in competition for resources among the competing firms, and the limited availability of resources led economists to focus on the efficiency of the firm and to seek solutions by considering theoretical perspectives in reference to natural resources. For instance, Paul Walker states that theoretical understanding is important to knowing how an economy functions; accordingly, advice can be given on finding better economic policies to manage resources.[276] Thus, scholars developed the theory of the firm as a tool to increase the efficiency of the firm in managing limited natural resources. However, the concept of the theory of the firm is vast and is continuously being developed by economists; thus, Walker argues that there is no universally accepted theory of the firm.[277]

One of the major contributors to the new economic theory, Professor Michael Jensen, predicted that this theory of the firm would revolutionise knowledge about

[273] See footnote 1 of William W Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (1989) 41 Stan L Rev 1471, 1471.

[274] Nicolai J Foss, Henrik Lando, and Steen Thomsen, 'The Theory of the Firm' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics* Vol 1 (Edward Elgar 1999) 632.

[275] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edwin Cannan ed, Methuen 1904) Vol 1.

[276] Paul Walker, *The Theory of the Firm: An Overview of the Economic Mainstream* (Revised Edition, 2021) <https://ssrn.com/abstract=3766453> accessed on 13th April 2020, 2.

[277] ibid.

organisations over the coming decades.[278] Jensen's prediction has come true: the theory of the firm is continuously evolving, and new aspects are being continuously forwarded by legal scholars. In the contemporary world, certain theories of the firm are being challenged by contrasting ideas advocated by scholars of stakeholderism scholars such as Freeman, Walsh and Jones, who have championed the stakeholder approach, arguing that 'non-shareholders' – such as employees, consumers, creditors, and society at large, including the natural environment – play an important role in the firm.[279] For instance, Heed and Shrivastava have found through empirical analysis that business has a considerable impact on the natural environment that can adversely affect the firm in return.[280] Thus, the natural environment is an important stakeholder in addition to shareholders. The natural environment is essential to securing the firm's existence and its stakeholders (including consumers) for various reasons, such as the availability of natural resources, *the embedding into and dependence on ecosystems, and the intrinsic value of nature for stakeholders*.[281] In response, the concept of sustainable development aims to strike a balance between the different needs of environment, society and economy and the growth and development of civilisation. The UN has developed its sustainable development goals (SDGs) for this exact purpose.[282] Since natural resources are limited, environmental sustainability has increasingly become an important factor to be considered in corporate governance.

The theory of the firm mainly focuses on shareholder profit maximisation, whereas the stakeholder approach focuses not only on shareholder profit maximisation but also on the welfare of non-shareholder constituencies. It is important to note that this research aims to strike a balance between these two actors through legislation. Economists have different views about shareholders. Friedman, Hansmann, Kraakman and Jensen have argued that shareholders are the ultimate owners of the firm, and some have argued that shareholders own a piece of paper

278 See footnote 8 of Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (n 273) 1472.

279 Edward R Freeman, *Strategic management: A stakeholder approach* (Pitman 1984).

280 Richard Heede, 'Tracing anthropogenic carbon dioxide and methane emissions to fossil fuel and cement producers, 1854–2010' (2014) 122 Climatic Change 229; Paul Shrivastava, 'The role of corporations in achieving ecological sustainability' (1995) 20 Academy of Management Review 936.

281 Jacob Hörisch, and Stefan Schaltegger, 'Business, the Natural Environment, and Sustainability: A Stakeholder Theory Perspective' in Jeffrey S Harrison and others (eds), *The Cambridge Handbook of Stakeholder Theory* (Cambridge University Press 2019) 132.

282 United Nations 'Transforming our world: The 2030 Agenda for Sustainable Development', Resolution adopted by the General Assembly on 25 September 2015, New York, United Nations.

that entitles them to certain benefits (residual income).[283] However, shareholders are not explicitly defined specifically in corporate law statutes in jurisdictions such as the UK and Finland. However, the Sri Lankan Companies Act states that the term 'shareholder' means a person whose name is entered in the share register as the holder of one or more shares in the company.[284] The FCA also provides for a shareholder register *containing the name and addresses of the shareholder and the quantity of shares held by each shareholder.*[285] Shareholder interest in the company may vary – from the type of investments they make to which interests they prioritise. In other words, day traders and short-term investors may seek short-term returns, whereas long-term investors may seek sustainable and long-term results.

This research attempts to address issues of corporate governance by utilising concepts from both the theory of the firm and stakeholderism. The corporate governance remedies related to sustainability and long-term profit maximisation indicated by stakeholder scholars are not disputed by contractarians. This research argues that long-term sustainability in corporate governance can be achieved together with increasing the efficiency of the firm by addressing agency problems. The classic agency problem between managers and owners exists owing to the separation of ownership and control in the firm. This is the first type of agency problem discussed in this research. The separation of ownership and control is also a contributing factor to the other two types of agency problems. Here, unfair prejudice, oppression and mismanagement remedies will be utilised as an enforcement mechanism to reduce these agency problems and promote sustainability in corporate governance. Thus, this research highlights the importance of said remedies in promoting sustainable corporate governance.

In this research, three main agency problems are discussed. The first agency problem is the classic conflict between manager and shareholder. The second agency problem is between the controlling shareholder and the minority shareholder. This research further examines the third agency problem, which *involves the conflict between the firm itself – including, particularly, its owners – and the other parties with whom the firm contracts, such as creditors, employees, and customers.*[286] The third agency problem exists mainly from a law and economics perspective with a focus on policymaking. This research focuses on the environment as the non-

[283] Andrew C Wicks, F A Elmore and David Jonas, 'Connecting Stakeholder Theory to the Law and Public Policy' in Jeffrey S Harrison and others (eds), *The Cambridge Handbook of Stakeholder Theory* (Cambridge University Press 2019) 100.

[284] Section 86 (1) of Sri Lankan Companies Act, No. 07 of 2007.

[285] FCA 3:15 (2).

[286] John Armour, Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies' in Reinier Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 36.

shareholder constituent to limit the scope of the third agency problem. Crucially, the legal findings in this research are useful in reducing agency costs that can arise from the third agency problem, specifically focused on the environment. Corporate governance concepts such as 'agency costs' and 'doctrine trusteeship' are utilised to explain the economic rationale for implementing cost-effective provisions in corporate governance in support of long-term sustainability. The unfair prejudice, oppression and mismanagement remedies will be utilised to enforce these provisions and to act as a proactive measure to reduce the agency costs, specifically those between the controlling shareholders and the minority shareholders.

The first part (3.2) of this chapter discusses the historical development of the theory of the firm. The second part (3.3.–3.6) examines several general theories within the theory of the firm that are relevant to this research and its findings. The third part (3.7) highlights relevant perspectives from the transaction costs theory in relation to shareholder costs and stakeholder costs. The fourth part (3.8) considers the principles of agency problems in corporate governance and the legal strategies available to reduce agency costs. This part is critical to this research because its findings are based on these agency problems. The fifth part (3.9) discusses the general principles of stakeholderism and the relevance of the stakeholder approach in the third agency problem discussed in this research. This part highlights that the goals of the stakeholder approach can be incorporated through the principal-agent theory, thereby balancing the goals of both theories for long-term sustainable profit maximisation. Furthermore, this part underlines the importance of unfair prejudice, oppression and mismanagement remedies in striking the balance between the needs of the environment, societies and economies and those of business growth. Finally, the remarks (3.12.) present the economic framework for the comparative parts of this research. Additionally, it sets an agenda for future research based on the third agency problem. In sum, the aim of discussing the economic theories in this research is to establish the theoretical framework for the comparative part of this research and to highlight the economic importance of the stakeholder perspective.

3.2 Developments and evolution of the theory of the firm with a focus on the agency problem

Early writings on the theory of the firm were those by Frank Knight (1921)[287] and Ronald Coase (1937).[288] Since then, many scholars from all over the world have

[287] See Frank H Knight, 'Cost of Production and Price over Long and Short Periods' (1921) Journal of Political Economy 304; Frank H Knight, *Risk, Uncertainty and Profit* (Houghton Mifflin Company 1921).

[288] Ronald H Coase, 'The Nature of the Firm' (1937) 16 (4) Economica 386.

contributed to the theory of the firm. This theory increasingly attracted interest from the mid-1970s because of advances in the economics of market failures, property rights, information and uncertainty.[289] Thus, the year 1970 can be identified as the dividing line between the past and present theory of the firm, which can assist legal scholars in understanding the general ideas of the theory of the firm in policymaking. Present mainstream approaches to the theory of the firm started to develop in writings by Williamson,[290] Alchian and Demsetz,[291] Jensen and Meckling,[292] and Klein, Crawford and Alchian.[293] These scholars' work was mainly based on that of Ronald Coase.[294] For instance, Alchian and Demsetz revisited Coase's work on the nature of the firm in 1972 and worked on the internal dynamics of the firm, as they require monitoring to ensure efficient outcomes.[295] Both this duo and Jensen and Meckling defined a firm as a 'set of contracts between the factors of productions'.[296] Alchian and Demsetz also argued that the firm is based on several limited or unlimited contractual relationships between interested parties. In other words, the principal and agent.[297] In addition, Williamson's inputs on the importance of shareholders and transaction costs provided a distinct perspective within the modern economics of organisations.[298] Evidently, then, the theory of the firm consists of several concepts and ideas forwarded by scholars. This research will discuss the important concepts of the theory of the firm that are relevant to this research.

289 Foss, Lando and Thomsen (n 274) 632.

290 Oliver E Williamson, 'The vertical integration of production: market failure considerations' (1971) American 61(2) Economic Review 112; Oliver E Williamson, 'Markets and Hierarchies: Some Elementary Considerations', (1973) 63(2) American Economic Review 316; Oliver E Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (The Free Press 1975).

291 Alchian Armen and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62(5) American Economic Review 777.

292 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J. Fin. Econ. 305.

293 Benjamin Klein, Robert G Crawford and Armen A Alchian, 'Vertical Integration, Appropriable Rents, and the Competitive Contracting Process' (1978) 21(2) Journal of Law and Economics 297.

294 Walker (n 276) 4.

295 Carl Landauer, 'Beyond the Law and Economics Style: Advancing Corporate Law in an Era of Downsizing and Corporate Reengineering' (1996) 84 Cal L. Rev. 1693, 1700.

296 Panda Brahmadev and N M Leepsa, 'Agency theory: Review of Theory and Evidence on Problems and Perspectives' (2017) 10(1) Indian Journal of Corporate Governance 74, 77.

297 Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n 291).

298 Foss, Lando and Thomsen (n 274) 632.

3.2.1 Pre-1970s and post-1970s developments

The theory of the firm was not an interesting topic to economic scholars prior to the 1970s. During this period, economists were mostly invested in developing a theory of markets in which business enterprises (the firm) were important actors. Neoclassical economists viewed the firm as a 'black box' that operated to maximise profits.[299] They further argued that proper coordination and teamwork among the parties involved were crucial factors in achieving the maximisation of wealth.[300] This concept of profit maximisation remains part and parcel of the theory of the firm and in general in the practical business world.

The foundational work of the modern theory of the firm was Ronald Coase's 'The nature of the Firm', published in 1937. In his work, Coase differentiated the internal hierarchy of the firm from the markets.[301] For Coase, Oliver Williamson, Bengt Holmström and Oliver Hart the theory of the firm in this era involved the classic theory of production and the development of the neoclassical model of the firm. Briefly, the theories examined were the behavioural, managerial and X-inefficiency models of the firm. However, neoclassical theory was badly affected when Berle and Means identified the concept of 'separation of ownership and control' in business enterprises during the 1960s. Berle and Means argued that dispersed ownership in corporations made it difficult for a shareholder to materially affect the corporation's management, highlighting the conflict of interest between managers and owners that was ignored in the neoclassical theory.[302] Thus, neoclassical theory assumed that profit maximization was the main objective of managers. However, this assumption of perfect rationality was challenged by Simon and March[303] and Cyert and March,[304] who argued that the existence of the firm was primarily a matter of economizing with bounded rationality.[305] Moreover, Kenneth Arrow argued that firms could be understood in terms of market failures arising

299 Brian R Cheffins, 'Corporations' in Mark Tushnet and Peter Cane (eds) *The Oxford Handbook of Legal Studies* (OUP 2018) 5.
300 Brahmadev (n 296) 77.
301 Cheffins, 'Corporations' (n 113) 5.
302 Stephen M Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (1997) 82 Cornell L. Rev. 856, 862.
303 Simon A Herbert and March G James, *Organizations* (Wiley 1958).
304 Richard M Cyert and James G March, *A Behavioral Theory of the Firm* (Prentice-Hall 1963).
305 Foss, Lando and Thomsen (n 274) 633.

under conditions of externality, economies of scale and information asymmetries.[306] Thus, several unresolved queries were raised concerning the theory of the firm.

All these unresolved queries encouraged researchers to increasingly engage in finding answers in corporate governance through the theory of the firm. As a result, research on the theory of the firm exploded after 1970. This is now sometimes called ‘new institutional economics’. After 1970, economists developed the mainstream theory of the firm based on the works of Frank Knight (1921)[307] and Ronald Coase (1937).[308] Within this mainstream theory of the firm, two general groups of theories can be identified: ‘incomplete contract models’ and ‘principal-agent models’.[309] For instance, Jensen and Meckling and Fama and Jensen were able to develop agency cost theory through the principal-agent theory.[310] Jensen and Meckling argued that the firm incurred several internal costs owing to agency conflicts, and that these costs were generally termed as ‘agency costs’. Specifically, they defined agency costs as the sum of the *monitoring expenditures by the principal*, *the bonding expenditure by the agent*, and *the residual loss*.[311] Agency cost theory is further discussed in dept in this research.

Orts argues that it is important to appreciate the richness of the legal meaning and context of concepts such as ‘implicit contracts’ and ‘agency cost’ in the law and economic scholarship.[312] In the next section, several theories of the firm and their recent developments are discussed to obtain a general overview of the contractarian’s perspective on the theory of the firm. These theories will be helpful to policymakers with respect to corporate governance.

3.3 Incomplete contracts: theoretical models

Incomplete contract models are based on the assumption that it is costly to write elaborate contracts and thus they have inefficient provisions. As a remedy, *ex post* governance is required.[313] Foss, Lando and Thomsen have identified five subgroups

[306] See Kenneth J Arrow, ‘The Organization of Economic Activity’, in Kenneth J Arrow (ed), *The Economics of Information* (Basil Blackwell 1969); Kenneth J Arrow, *The Limits of Organization* (W.W. Norton 1974).

[307] See Knight (n 287).

[308] Coase, ‘The Nature of the Firm’ (n 288).

[309] Walker (n 276) 5.

[310] Dieter Schneider, ‘Agency Costs and Transaction Costs: Flops in the principal-Agent-Theory of financial Markets’ in Günter Bamberg and Klause Spermann (eds), *Agency Theory, Information, and Incentives* (Springer-Verlag 1989).

[311] Jensen and Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (n 34) 308.

[312] Eric W Orts, *Business Persons: A Legal Theory of the Firm* (OUP 2013) 17.

[313] Walker (n 276) 76.

under this model: (1) the authority view; (2) the firm as a governance mechanism; (3) the firm as an ownership unit; (4) relational or implicit contracts; and (5) the firm as a communication hierarchy.[314] In their work on the authority view, Coase and Simon[315] stress the importance of the employment relationship that was still being developed during the pre-1970s period to the current mainstream theory of the firm.[316]

Williamson advocates the firm as a governance mechanism. He assumes that in contractual incompleteness and opportunism, thought of '*self-interest with guile*'[317] will result in the firm's governance, thus requiring the safeguarding of contractual agreements.[318] These safeguards can be provided through government legislation, such as the Companies Act and financial market regulations. Grossman, Hart and Moore describe the firm as an ownership unit that emphasises *the importance of ownership of assets for affecting incentives when contracts must be renegotiated.*[319] In other words, the principal must trade-off the agent's behaviour in a given circumstance with a proper payment structure by renegotiating the contracts. In this scenario, the principal is the shareholders. This theory highlights that the shareholders (who have residual control rights) are the source of power for their appointed directors. However, this is not always true, because some minority shareholders do not have the capacity to appoint directors unless they are working together with a majority shareholder in corporate affairs in certain jurisdictions.

[314] ibid 85.

[315] See Herbert A Simon, 'A Formal Theory of the Employment Relationship' (1951) 9(3) Econometrica 293-305; Coase, 'The Nature of the Firm' (n 288).

[316] Walker (n 276) 86.

[317] Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (n 290) 46.

[318] See Oliver E Williamson 'The vertical integration of production: market failure considerations' (n 290); Williamson, 'Markets and Hierarchies: Some Elementary Considerations' (n 290); Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (n 290); Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22(2) Journal of Law and Economics 233; Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985); Williamson, *The Mechanisms of Governance* (Oxford University Press, 1996a).

[319] See Oliver D Hart and John Moore, 'Property Rights and the Nature of the Firm' (1990) 98(6) Journal of Political Economy 1119; Hart and Moore, 'Incomplete Contracts and Ownership: Some New Thoughts' (2007) 97(2) American Economic Review 182; Hart and Moore, 'Contracts as Reference Points' (2008) 123(1) Quarterly Journal of Economics 1;Moore, 'Introductory Remarks on Grossman and Hart (1986)' in Philippe Aghion and others (eds), *The Impact of Incomplete Contracts on Economics* (Oxford University Press 2016).

3.4 Relational contracts: theoretical models and the firm as a communication network theory

Baker, Gibbons and Murphy explains relational contracts as informal agreements and unwritten codes of conducts which powerfully affect the behaviour of individuals within firms. For instance, there are unwritten understandings between the managers and employees about promotions, task assignments, and termination decisions.[320] Further, relational contract theory highlights that if a firm outsources its work to an independent contractor, the latter can take the assets belonging to it with him/her. As the independent contractor is not bound by any internal rules of the firm, he/she can sell the completed product or the knowledge gained during the contract period. In other words, the independent contractor is not bound by the restraints of trade clauses, whereas employees cannot freely commercialise their own skills and/or knowledge gained during their employment having resigned for a certain period, depending on the jurisdiction.

In a complementary theory, Marschak and Radner have advanced the concept of the firm as a communication network, advocating that one of its primary functions is to adapt to and process new information, with a strong emphasis on internal coordination and communication. From this viewpoint, the firm operates as a communication network, aiming to minimise the costs of processing new information and those associated with distributing information among its members. This is done by appointing specialised agents who are efficient in the processing of particular types of information.[321] Furthermore, it is evident from comparative corporate governance that many possible legal frameworks exist within which firms can competitively produce a widget or construct and operate a communications network to increase the efficiency of the firm.[322] In other words, legal tools can be used to make it mandatory to appoint only specialised agents for specific positions to save costs. These specific rules can be provided in the company's articles of association, and general rules can be provided in the Companies Act. In turn, corporate governance code could provide guidance or set out qualifications in appointing specialised agents for specific positions. For instance, having managers in a construction company with an engineering background would increase the

[320] George Baker, Robert Gibbons and Kevin J Murphy, 'Relational Contracts and the Theory of the Firm' (2002) 117(1) Quarterly Journal of Economics 39, 39.

[321] Jacob Marschak and Roy Radner, *Economic Theory of Teams* (Yale University Press 1972); Roy Radner, 'Hierarchy: The Economics of Managing' (1992) 30(3) Journal of Economic Literature 1382.

[322] William W Bratton, 'An anatomy of Corporate Legal Theory' in Dana Gold (ed), *Law & Economics: Towards Social Justice*, Vol 1 (Emerald Publishing 2009) 24.

efficiency of the firm. These aspects of the law and economic theories could be implemented in policymaking to reduce the costs of the firm.

3.5 Complete contracting in the theory of the firm

Complete contracting models include the nexus of contract view and principal and agent theories. Here, the firm is viewed as a complex 'nexus of voluntary contracts' designed to minimise the agency cost.[323] The scholarly works of Alchian and Demsetz,[324] Jensen and Meckling,[325] Cheung,[326] Butler and Ribstein,[327] and Easterbrook and Fischel[328] have contributed immensely to the development of this theory.

Building on the foundational concepts of complete contracting, the specifics of the 'nexus of contracts' theory are further explored. Scholars have provided several definitions of the concept of 'the firm' in connection to the 'nexus of contract' theory. Bratton states that *the neoclassical variant's central point is that the firm is a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.*[329] Bainbridge states that *the firm is an aggregate of various inputs acting together to produce goods or services.*[330] Accordingly, the firm is a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs that make up the firm.[331] Fama states that *the firm is a set of contracts among factors of production, with each factor motivated by its self-interest.*[332] Jensen and Meckling define the firm as follows: *'The private corporation or firm is simply [...] a nexus for contracting relationships [that] [...] serves as a*

323 Stephen G Marks, 'The Separation of Ownership and Control' in Bouckaert and Boudenwin (eds), *Encyclopaedia of Law and Economics,* Vol 1 (Edward Elgar 1999) 704.

324 Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n 291).

325 Jensen and Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (n 34) 305.

326 Steven N S Cheung, 'The Contractual Nature of the Firm' (1983) 26 Journal of Law and Economics 1.

327 Henry N Butler and Larry E Ribstein, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65 Washington Law Review, 1 ff.

328 Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1st edn, Harvard University Press 1991).

329 Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (n 273) 1478.

330 Stephen M Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 Wash & Lee L Rev 1423, 1426 and 1427.

331 ibid.

332 Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288, 289.

focus for a complex process in which the conflicting objectives of individuals [...] are brought into equilibrium within a framework of contractual relations'.[333] All the above definitions share similar characteristics, such as, inter alia, 'nexus of contract', 'complex relationships', and 'self-interest'.

Transitioning from the nexus of contract theory to its application, the assumptions underlying in complete contracting models become crucial. The basic assumptions of this view is that its actors are rational, economic actors driven by their divergent self-interests, and seeking to maximise value for themselves.[334] Butler states that the nexus of contract view can be founded in private contracts and the government is limited to enforcing these private contracts and to recognition of the firm.[335] Demsetz also notes that it is important to consider which body of law determines the liability of the parties involved in the nexus of the contract.[336] Thus, various economists have taken legal aspects into consideration when developing the theory of the firm, indicating that the economic theories cannot be separated from the legal aspects of corporate governance.

Within the nexus of contract theory, certain core characteristics stand out for their vital role in the survival and efficiency of business organisations. The nexus of contract theory consists of core characteristics forwarded by contractarian scholars in the strong belief that they are vital to the survival of the business organisation. Some of them are that, considering the given actors' capabilities and intense competition, only the best contracting strategies survive.[337] Butler argues that the 'market for corporate control' provides the glue that holds together the nexus of contracts.[338] This glue is the contracting strategies, and if the contracting strategies are not optimal in a given situation, the firm may lose the market for corporate control, resulting in the firm bearing increased costs. Corporate control is the process of controlling and monitoring activities within a company, thereby reducing inefficiencies arising from the agency problem. Thus, if contracting strategies could be drafted *ex ante*, it could assist in reducing agency costs. Legal provision in corporate governance acts as *ex ante* contracting strategies to reduce agency costs. For instance, directors'' fiduciary duties reduce the agency problem between the

333 Cheffins, 'Corporations' (n 113) 311.
334 William W Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (1988-1989) 74 Cornell L Rev 407, 417.
335 Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11 Geo Mason U L Rev 99, 100.
336 Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 12.
337 Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (n 273) 1478.
338 Butler, 'The Contractual Theory of the Corporation' (n 335) 114.

shareholders and the directors. This research attempts to contribute contract strategies to reduce the costs that may arise in the identified agency problems.

In discussing contracts, it is essential to understand that the definition of 'contract' in economic terms differs significantly from its legal definition, a discrepancy that holds substantial implications for corporate governance. The economist's definition of 'contract' is different to its legal definition. This difference between law and economics is paramount in corporate governance, specifically in law and economics discussions. Economists believe that the nexus of contract is a set of contracts that co-exist with and depend on each other. In other words, the employees of the firm provide labour in return for daily wages, creditors provide debt capital, shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of the managers and directors, and managers and directors monitor the performance of the firm by monitoring employees and coordinating the activities of all the firm's inputs. Thus, the economist sees that each actor is interconnected and interdependent for success, and the firm is a complex nexus of contracts. The most important aspect is for the firm to survive, and 'equity capital' is one of the most important inputs that a firm needs to succeed.[339]

While the structure of ownership may vary, the continual input of equity remains critical to the firm's structure and success. The ownership of the firm is a not a matter of concern in the nexus of contract view because shareholders, specifically those in publicly listed companies, can sell their shares at any time and leave. What does matter is the input of equity, which contractarians argue is the backbone of the structure of a business organisation. Accordingly, a firm should target having a diverse share ownership that attracts equity continuously. This will lead the firm to expand and grow. For this reason, it is vital for countries to have strong rules that protect shareholders' rights, especially those of minority shareholders, as minority shareholder rights encourage diverse share ownership. For instance, an empirical study conducted by Guillén and Capron has found that minority shareholder remedies such as the oppression legal remedy has integrated robust markets by higher capitalisation in countries such as the UK and the US economies through strengthening small-scale investors' rights in corporate governance.[340] Thus, the economic theories support the position that *ex ante* contract strategies contribute to firm expansion. In this scenario, *ex ante* contract strategies reflect minority

[339] Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (n 245) 1427 and 1442.

[340] Mauro F. Guillén, and Laurence Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (2016) 61 (1) Administrative Science Quarterly 125, 135.

shareholder protection rights in company law. This is the reason why oppression, mismanagement and unfair prejudice remedies are selected for this research to consider the economic benefits of the said remedies in addressing the second agency problem.

Pivoting to the underlying objectives of these theories, profit maximisation emerges as a fundamental principle. In the context of this research, it is important to discuss the components and underlying objectives of the theory of the firm. It is an established principle in corporate governance that the objective of a corporation is to enhance corporate profits and increase shareholder gains,[341] and economists accordingly assume that the economic man's rational choice is to maximise company profits.[342] This is an established corporate governance principle in almost every country. Furthermore, in some jurisdictions, it is specifically stated in corporate law that the purpose of the company is to make profits for its shareholders.[343] Judge Posner argues that the theory of the firm's components of freedom of 'private contracts' and 'wealth maximization' are linked to 19th-century 'laissez-faire ideology'.[344] Thus, a legal system that supports corporate wealth maximisation allows individuals such as shareholders to pursue the accumulation of wealth. Managers and/or directors are permitted to exercise 'business judgment' to take decisions considering shareholder interests into account, and all decisions must be oriented towards the goal of maximising shareholder value.[345] Nonetheless, the debate continues among academic scholars as to whether shareholder interest should be short-term or long-term in focus. Ultimately, such interest should depend on the prevailing circumstances and type of shareholders. For instance, shareholders seeking long-term interest or short-term interest.

However, the issue of minority shareholder protection emerges as a crucial factor in ensuring that the benefits of profit maximisation are equitably distributed. In some jurisdictions with less minority shareholder protection, all shareholders cannot enjoy the benefits of profit maximisation: only the controlling shareholders reap these benefits based on minority shareholders being oppressed and/or treated unfairly. In such scenarios, minority shareholders may attempt to disrupt corporate affairs through legal actions or internal management, resulting in the firm bearing costs. Furthermore, small-scale investors are discouraged from investing in jurisdictions

341 Bratton, An Anatomy of Corporate Legal Theory' (n 165) 37.

342 Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 872.

343 FCA 1:5 (The purpose of a company is to generate profits for the shareholders, unless otherwise provided in the Articles of Association.).

344 See Posner, *The Problems of Jurisprudence* (n 241).

345 Ronald M Green, 'Shareholders as Stakeholders: Changing Metaphors of Corporate Governance' (1993) 50 Wash & Lee L Rev 1409, 1410.

where less legal protection is offered to minority shareholders. In such situations, companies will have to depend on major investors whose terms may have a detrimental effect on the existing managers and shareholders. Thus, firms would not be able to grow and expand because continuous equity would not be forthcoming, and the jurisdiction with lesser protected rights for minority shareholders would not be able to enjoy the fruits of wealth maximisation. In response, introducing strong legal mechanisms (eg minority shareholder protection legal remedies) to safeguard these investors would facilitate the attraction of continuous equity into the firm through small-scale investors. This would also contribute to profit maximisation since the capital received from the small investors would assist in developing the company and eventually increasing its profits.

Transitioning to the broader goals in corporate governance, 'profit maximisation' and 'resource allocation' are identified as twin goals that offer substantial societal benefits. Melvin Eisenberg argues that the characterization of the corporation as a nexus of contracts is inaccurate because a corporation is a group of people with assets seeking profits and organised by rules. These rules are determined by private contracts and government-imposed rules and regulations.[346] It is important to extract the societal benefits of wealth maximisation by regulating corporate behaviour through government-imposed rules. This will promote the efficient distribution of benefits acquired through the wealth maximisation norm.

Bainbridge argues that economic liberty to pursue wealth is an effective means to achieve a variety of moral ends.[347] In this light, De Bow and Lee describe twin goals in corporate governance that are linked to each other and that indirectly benefit society at large: profit maximisation and resource allocation. They argue that wealth maximisation promotes efficient resource allocation on a societal basis.[348] Efficient resource allocation means sustainable development without causing adverse impact to the environment as well as the wellbeing of the other constituencies. Nonetheless, shareholder wealth maximisation is still and will remain the dominant corporate governance norm, and the freedom for individuals to enter into private contracts is the foundation of wealth maximisation in the theory of the firm. However, this freedom can be monitored by government-imposed legal mechanisms to safeguard all the parties to the contract. In other words, complete freedom to maximise wealth would endanger certain parts of society. For instance, complete wealth maximisation

346 Melvin Aron Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461, 1487.

347 Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 898.

348 Michael E De Bow and Dwight R Lee, 'Shareholders, Non-shareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 Del J Corp L 393, 416.

without considering other stakeholders in a rubber company or toxic chemical production industry would harm the environment. Thus, external environment laws and internal safeguards as legal mechanisms to protect the environment are pivotal. In other words, legislation that is external to corporate governance. These legal mechanisms would also promote efficient resource allocation. It is further argued in this research that internal mechanisms (in lieu of external mechanisms) would promote efficiency in corporate governance in addition to efficient resource allocation.

Lastly, the concept of agency holds a pivotal role in the theory of the firm, especially concerning the scrutiny of board of directors/managers behaviours in conducting corporate affairs. Cheffins argues that when corporations periodically increase cash to implement business strategies, the management becomes subject to scrutiny.[349] More specifically, when the capital is sought from outside investors, their jobs may be at risk because the new owners may replace them to generate profit. This will also affect the job market for the managers and directors, as their reputations will be tarnished. This fear or threat gives managers and directors an incentive to run their companies in a manner that increases the shareholders' wealth.[350]

This crucial aspect of scrutiny of managers and directors developed from one of the most important theories in the theory of the firm during the 1970s: the principle-agent theory. 'Agency cost' theory is a part of principal-agent theory resulting from the agency problem. This theory has contributed immensely to increasing the efficiency of the company by improving corporate governance. The assumption of this theory is that agents write elaborate contracts characterized by *ex ante* incentive alignment under the constraints imposed by the presence of asymmetric information.[351] Agency costs are proposed in the works of Jensen and Mackling[352] and Fama and Jensen.[353] Fama and Jensen categorise the decision-making process into two areas in which the agents play a crucial role: decision management and decision control.[354] Fama further argues that competition within the firm enables the monitoring of the performance of the entire team as well as individuals.[355]

349 Cheffins, 'Corporations' (n 113) 4.
350 ibid 5.
351 Foss, Lando and Thomsen (n 274) 634.
352 Jensen and Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (n 34).
353 Fama F Eugene and Jensen C Michael, 'Agency Problem and Residual Claims' (1983) 26 Journal of Law and Economics 327.
354 ibid.
355 Brahmadev (n 296) 78.

Elsewhere, Holmström and Milgrom consider the firm as an incentive system.[356] Eisenhardt argues that agency theory can be categorised into two models: 'positivist agency model' and 'principal-agent model'. The principal-agent model describes principals as risk-neutral and profit-seeking, and agents as risk-averse and rent-seeking. While the principal-agent model is more mathematical in nature, positive agency theory examines the causes of agency problems and the agency costs arising as a result of these agency conflicts.[357] The theoretical framework and the types of agency problems discussed in this research weigh more towards positive agency theory.

3.6 Transaction cost theory

Several cost theories have been forwarded by law and economics scholars. Coase and Williamson are notable advocates of 'transaction cost' theory as an alternative variant of the agency cost model. The works of Alchian and Demsetz, in considering the firm as a solution to moral hazards in teams, have also contributed to the expansion of the concept.[358]

Transaction cost theory perceives the firm in a similar way to agency cost theory. It describes the costs that occur owing to the firm's internal and external transactions. These costs *stand separate from and in addition to ordinary production costs*.[359] Transaction theory has several key characteristics, as observed by economic scholars. The general characteristics are as follows: uncertainty, transactions may reoccur, corporate decisions are taken on bounded rationality (meaning that decision-making is limited by the available information) and opportunistic behaviour of the human actors involved in contracting. These general characteristics are similar to the three mentioned by Williamson, the founding father of transaction cost theory, who argues that the aforesaid uncertainty is the main reason for transaction costs.[360] Coase has argued that creating legal contracts reduces transaction costs.[361] This is because it reduces the uncertainty. Likewise, clear legislations, rules and regulations also decrease the uncertainty and thus reduce the transaction costs. Although transaction

[356] Bengt Holmström and P Milgrom, 'The Firm as an Incentive System' (1994) 84 American Economic Review 972.
[357] Kathleen M Eisenhardt, 'Agency theory: An assessment and review' (1989) 14(1) Academy of Management Review 57; and Brahmadev (n 296) 78.
[358] Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n 291).
[359] Foss, Lando and Thomsen (n 274) 633.
[360] Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (n 318) 239.
[361] Foss, Lando and Thomsen (n 274) 639.

cost is a broad concept, Reinhard Schmidt has argued that the concept of agency costs cannot be placed on the same level as the concept of transaction costs.[362] Indeed, some economists argue that transaction costs represent some sort of sunk cost that firms are better off not recovering.

The types of transaction costs identified by economists include: (1) search and information costs; (2) bargaining and decision costs; and (3) policing and enforcement costs. The search and information costs in transaction theory are the costs that the firm must bear when finding resources. For instance, the cost of finding a supplier. The bargaining and decision costs are those that the firm must bear when a decision is taken to enter into a contract. For instance, deciding to buy land for the firm. Furthermore, 'bureaucratic costs' are included under this category; Alchian and Demsetz argue that the firm will have to bear this cost when all the owners participate in each decision and *many owners would shirk the task of becoming well informed on the issue to be decided.....*[363] Lastly, the policing and enforcement costs are those that the firm must bear when monitoring the quality performance of the work. In other words, the activities of the employees/directors/managers of the firm. In addition, legal fees in enforcing contracts also fall under this category. It is assumed under this theory that actors involved in transactions are opportunistic and untrustworthy. Alternatively, Schneider argues that transaction costs can be defined as 'opportunity costs'.[364] Thus, the firm must bear costs in providing the actors with incentives and continuous monitoring, and several other costs (including those mentioned above) to ensure that the interests of each party are protected.

The objective of the transaction costs are similar to that of the agency costs, which is to reduce costs in corporate affairs.[365] Millon has stated that '*commonplace to recall Ronald Coase's insight that, if transaction costs are minimal, the efficient outcome will emerge regardless of the initial assignment of advantage*'.[366] Both transaction cost theory and agency cost theory can be helpful in fashioning legal mechanisms for efficiently governing the corporation. Thus, according to these two cost theories, both have the same objective of reducing the costs created by the three agency problems studied here. As Coase notes, creating legal contracts – or, in other words, proactively codifying the fiduciary duties of directors towards the non-

[362] Reinhard H Schmidt, 'Agency Costs are not a 'Flop'!*)' in Günter Bamberg and Klause Spermann (eds), *Agency Theory, Information, and Incentives* (Springer-Verlag 1989) 508.

[363] Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n 291). 788.

[364] Schneider (n 310) 489.

[365] Benjamin M Oviatt, 'Agency and Transaction Cost Perspectives on the Manager-Sha' (1988) 13 Acad Manage Rev 214, 214 and 215.

[366] Landauer (n 220) 1704.

shareholder stakeholders and those of the majority (controlling) shareholders – will reduce uncertainty and the transaction costs. However, as mentioned by the Nordic scholars, it is not possible to *ex ante* codify every aspect of the directors' decision-making because the future results of corporate decisions can be uncertain.[367] However, I believe that common self-interest decisions taken by the directors and/or shareholders can be identified through previous cases and categorise them to *ex ante* codify rules to hinder reoccurring of such decisions. For instance, provisions of the UK Companies Act 2006 on consideration of stakeholders in corporate decision-making by directors *ex anté* reduce costs related to the third agency problem.[368]

3.6.1 'Shareholder cost' and 'stakeholder cost' in transaction cost theory

In the recent book, *The Anatomy of Corporate Law: A Comparative and Functional Approach,*[369] various scholars have discussed the agency problem between controlling shareholders and minority shareholders and the legal measures to reduce the ensuing costs. This agency problem is further discussed under the type two agency problem. This research argues that the type of transaction cost that may arise from this second agency problem can be termed as 'shareholder costs'. The firm has to bear certain costs in relation to the second agency problem to reduce possible residual losses to the shareholders or the firm, eg monitoring costs to reduce controlling shareholders' opportunism. In turn, the costs that can arise from the third agency problem can be termed as 'stakeholder costs'. For instance, reputation loss owing to environmental pollution can have sustained long-term economic consequences for the firm. Likewise, in the third agency problem, the firm has to bear costs in relation to its stakeholders to reduce long-term residual losses. For instance, costs of managing and reducing CO_2 emissions. Here, a lack of proper stakeholder management can result in residual losses for the shareholders, which can have a long-term adverse effect. In other words, costs owing to negative stakeholder actions, such as bad press, legal suits, boycotts, strikes and adverse regulation.[370] On

[367] Paul Krüger Andersen and others, 'Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars' (October 7, 2020), *Nordic & European Company Law* Working Paper No. 20-12, University of Copenhagen Faculty of Law Research Paper No. 100. <https://ssrn.com/abstract=3709762> accessed on 13th April 2020.

[368] See Section 172 of the UK companies act of 2006.

[369] Armour, Hansmann and Kraakman (n 286).

[370] Thomas M Jones and Jeffrey S Harrison, 'Sustainable Wealth Creation: Applying Instrumental Stakeholder Theory to the Improvement of Social Welfare' in Jeffrey S Harrison and others (eds), *The Cambridge Handbook of Stakeholder Theory* (Cambridge University Press 2019) 78.

the other hand, the ethical treatment of stakeholders would increase the firm's ethical reputation, resulting in economic growth. For instance, increasing investors, customers purchasing products, fewer regulations by government, attracting efficient employees, and community interests in being local partners with the firm.[371] Thus, it is important for scholars to dig deep into the third agency problem and research more on addressing opportunistic behaviours that can result in long-term economic losses to the business organisation.

In the above-mentioned book, Kraakman and others discuss certain legal strategies to tackle certain second and third agency problems.[372] This research focuses on further improving these legal strategies and mechanisms to reduce the agency costs, specifically those in relation to the second and third agency problems. The comparative part of this study focuses on identifying corporate law strategies – including oppression, mismanagement and unfair prejudice remedies – that already exist in selected jurisdictions to tackle the reduction of 'shareholder costs' and 'stakeholder costs'. Elmore and Jonas argue that legal rules and norms in specific countries provide both constraints and imperatives on what purpose they serve, how firms operate and how non-shareholder stakeholders' interests are looked after.[373] The aim of this research is to reduce said costs by fashioning a *sui generis* legal mechanism by utilising legal strategies coupled with oppression, mismanagement, and unfair prejudice remedies.

3.7 Agency problems in corporate governance

The principal-agent relationship can be traced back to the ancient Roman Empire with its master and slave equivalent. This type of relationship was sustained based on sanctions (backed with cruel punishments) and the slave's fear of the master as a common social practise of the period. Thereafter, Roman law, as well as Greek, Egyptian and Jewish law, were developed to govern and regulate master-slave/employer-employee relationships. As a result, 'agency' did not develop as a separate concept (distinct from master-servant) until 1811. Laws on governing and regulating principal-agent relationships developed during the industrialisation and the rise of business firms towards the end of the 17th century, while agency did not become a distinct concept until the turn of the 19th century. Thereafter, legal

371 ibid.

372 Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (n 3).

373 Wicks, Elmore and Kraakman (n 283) 98.

principles relating to agency developed in parallel in both civil and common law jurisdictions.[374]

Transitioning from its historical roots, the concept of agency now plays a critical role in contemporary economic and legal spheres. Modern agency is an important concept in the economic and legal world. Economists contend that agency is everywhere, especially in the business world. Agency allows businesses to function efficiently, and it is one of the main concepts that strengthen the internal structure of a business enterprise. When a business starts to grow, rules are required to govern and regulate the expanding web of agency in a business enterprise, particularly in a conglomerate, for the business to function efficiently. Agency is hence an important concept in corporate governance when formulating laws to *ex ante* govern the web of agency in pursuit of improved corporate control within the firm.

The importance is further emphasised when we consider subtle differences in how agency is perceived across different disciplines. The economist's concept of agency is different to the legal definition of agency, ie a formal agency relationship that is dependent on the explicit or implicit consent of the parties involved. For an economist, an agency relationship could exist without any legal formalities. A simple definition of the agency relationship in economics is that a relationship could arise *whenever one individual depends on the action of another.*[375] This action will be taken by the agent, and the affected party would be the principal.[376] Generally, an agency relationship occurs when the principal (eg a shareholder) confers his/her authority and power to the agent (eg a director/manager) to represent him/her in actions taken on his/her behalf.

Thus, the economic idea of agency is best interpreted when it is coupled with the legal definition of agency in the corporate context. Ross argues that the agency problem is a problem of incentives.[377] Accordingly, principal-agent is an incentive structure that uses self-interest to compel one party to act in the best interests of another.[378] In corporate matters, said acts could be those of directors/managers taken on behalf of shareholders in corporate decision-making in conducting the daily affairs of the company and its assets management. Erich Schanze argues that the

[374] Wolfram Müller-Freienfels, 'Legal Relations in the Law of Agency: Power of Agency and Commercial Certainty' (1964) 13(2) The American Journal of Comparative Law 193, 196.

[375] M E DeBow and D R Lee, 'Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 Del J Corp L 393, 417.

[376] John W Pratt and Richard J Zeckhauser, 'Principals and Agents: An overview' in John W Pratt and Richard J Zeckhauser (eds), *Principals and Agents, the structure of Business* (Harvard Business School Press 1985) 2.

[377] Brahmadev (n 296) 77.

[378] Robert D Cooter, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 N.Y.U. L. Rev. 1045, 1047.

agency relationship in the corporate environment is interlinked with contract and agency features: *Agency is dependent on legal rules concerning sanctions for breach of loyalty and sanction for non-performance*; thus, the agency relationship has *high front/end costs.*[379] For instance, in the case of a third agency problem between the firm and the environment, sanctions imposed by environmental laws and disrepute to the company caused by the media in response to environmental pollutions represent high end costs to the firm. Thus, it is important to regulate the corporate governance to reduce any possible occurrence of these high-end agency costs. Schanze further argues that *Agency theory refers to a model of delegation of preferences and the monitoring of discretion of a third party.*[380] The corporate governance enables the shareholders to delegate the duty of profit maximisation and also enables a monitoring mechanism to hinder agents' incentives to act in opportunism. Thus, agents' discretion is monitored by corporate governance rules, which reduce the uncertainty for agents in their work across the jurisdiction, eg agents know that they are prohibited from engaging in insider dealings or related-party transactions. In turn, the state has a duty to legislate such laws in company law. However, the State should be careful in drafting legislations that may hinder actors' freedom in contracting.

While the theoretical foundations of agency are well-established, its practical implications in the realm of corporate governance present a complex interplay of responsibilities between the state and individuals. As mentioned above, the economic theory of the firm focuses on the individual participant's freedom to enter into contracts that strengthen the business's autonomy and independent actions. Theories of the firm are primarily based on principles of freedom of contract, freedom of association[381] and protection of the private property of the participants in the business; the government's involvements are limited only to protecting these freedoms. In other words, legislators and government law enforcement institutions support the enforcing of these principles. In turn, law and economics scholars have argued that the relationship between the principal and agent is fiduciary in nature. In the corporate environment, it is expected of the agent to represent the principal's interest as his/her own. Thus, trust and loyalty are paramount in this agency relationship. Since it is fiduciary in nature, it is not a social practise or an informal norm, but a legal relationship created with contracts enforceable in the courts.[382] In

[379] Erich Schanze, 'Contract, Agency, and the Delegation of Decision making' in Günter Bamberg and Klause Spermann (eds), *Agency Theory, Information, and Incentives* (Springer-Verlag 1989) 467.

[380] ibid 469.

[381] Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 13.

[382] ibid 55.

this way, Green argues that directors have fiduciary duties to the firm and its owners that stem from the special obligations they freely incurred when they agreed (through contracting) to serve as agents for shareholders.[383] These contracts are individual contracts freely entered without government intervention and thus benefit from freedom of contracting. For instance, employment contracts, contracts with banks, *etc*. It should be noted that trust is an important concept in any principal-agent relationship. Moreover, the concept of trust is a tool that can be utilised to reduce agency costs. This research identifies three principal-agent relationships in the corporate environment, and the concept of trust is discussed further in relation to these agency relationships.

The intricacies of these relationships become even more pronounced when viewed through the lens of investment strategies within firms. According to the theory of the firm, capital is paramount to the survival of the firm. Capital can be attracted to the firm through, inter alia, two main methods. One is through major investments, in which a wealthy investor buys the majority of shares in a company. A major investment could also be by way of two or a group of wealthy shareholders buying shares of the company together to gain control over it. Such wealthy investors could be public funds, conglomerates, pension funds, wealthy families and governments. The other method is through diversifying shareholders. This could be achieved by issuing shares to several small-scale investors, thereby allowing a larger percentage of investors to invest in the company and resulting in larger amounts of capital being injected compared to one or a group of major investments. Furthermore, this method allows corporate executives to retain control of the company without fear of a major investor replacing them.

This diversification also introduces its own set of challenges, particularly in the context of minority shareholders. The diversification of shareholder ownership results in the creation of several minority shareholders in the company. The fact that a controlling shareholder is not in the picture bears a high influence on small-scale investors' decisions to invest in the company, especially in the case of growing SMEs. However, in these situations, the directors should be monitored strictly since a majority shareholder is not present to oversee the functions of the company. These small-scale investors could be members of the public who have saved money to invest in stocks, while online crowd-investing platforms are becoming increasingly popular thanks to technological advancement as a means to increase capital through small investors. Foreign small-scale investors may equally be encouraged to invest in incorporated companies in jurisdictions that provide higher protection for minority shareholders, specifically through said online platforms. For instance, research by

383 Green (n 214) 1410.

Guillen and Capron suggests that minority shareholder remedies increase small-scale investors and develop stock markets.[384] Bratton argues that shareholder legislative intervention based on the principal-agent model would economically improve the firm.[385] This research argues that legislative intervention through oppression, mismanagement and unfair prejudice remedies would economically improve the firm by facilitating investor attraction. These remedies could also be utilised as a tool to monitor the directors, allowing minority shareholders to take action against directors for mismanagement. Thus, these remedies act as a proactive measure to monitor the directors in diversified companies. It is evident that the law and economics scholarship has influenced legal policymaking, specifically in corporate governance, and the functions of these remedies are further analysed in the comparative parts of this research.

This need for oversight hints at the broader advantages and inherent complications associated with the principle of agency in corporate governance. The first agency problem provides an essential foundation for the legal structure of the modern firm, and the agency cost relating to the first agency problem has been extensively addressed by scholars.[386] Law and economics scholars have found several benefits of agency in the corporate entity. Agency in corporations allows investors to explore more possibilities because the agent saves the investors' time and the workload can be shared between the agents, ultimately increasing the firm's efficiency. Agent expertise also provides valuable skills for the business to develop further. In other words, an agent with an expert skill and knowledge increases the efficiency of the firm and its chances of delivering robust results. Thus, agency saves the principal time and money. Accordingly, economic scholars have argued that it represents a sensible delegation of power by shareholders to individuals who have the expertise to run a business.[387] Furthermore, Coase has argued that investors increase value through agency by reducing transaction costs.[388] As shown above, agency cost and transaction cost are two different economic theories that are useful to increase the efficiency of the business. Thus, both these theories are useful in legal policymaking to fashion efficient laws.

384 Guillén and Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (n 2) 133.

385 Bratton, An anatomy of Corporate Legal Theory' (n 165) 34.

386 See Eric W Orts, 'Shirking and Sharking: A Legal Theory of the Firm' (1998) 16 Yale Law and Policy Review 265; Donald C Langevoort, 'Agency Law Inside the Corporation: Problems of Candor and Knowledge' (2003) 71 University of Cincinnati Law Review 1187, 1191.

387 See Butler, 'The Contractual Theory of the Corporation' (n 335) 106 and 108; L E Ribstein, 'The Mandatory Nature of the ALl Code' (1993) 61 George Washington L.Rev. 984, 991 and 993.

388 Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (n 112) 454.

However, alongside these numerous benefits, there are inherent drawbacks in agency models, known as 'agency costs', which firms must strategically address for better survival in the global business environment. Agency models have their drawbacks in addition to the aforesaid benefits. Firms that offset these drawbacks stand a better chance of survival in the global business environment. Furthermore, the legal mechanisms can be utilised to support firms to minimise drawbacks of agency models. Scholars have identified these drawbacks in agency models as 'agency costs'. The underlying cause for agency costs in economics is the divergence of interest between the principal and agent, which results in an incentive problem. Economists argue that, as discussed above, the agents have an incentive to benefit themselves from the agency relationship because information is distributed asymmetrically between the principal and the agent.[389] Armour, Hansmann and Kraakman argue that the core difficulty in an agency relationship is that the agent has superior first-hand information on company affairs compared to the principal.[390] As the agent engages in profit-earning activities on behalf of the principal, the fact that the agent does not receive all the returns accrued from said activities prompts the agent to siphon part of the returns. Thus, it cannot be guaranteed that the agent will always act in the best interests of the principal, and the agent always has an incentive to act opportunistically to benefit himself/herself by (directly or indirectly) deriving value for the principal's returns. Economists argue that when agents put their interests first, the result is the creation of 'agency costs'.

These agency costs necessitate regulatory measures to ensure the performance of the agent, leading to additional monitoring costs for the principal. To ensure the performance of the agent, the principal must bear an additional monitoring cost. Armour, Hansmann and Kraakman argue that the greater the expertise required for the tasks in which the agents are involved, the larger the agency costs are likely to be.[391] This is mainly because the information available to the principal is limited or requires expert knowledge to understand; thus, the agents involved in these tasks have a greater incentive to act opportunistically. However, while these agency costs are unavoidable, legal mechanisms could be utilised to minimise them by regulating the agency relationship. Law and economics scholars are increasingly focusing on agency cost analysis to improve corporate law.[392] This is owing to the importance and practical application of agency cost theory in corporate law and governance. Cooter argues that *a cost benefit analysis commends changes for which the sum of*

389 Schmidt (n 362) 501.
390 Armour, Hansmann and Kraakman (n 286)
391 ibid 29.
392 Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (n 112) 408.

benefits exceed the sum of costs.[393] In the case of a deficit of benefits and higher costs, policymakers can take proactive measures through legal tools to reduce the costs, thereby assisting businesses to run efficiently. Cooter further posits that cost benefit analysis is a useful guide for policymaking.[394]

In this research, the three types of agency problems are operationalised as a framework to identify possible agency costs that may arise from the agency relationships in the organisation's business environment. The ideas discussed in this research in respect of the second and third agency problems are novel to the law and economics approach. It is argued that identifying and addressing possible agency cost problems between principal and agent in the agency problems will provide long-term efficiency in the operation of the firm. Indeed, the first agency problem has already been addressed to a certain extent in many jurisdictions through legal mechanisms.[395]

In addressing agent wrongdoings, corporate law plays a pivotal role by regulating potential malfeasance or nonfeasance within the principal-agent fiduciary relationship. Cooter argues that the agent can commit two types of wrongdoings in the principal-agent fiduciary relationship in a firm. The first is that the agent may misappropriate the principal's assets or some of its value. This type of misconduct is an act of malfeasance. The second type of wrongdoing is that the agent may neglect the assets of the firm, and this type of misconduct is an act of nonfeasance. Cooter further states that both types of wrongdoings are controlled by legal mechanisms imposed by the government and the individual contracts between the principal and agent, which can be enforced with the help of government institutions, eg law enforcement institutions such as the police and the courts. In other words, governments impose legal mechanisms through legislation (such as the Companies Act) for actors to fairly conduct business affairs in relation to a business organisation. Corporate law governs laws relating to the aforesaid wrongdoings based on the agent's duty of care, skill and fiduciary duties. These are specifically covered under the directors' duties provisions enacted in corporate law statutes.

Law and economics have highlighted the importance of regulating the principal-agent relationship between directors and shareholders if businesses are to economically benefit from efficient governance within the firm. These theories have been useful in corporate governance policymaking, ie directors' fiduciary duties, shareholder maximisation and criminal liabilities for directors are incorporated into the Companies Acts in most jurisdictions. Shareholders' rights are protected through,

[393] Cooter, 'Best Right Laws: Value Foundations of the Economic Analysis of Law' (n 166) 828.

[394] ibid 831.

[395] Lombardo (n 176) 51.

inter alia, corporate law, eg provisions relating to AGMs, derivative actions and minority buy-out rights. These provisions encourage investors to invest in companies in jurisdictions that provide stronger legal protection.

In addition to the well-documented first agency problem, there exist other critical agency problems within corporate governance that have significant implications for all stakeholders involved. Until now, law and economics research has mainly focused on the director/manager-shareholder agency relationship in the principal-agent theory. In connection to several other studies by law and economics scholars, this research argues that two other generic agency problems persist in corporate governance. For instance, Armour, Hansmann and Kraakman argue that there are other generic agency problems in a business firm.[396] The other two generic agency problems are the agency problem between controlling shareholder and minority shareholder and the agency problem between the firm and its stakeholders. Freeman has championed the stakeholder approach in corporate governance and highlighted several stakeholders important to the company's affairs. This research particularly focuses on the environment as the stakeholder in relation to the third agency problem. Further, it aims to facilitate policymaking in connection to the third agency problem, specifically in directors' duties in corporate governance, to improve sustainability. This research also argues that directors not only have a fiduciary duty towards shareholders but also towards non-shareholder stakeholders. Given that fiduciary duty is an important principle in reducing agency costs, three generic agency relationships are discussed in the following subsections.

The first agency problem, extensively examined by scholars, revolves around the potential conflict of interest between a company's owners and its directors. The first agency problem has been extensively examined in the scholarly research by several notable scholars, including Cooter. It occurs between the firm's owners and its directors. In this first agency problem, the owners are the principals, and the directors are the agents. The main issue arising in this agency problem is the opportunity for directors to benefit and/or siphon off the principal's wealth, resulting in negative impacts on the welfare of the principals. In response, the law has introduced several monitoring mechanisms to reduce the agency costs arising from director opportunism. Directors' duties, AGMs, oppression and mismanagement remedies and disclosure provisions are some of the monitoring mechanisms already present in corporate law, the core principle of which can also be utilised in reducing agency costs in the other two generic agency problems discussed in this research.

The second agency problem highlights the tension between controlling shareholders and minority shareholders, where the potential for exploitation and

[396] Armour, Hansmann and Kraakman (n 286) 29-30.

conflict is rife. The second agency problem is the conflict between the controlling shareholders (majority shareholders) and minority shareholders who are the noncontrolling owners of the company. Controlling owners act as agents for the minority shareholders by looking after the latter's interests. In this scenario, the problem is that the majority shareholders have the opportunity to expropriate and oppress the minority shareholders to gain personal benefits or increase their share value. Enriques and Volpin argue that this problem can be seen mostly in companies where the degree of ownership enjoyed by the controlling shareholders is small.[397] As a result, the agency cost in relation to the second agency problem is considerably higher in a company that has a higher percentage of minority share ownership. Agency conflicts between ordinary and preference shareholders fall under this type of agency problem.[398] This research argues that agency costs arising from the second agency problem can be reduced through proactive corporate governance provisions coupled with an efficient enforcement mechanism such as the unfair prejudice, oppression and mismanagement remedies. It also discusses the possible costs that can arise from this second agency problem and suggested controlling mechanisms to reduce the agency costs that arise in this agency relationship, which is proposed as 'shareholder costs', in transaction cost theory (see the discussion under section 3.6.1.).

The third agency problem extends the scope of agency theory by considering the relationship between the firm and its broader range of stakeholders, particularly emphasising the environment. The third agency problem discussed in this research is in connection to the stakeholder approach advocated by Freeman. This approach is becoming increasingly popular among academics and practitioners, and stakeholder theorists are currently challenging several aspects of the theory of the firm such as, inter alia, shareholder maximisation and short-term financial returns to shareholders. The proponents of stakeholderism argue that the goal of the firm should not only be the interests of shareholder welfare but of all stakeholders' welfare. For instance, Preston and Sapienza have found that firms that considered the interests of multiple stakeholders *had ten-year rates of return that were positively correlated with each of their stakeholder variables.*[399] Freeman argues that there can be several stakeholders in a very large organisation. For instance, owners, customers, employees, suppliers, financial community, unions, competitors, government, political groups and activist groups.[400] Activist groups promote environmental interests, society's interests, human rights interests and labour interests. The importance of these external stakeholders'

397 Luca Enriques and Paolo Volpin, 'Corporate Governance Reforms in Continental Europe' (2007) 21(1) Journal of Economic Perspectives 117, 122.

398 When creditors are the effective owners of the company.

399 Jones and Harrison (n 370) 79.

400 Freeman, *Strategic management: A stakeholder approach* (n 29) 55.

interests in corporate affairs for sustainability in corporate governance is highlighted by stakeholderists. Moreover, these external stakeholders are protected to a certain extent by specific legislation, and the laws relating to said external stakeholders influence the corporate governance and efficiency of the firm. The organisation is bound by the law of the jurisdiction, and corporate decisions should not violate any such laws. For instance, labour legislation, consumer protection legislation, human rights legislation, criminal legislation and environmental protection legislations. This research argues that the 'environment' as an external stakeholder is crucial to the long-term success of the organisation. Phillips and other argue that *stakeholder theory views the firm as very complex and thus accommodates a wide range of theoretical perspectives.*[401] The stakeholder approach is discussed here in connection to the principal-agent theory as the third agency problem, specifically focusing on the environment as stakeholder.

The third agency problem exists within the firm. The managers/directors (or the firm as a collective body of people) act as the agents for non-shareholder constituencies as principals to look after the latter's interests. The firm includes the directors, shareholders or any other stakeholder who take a corporate decision on behalf of the firm. The firm as a collective body will be the agent, regardless of which actor takes the corporate decisions, as long as the corporate decision is taken on behalf of the firm and the firm implements the decision that affects the principal (stakeholder). Ross opines that these agency problems are not confined only to the firm, but also in society.[402] As stated above, this research focuses on the environment as the principal and the firm as the agent. The agency cost will arise in this third agency problem as a result of the firm acting opportunistically towards the environment. The concept of sustainability in corporate governance is discussed in connection to this third agency problem.

It has been argued that opportunism towards the environment creates long-term costs, underscoring the need for a sustainable approach to corporate governance that considers environmental impacts. For instance, a decrease in the organisation's brand value owing to a public outcry in response to environmental pollution. In this way, the concept of sustainability is integrated into the third agency problem discussed in this research. It is argued that sustainability in corporate governance would facilitate the achievement of the goals set in the Paris Agreement and the UN SDGs. It is further argued that the oppression and mismanagement remedies – coupled with proactive corporate governance legal provisions – can be utilised to

[401] Robert A Phillips and others, 'Stakeholder Theory' in Jeffrey S Harrison and others (eds), *The Cambridge Handbook of Stakeholder Theory* (Cambridge University Press 2019) 12.

[402] Brahmadev (n 296) 77.

reduce the agency costs arising from the third agency problem and to facilitate sustainability in corporate governance. The proposed solution aims to strike a balance between the different needs of environment, society and economy and those of business growth and development.

3.7.1 Orts' web of agencies in corporate governance

Orts argues that three parties are required for a web of agency relationship in a modern corporation to be meaningful: the principal, the agent and a third party affected by the agency relationship. This web of agency relationship is helpful in policymaking mechanisms to govern and regulate agency relationships to reduce costs. Orts further argues that this tripartite relationship helps to explain the power and authority within a corporate structure in connection to possible consequences for third parties in society.[403] In turn, Orts's tripartite relationship can be formulated in relation to Armour, Hansmann and Kraakman's work on three generic agency problems in a firm. This formulation can be utilised to predict the affected parties in a generic agency relationship. Furthermore, this formula shows that stakeholders are important actors in the theory of the firm, specifically in principal-agent theory. Accordingly, aspects of stakeholderism can be incorporated into the theory of the firm for the purpose of policymaking. Moreover, this formula shows that in almost all agency relationships, the firm affects third parties, which highlights the importance of monitoring the agency problems efficiently to reduce unnecessary costs. Thus, this formula can be utilised in policymaking to *ex ante* identify the affected party in order to reduce the agency costs.

Table 1 – Tripartite relationship in relation to the three generic agency problems

	The principal	**The agent**	**Third party**
Agency problem 1	Shareholders	Directors	Other non-shareholder stakeholders, including the firm
Agency problem 2	Minority shareholders	Controlling shareholders	Other non-shareholder stakeholders, including the firm
	Minority shareholders	Directors under the influence of controlling shareholders	Other non-shareholder stakeholders, including the firm
Agency problem 3	Other non-shareholder stakeholders, eg the environment	The firm itself – including, particularly, its owners	Shareholders, non-shareholder stakeholders, including the firm

403 Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 57.

Orts argues that *agency relationships within the firm can be both vertical (hierarchical) and horizontal (mutual).*[404] The agency problems presented in Table 1 are hierarchical relationships, meaning that one party exercises power and authority over the other through the rights vested in corporate law. The authority has the capacity to influence the other party. In other words, shareholders can influence the directors' decision-making by setting goals to reach that are backed by sanctions, such as removing the director if the goals are not achieved in time. What Orts means by power here is the capacity of one party to exploit the other. In other words, shareholders have rights vested by corporate law to appoint and remove directors, and thus the shareholders have the capacity to exploit the director by demanding excessive working hours. However, external laws such as labour laws may limit these rights. Nevertheless, shareholders exercise power and authority over directors in the first agency problem. Thus, the principal is superior to the agent in the first agency problem when considering the general rights vested in corporate law. The reason is that the agent has the incentives to act in opportunism, eg directors have the incentive to act opportunistically owing to the information asymmetry within the firm.

3.7.2 Presumption of agent's incentive to act opportunistically in the second and third agency problems

It is an established principle in the principal-agent theory that the agent has an incentive to act opportunistically owing to the information asymmetry within the firm. Accordingly, it is presumed in the second and third agency problems that the agent has an incentive to act opportunistically. According to Table 1, the third party will be affected by the agent's act of opportunism, and thus the firm will ultimately suffer economically. In all three agency problems, the firm is an affected party, ie considering the first agency problem, as a result of the directors' act of opportunism, the directors will benefit at the expense of the firm.

Economists identify the results of opportunism as 'agency costs', or more specifically 'residual loss'. However, the stronger rights vested by corporate law to shareholders minimise the damage that can be caused by directors' opportunism. Thus, in most jurisdictions, corporate law has provided stronger rights to shareholders to control directors' acts of opportunism, specifically those based on information asymmetry. Balance has hence been achieved by incorporating monitoring and transparent legal mechanisms into corporate law. In other words, in most jurisdictions, the first agency problem has been addressed to a large extent.

[404] ibid.

Accordingly, the comparative part of this research focuses on analysing proactive measures of the principal's right against agent's incentives to act opportunistically in second and third agency relationships.

However, compared to the academic work on the first agency problem, little research has been conducted in relation to the other two agency problems, especially the third agency problem. Furthermore, the equilibrium of rights vested by corporate law in response to the principal and the agent's information asymmetry is no longer intact in respect of the second and third agency problems in contemporary corporate law, eg corporate law has vested stronger rights to controlling shareholders compared to minority shareholders. Although minority shareholders are vested with certain limited rights (depending on the jurisdiction), they are not as strong as those of controlling shareholders. This can be attributed to the company law principle of 'majority rule', which provides greater rights to the controlling shareholders. In addition, controlling shareholders benefit more greatly from the information asymmetry compared to minority shareholders. In other words, controlling shareholders appoint and remove the directors, and thus directors will be loyal to the controlling shareholders, resulting in the controlling shareholders gaining easy access to corporate information through the directors. Furthermore, the controlling shareholders enjoy the 'private benefit of control', ie they wilfully acquire disproportionate returns at the expense of the minority shareholders.[405]

Minority shareholder remedies act as a monitoring mechanism to mitigate controlling shareholders' opportunism. However, the protection offered to minority shareholders is low in company law given the 'majority rule' principle. Thus, in the second agency problem, corporate law favours the agent with stronger rights in addition to the agent having the incentive to act opportunistically towards the principal. This situation can create higher agency costs for the firm. The most damaging cost is when an agency problem escalates to court litigation, resulting in the firm suffering economically higher agency costs. The costs of monitoring mechanisms to control such events can be termed as 'shareholder costs', which is a monitoring cost in agency cost theory. The main reason for this agency cost is controlling shareholders' acts of opportunism; in the long term, the firm may suffer economically due to the uncertainty and other harmful effects of court litigation between controlling shareholders and minority shareholders. Some jurisdictions have adopted proactive measures and other mechanisms to reduce these costs. In other words, several Nordic countries have made it mandatory for shareholders to

[405] See Tatiana Nenova, 'The Value of Corporate Voting Rights and Control: A Cross-Country Analysis' (2003) 68 Journal of Financial Economics 325, 336; Alexander Dyck and Luigi Zingales, 'Private Benefits of Control: An International Comparison' (2004) 59 Journal of Finance 537, 551.

attempt arbitration prior to court litigation. However, the firm still needs to bear (in full or in part) the costs of arbitration and any indirect costs arising as a result. Additionally, common law countries have incorporated the oppression, mismanagement and unfair prejudice remedies as a proactive measure for controlling shareholder opportunism. The measures adopted by jurisdictions to reduce the agency cost in the second agency problem will be further examined in the comparative part of this research. The findings will be useful in fashioning proactive company law provisions to reduce the agency cost in the second agency problem.

The third agency problem consists of several principal-agent relationships and is thus the most complex agency problem compared to the other two. The corporate decisions taken by the managers/directors and/or shareholders on behalf of the firm have a direct or indirect effect on the firm, including non-shareholder stakeholders. Thus, any economic loss to the firm will have a direct/indirect economic effect on the firm's stakeholders, eg loss of business may result in loss of employment. Accordingly, managers/directors and/or shareholders making decisions on behalf of the 'firm itself – including, particularly, its owners' (the firm) are the agents for several non-shareholder stakeholders, and the firm has the power and authority over the non-shareholder stakeholders. In other words, the managers/directors and/or shareholders can benefit by expropriating, inter alia, the employees, customers, creditors and the environment. The firm also has an incentive to act opportunistically towards non-shareholder stakeholders. In other words, employees are in an insecure position because the firm exercises power over their job security and benefits by expropriating them. Employee insecurity is another incentive for the firm to engage in opportunistic conduct by expropriating its employees.

Furthermore, the firm benefits from the asymmetric information regarding employee affairs. Corporate law has vested minimal rights on non-shareholder stakeholders. This is specifically owing to the shareholder maximisation norm. Thus, the firm has a higher incentive to act opportunistically. The balance between the principal's right and the agent's incentives to act opportunistically is not at all intact in some jurisdictions. While some have provided trivial rights to the non-shareholder stakeholders, scholars have argued that it is important to consider stakeholders in corporate governance because the firm's opportunism towards the non-shareholder stakeholder may result in long-term economic losses to the firm, resulting in residual loss. This research focuses on the non-shareholder stakeholder – in this case, the environment – and the concept of sustainability in corporate governance is promoted in connection to the environment.

The firm acts as the agent for the environment in adopting mechanisms in corporate decision-making to act in good faith on environmental sustainability. In other words, the firm should at all costs adopt mechanisms to minimise environment pollution that may result from its business activities. The firm has the power over

the environment to take decisions to pollute or protect. As noted above, corporate law provides minimal protection to this non-shareholder stakeholder. However, external laws (ie environmental laws) provide protection rights to the environment. For instance, New Zealand has granted legal standing for elements of the environment, such as rivers.[406] This enables stakeholder groups, including activist groups, to sue firms for environmental pollution.[407] Thus, the New Zealand example shows that rights can be provided to environmental activist groups in corporate law. Furthermore, O'Donnell and Talbot-Jones argue that the most efficient method of protecting the natural environment is by providing legal standing through creating legislative enactments by government institutions.[408] This would also reduce the uncertainty in respect of corporate decision-making when directors are addressing environmental matters. In some countries, however, such attempts to provide legal status to the natural environment have failed through judicial process. Nonetheless, incorporating extra protection in respect of non-shareholder stakeholders within corporate governance would act as a proactive measure to hinder environmental pollution within the business organisation. As such, the comparative part of this research will focus on the function of the law in protecting the environment, specifically in corporate law. Special emphasis will be given to directors' duties and sustainability in corporate governance. The stakeholder approach, the agency cost theory in relation to the third agency problem, and agency cost mitigation methods are also discussed under section 3.9. It is further discussed that the mismanagement remedy coupled with 'sustainability related rules' can be utilised to facilitate sustainability in corporate governance. Currently, this stakeholderism approach and sustainability in corporate governance are highly debated in the academic world.[409]

3.7.3 Agency costs from a policymaking perspective

As discussed above, Jensen and Meckling have identified 'monitoring cost', 'bonding cost' and 'residual loss' as elements of the agency cost. Monitoring costs involves expenditure on monitoring and assessing the agent's behaviour. For instance, boards to monitor the performance of managers. The firm bears the

[406] The Te Awa Tupua (Whanganui River Claims Settlement) Act 2017 gave legal rights to 'The Whanganui River in New Zealand'.

[407] Freeman, *Strategic management: A stakeholder approach* (n 29) 20-21.

[408] Erin O'Donnell and Julia Talbot-Jones, 'Creating legal rights for rivers: lessons from Australia, New Zealand, and India' (2018) 23(1) Ecology and Society 7 <http://www.ecologyandsociety.org/vol23/iss1/art7/> accessed on 14th April 2020.

[409] See Colin Mayer, 'Shareholderism versus Stakeholderism - A Misconceived Contradiction: A Comment on the Illusory Promise of Stakeholder Governance by Lucian Buchuk and Roberto Tallarita' (2020) Cornell L. Rev. 106, 1859.

expenditure needed to set up a defined system in which the agents operate; this is known as bonding costs. For instance, contracts providing remuneration to the agent that are backed by sanctions if the agent takes any action that harms the principal. Residual loss occurs when the agent takes decisions that are not aligned with maximising the wealth of the principal. Williamson argues that mitigating residual loss is the key component in increasing firm efficiency; the principal must therefore bear monitoring costs and bonding costs to reduce the residual losses.[410]

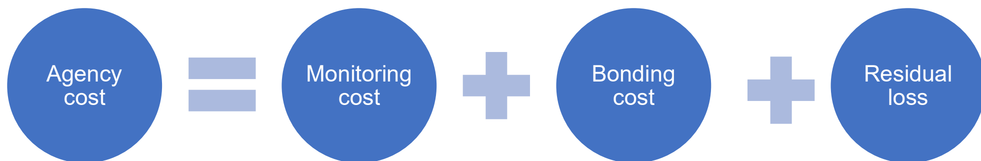

Figure 1 - Elements of agency costs. Source: Jensen & Meckling (1976)

It can be argued from a positivist agency theorist's view that certain types of transaction costs, which incur owing to agency conflicts, may also contribute to agency costs. For instance, the shareholder costs and stakeholder costs discussed in this research are elements of monitoring costs in agency cost theory. Shareholder costs are incurred due to the 'controlling mechanism' of internal disputes between shareholders, while stakeholder costs occur due to the 'controlling mechanism' of agency conflict between the firm and its non-shareholder stakeholders. Thus, the firm must bear additional monitoring costs. In other words, it must bear costs incurred through imposing controlling mechanisms to minimise the second and third agency problems. These costs are discussed further here under the second and third agency problems.

Schneider argues that opportunity cost is a type of transaction cost that includes monitoring costs and bonding costs to minimise the residual loss of the owners of the firm.[411] Accordingly, transaction costs (such as monitoring costs and bonding costs) can occur owing to the internal transactions of the firm, specifically the agency conflicts. Thus, agency cost from a transaction cost theory point of view can comprise several elements of certain types of internal transactions costs.

410 Oliver E Williamson, 'Corporate finance and corporate governance' (1988) 43(3) Journal of Finance 567.

411 Schneider (n 310) 489.

Figure 2 - Elements of agency costs from a positivist perspective. Source: Author's own

Incorporating legal mechanisms into corporate law reduces the monitoring costs and bonding costs that the principal must otherwise bear. Furthermore, legal mechanisms to control other types of internal transaction costs reduce the agency cost, specifically residual loss. For instance, proactive oppression and mismanagement remedies reduce shareholder disputes and mismanagement of the company. Thus, it is argued in this research that incorporating oppression and mismanagement remedies as legal mechanisms will reduce the agency costs.

As observed above, owners incur monitoring costs and bonding costs to reduce residual loss. Likewise, owners incur certain types of internal transaction costs. In other words, owners incur bonding costs on contracting prior to investing through shareholder agreements and monitoring costs to monitor the controlling parties of the firm. Furthermore, owners incur stakeholder costs to reduce the residual loss. Incurring costs for sustainability and environment-friendly policies in the firm reduces residual loss and benefit the firm in the long term. Thus, to reduce the long-term residual loss, the owners incur stakeholder costs. In other words, the owners will have to bear short-term losses to gain long-term value and reduce long-term residual losses. These costs are further discussed in this research.

3.7.4 Agency problems and their relation to the stock market

Law and economics scholars have conducted extensive research into the first agency problem between the shareholders and directors of the firm. Jensen and Meckling in their seminal work[412] first provided a systematic way to analyse the differences between the interests of the owners and managers of the firm. Agency costs are more relevant to publicly listed companies as investors tend to invest in companies with

[412] Jensen and Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (n 34).

the lowest agency costs. Most companies with lower agency costs tend to have steady returns in the stock markets; this has led law and economics scholars to draw assertions on the connection between agency costs and the performance of stocks in the stock markets. Cheffins argues that *agency cost theory offered an intellectual elegant account of various counterstains that were potentially relevant to a publicly quoted company.*[413] This argument is based on Manne's findings on factors such as the capital market, the market for products and services, the market for managerial talent, and the market for corporate control.[414] Manne argued that corporate executives are under the continuous close scrutiny of investors because public companies are required to periodically raise capital to implement business strategies. If they act recklessly or dishonestly, their conduct would damage the company's market value and their jobs as a result. Other companies would also not recruit such misbehaving corporate executives. In arguing for constraints on corporate executives, economists have relied on the concept of 'efficient capital market hypothesis' (ECMH), and financial economists have assumed that share prices reflect all the publicly available information, including the performance of corporate executives.[415]

This connection between agency costs and the stock market presents two assertions on which law and economics scholars can rely. The first is that publicly listed companies could easily attract capital if their corporate governance is efficient. This could be achieved through proactive legal mechanisms to regulate agency relationships, specifically the behaviour of corporate executives in the first agency problem. For this purpose, it is necessary for governments to take *ex ante* measures by drafting *sui generis* legal mechanisms.[416] State intervention in governing and regulating agency relationships can be justified if low-cost enforcement mechanisms can be provided. These mechanisms can operate as surveillance for corporate executives to behave prudently in conducting corporate affairs. Bratton argues that it is important to reduce the agency cost ahead of time, because it is the principle of natural selection that the lowest-cost contract forms survive. Bratton further states that agency costs are the costs of 'shirking':[417] *Losers maximise their position by taking actions to avoid having to perform their promises fully – the theorists call this*

413 Cheffins, 'Corporations' (n 113) 498.
414 See Henry G Manne, 'Intellectual Styles and the Evolution of American Corporate Law', in G Radnitzky and P Bernholz (eds), *Economic Imperialism: The Economic Approach Applied outside the Field of Economics* (Paragon House Publishers 1987).
415 Cheffins, 'Corporations' (n 113) 492.
416 Legal mechanisms are generally referred to as legislations, rules, governance codes and ethical codes.
417 Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (n 273) 1479.

'shirking'.[418] In other words, an agent will work less when there are no chances of higher returns provided by the firm. To reduce the impact of shirking, the government can regulate agency costs through legal mechanisms. This provides cost-benefits to the business organisation. Thus, law and economics researchers should attempt to identify the agency costs in advance and address their root causes, thereby increasing the efficiency of the firm through legislative mechanisms. The comparative parts of this research will examine the directors' duties and legal provisions in the selected jurisdictions' corporate laws and related landmark cases. Loopholes in corporate law can be found by examining decided cases. Fashioning corporate law provisions to address these loopholes can proactively operate to avoid escalating to litigation. Such litigation represents high agency costs to the firm because it increases its residual loss. Accordingly, this research will address the root causes of agency costs *ex ante* through legal mechanisms to minimise disputes that escalate to litigation.

The second assertion is that the corporate executives of a well-performing corporation may enjoy access to a superior job market based on their managerial credentials. This increases their sense of job security and thus acts as a motivation to perform well as an agent, ie in the best interests of the company and its owners. This is not applicable to closely held corporations as they are not listed on the stock market. However, oppression, mismanagement and unfair prejudice remedies coupled with corporate rules and technological means to access information for shareholders may resolve this issue in closely held corporations, specifically in relation to minority shareholders. Oppression, mismanagement and unfair prejudice remedies would reflect good governance within the corporation. Combining economic elements with robust legal remedies – together with strong enforcement mechanisms such as oppression, mismanagement and unfair prejudice remedies – would efficiently regulate and govern the corporate executives' behaviour within the corporation. As a result, governments could create investor-friendly contexts for attracting business investments, and this would not be limited to publicly quoted companies. Oppression, mismanagement and unfair prejudice remedies would provide small investors with reassurances that the management of SMEs are well regulated in their chosen jurisdictions. In turn, efficient enforcement mechanisms would provide greater protection for investors to take robust actions if corporate executives were misbehaving and siphoning off the firm's profits. This comparative study also focuses on the role of oppression, mismanagement, and unfair prejudice remedies in mitigating the above-discussed acts of managerial misconduct in the selected jurisdictions.

[418] Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (n 112) 417.

This research argues that the agency costs in respect of the third agency problem, which is connected to the stakeholder approach, should be highlighted in achieving sustainability in corporate governance. Axel Werder argues that *management has to balance the inducements for and the contributions of all necessary stakeholders adequately to ensure the value creation capability of the company.*[419] Agency costs that may arise from an environmental perspective are discussed in relation to the third agency problem. Directors and management play a major part in all three types of agency problems. Thus, directors' duties play a major role in corporate law to *ex ante* reduce agency costs. Accordingly, the comparative part of this research extensively examines the directors' role in decision-making in connection to minority shareholders and non-shareholder stakeholders (in this case, the environment).

3.7.5 The second agency problem and its relation to agency costs

The shareholders of a large corporation can consist of several subgroups of shareholders all with different interests in the company, eg large and small, institutional and private, active and passive, and short-term and long-term shareholders. This divergence of interest motivates shareholders to act in opportunism to their benefit and at the expense of other subgroups of shareholders. Controlling shareholders have the most incentive to act in this way, as discussed above, ie *controlling shareholders can and/or try to misrepresent during a squeeze out the value of the focal company to push the settlement payments to the minority shareholders below the fair share price.*[420] Scholars like Shleifer and Vischny,[421] Bebchuk and others[422] and Johnson and others[423] have conducted extensive research into the conflict between controlling and minority shareholders. Moreover, the recently published law and economics book *The Anatomy of Corporate Law*[424] has highlighted several important aspects in relation to the second agency problem.

[419] Axel V Werder, 'Corporate Governance and Stakeholder Opportunism' (2011) 22(5) New Perspectives in Organization Science 1345, 1353.

[420] ibid 1350.

[421] Andrei Shleifer and Robert W Vishny, 'A survey of corporate governance' (1997) 52(2) Finance 737.

[422] Lucian A Bebchuk, Reinier Kraakman, and George Triantis, 'Stock pyramids, cross-ownership, and dual class equity: The mechanisms and agency costs of separating control from cash-flow rights' in R K Morck (ed), *Concentrated Corporate Ownership* (University of Chicago Press 2000).

[423] Simon Johnson and others, 'Tunnelling' (2000) 90(2) Amer. Econom. Rev. Papers Proc 22.

[424] Kraakman and others (n 3).

Controlling shareholders have the incentive to expropriate minority shareholders' interests in the company, which can result in creating agency costs. This can occur in the form of the controlling shareholders benefiting from disproportionate returns at the expense of minority shareholders. Incidences of expropriation can result in shareholders ending up in court litigation, creating a heavy costs burden directly or indirectly for the organisation. In transaction cost theory, this burden can be termed as 'shareholder costs', because costs are created as a result of shareholder disputes. Furthermore, in a jurisdiction where the minority buy-out rights remedy is available, minority shareholders may force the company or majority shareholders to buy their shares and exit the company. This would result in the company suffering from loss of capital for growth, as well as loss of reputation if the minority shareholders exit owing to opportunistic behaviour on the part of the majority shareholders. Oppressive conducts against minority shareholders could be routed through the directors appointed by the controlling shareholders; these directors may favour one group of shareholders, especially a group of majority shareholders. Such oppressive conduct may also result in creating a high costs burden for the organisation. Oppressive acts may amount to 'burdensome', 'harsh' and 'wrongful' conduct.[425]

The outcome of this oppressive conduct can be identified as 'agency costs' in relation to the second agency problem. A dispute between shareholders may affect the financial performance of the company; if it is a listed company, it may be reflected in the stock market. If it is not, it may be reflected in the financial performance statements: poor performance based on shareholder disputes may result in loss of reputation and may hinder attracting small-scale investors to invest in the company. Furthermore, the loss of reputation would inhibit the company's capacity to attract capital in the future. Thus, it is important that the agency problem between the controlling and minority shareholders is addressed proactively. The same techniques utilised to reduce the agency costs in the first agency problem could be used to address the second agency problem. For instance, monitoring devices: *These include common features of the corporate landscape such as independent directors and accountants, and legal rules against self-dealing.*[426] Most of these remedies are already available in many jurisdictions. This research will focus on how oppressive and mismanagement remedies would provide added protection as a proactive measure to minimise agency costs in relation to the second agency problem.

[425] KR Chandratre, *Law & Practice Relating to Oppression & Mismanagement – Minority Shareholders' Remedies* (S Balasubramanian ed, 2nd edn, Bharat Law House 2016), 143.

[426] Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (n 273) 1479.

3.7.6 The second agency problem and legal strategies

In 'The Anatomy of Corporate Law',[427] various law and economics scholars have found remedies under 10 legal strategies to reduce the agency costs that may arise from the second agency problem.[428] Minority shareholders' rights to appoint corporate executives afford them better access to information and to get involved in company decision-making. In addition, if directors appointed by the minority shareholders are assigned to key committee roles and granted veto powers on certain board decisions, this would increase minority shareholders' interests in the business. Currently, Russian[429] and Brazilian[430] law provides for similar remedies to boards with directors appointed by minority shareholders. Furthermore, the UK listing rules provide 'veto' voting power to minority shareholders to appoint independent directors in a company controlled by majority shareholders.[431] This provides minority shareholders to actively become involved in company affairs through their represented directors. Enriques and others further state that several jurisdictions have permitted opting into 'voting caps' through charter provisions.[432] This allows individual companies to attract small-scale investments depending on the capital requirements of the company.

Moving from broad strategies to particular methods, the focus shifts to specific mechanisms like 'veto voting powers' and 'voting caps', created to limit the excessive influence of majority shareholders. These 'veto voting powers' and 'voting caps' are deviations from the traditional default rule of 'one-share-one-vote' in corporate governance, which allows majority shareholders to control the company and thus creates incentives to benefit at the minority shareholders' expense. As discussed above, this can result in minority shareholders being oppressed and escalating disputes to court litigation, thus creating high agency costs. Furthermore, the 'one-share-one-vote' concept can operate as a barrier for the company to attract capital through equity financing, because the minority shareholders are only vested

427 Kraakman and others (n 3).

428 See Armour, Hansmann and Kraakman (n 286) 31-45.

429 See Art. 78 Russian Joint-Stock Companies Law.

430 See Art. 142, § 2º (The Company Act) Lei das Sociedades por Ações <http://conteudo.cvm.gov.br/export/sites/cvm/subportal_ingles/menu/investors/anexos/Law-6.404-ing.pdf> accessed on 8th Feb 2021.

431 See Rules 9.2.2E and 9.2.2F United Kingdom Listing Rules.

432 Luca Enriques and others, 'The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies' in Reinier Kraakman, and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 80-83.

with limited rights.[433] In response, oppression, mismanagement and unfair prejudice remedies are effective enforcement mechanisms for 'veto voting powers' and 'voting caps'.

Beyond these protective measures, 'direct decision rights' offer another layer of defence for minority shareholders, empowering them with greater influence in corporate affairs. Direct decision rights in the company provide protection for minority shareholders' interests and increase minority shareholder activism in the company. In other words, minority shareholders' rights to challenge the tenure of an ineffective management group. This would enable minority shareholders to be directly involved with the affairs of the company, if required. However, if such rights are not available, minority shareholders may opt to seek the minority buyout right remedy, which would result in the company losing its capital and thus affecting its growth.

Direct decision rights also include the 'statutory blocking right' for minority shareholders on certain crucial matters in the business. In other words, the statutory requirement of 75% or more voting shares in certain transactions; in the context of major transactions, this statutory blocking right can prevent the expropriation of minority share interest.[434] Enriques and others argue that providing statutory rights to minority shareholders to bring suit in the company's name against a party with whom the company may have a cause of action is a strong direct decision right of minority shareholders.[435] However, it should be noted that in some jurisdictions, minority shareholders require majority approval to bring a suit in the name of the company, especially a derivative action. Elsewhere, the law has provided only a minimal threshold to bring a lawsuit in response to oppression and mismanagement actions. For instance, Sri Lankan company law requires only 5% of the total number of shareholders or shares, which together carry only 5% of the voting rights at a general meeting of the company.[436] Accordingly, a group of minority shareholders could bring an action that would reduce the litigation costs of a single shareholder. Thus, in respect of the minority shareholders' decision rights, the oppression and mismanagement remedies provide a higher enforcement right. These remedies would also allow minority shareholders to bring direct actions against any shareholder or director who has misbehaved or oppressed the minority shareholder. Thus, a personal action could be brought by a shareholder against the company or the management. However, company legislation should proactively discourage

433 Kristian Rydkvist, 'Dual-class Shares: A Review' (1992) 8 Oxford Review of Economic Policy 45.
434 See Section 143 and 185 of the Sri Lankan companies Act, No. 07 of 2007.
435 Enriques and others (n 432) 84.
436 See Section 226 of the Sri Lankan companies Act, No. 07 of 2007.

escalating disputes to court litigation as a means to reduce agency costs. Oppression, mismanagement and unfair prejudice remedies, together with other methods, can be utilised to act as proactive measures to reduce agency costs that may arise from shareholder disputes. Currently, some jurisdictions harness established legal mechanisms to prevent direct court litigation related to internal company matters. For instance, in India, a separate tribunal is set for certain company disputes, while shareholder disputes in Finland can first be referred to arbitration. However, leading English case law hinders certain unfair prejudice (including oppression) remedies to opt into arbitration based on the legal principle that equitable remedies are barred from being tried through arbitration. This equitable aspect of the oppression remedy represents a challenge to incorporating elements of oppression, mismanagement and unfair prejudice remedies into Finnish company law.

In the continuum of legal strategies, the ‘equal treatment norm’ emerges as a foundational principle advocating for the impartial and equitable treatment of shareholders. Minority shareholder protection includes several other legal rights, including the equal treatment norm, minority buy-out rights and the right to investigate company affairs. The equal treatment norm is an important principle in protecting minority shareholders. This norm has become more popular in recent times and is considered the best available minority shareholder protection in Nordic countries, particularly in Sweden and Finland. However, the extent of the *equality norm varies greatly, both within and between jurisdictions.*[437] This research aims to compare the effectiveness of said minority shareholder protection remedies, specifically that of the equal treatment remedy with the oppression, mismanagement and unfair prejudice remedies. When comparing, special emphasis is given to the effectiveness of these remedies in respect of the agency costs. Accordingly, the results will indicate whether the standalone equality norm is sufficient for minority shareholder protection or whether oppression, mismanagement and unfair prejudice remedies provide a higher protection needed to attract small-scale investments. This will assist in identifying whether Finnish company law should incorporate elements of oppression, mismanagement and unfair prejudice remedies or expand the equitable norm by integrating oppression, mismanagement and unfair prejudice elements therein.

Extending beyond statutory rights and norms, the discussion now turns to the ‘doctrine of trusteeship’, which underscores the moral and fiduciary responsibilities inherent in corporate governance. The doctrine of trusteeship is an important concept to discuss in the economic approach to law. Merrick Dodd has argued that it can be

[437] Enriques and others (n 432) 87.

applied to both directors and controlling shareholders.[438]. The board of directors acts as the agent for the shareholders, and the controlling shareholders act as agents for the minority shareholders. Thus, both the directors and the controlling shareholders are placed in a position of trust on behalf of their principals. The doctrine of trusteeship has been extensively studied in relation to the first agency problem. Several scholars such as Mitchell and O'Connor highlight the importance of 'trust' as a social virtue along with its role in corporate relationships. [439] Similarly, Klause Spermann *society could encourage trust* in order to reduce agency costs. He further states that encouragement of trust could be done via a process of indoctrination and rewarding behaviours, such as *honesty, reliability and altruism.*[440] However, transaction cost theorists argue that owing to the existence of uncertainty, contracts cannot fully replace trust in intra-corporate activities.[441] Specifically, in entrepreneur businesses and closely held companies, the business began with the trust that each party had placed in each other. Furthermore, unlike listed companies, no state institutions oversee the operations of closely held companies, which are mostly run based on trust among family members or friends.

Trust is a moral obligation in corporate affairs. The concept of trust has been regulated in respect of the ways in which the directors should behave in a corporate environment. Berle and Means highlight that the fiduciary duties of directors are to fulfil the shareholders' expectations.[442] Green has stated that *employee managers and corporate directors are bound as trustees for corporate owners,*[443] and Cheffins highlights that *directors have duties to a company which are akin to those that a trustee owes to a beneficiary.*[444] In turn, the nexus between trust and the fiduciary concept in corporate law was highlighted by Bratton: '[…] *the law facilitate trust through state created obligations. In corporate law context, the fiduciary conception usually plays this role*'.[445] Government-created obligations are provided under directors' duties in corporate law legislations; in doing so, governments have

438 Merrick E Dodd, Adolf A Berle, and Gardiner C Means. 'The Modern Corporation and Private Property' (1933) 81 University of Pennsylvania Law Review and American Law Register 782, 783.

439 Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 874.

440 Klause Spermann, 'Agency theory and risk sharing' in Günter Bamberg and Klause Spermann (eds), *Agency Theory, Information, and Incentives* (Springer-Verlag 1989) 25 and 26.

441 See footnote 56 in Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 871.

442 Landauer (n 220) 1702.

443 See – footnote 4 in Green (n 214) 1410.

444 Cheffins, 'Corporations' (n 113) 13 – 14.

445 Bratton, 'Nexus of Contracts Corporation: A Critical Appraisal' (n 112) 451.

introduced a way to enforce 'trust obligations' owed by directors to the shareholders and the company in corporate governance. However, it is not practical to regulate all the trust obligations in corporate affairs that directors may encounter. Thus, a director's reputation as a self-enforcing trustee who honours his/her moral obligations to all stakeholders must be an important characteristic when hiring. Likewise, the importance of directors exercising their discretion in terms of the 'highest moral obligation' is evident from the business judgment rule principle, which states that directors are presumed to act in good faith towards the company and its shareholders. The directors are normally better informed of the company affairs than a shareholder, and they are also better equipped than an uninformed judge.[446] Thus, in terms of the business judgment rule, the court is not allowed to interfere with corporate executives' decisions regarding everyday transactions and investments.[447] In the US, this rule has given unfettered discretion to corporate executives to *exercise independent decision-making authority on a wide range of decisions under ordinary circumstances*.[448] This provides opportunity and security for the corporate executives to act in the best interests of the business.

However, law and economics scholars have not touched on the concept of 'moral obligations', which can be regulated as fiduciary duties of controlling shareholders towards the minority shareholders in corporate law. The government has the possibility to regulate the trust obligation of controlling shareholders through company legislation that provides the fiduciary duties of the controlling shareholders to the minority shareholders. Corporate law provisions on fiduciary obligations of the controlling shareholders may reduce shareholder disputes and accordingly reduce the agency costs. The comparative parts of this research examine unfair prejudice cases on the 'moral obligations' of the controlling shareholders on the other shareholders, eg courts considering the underlying reasons for being a member of a quasi-partnership in *O'Neill v Phillips*.[449] The codification of these moral obligations of controlling shareholders may act as a proactive measure to minimise agency costs in relation to the second agency problem. Furthermore, incorporating the moral obligation of controlling shareholders into the corporate law may result in increasing the efficiency of the firm and the protection of minority shareholders' rights.

[446] Wicks, Elmore and Kraakman (n 283) 100 – 101; also see Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 43.
[447] Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 43.
[448] ibid 27.
[449] O'Neill and another v Phillips and Others [1999] 1 WLR 1092.

Both the trusteeship strategy and the appointment of independent directors to the board are important concepts mentioned in *The Anatomy of Corporate Law*[450] as monitoring devices for reducing agency costs. Independent directors on a company board are motivated to safeguard the interests of all stakeholders, including shareholders as a class. This is because the independent directors are motivated by upholding their personal reputations, professionalism and specifically to secure their job market opportunities.[451] Majority shareholders have an incentive to act opportunistically through their represented non-independent directors, but this incentive is not available through independent directors. Thus, the trusteeship strategy contributes to reducing agency costs and assists in protecting minority shareholders' interests. However, the effectiveness of the operation of trusteeship strategies in practise is still unproven. Nevertheless, there can be circumstances in which an independent director may act in the interest of a controlling shareholder owing to financial benefits. In other words, those instances where excessive compensation packages have been approved by boards of directors, including with the approval of independent directors. Thus, independent directors may also engage in an opportunistic behaviour rather than acting in the interests of the company.[452] Likewise, opportunistic behaviours by corporate actors cannot be 100% reduced through legal mechanisms. However, monitoring mechanisms could be implemented to create a check and balance for corporate actors. In other words, minority shareholders may question the board of directors or independent directors around the approval of their excessive compensation packages. Furthermore, corporate law could impose heavy sanctions against the independent directors for breach of their fiduciary duties.

Oppression and unfair prejudice remedies act as a proactive measure to prevent controlling shareholders from engaging in oppressive and unfairly prejudicial conducts against minority shareholders. In other words, proactive measures against controlling shareholders' incentive to act in opportunism. The comparative part of this research will focus on examining the decided cases on oppressive conduct in which controlling shareholders have engaged to oppress minority shareholders. Thereafter, it will be considered whether the prohibiting clauses in respect of such oppressive conduct by controlling shareholders can be incorporated into the corporate law. For instance, incorporating mandatory provisions on prohibiting share interest dilution of minority shareholders by the controlling shareholders.[453] This will increase the rights of minority shareholders. It is arguable that oppression,

450 Kraakman and others (n 3).
451 Enriques and others (n 432).
452 Werder, 'Corporate Governance and Stakeholder Opportunism'(n 419) 1353.
453 Dodd (n 438) 784.

mismanagement and unfair prejudice remedies as a proactive legal mechanism – coupled with trusteeship strategies to prevent the controlling shareholders from acting in opportunism – can provide efficient results to reduce the agency costs in the second agency problem.

3.8 General principles of the stakeholder approach in corporate governance

The great debate between Adolph Berle and Merrik Dodd has created two perspectives on corporate governance, which feature 'corporate capitalism' and 'corporate communism' views, respectively. Berle argued that the ultimate object of the firm is shareholder primacy with increased competition for innovation; for Dodd, it is to secure employment, quality products for customers and contributions for the good of society.[454] Despite the links between stakeholderism and socialism, 'corporate capitalism' and 'corporate communism' are highly controversial terms among corporate scholars;[455] David Millon has used the words 'economic man' and 'communitarian man' in place of these two terms.[456]

As a result of this great debate, the idea of stakeholder strategy in economics first came to light during the mid-1980s. Freeman's book *Strategic Management – A Stakeholder Approach* (1984) can be mentioned here as an important scientific book on the emergence of stakeholder strategy in economics.[457] Freeman's work on stakeholder strategy is based on previous work by Ian Mitroff and Richard Mason, as well as James Emshoff.[458] Edward Freeman and John McVea state that research on stakeholder strategy is taking place in four sub-fields: corporate governance and organizational theory, strategic management, normative theories of business and corporate social responsibility and performance.[459] Stakeholders are identified as a group of individuals who are affected by and/or can affect the achievement of an

[454] Jeffrey S Harrison, Robert A Phillips, and R Edward Freeman, 'On the 2019 Business Roundtable: Statement on the Purpose of a Corporation' (2019) 46 (7) Journal of Management 1223, 1226.

[455] Intellectual roots of stakeholder approach can be found in Christian socialism. See Rich Lowry, 'Staking out the Center' (1996) NAT'L RE 21, 21.

[456] David Millon, 'Communitarianism Corporate Law: Foundations and Law Reform Strategies' in Lawrence E Mitchell (ed), *Progressive Corporate law* (Westview Press 1995).

[457] Freeman, *Strategic management: A stakeholder approach* (n 29).

[458] Richard O Mason and Ian I Mitroff, *Challenging Strategic Planning Assumptions: Theory, Cases, and Techniques* (1st edn, Wiley-Interscience 1981).

[459] Richard Freeman and John McVea, 'A Stakeholder Approach to Strategic Management' in M Hitt, R Freeman and J Harrison(eds), *The Blackwell handbook of strategic management* (Blackwell 2001).

organisation's objectives.[460] Proponents of the stakeholder approach support the view that the managers/directors, in addressing the daily affairs of the company, should take other stakeholders' interests into consideration in addition to the shareholders' interests. Millon states that the company has obligations to non-shareholder stakeholders that extend beyond mere contractual obligations.[461] Freeman argues that the total value that a firm creates is not only the value created for shareholders, but also the value created for its customers, suppliers, financiers, employees and communities.[462] Phillips and others argue that the idea of stakeholder thinking is as follows:

> Business is a set of value-creating relationships among groups that have a legitimate interest in the activities and outcomes of the firm and upon whom the firm depends to achieve its objectives. It is about how customers, suppliers, employees, financiers (stockholders, bondholders, banks, etc.), communities, and management work cooperatively to create value. Understanding a business means understanding how these relationships work. The manager's job is to shape and direct these relationships.[463]

The stakeholder approach is gaining popularity among academic scholars in the UK, where some scholars identify the company by reference to its non-shareholder stakeholders – including society at large – *potentially having a 'stake' in the business*. Furthermore, UK regulations secure fair treatment for all the stakeholders of the company.[464] The influence of the stakeholder approach on UK corporate law is examined further in the comparative part of this research.

3.8.1 Contentions of the stakeholder approach

The main argument of stakeholderism scholars is that the stakeholder approach benefits the company in the long term. As Bainbridge states that in communitarians' view, '… *corporate decisionmakers need to be sensitive to the needs of all the corporation's constituencies; fair dealing requires that intercorporate relationships not to be unilaterally abrogated to benefit shareholders*'.[465] In addition, several scholars advocating this approach have openly criticised the theory of the firm in

[460] ibid 180.
[461] Millon (n 456).
[462] Harrison (n 468) 1229.
[463] Phillips and others (n 401) 3.
[464] Cheffins, 'Corporations' (n 113) 502 and 505.
[465] Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241) 875.

terms of company management. Ghoshal has argued that '*bad management theories are destroying good management practices*',[466] while Stout has argued that the shareholder primacy model has led to harmful management practices.[467]

Proponents of the stakeholder approach argue against the basic premise of the theory of the firm, which targets short-term profit maximisation for one group of stakeholders, namely, the shareholders. It is further argued that short-termism only brings positive results in the short run at the expense of the long run.[468] In fact, stakeholderists argue that having managers act in the long-term interest of the company ultimately benefits the shareholders' interests in the long term. Moreover, it is argued that all stakeholders are equally important because they all have moral standings.[469] Thus, in contrast to the theory of the firm, the stakeholder approach relies more on 'ethical views' and 'resource-based' ideas.[470]

Donaldson and Preston have proposed a four-part taxonomy for the stakeholder approach: descriptive, instrumental, normative and managerial.[471] Scholars such as Donaldson, Preston and Jones have worked on non-normative stakeholder models – including instrumental stakeholder theory (IST) – as an alternative economic theoretical framework to analyse the stakeholder approach.[472] IST has recently gained considerable attention owing to the global financial crisis in 2008 and the COVID-19 pandemic. It is based on the assumption that '*firms that contract (through their managers) with their stakeholders on the basis of mutual trust and cooperation will have a competitive advantage over firms that do not*'.[473] The two objectives of IST are advancing social welfare (morally legitimate social systems) and preserving

466 Sumantra Ghoshal, 'Bad management theories are destroying good management practices' (2005) 4 Academy of Management Learning & Education 75, 76.

467 Lynn A Stout, *The shareholder value myth: How putting shareholders first harms investors, corporations, and the public* (Berrett-Koehler 2012).

468 See Jeffrey S Harrison and James O Fiet, 'New CEOs pursue their own self-interests by sacrificing stakeholder value' (1999) 19 Journal of Business Ethics 301; Robert S Kaplan and H Thomas Johnson, 'Relevance lost: The rise and fall of management accounting' (Harvard Business School Press, 1987); ibid.

469 R Edward Freeman and John F Mcvea, 'A Stakeholder Approach to Strategic Management' (2001) Darden Graduate School of Business Administration, Working paper No. 01-02 <https://ssrn.com/abstract=263511> accessed on 30th March 2021 11.

470 Freeman, *Strategic management: A stakeholder approach* (n 29) and R Edward Freeman, Andrew C Wicks and Bidhan Parmar, 'Stakeholder theory and the corporate objective revisited' (2004) 15 Organisation Science 364.

471 Harrison (n 468) 1229.

472 Thomas Donaldson and Lee E Preston, 'The stakeholder theory of the corporation: Concepts, evidence, and implications' (1995) 20 Academy of Management Review 65-91; Thomas M Jones, 'Instrumental stakeholder theory: A synthesis of ethics and economics' (1995) 20 Academy of Management Review 404-437.

473 ibid 422.

key elements of shareholder wealth maximisation.[474] Jones argues that ethical management of the firm through IST principles such as, inter alia, fairness, trustworthiness, respect, loyalty, care and cooperation reduces contracting costs between firms and stakeholders.[475] Jones and Harrison also contend that from an agency cost perspective, both monitoring costs and bonding costs will be reduced because actors can trust that an agreement will be satisfied and they do not have to worry about opportunistic behaviour. Furthermore, residual loss will be reduced because expenditure on the monitoring and bonding mechanisms will be lower. Jones and Harrison further argue that from a transaction cost perspective, ethical treatment can reduce transaction costs, including searching costs, negotiating costs, monitoring costs, enforcement costs and residual loss.[476]

3.8.2 Mainstream strategic theories and the stakeholder approach

Harrison and John have successfully integrated ideas from mainstream strategy theories, such as industrial organization economics, the resource-based view, cognitive theory and the institutional view of the firm, together with the stakeholder approach.[477] These combinations have led to the expansion of the stakeholder approach. For instance, many arguments in the stakeholder approach are based on the resource-based view, ie constructive stakeholder relations represent important resources.[478] Stakeholder scholars analysing *the processes by which different stakeholders provide or represent important resources of the firm argue that the differences in the competitive advantage of firms in the same industry or product market can be traced back to differences in the access, configuration, and combination of resources.*[479] This provides efficient management of resources and increases profitability. In turn, data in relation to stakeholder inputs to the firm can be efficiently analysed by utilising advanced technology such as artificial intelligence (AI) to increase profitability and sustainability. Indeed, evidence has shown that incorporating the stakeholder approach into corporate governance could

474 Jones and Harrison (n 370) 77.

475 Jones, 'Instrumental stakeholder theory: A synthesis of ethics and economics' (n 472).

476 Jones and Harrison (n 370) 77 and 78.

477 Freeman and McVea, 'A Stakeholder Approach to Strategic Management' (n 469) 23.

478 Jeffrey S Harrison,, Douglas A Bosse, and Robert A Phillips, 'Managing for stakeholders, stakeholder utility functions, and competitive advantage' (2010) 31 Strategic Management Journal 58.

479 Konstantin Bottenberg, Anja Tuschke, and Miriam Flickinger, 'Corporate Governance Between Shareholder and Stakeholder Orientation: Lessons From Germany' (2017) 26(2) Journal of Management Inquiry 165, 171.

amount to long-term increases in shareholder value thanks to higher financial performance, innovations and the effective use of resources.[480]

3.8.3 The debate between stakeholderists and contractarians

The conflict between shareholding stakeholders and non-shareholding stakeholders continues to grow. Neo-classicists like Friedman have argued that firms should focus only on enhancing returns for shareholding stakeholders, while non-shareholding stakeholders' interests should be disregarded in decision-making.[481] On the other hand, stakeholderists such as Freeman, Jones and Felps have argued that firms should take all stakeholders' interests into account in decision-making, and that doing so is in the shareholders' long-run interest.[482] Contractarians argue that external environment law and labour law are the preferred methods of addressing the problems of the non-shareholder stakeholders. However, stakeholder theorists argue that corporate governance should vest responsibilities on directors/managers to consider non-shareholder stakeholders' interests in corporate decision-making. This research aims to strike a balance between the interests of shareholders and those of non-shareholder stakeholders in corporate affairs. This aim is supported by both Merrick Dodd and Berle and Mean's arguments on the role of the business organisation. Dodd's notion is that '*the adoption of a new concept of the corporation by which the community may demand that it 'serve not alone the owners or the control but all society*',[483] while Berle and Mean posit that the firm '*needed to be understood not only as a business entity but also has a social and political institution*'.[484] Dodd adds that the interests of all stakeholders can only be given due regard through legislation.[485] Thus, I believe that balancing the interests of both shareholders and non-shareholder stakeholders can be achieved through efficient corporate law provisions.

480 Harrison (n 468) 1227.

481 Milton Friedman, 'The social responsibility of business is to increase its profits' (1970) 13 New York Times Magazine 32.

482 See – Freeman, *Strategic management: A stakeholder approach* (n 29);Thomas M Jones and Will Felps, 'Stakeholder happiness enhancement: A neo-utilitarian objective for the modern corporation' (2013) 23 (3) Business Ethics Quarterly 349;also see footnote 41 Stephen M Bainbridge, 'In Defence of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 Wash & Lee L Rev 1423, 1435.

483 Dodd (n 438) 785.

484 Cheffins (n 113) 4.

485 Dodd (n 438) 785.

In several jurisdictions, the business judgment rule allows corporate executives to take non-shareholder stakeholders' interests into account when making a corporate decision, especially the interests of local communities, employees and the environment. However, when doing so, the directors are required to consider the benefits accruing for the shareholders.[486] Legal measures can be incorporated into corporate law for directors to consider important stakeholders' interests in their corporate decision-making. In other words, directors could be given 'multi-fiduciary' duties towards non-shareholder stakeholders. While several stakeholderists have argued in favour of this approach, it has been opposed by contractarian scholars. For instance, Dodd's multi-fiduciary stakeholder view has been criticised by Adolf Berle, who states that such a view would lead to a '*social-economic absolutism of corporate administrators*'.[487] Furthermore, Green has said that '*managers responsible to everyone are responsible to no one*'[488] and that '*when conflicting stakeholder interests are present, corporate decision making might be paralysed and the efficiency and productivity might vanish*'.[489] Similarly, Marxoux has pointed out that *it is both conceptually and practically impossible to extend fiduciary duties of directors to multiple stakeholders.*[490] However, the court systems of common law countries can address each specific stakeholder issue for each company as they arise in court cases, if enabled through legislation.[491] Accordingly, substantial case law will be developed over time to establish legal principles on stakeholder-related issues; civil law jurisdictions can also codify possible circumstances of stakeholder issues through research and scenarios taken from common law.

The 2019 business roundtable has provided strong views on multi-fiduciary stakeholder duties under the theme '*the Purpose of a Corporation to Promote 'An Economy That Serves All Americans*'.[492] This maybe because of the prevailing

486 See Revlon, Inc v MacAndrews & Forbes Holdings, Inc 506 A.2d 173 (Del, 1986) and Green (n 214) 1411.

487 Green (n 214) 1418.

488 ibid 1417.

489 Green (n 214) 1417.

490 David Rönnegard and Craig N Smith, 'Shareholder Primacy vs. Stakeholder Theory: The Law as Constraint and Potential Enabler of Stakeholder Concern' in Jeffrey S Harrison and others (eds), *The Cambridge Handbook of Stakeholder Theory* (Cambridge University Press 2019) 125; Alexei M Marcoux, 'A Fiduciary Argument Against Stakeholder Theory' (2003) 13(1) Business Ethics Quarterly 1.

491 Rönnegard and Smith, 'Shareholder Primacy vs. Stakeholder Theory: The Law as Constraint and Potential Enabler of Stakeholder Concern' (n 490) 125.

492 Business Roundtable, 'CORPORATE GOVERNANCE: Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans', (1 Aug 2019) < https://www.businessroundtable.org/business-roundtable-

COVID-19 pandemic and its impact on the stakeholders involved. This highlights that managers should not only have fiduciary duties towards shareholders but for all the stakeholders of the firm. Harrison and James have argued that frontline corporate law experts have provided views that commitment to stakeholders' interests does not violate the fiduciary duties of managers. In other words, multi-fiduciary duties towards other stakeholders are not illegal.[493] As discussed above, fiduciary duties enable the moral and ethical duties of directors to be legally enforced. This allows cost reductions for the firm and increases its efficiency because the uncertainty in decision-making is minimised. Thus, according to the long-term benefit argument, the multi-fiduciary duties of directors to take the non-shareholder stakeholders' interests into account can result in increased long-term cost-efficiency, thereby benefitting the long-term interests of the firm and its shareholders. The comparative part of this research examines the existing legal provisions in corporate law and other legislation in protecting non-shareholder stakeholders, specifically focusing on the environment. This research finds that firms can benefit over the long term if corporate law can expand its protection to the environment.

The main argument of the contractarians is that when directors take decisions based on maximising profits for shareholders, the other stakeholders will ultimately benefit as well. Easter and Fischel argue that 'a successful firm provides jobs for workers and goods and services for consumers'.[494] From an environmental standpoint, their argument is that prosperous societies want cleaner air and water; thus, successful firms will take environmental concerns seriously. However, in a utopian world, Easter's and Fischel's view may be correct; the same is not always true of the real world, where many firms struggle to be successful. Moreover, on the road to success, plenty of opportunities will exist for the managers/directors of a business organisation to act in line with maximising the profits of shareholders at the expense of the environment. For instance, suffering from poverty before the year 1978, China's economy has since been mainly driven by rapid industrialisation: '*Air pollutants produced by extensive industrialization remain a major source of pollution in China*'.[495] In other words, over 40 years of corporate decisions have caused environmental pollution in China. This may be the case in many developing countries, and the data are not always available or accurate in other countries. Thus, corporate executives' decisions should be regulated to some extent through corporate

redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans> accessed on 26th February 2023.

493 Harrison and James (n 468) 1229.

494 Easterbrook, *The Economic Structure of Corporate Law* (n 130) 38 and Cheffins, 'Corporations' (n 113) 493.

495 Na Yang and others, 'Economic Growth and Pollution Emission in China: Structural Path Analysis' (2018) 10 Sustainability 1, 4.

law so that all companies are on the same level and achieve sustainability. The comparative part of this research aims to analyse decided cases on the business judgment rule's capability to make decisions that factor in non-shareholder stakeholders. Furthermore, it examines the existing 'multi-fiduciary' duties of directors in the selected jurisdictions. In the words of Green, finding existing answers to the stakeholder approach in a *body of law consists of a slate of varied priorities for corporate management through comparative principles.*[496]

It is clear from the above discussion that a conflict exists between the theory of the firm and the stakeholder approach in corporate governance. This has created several divisions among law and economics scholars and is greatly argued in the corporate governance literature. This division has also created several views on the firm, including those of contractarians and of communitarians. The former promote the theory of the firm, while the latter promote the stakeholder approach in corporate governance.[497] Millon differentiates this conflict into two perspectives. First, the stakeholder theorists focus on the '*sociological and moral phenomenon of the corporation as community*'; second, the contractarians focus on the '*individualistic, self-reliant, contractarian stance*' of mainstream corporate scholars.[498] Similarly, Bratton argues that *contractarians force society to evolve into a model in which everyone is capable of self-protection and is fully self-reliant.*[499] In other words, only the best will survive in society; in cost-effective firms, the influential and resourceful stakeholders will survive. In contrast, from a stakeholder theorist's perspective, stakeholders such as employees and communities will suffer, particularly in countries where corruption is high.

3.8.4 Stakeholder approach elements in the theory of the firm

This research aims to focus on bringing stakeholder ideas into the framework of principal-agent theory, ie the third generic agency problem, which indicates that the firm (through directors and shareholders) acts as the agent for the non-shareholder stakeholders as the principal. The third parties in this case would be shareholders and other stakeholders who would be affected by the agency relationship between

[496] Green (n 214) 1419.
[497] Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (n 241).
[498] Millon, 'Communitarianism Corporate Law: Foundations and Law Reform Strategies' (n 456).
[499] William W Bratton, 'Game Theory and the Restoration of Honour to Corporate Law's Duty of Loyalty' in Lawrence E Mitchell (ed) *Progressive Corporate law* (Westview Press, 1995).

the environment and the firm. This research further aims to identify agency costs in the third agency problem with a specific focus on environment as the non-shareholder stakeholder. Pursuant to identifying possible costs, it is the aim of this research to address cost-reduction mechanisms through legal means. Scholars have already examined the second agency problem discussed in this research and have introduced several legal mechanisms to reduce the corresponding agency costs. This research allows for law and economics scholars to explore several types of agency problems and the agency costs within the third agency problem in relation to the stakeholder approach.

The concept of the third agency problem within a firm encompasses several distinct yet interrelated types of agency conflicts, each representing different dynamics between principals, agents, and third parties. This intricate framework extends beyond traditional binary relationships to involve a range of stakeholders, significantly broadening the scope of agency considerations. In one notable type, the environment serves as the principal, assigning the role of agent to the firm itself, particularly its owners, with other stakeholders and shareholders involved as the impacted third parties. This setup underscores the growing emphasis on environmental stewardship, necessitating firms to balance their operational objectives with sustainable and eco-friendly practices. The firm's environmental policies, or lack thereof, can have far-reaching implications, affecting not only ecological aspects but also the interests and perceptions of other stakeholders and shareholders.

Similarly, employees, consumers, suppliers, and the local community can each be considered principals in their own unique agency problems with the firm. Employees entrust their welfare and career aspirations to the firm's leadership; consumers demand quality and value; suppliers require fair dealings and ethical practices; and the local community expects the firm to contribute positively to its socio-economic and wellbeing fabric. In all these dimensions, the firm, especially its owners, acts as the agent whose decisions and actions will resonate with a wider audience of stakeholders and shareholders.

The stakeholder approach, therefore, finds a comprehensive framework within agency theory, acknowledging the multifaceted relationships and responsibilities a firm maintains within its operational ecosystem. This perspective is not only academically intriguing but also pragmatically essential for policymakers. By understanding these subtle agency relationships, especially the firm's role as an environmental steward, policymakers are better positioned to fashion legal provisions that promote corporate responsibility, ethical business practices, and sustainable development. This holistic approach ensures that legal frameworks encapsulate the diverse interests and concerns of all parties, fostering a more balanced and equitable corporate landscape. The theory of the firm and the

stakeholder approach contain opposing views, and the tension in the debate between the two is increasing. Nonetheless, this research aims to focus on fashioning legal remedies to issues in corporate governance by utilising both these theories. The recently published and highly controversial report 'EY Study on Directors' Duties and Sustainable Corporate Governance'[500] indicates several goals to achieve through the stakeholder approach in corporate governance. Although this report has been heavily criticised by several scholars around the world, the goals indicated therein are not disputed.[501] As such, this research aims to find solutions through cost-effective and long-term value creation for the firm to increase sustainability in corporate governance, thereby achieving the goals stated in said report. Furthermore, this research aims to utilise oppression, mismanagement and unfair prejudice remedies as proactive enforcement mechanisms to achieve sustainability in corporate governance.

3.9 The third agency problem focusing on the environment as stakeholder

The third agency problem is a wider concept compared to the other two agency problems because several types of agency relationships exist within it. Stead has argued that the natural environment is a stakeholder because it can be affected by a firm's objectives, and *vice versa* it can influence the growth of a firm, eg through natural disasters or the provision of raw materials required for a business.[502] However, the natural environment is unable to articulate its stakes without human interaction, so the articulation is done by environmental interest groups.[503] These

[500] EY, 'Study on Directors' Duties and Sustainable Corporate Governance' Final Report (2020) <https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/languageen?mc_cid=664fe83cf0&mc_eid=657d91711d> accessed on 14th January 2021.

[501] Mark Roe and others, 'The European Commission's Sustainable Corporate Governance Report: A Critique' (2020) <https://www.hbs.edu/ris/Publication%20Files/21-056_51410b50-5488-477a-9aa3-df8f81138e53.pdf > accessed on 17th February 2021 and Andersen and others, 'Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars' (n 367).

[502] Hörisch and Schaltegger, 'Business, the Natural Environment, and Sustainability: A Stakeholder Theory Perspective' (n 281) 134; Edward W Stead and Jean Garner Stead, *Management for a small planet* (Sage Publication 1996) and Mark Starik, 'Should trees have managerial standing? Toward stakeholder status for nonhuman nature' (1995) 14 Journal of Business Ethics 207.

[503] See Ritva Pykäläinen-Syrjänen, *Säätiön tehokkuus: corporate governance -säännösten vaikutuksesta säätiön tarkoituksen tehokkaaseen toteuttamiseen* (WSOYpro 2007) (Pykäläinen-Syrjänen has considered environment in relation to the firm's efficiency).

groups increasingly collaborate with businesses to protect environmental interests.[504] Thus, the environment in the third agency problem consists of both the natural environment and these environmental interest groups (as the human interaction).

Agency costs generally arise in an agency problem because of the agent's incentive to act opportunistically towards the principal. The third agency problem has similar concepts to those discussed in the first and second agency problems. In other words, agency costs in relation to the third agency problem arise because of the firm's incentives to act opportunistically towards the environment, and corporate decisions are taken by the board and managers on behalf of the firm for its owners – the shareholders. In this instance, the firm can benefit at the expense of environmental interests to gain profit. In other words, large corporations with major funding can execute projects to gain profit by expropriating environmental interests. Additionally, the management of the firm that does so stands to benefit through better job opportunities in other firms and through other monetary bonuses. Thus, the management acting on behalf of the firm and its owners has the incentive to act in opportunism and, crucially, against the other stakeholders. This management opportunism in relation to the first agency problem is an important concept in agency cost theory, and the same concept is relevant to the third agency problem.

On the other hand, Werder has identified the presence of 'stakeholder opportunism', arguing that the management of the company can behave opportunistically not only towards its shareholders but also towards all its stakeholders. Werder further argues that each stakeholder can behave opportunistically towards other stakeholders; stakeholders thus bear the risk of being a victim of the opportunism acts of other stakeholders:[505]

> […] all stakeholders of a company can (and will to some extent) have options to behave opportunistically in the sense that they deliberately generate and (at the first 'opportunity') exploit incompleteness of their contracts with other stakeholders to unfairly increase their benefits at the expense of others.[506]

Werder's argument opens up further research into agency relationships among stakeholders. Opportunism exists in all the agency relationships in a firm because, in the business environment, the agent will always have an opportunity to act in '*self-*

This publication, being in Finnish, falls beyond the linguistic range of this study and is consequently not examined herein.

504 Hörisch and Schaltegger, 'Business, the Natural Environment, and Sustainability: A Stakeholder Theory Perspective' (n 281); Rob van Tulder and others, 'Enhancing the impact of cross-sector partnerships' (2016) 135 Journal of Business Ethics 1.

505 Werder, 'Corporate Governance and Stakeholder Opportunism' (n 419) 1345.

506 ibid (emphasis added).

interest seeking with guile'.[507] For instance, the firm may act opportunistically towards consumers when products sold are not up to the promised standard and cannot be returned or any legal action taken because doing so is not economically worthwhile.[508] This kind of opportunistic act would result in the firm's long-term reputational loss. In the long run, such opportunism can result in dire indirect economic losses to the firm that will ultimately affect all stakeholders.

Collective opportunism can also exist among stakeholders. Werder has argued that several stakeholders of the firm can form coalitions to exploit other stakeholders opportunistically. In other words, the firm, its employees, its shareholders and its communities can act in coalition to exploit the environment. The communities can be silent on environmental exploitation for many reasons, such as receiving private benefits in the form of donations or employment for the locals, employees receiving massive bonuses, or shareholders receiving higher dividends. Accordingly, two or more stakeholders can act opportunistically together to exploit the environment.

3.9.1 Agency costs in exploiting the environment

At this point, one can ask: What are the agency costs that the firm can suffer owing to the managers' opportunism towards the environment? Crucially, a firm could directly or indirectly suffer dire economic consequences for such actions. One such consequence is that a firm could suffer a long-lasting reputational loss, especially given the speed of information spread through social media in the contemporary world. Indeed, many of today's consumers consider the sustainability of a product and the manufacturer's sustainability credentials prior to purchasing. Thus, any reputational loss owing to environmental pollution may result in revenue loss. Furthermore, in public companies, the share value may decrease as a result of such reputational harm; in a private equity company, the selling price of a portfolio company may decrease. The risk can also result from indirect associations, such as supply chain partners' practices or investments in environmentally detrimental projects. Companies immersed in sectors with high environmental impact are particularly vulnerable to negative public perception and consequential market penalisation. The worst-case scenario would be that the company would have to shut down operations. For instance, the conglomerate-owned Latex Glove Factory had to be closed in Rathupaswala, Sri Lanka because its toxic waste had caused the

[507] Williamson, 'Markets and Hierarchies: Some Elementary Considerations' (n 290) 46.

[508] Eitan Gerstner and Barak Libai, 'Why does poor service prevail?' (2006) 25 (6) Marketing Sci. 601; Florian Wangenheim and Tomás Bayón, 'Behavioural consequences of overbooking service capacity' (2007) 71 (4) Marketing 36.

groundwater in the area to become acidic.[509] If the company had taken precautions and/or the necessary steps to monitor its disastrous environmental impact, it could have avoided the losses incurred from both shutting down the factory and relocating. Additionally, the pollution of the drinking water provoked the local community, and the ensuing public riots, which gained widespread media attention, led to a long-term reputational loss for the company. Together, these factors contributed to long-term residual loss for the firm and long-lasting damage to the natural environment, the latter of which could have been avoided if the company had taken protective measures at the beginning of its operations. In this example, the costs to take protective measures represent 'stakeholder costs' in transaction cost theory and 'monitoring costs' in agency cost theory. This could have prevented long-term residual loss for the investors.

Numerous examples exist of companies suffering economically because they acted opportunistically towards the environment or they did not give proper consideration to the environment as a company stakeholder.[510] For instance, the Exxon Shipping Company's decision to short-change investments in safety measures to increase its profit margins resulted in a massive economic loss to the company and caused environmental damage.[511] Analysing the Exxon incident, Alpaslan, Green and Mitroff, argue that '[...] *it may be both fair and efficient for corporations to have multiple objectives, and to put emphasis on moral claimants, not only on 'explicit' residual claimants*'.[512] It should be noted that environmental pollution matters are also pursued as human rights cases. For instance, many environmental pollution cases have been taken up in the European Court of Human Rights. Thus, it is important to take sustainability management seriously, particularly in a company in an industry that produces toxic waste. As stated in a recent study on directors' duties and sustainable corporate governance, '*the consequences of unsustainability are very serious and have EU-wide (and global) implications*'.[513] Furthermore, the above-mentioned Sri Lankan case is a good example of Jones and Harrison's argument that the *continuing pursuit of shareholder wealth maximisation is likely to*

[509] Centre for Environmental Justice (guarantee) limited and others vs Central Environmental Authority and others C.A. (Writ) Application No. 385 of 2013.

[510] Cordella and Others v. Italy (applications nos. 54414/13 and 54264/15) and also see European Court of Human rights, Annual report 2020, 17. <https://www.echr.coe.int/Documents/Annual_report_2020_ENG.pdf > accessed on 8th March 2021.

[511] Wicks, Elmore and Kraakman (n 283) 103.

[512] Can M Alpaslan, Sandy E Green and Ian I Mitroff, 'Corporate governance in a context of crises: Towards a stakeholder theory of crisis management' (2009) 17 (1) Journal of Contingencies and Crisis Management 38, 47.

[513] EY, 'Study on Directors' Duties and Sustainable Corporate Governance' (n 500) vi.

be unsustainable if the firm become increasingly separated from the communities in which they operate.[514]

The recent EY study notes that the main cause of unsustainability is corporate governance that focuses on 'short-term' benefits rather than the long-term benefits of the firm. The report identifies seven key problem drivers of long-term sustainability risks that result in *overwhelming environmental, social, and economic consequences for companies, shareholders, investors, and society at large.*[515] It further indicates that as a result, it is unlikely that the goals set in the Paris Agreement and the UN's SDGs can be met. Accordingly, the provisions of directors' duties in corporate law are one of the major elements requiring reforms to achieve long-term sustainability. However, the report has been highly controversial and criticised by several scholars who contend, inter alia, that it has not defined the problem properly and that the evidence presented is inapposite.[516] One group of Nordic scholars has criticised the report by stating, inter alia, that it fails to understand the legal discourse and that because of uncertainty, directors may not be able to foresee long-term sustainable risks.[517] They further observe that the concept of the 'business judgment rule' does not hold honest directors liable for such failure to foresee honest mistakes.

3.9.2 Legal strategies in environmental agency costs

Through the business judgment rule, corporate law can provide guidance for directors to take decisions while considering stakeholder interests alongside the long-term interests of shareholders. Legislation such as environmental law already provides a framework for directors to take corporate decisions accordingly. However, the question is whether said external laws are sufficient to proactively reduce the agency costs that can result from the third agency problem. In practice, these external laws mainly act as sanctions that can damage the company's reputation, causing an economic loss. This will affect the other stakeholders, including the shareholders' long-term interests. Accordingly, it will be too late for shareholders' intervention to question directors for their acts of opportunism towards the environment, and the sanctions for violating the environmental laws will result in the firm suffering an economic loss. Thus, in the contemporary world, investors consider corporate law provisions to protect non-shareholder stakeholders in their respective jurisdiction.

514 Jones and Harrison (n 370) 87.
515 EY, 'Study on Directors' Duties and Sustainable Corporate Governance' (n 500) vi.
516 Roe (n 501) 16.
517 Andersen and others, 'Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars' (n 367).

Wicks, Elmore and Kraakman have argued that a board of directors is created to ensure that the firm operates within the legal and ethical parameters set by society.[518] However, the question is then whether the board of directors could act within these ethical parameters in respect of non-shareholder stakeholders when doing so conflicts with the shareholder wealth maximisation norm that is clearly provided in corporate law and case law. As shown above, directors may have an incentive to act opportunistically towards the environment to gain short-term benefits in the stock market and improve their job market opportunities. When the firm is suffering a long-term economic loss (eg loss of ethical reputation) owing to the opportunistic decision-making of dishonest directors, without any due regard to other stakeholder interests, those directors may even already have been recruited by another firm, or they may even bring a defence through the business judgment rule for their opportunistic acts, providing a rationale that the decision was taken to benefit the shareholders' interest in profit maximisation. After all, the director's decision is interpreted according to the business judgment rule, and the interpretation may be favourable towards the dishonest directors because it is presumed that the directors act in the best interests of the company, and corporate law provides a background for such actions in pursuit of shareholder wealth maximisation. Thus, incorporating multiple fiduciary duties towards the non-shareholder stakeholders may remedy this presumption. This highlights the importance of protective provisions relating to non-shareholder stakeholders' interests in corporate law. In this way, it would be difficult for dishonest directors to circumvent short-term opportunistic decisions through the business judgment rule. However, these provisions should be drafted without impeding the shareholders' interest in profit maximisation; rather, corporate governance should provide guidelines for directors to balance the two interests. Evidently, the concept of fiduciary duties plays a sizeable role in this balancing act between the interests of shareholders and non-shareholder stakeholders. In most jurisdictions, the director's fiduciary duties are only in relation to the first agency problem, ie towards the shareholders.

Scholars have identified that these fiduciary duties reduce the agency costs and increase the efficiency of the firm. Thus, it can be argued that incorporating directors' fiduciary duties towards the non-shareholder stakeholders into corporate law may reduce agency costs that can arise in the third agency problem. Directors' fiduciary duties prohibiting environmental pollution would allow shareholders to take prompt actions restricting such decision-making through the enforcement mechanism of the mismanagement remedy: shareholders may bring an action for mismanagement of the company for violating its fiduciary duties, because said

[518] Wicks, Elmore and Kraakman (n 283) 99.

violation may indirectly affect the shareholders' long-term interests. This would represent a proactive measure to halt possible actions by directors that could bring long-term reputational and economic losses to the firm. In this case, the mismanagement remedy would function as the proactive measure to enforce the directors' multi-fiduciary duties. Coupled with directors' duties and mandatory provisions, the mismanagement remedy could be utilised to efficiently reduce costs in the aforesaid third agency problem, especially long-term residual losses.

Benefit corporation statutes in various US states have adopted common features that would facilitate sustainability in corporate governance. In other words, the statutes have incorporated fiduciary duties for directors to include the interests of non-shareholder stakeholders in their corporate decision-making process, while also foregrounding accountability by requiring the firm's social and environmental performance to be reported to an independent third party.[519] Furthermore, the Corporate Constituency Statutes (CCSs) adopted by several US states require and/or allow directors to consider the interests of non-shareholder stakeholders in their decision-making. Millon argues that CCSs allow directors to have fiduciary duties towards non-shareholder stakeholders.[520] For instance, the UK has already implemented directors' multi-fiduciary duties towards non-shareholder constituencies in connection to the success of the firm: Section 172 provides that the directors of a company should act in good faith to promote the success of the company for the benefit of its *members as a whole.*[521] This section further mentions that directors should give due regard to the non-shareholder stakeholders' interests in their corporate decision-making, while Section 172 (1) (d) provides for the *impact of the company's operations on the community and the environment.*[522] This research attempts to respond to the goals set by the aforementioned study on directors' duties and sustainable corporate governance, which are to achieve the objectives of the UN SDGs and those of the Paris Agreement and to preserve the principles of *private property rights, efficiency and innovation by competition, shareholder rights, and cross-border economic activity by establishment, service or out-sourcing.*[523]

Oppression, mismanagement and unfair prejudice remedies strengthen minority shareholders' rights, and these remedies can thus assist companies to attract small-scale investors, resulting in their ability to easily increase capital. Together with the stakeholder protection provisions mentioned above, these oppression,

[519] Jones and Harrison (n 370) 91.
[520] Wicks, Elmore and Kraakman (n 283) 101.
[521] See Section 172 of the United Kingdom companies Act 2006.
[522] ibid.
[523] Andersen and others, 'Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars' (n 367) 24.

mismanagement and unfair prejudice remedies can promote the contractarian view that attracting investments is vital to a company. Indeed, the recent research on the relationship between investments and the interests of non-shareholder stakeholders suggests that investors tend to invest in companies with a low cost in fulfilling non-shareholder stakeholders' interests and a high perceived sustainability, to the benefit of the long-term success of the company.[524] Furthermore, recent research has found that private equity ownership leads to a 70% reduction in the use of toxic chemicals and a 50% reduction in CO_2 emissions.[525] It has also been found that this reduction can be explained by two economic reasons. The first is that '*better corporate governance following the private equity acquisition leads to a reduction in pollution when it maximizes long-term shareholder value*'. Second, an environmentally friendly company's reputation increases the selling price of the portfolio company.[526] Accordingly, the third agency problem can be utilised to reduce the agency costs while still fulfilling non-shareholder stakeholders' interests. In turn, the oppression, mismanagement and unfair prejudice remedies – combined with mandatory provisions in corporate law – can be utilised to implement low-cost mechanisms to assist or guide managers to take decisions that consider non-shareholder interests. Furthermore, general corporate law provisions fashioned in line with sustainability provisions can be utilised to level the playing field for all companies to take decisions in light of the long-term sustainability of the firm and without receiving any negative effects from competitors.

An empirical study by Guillén and Capron has found that minority shareholder remedies such as the oppression remedy have integrated robust markets by higher capitalisation through the strengthening of small-scale investors' rights as a means to attract several small-scale investments to expand the business.[527] Thus, it can be argued that the incorporation of mandatory corporate law provisions around sustainability, coupled with oppression, mismanagement and unfair prejudice remedies, can attract investments that allow SMEs to easily increase private equity when needed to grow, expand and develop. Furthermore, considering the aspect of increased selling price of portfolio companies, foreign investors would tend to invest

[524] Tanja Schwarzmüller and others, 'Investors' reactions to companies' stakeholder management: the crucial role of assumed costs and perceived sustainability' (2017) 10 Business Research 79, 80.

[525] Bellon Aymeric, 'Does Private Equity Ownership Make Firms Cleaner? The Role of Environmental Liability Risks' (2020) European Corporate Governance Institute – Finance Working Paper No. 799/2021, Available at SSRN <http://dx.doi.org/10.2139/ssrn.3604360 > accessed on 14th April 2021.

[526] ibid 31.

[527] Guillén and Capron, 'State Capacity, Minority Shareholder Protections, and Stock Market Development' (n 2) 125 and 135.

in companies situated in jurisdictions that promote sustainability. It is evident from the comparative part of this study that the unfair prejudice remedy provides wider protection compared to the oppression and mismanagement remedies. Nonetheless, the economic aspects discussed here highlight the importance of incorporating elements of all three (oppression, mismanagement, unfair prejudice) remedies.

3.10 Comments on the third agency problem in general

The agency problem between the firm and its employees falls under the third agency problem. This agency problem has been extensively addressed in the law and economics literature, specifically by scholars such as Blair, Roe, Heery, Wood, Jackson, Gospel and Pendleton.[528] Cheffins states that employees are an integral part of a company because they develop *firm specific skill throughout their employment* and hence they cannot be separated from the affairs of the company.[529] If a firm exploits its employees, they may leave and join a competitor, taking the skills developed during the former employment with them. Thus, the firm will lose skilled employees and sustain long-term economic losses owing to the competitor firm benefitting from the skilled employees. As a result, the firm will have to bear higher costs if the agency relationship between the firm and the employees is not properly managed. In response, corporate governance should *ex ante* address the agent's opportunism that is present in all the agency categories within the third agency problem.

The agency problem between the management (firm) and non-shareholder stakeholders and among these stakeholders lacks research in this field. The opportunism of both the firm and its stakeholders within the third agency problem can create exorbitant costs and reduce the efficiency of the firm. Specifically, corporate executives acting in opportunism towards the environment, and taking corporate decisions to maximise the firm's profits without due consideration for the environment could result in exorbitant costs that the firm may have to bear over the long term, mainly resulting from loss of reputation. The effects of said opportunism towards the environment could also create long-term negative consequences to the

[528] See Charles R Knoeber, *Employees and Corporate Governance* (M M Blair, and M J Roe, eds, Brookings Institution Press 1999); Edmund Heery and Stephen Wood, 'Employment relations and corporate governance' (2003) 41 (3) British J. Indust. Relations 477; Jackson Gregory, 'Stakeholders under pressure: Corporate governance and labour management in Germany and Japan' (2005) 13 (3) Corporate Governance: Internat. Rev. 419; Howard Gospel and Andrew Pendleton, *Corporate Governance and Labour Management: An International Comparison* (Oxford University Press 2006).

[529] Cheffins, 'Corporations' (n 113) 11.

public or society. For instance, the lack of clean drinking water in the case of Rathupaswala, Sri Lanka owing to groundwater contamination with toxic waste. Thus, the circumstances in which the stakeholders can act opportunistically should be identified by researchers and addressed categorically through provisions of corporate law. As Werder states, firms can be '*conceptualized as a network of actors that are characterized by specific opportunism option and opportunism risk profiles*'.[530] Such conceptualisation as a network of actors in relation to opportunism can be utilised in proactive policymaking to reduce the costs arising from opportunism. Ultimately, the above discussion on the third agency problem between the management (firm) and the non-shareholder stakeholders supports the position that the stakeholder approach can be connected with agency problem theory for efficient policymaking purposes. As Freeman has argued, stakeholder theory and shareholder theory *are not necessarily incompatible.*[531]

When making corporate decisions, the management can act opportunistically towards other non-shareholder stakeholders. As shown above, multi-fiduciary duties and regulations backed by sanctions protecting non-shareholder stakeholders would prevent or minimise the management's incentives to act opportunistically towards the other stakeholders. As Werder notes, when an actor (eg shareholders, managers, directors, stakeholders) make a decision to act opportunistically, they will have to give consideration to the legal protection afforded by laws such as, inter alia, corporate law, environmental law, capital market law, labour law, contract law (contractual agreements entered between parties) and consumer protection law.[532] These laws affect corporate decisions and act as proactive countermeasures against acts of opportunism. However, as discussed above, the business judgment rule will safeguard dishonest directors' opportunistic actions towards stakeholders, and the firm will still have to suffer any external legislative sanctions and reputational losses. This highlights the importance of corporate law mandatory provisions to protect stakeholder interests. Further, Matten and Crane have argued that corporate law could empower stakeholder democracy meaning that stakeholders '*can play a role in managing the relationship between us as citizens and corporations as*

530 Werder, 'Corporate Governance and Stakeholder Opportunism' (n 419) 1347.

531 Rönnegard and Smith, 'Shareholder Primacy vs. Stakeholder Theory: The Law as Constraint and Potential Enabler of Stakeholder Concern' (n 490) 118; Edward R Freeman and others, *Stakeholder theory: The state of the art* (Cambridge University Press 2010).

532 Axel V Werder, 'Ökonomische Grundfragen der Corporate Governance' in P Hommelhoff, K J Hopt and A V Werder (eds), *Handbuch Corporate Governance: Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis* (2nd ed, Schäffer Poeschel 2009); Werder, 'Corporate Governance and Stakeholder Opportunism'(n 419) 1352.

administrators of our citizenship'.[533] I believe that stakeholder democracy can be given effect by imposing rights on stakeholders to appoint representatives to the board. Similarly, Galai and Wiener have suggested that stakeholder board representatives can reduce agency costs for the firm.[534] In this regard, the comparative part of this research focuses on finding each jurisdiction's function of the law in protecting the environment as a non-shareholder stakeholder. More specifically, the factors that will be researched are legal provisions relating to stakeholder democracy, the *outcome of the cases filed in the court in relation to the environment*, *easiness or difficulty to enforce the legal protection afford against the violation*, and the *legal sanctions for wrongdoers.*[535]

3.11 Agenda for future research

There is a current dearth of studies on the second and third agency problems, especially on the third type of agency relationship. This research does not focus on Orts's horizontal (mutual) relationships in the firm.[536] Orts argues that a mutual relationship exists between two partners where the bargaining power to take decisions is equal in corporate settings. Highlighting the interdependencies of opportunism, Werder has argued that opportunism can exist between the non-shareholder stakeholders and between groups of stakeholders.[537] Thus, according to Orts's mutual relationships' contention it can be argued that opportunism can exist between two principals in the web of third agency relationships. In other words, in the third agency problem, two agency relationships can exist. The first is between the firm as the agent and the environment as the principal. The second is between the firm as the agent and the consumer as the principal. For instance, in relation to these two agency relationships, the consumer may require lower-price products at the expense of environmental interests. Companies incorporated in a jurisdiction that provides higher environmental and/or labour protection may invoke additional costs that result in a higher price tag for the product. As a result, consumers may purchase a lower-price product from a company incorporated in a jurisdiction that does not

533 Dirk Matten and Andrew Crane, 'Corporate citizenship: Toward an extended theoretical conceptualization' (2005) 30 (1) Academy of Management Review 166, 177.

534 Rönnegard and Smith, 'Shareholder Primacy vs. Stakeholder Theory: The Law as Constraint and Potential Enabler of Stakeholder Concern' (n 490) 124; Zvi Wiener and Dan Galai, 'Stakeholders and the composition of the voting rights of the board of directors' (2008) 14 (2) Journal of Corporate Finance 107.

535 Werder, 'Corporate Governance and Stakeholder Opportunism' (n 419) 1352.

536 Orts, *Business Persons: A Legal Theory of the Firm* (n 35) 58.

537 Werder, 'Corporate Governance and Stakeholder Opportunism' (n 419) 1348 and 1349.

pay as much attention to the pollution of the environment and/or the exploitation of labour. Thus, in this case, one principal is acting opportunistically towards other principals:

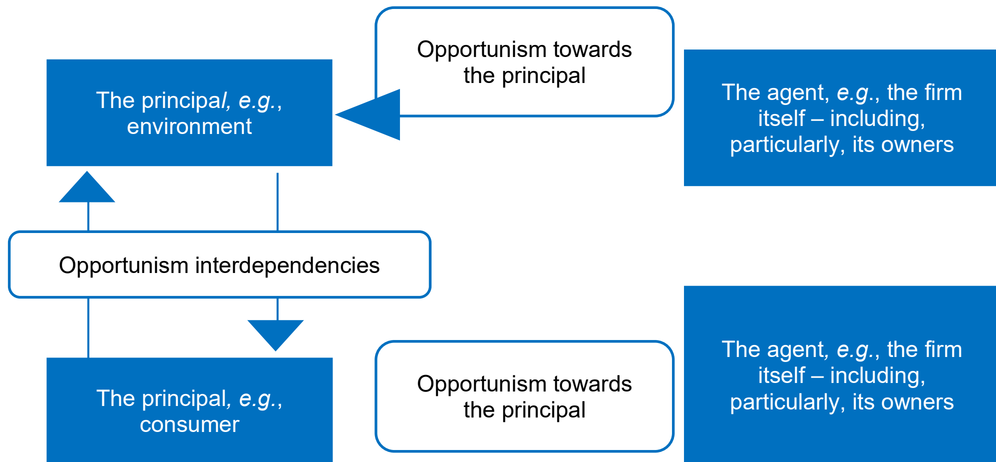

Figure 3 - Opportunism interdependencies

Furthermore, Perrow argues that positivist agency theorists have not given much thought to possible events in which principals may act opportunistically by deceiving, shirking or exploiting the agents.[538] In other words, external groups may act opportunistically in the interest of competing firms to unnecessarily burden companies with spending on safety measures owing to the influential power of external environmental groups. Legal provisions should therefore be able to fashion a balance mechanism to safeguard the interests of all parties in line with the different needs of the environment, the economy and society, as well as business growth. In turn, the identification of the types of agency problems and the existence of opportunism will assist policymakers in fashioning legal rules to efficiently deliver justice while giving their economic aspects full consideration.

3.12 Remarks

Approaches from the field of law and economics can be utilised to promote efficient legal drafting. This research shows that two or more economic theories can be utilised in legal drafting by carefully balancing the elements of these economic theories. In legal drafting, the balancing approach may increase efficiency in

[538] Charles Perrow, *Complex organizations* (Random House 1986).

delivering justice. Both theories utilised in this research address the shortcomings of one another. In other words, as Choudhury and Petrin argue, the contractarian approach through *increased risk-taking and neglect of non-financial impacts of corporate activities could lead to negative corporate externalities*, resulting in long-term losses to the corporation. On the other hand, the stakeholder approach could *impair innovation and economic growth if it substantially reduces capital investment and results in costs that are difficult for businesses to absorb.*[539]

Combining both these theories and drafting laws to address their respective shortcomings would provide a sustainable and efficient corporate governance framework. Crucially, it is important to strike a balance between both theories' perspectives. In other words, the stakeholder approach promotes sustainability by considering the environment in corporate governance, while the theory of the firm promotes innovation and economic growth. Economic developments cannot take place with zero cases of pollution of the environment, especially in the context of developing countries, as observed by Phillips and Reichart.[540] Realistically, therefore, directors cannot take corporate decisions that can be fully environmentally friendly. This is particularly relevant in industries such as, inter alia, energy supply, chemical production, *etc*.[541] Thus, special care should be taken in relation to firms operating in certain industries and allowing honest directors in such firms to rely on the business judgment rule when drafting corporate laws to protect the environment. Contractarians argue that the creation of corporate profit would result not only in wealth creation but also the transfer of resources from non-shareholder stakeholders to the firm.[542] Thus, it is unavoidable in specific industries to halt such resource transfer. However, corporate law should be able to halt excessive pollution of the environment. Moreover, it must be able to create a legal background for high-risk companies to compensate for environmental pollution caused by industrial activities. Corporate law could also provide guidance on aspects of public policy for such companies to engage in alternative approaches to contributing to stakeholders.[543] For instance, investing in research and development projects to promote sustainable

539 Barnali Choudhury and Martin Petrin, 'Corporate governance that "works for everyone": promoting public policies through corporate governance mechanisms' (2018) 18 (2) Journal of Corporate Law Studies 381, 390.

540 Robert A Phillips and Joel Reichart, 'The environment as a stakeholder? A fairness-based approach' (2000) 23 Journal of Business Ethics 185–197.

541 See European Environment Agency <https://www.eea.europa.eu/data-and-maps/indicators/industrial-pollution-in-europe-3/assessment > accessed on 9th March 2021.

542 Choudhury and Petrin (n 539) 392.

543 ibid 392.

products and technologies. In this way, legal measures can be taken to balance both the interests of contractarians and stakeholderists.

This research shows that oppression, mismanagement and unfair prejudice remedies coupled with provisions in corporate law can strike the necessary balance between the general interests of the contractarians and the stakeholderists. In other words, these remedies facilitate the attraction of capital to the companies while acting as proactive measures and enforced sanctions against corporate decisions by directors to pollute the environment. As discussed above, oppression and mismanagement remedies reduce agency costs, especially residual costs in relation to agency problems. This results in increased firm efficiency. Thus, this research highlights the economic benefits of incorporating said remedies as an enforcement mechanism combined with mandatory corporate provisions. It also shows that said remedies will economically improve the firm by reducing the agency costs in agency problems, as they act as proactive measures against directors' acts of opportunism, strengthen the enforcement of multi-fiduciary duties of directors, protect minority shareholders against controlling shareholders' acts of opportunism and safeguard non-shareholder stakeholders' interests against management's acts of opportunism. Ultimately, these remedies operate as low-cost monitoring mechanisms imposed by government and resulting in reduced residual losses, thereby allowing companies (especially SMEs) to benefit from increased investments to grow, expand and diversify.

Furthermore, this research identifies the economic benefits of said remedies by examining the agency problems discussed above. The discussion shows that the existence of the third agency problem between the management of the firm and its non-shareholder stakeholders is undeniable, particularly from a positivist agency model perspective and in line with Calabresi's findings on law and economics. This research clearly explains management incentives to act opportunistically towards non-shareholder stakeholders. In turn, it has highlighted categories of agency relationships within the third agency problem, thus opening research areas for scholars to further examine opportunism and agency costs in the third agency problem in respect to other stakeholders.

Keay argues that in the future, the stakeholder model may become the dominant model used in corporate governance law in the US, the UK, Canada, Australia and New Zealand.[544] The recent developments of the stakeholder approach in some of these jurisdictions will be further examined in the comparative part of this research, and the economic benefits will be further examined together with the legal principles in examining the function of oppression and mismanagement remedies in the

544 Andrew Keay, 'The corporate objective, corporations, globalization and the law' (Edward Elgar Publishing 2011).

selected jurisdictions. The main aim of this chapter is to establish an economic theoretical framework for the comparative chapter. Accordingly, the comparative part will focus on each jurisdiction's 'similarities and differences' and functions of corporate law in mitigating agency costs. Based on the economic theories, the questions to be examined in the comparative study in chapter four are as follows:

Legal strategies in response to the second agency problem

1. What rights are shareholders vested with to proactively reduce agency costs in the second agency problem?
2. What is the function of corporate law in avoiding litigation and ensuring cost-effectiveness in enforcement mechanisms?
3. What is the function of the equal treatment remedy?
4. What is the function of corporate law in defining oppressive conduct?

Legal strategies in response to the third agency problem (focusing on sustainability)

1. What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?
2. What is the role of unfair prejudice, oppression, and mismanagement remedies in achieving sustainability in corporate governance?

Accordingly, the outcome of this research promotes increasing the wealth of shareholders without reducing the value of non-shareholder stakeholders, specifically focused on the environment, by utilising oppression and mismanagement remedies.[545] Thus, the objective of drafting corporate law through law and economics is to maximise the wealth of shareholders without hindering the interests of other stakeholders. This would enable companies to attract investments and incorporate sustainability into corporate governance.

[545] Phillips and others (n 401).

CHAPTER FOUR – COMPARATIVE STUDY ON THE FUNCTION OF LAWS TO RESOLVE SECOND AND THIRD AGENCY PROBLEMS

4.1 Introduction

The comparative study examines approaches adopted by different jurisdictions to address the agency problems discussed in the economic chapter. The reports have been narrowed down to certain questions formulated according to the second and third agency problems.

The questions based on the second agency problem attempt to examine the similarities and differences of rights vested in shareholders, eg economic rights, control rights, access to information rights, enforcement rights and litigation rights. Special attention is given to strong minority protection rights such as the equal treatment principle, oppression and mismanagement remedies and unfair prejudice remedies. The comparative questions based on the second agency problem are as follows:

1. What rights are shareholders vested with to proactively reduce agency costs in the second agency problem?

The first question aims to gather comprehensive information regarding the specific legal rights available to shareholders, which serve to strengthen their economic positions within the company. To achieve this, we conduct an analysis of shareholder rights (eg economic rights, control rights, access to information rights, and enforcement mechanisms, including litigation rights) across the jurisdictions of Finland, the UK, and Sri Lanka. Each category plays a crucial role, equipping shareholders with the necessary tools to protect their interests and positively contribute to the company's stability. This, in turn, helps to reduce agency costs, a topic that has been thoroughly explored in Chapter three.

2. What is the function of corporate law in avoiding litigation and ensuring cost-effectiveness in enforcement mechanisms?

The second question examines the legal strategies used in company law to prevent litigation, which could result in exorbitant costs for the company. It also explores the strategies used to enforce awards or decisions in shareholder disputes cost-effectively.

3. What is the function of the equal treatment remedy?

The third question seeks information about how the equal treatment remedy operates and its cost-effectiveness in reducing the second agency cost.

4. What is the function of corporate law in defining oppressive conduct?

The fourth question seeks information about how the law tackles oppressive conduct and the cost-effectiveness of these methods in reducing the second agency cost.

The third agency problem is focused on sustainability issues in reference to the environment. The formulated questions examine how the selected jurisdictions address environmental issues in the third agency problem. Special focus is given to the function of 'director's duties' and other specific remedies available for prosocial investors in respect of reducing the agency cost in the third agency problem. The comparative questions based on the third agency problem are as follows:

5. What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?

The fifth question aims to gather information on legislation that protects non-shareholder stakeholders. Creditors, employees, consumers, and the environment are considered non-shareholder stakeholders in law and economics theories. At present, most jurisdictions provide legislation, separate from company law, to safeguard these non-shareholder stakeholders. However, an ongoing debate persists about whether this legislation alone is adequate, or if there is a need for mechanisms within company law for effective protection. Chapter three argues that external protection mechanisms can impose excessive costs, such as liability costs, potentially prompting companies to avoid these costs by internalising protection measures. It should be noted that this research emphasises the environment as a non-shareholder stakeholder, and the comparative study is primarily confined to this context. External legislation is also discussed to underscore the potential liability risk within the legal culture. Certain legal strategies, such as the solvency test, are examined to understand how legal culture safeguards creditors, serving as an example of mitigating agency costs arising from the third agency problem. Furthermore, the topic of redefining the 'purpose of the company' with a focus on the environment as a non-shareholder stakeholder is thoroughly addressed in Chapter five. Therefore, a comparative examination of the company's purpose is not included in this chapter to avoid repetition and ensure a focused discussion.

6. What is the role of unfair prejudice, oppression, and mismanagement remedies in achieving sustainability in corporate governance?

The sixth question seeks to understand whether these remedies have or can have a role in curtailing third agency costs and fostering sustainability in corporate governance.

The jurisdictions chosen for this comparative study are Sri Lanka, Finland, and the United Kingdom (UK). Within the scope of the Sri Lankan comparison, the study also reflects on the practices adopted by other jurisdictions such as India, New Zealand, and Canada, specifically discussing the arbitrability of oppression and mismanagement disputes (See -section 4.3.2.4.). In particular, section 4.3.2.4 delves into the provisions of oppression and mismanagement in India as part of the Sri Lankan comparative study. This is because Sri Lankan courts often refer to Indian cases when addressing legal lacunae. It should be highlighted here that common law countries receive greater attention in this comparative study due to the author's background in common law. However, this study would greatly benefit researchers and policymakers from civil law countries by shedding light on the functioning of common law in corporate law - a process of gaining new insights.

Furthermore, it is worth noting that environmental acts are mentioned in this comparative study to provide an overview of the external protections available for the environment and to highlight the potential costs (eg reputational and liability costs) that a company may incur by violating such external laws. This comparative study is aimed at gaining a deeper understanding of how the laws in each jurisdiction contribute to achieving economic efficiency and sustainability. The data for this study have been primarily sourced from, among other sources, relevant legislation, case law, academic publications, and administrative and expert reports.

4.2 Comparative study of Finland

4.2.1 Finnish company law in general

The Finnish securities market is governed by the *Securities Market Act* (*Arvopaperimarkkinalaki*, 746/2012),[546] and corporate governance is regulated by the *Finnish Limited Liability Companies Act* (*Osakeyhtiölaki*, 624/2006; FCA).[547] FCA applies to all forms of limited liability companies, including listed companies registered according to Finnish law, unless otherwise provided in this Act or any

[546] Finnish Securities Markets Act (746/2012, as amended).

[547] Finnish Limited Liability Companies Act (624/2006, as amended).

other Act.[548] Finnish company law consists of provisions taken from traditional Nordic company law and mainly from Anglo-American models. Traditional Nordic company law has been integrated into Finnish company law through the *laki osakeyhtiöstä, 22/1895*, which was strongly influenced by Swedish and Norwegian legislation. However, pursuant to the country's EU membership and the implementation of EU company law directives, Finnish company law also adopted many typical Anglo-American models, thereby enhancing flexibility and competitiveness by facilitating freedom of contract.[549]

The goal of the Finnish government in the 2006 FCA was to boost this flexibility and competitiveness while simultaneously protecting minority shareholders and creditors.[550] Thus, modern-day Finnish company law is a comprehensive piece of legislation combining elements from the traditional Nordic company law doctrines with EU law and the Anglo-American models.[551] In addition to the FCA, the Finnish Corporate Governance Code[552] plays a pivotal role in public listed companies' corporate governance, highlighting best practices, inter alia, by clarifying the duties of agents to reduce the agency costs that can arise from the first agency relationship.[553] The Finnish Code is based on the 'comply-or-explain' principle. In addition, publicly listed companies in Finland are well regulated by the guidelines, recommendations and rules issued by Finnish and European Union (EU) authorities, eg the Finnish Financial Supervisory Authority (FIN-FSA), the Helsinki Stock

[548] Further information about the Finnish securities market laws, corporate governance and forms of Finnish companies please see Matti J Sillanpää, 'Finland' in Jesper Lau Hansen (ed), *Nordic Financial Market Law* (DJØF 2003); Ville Pönkä, 'Forms of Finnish companies and the main principles of company law' in Kimmo Nuotio, Sakari Melander and Merita Huomo-Kettunen (eds) *Introduction to Finnish Law and Legal Culture* (Forum iuris, Helsingin yliopisto, oikeustieteellinen tiedekunta, Helsinki 2017) 143-151; Ville Pönkä, *Group of companies – The Finnish Model* (SSRN 2017) <https://ssrn.com/abstract=3052128> or <http://dx.doi.org/10.2139/ssrn.3052128 > accessed on 26th July 2021.

[549] Ville Pönkä and Matti Sillanpää, 'Finland' in Carsten Gerner-Beuerle and others (eds), *The Private International Law of Companies in Europe* (Hart 2018) 364.

[550] Hallituksen esitys 109/2005 uudeksi osakeyhtiölainsäädännöksi (Government proposal No. 109/2005 for the new company legislation) (HE 109/2005), 16.

[551] Jukka T Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (July 20, 2020) in Andreas M Fleckner and Klaus J Hopt (eds) *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge University Press 2013), University of Oslo Faculty of Law Research Paper No. 2020-19. SSRN <https://ssrn.com/abstract=3656225> accessed on 26th July 2021, 397.

[552] Finnish Corporate Governance Code 2020, Securities Market Association. <https://cgfinland.fi/wp-content/uploads/sites/39/2019/11/corporate-governance-code-2020.pdf > accessed on 26th July 2021.

[553] Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (n 551) 405.

Exchange (operated by Nasdaq Helsinki Ltd.) and the European Securities and Markets Authority (ESMA).[554] Recent amendments made on 10th June 2019 to Finnish company law – specifically to the Corporate Governance Code 2020 (Finnish Code 2020) – were influenced by the EU's Second Shareholder Rights Directive (SHRD II).[555] These amendments strengthen shareholders' rights as a whole and encourage long-term shareholder engagement. In doing so, they reflect the requirements of the SHRD II, ie reporting on the independence of the board, remuneration, monitoring and assessment of related-party transactions and the competence, expertise and duties of the directors. However, issuers of shares listed on the Nasdaq First North Growth Market Finland are not obligated to comply with this CG code.[556] This enables strong controlling rights for controlling shareholders through boards in private listed companies on the Nasdaq First North Growth Market Finland. Moreover, company-specific rules of procedure, eg board and CEO work ordinances and stock listing rules (such as Nasdaq OMX Helsinki's regulations) cannot be neglected in Finnish corporate governance as sources of law.

Self-regulation plays a pivotal role in the Finnish business environment, and Mähönen argues that self-regulation acts as a gap-filling tool for mandatory rules.[557] For instance, investors/shareholders can agree on certain specific terms about the operation of the company in the company's articles. However, such terms should not violate the country's mandatory laws. Furthermore, both the Finnish Code and Helsinki Takeover Code, which are regulated by the Securities Market Association, provide best-practice guidance on self-regulation. In this way, self-regulations provide flexibility and increased competitiveness for businesses to adapt to challenging changes in the global business environment.

The above-discussed statutes, eg *FCA* and *the Securities Market Act*, as well as other supplementary legal instruments such as the Finnish Corporate Governance Codes, the Helsinki Takeover Code, regulations, recommendations and guidelines from the FIN-FSA and Nasdaq OMX Helsinki's regulations provide the foundations for minority shareholder protection in Finland in listed companies in the main

554 Risto Ojantakanen, Ville Kivikoski and Linda Pihonen, 'Finland' in Willem J L Calkoen (ed) *The Corporate Governance Review* (Law Business Research Ltd 2020) 64.

555 Directive (EU) 2017/828 of the European Parliament and of the Council amending Directive 2007/36/EC.

556 Matti J Sillanpää, *Festschrift für Theodor Baums zum siebzigsten Geburtstag: Band I* (Mohr Siebeck 2017), 1185.

557 Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (n 551) 404.

market.[558] The Finnish IPO market includes both Nasdaq OMX Helsinki and Nasdaq First North Growth Market Finland. The former operates as the main IPO market for large companies, while the latter operates as a legal multilateral trading facility for smaller companies. The Finnish government is a large shareholder in many of the listed companies on the Nasdaq OMX Helsinki, and large mutual pension insurance companies also play a significant and influential part as a major shareholder in some listed companies.[559] Generally, ownership in Finland is concentrated among a single or small number of shareholders.[560]

Decision-making in Finnish companies is based on the majority rule principle. However, Finnish company law provides several distinct ways through mandatory laws and self-regulation to protect minority shareholders from the majority rule principle. They are, inter alia, *protection against dilution*, *director appointment rights*, *protection against takeover bids*, *ability to act and seek remedies on behalf of the company*, *participation rights in respect of decision-making*, and *rights against other shareholders*, specifically controlling shareholders.[561] Toiviainen contends that in the Finnish context, effective protection of minority shareholders, as well as other stakeholders like creditors and society, necessitates clear legal stipulations about company governance and the division of powers within. However, Toiviainen emphasises that the law should not become a hindrance to entrepreneurial activities. The challenge, therefore, lies in formulating laws that not only foster entrepreneurship but also ensure the protection of all parties involved and society at large. This balance should be maintained without intruding unjustly on the freedom of collaborating parties to establish their own operating rules. Thus, striking the right balance in corporate legislation is crucial for promoting robust entrepreneurship and societal well-being.[562]

558 It is not mandatory for companies listed in the First North Growth Market and private companies to adhere to recommendations and guidelines stipulated in the Corporate Governance Code.

559 Ojantakanen, Kivikoski and Pihonen (n 554) 73; also see Heikki Toiviainen, *An Introduction to Finnish Business Law: A Comprehensive Survey of the Foundations and Main Rules of Finnish Corporate Law* (Edita 2008) 1003.

560 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 514 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

561 ibid 514.

562 Toiviainen, *An Introduction to Finnish Business Law: A Comprehensive Survey of the Foundations and Main Rules of Finnish Corporate Law* (n 272) 448-449.

4.2.2 Legal strategies in relation to the second agency problem

4.2.2.1 What are the rights vested in shareholders to proactively reduce agency costs in the second agency problem?

The specific rights under discussion in this topic encompass economic rights, control rights, access to information rights, and enforcement mechanisms, which include litigation rights.

Focusing now on the economic rights of shareholders, Finnish companies generally uphold a principle of equal treatment for all shareholders. This ensures the provision of equal economic rights, corresponding to their respective classes of share ownership, unless specified otherwise in the Articles of Association.[563] Consequently, this implies that shareholders have the right to avoid compulsory acquisition of their shares, with the exception of a squeeze-out procedure[564] or a (pro-rata) redemption based on either a shareholders' agreement or a redemption clause included in the Articles of Association.[565]

Finnish law also accommodates self-regulation on separate share classes, enabling a diverse and flexible range of business financing methods. This underscores the considerable contractual flexibility and freedom accorded to investors in Finnish businesses. It remains a contractual matter to outline various financial rights concerning different classes of shares in the company's Articles.[566] Additionally, the right to vote may also differ among share classes.[567] Consequently, these share classes can carry different economic and voting rights, but all shares within a single share class uphold equal economic rights as per the agreed terms in the company's Articles.[568] It is also possible to limit the transferability of shares, including specific share classes, within the company's Articles — but this applies exclusively to private companies.[569]

However, alterations to the rights associated with share classes are subject to more stringent majority decisions by shareholders, such as a qualified majority.[570] This strengthens minority shareholder rights because it ensures that, in the event of such changes to rights, minority shareholders' votes are also taken into account to a

563 FCA 1:7.
564 Chapter 18 of FCA.
565 Chapter 15 of FCA.
566 FCA 3:1.
567 FCA 3: 3 and 4.
568 Pyy-Zhong and Vähä-Karvia (n 560) 2748.
569 FCA 3: 6, 7 and 8.
570 FCA 5: 28.

certain extent — for instance, due to the qualified majority requirement. Minority shareholders with non-voting shares typically do not enjoy specific minority protection beyond the principle of equal treatment of shareholders. Nevertheless, in matters that necessitate the consent of all shareholders, the approval of non-voting shareholders also becomes relevant — for example, for matters outlined under FCA 5:29.[571]

The FCA empowers minority shareholders by allowing for the mandatory participation of multiple shareholders or shareholder groups. For example, minority shareholders can demand a distribution of dividends from the company's annual profits if at least one-tenth of the total votes threshold is satisfied.[572] Furthermore, according to the FCA 13:7, minority shareholders have a statutory right to demand dividends. If shareholders holding at least one-tenth (1/10) of all shares make such a demand at the Ordinary General Meeting, the company must distribute at least half of the profits from the financial period, less any amounts prohibited from distribution by the company's articles.[573] This right, however, is not unlimited. The Act permits the inclusion of different provisions about the minority dividend in the company's Articles of Association. Moreover, the right to a minority dividend can be restricted, but only if all shareholders consent to the restriction.[574] Thus, while the law generally upholds the rights of minority shareholders to demand dividends, these rights can be subjected to certain conditions.

In addition to these mandatory provisions, contractual freedom in company law enhances flexibility in minority shareholders' rights and/or obligations to exit the company. Such terms can be included in the company's articles and/or shareholder agreements. Minority shareholders can invoke these mandatory provisions to exit the company in situations like mergers,[575] demergers,[576] abuse of influence by other shareholders,[577] and in the case of a mandatory takeover. However, the FCA stipulates certain prerequisites to exercise these exit rights, such as requiring the shareholder to have voted against such mergers or demergers.

According to the Securities Market Act, any shareholder whose holdings exceed 30% and 50% of the total number of shares is obligated to offer a mandatory takeover

[571] Pyy-Zhong and Vähä-Karvia (n 560) 2751; also see FCA 5: 29.
[572] Ojantakanen, Kivikoski and Pihonen (n 554) 71.
[573] FCA 13: 7 (1).
[574] FCA 13: 7 (2).
[575] FCA 16:13.
[576] FCA 17:13.
[577] Chapter 23 of the Finnish Limited Liability Companies Act.

bid to the remaining shareholders in the company.[578] If a shareholder's holdings exceed 90% of all shares and votes, they can compel the remaining shareholders to exit the company by redeeming their shares at a fair market price, a process known as a squeeze-out.[579] Simultaneously, minority shareholders have the right to demand such redemption, known as a sell-out right.[580] This offers minority shareholders the opportunity to sell their shares at a potentially higher price and exit the company while allowing new controlling shareholders to run the company as they see fit.

In the case of a voluntary exit or mandatory squeeze-out of the company, the redemption price of the share must be based on the share's fair market value.[581] If the minority shareholder is not satisfied with the redemption price, an appeal procedure is specified in the FCA to institute arbitration proceedings or decide not to exit the company voluntarily. Exercising the right to exit the company in a scenario of an abuse by another shareholder is rather strict, and rarely is such a remedy granted by the court to a minority shareholder in Finland.[582]

While the liquidity and transferability of shares are not limited or restricted in company law in Finland,[583] Finnish law has provided the flexibility for businesses to impose limitation or restrictions through articles of association.[584] However, according to Rule 2.11.1 of the Nordic Main Market Rulebook for Issuers of Shares (Nasdaq Helsinki), such restrictions in the articles of association of listed companies are forbidden.[585]

In addition, minority shareholders are protected from the dilution of value of their shareholdings based on mandatory provisions of pre-emption subscription rights in case of a new share issue.[586] However, in certain circumstances, it is possible to deviate from this pre-emption subscription right requirement if such deviation is backed by a qualified majority decision[587] justified by a 'weighty financial reason'

578 Section 19 of the Finnish Securities Market Act ;also see Ojantakanen, Kivikoski and Pihonen (n 554) 72.https://www.finlex.fi/fi/laki/kaannokset/2012/en20120746_20130258.pdf > accessed on 18th July 2023; also see Ojantakanen, Kivikoski and Pihonen (n 554) 72.

579 FCA 18:1.

580 Chapter 18 of FCA.

581 FCA 18: 1.

582 Pyy-Zhong and Vähä-Karvia, *Finland* in Study on minority shareholders protection (final report) by TGS Baltic European Commission (n 560) 516.

583 FCA 1:4.

584 FCA 3: 6-8.

585 Rule 2.11.1 of the Nordic Main Market Rulebook for Issuers of Shares Harmonized part effective 1 February 2021 <https://www.nasdaq.com/docs/2021/04/08/Nordic-Main-Market-Rulebook-for-Issuers-of-Shares-1-February-2021_0.pdf > accessed on 30th July 2021.

586 FCA 9:3.

587 FCA 5: 27.

and a ‘fair market value’ set as a subscription price for the shares to be issued.[588] Thus, in general, the economic rights of shareholders in a Finnish company are well protected. However, a controlling shareholder acting together with a group of minority shareholders could deviate from the pre-emption subscription right at the expense of another group of minority shareholders. It is noteworthy that Finnish company law does not provide a specific definition of a 'weighty financial reason', thereby creating a potential avenue for the controlling shareholders to oppress minority shareholders.

In a situation where the majority shareholders have withheld the company’s dividends without distribution for a certain number of years while at the same time enjoying the perks of remuneration as company directors, the minority’s action to claim damages for the preceding years of non-payment of dividends may not succeed. In such a situation, the only remedy would be to invoke the equal treatment principle under the terms of the FCA 1:7 on the basis that the majority shareholders have deliberately abused their positions of influence in the company by withholding the dividends over a long period, which runs contrary to the principle of equal treatment of shareholders. However, this remedy is restricted only to having the minority shareholders’ shares bought out. Doing so is also conditional on the basis that it is necessary; if there is a probability that the conduct complained is likely to continue.[589] Accordingly, if the company is doing well and the majority’s goal is to freeze out the minority, the majority shareholders would receive an undue benefit from such a scenario at the expense of the minority shareholders, and the latter would not be able to claim damages for such an undue benefit received by the former.[590] The principle of the equal treatment remedy is further discussed below in section *4.2.2.3*.

Turning our attention to the control rights of shareholders in Finnish companies, shareholders exercise their control over the company predominantly through the General Meeting (GM), and when necessary, through an Extraordinary General Meeting (EGM).[591] Toiviainen states that the GM is a forum for the shareholders to decide on matters within their scope of authority. According to Chapter 6 of the FCA, responsibilities relating to the management of the company are vested with the board of directors.[592] The FCA has made it mandatory for companies to hold a GM annually and within a certain period of the incorporation of the company.

588 FCA 9:4.
589 FCA 23:1.
590 See Pierre-Henri Conac, ‘Shareholders and Shareholder law’ in Mathias Siems and David Cabrelli (eds) *Comparative Company Law A Case-Based Approach* (Hart Publishing 2013) 239 -241.
591 Chapter 5 of the Companies Act.
592 Toiviainen (n 272) 469.

Generally, as said above, Finnish companies operate on the majority rule principle, meaning that majority shareholders control the company. However, certain matters specified in the Companies Act require qualified majority votes, which result in vesting controlling rights to certain groups of minority shareholders. The company's articles can also empower certain matters to be voted on in qualified majority. Thus, minority shareholders can extend their controlling power through contractual means and extend their protection. However, in practice, minority shareholders do not hold enough bargaining power to include such rights in the company's articles. The sources of law listed above that apply to listed companies in regulated markets, specifically in the main market, make it obligatory (but not mandatory if proper reasons are given) to comply with certain recommendations and guidelines that provide certain controlling powers to minority shareholders.

The board of directors plays a large role in protecting minority shareholders' interests in the company. However, minority shareholders are not given any special appointment rights to the board through the FCA. That said, certain provisions in the FCA provide protection to minority shareholders against unreasonable, negligent or unjust acts of boards of directors who are appointed by the majority shareholders, eg the equal treatment principle and duty of management. Furthermore, listed companies are under an obligation in terms of the recommendations set out in the relevant securities market laws to appoint, inter alia, independent directors.[593]

All the shareholders of a Finnish company have the right to participate in the GM, but certain companies may require prior notification.[594] Further, a shareholder have right to have a matter dealt with by the GM.[595] Shareholders have the option to send a proxy notification and to bring an advisor to the general meeting.[596] Prior to the general meeting, the shareholders have the right to receive a set of documents, including the company's financial statement, which highlights the *status quo* of the company.[597] In addition, the shareholders have the right to seek further information on matters on the meeting agenda and to ask further questions.[598] Most importantly, minority shareholders have the right to demand that an EGM is called to address a specific issue that cannot be resolved in a general meeting.[599] Furthermore, the FCA

593 The Finnish Corporate Governance Code 2020, 28 <https://cgfinland.fi/wp-content/uploads/sites/39/2019/11/corporate-governance-code-2020.pdf > accessed on 29th July 2021.

594 FCA 5:6.

595 FCA 4:5.

596 FCA 4:8.

597 FCA 5:21.

598 FCA 5:25.

599 FCA 5:4.; also see Ojantakanen, Kivikoski and Pihonen (n 554) 71.

allows vote cutter provisions to be included in the company's articles.[600] Vote cutter provisions enable the restriction of voting rights of a shareholder in a general meeting and can thus be utilised to hinder majority control in a listed company.

Concerning major transactions, minority shareholders are protected to a certain extent by the FCA, ie transactions that would significantly affect the value of the company require a qualified majority vote.[601] However, minority shareholders are not vested with controlling rights with respect to related-party transactions, ie minority shareholders are not vested with the right to block or approve related-party transactions.[602] In contrast, the controlling shareholders have their say in any transaction related to the company. However, any shareholder (including a controlling shareholder) is disqualified from voting on any matter from which he/she derives an essential benefit that is contrary to the interests of the company, eg voting on a matter pertaining to a civil action instituted against the shareholder or a related party to said shareholder, and on any matter in relation to a listed company in which the shareholder is a related party, with certain exceptions.[603] In addition, minority shareholders are vested with the right to demand a special audit concerning certain transactions in the company.[604] Furthermore, all shareholders have a right to receive information on the related-party transactions from the annual report.[605]

Shifting our focus to the access to information rights of shareholders in Finnish companies, it is generally observed that shareholders are endowed with extensive rights in this regard. As discussed above, the FCA has made mandatory provisions in respect of shareholders' right to receive information, specifically in relation to the GM and meeting documents.[606] At the request of a shareholder, the management is obligated to provide detailed information that may affect the evaluation of a matter handled in the general meeting. However, the management may deny any such requests if the information is extremely sensitive (eg trade secrets, confidential information), as divulging such information may result in substantial economic harm to the interests of the company.[607] Nonetheless, basic information regarding the company, such as financial statements, annual reports, auditor's reports, and consolidated financial statements and notifications submitted by the company, are

600 FCA 3:3(2) and (4) (1) (1); also see Chapter 5, Section 12 (1) of the Finnish CA.
601 FCA 5:27.
602 Pyy-Zhong and Vähä-Karvia, *Finland* in Study on minority shareholders protection (final report) by TGS Baltic European Commission (n 560) 144.
603 Ojantakanen, Kivikoski and Pihonen (n 554) 71.
604 FCA 7:7(2).
605 FCA 8:6.
606 FCA 5:21; FCA 17:11.
607 FCA 5:25; Ojantakanen, Kivikoski and Pihonen (n 554) 72.

available in the Finnish Trade Register.[608] This information can be easily accessed online, by telephone or physically on the premises. Information regarding shareholders can be accessed at the premises of the company. Such information can even be accessed by third parties.

As previously discussed, minority shareholders who hold at least 10% of the shares can gain insights into the company's financial standing through a special audit enquiry of the administration and accounts of the company.[609] Furthermore, minority shareholders who hold at least one-tenth (1/10) of all shares or at least one-third (1/3) of the shares represented at a meeting have the right to demand an approved auditor.[610] These provisions can be employed as a legal tool by minority shareholders to investigate irregular financial transactions within the company; consequently, this right serves as a proactive measure against any potential financial irregularities. Listed companies are also subject to certain extensive disclosure requirements, such as, inter alia, preparing and publishing interim financial statements and reports, non-financial reports and corporate governance reports. In addition, listed companies are required to provide extensive information to the media, the Financial Supervisory Authority, and the stock exchange and to disclose information on the company's website. Article 17 of the Market Abuse Regulation (Regulation [EU] No 596/2014) makes it mandatory for listed companies to disclose insider information in the manner stipulated in the Article. In addition, Article 17 requires companies to retain sufficient information on factors that may have a material effect on the share value equally for all shareholders and investors.[611] The mandatory nature of access to important information increases the transparency in Finnish companies, making it more difficult for controlling shareholders to act opportunistically.

Addressing the enforcement mechanisms and litigation rights of shareholders in Finnish companies, it is worth noting that shareholders can challenge a decision made by the General Meeting if it violates mandatory provisions stipulated in the Finnish Companies Act (FCA) or infringes upon contractual rights established through the company's Articles of Association. For instance, as per the FCA 21:1, a shareholder can bring an action against the company if the Act's procedures or the Association's Articles have been violated, influencing the decision's content or a shareholder's rights. This could form the basis for challenging the decision. Moreover, as per FCA 22:1, A Member of the Board of Directors, a Member of the

608 Finnish Patent and Registration Office <https://www.prh.fi/en/kaupparekisteri.html> accessed on 19 July 2023.

609 Pyy-Zhong and Vähä-Karvia, *Finland* in Study on minority shareholders protection (final report) by TGS Baltic European Commission (n 560) 163; also see- FCA 7:7.

610 FCA 7:5.

611 Pyy-Zhong and Vähä-Karvia, *Finland* in Study on minority shareholders protection (final report) by TGS Baltic European Commission (n 560) 519.

Supervisory Board and the Managing Director is likewise liable in damages for the loss that he or she, in violation of other provisions of this Act or the Articles of Association, has in office deliberately or negligently caused to the company, a shareholder or a third party.[612] *Shareholders of companies listed on the regulated market or MTF can also seek compensation based on Securities Market Act.*[613] However, shareholders may be reluctant to institute legal proceedings in Finland owing to the reason that court proceedings can be lengthy and expensive when compared to the economic interest of the case.[614]

Additionally, shareholders have rights to bring an action in their own name for the collection of damages to the company under sections 1–3 or under chapter 10, section 9 of the Auditing Act (1141/2015; *Tilintarkastuslaki*). The Auditing Act 10:9 (1141/2015; *Tilintarkastuslaki*) provides that, inter alia, an auditor is liable for damages caused by her or him, deliberately or out of negligence, to a corporation or foundation when carrying out the duties. This provision also extends liability (loss caused) to a shareholder, a partner, or a member of the corporation or another person by a violation of this Act, an Act applicable to the corporation or foundation, or articles of association, rules, or deed of partnership.[615] The FCA 22:6 provides that, inter alia, 'As provided in chapter 6, section 2 of this Act, the Board of Directors makes the decisions on matters relating to the right of the company to damages under sections 1–3 of this chapter or under chapter 10, section 9 of the Auditing Act (1141/2015; *Tilintarkastuslaki*). However, these matters may also be decided by the General Meeting'.[616] Furthermore, the FCA 22:7 provides that, inter alia, 'One or more shareholders have the right to bring an action in their own name for the collection of damages to the company under sections 1–3 or under chapter 10, section 9 of the Auditing Act (1141/2015; *Tilintarkastuslaki*), if it is probable at the time of filing of the action that the company will not make a claim for damages and: 1) the plaintiffs hold at least one tenth (1/10) of all shares at that moment, or 2) it is proven that the non-enforcement of the claim for damages would be contrary to the principle of equal treatment, as referred to in the FCA 1:7'.[617] The shareholders

612 FCA 22:1.

613 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 520 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

614 ibid.

615 Auditing Act (Finland) 1141/2015, unofficial translation by the Ministry of Economic Affairs and Employment, Finland <https://www.finlex.fi/fi/laki/kaannokset/2015/en20151141.pdf> accessed on 16th October 2023.

616 FCA 22:6.

617 FCA 22:7.

bringing the action bear the legal costs themselves, but they have the right to be reimbursed by the company, insofar as the funds accruing to the company by means of the proceedings suffice for reimbursement, and a shareholder does not have the right to damages for loss caused to the company. [618]

Furthermore, under the FCA 23:1, if a shareholder has knowingly misused their influence, causing a violation of the equal treatment principle or other breaches of this Act or the Articles of Association, another shareholder may commence an action to redeem their shares within a specified period.[619] This redemption, based on the fair market value of the share, less any impact of the abuse of influence, serves as an essential remedy if the abusive conduct is likely to continue.[620] The company will be given an opportunity to respond unless it is clearly unnecessary.[621] Accordingly, a minority shareholder, as a victim of such abusive influence, can seek the redemption of shares and dissolution of the company.[622] However, practitioners from the jurisdiction assert that *such situations are uncommon and would require a harsh violation to have taken place.*[623]

4.2.2.2 What is the function of corporate law in avoiding litigation and securing cost-effectiveness in enforcement mechanisms?

FCA has empowered two possible methods to resolve disputes in company matters, ie court proceedings and arbitration. As noted above, court proceedings are lengthy and expensive, so FCA provides mandatory/statutory arbitration on specific types of disputes. For instance, FCA has mandated redemption disputes to be resolved by arbitration.[624] These types of disputes are specifically mentioned under FCA 24:4 (Statutory arbitration), which specifically refers to mergers, demergers, squeeze-out and sell-out.[625] Part V, Chapter 18, Section 5 allows minority shareholders to obtain the guidance of a special representative to oversee their interests in an arbitration procedure. Part V, Chapter 18, Section 8 stipulates that the redeemer shall bear the cost of arbitration unless there is a special reason that it is reasonable to order otherwise. All these provisions provide proactive measures for the redeemer to offer

618 Ibid.
619 FCA 23:1.
620 ibid.
621 ibid.
622 Chapter 23 of FCA; also see Pyy-Zhong and Vähä-Karvia, *Finland* in Study on minority shareholders protection (final report) by TGS Baltic European Commission (n 560) 185.
623 Ojantakanen, Kivikoski and Pihonen (n 554) 71.
624 FCA 18:3.
625 FCA 24:4.

a fair market price to the minority shareholders.[626] In this way, these provisions reduce litigation and increase cost-efficiency in companies. Additionally, the FCA has provided the freedom for the parties to decide on what matters to be resolved in arbitration by inserting such matters in the company's articles – specifically through an arbitration clause.

The FCA has not made it mandatory for equal treatment disputes to be resolved by arbitration. In my opinion, this is because investors have the freedom to include such arbitration clauses in the company's articles. The Arbitration Act (967/1992; *laki välimiesmenettelystä*) provides that if such an arbitration shareholder dispute clause exists in the company's articles, the relevant parties to the dispute are bound to resolve the matter through arbitration.[627] Thus, the contractual freedom is available for investors to resolve certain matters such as shareholder disputes through arbitration without needing to air their dirty laundry in public. Furthermore, resolving shareholder disputes through arbitration would act as a proactive measure ie., the shareholders and managers would act equally without engaging in opportunistic behaviour, since failure to do so would severely hamper the wrongdoers burdened with the costs of arbitration and, if any, those of a special representative (if separately agreed in the company's articles) to look after minority shareholders' interests. Most importantly, a minority shareholder who is a victim of an abuse of influence may not hesitate to institute arbitration proceedings because the costs and duration of the proceedings may be more economically viable than a court proceeding.

In my opinion, it is in the best economic interest for the parties to resolve or commence 'redemption' and 'equal treatment' disputes through arbitration. Arbitration can explore the factual scenarios and decide on matters such as, inter alia, the fair market price, the redemption and whether the company should be liquidated or deregistered, depending on the factual background and economic considerations. Additionally, the award can provide reasons in detail pursuant to considering evidence in respect of the two limbs stated under FCA 23:1 for redemption and the two limbs stated under Section 2 for liquidation or deregistration. The two limbs for the duty of redemption are as follows:

> (1) the shareholder has deliberately <u>abused his or her influence</u> in the company by contributing to a decision contrary to the principle of equal treatment referred

[626] Squeeze-out – FCA 18:1 / Merger – FCA 16:13 / Demerger into existing Company – FCA 17:13.

[627] FCA 24:3 (1).

to in chapter 1, section 7, or to other violations of this Act or the Articles of Association; and

(2) redemption is a necessary remedy for the other shareholder, taking due note of the probability of the conduct referred to in subsection (1) being continued and of the other relevant circumstances'.[628]

The two limbs for liquidation or deregistration are as follows:

(1) the criteria for the redemption of the shares of the plaintiff, as referred to in section 1(1), exist but the person abusing his or her influence is probably not going to comply with the duty of redemption; and

(2) there are especially weighty reasons for liquidation in view of the shareholders' need for a remedy and their interests.[629]

Pursuant to resolving such matters through arbitration, the parties can settle the matter accordingly or enforce such an award in the respective district court. This is the same court as the first instance court stipulated under FCA 24:1 for company matters and also for arbitration awards under the terms of Section 43 of the Arbitration Act (967/1992; amendments up to 754/2015)[630] and Section 19 of the Enforcement Code (705/2007; amendments up to 987/2007).[631] According to the comparative study conducted in other jurisdictions, the arbitral tribunal does not have the authority to order liquidation or deregistration because they can affect third parties and thus fall outside its jurisdiction.[632] However, the award can highlight the factual scenarios and reasons for the Court to decide on liquidation or deregistration, which can save the court time in exploring the facts.

Furthermore, the FCA can fashion a hybrid mechanism to enforce company arbitration awards. For instance, liquidation of the company by the court after

628 FCA 23:1 (emphasis added).

629 FCA 23:2 (emphasis added).

630 See the Enforcement Code (705/2007; amendments up to 987/2007) <https://www.finlex.fi/fi/laki/kaannokset/2007/en20070705_20070987.pdf > accessed on 4th August 2021.

631 See Arbitration Act ((967/1992; amendments up to 754/2015) <https://www.finlex.fi/fi/laki/kaannokset/1992/en19920967_20150754.pdf > accessed on 4th August 2021.

632 For more information on the arbitrability of shareholder disputes please refer the Sri Lankan comparative study under the oppression and mismanagement provisions which discuss and study the position of other jurisdictions including the United Kingdom, Singapore, India, Canada, and Australia.

arbitration awards have recommended such a relief pursuant to going through the factual and economic background of the dispute. Accordingly, shareholder disputes (including equal treatment disputes) can be efficiently resolved by arbitration in compliance with the statutory provisions of the FCA; thereafter, if necessary, the parties can efficiently enforce the award through the court procedure. This hybrid mechanism would provide a proactive mechanism and increase cost-efficiency.

4.2.2.3 What is the function of the equal treatment remedy?

Together with the duty of management, the equal treatment remedy (in Finnish – *Yhdenvertaisuus*) plays a vital role in protecting the interests of minority shareholders in Finnish corporate governance in both private and listed companies. The FCA 1:7 stipulates that:

> All shares shall carry the same rights in the company, unless it is otherwise provided in the Articles of Association. The General Meeting, the Board of Directors, the Managing Director or the Supervisory Board shall not make decisions or take other measures that are conducive to conferring an undue benefit to a shareholder or another person at the expense of the company or another shareholder.[633]

FCA 1:7 provides a frame of reference for the interpretation of its provisions.[634] According to Section 7, it is still possible to agree between the shareholders/investors on separate share classes that carry different rights and obligations through the company's articles, which may differentiate the principle of equal treatment between different classes of shares, eg ordinary shares, preference shares, cumulative preference shares.[635] However, equal treatment still applies to decisions relating to shareholders within the same classes of shares. Additionally, in general, the measures taken by the company cannot confer an undue benefit to a shareholder or another person at the expense of the company or another shareholder. Furthermore, Mähönen states that the equal treatment provisions impose a fiduciary duty on controlling shareholders. It can be argued that such a fiduciary duty can be extended to the agents appointed by the controlling shareholders (eg directors) towards the company and its other non-controlling shareholders. In other words, related-party

633 FCA 1:7 (emphasis added).
634 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 520 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.
635 FCA 3:1.

transactions that are not profitable to the company (including forms of 'tunnelling') are unlawful and are thus tantamount to an abuse of power under the terms of the equal treatment provision.[636] The general provision on abuse of power was introduced to FCA during the 1930s and was influenced by Cederberg;[637] all the other Nordic countries later adopted this principle to protect minority shareholders.[638]

FCA contains mandatory provisions on certain matters stipulating that the company cannot act contrary to the principle of equal treatment. FCA 5:13 specifically states that '*The General Meeting shall not make decisions contrary to the principle of equal treatment referred to in chapter 1, section 7*'. Thus, all the decisions taken by shareholders in the general meeting should not violate the equal treatment principle unless such consent is obtained from the shareholder, at whose expense the unjust benefit is to be given on a specific matter.[639] If such consent is not obtained and such a decision on the general meeting runs counter to the equal treatment principle referenced in the FCA 1:7, such a decision shall be void and can be challenged in court.[640]

Furthermore, in terms of the FCA 6:1 (2), the equal treatment principle should be read together with the FCA 1:8 on the 'duty of care' and the FCA Chapter 22 on 'liability in damages'. FCA 6:1(2) reads as follows: '*Chapter 1, section 7, contains a prohibition of decisions contrary to the principle of equal treatment, chapter 1, section 8, on the duty of care, and chapter 22 on liability in damages*.' Chapter 1, Section 8 on the duty of care and duty of management reads as follows: '*The management of the company shall act with due care and promote the interests of the company'.*[641] Mähönen and Vila state that this rule includes both the principle of loyalty and the principle of care, the latter interpreted according to the business judgment rule.[642] Accordingly, if the management of the company do not 'act with due care' and do not 'promote the interest of the company', this may amount to a breach of the equal treatment principle and thus a shareholder who has suffered a loss based on the circumstances stipulated in *Chapter 22 on liability in damages can bring an action on behalf of the company if the requirements in chapter 22, section*

[636] Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (n 551) 415.
[637] Lauri Cederberg, Osakeyhtiölain uusiminen vähemmistösuojaa silmällä pitäen (1934).
[638] See footnote 13 of Sillanpää (n 556).
[639] FCA 5: 29 (3).
[640] FCA 21: 2 (1) (3).
[641] FCA 1:8.
[642] Jukka Mähönen and Seppo Villa, *Osakeyhtiö I: Yleiset opit (Limited Liability Company I: General Principles)* (WSOYpro 2006) 107–150; Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (n 551) 413.

7 are satisfied.[643] In these circumstances, the company can recover damages for the management's failure to act according to the principles of loyalty and care.

The aforesaid Chapter 22 on liability in damages empowers proactive measures for the management, board of directors, shareholders, chairperson of the general meeting and auditors to act prudently without causing any loss to the company or indirectly to its shareholders. It is argued that incorporating proactive provisions in the FCA and company articles of association to reduce the agency costs discussed in this research would increase the efficiency of the firm. The reason for this is that these proactive provisions would be backed by Chapter 22, thus compelling the actors to act diligently in their corporate decision-making. Accordingly, further strengthening minority shareholders' rights would indirectly facilitate the attraction of diversified investments. The liability chapter itself specifically addresses imposing liability in damages on the company itself for losses caused by said actors acting in contravention of the equal treatment principle. Additionally, the board of directors and/or general meeting is vested with the right to discharge a board member, a member of the supervisory board or the managing director from liability.[644] However, as said above, the decision of the general meeting should not contravene the equal treatment principle, meaning that discharging a director from liability may itself render the decision void in terms of the equal treatment principle.

Importantly, the FCA 22:7 (1)[645] and FCA 23:1,[646] discussed above in section 4.2.2.2. on enforcement mechanisms and litigation rights of shareholders, provide strong provisions through which a minority shareholder can seek redress for violations of the equal treatment principle. Specifically, under FCA 22:7 (1), a shareholder, if a victim of an act contravening this principle, does not need to satisfy any voting threshold. However, it is worth noting that under an abuse of the equal treatment principle, a shareholder cannot claim personal damages for any abuse of influence (*Yhdenvertaisuus*). The only available remedies are the redemption of shares or, as previously discussed, the liquidation or deregistration of the company.

Furthermore, the right to redemption of shares is not available to an aggrieved shareholder if such acts that are contrary to the *Yhdenvertaisuus*, the provisions of FCA and the company's articles are performed by a person other than a shareholder, eg a manager, the board of directors. Furthermore, in my opinion, if a shareholder deliberately abuses their influence, it is seemingly difficult to prove that such an act was committed by said shareholder unless the shareholder takes responsibility – such a shareholder may be able to justify that such an act was taken in the best interests

[643] Chapter 22 of FCA.
[644] FCA 22:6.
[645] FCA 22:7.
[646] FCA 23:1.

of the company, or a controlling shareholder may have influenced an abusive act through his/her appointed director or manager that can then be justified under the business judgment rule.[647] Thus, practically speaking, in such a circumstance, it may be difficult for a minority shareholder to redeem his/her shares. Thus, a shareholder cannot claim any punitive damages and other consequential economic damages for the acts of abuse other than redeeming his/her shares, the collection of damages to the company on the losses suffered and dissolving the company.[648]

Additionally, in this context, it is crucial to acknowledge that the FCA currently omits any provisions aimed at preventing oppressive conduct, mismanagement, and unfair prejudice within corporate governance structures.

4.2.3 Legal strategies in relation to the third agency problem (focusing on sustainability)

4.2.3.1 What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?

Generally, Finnish companies are concerned about reputational risks to the brand name of the company resulting from any harm caused to its non-shareholder stakeholders, including the environment.[649] Listed Finnish companies are required to disclose non-financial information according to Directive 2014/95/EU and in connection to regulatory reporting, including information on, inter alia, environmental issues. Moreover, in their non-financial information reporting, large listed companies are required to publish their policies, risks and future actions in relation to, inter alia, environmental matters, as well as social and employee-related matters. Thus, listed companies are increasingly focusing on corporate social responsibility reporting.[650] However, FCA is silent on non-shareholder stakeholders, meaning that private companies are not obligated to disclose any reporting on non-financial information. Generally, Finnish companies and their management are

[647] 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 520 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

[648] Chapter 23 of FCA.

[649] Ojantakanen, Kivikoski and Pihonen (n 554) 69.

[650] Klause Ilmonen and Lauri Marjamäki, 'Finland: Corporate Governance Laws and Regulations 2020' (ICLG 14th July 2020) <https://iclg.com/practice-areas/corporate-governance-laws-and-regulations/finland> accessed on 29th July 2021; Ojantakanen, Kivikoski and Pihonen (n 554) 69.

obligated to act prudently without violating national environmental legislation. In Finland, this legislation consists of a comprehensive regulatory framework on protecting the natural environment, including the adoption of several EU laws, either as directly applicable law or implementation of EU law. Finnish companies are obligated to operate within the guidelines set by numerous environmental legislations.[651] Adherence to those laws ensures that their operations do not contravene any of the environmental legislation.

In a situation where violation occurs, the board of directors can be held responsible under FCA 1:8 under the duty of management, on the basis that the management has not acted with due care in promoting the interests of the company. For example, in the case KKO:2016:58,[652] the Finnish Supreme Court has ruled that board members A and B of a potato flake company were criminal liable for environmental damage (in violation of the Waste Act 646/2011[653] and Section 7 of the Environmental Protection Act 527/2014)[654] caused by the release of potato soil sludge due to their gross negligence. Despite obtaining an environmental permit, they did not familiarise themselves with its contents or ensure the management followed its stipulations. While they relied on the managing director for environmental compliance, their lack of oversight and guidance were considered severe neglect of their responsibilities. Thus, the ruling reaffirms that Board of Directors' duties include environmental supervision and, when neglected, can lead to legal consequences.

In situations where a company has caused environmental degradation or engaged in greenwashing, even without any negligent behaviour, the company itself may likely have to bear the costs associated with compensating for the environmental

[651] These include, among others, the Environmental Protection Act (*Ympäristönsuojelulaki*), Waste Act (*Jätelaki*), Water Act (*Vesilaki*), Nature Protection Act (*Luonnonsuojelulaki*), Act on Compensation for Environmental Damage (*Laki ympäristövahinkojen korvaamisesta*), Act on Remediation of Certain Environmental Damage (*Laki eräiden ympäristölle aiheutuneiden vahinkojen korjaamisesta*), Act on Environmental Impact Assessment Procedure (*Laki ympäristövaikutusten arviointimenettelystä*), Act on Environmental Impact Assessment of Plans and Programmes of the Authorities (*Laki viranomaisten suunnitelmien ja ohjelmien ympäristövaikutusten arvioinnista*), Land Use and Building Act (*Maankäyttö- ja rakennuslaki*), Emissions Trading Act (*Päästökauppalaki*), Land Extraction Act (*Maa-aineslaki*), Mining Act (*Kaivoslaki*), Forest Act (*Metsälaki*), Chemical Act (*Kemikaalilaki*), and the Nuclear Energy Act (*Ydinenergialaki*).

[652] KKO 2016:58 (Supreme Court of Finland, 2016) <https://finlex.fi/fi/oikeus/kko/kko/2016/20160058> accessed on 20 July 2013.

[653] See *Jätelaki* 646/2011 <https://www.finlex.fi/en/laki/kaannokset/2011/en20110646> accessed on 20 July 2023.

[654] See *Ympäristönsuojelulaki* 527/2014 <https://www.finlex.fi/fi/laki/smur/2014/20140527> accessed on 20 July 2023.

damages, eg reputational damage. Under such circumstances, a shareholder might be unable to recover any loss incurred by the company. The company's management could argue that the environmental legislation was inadvertently violated as a result of a decision made in the company's best interest. For example, if the management decides to expand the business and increase production, which subsequently results in unintended environmental pollution by exceeding the permissible limit for greenhouse gas emissions, a shareholder may not be able to recover any losses sustained by the company. This is particularly true for reputational losses, as the management's decision was made with the intention of furthering the company's interests.

This position is further strengthened as the FCA 1:5 stipulates that the purpose of the company is to generate profits for the shareholders, unless otherwise provided in the Articles of Association.[655] Ultimately, therefore, a decision taken to promote the interests of the company and to generate profits can result in a long-term economic loss specifically through reputational loss. This is particularly relevant to energy production companies in Finland. Thus, it is important that FCA regulates the management decisions to consider other non-shareholder interests, specifically those of the environment. Moreover, it is important to obligate management to consider the environment in their decision-making to attract investments, given the fact that a new shareholder who purchases shares of a company (including a minority shareholder) inherits the pre-acquisition environmental liability in a share sale as part of the aforementioned rights, duties and liabilities.[656] In turn, strengthening environmental protection through FCA would promote the attraction of investments from global Environmental, Social, and Governance (ESG) mutual funds.

At this point, it is important to highlight growing concerns in Finland about the environmental damage caused by industrial activities.[657] It is essential for the company, its shareholders, and all other parties involved to take environmental considerations into account when making corporate decisions. This would facilitate investor attraction, owing to the fact that a shareholder could claim liability in damages for the losses suffered by the company based on the negligence of

655 FCA 1: 5.

656 Mika Alanko and Robert Utter, 'Environmental law and practice in Finland: overview, Practical Law Country Q&A' (Thomas Reuters 16th Sep 2013) <https://uk.practicallaw.thomsonreuters.com/4-376-3598?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed on 29th July 2021.

657 See Amelie Klein and others, 'Finnish businesses and the biodiversity crisis, opportunities and risks associated with biodiversity loss' (WWF Finland and Bain & Company, 15 February 2023) <https://wwf.fi/app/uploads/3/n/t/brj1gr8rj0yjt1az27juij/finnish-businesses-and-the-biodiversity-crisis.pdf> accessed on 17 October 2023.

management decisions, specifically the reputation losses evidenced through the drop in share value. In addition, such obligations regarding decision-making would increase the overall sustainability of the company, its shareholders and its non-shareholder constituencies. Accordingly, the company would benefit in the long term, as discussed in the chapter three of this research.

Kärki, Ruohonen and Vahtera state that 'creditor protection norms are of essential importance in the stakeholder balance within the modern limited liability companies'.[658] It is also important to note that FCA 13: 2 states that the company's assets should not be distributed if the company is insolvent or the distribution will cause the company to become insolvent.[659] Insolvency is not defined in FCA, but Section 4 of the *Laki takaisinsaannista konkurssipesään (758/1991*; in English – the Act on the Recovery of Assets to Bankruptcy Estates) states that '*a debtor is insolvent where the debtor is not able to pay his or her debts when they become due and this is not a temporary situation*'[660] FCA 13:2 specifically states that '*Assets shall not be distributed, if it is known or should be known at the time of the distribution decision that the company is insolvent or that the distribution will cause the insolvency of the company'*[661] *Kärki,* Ruohonen and Vahtera state that the restriction imposed by FCA 13:2 applies to 'all asset distributions, regardless of the context or chosen method'[662] Even though the outcome of a solvency test is predominantly influenced by a company's cash flow assessment, there are no specific factors that singularly determine the results. Rather, it is the comprehensive evaluation of multiple elements that collectively contribute. These include the accounting information and financial statements of the company, meticulous appraisals in accounting, and other relevant fiscal data. External factors, such as the economic climate of society, market conditions, as well as company-specific developments in risk and uncertainties, also play a significant role.[663] Thus, the

[658] Anssi Kärki, Janne Ruohonen and Veikko Vahtera, 'Modernising creditor protection in limited liability companies – equity and finance' (2021) 1 Nordisk Tidskrift for Selskabsret 1,1.

[659] FCA 13:2 (Solvency).

[660] Michal Zurek and Kamil Szmid, 'Capital Maintenance' in Mathias Siems and David Cabrelli (eds) Comparative Company Law A Case-Based Approach (Hart Publishing, 2013), 209; also see the Finnish version Section 4 of the *Laki takaisinsaannista konkurssipesään (758/1991) 'Maksukyvyttömyydellä tarkoitetaan tässä laissa sitä, että velallinen muuten kuin tilapäisesti on kykenemätön maksamaan velkojaan niiden erääntyessä. Ylivelkaisuudella tarkoitetaan sitä, että velallisen velat ovat suuremmat kuin hänen varansa.'.*

[661] FCA 13:2.

[662] Kärki, Ruohonen and Vahtera (n 658) 11; also see Janne Ruohonen, *Osakeyhtiön voitonjaon maksukykytesti ja vastuu maksukyvyn säilymisestä* (Edita 2013) 243-247.

[663] Ruohonen (n 662) 269-273.

solvency test is a complex process, with its outcome shaped by a dynamic interplay of various internal and external elements. Further, it would be an interesting argument to put forward whether the liability risks from environmental factors will also influence the solvency test.

Toiviainen states that the Solvency test (FCA 13:2) must be read together with the 'balance sheet test' in FCA 13:3. Thus, even if the free equity capital shown in the balance sheet would technically allow distribution, it would still be prohibited if the 'solvency test' is not satisfied.[664] Accordingly, *Kärki, Ruohonen and Vahtera* state that the Solvency test was '*adopted to complement the balance sheet test as there are more and more value asset categories that are hard to define, such as intellectual property*'.[665] The balance sheet test, when applied, offers a straightforward methodology for computing distributable amounts. Lautjärvi states that its most notable advantage is its ease of use.[666] However, Kärki, Ruohonen and Vahtera argue that this test is not without its drawbacks, primarily its reliance on historical data and, at times, subjective accounting assessments. They suggest that these criticisms can be mitigated through the use of the solvency test and, in some jurisdictions, through a rule of caution test.[667] Importantly, Kärki, Ruohonen and Vahtera suggest for the adoption of this rule of caution test[668] within the Finnish legal framework to provide enhanced protection for creditors.[669]

Toiviainen highlight that FCA 13:2 has been justified under two grounds: first, it emphasises the residual rights of shareholders, and second, it aims to improve creditor protection by expressly restricting the right to distribute corporate assets in a going concern.[670] However, Toiviainen argues that the second justification is

[664] Toiviainen (n 272) 642.

[665] Kärki, Ruohonen and Vahtera (n 658) 11.

[666] Kari Lautjärvi, *Välipääomarahoitusinstrumentit: Yhtiöoikeudellinen tutkimus vieraan pääoman ehtoisen välipääomarahoittajan asemasta osakeyhtiössä* (Talentum 2015) ch 3.7.3.3.

[667] Kärki, Ruohonen and Vahtera (n 658) 10.

[668] '*Section 179 of the Danish Selskabsloven (Companies Act) 2010 enacts a rule of caution that limits asset distribution. This rule places the onus on the company's primary governing body to ensure that any distributions do not surpass what is reasonable given the company's, and in the case of parent companies, the group's financial standing. It further stipulates that no distribution should be made that would be detrimental to the company or its creditors. This provision necessitates a consideration of future risks and investment requirements, provided they can be reasonably foreseen. This section must be interpreted in conjunction with section 115, item 5, which mandates the company's board of directors to continuously ensure that the company's financial resources are adequate and that there is enough liquidity to cover both current and future liabilities as they become due*'. See ibid 13.

[669] ibid 15.

[670] Toiviainen (n 272).

unfounded because FCA 13:2 was formulated without any societal impact analysis or comparison of the stipulation with the law as it was in the previous Finnish Limited Liability Companies Act of 1978 (Finnish CA 1978).[671] Accordingly, he points out that the previous Finnish CA 1978 required the board of directors to propose or consent to profit distribution margins, and shareholders at the General Meeting should not exceed this recommendation. Therefore, he argues that it was under the board of directors' general duty of care to distribute assets without causing economic harm to the company and its constituents, not limited to the shareholders. This argument hinges on the notion that the board of directors is in the best position to evaluate how much of the surplus, including profits from the previous accounting period and other 'free equity' items, could be distributed without compromising the company's future.[672]

Moreover, Toiviainen raises concerns about the solvency test stipulated in FCA 13:2, highlighting that it has introduced a new set of problems. The first issue he identifies is the lack of a definition for insolvency in FCA. As noted earlier, the definition is provided in Section 4 of the *Laki takaisinsaannista konkurssipesään* (758/1991; English translation – the Act on the Recovery of Assets to Bankruptcy Estates). The second issue according to Toiviainen concerns the ambiguity over the relevant time period, during which insolvency should not be imminent due to distribution.[673] Kärki, Ruohonen and Vahtera argue that '*the circumstances of the company and its operational market sector significantly influence what is considered the relevant time period'*.[674] They further highlight the inherent ambiguity in determining this period, stating that an attempt to predict future circumstances can lead to increased inaccuracies and uncertainties. They caution that prescribing a specific time period in law could unnecessarily constrict or broaden the evaluation scope. Consequently, they propose that the determination of the time period should be an *in casu* assessment, made in the context of the directors' business judgment.[675]

Apart from the criticisms previously discussed, Kärki, Ruohonen and Vahtera highlight two additional issues: the parties responsible for conducting the solvency test and the documentation required in performing this test. FCA 13:2 does not explicitly stipulate the parties responsible for administering the solvency test, yet academic discourse suggests that the decision-making structure inherently places the onus on the board of directors, given their central role in asset distribution

[671] ibid 643.
[672] ibid 643-644.
[673] ibid 647.
[674] Kärki, Ruohonen and Vahtera (n 658)12.
[675] ibid.

decisions.[676] Savela highlights the role of other potential parties, such as the Chief Executive Officer and the General Meeting, who might also need to validate the legitimacy of any distribution.[677] Moreover, Kärki, Ruohonen and Vahtera contemplate the involvement of the auditor, even though they acknowledge the probability of the said decision-making bodies being held liable for neglecting the solvency test to be relatively low.[678]

In response to the ambiguity surrounding the documentation associated with performing the test, Kärki, Ruohonen and Vahtera propose the creation of a formal record, such as meeting transcripts. These could serve as evidence, provide indemnity, and be archived for future reference.[679] Furthermore, it could be beneficial to share such documentation with creditors, particularly those who have extended a substantial amount of credit in relation to the size of the company.

4.2.4 Remarks

FCA is either silent or unclear about what constitutes a major transaction. Similarly, it is not clear whether the board of directors or the general meeting has the final say on a transaction that may potentially affect the company in the short or long term. The underlying reason for this is that the Holzmüller doctrine[680] is not recognised under Finnish law. In the case referred to as Holzmüller,[681] the German Federal Court of Justice (*Bundesgerichtshof* – 'BGH') established that a management decision that has a significant economic effect on the company must pass through the general meeting of the stock corporation (German *Aktiengesellschaft*). This is particularly relevant within a publicly listed corporate group structure in balancing the power between shareholders and directors.[682] In response, greater certainty around what amounts to a major transaction and recognising the Holzmüller doctrine would improve investor attraction in the companies listed in the Finnish securities markets.

Auditors also play a pivotal role in protecting the overall interests of the company and in divulging its accurate financial position. Accordingly, the Finnish corporate governance has increased transparency by imposing greater responsibility on

676 ibid.
677 Ari Savela, *Vahingonkorvaus osakeyhtiössä* (3rd edn, Alma Talent 2015), 431.
678 Kärki, Ruohonen and Vahtera (n 658) 12.
679 ibid 11-12.
680 See eg Marc Löbbe, 'Corporate Groups: Competences of the Shareholders' Meeting and Minority Protection – the German Federal Court of Justice's recent Gelatine and Macrotron Cases Redefine the Holzmüller Doctrine,' German Law Journal 5/9 (2004), 1057–1079.
681 February 25, 1982 (BGHZ 83, 122).
682 Löbbe (n 680) 1057.

auditor: the Auditing Act (1141/2015; *tilintarkastuslaki*) regulates auditors' functions, duties and sanctions for negligent acts. In addition, the Finnish media is active in divulging economic crimes to the public.[683]

In sum, FCA is based on the majority rule principle in addition to generating profits for shareholders. According to the provisions of FCA, controlling shareholders are vested with significantly stronger rights, which are balanced to a certain extent with the principle of equal treatment and the duty of management to protect the rights of the minority shareholders. Moreover, recent amendments to the Corporate Governance Code in line with SHRD II have provided further protection to minority shareholders, eg independent directors on the board, related-party transactions and targets for sustainable development. However, private companies and SMEs listed on the Nasdaq First North Growth Market Finland are not obligated to comply with the recommendations and guidelines stipulated in the CG code. Thus, investors such as mutual funds may be reluctant to diversify their investments in these listed companies, as well as private companies listed on crowd equity platforms. Thus, Finnish SMEs are at a disadvantage compared to other developed countries in attracting the investments needed to grow and expand.

Additionally, minority shareholders cannot claim consequential damages for losses they personally suffer due to the actions of controlling shareholders and/or management;[684] neither can they claim damages for any oppressive acts committed by the controlling shareholders. In response to these limitations, statutory oppression or unfair prejudice remedies can provide enhanced protection for minority shareholders against the opportunistic actions of controlling shareholders.

4.3 Comparative study of Sri Lanka

4.3.1 Sri Lankan corporate governance in general

Sri Lankan company law has been based principally on UK company law until the Companies Act No. 07 of 2007 (hereafter referred to as 'CA2007') was incorporated, eg the *Joint Stock Companies Ordinance No. 4 of 1861* and the *Companies Act, No. 17 of 1982*.[685] Roman Dutch Law (RDL) applicable in Sri Lanka alongside English law as the common law of the land in respect of the law relating to corporations until

683 Mähönen, 'Finland: Corporate Governance: Nordic Tradition with American Spices' (n 551) 436.

684 FCA 22: 7 (4).

685 Harsha Cabral, *Companies Act No. 7 of 2007 and The Corporate law of Sri* Lanka (2nd edn, Published by Harsha Cabral 2019) 33.

the enactment of the amendment to the *Civil Law Ordinance by Ordinance.*[686] By the introduction of Section 3 of the Civil Law Ordinance, the application of RDL to the law relating to corporations was restricted in the following manner in Sri Lanka:

> In all questions or issues which may hereafter arise, or which may have to be decided in Ceylon [Sri Lanka] with respect of the laws of partnerships, corporations […] the law to be administered shall be same as would be administered in England […].[687]

Sri Lankan company law allows three types of companies to be incorporated under the *Companies Act No. 7 of 2007*: a) a company that issues shares, whereby the holders of such issued shares have a liability to contribute to the assets of the company, if any, as specified in the company's articles attached to those shares (referred to as a 'limited company'); b) a company that issues shares and the holders of such issued shares have an unlimited liability to contribute to the assets of the company under its articles (referred to as an 'unlimited company'); and c) a company that does not issue shares and its members contribute to the assets of the company in an amount specified in the company's articles in the event of its being placed into liquidation (referred to as a 'company limited by guarantee').[688]

The aforementioned limited liability companies that issue shares can be further separated into two categories: public limited company and private limited company. Public limited companies are listed on the stock exchange, and the abbreviation 'PLC' is used after the company name to identify the nature of the incorporation. For instance, Hayleys PLC and Aitken Spence PLC.[689] A private limited company is one that prohibits through its articles the issue of shares and other securities to the public and limits the number of shareholders to 50.[690] Those companies that fulfil such requirements as provided in Section 27 of the CA2007 use the abbreviation '(Pvt) Ltd.' at the end of their names.[691] For instance, Fairway Holdings (Pvt) Ltd. and Alco Industries (Pvt) Ltd.

Generally, unlimited companies are mostly used by the business community not to trade but mainly for the purpose of holding investments and land. The term 'company limited by guarantee' is mostly used for charitable or non-profit activities.

686 Ordinance Nos. 5 of 1852, 22 of 1866, 2 of 1889, 18 of 1914, 25 of 1927, 51 of 1938, 17 of1944 and also see Henry Wijayakone Tambiah, *Principles of Ceylon law* (H.W. Cave 1972).
687 Section 3 of the Civil Law Ordinance (emphasis added).
688 Section 3 of the CA2007.
689 Section 6 (c) of the CA2007.
690 Section 27 of the CA2007.
691 Section 6 (b) of the CA 2007.

The form of 'limited liability company' is mostly used by the business community for trading purposes. As of 4th October 2021, the Department of the Registrar of Companies in Sri Lanka indicates that there are 103,832 private limited companies and 4,375 public companies in the country.[692] The Colombo Stock Exchange (CSE), meanwhile, indicates that 287 public companies are listed on the stock market as of 31st August 2021, with a market capitalisation of LKR 4.00946 billion.[693]

The CA2007 applies to all three types of companies, ie limited companies, unlimited companies and companies limited by guarantee. The listed companies (eg PLCs) are highly regulated: in addition to the CA2007, they are further regulated by other laws and regulations such as the *Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021 (SEC Act 2021)*, *Listing Rules issued by the CSE*[694] and the *Code of best practice on Corporate Governance 2017 (CG code 2017).*[695] The Sri Lankan Parliament recently (on 21st September 2021) repealed and replaced the *Securities and Exchange Commission Act No. 36 of 1987* with the *Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021*. The Securities and Exchange Commission of Sri Lanka (SEC), established under Section 4 of the SEC Act 2021, is empowered to issue further rules, regulations, directives, circulars and guidelines. For instance, the Takeovers and Mergers Code, the Unit Trust Code, SEC Rules and SEC Regulations.[696] Additionally, the CSE has also issued listing rules,[697] trading rules[698] and circulars[699] to regulate listed companies.

The SEC Act 2021 provides authority to the Commission to issue licenses to a central depository in order to establish and operate a system for the central handling

[692] The Department of the Registrar of Companies webpage <http://www.drc.gov.lk/en/> accessed on 4th October 2021.

[693] The Colombo Stock Exchange <https://www.cse.lk/pages/listed-company/listed-company.component.html?status=2> accessed on 4th October 2021.

[694] Listing Rule <https://cdn.cse.lk/pdf/cse-rules/listing-rules/Contents-Updated-as-at-22-06-2021.pdf> accessed on 7th October 2021.

[695] The Code of best practice on Corporate Governance 2017 <https://www.casrilanka.com/casl/images/stories/2017/2017_pdfs/code_of_best_practice_on_corporate_governance_2017_final_for_web.pdf> accessed on 4th October 2021.

[696] The SEC Rules and Regulations <https://www.sec.gov.lk/index.php/rule-regulations-2/> accessed on 4th October 2021.

[697] Listing Rules <https://www.cse.lk/pages/listing-rules/listing-rules.component.html> accessed on 4th October 2021.

[698] Trading Rules -<https://cdn.cse.lk/pdf/cse-rules/ats-rules/ATS-Rules_Amended-September-2021.pdf> accessed on 4th October 2021.

[699] CSE Circulars <https://www.cse.lk/pages/cse-circulars/cse-circulars.component.html> accessed on 4th October 2021.

of securities.[700] The Central Depository Systems (Pvt) Ltd. (CDS),[701] which acts as the central depository in Sri Lanka as a market intermediary and clearing house, is a wholly owned subsidiary of the CSE. The CDS operates as a central depository in respect of securities traded on the CSE and holds securities in custody on behalf of the shareholders of listed companies.[702] The duties of the CDS are stipulated in Section 56 of the SEC Act 2021. The new SEC Act stipulates stringent provisions to take actions against corporate wrongdoers to protect investors. Part V of the SEC Act 2021 provides extreme measures against market misconduct such as 'Prohibited Conducts'[703] and 'Insider Trading' focusing on securities.[704] These sanctions are backed by heavy fines and imprisonment, both in the civil[705] and criminal jurisdictions.[706]

The CG Code 2017 is issued by the Institute of Chartered Accountants of Sri Lanka (ICASL) together with the SEC. It should be noted that in Sri Lanka, the CG Code is entirely voluntary and is not based on the 'comply or explain' basis. The Code mainly focuses on board composition, board meetings, board's role, ESG reporting, director training, related-party transaction committees and extensive reporting on, inter alia, cyber security. However, the Listing Rules issued by the CSE contain mandatory provisions on certain matters that fall under the purview of corporate governance, eg it is mandatory for companies intending to list their securities to disclose the names of directors who are independent. In addition, certain matters provided in the Listing Rules issued by the CSE operate on the basis of 'comply or explain'. Section 7 of the Listing Rules (continuous listing requirements) require listed entities to issue a statement of compliance, if not to set out the reasons for non-compliance in the annual report on certain matters, which falls under the purview of corporate governance. These matters are set out in Section 7.10 of the Listing Rules, eg corporate governance matters relating to non-executive directors, independent directors, disclosures relating to directors, criteria for defining

[700] See Interpretation of Central Depository under Section 188 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021.

[701] The Central Depository Systems (Pvt) Limited webpage <https://www.cds.lk> accessed on 6th October 2021.

[702] The Colombo Exchange webpage <https://www.cse.lk/pages/aboutus-cds/aboutus-cds.component.html> accessed on 6th October 2021.

[703] Chapter 1 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021.

[704] Chapter 2 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021 and see the interpretation for 'Securities' at Section 188,164.

[705] Section 152 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021.

[706] Section 149 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021.

'independence', remuneration committees and audit committees.[707] Furthermore, the Listing Rules stipulate that the listed companies are obliged to report on the content of the annual report, eg corporate governance matters stipulated in Rule 7.10.3; disclosures relating to directors – Rule 7.10.5 c.; disclosures relating to the remuneration committee – Rule 7.10.6 c.; disclosures relating to the audit committee of Section 7 of the Rules and *Related party transactions exceeding 10% of the Equity or 5% of the total assets of the Entity as per Audited Financial Statements, whichever is lower*.[708] Thus, the Sri Lankan CG regulatory framework means that corporate governance aspects function through three different modes of operations, ie mandatory, comply or explain and voluntary.

4.3.2 Legal strategies in relation to the second agency problem

4.3.2.1 What are the rights vested in shareholders to proactively reduce agency costs in the second agency problem?

The specific rights under discussion in this topic encompass economic rights, control rights, access to information rights, and enforcement mechanisms, which include litigation rights. Section 86 of the Sri Lankan company law sets out the meaning of the term 'shareholder'.[709] Thus, the economic rights of a company member are secured as a shareholder if said member falls within the four corners of the definition set out in Section 86 of the CA2007. Shareholders' rights and liabilities[710] are determined by the provisions of the CA2007, the company's articles[711] and shareholder agreements. Shareholder agreements are subject to the provisions of the CA2007 and the company's articles. Furthermore, shareholder agreement is voluntary.

The board of directors has sole discretion to issue new shares. However, such discretion must be made in good faith and meet several conditions, ie it is subject to scrutiny under the provisions of the CA2007 and the company's articles, pre-emptive

707 Rule 7.10 of the Listing Rules issued by the CSE (Incorporating amendments up to 16th August 2021).
708 Rule 7.6 of the Listing Rules issued by the CSE (Incorporating amendments up to 16th August 2021).
709 See Section 86 of the CA2007.
710 See Section 87 of the CA2007 for liability of shareholders.
711 Section 16 of the CA2007.

rights of existing shareholders,[712] rights of interest groups,[713] directors' duties[714] and, in the case of a public offering, compliance with SEC and CSE regulations.[715] The provisions of the CA2007 protect shareholders' economic rights already vested in shares in case of a new issue of shares, eg Section 13(b) – the rights and obligations of shareholders of the company; Section 15 – adoption or amendment of articles; Section 49 – nature and types of shares; Section 51 – issue of shares; Section 52 – consideration for issue of shares; Section 53 – pre-emptive rights to new issues; Section 99 – alteration of shareholder rights; and Section 188 – directors' obligation to comply with the Act and articles.

Section 49 (2) specifically provides that, subject to the company's articles, a share transfer in a company shall transfer three fundamental economic rights to a shareholder. They are as follows:

> (a) the right to one vote on a poll at a meeting of the company on any resolution;
>
> (b) the right to an equal share in dividends paid by the company; and
>
> (c) the right to an equal share in the distribution of the surplus assets of the company on liquidation.[716]

Thus, subject to the company's articles, a shareholder has specific rights to dividends and distribution of surplus assets. The freedom of contracting allows investors to negotiate stronger economic rights through the company's articles. Section 51(2) provides that if the new issue of shares confers rights other than those set out in Section 49 (2), the board must approve terms of issue that set out the rights and obligations attached to those shares. Section 51(3) provides that Terms of Issue approval by the board under Section 51(2) shall be consistent with the company's articles, meaning that the rights conferred must be consistent with those agreed in the company's articles by shareholders.[717] Furthermore, Section 52 of the CA2007 specifically stipulates that *the Board shall resolve that in its opinion that*

712 Section 53 of the CA2007.
713 Section 99 of the CA2007.
714 Section 187 of the CA2007.
715 Kanaganayagam Kanag-Isvaran and Dilshani Wijayawardana, *Company Law* (Published by K. Kanag-Isvaran 2014) 142.
716 Section 49 (2) of the CA2007.
717 This is according to the author's opinion and interpretation of the specific Sections.

consideration is fair and reasonable to the company and to all existing shareholders.[718]

The Sri Lankan CA2007 specifically provides that a share in a company is a 'movable property'.[719] The legal nature of shares is generally recognised as a 'bundle of rights and obligations binding the company and its shareholders'.[720] Sri Lankan company law provides freedom for companies to issue different classes of shares. Section 49(3) stipulates that:

> A company may issue different classes of shares, and in particular may issue shares which —
>
> (a) are redeemable;
>
> (b) confer preferential rights to distributions; or
>
> (c) confer special, limited, or conditional voting rights or confer no voting rights.[721]

However, the CA2007 does not provide a specific definition for any type of shares, and investors thus have the flexibility to create their own types of shares within the four corners of the CA2007. The rights and obligations of each share type can be set out in the company's articles at the initial stage of incorporating the company, or they can be amended according to the provisions of the CA2007 and the company's articles. If new shares are issued by the board, the rights and obligations set out in the Terms of Issue must reflect the provisions of the company's articles,[722] which can only be amended via a special resolution[723] – in other words, only by shareholders.[724] Thus, only shareholders can agree on the rights and obligations that can be attached to a share.

The board may issue different classes of shares, subject to the provisions of the company's articles.[725] The common classes of shares are 'ordinary shares', 'preference shares', 'redeemable preference shares', 'non-voting shares', 'deferred

[718] Section 52 (1) (b) of the CA2007.
[719] Section 49 (1) of the CA2007.
[720] Borland's Trustee v Steel Brothers & Co Ltd (1901) 1 Ch 279.
[721] Section 49(3) of the CA2007.
[722] Section 51 (3) (a) of the CA2007.
[723] Section 15 of the CA2007.
[724] See Special resolution, Section 143 of the CA2007.
[725] Section 51 of the CA2007.

shares' and 'employee shares'.[726] Furthermore, Section 49 (5) stipulates that a share in a company is transferable subject to the company's articles. Thus, the company's articles can impose restrictions on the transferability of shares. This may affect the liquidity of shares in companies that are not listed on the CSE, as the Listing Rules of the CSE require that shares listed must be freely transferable and that such listed shares must not be subject to any restrictions on transferability.[727]

Section 53 of the CA2007 provides that *subject to the company's articles, where a company issues new shares which rank equally with or above existing shares in relation to voting or distribution rights, those new shares shall be first offered to the existing shareholders*.[728] While the CA2007 specifically provides for voting and distribution rights, the company's articles can restrict or include other rights to be subject to the pre-emptive rights of existing shareholders. The CA2007 provides the flexibility for investors to agree on such matters in the articles of the company. It should be noted that if a new right is attached to a new issue of shares that affects the existing shareholders' rights, it can be subjected to an oppression and mismanagement action by an affected existing shareholder.

Distribution is an important concept in Sri Lankan company law for shareholders' economic rights such as, inter alia, the payment of dividends, the redemption or other acquisition of share/s, distribution of indebtedness or otherwise. Sri Lankan company law defines the term 'distribution' as follows:

> (a) the direct or indirect transfer of money or property, other than the shares of a company, to or for the benefit of a shareholder; or
>
> (b) the incurring of a debt to or for the benefit of a shareholder, in relation to a share or shares held by that shareholder, whether by means of a payment of a dividend, a redemption or other acquisition of the share or shares, a distribution of indebtedness or otherwise;[729]

Section 60 (1) of the CA2007 states that a dividend is a distribution made out of the profits of the company. This section specifically states that an acquisition by the

726 Kanag-Isvaran and Wijayawardana (n 715) 134.

727 See Section 6 A. 1. of the Listing Rules issued by the CSE (Incorporating amendments up to 16th August 2021) <https://cdn.cse.lk/pdf/Section-6.pdf> accessed on 9th October 2021.

728 Section 53 of the CA2007. This Section is based on Section 45 of the New Zealand Company Act of 1993 and Section 28 of the Canada Business Corporation Act of 1985.

729 See interpretation section - Section 529 of the CA2007. The term 'Distribution' is very similar to the definition of the term in Section 2 of the New Zealand Company Act of 1993.

company of its own shares or a redemption of shares by the company[730] does not fall under the definition of dividend.[731] Accordingly, shareholders' main economic right to dividends is subject to the laws relevant to distribution. The Sri Lankan CA2007 stipulates three prerequisites to be satisfied before a company makes a distribution: (1) a distribution must be approved by the board of directors of the company;[732] (2) unless the company's articles provide otherwise, a distribution must be approved by the shareholders by way of an ordinary resolution;[733] and (3) a distribution must be subject to the 'solvency test'.[734] Thus, in making a dividend must satisfy the aforesaid three prerequisites. In the case of the third prerequisite, this fundamental safeguard states that the company must be solvent after it pays the dividends.[735] If payment of dividends was made in breach of the solvency test, the directors would be personally liable, and the clawback provisions, eg Section 61 of the CA2007, would be helpful to the company in recovering the dividends from the shareholders. Such safeguards are provided as proactive measures to protect creditors and to prevent misuse of company funds to avoid businesses from being bankrupted. In addition, the payment of dividends is subject to the presumption of equality in common law, which is codified under Section 60 (2) of the CA2007:

> (2) The board of a company shall not authorise a dividend in respect of some shares in a class and not others of that class or of a greater amount in respect of some shares in a class than other shares in that class, except where—
>
> (a) the amount of the dividend is reduced in proportion to any liability attached to the shares under the company's articles; or
>
> (b) a shareholder has agreed in writing to receive no dividend or a lesser dividend than would otherwise be payable.[736]

Furthermore, a shareholder or group of shareholders may institute an action under oppression and mismanagement if a shareholder is oppressed by an act of irregularly made distribution.

[730] See Section 67 of the CA2007.
[731] Section 60 (1) of the CA2007.
[732] Section 56 (1) (a) of the CA2007.
[733] Section 56 (1) (b) of the CA2007.
[734] Section 57 of the CA2007.
[735] See Solvency test Section 57 of the CA2007.
[736] Section 60 (2) of the CA2007.

The Sri Lankan CA2007 provides the opportunity for the company to redeem a redeemable share in accordance with the limitations provided in Sections 66 to 69.[737] In addition, a company may also re-purchase its own share according to the conditions stipulated in Sections 63 to 65 of the CA2007. The company's articles must make provisions allowing both the redemption of a redeemable share and the re-purchase of shares. Furthermore, a shareholder may also require the company to purchase his/her own shares in the case of a minority buy-out situation, as provided in Section 93 of the CA2007. However, minority buy-out does not amount to an act of distribution; thus, the stringent provisions applicable to repurchase and redemption of shares do not apply in a minority buy-out situation. Minority buy-out rights are further discussed below (See page 182). The CA2007 is also silent on 'drag along and tag along' rights, meaning that drag along[738] and/or tag along rights[739] terms can be agreed in the shareholder agreement or the company's articles.

Turning our attention to the control rights of shareholders in Sri Lanka it is important to note that under Section 184 of the CA2007, the board of directors is vested with all the powers necessary to manage the affairs of the company. Such management power vested in the board of directors is subject to the company's articles. Thus, shareholders have the freedom to limit or increase directors' management power. On the other hand, shareholders can also reserve certain controlling powers for themselves through the company's articles. However, in Sri Lanka, it is not common practice to vest management control power in shareholders. Nonetheless, the CA2007 has vested certain important decision-making powers in the shareholder, eg appointment and removal of directors and major transactions. The CA2007 has also vested controlling rights such as, inter alia, the aforesaid voting to remove directors and appoint new directors,[740] questioning on matters related to the company in AGMs and passing resolutions accordingly,[741] voting as part of an interest group against the company (which, in most circumstances, can be utilised by non-controlling shareholders),[742] voting for or against major transactions of the

[737] Section 63 (2) of the CA2007.

[738] A drag along right allows majority shareholder (usually more than 50% shares) to force a minority shareholder/s to accept an offer from a third-party purchaser when there is a good offer available for the majority shareholder. Drag along rights also allow minority shareholders to receive the same offer made to the majority shareholder.

[739] Tag along rights (co-sale rights) allows minority shareholders to sell their shares at the same time for the same price if majority shareholders sell their shares. This protects minority shareholders (eg usually less than 10%) against devaluing their shares or resulting in holding unsalable shares pursuant to the majority shareholder's share sale.

[740] Section 205 and 206 of the CA2007 respectively.

[741] Section 136 of the CA2007.

[742] Section 99 of the CA2007 and see the Interpretation Section 529 for 'interest groups'.

company,[743] altering the company's articles,[744] and voting against a fundamental change to the company and, as a result requiring the company to buy their shares.[745] Subject to the company's articles, the shareholder's right to vote is a proprietary right attached to the share. Moreover, whether all the shareholders have the same right to attend the AGM and the number of votes attached to each share are matters that can be provided in the company's articles.[746] In this way, the flexibility to widen the management power of shareholders by themselves through the company's articles and the vital management powers vested through the CA2007 operate as oversight mechanisms against directors' opportunism in managing the affairs of the company. Such proactive measures specifically reduce the agency costs resulting from the first agency problem discussed in this research.

Shareholders can exercise the powers reserved for them at a meeting of shareholders or by a resolution in lieu of a meeting according to the terms of Section 144 of the CA2007. The two available types of meeting are annual general meetings (AGMs) and extraordinary general meetings (EGMs). The quorum required for the meeting can be agreed upon in the company's articles. Without the quorum, no resolution can be passed, and no business can be transacted. Section 134 of the CA2007 provides that shareholders can require the board to convene a meeting on specific identified issues pursuant to satisfying the requirements set out in Section 134. Furthermore, according to common law, when an issue arises during the management of the company that requires the attention of shareholders, the directors can convene an EGM whenever they see fit.[747] The board of directors is obligated by law to call an AGM,[748] and failure to hold an AGM is an offence under Sri Lankan company law.[749] However, this requirement is subject to Sections 133 (2)[750] and 144 of the CA2007. A resolution in writing can be passed rather than conducting an AGM under the terms of Section 144 of the CA2007.[751] In addition, Section 144 allows shareholders to pass resolutions without the need to convene an EGM. This is beneficial to small companies, as passing a resolution in writing by the majority of

743 Section 185 of the CA2007.

744 Section 15 of the CA2007.

745 Section 93 of the CA2007.

746 Section 49 (2) of the CA2007.

747 Kanag-Isvaran and Wijayawardana (n 715) 333; also see Section 220 (1) of the CA2007 which require board of directors to call an EGM for the purpose of bringing the shareholder attention in a case of a serious loss of capital.

748 Section 133 (1) of the CA2007.

749 Section 133 (6) of the CA2007.

750 Section 133 (2) of the CA2007 - A company is not required to hold its first annual general meeting in the calendar year of its incorporation but shall hold that meeting within eighteen months of its incorporation.

751 Section 144 (3) of the CA2007.

shareholders evades the cumbersome procedure of calling a meeting and sending out notices, thereby saving costs. More specifically, Section 144 provides that:

> (1) Subject to the provisions contained in the company's articles, a resolution in writing signed by not less than eighty-five per centum of the shareholders who would be entitled to vote on that resolution at a meeting of shareholders, who together hold not less than eighty-five per centum of the votes entitled to be cast on that resolution, shall be as valid as if it had been passed at a meeting of those shareholders.
>
> (2) Subject to the provisions contained in the company's articles, a resolution in writing that—
>
> (a) relates to a matter that is required by this Act or by the articles to be decided at a meeting of the shareholders of a company; and
>
> (b) is signed by the shareholders specified in subsection (1),
>
> is deemed to be made in accordance with the provisions of this Act or the articles of the company.[752]

Section 144 is based on Section 122 of the New Zealand Company Act (NZCA) of 1993 and Section 136 of the Canada Business Corporation Act (CBCA) of 1985. It has mandated shareholders to efficiently exercise their voting power in management decisions and to increase shareholder activism in these three countries.

The powers reserved for shareholders are exercised by them at the aforementioned meetings either by way of an '*ordinary resolution*' or by way of a '*special resolution*'.[753] Section 529 of the CA2007 states that 'ordinary resolution' means '*a resolution that is approved by a simple majority of the votes of those shareholders entitled to vote and voting on the question*' – this interpretation is similar to that of New Zealand and Canada company law legislation.[754] Accordingly, any matter that does not require a special resolution can be resolved by adopting an ordinary resolution, subject to the company's articles. For instance, certain matters

[752] Section 144 (1) and (2) of the CA2007.
[753] Section 91 and 92 of the CA2007.
[754] Section 105 of the New Zealand Company Act of 1993; Section 2 (1) of the Canada Business Corporation Act of 1985.

related to distribution,[755] the appointing and removing of directors,[756] the appointment of company auditors[757] and decisions regarding remuneration and other benefits to directors.[758] In contrast, a special resolution is mainly utilised as a decision-making tool when the company is deciding on an important act or is making a fundamental change to itself. The special resolution method is designed to secure that the greater body of shareholders, including non-controlling shareholders of the company, are involved when an important decision is made. Section 143 of the CA2007 provides that:

> (1) A resolution shall be a special resolution when it has been passed—
>
> (a) by a **majority of seventy-five per centum** of those shareholders entitled to vote and voting on the question;
>
> (b) at a general meeting of which not less than fifteen working days' notice, specifying the intention to propose the resolution as a special resolution has been duly given :
>
> Provided that, where it is so agreed by **the shareholders having the right to attend and vote at any such meeting, being shareholders together representing not less than eighty-five per centum of the total voting rights at that meeting**, a resolution may be proposed and passed as a special resolution at a meeting of which less than fifteen working days' notice has been given.[759]

Specifically, the CA2007 lists certain matters to be resolved only by way of a special resolution, notwithstanding anything to the contrary contained in the company's articles.[760] Accordingly, the company's articles can provide further matters or even take out matters provided in the CA2007 to be resolved by a special resolution. As noted above, the matters provided in Section 92 (1) of the CA2007 relate to altering the company's articles,[761] decisions regarding a major

755 Section 56 of the CA2007.
756 Section 205 and 206 of the CA2007.
757 Section 154 of the CA2007.
758 Section 216 of the CA2007.
759 Section 143 of the CA2007 (emphasis added).
760 Section 92 of the CA2007.
761 Section 15 of the CA2007.

transaction,[762] approving an amalgamation,[763] reducing the company's stated capital,[764] voluntarily winding up the company under Section 319 of the CA2007, name changes for the company,[765] and changing the status of the company.[766]

Shareholders in a private company have a special power recognised as the 'doctrine of unanimous assent'. Section 31 (1) of the CA2007 provides that any action taken is deemed to be validly authorised by the company where all the shareholders of a private company agree in writing to any action that has been taken or is to be taken by the company, notwithstanding any provision in the company's articles to the contrary. The doctrine of unanimous assent enables shareholders to address business issues efficiently by saving costs on meetings and time. This is especially important for SMEs, where budgets for internal governance are typically small. Furthermore, provisions relating to major transactions play a pivotal role in reducing the agency costs that can arise from the agency problems between shareholders and managers and between controlling and non-controlling shareholders. Section 185 (1) of the CA2007 provides four methods of approving a major transaction:

(a) approved by special resolution; or

(b) contingent on approval by special resolution; or

(c) consented to in writing by all the shareholders of the company; or

(a) a transaction which the company is expressly authorised to enter into by a provision in its articles, which was included in it at the time the company was incorporated.[767]

Thus, directors cannot take decisions that amount to a major transaction without shareholders' knowledge and consent. Major transactions can be detrimental to the company; thus, major transaction provisions protect shareholders from directors' opportunistic actions that could affect their proprietary rights without their knowledge.

Section 185 (2) of the CA2007 defines a major transaction as follows:

762 Section 185 of the CA2007.
763 Section 241 of the CA2007.
764 Section 59 of the CA2007.
765 Section 8 of the CA2007.
766 Section 11 of the CA2007.
767 Section 185 (1) of the CA2007.

(a) the acquisition of or an agreement to acquire whether contingent or not, assets of a value which is greater than half the value of the assets of the company before the acquisition;

(b) the disposition of an agreement to dispose of, whether contingent or not, the whole or more than half by value of the assets of the company;

(c) a transaction which has or is likely to have the effect of the company acquiring rights or interests or incurring obligations or liabilities of a value which is greater than half the value of the assets before the acquisition; or

(d) a transaction or series of related transactions which have the purpose or effect of substantially altering the nature of the business carried on by the company.[768]

Accordingly, decisions that can directly affect shareholders' economic and control rights are proactively protected through Section 185 of the CA2007. In addition, Section 93 provides that, inter alia, if a shareholder casts all his/her votes against a decision on major transactions as stipulated in Section 185 (2) (a) and (b) of the CA2007, all such dissenting shareholders shall be entitled to require the company to purchase those shares in accordance with Section 94 of the CA2007.[769] In turn, a non-controlling shareholder has the possibility to exit from the company without being stuck with opportunistic controlling shareholders. However, Sri Lankan company law does not provide restrictive provisions on the use of shareholder votes; shareholders can thus use their votes out of self-interest. Therefore, the exit right is a good recourse for non-controlling shareholders trapped with controlling shareholders who use their votes selfishly as well as those who seek to benefit from the economic rights vested in them through their shares.

Shifting the focus to shareholders' rights of access to information in Sri Lanka, it is observed Section 220 of the CA2007, mandates the board of directors to convene an Extraordinary General Meeting and present a report on any serious loss of company capital directly to the shareholders.[770] This report must contain *the nature and extent of the losses incurred by the company*, *the cause or causes of the losses incurred by the company*, and *the steps, if any, which are being taken by the board*

[768] Section 185 (2) of the CA2007.
[769] Section 93 of the CA2007.
[770] Section 220 (1) of the CA2007.

to prevent such losses or to recoup the losses incurred.[771] Furthermore, the shareholders have a right to ask questions of the directors about both the report and the affairs of the company management in general.[772]

Section 119 of the CA2007 vests shareholders with the right to inspect company records, including minutes of all meetings and resolutions of shareholders; copies of written communications to all shareholders or to all holders of a class of shares during the preceding ten years, including annual reports, financial statements, and group financial statements; certificates issued by directors under this Act; and the interests register of the company.[773] The manner in which these documents can be inspected is provided in Section 121 of the CA2007. Additionally, Section 122 enables shareholders to take a copy or extract from those documents made available for inspection under Section 119.[774]

The 'financial statement' consists of vital information on the up-to-date financial status of the company. Preparation of the financial statement is only possible if a company periodically and systematically maintains its accounting records.[775] According to Section 148 of the CA2007, it is important to have accurate accounting records in the company because the records speak for themselves.[776] Financial statements are defined in Section 529 of the CA2007 as follows:

> (a) a balance sheet for the company as at the balance sheet date; and
>
> (b) in the case of—
>
> > (i) a company trading for profit, a profit and loss statement for the company in relation to the accounting period ending at the balance sheet date; and
> > (ii) a company not trading for profit, an income and expenditure statement for the company in relation to the accounting period ending at the balance sheet date,

771 Section 220 (2) of the CA2007.
772 Section 220 (3) of the CA2007.
773 Section 119 (1) of the CA2007.
774 Section 122 (1) of the CA2007.
775 Kanag-Isvaran and Wijayawardana (n 715) 353.
776 See Maloc Construction Ltd (in liq) v Chadwick (1986) 3 NZCLC 99, 794; Crott v Touche Ross & Co (1992) 6 NZCLC 67, 824; Warren V Bartlett (1979) 4 ACLR 354.

> together with any notes or documents giving information relating to the balance sheet or statement.[777]

The company financial statement must give a true and fair view of the state of affairs of the company at the balance sheet date, thus allowing shareholders to obtain an up-to-date view of the current affairs of the company. This protects shareholders' rights and creates and avenue for investors to obtain up to date information on the company performance to take proactive investment decisions. Failure of the company to provide accurate information in the financial statement – and specifically in its accounting records – can amount to civil and criminal actions.[778]

The 'annual report' is a vital source of information on the performance and affairs of the company for its shareholders. Section 166 of the CA2007 provides that the board is obligated to prepare an annual report within six months from the balance sheet date of the company and to send the report to every company shareholder no less than 15 working days before the date fixed for the AGM.[779] Section 168 of the CA2007 provides the contents of the annual report. Accordingly, shareholders can peruse the annual report and ask questions of the board of directors at the AGM. Failure to prepare and deliver an annual report to all shareholders is an offence under the CA2007.[780]

'Investigation of company's affairs' by shareholders has been made possible through the CA2007. Section 172 of the CA2007 grants provisions to shareholders to investigate the company's affairs by making an application to the Registrar[781] to appoint one or more inspectors. The requirements and the threshold required for such an application is provided in Section 172 (1) of the CA2007. Additionally, Section 173 provides other reasons for the Registrar to investigate: specifically, inter alia, *if shareholders have not been given all the information with respect to the company's affairs which they might reasonably expect.*[782] However, Section 172 (2) of the CA2007 requires that such an application by shareholders must be supported by evidence to show good reason for the Registrar to instigate such an investigation. However, the law is silent on shareholders obtaining confidential company information, and shareholders may therefore have to provide sufficient evidence to the Registrar as per Section 172 (2) of the CA2007 to obtain such confidential

777 Section 529 of the CA2007.

778 See Section 224 and 225 oppression and mismanagement provisions respectively and Section 148 (3) of the CA 2007.

779 Section 167 of the CA20047.

780 Section 166 (2) and 167 (2) of the CA2007.

781 Section 529 of the CA2007 define Registrar as the Registrar general of Companies or other officer performing the duty of registration of companies under the CA2007.

782 Section 173 (1)(b)(iv) of the CA2007.

information. Minority shareholders may also be disadvantaged by the requirement to show evidence, owing to the difficulty in obtaining such evidence if opportunistic directors are acting in opportunism together with the controlling shareholders. In such a situation, the affected minority shareholders may be able to invoke oppression statutory provisions to remedy such opportunistic behaviours by the directors.[783]

Generally, then, the CA2007 has vested shareholders with stronger access to information rights, including transparency in corporate governance matters and investigation rights of the company.

Addressing the enforcement mechanisms and litigation rights of shareholders in Sri Lanka, CA2007 provides shareholders with various rights of action, tailored to the specific nature of the infringed rights. A shareholder may bring a personal action against the company if an individual right is infringed. Sections 224 and 225 of the CA2007 provide for oppression and mismanagement actions for shareholders. Oppression and mismanagement actions can also be brought as representative actions by a group of shareholders; the threshold for such actions is provided in Section 226 of the CA2007. Oppression and mismanagement actions are further discussed below in this section (4.3.2.4.). Section 234 of the CA2007 provides for a derivative action, whereby a shareholder or director can sue any wrongdoers in the name of the company. This action is specifically sought by non-controlling shareholders where controlling shareholders or their agents or controlling directors are the wrongdoers. The advantage of proceeding with the derivative action is that the cost of the proceedings is met by the company, if leave is granted by the court under Section 234 of the CA2007.[784] However, derivative actions in Sri Lanka are rare compared to oppression and mismanagement actions because the party seeking to enforce the right has to bear the additional burden of obtaining leave from the court pursuant to satisfying the conditions stated in Section 234 (2) and (3) of the CA2007.[785] Section 236 of the CA2007 grants wide-ranging powers to the court to remedy matters raised by the petitioner if said leave is obtained.[786] Section 233 of the CA2007 provides restraining orders against any conduct that would contravene the articles of the company or any provision of the Act; this remedy is based on Section 164 of the New Zealand Company Act of 1993. The restraining orders under Section 233 of the CA2007 take the form of a *quia timet* injunction, meaning that the wrongful conduct that the party is seeking to restrain is imminent but has not

783 Invoking of the oppression statutory provisions depends on the factual background of the case.
784 Section 235 of the CA2007.
785 Section 234 of the CA2007.
786 Section 236 of the CA2007.

been completed.[787] If such wrongful conduct has already been completed, a party cannot seek remedies under this Section.

The above-discussed Section 172 of the CA2007 is a vital provision for shareholders who have been side-lined from the company's affairs to request the Registrar of Companies to investigate these affairs based on good reasons.[788] Likewise, the shareholder minority buy-out rights in the terms of Sections 93 to 98 are important provisions for non-controlling shareholders in the company. Similar provisions can be found in Sections 110–115 of the New Zealand Company Act of 1993 and Section 190 of the Canada Business Corporation Act of 1985. The basis for the incorporation of the minority buy-out right is an attempt to balance the conflicting interests of controlling and non-controlling shareholders. For instance, when the controlling shareholders propose a fundamental change to the company and the non-controlling shareholders oppose it, the minority buy-out remedy allows the minority shareholders to exit the company and invest their money elsewhere. Section 93 of the CA2007 provides three specific instances where fundamental change of the company can occur: *proposed alteration imposes or removes a restriction on the business or activities in which the company may engage,*[789] *alter company's articles,*[790] *approve a major transaction for the purpose of paragraphs (a) or (b) of subsection (1) of section 185 of this Act,*[791] and *approve an amalgamation of the company under section 241 of this Act.*[792] Furthermore, under the terms of Section 93 of the CA2007, a shareholder who exercises all his/her votes against a proposal as mentioned above[793] or who did not sign a Section 144 resolution proposing a fundamental change[794] can request the company to purchase his/her shares.[795]

Additionally, if a company proposes an action that affects certain rights attached to the shares of an interest group and the company becomes entitled to take said action because the majority of an interest group approved such an action, any shareholder within said interest group who voted against such an action or who did

787 Section 223 (4) of the CA2007; also see Jay M Mann and Curtis A Jennings, 'Quia timet: a remedy for the fearful surety' The Forum (Section of Insurance, Negligence and Compensation Law, American Bar Association), vol. 20, no. 4, American Bar Association, 1985, 685–710.

788 Section 172 of the CA2007.

789 Section 93 of the CA2007.

790 Section 93 read together with Section 92 (1) (a) of the CA2007.

791 Section 93 read together with Section 92 (1) (b) and Section 185 (1) (a) and (b) of the CA2007.

792 Section 93 read together with Section 92 (1) (c) and Section 241 of the CA2007.

793 Section 93 (a) of the CA2007.

794 Section 93 (b) of the CA2007.

795 Section 94 (b) of the CA2007.

not sign a resolution in terms of Section 144 can require the company to purchase his/her shares under the terms of Section 94 of the CA2007.[796] Upon such a request, the company shall nominate a fair and reasonable price for the shares, and if the shareholder objects to the price nominated by the company, the question of what amounts to a fair and reasonable price must be referred to the auditors under Section 95 (a) of the CA2007. However, the CA2007 does not make it obligatory for the company to reveal the basis on which the fair and reasonable price (or, in other words, the 'fair market value of the shares') was formulated; it is at the company's discretion to do so. Under Section 96 of the CA2007, the company may enter into an agreement with a third party to purchase the shares of the shareholder who has issued a notice requiring the purchase of shares in line with Section 94 of the CA2007. Interestingly, the CA2007 includes provisions granting powers to the court to exempt the purchase of shares in certain situations on the application of the company[797] and to provide remedies for the shareholders affected by such exemptions.[798]

The CA2007 provision of protection to interest groups increases the protection of minority shareholders on the basis that it establishes membership of a group in relation to a given proposal. Here, the term 'interest group' is defined as follows:

> 'interest group' in relation to any action or proposal affecting rights attached to shares, means a group of shareholders—
>
> (a) whose affected rights are identical; and
>
> (b) whose rights are affected by the action or proposal in the same way.[799]

Thus, minority shareholders whose common rights are affected can consult together as to their common interests. Section 99 of the CA2007 highlights examples of the rights attached to shares where a group of shareholders can join together against any action that would affect such rights. Any such action must first be approved by a special resolution from each interest group, meaning that 75% of votes should be obtained by the affected shareholder group (interest group). As mentioned above, shareholders who vote against such actions of proposal affecting the rights attached to shares can exit the company.[800] Thus, the classification of rights as those belonging to an interest group is significant for the protection of minority

[796] Section 100 of the CA2007.
[797] Section 97 (1) and 98 (1) of the CA2007.
[798] Section 97 (2) and 98 (2) of the CA2007.
[799] Section 529 of the CA2007.
[800] Section 100 of the CA2007.

shareholder rights and interests. For instance, a group of minority shareholders representing green mutual funds can exit the company if the company proposes to act contrary to sustainability interests as incorporated in the company's articles. Oppression and mismanagement provisions can operate here as a proactive mechanism to safeguard the affected shareholders' right to exit provisions, ie under Sections 93–100 of the CA2007.

4.3.2.2 What is the function of corporate law in avoiding litigation and securing cost-effectiveness in enforcement mechanisms?

In Sri Lanka, the aforementioned shareholder remedies are enforced at the High Court established by *Article 154P of the Constitution* for a Province, empowered with civil jurisdiction by order published in the Gazette under *Section 2 of the High Court of the Provinces (Special Provisions) Act, No. 10 of 1996* (the Act1996), within the province for which such High Court is established.[801] Currently, only one high court is established under the *Article 154P of the Constitution*: the High Court for the Western Province, which exercises original civil jurisdiction, also referred to as the 'Commercial High Court'. Section 534 of the CA2007 amends the First Schedule to the Act1996 as '*All application and proceedings under the Companies Act, No. 07 of 2007*'.[802] Sections 25, 78(3), 97 (2), 98(1), 108, 118, 128, 137, 142 (5), 213, 214, 219, 224, 225, 233, 234, 241, 246, 252, 253, 256, 257, 272, 274, 298 and 301 are the provisions in the CA2007 referring to applications and proceedings. As such, any other matter must be instituted in the respective district court.

The CA2007 does not mention anything related to dispute resolution other than reference to the Companies Disputes Board (CDB).[803] Section 508 states that a dispute arising in giving effect to the provisions of the CA2007, or which relates to the affairs or management of a company, and a dispute already pending before the court can be referred to a member of the CDB.[804] However, the CA2007 provides that such matters can be referred to the Companies Dispute Board only on obtaining the mutual consent of each party in the dispute. In reality, it is unlikely that the parties will mutually agree at the time of the dispute to refer the dispute to the CDB.

Sri Lankan company law provides contractual freedom to the parties involved to include any matter in the company's articles if it is not inconsistent with the

[801] Article 154P of the Constitution read together with the High Court of the Provinces (Special Provisions) Act, No. 10 of 1996.

[802] Section 534 of the CA2007; also see Fist Schedule item no. 2 of the High Court of the Provinces (Special Provisions) Act, No. 10 of 1996.

[803] Section 507 of the CA20087.

[804] Section 508 (1) and (2) of the CA2007.

provisions of the CA2007.[805] Thus, alternative dispute resolution mechanisms can be inserted into the company's articles. For instance, arbitration in respect of shareholder disputes. However, the arbitration of oppression and mismanagement is a controversial topic in many jurisdictions. In Sri Lanka, too, it is uncertain whether inserting an oppression and mismanagement dispute arbitration clause into the company's articles could exclude the jurisdiction of the court. For instance, in the recent case of *Mahenthiran Subranabiam and others vs Mascons (pvt) Ltd. and others,*[806] it was held that the arbitration clause related to an oppression and mismanagement dispute does not exclude the jurisdiction of the court. Unfortunately, this matter was not settled in the Supreme Court of Sri Lanka. Furthermore, Section 5 of the recent *Draft Arbitration Act 2022* specifically states that, inter alia, '*Any dispute which the parties have agreed to submit to arbitration under an arbitration agreement may be determined by arbitration unless the matter in respect of which the arbitration agreement is* […] *not capable of determination by arbitration*'.[807] Several jurisdictions, including Singapore and the UK, have provided that certain matters falling under oppression and mismanagement disputes cannot be determined by arbitration. The arbitrability of oppression and mismanagement disputes is further discussed under oppression and mismanagement in comparison with other jurisdictions (4.3.2.4.).

4.3.2.3 What is the function of the equal treatment remedy?

The Sri Lankan CA2007 makes no specific provisions for the equal treatment of shareholders, as in Nordic or certain other civil law jurisdictions. However, the principle of equal treatment is instilled in Sri Lankan company law as a general principle. In other words, in general, equality is presumed between all shareholders in company law, meaning that all shareholders rank equally with each other.[808] However, as discussed above, the company is vested with the power and freedom to rebut this presumption through the company's articles. In other words, under Section 49 (2) and (3) of the CA2007, the company can issue different classes of shares with different rights and obligations.[809] The presumption of equality between all

[805] Section 13 of the CA2007.
[806] HC/Civil/31/2018/CO.
[807] Draft Arbitration Act 2022 for the Democratic Socialist Republic of Sri Lanka, Ministry of Justice, Justice sector reform program prepared by Justice Saleem Marsoof PC, (Chairman), Justice Arjuna Obeyesekere, Mr. Shanaka Cooray (Convener), Dr. Romesh Weeramantry, Dr. Asanga Gunawansa, Mr. Hiran de Alwis, and Mrs. Shehara Varia. At the time of writing this research, the draft act has still not come to effect.
[808] Kanag-Isvaran and Wijayawardana (n 715) 248.
[809] See Section 49 (2) and (3) of the CA2007.

shareholders within the same classes of shares can still be rebutted by the company's articles. Furthermore, the *prima facie* rule of equal treatment of shares applies in a winding-up situation for all shares, including preference shares, unless otherwise provided in the company's articles. Thus, it cannot be presumed that the rights of preference shares to dividends also carry the same preference right to capital.[810]

The equal treatment of shareholders principle applies in a situation where the company's capital is reduced. Under the previous CA1982, the court had the final authority to sanction a reduction of share capital, and the court followed guided principles established by previously decided cases in the reduction of share capital. For instance, in *Re Ratners Group plc.,* judge Harman observed, inter alia, that all shareholders must be treated equally in any reduction.[811] Under the new CA2007, the court's authority to sanction a reduction of share capital is now vested in the board of directors, and the board is required to follow the same guided principles in addition to the solvency test requirement.

Section 60 (2) of the CA2007 specifically codifies the equal treatment principle in respect of dividends, stating that the board cannot authorise a dividend of some shares in one class and not others of that same class or of a greater amount of some shares in a class than other shares in the same class. However, if the company's articles permit such unequal treatment among the same class of shares, and if the affected shareholders in the same class agree in writing to such unequal treatment, the board may authorise such unequal dividends.[812]

According to Section 66 of the CA2007, redeemable shares can be issued in three possible ways, if the company's articles permit: at the option of the company, at the option of the holder of the shares or on a date specified in the articles.[813] The application of the general equal treatment principle is clearly visible in the first two possibilities. In other words, Section 64 (3) of the CA2007 has integrated the equal treatment principle by requiring the board to resolve that an acquisition of shares is fair to the shareholders to whom the share acquisition offer is not made or with whom no agreement is entered to acquire shares.[814] Section 64 (3) requirements are applicable in a situation where 'the company purchases its own shares under Section 63 to 65 of the CA2007' and 'redemption of shares at the option of the company in terms of Section 67of the CA2007'. In contrast, the CA2007 is silent on the application of Section 64 (3) on the 'redemption of shares by the company at the

[810] Kanag-Isvaran and Wijayawardana (n 715) 136; Francis B Palmer and Geoffrey Morse, *Palmer's Company Law* (23rd edn, Sweet & Maxwell 1992) 419.
[811] (1988) BCLC 685.
[812] Section 60 (2) of the CA2007.
[813] Section 66 of the CA2007.
[814] Section 64 (3) of the CA2007.

option of the holder of the shares and on a date specified in the company's articles'.[815]

4.3.2.4 What is the function of corporate law in defining oppressive conduct?

The prevention of oppression and mismanagement was first introduced to Sri Lankan company law in 1964 through the *Companies (Amendment) Act, No. 15* to the existing *Companies Ordinance (Chapter 145) of 1938*.[816] This remedy was introduced as an alternative to winding up a company following Section 210 of the UK Companies Act of 1948.[817] The *Companies Act No. 17 of 1948* repealed the *Companies Ordinance (Chapter 145) of 1938* and introduced the prevention of oppression and mismanagement.[818] Its mismanagement provisions were based on the new concept introduced in the Indian Companies Act of 1956, which was to afford relief in the case of 'mismanagement'. The reason behind the introduction of this 'mismanagement' remedy was to prevent gross mismanagement of the affairs of a company that could not otherwise be suitably addressed under the oppression and other provisions of company law.[819]

In this backdrop, the law relating to oppression and mismanagement in India is examined below together with the corresponding Sri Lankan law owing to their similarities. Prior to the Indian Companies Act of 2013, the oppression and mismanagement remedies in both countries were similar. Section 224 of the CA2007 concerns the prevention of oppression. Section 224 (1) states that:

> (1) Subject to the provisions of section 226, **any shareholder** or shareholders of a company **who has a complaint against the company that the affairs of such company <u>are being</u> conducted in a manner oppressive to any shareholder** or shareholders (including the shareholder or shareholders with such complaint) may make an application to court, for an order under the provisions of this section.[820]

[815] See Section 68 and 69 of the CA2007.
[816] Sections 153A to Section 1531 of the Companies Ordinance of 1938 <https://www.lawnet.gov.lk/companies-4/> accessed on 26th October 2021.
[817] See the United Kingdom comparative study and Section 210 of the UK Companies Act 1948.
[818] See Section 210 and Section 211 of the CA1982.
[819] KR Chandratre, *Law & Practice Relating to Oppression & Mismanagement – Minority Shareholders' Remedies* (S Balasubramanian ed, 2nd edn, Bharat Law House 2016), 89.
[820] Section 224 (1) of the CA2007 (emphasis added).

The three important elements of Section 224 (1) are that the conduct must be oppressive towards the shareholder's rights as a shareholder in the company, that it must be in connection to the affairs of the company (ie the management has caused the oppressive conduct towards the shareholder in connection to the affairs of the company) and it must be a continuing act at the time of the complaint by the shareholder.

In *Ratnam and Others v Jayathilaka*, Udalagama J was of the view that a shareholder could seek remedy under the prevention of oppression if all the events amounting to oppressive conduct in connection to the affairs of the company *can be considered as a part of a continuing story as opposed to an individual event in isolation* at the time of the complaint.[821] What constitutes 'the affairs of the company' is important in the context of the oppression and mismanagement statutory provisions. In *Scottish Co-operative Wholesale Society Ltd. v Meyer,*[822] it was observed that to invoke the oppression statutory provision, it is essential to show that the oppression is related to the conduct of the affairs of the company. Here, the term 'affairs of the company' has a wider meaning than both the 'business' and 'management' of the company. In other words, the meaning of the affairs of the company covers activities of the management including the actions or activities of the minority shareholders. For instance, dividends, voting rights, financial matters, restricting of the company's business, accounts, matters related to shares and matters related to the company's assets.[823] In addition, a shareholder must make a *prima facie* case of oppressive conduct by the management of the company in respect of the affected shareholder's legal and proprietary rights in the company. Section 49 (2) provides certain rights conferred on a shareholder, subject to the company's articles. Accordingly, the rights vested in a shareholder in the company's articles and the CA2007 are also taken into account when considering whether the conduct of the management is oppressive towards the shareholder. Since the CA2007 does not provide a specific definition of what amounts to oppressive conduct, the court has a wide discretion depending on the facts and circumstances of the case in terms of what amounts to oppressive conduct in the commercial context.

The question of whether an act is legal or illegal does not play a pivotal role in invoking the oppression statutory provisions. Legally permissible acts can also amount to oppressive conduct if they fall within the test of unfairness.[824] For instance, in *V. S. Krishnan v Westfort Hi-Tech Hospital Ltd.*, it was observed that:

[821] Ratnam and Others v Jayathilaka (2002) 1 SLR 409.
[822] (1959) AC 324: (1958) 3 WLR 404: (1958) 3 ALL ER 66: (1959) 29 Comp Cas 1 (HL).
[823] Chandratre (n 7) 188.
[824] Re Saul D Harrison & Sons plc (1995) 1 BCLC 14.

The oppressive act complained of may be fully permissible under law but may yet be oppressive and, therefore, the test as to whether an action is oppressive or not is not based on whether it is legally permissible or not since even if legally permissible, if the action is otherwise against probity, good conduct or is burdensome, harsh or wrong or is mala fide or for a collateral purpose, it would amount to oppressive […]'.[825]

Examples of what amounts to oppression can also be observed from established precedents in other jurisdictions that have similar legal provisions on the prevention of oppression. For instance, erosion of value of shares owing to the affairs of the company being conducted in a manner oppressive to a shareholder;[826] oppressive conduct in connection to the affairs of the company towards a person must be in his/her capacity as a shareholder and not as a director;[827] company conduct that is unfair, lacks probity and causes prejudice to the shareholder's legal and proprietary rights can amount to oppressive conduct;[828] company conduct that denies the shareholder's rights or legitimate expectations, which the company should honour from a legal basis and which a shareholder can demand as a right, can amount to oppressive conduct;[829] oppressive conduct can also amount to burdensome acts, harsh acts, wrongful acts and acts of unfair abuse of power that result in an impairment of confidence in the probity with which the company's affairs are being conducted;[830] in some cases, the court has held that the conduct is oppressive given that it represents a clear departure from the standards of commercial fair dealing or is unfair;[831] the test for whether conduct amounts to oppression is objective, meaning that the court should decide whether an act is unfair in a commercial context based

825 V S Krishnan v Westfort Hi-Tech Hospital Ltd (2008) 142 Comp Cas 235 (SC).

826 Re Bovey Hotel Ventures Ltd (unreported, 13 July 1981) referred to in Hough v Hardcastle, Re Grandactual Ltd (2006) BCC 73 and Re Little Olympian Each- Ways Ltd (No 3) (1995) 1 BCLC 636 /Ch D).

827 See Lundie Bro. Ltd (1965) 2 All ER 692 at p. 699; Re Bellador Silk Ltd (1965) 1 All ER 667.

828 Needle Industries (India) Ltd v Needle Industries Newey (India) Holding Ltd, 51 Comp Cas 749, SC; AIR 1981 SC1298.

829 Re Richard Pitt & Sons Pty Ltd (1979) 4 ACLR 459; also see Vinelotte J observations in RE a company, *ex parte* Burr (1992) BCLC 724 at 727 Ch D on legitimate expectation – 'Any legitimate expectation of the shareholders must be found in the articles of association or in the general principles applicable to the conduct of the directors of a limited liability company'.

830 H.R. Harmer Ltd (1958) 3 All ER 689.

831 Elder v Elder & Watson Ltd. (1952) SC 49; RE Five Minutes Car Wash Service Ltd (1966) 1 All ER 242, 246 and 247; Wayde v New South Wales Rugby League Ltd (1985) 10 ACLR 87, 95-96.

on the facts;[832] the business judgment rule can be taken as a defence for the company against an oppression action;[833] and finally, unfair conduct of a parent company towards its subsidiary, which is formed of an independent minority of shareholders, can amount to oppressive conduct.[834] These legal precedents are important as guidelines for the court to grant remedies as it sees fit under the oppression provisions. The CA2007 has granted wide discretionary powers to the court to make such orders *as it sees fit* to remedy any matter complained of under oppression, depending on the factual background of the case.[835] Additionally, pending such a final order, the court may under Section 224 (3) make an interim order to regulate the conduct of the company's affairs in consideration of the *just and equity* principles.[836]

The Sri Lankan mismanagement remedy provided in Section 225 (1) of the CA2007 is based on Section 398 of the Indian Companies Act of 1956, which has since been repealed by Section 241 of the Indian Companies Act of 2013. The aim of the mismanagement remedy in terms of Section 225 (1) is to provide relief to shareholders against mismanagement of the company by controlling shareholders or their agents that cannot otherwise suitably be addressed under any other provisions of the Companies Act.[837] For instance, in the Indian case of *Subhash Chand Agarwal v Associated Limestone Ltd.*,[838] it was held that if the oppression prevention statutory provisions do not warrant remedying the alleged conducts, and the company's economic status does not warrant a winding-up, the court should look to whether the statutory provisions relating to prevention of mismanagement can be applicable to remedy the complained conducts. Section 225(1) provides as follows:

> (1) Subject to the provisions of section 226, any shareholder or shareholders of a company, having a complaint—
>
> (a) that the affairs of the company are being conducted in a manner prejudicial to the **interests of the company**; or

832 O'Neill and another v Phillips and others (1999) 1 WLR 1092; Re Saul D Harrison & Sons plc (1995) 1 BCLC 14; Re R. A. Noble & Sons (Clothing) Ltd (1983) BCLC 273 (Ch D). The test for unfairness in oppression is further discussed in this chapter.

833 Carlen v Drury (1812) 1 V B 154: 35 ER 61.

834 Scottish Co-Operative Wholesale Society Ltd. v Meyer (1958) 3 All ER (HL).

835 224 (2) of the CA2007.

836 224 (3) of the CA2007 and also see Section 521 of the CA2007 (Grant of interim relief).

837 Kanag-Isvaran and Wijayawardana (n 715) 524.

838 (1998) 2 Comp LJ 329 (CLB).

> (b) that a **material change** (not being a change brought about by or in the interest of any creditors, including debenture holders or any class of shareholders of the company) **has taken place in the management** or **control of the company**, whether by an alteration in its board of directors or of its agent or secretary or in the constitution or control of the firm or body corporate acting as its agent or secretary or in the **ownership of the shares of the company** or **in any other manner whatsoever**, and that by reason of such change it is likely that the affairs of the company may be conducted in a manner prejudicial to the interests of the company,
>
> may make an application to court for an order under the provisions of this section.[839]

According to Section 225 (1) (a), an action or even a non-action of the management that results in the affairs of the company being conducted in a manner prejudicial to the interests of the company can amount to an act of mismanagement. For instance, in *Chander Krishan Gupta v Pannalal Girdharilal Pvt Ltd.*, B.N. Kirpal J stated that mismanagement of the company can occur through a positive act as well as through a non-conduct of the affairs of the company by the management. B.N. Kirpal J further stated that '*the non-conduct may arise for a variety of reasons including serious disputes amongst the board of directors of the company which results in a complete deadlock or stalemate*'.[840] Thus, Section 225 (1) (a) imposes responsibility on the management to regulate the company at all times in a manner that is not prejudicial to the interests of the company.

Section 225 (1) (b) has two aspects: the '*cause*' and the '*effect*'.[841] The *cause* is that a material change has taken place in the management or control of the company. This can occur by way of an alteration in the company's board of directors, in the company's agent, in the company secretary, in the company's constitution, in the control of the firm, in the body corporate acting as the company's agent or secretary, in the ownership of the shares of the company, or in any other manner whatsoever.[842] Accordingly, the CA2007 has provided wide discretion to the court to consider what amounts to a *material change* in Section 225 (1) (b) by inserting the wording that

839 Section 225 (1) of the CA2007.
840 Chander Krishan Gupta v Pannalal Girdharilal Pvt Ltd (1984) 55 Comp Cas 702, 717-718. Delhi.
841 Kanag-Isvaran and Wijayawardana (n 715) 525.
842 Section 225 (1) (b) of the CA2007.

alteration in '*any other manner whatsoever'* may result in a material change. In turn, the effect of Section 225 (1) (b) is that *there is a likelihood* that the aforesaid material change may result in the affairs of the company being conducted in a manner prejudicial to the interests of the company. The legality of the material change is irrelevant when deciding whether an act of mismanagement has occurred; what is important is whether any such material change has a probable effect on the future interests of the company.[843] Furthermore, in *Dr. V. Sebastian v City Hospitals Pvt Ltd*., it was held that '*the normal rule is* […] *the status of affairs complained of should exist at the time the Petition is presented, and the apprehension based on a possible change of management yet to take shape cannot justify remedial action at this stage. There must be material to show that the board of directors would be one or two ambitious men, and a lot of ballast*'.[844] The purpose behind the Section 225 (1) (b) provision is to prevent the likelihood of harm to the future interests of the company based on a material change that has already taken place.[845] Additionally, Section 225 imposes greater responsibility on the directors in managing the affairs of the company by strengthening the enforcement of their fiduciary duties. In *Great Eastern Railway Co. v Turner in re,* Lord Selborne L.C. stated that directors are trustees of the company's money and property,[846] which highlights the importance of directors' duties to act in a responsible manner. Moreover, the CA2007 states that material changes *brought about by or in the interest of any creditors, including debenture holders or any class of shareholders of the company* may not fall under the purview of Section 225 (1) (b). This shows the importance of, inter alia, creditor protection as a stakeholder in corporate governance.

Examples of what amounts to mismanagement can be observed from established precedents in other jurisdictions with similar legal provisions on the prevention of mismanagement. Acts of mismanagement considered include, eg assets-stripping operations by a controlling shareholder and his/her agents;[847] removal of a director without following the proper procedure;[848] misconduct of the company by a newly appointed director;[849] irregularities and failures to follow procedures laid down in the company's articles, shareholder agreements[850] and the CA2007 (eg procedures

[843] Mohanlal Ganpatram v Shri Sayaji Cotton and Jute Mils Co Ltd, AIR 1965 Guj 96.
[844] Dr. V. Sebastian v City Hospitals Pvt Ltd (1985) 57 Comp Cas 453,464 (Ker).
[845] Re Albert David Ltd (1964) 68 CWN 163, 172.
[846] (1872-72) 8 LR Ch App 149.
[847] Re Brightview Ltd (2004) BCC 542 /Ch D).
[848] Arun Kumar Mehta v Ganesh Commercial Co. ltd. (2006) 134 Com Cases 500; (2006) 6 Comp LJ 351 (CLB).
[849] Rai Saheb Vishwamitra v Amar Nath Mahrotra (1986) 59 Com Cases 854 (All.).
[850] Shareholder agreement must be a part of the company's articles.

for major transactions under the terms of Section 185);[851] the company continuing trading despite its failure to satisfy the solvency test and without a reasonable excuse;[852] directors' abuse of fiduciary duties, including fabrication of documents to obtain majority support;[853] and not providing information (such as balance sheet and profit and loss account) when requested by a shareholder.[854] The business judgment rule can be taken into account when defending *bona fide* actions taken by directors in a mismanagement dispute. In *Re Marco (Ipswich) Ltd*., Arden J stated that the court is unlikely to interfere with the business judgments of directors unless sufficiently serious allegations of mismanagement can be justified.[855]

Section 225 (2) provides wide discretionary powers for the courts as *it sees fit* to remedy acts amounting to mismanagement.[856] Furthermore, Section 225 (3) provides powers to the court to issue interim orders pending an action to regulate the conduct of the company's affairs based on the *just and equity* principles. These powers of the court provided in Sections 224 (2), 224 (3), 225 (2) and 225 (3) are generally read together with Section 228 when the court is making an order remedying such acts that amount to oppression and mismanagement. Section 228 stipulates the following:

> Without prejudice to the generality of the powers conferred on the court by section 224 or section 225, any order made under either of such sections, may provide for—
>
> (a) the regulation of the conduct of the company's affairs in the future;
>
> (b) the purchase of the shares or interests of any shareholders of the company by other shareholders thereof or by the company;

[851] See Central Government v Pentamedia Graphics Ltd. (2006) 70 SCL 13 (CLB) for gross violation of statutory procurements in relation to sale of assets; also see Akbarali A. Kalvert v Konkan Chemicals P. Ltd (1997) 88 Com Cases 245 (CLB) and S. Rehana Rao v Balaji Fabricators P. Ltd. (2004) 122 Com cases 804 for not following proper procedure in stated in the company's articles and company act in relation to, inter alia, meetings and transfer of shares.

[852] Re a company, *ex parte* Burr (1992) BCLC 724 (Ch D).

[853] Hemant D. Vakil v RDI Print and Publishing P. Ltd. (1995) 84 Com Cases (CLB-New Delhi).

[854] Narain Das (K.) v. Bristol Grill (P.) Ltd. (1997) 90 Com Cases 79.

[855] Re Marco (Ipswich) Ltd. (1994) 2 BCLC 354, 404 (Ch. D.).

[856] See Section 225 (2) of the CA2007.

(c) the termination, setting aside or modification of any agreement, however arrived at, between the company on the one hand and any of the following persons on the other, namely—

(i) the managing director;
(ii) any other director;
(iii) the board of directors;
(iv) the agent or secretary; or
(v) the manager;

upon such terms and conditions as may, in the opinion of the court, be just and equitable in all the circumstances of the case;

(d) the termination, setting aside or modification of any agreement between the company and any person not referred to in paragraph (c), upon such terms and conditions as may, in the opinion of the court, be just and equitable in all the circumstances of the case, but always so that no such agreement shall be terminated, set aside or modified, except after due notice to the party concerned and after giving such person an opportunity of being heard;

(e) the setting aside of any transfer, delivery of goods, payment, execution or other act relating to property made or done by or against the company within the three months immediately prior to the date of the application or the commencement of winding up proceedings, as the case may be, which would, if made or done by or against an individual, be deemed in a case of his insolvency, to be fraudulent preference; and

(f) any other matter for which in the opinion of the court it is just and equitable that provision should be made.[857]

Here, the generality of the powers conferred on the court by Sections 224 and 225 are not affected by the specific powers stipulated in Section 228. Accordingly, the powers stipulated in Section 228 are for guidance only; the court is not restricted to those powers but is vested with wide discretionary power to make any order as *it sees fit*. Thus, oppression and mismanagement remedies provide wide discretionary power for the court to remedy corporate disputes without winding up a healthy

[857] Section 228 of the CA2007.

company. This is the main purpose of introducing oppression and mismanagement provisions. Furthermore, the oppression and mismanagement statutory provisions provide proactive measures against possible unprofessional conduct against non-controlling shareholders and other stakeholders. Thus, these remedies facilitate the reduction of the agency costs mentioned in this research in relation to all three agency relationships.

Following this line of inquiry, attention shifts to India, a jurisdiction steeped in common law traditions and noted for its extensive repository of legal cases. These cases stand as potential sources of valuable precedents for Sri Lanka. The Supreme Court of India, in particular, has delivered numerous decisions that hold significance, especially in relation to provisions aimed at curtailing oppression and mismanagement, as delineated in the Indian Companies Act of 2013. This legal framework functions in a holistic manner, offering vital insights and potential resolutions that may be pertinent and applicable to Sri Lanka when faced with comparable legal scenarios.

The Indian Companies Act 2013 (ICA2013) has amended its oppression and mismanagement provisions and taken further steps to strengthen the interests of non-controlling shareholders. Seemingly, through statutory provisions on prevention of oppression and mismanagement, India has increased non-controlling shareholder protection to the same level as the UK's unfair prejudice remedy. This has affected the diversification of investments in the Indian stock market. It is interesting to note that Sri Lanka has still not pursued any amendments to its prevention of oppression and mismanagement provisions, which were based on the earlier version of Sections 397 and 398 in the Indian Companies Act of 1956. Against this backdrop, it is important to examine the Indian statutory provisions on the prevention of oppression and mismanagement.

Section 241, Chapter XVI of the ICA2013 stipulates as follows:

Application to Tribunal for relief in cases of oppression, etc.—

(1) Any member of a company who complains that—

(a) the affairs of the company have been or are being conducted in a manner **prejudicial** to **public interest** or in a manner **prejudicial** or **oppressive** to him or any other member or members or in a manner prejudicial to the interests of the company; or

(b) the material change, not being a change brought about by, or in the interests of, any creditors, including debenture holders or any class of shareholders of the company, has taken place in the

management or control of the company, whether by an alteration in the Board of Directors, or manager, or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to its interests or its members or any class of members,

may apply to the Tribunal, provided such member has a right to apply under section 244, for an order under this Chapter.

(2) The Central Government, if it is of the opinion that the affairs of the company are being conducted in a manner prejudicial to public interest, it may itself apply to the Tribunal for an order under this Chapter.[858]

Section 241 of the ICA2013 has made significant amendments to the oppression and mismanagement statutory provisions in the previous Indian Companies Act of 1956. First, Section 241 inserts 'have been or are being' to replace 'are being' from the previous section to invoke oppression and prejudicial actions that have the effect of even past acts, but which are continuing to the date of the petition. Second, Section 241 has enabled the central government to invoke Section 241 action if the affairs of the company are prejudicial to the public interest. This provides a proactive mechanism for companies to operate in a manner that is not prejudicial to the public interest. It can be argued that stakeholders such as the environment and local communities can also fall under the public interest category. Accordingly, Section 241 operates as a proactive mechanism for protection against any conduct in relation to the affairs of the company that is prejudicial to the interests of the environment and local communities. Third, the addition of the word 'prejudicial' before the word 'oppressive' provides significant scope for the National Company Law Tribunal (NCLT) to provide remedies not only for oppressive acts but also for prejudicial acts.[859] The changes brought to Section 241 bring the effect of the Indian and the UK statutory provisions closer to each other, having emanated 'as an alternative remedy for winding up'. The only difference here is that the word 'unfair' is no longer present in front of the word 'prejudicial'. However, academics and practitioners have argued that the concept of 'oppression' has the element of unjustness or unfairness. Furthermore, both the terms 'unfair prejudice' and 'oppression' originate from the

[858] Section 241 of the ICA 2013.
[859] Chandratre (n 7) 138.

alternative remedy for winding up a company, which is a remedy based on the *just and equity* principles.[860]

Both academics and practitioners have argued that the 'unfairly prejudicial' expression is much wider in scope than 'oppression'.[861] In a legal context, the word 'prejudice' can refer to injury, loss, or damnification.[862] The prejudice may be either financial or non-financial. The main reason why 'unfair prejudice' is wider in scope than 'oppression' is that the former has the capacity to remedy any damage or injury resulting from some action of another disregard of one's rights. For instance, in *Coroin Ltd. In re,*[863] it was held that '*Prejudice will certainly encompass damage to the financial position of a member. The prejudice may be damage to the value of his shares but may also extend to other financial damage which in the circumstances of the case is bound up with his position as a member* […]'.[864] Furthermore, in *V. S. Krishnan v Westfort Hi-tech Hospital Ltd.,*[865] it was observed that mere unfairness did not constitute oppression. However, in the same case, the Supreme Court indirectly linked the concept of oppression with unfair prejudice by holding that '*where no unfair prejudice is caused to any member(s) of the company, the CLB would not interfere*'.[866] Thus, prior to enacting Section 241, there has been a dilemma around what amounts to conduct of unfair prejudice and oppression. However, the enactment of Section 241 has resolved these differences by empowering the NCLT to pass an order to remedy a prejudice or oppression allegation.

Several cases have examined whether non-payment or payment of insufficient dividends can amount to oppression, and the similarities between 'unfairly prejudicial' and 'oppression' in remedying such situations. The outcome of each case depends on its specific factual background. However, the English principle of unfair prejudice is seemingly vested with a wide discretionary power to provide remedies compared to the oppression remedy. For instance, in *Re Sam Weller & Sons Ltd.*, it was held that where a payment of low dividends is prejudicial to all the members equally, it could still amount to being unfairly prejudicial to the *interest of some part of its members.*[867] The reason for this is that some *members have different interests even if their rights as members are effectively the same*; thus, some members may

[860] ibid 430.
[861] Kanag-Isvaran and Wijayawardana (n 715) 509.
[862] Henry Campbell Black, *Black's Law Dictionary* (2nd edn, The Lawbook Exchange, Ltd 1995).
[863] (2012) EWHC 2343 (Ch).
[864] Members means a shareholder in the United Kingdom.
[865] (2008) 142 Comp Cas 235: (2008) 2 Comp LJ 1 (SC).
[866] V. S. Krishnan v Westfort Hi-Tech Hospital Ltd (2008) 142 Comp Cas 235 (SC); also see Chandratre (n 7) 155.
[867] Re Sam Weller & Sons Ltd (1989) 5 BCC 810 (Ch D).

have suffered damage as a result.[868] Likewise, in *Re a Company No. 00370 of 1987,*[869] it was held that not issuing adequate dividends equally to all shareholders does not amount to being 'unfairly prejudicial' only to some part of the members, if some part of the members have not suffered damage by such payment of dividends. However, in India, prior to the incorporation of Section 241, the courts had been reluctant to exercise their wide discretionary powers in terms of oppression statutory provisions. Instead, the test of unfairness has played a pivotal role in considering the conduct as oppressive, rather than looking at the outcome of such low payment of dividends to some shareholders. For instance, in *Jaladhar Chakraborty v Power Tools and Appliances Co. Ltd*., the court observed according to the test of unfairness whether deliberately not declaring dividends had caused the value of the shares to fall and resulted in compelling the minority shareholders to sell their shares to the majority.[870] In *Dr. Percy Rutton Kavasmaneck and another v Gharda Chemicals Ltd. and others,*[871] it was held that according to the test of unfairness, the payment of low dividends cannot amount to oppression to minority shareholders because it affects all shareholders. In *Maharani Lalita Rajya Lakshmi v Indian Motor Co. (Hazaribagh) Ltd.*, it was held that no company law obliges a board of directors to use up all its profits by declaring dividends and thus the payment of dividends is a business judgment on the part of the board.[872] In this way, the courts have utilised the test of unfairness to consider whether directors have acted deliberately to set the minority at a disadvantage in respect of the payment of dividends. In turn, the courts have granted remedies under the oppression statutory provisions if such conduct relating to the payment of dividends satisfies the test of unfairness. Thus, mere unfairness is not enough to invoke oppression provisions. However, to invoke the English 'unfair prejudicial' principle, it is not essential to show that directors have deliberately put the minority at a disadvantage, but it is essential to show that the minority has suffered 'damage'. Thus, the English principle of unfair prejudice is wider in scope in terms of providing remedies to non-controlling shareholders compared to the oppression statutory provisions.

Further, the amendments made to the ICA2013 have increased the efficiency of the enforcement mechanisms of Section 241. Section 2 (90) of the ICA2013 defines

[868] Chandratre (n 7) 278.
[869] (1988) 4 BCC 506: (1988) 1 W.L.R. 1068.
[870] Jaladhar Chakraborty v Power Tools and Appliances Co. Ltd. (1994) 79 Comp Cas 505: (1992) 8 CLA 50 (Cal). See also Joseph K.M.J. v Kuttanad Rubber Co. Ltd., [1984] 56 Comp Cas 284 (Ker) where value of the shares was not affected by non-declaration of dividend.
[871] (2011) 166 Comp Cas 292 (Bom).
[872] Maharani Lalita Rajya Lakshmi v Indian Motor Co. (Hazaribagh) Ltd. (1962) 32 Comp Cas 207, 212.

the NCLT, which is constituted under Section 408. This special forum was created solely to exercise and discharge such powers and functions according to the ICA2013. Accordingly, the central government has created the NCLT's own rules for the efficient delivery of justice regarding company disputes.[873] For instance, *Notification No. GSR 716(E), dated 21-6-2016, w.e.f. 21-6-2016 a NCLT.* Additionally, the central government has created the National Company Law Appellate Tribunal (NCLAT) for the purpose of hearing appeals against the orders of the NCLT. The use of said forums for company disputes has been made mandatory by Section 430. In other words, under the terms of Section 430, the civil court is prohibited from entertaining any matter that the NCLT is empowered to determine under the ICA2013. Thus, the ICA2013 has taken a further step in creating a special forum to resolve company disputes and provide efficient remedies.

In this context, it becomes essential to analyse the judiciary's stance on referring disputes, particularly those related to oppression and mismanagement, to arbitration. The early rulings in this domain have not provided a clear and straightforward resolution to this complex legal issue. As a result, the subsequent sections will delve into the arbitrability of disputes concerning oppression and mismanagement, starting with the Indian jurisdiction and extending the analysis to other common law regions such as the UK, Sri Lanka, and Singapore.

Within the Indian legal framework, the case of *Kare P. Ltd. Surendra Kumar Dhawan v R. Vir*[874] serves as a significant point of reference. In this instance, the court affirmed that shareholders hold a statutory right to invoke the provisions against oppression and mismanagement. Consequently, the court ruled that such a statutory jurisdiction could not be invalidated or overridden by the presence of an arbitration clause in the company's agreements or statutes.[875] However, in *O. P. Gupta v Shiv General Finance (P.) Ltd.,*[876] it was held that the court is vested with a discretionary power to stay the proceedings and refer the matter to arbitration. On the contrary, in *Pinaki Das Gupta v Maadhyam Advertising (P.) Ltd.,*[877] it was held that if Section 8 of the Arbitration Act is satisfied and if all the issues raised in the petition are covered by the arbitration agreement, then the matter should be referred

[873] Section 469 of the ICA2013.
[874] (1997) 47 Comp Cas 276 (Del).
[875] In Manavendra Chitnis v Leela Chitnis Studios P. Ltd. (1985) 58 Comp Cas 113 (Bom) a similar position was taken on the basis that specific powers in terms of the Section 397 and 398 conferred under the Act on the court cannot be exercised by an arbitrator.
[876] (1977) 47 Comp Cas 279 (Del).
[877] (2002) 49 CLA 9: (2002) 4 Comp LJ 318: (2002) 38 SCL 170 (CLB): (2003) 114 Comp Cas 346 (CLB).

to arbitration. Likewise, in *V. L. S. Finance Limited v Sunair Hotels Limited,*[878] it was observed that if the conditions stipulated in Section 8 are not satisfied, the court cannot refer the matter to arbitration. In *Vijay Kumar Chopra v Hind Samachar Ltd.,*[879] the CLB observed that by virtue of the mandatory nature of Section 8 of the Arbitration Act,[880] even matters falling under the purview of Sections 397 and 398 must be referred to arbitration. Accordingly, it was observed in *Enercon Gmbh v Enercon (India) Ltd,*[881] that matters under the purview of Sections 397 and 398 should be referred to arbitration if the commonality of parties, subject matter and provisions in the Arbitration Act are fulfilled and the arbitration clause warrants such disputes to be resolved by arbitration. Likewise, in *Dr. G. L. Purohit v Dr. S. S. Agarwal,*[882] it was observed[883] and the subject matter provided in the petition does not fall within the four corners of the arbitration agreement. Thus, it is important that the company must be a party to the arbitration agreement,[884] and the subject matter of the dispute must be covered in said agreement for the court to refer the matter to be settled by arbitration.[885]

However, in *Dhananjay Mishra v Dynatron Service P. Ltd. and others,*[886] a recent case filed under Sections 241–244 of the ICA2013, the tribunal held that the matter is non-arbitrable on the basis of, inter alia, the issues raised in the judicial authority being separate to the ground urged in the arbitration application and the reliefs sought in the judicial authority did not arise out of any contractual obligation.

[878] (2001) 4 Comp LJ 321: (2001) 44 CLA 207: (2002) 110 Comp Cas 772: (2001) 33 SCL 475 (CLB).

[879] (2001) 2 CLC 867: (2001) 40 CLA 313: (2002) 108 Comp Cas 115: (2001) 2 Comp LJ 133: (2001) 30 SCL 80 (CLB).

[880] Power to refer parties to arbitration where there is an arbitration agreement.—1 [(1)A judicial authority, before which an action is brought in a matter **which is the subject of an arbitration agreement** shall, if **a party to the arbitration agreement** or any person claiming through or under him, **so applies not later than the date of submitting his first statement on the substance of the dispute**, then, notwithstanding any judgment, decree or order of the Supreme Court or any Court, refer the parties to arbitration unless it finds that *prima facie* no valid arbitration agreement exists.]

[881] (2008) 143 Comp Cas 687 (CLB) and also see – Rajendra Kumar Tekriwal v Unique Constructions Pvt Ltd. (2008) CLC 639 (CLB).

[882] (2011) 163 Comp Cas 205 (CLB).

[883] Also, where commonality of parties is not established.

[884] SRG Infotech Ltd. v Datapro Electronicts Pvt. Ltd. (2005) 123 Comp Cas 43: (2004) 62 CLA 147: (2005) 6 CLC 108 (CLB).

[885] Griesheim GMBH v Goyal MG Gases Pvt. Ltd. (2005) 123 Comp Cas 280: (2004) 62 CLA 141: (2005) 6 CLC 102 (CLB); also see other recent cases – Surender Bahety v Ratika Computronix P. Ltd. (2010) 157 Comp Cas 225; Vijay Sekhari v Union of India (2011) 163 Comp Cas 195; Bialetti Industries S. P. A. v Rachit Suresh Gangar (2012) 172 Comp Cas 315 (CLB).

[886] Company Appeal (AT) No. 389 of 2018.

In this case, the tribunal further held that the powers vested in the tribunal to adjudicate issues relating to oppression and mismanagement, financial irregularities and appointment of directors cannot be exercised by a sole arbitrator. On appeal, the NCLAT held that the statutory jurisdiction vested in the tribunal cannot be exercised by an arbitrator.[887] The NCLAT observed the following in summing up the judgment:

> On a plain reading of Section 242, it is manifestly clear that the facts should justify the making of a winding up order on just and equitable grounds. Admittedly, Arbitrator would have no jurisdiction to pass a winding up order on the ground that it is just and equitable which falls within the exclusive domain of the Tribunal Company Appeal (AT) No. 389 of 2018 under Section 271(e). That apart acts of non-service of notice of meetings, financial discrepancies and non-appointment of Directors being matters specifically dealt with under Companies Act and falling within the domain of the Tribunal to consider grant of relief under Section 242 of Companies Act render the dispute non-arbitrable though it cannot be disputed as a broad proposition that the dispute arising out of breach of contractual obligations referable to the MOUs or otherwise would be arbitrable. It is also indisputable that the statutory powers and plenary jurisdiction vested in the Tribunal renders it the appropriate forum to deliver result-oriented justice.[888]

The Indian judicial authorities presented above show that the 'question of whether an oppression and mismanagement matter can be referred to arbitration to empower the arbitration agreement' depends on the factual background of the case in hand. Seemingly, the courts have been reluctant to suspend proceedings and transfer the matter to arbitration if the case in hand requires arbitrators to provide reliefs such as, inter alia, winding-up orders based on just and equity, investigation of financial irregularities and appointment of directors.

The UK and other common law jurisdictions take a similar position and are thus worthy of consideration. In the earlier case of *A. Best Floor Sanding Party Ltd. v Skyer Australia Party Ltd.*[889] decided in Australia, it was held that an arbitration agreement cannot oust a right to invoke relevant statutory remedies, specifically the right to apply to the court for a winding-up order. This decision was followed by the English High Court in *Exeter City Association Football Club Ltd. v Football*

[887] Chandratre (n 7) 293-294.

[888] Dhananjay Mishra v Dynatron Service P. Ltd. and others Company Appeal (AT) No. 389 of 2018 <https://nclat.nic.in/Useradmin/upload/1610476525cadb92e6423b.pdf > accessed on 3rd January 2022, 18-19.

[889] [1999] VSC 170.

Conference Ltd.,[890] where it was decided that the statutory right conferred on the members of the company to seek relief at any stage is inalienable. However, in *Fulham Football Club (1987) Ltd. v Sir David Richards and The Football Association Premier League Ltd.*[891] (Fulham), another English case, held that Section 994 *unfair prejudice* matters are arbitrable if the matter in hand does not affect third parties. In this case, Patten LJ said that the law does not prohibit the arbitrability of unfair prejudice disputes if it is covered in the arbitration agreement between the relevant parties and, most importantly, the arbitral tribunal has the authority to grant the remedies sought in the arbitration application. In other words, if a party in an arbitration dispute is seeking a remedy such as, inter alia, winding up of the company based on *just and equitable* grounds, or to make an order regulating the affairs of the company, such disputes are not arbitrable. The reason is that such orders affect third parties, including stakeholders of the company. Accordingly, contractual disputes that do not engage third-party rights or impinge on any statutory safeguards available for the benefits of third parties such as, eg through the company's articles or other agreements, are generally arbitrable. In the *Fulham* case, Patten LJ commented an *obiter*, stating that the arbitral tribunal can first decide on the subject matter of the claim and see whether a lesser remedy is suitable that does not require judicial authority.[892] If the arbitrator decides that winding-up proceedings would be justified, then only a member would be entitled to present a petition to seek the statutory remedy, which only the court has the authority to grant. Patten LJ commented further that in such a dispute that affects third parties, '*I can see no reason in principle why their views could not be canvassed by the arbitrators before deciding whether to make an award in those terms'*.[893]

The Fulham approach to arbitrability of unfair prejudice actions has been followed in a number of other jurisdictions. In *Tomolugen Holdings Ltd. and another v Silica Investors Ltd. and other appeals,*[894] the Singapore Court of Appeal – following the Fulham approach – held that unfair prejudice or oppression actions are concerned with protecting the commercial agreements of parties and not with furthering any public interest. In *Tomolugen's case*, Court of Appeal referred to a passage of Lord Hoffmann's judgment in *O'Neill v Phillips,*[895] which explains the nature of oppression and unfair prejudice claims as follows:

[890] [2004] 1 WLR 2910.
[891] [2010] EWHC 3111 (Ch).
[892] Fulham Football Club (1987) Limited v Sir David Richards, The Football Association Premier League Limited [2011] EWCA Civ 855, 2011 WL 2747689, 28.
[893] ibid.
[894] [2015] SGCA 57.
[895] [1999] 1 WLR 1092.

> In the case of section 459 [of the Companies Act 1985 (c 6) (UK)-repealed by the 2006 Act], the background has the following two features. First, a company is an association of persons for an economic purpose, usually entered into with legal advice and some degree of formality. The terms of the association are contained in the articles of association and sometimes in collateral agreements between the shareholders. Thus, the manner in which the affairs of the company may be conducted is closely regulated by rules to which the shareholders have agreed. Secondly, company law has developed seamlessly from the law of partnership, which was treated by equity, like the Roman societas, as a contract of good faith. One of the traditional roles of equity, as a separate jurisdiction, was to restrain the exercise of strict legal rights in certain relationships in which it considered that this would be contrary to good faith. These principles have, with appropriate modification, been carried over into company law.
>
> The first of these two features leads to the conclusion that a member of a company will not ordinarily be entitled to complain of unfairness unless there has been some breach of the terms on which he agreed that the affairs of the company should be conducted. But the second leads to the conclusion that there will be cases in which equitable considerations make it unfair for those conducting the affairs of the company to rely upon their strict legal powers. Thus, unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith.[896]

In the *Tomolugen* case, it was further stated that the above passage makes it plain that the essence of oppression or unfair prejudice claims is the '*upholding* [of] *the commercial agreement between the shareholders of a company*'[897] in solvent companies. Accordingly, in *Tomolugen's* case, it was stated that the purpose of remedies under oppression or unfair prejudice is to protect the commercial expectations of the parties involved. Thus, if parties have chosen to resolve their dispute via arbitration, they should be entitled to do so, subject to certain conditions: '*There is, in general, no public element in disputes of this nature which mandate the conclusion that it would be contrary to public policy for them to be determined by an arbitral tribunal rather than by a court'*.[898] Furthermore, in *L Capital Jones Ltd.*

[896] (1999) 1 WLR 1092 1098–1099 (emphasis added).
[897] Tomolugen Holdings Ltd. and another v Silica Investors Ltd. and other appeals [2015] SGCA 57 at point 88. <http://www.uncitral.org/docs/clout/SGP/SGP_261015_FT.pdf > accessed on 4th January 2022.
[898] ibid.

v Maniach Pte Ltd.,[899] it was held that minority oppression claims are generally arbitrable.[900]

Judgments from around the world provide guidance on drafting arbitration clauses. In Hongkong, the recent case of *Dickson Holding Enterprise Co Ltd. v Moravia CV and others,*[901] it was held that, inter alia, unfair prejudice disputes arising out of the Companies Act and the company's articles cannot be resolved by arbitration because the arbitration clause in the company's articles did not specifically contain the wording '*any dispute between them relating to the affairs of the company*'. This is because the wording in the arbitration clause in the shareholder agreement – '[…] *any dispute, controversy or claim arising out of or relating to this Agreement, or the breach, termination or invalidity thereof*' – was only limited to matters in the shareholder agreement, and the affairs of the company (which also includes matters related to the company's articles and the Companies Act) fell outside the four corners of the arbitration clause. Accordingly, the court in the *Dickson* case found that the dispute related to unfair prejudice proceedings was based on the Companies Act and not the shareholder agreement, meaning that the matter was outside the subject matter of arbitration. As a result, the arbitration clause in relation to unfair prejudice or oppression disputes must be carefully drafted to hinder company shareholders from airing their dirty laundry in public.[902] Additionally, countries such as Brazil and Russia provide separate statutory frameworks for corporate disputes to be resolved by arbitration.[903]

As discussed above, the general conditions that require unfair prejudice or oppression disputes to be referred to arbitration are when the subject matter of the dispute is within the four corners of the arbitration clause.[904] Arbitration of unfair prejudice or oppression disputes should not affect third parties and should not be contrary to the public interest; the remedies sought in the arbitration should not be under the extraordinary jurisdiction of the court and other requirements stipulated in the local laws, eg laches, *etc*. I believe that the arbitrability of oppression disputes

[899] [2017] SGCA 03.

[900] Also see British Virgin Islands (Ennio Zanotti v Interlog Finance Corp *et al* BVIHCV 2009/0394) and Hong Kong (Quiksilver Glorious Sun JV Ltd [2014] 4 HKLRD 759).

[901] [2019] HKCFI; HCMP 2665/2017.

[902] See Frederico Singarajah, 'Don't air your shareholders' dirty laundry' (Practical law Arbitration blog, 25th September 2017) <http://arbitrationblog.practicallaw.com/dont-air-your-shareholders-dirty-laundry/> accessed 4th November 2021.

[903] See Elena Matlak, 'Arbitrating corporate disputes in Russia: the conditions and what they mean for arbitration clauses' (Practical law Arbitration blog, 4th July 2019) <http://arbitrationblog.practicallaw.com/arbitrating-corporate-disputes-in-russia-the-conditions-and-what-they-mean-for-arbitration-clauses/> accessed on 4th November 2021.

[904] See the discussion in relation to the *Dickson's* case.

will operate as a proactive measure, reducing the agency cost incurred in the second agency problem. For instance, in *Mitsubishi Motors Corp. v Soler Chrysler-Plymouth, Inc.,*[905] the US Supreme Court held that the statutory provisions would continue to operate as a proactive measure through its remedial and deterrent function if the invoking party could effectively pursue its statutory cause of action in the arbitration forum, owing to the many benefits of arbitration.

In this light, it is important to examine the Sri Lankan court's position on the arbitrability of oppression and mismanagement matters. This will reflect how jurisdictions have different views on the arbitrability of oppression disputes. In the case of *Aitken Spence v Garment Group Ltd. & others*[906] (Aitken), Wimalachandra J in the Commercial High Court (CHC) held that in terms of Sections 210 (oppression) and 211 (mismanagement), the court is vested with an extraordinary and summary jurisdiction that is equitable in character, and such powers cannot be exercised by an arbitrator. In other words, in terms of the oppression and mismanagement provisions, the court is vested with the power to grant *just and equitable* reliefs that cannot otherwise be granted by arbitrators. The CHC decision is primarily based on Indian case law, and the Supreme Court upheld the CHC decision on appeal.[907] In *Sumith Chandrasiri Galamangoda Guruge v Serene Pavilions (Pvt) Ltd. and others,*[908] the decision of the *Aitken* case was followed and held that an arbitrator has no powers to address complex and complicated situations.[909] However, in the case of *Heung in Enterprises Company v Alumex (Pvt) Ltd. and others,*[910] Salam J specifically held that a party can object to the court exercising its jurisdiction on certain types of oppression and mismanagement disputes arising out of joint venture agreements covered under the arbitration clause.

All the above cases were re-examined in the case of *Mahenthiran Subranabiam v Mascons (Pvt) Ltd. and others*[911] by Fernando J in the CHC, who observed, inter alia, that it is crucial to identify situations in which the extraordinary jurisdiction of the court under Sections 224 (oppression) and 225 (mismanagement) of the Companies Act should be exercised to avoid dressing up actions in the guise of Sections 210 and 211 to avoid arbitration. Thus, there cannot be a blanket rule that Sections 224 and 225 actions are not arbitrable. In considering the facts of the case,

[905] 473 U.S. 614.

[906] CHC 02/2003 (2) and SC CHC APPEAL 08/2005.

[907] See the *Aitken Spence v Garment Group Ltd & others* SC CHC APPEAL 08/2005 judgment dated 5.7.2018, 12-13.

[908] HC/Civil/41/2013/CO.

[909] HC/Civil/41/2013/CO; also see the Order dated 25.06.2018 of CHC in *Mahenthiran Subranabiam v Mascons (Pvt) Ltd and others* /Civil/ 31/2018/CO, 9.

[910] HC/Civil/06/2005(02).

[911] HC/Civil/ 31/2018/CO.

the court held that there was no material to show that the mismanagement petition was *mala fide*, vexatious or mere 'dressing up' to avoid an arbitration clause. The court further held that continuing and urgent disputes of serious financial mismanagement and fraudulent acts are not capable of being adjudicated and settled by arbitration with regard to their nature and circumstances, ie *acts of financial mismanagement and fraudulent acts of the two directors who financed the 2nd Respondent company at the expense of the 1st Respondent company.*[912] Thus, the Sri Lankan courts have examined the crux of the matter, especially the wide reliefs that can be granted by the extraordinary jurisdiction of the court *as it sees fit* in deciding whether a dispute is arbitrable. Ultimately, the series of judgments on the arbitrability of oppression/mismanagement disputes in Sri Lanka indicates that depending on the nature and circumstances of the case, the court has the discretion to stay the proceedings and give effect to the arbitration clause. However, this adds up to the uncertainty of the legal process and defeats the goals of arbitration, ie less costs and a more efficient dispute resolution process. Proactive legal drafting can resolve this uncertainty. It is also aimed in this research to fashion efficient methods for resolving said disputes.

4.3.3 Legal strategies in relation to the third agency problem (focusing on sustainability)

4.3.3.1 What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?

Through the CA2007, Sri Lanka has introduced proactive measures and stringent provisions to protect the interests of certain non-shareholder stakeholders. For instance, the solvency test, which is the golden thread that runs through the entire fabric of the CA2007. Additionally, the CA2007 facilitates companies providing incentives to employees by issuing shares.

The concept of the 'solvency test' operates as a protection mechanism for creditors. In other words, according to the solvency test, the company at a given time must be financially healthy; if not, the company should take immediate steps to make it financially stable to secure its creditors. More specifically, Section 57 (1) of the CA2007 defines the solvency test as follows:

[912] The Order dated 25.06.2018 of CHC in *Mahenthiran Subranabiam v Mascons (Pvt) Ltd and others* /Civil/ 31/2018/CO, 24.

A company shall be deemed to have satisfied the solvency test, if—

(a) it is able to pay its debts as they become due in the normal course of business; and

(b) the value of the company's assets is greater than —

(i) the value of its liabilities; and
(ii) the company's stated capital.[913]

The responsibility of keeping the company financially healthy is cast upon the board of directors. If the directors act negligently and ignore the signs of insolvency, they are made liable for their actions and/or inaction. In other words, it is the duty of the board to ensure that the solvency test is satisfied before making any distributions,[914] eg distributing dividends to shareholders. The principle is that shareholders are ranked after the creditors in an insolvency scenario, and thus it is inappropriate for shareholders to receive benefits ahead of creditors at a time when the company is insolvent.[915] Accordingly, any irregular distribution made is subject to clawback provisions, meaning that such irregular distributions are recoverable, and directors will be personally liable for any such irregular distributions that are not recoverable from shareholders.[916] In a private company, if shareholders have given *unanimous assent* to approve a distribution, and such a distribution fails to satisfy the solvency test, the company can still recover said distribution made contrary to satisfying the solvency test.[917] Furthermore, the company should immediately stop trading activities and take the steps stipulated in Section 219 of the CA2007 if it cannot satisfy the solvency test. Failure to do so would expose the negligent directors to pay all or part of any losses suffered by creditors as a result of continuing the trading activities of the insolvent company.[918] The above definition of the solvency test is based on Section 4 of the NZCA of 1993. However, Sri Lankan company law provides more stringent protection to creditors by requiring the companies to show that the value of the company's assets is greater than the value of its liabilities and its stated capital.[919]

913 Section 57 (1) of the CA2007.
914 Section 529 of the CA2007.
915 Re DML Resources Ltd (2004) 3 NZLR 490.
916 Section 61 of the CA2007.
917 Section 31 of the CA2007.
918 Section 219 (2) of the CA2007.
919 Second limb of the Solvency test provided in Section 57 (1) (b) of the CA2007.

Under the provisions of the previous Companies Act of 1982, subject to the company's articles, the board of directors and the shareholders were required to obtain the court's confirmation to reduce the company's share capital.[920] However, under the new CA2007, this discretion is now vested with the board of directors. The main question to be addressed in reducing the stated capital is whether the creditors have been safeguarded by satisfying the solvency test in reducing the stated capital. Accordingly, the entire scheme of reducing the stated capital falls under the purview of the solvency test. Additionally, Section 59 of the CA2007 provides stringent provisions to protect any existing and future creditors, eg public notice should be given no less than 60 days before the special resolution to reduce the stated capital is passed.[921]

Under the provisions of the previous Companies Act No. 17 of 1982 (as amended), giving financial assistance in connection with the purchase of shares was prohibited. The reasons for such prohibition are, inter alia, to prevent the abuse of company funds for personal gains. For instance, insiders taking control of the company, and creditor protection against the capital of the company being returned to the shareholders.[922] However, under the CA2007, giving financial assistance in connection with the purchase of shares is allowed but only under strict conditions such as in view of the best interests of the company,[923] being fair and reasonable to the company and shareholders not receiving such assistance[924] and creditor protection.[925] Creditor protection is provided by the fact that the company must satisfy the solvency test immediately after giving financial assistance.[926] Furthermore, if the amount of any financial assistance (including the outstanding financial assistance given by the company) exceeds 10% of the company's stated capital, it is mandatory for the company to obtain a certificate from its auditor to the effect that the auditor has made enquiries into the state of affairs of the company and *the auditor is not aware of anything to indicate that the opinion of the board that the company will, immediately after giving the assistance satisfy the solvency test, is unreasonable in all the circumstances.*[927] If the board fails to follow these provisions on creditor protection, the CA2007 imposes criminal liability on its directors.[928]

920 Section 67 of the CA1982.
921 Section 59 of the CA2007.
922 Kanag-Isvaran and Wijayawardana (n 715) 205.
923 Section 70 (2) (a) of the CA2007.
924 Section 70 (2) (b) of the CA2007.
925 Section 70 (2) (c) of the CA2007.
926 Section 70 of the CA2007.
927 Section 70 (3) of the CA2007.
928 Section 70 (5) and 59 (6).

Accordingly, the CA2007 provides proactive and stringent measures for creditor protection.

Sri Lankan company law provides for the issue of shares to its employees as an incentive. However, in practice, most companies impose restrictions on the employee share class, eg voting and transferability restrictions. Furthermore, Section 71 (2) (f) of the CA2007 specifically states that it is not prohibited to give financial assistance for the purpose of an employee share scheme, even it is prohibited by Section 70 of the CA2007 to give financial assistance in connection with the acquisition of its own shares (other than in accordance with Section 71).

Section 21 of the CA2007 protects non-shareholder constituencies, including creditors with no knowledge of the internal management of the company. In other words, any person claiming under the company cannot assert against a person dealing with the company or with any person who has acquired rights from the company that, inter alia, the articles of the company have not been complied with, a person presented by a company as a director or officer of the company has not been duly appointed or does not have authority to exercise company powers, or a document issued by a director of the company is not genuine, unless that person ought to have knowledge to the contrary.[929] Section 21 protects individuals dealing in good faith with the company against an escape route for any person on the company's behalf from claiming liability based on internal irregularities. Section 21 is a codification of the common law principle of the 'indoor management rule' first laid down in *Royal British Bank v Turquand*[930] (commonly referred to as the '*Turquand case*') and clearly elaborated by Lord Hatherley in *Mahony Holyford Mining Co*.[931] For instance, *when a cheque is signed by three directors, they are entitled to assume that those directors are persons properly appointed for the purpose of performing that function, and have properly performed the function for which they have been appointed*'.[932] Section 22 of the CA2007 provides that the fact that the company's articles are delivered to the Registrar's office and made available for inspection at any office of the company does not amount to constructive notice

[929] Section 21 of the CA2007.

[930] (1856) 6 E. & B. 327; also see Len S Sealy, 'Agency Principles and the Rule in Turquand's Case' (1990) 49 The Cambridge Law Journal 406.

[931] (1875) LR 7 HL 869 – Lord Hatherley stated that '...when there are persons conducting the affairs of the company in a manner which appears to be perfectly consonant with the articles of association, then those so dealing with them, externally, are not to be affected by any irregularities which may take place in the internal management of the company. They are entitled to presume that of which only they can have knowledge, namely, the external acts, are rightly done, when those external acts purport to be performed in the mode in which they ought to be performed.' See (1875) LR 7 HL 869, 894.

[932] Lord Hatherley in (1875) LR 7 HL 869, 894.

or knowledge of the contents of such documents.[933] When read together with Section 21, Section 22 of the CA2007 provides higher protection to a person dealing in good faith with the company. The codification of the 'indoor management rule' provides greater security for non-shareholder constituencies, such as, inter alia, creditors, consumers and employees who are involved with the company. However, such non-shareholder constituencies should not have knowledge of such internal irregularities by virtue of that person's position in or relationship with the company.[934] Furthermore, the Turquand rule of indoor management is seen in other common law countries, such as New Zealand and Canada. In other words, Section 21 of the CA2007 is based on Section 18 of the NZCA of 1993 and Section 18 of the CBCA of 1985.

In the US, the Caremark duty doctrine provides a duty on company directors to 'attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists'.[935] The Caremark doctrine and recent disclosure measures regarding climate change by the US SEC impose greater responsibility on company directors in listed companies to monitoring risks with a focus on environmental matters.[936] However, researchers have shown that in practice, plaintiffs have faced numerous obstacles to imposing liability under the Caremark duty, although recent cases in Delaware have provided hopes of increased possibilities of imposing liability under the Caremark duty.[937]

Sri Lankan company law does not provide specific laws for directors to consider stakeholder interests in their corporate decision-making. As mentioned above, the corporate governance code of Sri Lanka focuses on ESG reporting. Nevertheless, companies are not obligated to report on ESG matters provided in the CG code owing to its voluntary nature. However, Sri Lankan law consists of several stringent laws for environmental protection. The Sri Lankan Constitution stipulates that the state shall protect, preserve and improve the environment for the benefit of the

[933] Section 22 of the CA2007.

[934] Proviso to the Section 21 of the CA2007.

[935] Delaware, USA Caremark duty on monitoring risks focusing on environmental matters – see *Re Caremark International Inc. Derivative Litigation 698 A.2d 959 (Del. Ch. 1996), 970.*

[936] See SEC, 'Commission Guidance Regarding Disclosure Related to Climate Change' 17 CFR PARTS 211, 231, 241 <https://www.sec.gov/rules/interp/2010/33-9106.pdf> accessed on 1st March 2022; also see Sarah Solum, Valerie Ford Jacob, and Michael Levitt, 'The SEC's Upcoming Climate Disclosure Rules' Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/2021/09/01/the-secs-upcoming-climate-disclosure-rules/> accessed on 1st March 2022.

[937] See Brett McDonnell and others, 'Green Boardrooms?' (2021) Connecticut Law Review. 499, 387 – 389.

community,[938] and that it is a fundamental duty of every person in Sri Lanka to, inter alia, protect nature and conserve its riches.[939] The umbrella law in respect of environmental protection in Sri Lanka is the National Environmental (Amendment) Act, No. 56 of 1988 (NEA).[940] The NEA established the Central Environmental Authority (CEA) and provides its powers to protect and manage the environment.[941] In addition, several other pieces of environmental protection legislation are in place, eg the Plant Protection Act,[942] which boards should consider prior to making corporate decisions, specifically in terms of their environmental impact. This is specifically relevant in respect of the 'social license to operate' (SLO), which refers to the acceptance of the company's business activities by the local community.[943] Morrison argues that any disapproval by the local community may result in resistance that could harm business interests.[944] For instance, the *Rathupaswala* case discussed in the chapter three. Further, in the chapter three, it is argued that such harm to the business creates high cost through the eyes of the theory of the firm. Company law in Sri Lanka does not allow directors to take decisions considering the non-shareholder stakeholders as seen in Section 172 of the UKCA 2006. However, indirectly, according to Section 187 of the CA2007, directors should consider the non-shareholder stakeholders in their corporate decision-making if it is in the best interests of the company. In other words, in certain circumstances, it is in the best interests of the company to consider stakeholders in view of the cost-efficiency theory in connection to the third agency relationship.

In other common law countries, such as New Zealand, ESG matters must be reported, as per the NZX Corporate Governance Code 2020.[945] The Corporate Governance Handbook of New Zealand, which provides specific guidelines for non-listed companies, recommends that boards take the interests of stakeholders into

[938] Article 27 (14) of the Constitution of Sri Lanka <https://www.parliament.lk/files/pdf/constitution.pdf> accessed on 21st October 2021.

[939] Article 28 (f) of the Constitution of Sri Lanka <https://www.parliament.lk/files/pdf/constitution.pdf> accessed on 21st October 2021.

[940] The National Environmental (Amendment) Act, No. 56 of 1988 <http://www.cea.lk/web/images/pdf/acts/act56-88.pdf> accessed on 21st October 2021.

[941] The Central Environmental Authority <http://www.cea.lk/web/en/about-us> accessed on 21st October 2021.

[942] Plant Protection Act (No. 35 of 1999) <https://www.srilankalaw.lk/Volume-VI/plant-protection-act.html> accessed on 21st October 2021.

[943] Geert Demuijnck and Björn Fasterling, 'The Social License to Operate' (2016) 136 J Bus Ethics 675–685.

[944] John Morrison, *The social license to operate. How to keep your organization legitimate* (Palgrave MacMillan 2014).

[945] NZX Corporate Governance Code 2020, 21 <https://www.nzx.com/regulation/nzx-rules-guidance/corporate-governance-code> accessed on 21st October 2021.

account, especially the environmental factors.[946] New Zealand company law also requires directors to act in the best interests of the company subject to advancing the interests of other stakeholders, eg employees.[947] Furthermore, the handbook states that advancing stakeholder interests will have a positive long-term impact on society and the environment and, accordingly, it will ensure entities maintain their SLO.[948]

4.3.3.2 What is the function of the unfair prejudice, oppression, and mismanagement remedies' involvement in achieving sustainability in corporate governance?

The CA2007 has provided protection to creditors, specifically through the solvency test. Under the terms of Section 57 of the CA2007, a trading company is mandated to satisfy the solvency test. Section 57 (1) (a) provides that a company is deemed to satisfy the solvency test, inter alia, *if it is able to pay its debts as they become due in the normal course of business.*[949] If the company is unable to pay its debts as per Section 57 (1) (a), the board should apply to court for the winding-up of the company.[950] Thus, if a director continues to trade without the company being able to pay its debts in the normal course of business, and subsequently the company is placed into liquidation, the director may be liable to pay any part of the loss suffered by creditors as a result of carrying on the business.[951] Accordingly, the CA2007 has vested an obligation on the company directors to protect its creditors as stakeholders of the company. Although no provisions relating to the environment appear in the CA2007, all companies are generally required to comply with the laws enacted to protect the environment in Sri Lanka. All the above-listed provisions can be invoked through oppression and mismanagement proceedings. Most importantly, a shareholder has the possibility to invoke the mismanagement provisions if the board has taken a decision that hinders sustainability, eg a decision that adversely affects the environment, causing the company to incur reputational costs and suffer from an immediate or future profit loss. In such a scenario, a shareholder may be able to

[946] Corporate Governance Handbook 2018 by Financial Market Authority of New Zealand, 27 <https://www.fma.govt.nz/assets/Guidance/180228-Corporate-Governance-Handbook-2018.pdf> accessed on 21st October 2021.

[947] Section 132 of the New Zealand Company Act of 1993.

[948] Financial Market Authority of New Zealand, *Corporate Governance Handbook* (Auckland, 2018), 28 <https://www.fma.govt.nz/assets/Resources/180228-Corporate-Governance-Handbook-2018.pdf> accessed on 21st October 2021.

[949] Section 51 (1) (a) of the CA2007.

[950] Section 219 of the CA2007.

[951] Section 219 (2) of the CA2007.

invoke oppression provisions if such a decision has a group of minority shareholders and the majority shareholders stand to benefit from it.

4.4 Comparative study of the United Kingdom

4.4.1 United Kingdom company law in general

The UK corporate governance framework has influenced several jurisdictions around the world owing to its effectiveness as well as the impact of colonisation. For instance, India and Sri Lanka have essentially incorporated UK statutory company laws following independence. Corporate law in the UK helps to attract a wide pool of investors for international companies owing to its efficient shareholder protection statutory provisions. UK corporate law derives from common law, which is currently codified and supplemented by the Companies Act 2006 (CA 2006).[952] Both types of companies, ie public and private, are governed by the CA 2006, which includes provisions, inter alia, governing directors' conducts and regulating companies' financial (and other) disclosure obligations.[953] Articles of association are the principal constitutional document in both public and private companies that governs internal affairs, subject to the CA 2006 mandatory provisions and common law. Model articles of association of public companies and private companies limited by shares and by guarantee are provided in *Regulations 2008, SI 2008/3229.*[954] Articles of association are based on the economic principle of freedom of contract; as a result, companies have substantial discretion over the content of their articles.[955] Furthermore, shareholders have the option of entering into separate shareholder agreements in addition to the articles of association to regulate the relationship between themselves.[956] Shareholder agreements are common in small private

952 Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/contents> accessed on 21st August 2021.

953 Tom Rose and Dominic Sedghi, 'UK: Corporate Governance Laws and Regulations 2020' (ICLG 14th July 2020) <https://iclg.com/practice-areas/corporate-governance-laws-and-regulations/united-kingdom> accessed on 21st August 2021.

954 See The Companies (Model Articles) Regulations 2008, SI 2008/3229 <https://www.legislation.gov.uk/uksi/2008/3229/contents/made> accessed on 21st August 2021.

955 Rose and Sedghi (n 953).

956 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 381 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

companies. The Insolvency Act 1986 (IA 1986)[957] applies to both public and private companies and regulates, inter alia, the winding-up matters of an insolvent company.

In addition to the CA 2006, UK listed companies on the London Stock Exchange are heavily regulated by other domestic Acts, codes of practice and market guidance.[958] Public (listed) companies are specifically regulated by several other pieces of legislation, inter alia:

- Listing Rules and Disclosure Guidance and Transparency Rules (DTRs) issued by the Financial Conduct Authority (FCA), which is a statutory body;[959]
- Financial Service and Market Act 2000 (FSMA 2000);[960]
- City Code on Takeover and Mergers (known as the 'City Code'), issued and administered by the Takeover Panel.[961] This Code specifically requires a new buyer to make offers to acquire minority shareholders' shares upon exceeding a certain specified limit of share percentage in the subject company;[962]
- 'Insider dealing provisions' under the Criminal Justice Act 1993 (CJA 1993);[963]

957 Insolvency Act 1986 <https://www.legislation.gov.uk/ukpga/1986/45/contents> accessed on 21st August 2021.

958 Theis Klauberg, 'General Case on Directors' Duties' in Mathias Siems and David Cabrelli (eds) *Comparative Company Law: A Case-Based Approach* (Hart Publishing 2013).

959 FCA Handbook containing, inter alia, Listing rules and DTRs <https://www.handbook.fca.org.uk/handbook> accessed on 21st August 2021.

960 Financial Service and Market Act 2000 <https://www.legislation.gov.uk/ukpga/2000/8/contents> accessed on 21st August 2021.

961 Takeover panel <https://www.thetakeoverpanel.org.uk/the-code/download-code> and Takeover Code <https://www.thetakeoverpanel.org.uk/wp-content/uploads/2021/06/154384_-016_-The-Take-Over_Bookmarked_5.7.21.pdf?v=28Jun2021> accessed on 21st August 2021.

962 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 381 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

963 Part V of the UK Criminal Justice Act 1993 (CJA) <https://www.legislation.gov.uk/ukpga/1993/36/part/V> accessed on 21st August 2021.

- UK Corporate Governance Code (UKCG Code)[964] and UK Stewardship Code 2020 for institutional investors,[965] issued and administered by the Financial Reporting Council (FRC), which is also a statutory body.[966] The Listing Rules do not mandate companies to comply with the UKCG Code, but listed companies are required to state in their annual reports and accounts whether the company has applied the UKCG Code recommendations and to explain and justify any deviations.[967] The UK Stewardship Code stipulates guidelines on best practice for institutional investors when dealing with listed companies. These guidelines also operate based on 'comply or explain'.[968] The aim of the Stewardship Code is to enhance the quality of engagement between institutional investors, eg pension funds, mutual funds and companies to help improve long-term returns to shareholders and increase good practice of engagement with investor companies.[969]
- National Security and Investment Act 2021 (NSIA 2021).[970] This Act received royal assent on 29th April 2021 and was put into force on 4th January 2022. However, the NSIA 2021 applies retrospectively from 12th November 2020. The purpose of the Act is to scrutinise transactions in acquisitions on the grounds of national security, specifically in certain sectors such as, inter alia, artificial intelligence, transport, civils and nuclear.[971]

In addition, public companies in the UK generally adhere to non-binding guidelines produced by investor protection groups, eg the Investment Association

[964] UK Corporate Governance Code <accessed on 21st August 2021.https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> accessed on 21st August 2021.

[965] UK Stewardship Code 2020 <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf> accessed on 21st August 2021.

[966] The Financial Reporting Council <https://www.frc.org.uk/about-the-frc> accessed on 21st August 2021.

[967] Rose and Sedghi (n 953).

[968] Murry Cox and Hayden Cooke, 'United Kingdom' in Willem J L Calkoen (ed) *The Corporate Governance Review* (Law Business Research Ltd 2020) 330.

[969] Kanag-Isvaran and Wijayawardana (n 715) 294.

[970] National Security and Investment Act 2021 <https://www.legislation.gov.uk/ukpga/2021/25/contents/enacted> accessed on 21st August 2021.

[971] For more information on the NSIA 2021 see <accessed on 21st August 2021.https://www.traverssmith.com/knowledge/knowledge-container/the-uks-national-security-and-investment-act-2021-what-you-need-to-know/> accessed on 21st August 2021.

and the Pensions and Lifetime Savings Association.[972] Accordingly, any non-compliance with such guidelines is explained publicly. These guidelines supplement the above-mentioned legal provisions, regulations and codes of practice.[973]

4.4.2 Legal strategies in relation to the second agency problem

4.4.2.1 What are the rights vested in shareholders to proactively reduce agency costs in the second agency problem?

The specific rights under discussion in this topic encompass economic rights, control rights, access to information rights, and enforcement mechanisms, which include litigation rights.

The rights in focus within this discussion span economic rights, control rights, rights to access information, and enforcement mechanisms, including the right to litigate. When considering the economic rights of shareholders in UK companies, it is observed that UK corporate governance provides shareholders with considerable autonomy in negotiating their economic rights related to the company. The results of these negotiations are usually outlined in the company's articles of association or the shareholder agreement. UK companies have the ability to issue various classes of shares, each carrying distinct rights and obligations. These can range from, but are not limited to, entitlement to specific dividends or a share in the distribution of assets upon the company's winding up. To amend the rights attached to a particular class of shares, it is generally required to obtain consent from a 75% majority of the shareholders within that class.[974] Shareholders in UK companies are protected under the statutory pre-emption right in the instance of a new share issue by the company, allowing them to subscribe to further shares to maintain their share percentage.[975] However, the pre-emption right can be disapplied through a special resolution with

972 Pensions and Lifetime Savings Association <https://www.plsa.co.uk> accessed on 21st August 2021.

973 Cox and Cooke (n 968) 330.

974 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 382 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

975 Section 561 of the UK Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/part/17/chapter/3/crossheading/existing-shareholders-right-of-preemption> accessed on 22nd August 2021.

a 75% share of the vote. In addition to the pre-emption right, shareholders must approve a secondary share offering by a simple majority resolution.[976]

Shareholders in UK companies do not have a specific right to demand that the company and other shareholders purchase their shares, unless this is agreed upon in the articles of association or in the shareholder agreement. However, under the Takeover Code, a new buyer in an acquisition of a listed company is required to make an offer (termed as a ‘mandatory offer’) to the remaining shareholders to purchase their shares if the new buyer’s share percentage in the company increases by up to 30% or between 30% and 50% and acquires additional shares.[977]

Shifting the focus to control rights within UK companies, it is worth noting that the country’s company law typically does not impose a fiduciary duty on shareholders towards the company or fellow shareholders. This holds true unless there is a specific clause to that effect in the articles of association. This framework grants shareholders the freedom to utilise their voting rights in accordance with their individual interests.

However, it is crucial to highlight that the Companies Act 2006 sets forth specific limitations, particularly in relation to directors and their voting rights. Directors are expressly forbidden from partaking in votes where their decision does not align with the success of the company, a mandate clearly articulated in Section 172 of the Companies Act 2006. The Listing Rules contain the concept of the controlling shareholder, ie a shareholder who alone or acting in concert with other shareholders is able to control 30% or more of the voting rights.[978] Companies with controlling shareholders are required to comply with additional regulations to protect the rights of minority shareholders, ie such companies are required to contract with the controlling shareholders to ensure the independence of the board, along with additional disclosure requirements, and certain matters must be approved by the minority shareholders independently of the controlling shareholders.[979]

The affairs of the company in the UK are under the control of the board of directors. Unlike in German corporate governance, the UK framework provides a unitary board structure in all companies. While the board may create subcommittees

[976] Cox and Cooke (n 968) 340.

[977] Rule 9 of the Takeover Code <https://www.thetakeoverpanel.org.uk/wp-content/uploads/2021/06/154384_-016_-The-Take-Over_Bookmarked_5.7.21.pdf?v=28Jun2021> accessed on 22nd August 2021.

[978] See definition for ‘controlling shareholder’ – Listing rules stipulated in the FCA Handbook <https://www.handbook.fca.org.uk/handbook/glossary/G3382.html> accessed on 23rd August 2021.

[979] See LR 6.5 Controlling shareholders Listing rules stipulated in the FCA Handbook <https://www.handbook.fca.org.uk/handbook/glossary/G3382.html> accessed on 23rd August 2021.

to oversee certain company matters, the affairs of the company are mainly managed by the directors collectively, with only a small number of decisions requiring shareholder approval. Generally, the board delegates managerial authority by appointing a managing director and instead exercises an oversight function.[980] The UKCG Code recommends that members of the board and its committees should include expert individuals with an appropriate balance of skills, experience, independence and knowledge of the business to discharge their respective duties and responsibilities effectively.[981] Board members are appointed by a decision of the board of directors or by a shareholders' resolution passed by a simple majority. Thus, minority shareholders do not have a specific right to appoint members to the board. However, listed companies are obligated under the terms of the FCA Rules to appoint independent directors to enable boards of directors to act independently.[982] In addition, the UKCG Code provides that the majority of directors should be 'independent' non-executive directors.[983] Independent directors should be free from the majority influence and take decisions that are in the best interests of the company.

According to the UKCG Code, the primary function of independent directors is to monitor the performance of the company and to scrutinise its management affairs.[984] In addition, senior independent directors should be available to act as intermediaries for shareholders to contact to resolve matters that have otherwise been unresolved through the normal channels.[985] Thus, the independence of directors reduces majority shareholders' opportunistic influence on the decisions of the board.[986] A director may be removed from office by a resolution passed by a simple

[980] Cox and Cooke (n 968) 331.

[981] See principles UK Corporate Governance Code <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> accessed on 21st August 2021, 8.

[982] Chapter 15, LR 15.2.11 (06/03/2008) FCA Listing Rules <https://www.handbook.fca.org.uk/handbook/LR/15/2.html> accessed on 22nd August 2021.

[983] See Provision 17 See UK Corporate Governance Code <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> accessed on 21st August 2021.

[984] Provision 13 of the UK Corporate Governance Code <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> accessed on 23rd August 2021.

[985] Provisions 12 of the UK Corporate Governance Code <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> accessed on 23rd August 2021.

[986] Cox and Cooke (n 968) 332.

majority at a general meeting. Moreover, the UKCG Code recommends that the Board should constitute a nomination committee, an audit committee and a remuneration committee. These committees further strengthen minority shareholder interests.

Minority shareholders' rights relating to the general meeting vary depending on the type of company, ie public or private. Private companies are not obligated to hold an AGM, whereas public companies are obligated to hold an AGM within six months of its accounting reference date.[987] However, shareholders holding as little as 5% of the share percentage (or at the request of the board) can convene a general meeting. Thus, shareholders with this share percentage in private companies can convene a general meeting. Furthermore, minority shareholders' rights to vote includes special rights related to the general meeting, ie the right to receive notice of the general meeting and the right to voice and vote at the general meeting through a proxy.[988]

Minority shareholders are not generally consulted prior to major transactions in private companies unless otherwise agreed in the articles of association or the shareholder agreement. However, a company that has a premium listing must obtain shareholder approval by way of a 'vote' on larger proposed transactions according to Chapter 10 of the FCA Listing Rules.[989] Furthermore, the CA 2006 provisions on 'related-party transactions' – specifically, the law relating to 'non-cash asset transactions' – protect minority shareholders from opportunism on the part of majority shareholders and directors (eg tunnelling company assets).[990] Such substantial 'non-cash asset transactions' related to directors require approval by way of a shareholder resolution.[991] Shareholder approval by way of a simple majority is also required for loans and other credit transactions. Most importantly, if shareholders resist any board-recommended resolution with more than 20% of votes,

[987] 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 383 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

[988] Notice of Meeting - Section 307 and Proxies – Section 324 of the UK Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/part/17/chapter/3/crossheading/existing-shareholders-right-of-preemption> accessed on 22nd August 2021.

[989] Chapter 10 FCA Listing Rules <https://www.handbook.fca.org.uk/handbook/LR/10/?view=chapter> accessed on 22nd August 2021.

[990] Section 190 of the UK Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/part/17/chapter/3/crossheading/existing-shareholders-right-of-preemption> accessed on 22nd August 2021.

[991] Section 191 of the UK Companies Act 2006 <accessed on 22nd August 2021. https://www.legislation.gov.uk/ukpga/2006/46/part/17/chapter/3/crossheading/existing-shareholders-right-of-preemption> accessed on 22nd August 2021.

the UKCG Code recommends the company to consult with shareholders to ascertain the reasons for such resistance and, thereafter, to publicly announce their conclusions and remedial actions.[992]

Turning our attention to the rights pertaining to information access for shareholders in UK companies, it is observed that minority shareholders in private companies experience somewhat restricted access to information when compared to their counterparts in public listed companies within the UK. This is specifically owing to the reason that in listed companies, the information rights stipulated in the CA 2006 are supplemented by Listing Rules and other legal frameworks governing listed companies such as, inter alia, the UKCG Code. The CA 2006 stipulates that minority shareholders have the right to receive a copy of the company's annual accounts and to inspect its statutory registers of shareholders and directors. In addition, shareholders holding 10% of share capital have a right to request for the company accounts to be audited, even if the company has decided to exempt itself from annual audit requirements.[993]

On the other hand, publicly listed companies are subject to periodic, ad hoc and event-driven disclosure obligations, specifically under, inter alia, the FCA Rules. The most important disclosure obligations are on, inter alia, insider information, directors' remuneration, governance policies related to comply or explain matters, significant transactions, share capital and voting rights, disclosure of members of the board and key executives, and related-party transactions.

In considering the enforcement mechanisms and litigation rights of shareholders in UK companies, it is noted that UK company law predominantly adheres to the 'majority rule' principle. This means that decisions made in good faith by the majority of shareholders are typically upheld. However, if a decision is taken by the majority in bad faith (*mala fide*), the minority shareholders have a right to bring a civil claim to court, eg in an instance of a breach of their statutory rights or any other agreed provisions in the articles of association or shareholder agreements. In addition to this right to bring a civil claim, shareholders can bring a derivative action in the name of the company[994] as well as unfair prejudice action. Derivative actions are

[992] Provision 4 of the UK Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/part/17/chapter/3/crossheading/existing-shareholders-right-of-preemption> accessed on 23rd August 2021.

[993] 'Study on minority shareholders protection' (final report) by TGS Baltic European Commission (Luxembourg 2018) 383 https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en accessed on 14th July 2023.

[994] Section 260 of the Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/contents> accessed on 24th August 2021.

brought by shareholders on behalf of the company against the company's directors for breach of duty, breach of trust, negligence and default. Unfair prejudice actions are further discussed under Section *4.4.2.4.* It should be noted that derivative action is also available as a remedy to unfair prejudice claims,[995] however, it is rare. In addition to these statutory enforcement rights, shareholders can also seek remedial actions through common law principles, eg prohibiting actions that constitute a breach of the company's articles of association and remedying any abuse by directors of their fiduciary powers. Furthermore, under certain circumstances, company directors can be found to owe a direct duty of care to shareholders. An example might be when a shareholder suffers a loss due to a director's negligent breach of his/her duty of care regarding a major transaction that has been voted on and approved by the shareholders.[996] However, for such a duty of care to arise, the circumstances must be exceptional, a scenario which is, in practical terms, extremely rare.

4.4.2.2 What is the function of corporate law in avoiding litigation and securing cost-effectiveness in enforcement mechanisms?

As discussed above, the UK corporate governance framework for publicly listed companies is heavily regulated. As such, the UK legal provisions operate as a proactive mechanism to avoid litigation. Furthermore, the UK CA 2006 seeks to achieve compliance with these legal provisions by imposing heavy fines and penalties. The Department for Business, Innovation and Skills (it is now the Department for Business, Energy and Industrial Strategy) has stated that this approach has proven highly successful and, as a result, the UK has very high levels of compliance.[997]

Unlike FCA, the UKCA 2006 does not provide specific provisions for arbitration in dispute resolution. However, shareholders have the freedom to include an arbitration clause in the shareholder agreement or in the articles of association to resolve certain matters through arbitration. The arbitrability of unfair prejudice actions are discussed earlier in section 4.3.2.4 with references to other jurisdictions in the Sri Lankan comparative study.

[995] See Section 996 (2) (c) of the CA 2006.

[996] Rose and Sedghi (n 953).

[997] Company Law: Providing a flexible framework which allows companies to compete and grow (discussion paper) by Department for Business Innovation & Skills (Crown 2021) 9 <https://www.gov.uk/government/organisations/department-for-business-energy-and-industrial-strategy> accessed on 24th August 2021.

4.4.2.3 What is the function of the equal treatment remedy?

The CA 2006 does not encompass a specific provision on the equal treatment principle. However, a general shareholder equality principle is present in both UK company law and the Listing Rules. For instance, the ‘one share one vote norm’ and ‘distributions to shareholders (eg economic rights)’ are heavily regulated and required to be made anonymously in the market unless otherwise agreed. In addition, the disclosure requirements, which must be made available simultaneously to all shareholders, reflect the principle of shareholder equality. Shareholders who have access to confidential information are also prohibited from acting on said information until it is made public or ceases to be price-sensitive.[998]

However, the equal treatment principle does not operate as a major safeguard in the UK to protect minority shareholders in the same way as the unfair prejudice remedy. The UK courts have the exclusive jurisdiction – also developed by common law – to apply equitable principles to the case in hand. Equity is thus a core principle applied in resolving disputes under the unfair prejudice remedy. This is further discussed in the following subsection.

4.4.2.4 What is the function of corporate law in defining unfair prejudice or oppressive conduct?

In the UK, the initial statutory remedy available for acts of oppressive conduct was to wind up the company. However, this was later amended through Section 210 of the UK Companies Act 1948 to provide several other remedies *as the court sees fit* against oppressive conduct, owing to the reason that it was not the best remedy to wind up a company if the company was running its business well and remained solvent.[999]

Section 210: Alternative remedy to winding up in cases of oppression

> (1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) or, in a case falling within subsection (3) of section

[998] Cox and Cooke (n 968) 340.

[999] Section 210 of the UK Companies Act of 1948 <accessed on 26th October 2021. https://www.legislation.gov.uk/ukpga/1948/38/part/IV/crossheading/minorities/enacted> accessed on 26th October 2021.

one hundred and sixty-nine of this Act, the Board of Trade, may make an application to the court by petition for an order under this section.

(2) If on any such petition the court is of opinion—

(a) that the company's affairs are being conducted as aforesaid; and

(b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;

the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.[1000]

UK company law currently provides wider protection to minority members against unfair prejudice, which has evolved from Section 210 of the UK Companies Act of 1948 based on 'oppression'. Part 30 of the CA 2006 stipulates statutory provisions on the protection of members against unfair prejudice. Specifically, Section 994 provides that:

(a) A member of a company may apply to the court by petition for an order under this Part on the ground—

(b) that the **company's affairs** are being or have been conducted in a manner that is **unfairly prejudicial** to the **interests of members generally** or of some **part of its members** (including at least himself), or

[1000] ibid.

(c) that an **actual** or **proposed act** or **omission** of the company (including an act or omission on its behalf) is or would be so **prejudicial**.

(1A) For the purposes of subsection (1)(a), a **removal of the company's auditor** from office—

(a) on grounds of divergence of opinions on accounting treatments or audit procedures, or

(b) on any other improper grounds,

shall be **treated as being unfairly prejudicial** to the interests of some part of the company's members.]

(2) The provisions of this Part apply to **a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law** as they apply to a member of a company.

(3) In this section, and so far as applicable for the purposes of this section in the other provisions of this Part, 'company' means—

(a) a company within the meaning of this Act, or

(b) . . . . [1001]

According to Section 994, any member (ie shareholder) of the company can apply to court; a certain shareholding percentage is not a requirement to invoke said provision. In addition, Section 994 (2) of the CA 2006 stipulates that even if a person is not registered as a shareholder of the company but shares have been transferred to him/her by operation of law, he/she has the *locus standi* to apply as a member under this provision of unfair prejudice. An individual who is holding shares as the bare nominee or trustee can also present a petition under Section 994 of the CA 2006.[1002]

Furthermore, should investigations or reports reveal that the affairs of the company are being or have been conducted in a manner that is unfairly prejudicial, as defined in Section 994 of the CA 2006, the Secretary of State for Business,

[1001] ibid, section 994 (emphasis added).

[1002] See Atlasview v Brightview [2004] EWHC 1056 (Ch).

Enterprise and Industrial Strategy is empowered to bring an action under Section 995 of the CA 2006 for an order under Part 30 of the CA 2006.[1003] Although this provision has yet to be utilised, it can be argued that it practically functions as a proactive mechanism to prevent the occurrence of unfairly prejudicial acts.

Controlling shareholders are also able to bring an action under Section 994, but if they can readily rectify the prejudicial state of affairs themselves,[1004] the court may strike out the petition.[1005] A petition under Section 994 can be presented in relation to companies registered under the CA 2006 and the Companies Act 1985. However, an unfair prejudice petition may not be presented in relation to the affairs of an overseas company.[1006] Furthermore, the application of the unfair prejudice right in public and private companies may vary given that short-term investors in listed companies may have no interest in the company affairs other than that they are conducted according to what is agreed in the articles of association or any other agreement. A shareholder of a parent company may also bring an action under Section 994 if the parent company breaches its fiduciary duty to the subsidiary company.[1007] This is mostly pertinent in a situation in which the parent company directors are the same as in the subsidiary company.[1008]

Unfairly prejudicial conduct must be related to the affairs of the company and not limited to the unfairly prejudicial act by a fellow shareholder or the board of directors but also extending to the unfairly prejudicial conduct of the management.[1009] Corporate matters such as, inter alia, shareholder voting and selling shares, do not constitute unfairly prejudicial conduct, even though such actions may harm the other shareholder. In turn, the requirements to be satisfied within the two limbs of Section 994 of the CA 2006 to seek remedies accordingly are discussed below. The requirements are as follows: the conduct must be prejudicial to members' interests; it must be a single act or omission and it should be a potential conduct; and

[1003] Section 995 of the Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/contents> accessed on 27th August 2021.

[1004] Re Baltic Real Estate Ltd (No 2) [1992] BCC 629.

[1005] Re Legal Costs Negotiators Ltd [1999] BCC 547.

[1006] Matthew Morrison, *Unfair prejudice petitions under the Companies Act 2006: rights and remedies* (Thomas Reuters 2021), 3 <https://uk.practicallaw.thomsonreuters.com/2-529-1125?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed on 28th August 2021.

[1007] Re Grandactual Ltd [2005] EWHC 1415 (Ch.D.)

[1008] Gross v Rackind [2004] EWCA Civ 815; Hawkes v Cuddy [2009] EWCA Civ 291.

[1009] Re Oak Investment Partners XII Ltd [2009] EWHC 176 (Ch).

the prejudice must be suffered and must be unfair.[1010] Section 994 of the CA 2006 clearly states that the conduct must be '*unfairly prejudicial to the interests of the members generally or of some part of its members*'.[1011] Thus, a shareholder/member is not required to establish that he/she has been treated differently to other members, although it can strengthen his/her claim. For instance, *O'Neill and another v Phillips and others (1999)*[1012] and *Gamlestaden Fastigheter AB v Baltic Partners Ltd. and others (2007)*[1013] are two cases where prejudice towards a member's interests as a member has been found.

As per Lord Hoffmann in *O'Neill v Phillips*[1014], a member of a quasi-partnership[1015] may be able to bring an action giving effect to equitable principles under the terms of Section 994. For instance, an act or omission can constitute unfairly prejudicial conduct if such an act or omission is inconsistent with the parties' relationship (ie understandings, trust and confidence), even though such an act or omission is expressly permitted by, eg the company's constitution, a formal business agreement, or various express and implied agreements between the partners.[1016] The rationale is that when a party forms a business venture together with others injecting their capital, it is assumed that the party will also get involved with the management of the company and receive salaries and dividends as returns on their investment.[1017] In *Gamlestaden Fastigheter AB v Baltic Partners Ltd and others (2007),*[1018] prejudice towards a member's interests as a member was found even in an instance where a shareholder who loaned money as a creditor suffered a loss as a result of the company affairs being conducted in a manner that was unfairly prejudicial to said shareholder. Accordingly, in this case, the court did not preclude the shareholder from receiving relief that would only benefit him as a creditor but not as a shareholder.

[1010] Matthew Morrison, *Unfair prejudice petitions under the Companies Act 2006: rights and remedies* (Thomas Reuters 2021) 6, 7 & 8 <https://uk.practicallaw.thomsonreuters.com/2-529-1125?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed on 28th August 2021.

[1011] 994 (1) (a) of the CA 2006.

[1012] (1999) 1 WLR 1092.

[1013] Gamlestaden Fastigheter AB v Baltic Partners Ltd and others [2007] UKPC 26.

[1014] O'Neill and another v Phillips and others [1999] 1 WLR 1092.

[1015] Lord Wilberforce describes that the Quasi-partnerships are a species of private company – see Re Westbourne Galleries Ltd [1973] AC 360.

[1016] Re Hart Investment Holdings Ltd [2013] EWHC 2067.

[1017] Re Saul D Harrison & Sons plc (1995) 1 BCLC 14.

[1018] Gamlestaden Fastigheter AB v Baltic Partners Ltd and others [2007] UKPC 26.

The single act or omission of unfairly prejudicial conduct, which is sufficiently imminent, may also constitute the aforesaid second requirement.[1019] The petition should adduce evidence of an imminent threat, and the petitioner cannot rely on the fear of a future act or omission occurring. In addition, a petitioner cannot rely on an unfairly prejudicial past action, to which all the shareholders consented at the time, before the petitioner became a shareholder.[1020] The UK courts have also concluded that an act or omission is not sufficiently imminent in circumstances such as, eg when a controlling shareholder indicates a desire to engage in an unfairly prejudicial act but the board has not yet decided to follow the controlling shareholder's wishes,[1021] and steps that are taken that may facilitate later prejudicial acts but not imminently.[1022] In such instances, the court has held that the petitioner can only file a petition in due course when such steps are imminent.[1023]

One of the most important requirements under Section 994 of the CA 2006 is that both 'prejudice must be suffered' and 'unfairness' must be shown in seeking relief under said provision. Prejudice can be clearly seen, eg when the economic value of a member's share has been decreased.[1024] That said, UK company law has not strictly defined what amounts to an 'unfair prejudice act' and it is hence open for the courts to consider based on equitable principles and depending on the situation. However, in *Rock (Nominees) Ltd. v RCO (Holdings) Plc [2004]*[1025] it was held that the petitioner must be worse off as a result of the alleged conduct. Furthermore, the courts are reluctant to define unfairness based on vague and subjective notions of fairness and morality. In *Re Saul D Harrison [1994]*[1026] and *O'Neill and another v Phillips and others [1999],*[1027] Lord Hoffmann LJ stated that in appraising unfairness and prejudice, the court must '*take an objective approach applying established equitable principles*'[1028] and '*consider underlying the basis on which the Petitioner agreed to become a shareholder of the company*',[1029] ie by looking at the articles of association or shareholder agreements. In *Re Sunrise Radio Ltd [2009]*, it was held, inter alia, that unfair prejudice must be applied flexibly to meet the circumstances of the case and that the petitioner is not required to show bad faith or the existence of

1019 Section 994 (1) (b) of the CA 2006.
1020 Re Batesons Hotels (1958) [2013] EWHC 2530.
1021 Re A Company (No.4475 of 1982) [1983] Ch 178.
1022 Re Ringtower Holdings plc [1989] 5 BCC 82.
1023 ibid.
1024 Re Brenfield Squash Racquets Club Limited [1996] 2 BCLC 184.
1025 Rock (Nominees) Ltd v RCO (Holdings) Plc [2004] EWCA Civ 118.
1026 Re Saul D Harrison [1994] BCC 475.
1027 (1999) 1 WLR 1092.
1028 Lord Hoffmann LJ in Re Saul D Harrison [1994] BCC 475, 488.
1029 Lord Hoffmann LJ in O'Neill and another v Phillips and others [1999] 1 WLR 1092 at paragraphs 1098G-1099B.

conscious intention to cause prejudice.[1030] In this way, the courts have unfettered discretion based on just and equity and within the limitations discussed above to define what amounts to 'unfair prejudice conduct' in due consideration of the factual background. Examples of unfair prejudice conduct based on previously concluded cases are discussed below to support a better understanding of this.

In *Rock (Nominees) Ltd. v RCO (Holdings) plc [2004]*, it was held that breach of fiduciary duty is not itself unfair prejudicial unless such a breach has resulted in the petitioner suffering from prejudice.[1031] A good example of unfairly prejudicial conduct in a breach of fiduciary duty is the misuse or misappropriation of company assets to dilute minority shareholders' interests.[1032] In UK company law, mismanagement falls under the category of unfair prejudice. However, the court will be cautious of interfering in questions of commercial judgment. Rather, the court will consider whether mismanagement is sufficiently serious by considering the '*scale of financial loss arising*' and the '*Frequency and duration of acts or omissions constituting mismanagement*'.[1033] Failure to pay dividends in certain circumstances may amount to unfairly prejudicial conduct, eg if the petitioner became a member of the company on the basis of being paid a certain level of dividends, and payments below this level are subsequently received without justification.[1034] Similarly, payment of excessive remuneration may in certain circumstances amount to unfairly prejudicial conduct, eg the disguised payment of dividends or dressed-up return of capital,[1035] whereby directors are remunerated despite the understanding that they would not be, or they are remunerated above the agreed level.[1036]

As mentioned above, diluting minority shareholders' share value in certain circumstances such as, inter alia, right issue[1037] can amount to unfairly prejudicial conduct. In *Re Sunrise Radio Ltd. [2009],*[1038] an act of benefiting from a right issue by board members who were also controlling shareholders was held as unfairly prejudicial conduct. In *Re Coloursource Ltd [2004]*, it was held that an act in relation to the improper purpose of diluting a minority shareholder's share value amounts to

[1030] Re Sunrise Radio Ltd [2009] EWHC 2893 (Ch).
[1031] Rock (Nominees) Ltd v RCO (Holdings) plc [2004] EWCA Civ 118.
[1032] Re Woven Rugs Ltd [2010] EWHC 230 (Ch).
[1033] Re Macro (Ipswich) Ltd [1994] 2 BCLC 354, 404-406.
[1034] Re Gate of India (Tynemouth) Ltd [2008] EWHC 959 (Ch), 107-108.
[1035] Re Halt Garage [1982] 3 All ER 1016.
[1036] Fisher v Cadman [2005] EWHC 377 Ch, 98.
[1037] An offer of new shares or other securities made to existing shareholders in proportion to their shareholdings – see Practical Law, *Glossary: Right issue* (Thomson Reuters 2021) <https://uk.practicallaw.thomsonreuters.com/1-107-7173?originationContext=document&vr=3.0&rs=PLUK1.0&transitionType=DocumentItem&contextData=(sc.Default)&firstPage=true> accessed on 29th August 2021.
[1038] Re Sunrise Radio Ltd [2009] EWHC 2893 (Ch), 95-96.

unfairly prejudicial conduct under Section 994.[1039] Likewise, a breach of an agreed provision in the articles of association, shareholder agreements, other agreements entered between the shareholders and the company, and the CA 2006, may constitute an act of unfair prejudice. For instance, failure to hold an AGM to provide information on financial details,[1040] providing loans to directors without complying with Section 197 of the CA 2006,[1041] registering new members in contravention of the articles of association,[1042] and actions that are inconsistent with the express and implied terms of agreements between shareholders and the company.[1043] Inequitable acts include, inter alia, failure to provide information where it has been agreed to do so to the petitioner[1044] and irrevocable breakdown of trust and confidence in a quasi-partnership.[1045] According to Section 994 (1A) of the CA 2006, removing the company auditor based on *divergence of opinion on accounting treatments or audit procedures, or on any other improper grounds* also amounts to unfairly prejudicial conduct.[1046]

Section 996 of the CA 2006 specifies the powers of the court in providing remedies for members whose interests are affected by an actual or proposed act or omission of the company that is unfairly prejudicial. Accordingly, Section 996 stipulates that:

> (1) If the court is satisfied that a petition under this Part is **well founded**, it may make such order as **it thinks fit** for giving relief in respect of the matters complained of.
>
> (2) Without prejudice to the generality of subsection (1), the court's order may—

1039 Re Coloursource Ltd [2004] EWHC 3078 (Ch).
1040 Re Woven Rugs [2010] EWHC 230 (Ch).
1041 Re AMT Coffee Limited [2019] EWHC 46 (Ch), 145-146.
1042 Re Piccadilly Radio plc (1989) 5 BCC 692.
1043 See Fisher v Cadman [2005] EWHC 377 (Ch) at paragraph 90; Re Southern Counties Fresh Food Ltd [2008] EWHC 2810 (Ch), 49-50.
1044 Hawkes v Cuddy [2007] EWHC 2999 (Ch), Lewison J at paragraphs 271-275; [2009] EWCA Civ 291, 69.
1045 Boughtwood v Oak Investments Partners [2009] EWHC 176 (Ch), paragraphs 10-11; affirmed on appeal [2010] EWCA Civ 23, 119.
1046 Section 994 (1A) of the Companies Act 2006.

(a) regulate the conduct of the company's affairs in the future;[1047]

(b) require the company—

(i) to refrain from doing or continuing an act complained of, or

(ii) to do an act that the petitioner has complained it has omitted to do;

(c) authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct;

(d) require the company not to make any, or any specified, alterations in its articles without the leave of the court;

(e) provide for the **purchase of the shares of any members** of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly.[1048]

The most common order made by the UK courts in an unfair prejudice action is for the shares of the petitioning member to be bought by the controlling members of the company or for the company itself to repurchase said shares (purchase order),[1049] However, in certain rare circumstances, the court can order the majority shareholders to sell their shares to the minority shareholders, especially where the previous conduct of the majority shows that they are not competent in managing the affairs of the company.[1050] In addition to such remedies, a member of the company may also seek to wind up the company on the grounds that doing so is just and equitable[1051] and to seek other remedies available under the Insolvency Act 1986 and the CA

[1047] The Court could order to conduct a meeting to regulate the conduct of the company's affairs as in *McGuinness v Bremner plc [1988] 4 BCC 161* or set a code of conduct for future company busines; see Re H R Harmer Ltd [1959] 1 WLR 62.

[1048] Section 996 of the Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/contents> accessed on 27th August 2021 (emphasis added).

[1049] Derek French, Stephen W Mayson and Christopher Ryan, *Mayson, French & Ryan On Company Law* (2017-2018 edn, OUP 2017) 586.

[1050] Re Company (No 00789 of 1987) ex p Shooter [1991] BCLC 267.

[1051] See Ferdinand v Patel [2016] EWHC 1524 (Ch); Section 122(1)(g) of the Insolvency Act 1986.

2006. In *Apex Global Management Ltd. v Fl Call Ltd. [2015]*, it was held by Hildyard J that the court has the power under Section 996 to appoint a liquidator to investigate a specific alleged incident of misapplication of company assets.[1052]

On the contrary, UK company law has provided several barriers to limit the misuse of the Section 994 remedy. For instance, if an offer was made to the petitioner by which he/she could have reasonably expected all the advantages from the petition, continuing with the unfair prejudice proceedings would be considered an abuse of process by the court.[1053] In *Re Company (No. 4377 of 1986) [1987]*, the court struck out the petition because it was seeking to circumvent the remedies contractually prescribed in the articles of association or shareholder agreement.[1054] However, in quasi-partnerships, the operation of equitable principles may still define such conduct as unfairly prejudicial, notwithstanding such contractual provisions.[1055] Most importantly, in certain circumstances, the UK courts have granted remedies in unfair prejudice actions even though the petitioner has not come to court with 'clean hands', and certain remedies granted by the UK courts have not been based on just and equitable grounds.[1056] However, misconduct on the part of the petitioner that is relevant to the unfair prejudice is considered by the courts to gauge whether said misconduct is sufficiently serious to justify precluding the relief.[1057] Although the CA 2006 has no set time limitation for bringing an unfair prejudice petition, a long delay may ensue and, depending on circumstances, the court may find that the petitioner has acquiesced to the alleged unfairly prejudicial act or omission of which he/she is aware. Thus, the court has the discretion to refuse a petition brought after a period of long and unexplained delay.[1058]

As discussed above, UK corporate governance has provided strong protection to minority shareholders through the unfair prejudice statutory provision. Furthermore, depending on the circumstances of the case, the court has wider discretion as *it sees fit* to provide remedies in response to unfairly prejudicial conduct. It is wide open for the courts to decide what amounts to unfair prejudice depending on the surrounding circumstances and equitable principles. Accordingly, UK company law has taken a further step in protecting minority shareholders compared to the previous

[1052] Apex Global Management Ltd v Fl Call Ltd [2015] EWHC 3269 (Ch).
[1053] Road Nominees Ltd v Karvaski [2011] EWHC 2214.
[1054] Re Company (No. 4377 of 1986) [1987] 1 WLR 102; Holt v Faulks [2001] BCC 50.
[1055] See Re Company (No 00330 of 1991) *ex* p Holden, [1991] BCC 241.
[1056] Re London School of Electronics [1986] Ch 211.
[1057] Richardson v Blackmore [2005] EWCA Civ 1356.
[1058] Re Grandactual [2005] EWHC 1415.

protection offered through Section 210 of the UK Companies Act 1948 – '*Alternative remedy to winding up in cases of oppression*'.[1059]

In the context of listed companies, as Esser and Loughrey discuss, intra-corporate litigation—specifically, litigation initiated by shareholders against their company and/or directors, or by the company against its directors—is essentially non-existent.[1060] They observe that such litigation is practically non-existent in listed public companies with dispersed shareholder ownership, contrasting this with smaller companies, where shareholder litigation is more common due to the personal relationships often present between directors and individual shareholders.[1061] Esser and Loughrey suggest this discrepancy stems from the advantage dispersed ownership provides shareholders—a liquid market for their shares—offering them a simpler and less costly method to react to directors' prejudicial actions.[1062] Hannigan further expands on this concept, explaining that to avoid the entanglement of litigation, shareholders might even opt to sell their shares at a loss.[1063]

4.4.3 Legal strategies in relation to the third agency problem (focusing on sustainability)

4.4.3.1 What is the role of the law in protecting non-shareholder stakeholders, specifically the environment (with emphasis on directors' duties)?

The UK corporate governance framework provides proactive solutions for sustainable development by considering the interests of non-shareholder constituencies in corporate decision-making. This is due to the growing emphasis on improving engagement of both board and management with all stakeholders, combined with an increased focus on public disclosure by companies on ESG matters in addition to financial metrics.[1064]

Section 172 of the CA 2006, which relates to the directors' duty to promote the success of the company, stipulates that:

[1059] Section 210 of the UK Companies Act 1948; Kanag-Isvaran and Wijayawardana (n 715) 509.

[1060] Irene-Marie Esser and Joan Loughrey, 'Stock corporations: corporate governance and external and internal controls' in Andrea Vicari and Alexander Schall (eds), *Company Laws of the EU: A Handbook* (Beck/Hart 2020) 1534.

[1061] ibid 1535.

[1062] ibid.

[1063] Brenda Hannigan, *Company Law* (6th edn, Oxford University Press 2021) 432.

[1064] Rose and Sedghi (n 953).

(1) A director of a company must act in the way he considers, in good faith, would be most likely to **promote the success of the company** for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to -

(a) the likely consequences of any decision **in the long term**,

(b) the **interests of the company's employees**,

(c) the need to foster the company's business relationships with **suppliers, customers and others**,

(d) **the impact of the company's operations on the community and the environment**,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to **act fairly as between members of the company**.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, **subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes**.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, **to consider or act in the interests of creditors of the company**.[1065]

The primary duty of the company's board is to promote the interest of the company on behalf of its members, ie shareholders. More specifically, Rose and Sedghi state that the board's primary duty towards the shareholders of the company is subject to three qualifications. The first is that in common law, in an insolvency situation, the board should focus primarily on the company's creditors. The second is that, as per Section 172 of the CA 2006, the board should give due regard to the other stakeholders in promoting the success of the company, primarily for its

[1065] Section 172 of the Companies Act 2006 <https://www.legislation.gov.uk/ukpga/2006/46/contents> accessed on 24th August 2021 (emphasis added).

members. The third is that the articles of association of the company can include a purpose other than the aforementioned primary purpose.[1066]

The *Companies (Miscellaneous Reporting) Regulations 2018* (Regulations 2018) brought significant change in respect of mandatory reporting and disclosures, eg large private and public companies are now required to include a statement in their strategic reports[1067] on how the board has given due regard to non-shareholder stakeholders in the matters set out in Section 172(1)(a)–(f) of the CA 2006.[1068] Listed companies are also required to publish this statement – also known as 'the Section 172 Statement' – on their websites. In this way, the Section 172 Statement is a proactive mechanism for companies to consider the interests of non-shareholder stakeholders in their corporate decision-making, including the impact of the company's operations on the public interest and the environment. The FRC guidance on the strategic report states that the Section 172 Statement recognises, inter alia, *the long-term success of a business is dependent on maintaining relationships with stakeholders and considering the external impact of the company's activities.*[1069] The GC100, the association of general counsel and company secretaries working in UK FTSE 100 companies, has issued guidance, inter alia, recommending that boards consider how their companies can interact with stakeholders in their day-to-day business interactions.[1070] The COVID-19 crisis has also encouraged stakeholder involvement in the company; since the outbreak, boards have increasingly engaged *ever more frequently and deeply* with stakeholders in their Section 172 Statements, specifically to attract more investments.[1071] Moreover, the Regulations 2018 require

[1066] Rose and Sedghi (n 953).

[1067] '*In addition to 'a balanced and comprehensive analysis of [both] the development and the performance of the [company's] business during the financial year, and the position of the [company's] business at the end of that year',* ***the strategic report must contain a description of the principal risks and uncertainties affecting the company's business, information about the gender split of its directors, managers and employees, trend information and disclosure about certain environmental matters****'.* Cox and Cooke (n 968) 338.

[1068] The Companies (Miscellaneous Reporting) Regulations 2018 https://www.legislation.gov.uk/ukdsi/2018/9780111170298/regulation/14> accessed on 26th August 2021.

[1069] See Section 172 statement: How to make them more useful by Financial Reporting Council <https://www.frc.org.uk/getattachment/dda7a2e4-fd50-4710-8ed6-860867aebf24/Lab-Tips-on-s172-Oct-2020-(002).pdf> accessed on 25th August 2021.

[1070] James Palmer and others, 'GC100 guidance on section 172: focus on directors' duties' (Herbert Smith Freehills LLP, Thomas Reuters: Practical Law, 2018) <https://uk.practicallaw.thomsonreuters.com/w-017-7364?transitionType=Default&contextData=%28sc.Default%29> accessed on 25th August 2021.

[1071] Rose and Sedghi (n 953).

companies with more than 250 employees to report in the Directors' Report on matters related to, inter alia, engagement with employees, suppliers and customers.

In addition to the Section 172 Statement requirements on considering the environment in corporate decision-making, those companies listed in the main market are required to disclose and publish information on greenhouse gas emissions and energy usage. Companies may also voluntarily publish climate-change-related disclosures to attract investments, especially from green funds. Importantly, the Stewardship Code – which promotes the creation of '*responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society*'[1072] – requires signatories to, inter alia, disclose on voting policies, report on voting activities and take ESG matters into account in the decision-making process, particularly in investment decisions. Adherence to the Stewardship Code is entirely voluntary and based on the 'comply or explain' principle.

In December 2020, the FCA published new proposals on climate-related disclosure rules for listed companies and certain regulated firms. These proposals aligned with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD).[1073] They were also based on the 'comply or explain' principle. As a result, in moving towards the aim of long-term sustainable value-creation, the UK legal framework has created a corporate environment for directors to consider the impact of a company's operations on the wider community. Companies can then produce CSR reports outlining these considerations, specifically to promote the good name of the company.[1074] This is also pertinent to attracting investments in the company in the modern world. Thus, as discussed above, the UK corporate governance framework has incorporated certain steps to reduce the costs that can arise from the third agency problem.

4.4.3.2 What is the function of the unfair prejudice, oppression and mismanagement remedies' involvement in achieving sustainability in corporate governance?

In *Hawkes v Cuddy*, Lewison J held that the court has the power to consider the interests of relevant third parties and creditors in providing relief under Section

1072 The Stewardship Code 2020 <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf> accessed on 26th August 2021, 4.

1073 Financial Conduct Authority, 'FCA consults on further climate-related disclosure rules' *FCA* (London, 22nd June 2021).

1074 Rose and Sedghi (n 953).

994.[1075] Similarly, in *Re Hedgehog Golf Ltd* [2010], Richards J stated that when deciding who should continue managing the affairs of the company, the court should take into account the best interests of the company, the extent of the wrongdoing and the views of other stakeholders.[1076] According to the stakeholder theory, currently it would be in the best interests of the company to consider Section 172 of the UK CA 2006 in granting reliefs by the Court under Section 944 proceedings.

It is worth noting that the unfair prejudice remedy does not directly provide any protection for sustainable funds or prosocial investors. In today's world, due to increased awareness of the environmental consequences resulting from human activities and the ensuing threats to humanity, the public is becoming more conscious of the importance of investing responsibly in sustainable or green funds.[1077] As Hart and Zingales articulate, investors who prioritise societal and environmental sustainability can be termed 'prosocial investors'.[1078] I suggest that company law should pave the way by devising legal tools for these prosocial investors to enforce their rights, particularly because they bear additional costs and risks by choosing to invest in sustainability. In Chapter Six, this research proposes a novel legal strategy as an additional aspect of the unfair prejudice remedy, specifically to enhance the enforcement rights of prosocial investors. Moreover, this proposal is bolstered by the principle that equitable considerations ought to support prosocial investors when they invoke the Section 944 remedy, due to their fundamental investment objectives. For instance, they acquire membership in the company with the expectation of furthering, among other things, environmental sustainability and social interest.

1075 Hawkes v Cuddy [2007] EWCA 2999 (Ch), 251–252.

1076 Re Hedgehog Golf Ltd [2010] EWHC 390 (Ch), 76-87.

1077 Sustainable funds are gaining popularity and ESG fund such as the Parnassus Core Equity Fund actively managed and has about $23 billion in assets, according to MSCI's research. Other top sustainable funds are, inter alia, iShares ESG Aware MSCI USA ETF ($13.3bn), Vanguard FTSE Social Index Fund ($10.87bn), Stewart Investors Asia Pacific Leaders Sustainability Fund ($9.87bn), and Nordea 1 - Global Climate and Environment ($7.37 bn). – Rumi Mahmood, *The Top 20 Largest ESG Funds – Under the Hood* (MSCI ESG Research LLC 2021) p.? 5 <https://www.msci.com/documents/1296102/24720517/Top-20-Largest-ESG-Funds.pdf > accessed on 30th August 2021.

1078 Oliver Hart & Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (2017) 2 Journal of Law, Finance, and Accounting 247, 270.

CHAPTER FIVE – AGENCY PROBLEMS AND FURTHERING A SAFE AND JUST SPACE FOR HUMANITY

5.1 Introduction

The doctrine of shareholder wealth maximization (SWM) obliges corporations to singularly prioritise increasing the value of shareholders' shares, thereby enhancing their wealth, all while adhering to legal boundaries. This principle justifies stakeholder unfriendly corporate actions in the name of efficiency and forbids the corporation from sacrificing even the smallest amount of shareholder wealth to support environmental causes, philanthropic endeavours, or the interests of other stakeholders in the corporation.[1079] LoPucki observe that since the 1990s, the SWM doctrine has been experiencing a downward trend both in scholarly circles and within the corporate landscape owing to its extreme nature.[1080] It is important to highlight that Chandler expressly mentioned that '*fiduciary duties apply irrespective of whether a corporation is registered and publicly traded, dormant and delisted, or closely held*'.[1081] Meaning that directors' fiduciary duties to maximise the profits of shareholders apply to all forms of companies doing business.

Rodrigo-González, Grau-Grau and Bel-Oms emphasise that the pre-eminent academic and financial perspective over recent decades has been the maximisation of shareholder wealth, with share price serving as the sole criterion for analysis.[1082] This approach, deeply rooted in the norm of shareholder primacy, has often resulted in unwelcome outcomes and poses fresh challenges in our dynamically evolving

[1079] Lynn M LoPucki, 'The end of shareholder Wealth Maximisation' (2023) 56(5) UC Davis Law Review, 2019.
[1080] ibid.
[1081] eBay Domestic Holdings, Inc. v Newmark (2010) 16 A.3d 1 (Del Ch), 31.
[1082] Amalia Rodrigo-González, Alfredo Grau-Grau and Inmaculada Bel-Oms, 'Circular Economy and Value Creation: Sustainable Finance with a Real Options Approach' (2021) 13 Sustainability 7973, 8 <https://doi.org/10.3390/su13147973> accessed on 4 August 2023.

societal landscape. This chapter, aligning with the insights from the SMART project conducted by distinguished scholars,[1083] further accentuates that the antiquated models focused on shareholder wealth maximisation no longer offer reliable blueprints for value creation in today's world – neither short-term nor long-term. This is especially pertinent given the growing emphasis on sustainable practices and planetary boundaries.

The focus on shareholder wealth maximisation neglects the broader impact of business decisions, including their social, economic, and environmental consequences. In response to this issue, Fatemi and Fooladi argue that it is crucial to account for all relevant factors rather than externalising costs and impacts.[1084] This highlights the crucial need to internalise all pertinent factors rather than externalising costs and impacts - a sentiment resonating with the discussions on the third agency problem articulated in the Chapter three.

The traditional focus on shareholder wealth maximisation needs a paradigm shift towards fostering sustainable value creation. This alternative approach, concurring with Kate Raworth's 'doughnut model', necessitates the adoption of a business model that considers all germane costs and benefits. It encapsulates the objective of operating within the ecological ceiling (respecting planetary boundaries) while ensuring a strong social foundation (meeting basic human needs).

This chapter stresses the importance of transitioning from a purpose rooted in shareholder primacy to one focused on sustainable value creation within Raworth's proposed boundaries. It highlights the need to redefine the purpose of a company in line with sustainability, considering not only the financial aspirations of shareholders but also the broader ecological and social implications. This revised purpose aligns with our shared commitment to maintaining a safe and just space for humanity. To support this position, this chapter explores into deep-rooted scholarly discussions on shareholder primacy, focusing on shareholder wealth maximisation and the modern concept of sustainable value creation emerging from the doughnut economy model. Section 5.2 discusses the origins of shareholder primacy and its inherent elements. It provides insights into the historical context of the emergence of shareholder primacy and the contributions made by academics to its evolution. This section also explores how the shareholder primacy norm has been integrated into the legal domain and discusses the importance of defining the term 'best interest of the

[1083] Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (n 30).

[1084] Ali M Fatemi and Iraj J Fooladi, 'Sustainable finance: A new paradigm' (2013) 24 Global Finance Journal 101 <https://doi.org/10.1016/j.gfj.2013.07.006> accessed on 4 August 2023.

company', as well as the significance of the connection between the shareholder primacy norm and the 'business judgment rule' in corporate law.

Section 5.3 focuses on future perspectives, specifically the business judgment rule and emerging sustainability norms. Section 5.4 examines into scholarly arguments about the deep-rooted negativity of shareholder primacy towards public interest. Section 5.5 examines the shareholder-stakeholder dichotomy and the prominence of shareholder primacy in various jurisdictions, while Section 5.6 discusses sustainable value creation and its interpretation in the corporate world through the lens of the doughnut economy model.

5.2 Legal genesis of shareholder primacy revisited

5.2.1 Adam Smith's legacy: the 'self-interest' principle in business

The origin of the Shareholder primacy norm in company law can be traced back to Adam Smith's work on 'The Wealth of Nations'[1085] where Smith imagined that a business would succeed if the owners operated the business in their self-interest.[1086] Smith further argues that self-interest would inevitably drive the business to use the company resources efficiently for the strict purpose of accumulating profit for themselves.[1087] In Smith's argument, Smith strongly believes that the invisible hands of market forces combined with economic self-interest would facilitate further the best interest of the public at large.[1088] Mitchell argues that Smith's theory of self-interest behaviour in economic man is based on morally sensitive economic man and thus, owners will take into account the moral aspects in their self-interest decision-making.[1089] However, Zouwen argues that Smith's economic man which is based on owners' self-interest and efficiency cannot be applied to today's manager run companies where professional agents oversee the business of assets owned by investors.[1090] Similarly, Zouwen states that Smith's idea of economic man is based on an individual who owns and manage a small, private enterprise.[1091]

1085 Adam Smith, *The Wealth of Nations* (Strahan & Cadell 1776).
1086 Karen Z Ho, *Liquidated: An Ethnography of Wall Street* (Duke University Press 2009) 172.
1087 ibid 173.
1088 Lawrence E Mitchell, 'Financialism: A (Very) Brief History' (2010) 43 Creighton Law Review 323, 324.
1089 ibid.
1090 Ho (n 1086) 173.
1091 ibid 172.

Thus, Smith's concept of self-interest applies specifically to situations where owner-entrepreneurs manage their own companies for their own benefit. Smith himself has concluded that manager run companies cannot compete with owner-entrepreneurs as a business association.[1092] The reason he identified is that the self-interest of professional managers often leads them to prioritise their own benefits over those of the shareholders. Neoclassical economists adapted Smith's self-interest principle into a framework for the modern firm.[1093] According to this adaptation, managers should operate the company in the shareholders' interests, as shareholders are the owners, and corporate law should regulate managers' actions to prevent them from prioritising their self-interest over that of the shareholders. Accordingly, Schrader, Zouwen, and Sneirson argue that the shareholder primacy norm of neoclassical economists cannot be attributed to Smith.[1094]

5.2.2 The evolution of shareholder primacy: from ultra vires to Dodge v Ford

Bainbridge argues that in the 19th and 20th centuries, the *ultra vires* doctrine was the main tool to challenge corporate decisions which deviated from the corporate purpose – shareholder maximisation.[1095] For instance, in McCrory v Chambers,[1096] the court held that charitable contributions were *ultra vires*. This doctrine stands as clear evidence of the stringent application of the principle of shareholder wealth maximisation in historical corporate law. Furthermore, it is evident that Smith did not propose a radical version of shareholder wealth maximisation to companies run by managers, given that he stated self-interest does not result in the same benefits in manager-run companies.

Since there appears to be a misconception about the application of self-interest (in the form of shareholder wealth maximisation) in manager-run companies, it is worth examining the origin of the shareholder primacy norm that was advocated by neoclassical economists, a concept that can be traced back to Dodge v Ford.[1097] This case is considered historical in this context. The court opined that the overarching

[1092] ibid 173; Smith (n 1085) 33; Judd F Sneirson, 'The History of Shareholder Primacy, from Adam Smith through the Rise of Financialism' in Beate Sjåfjell and Christopher M Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press 2019) 73–85, and 78.

[1093] Schrader E. David, *The Corporation as Anomaly* (Cambridge University Press 1993).

[1094] ibid 10-11, Ho (n 1086) 175; Sneirson, 'The History of Shareholder Primacy, from Adam Smith through the Rise of Financialism' (n 1092) 73–85 and 79.

[1095] Stephen M Bainbridge, 'Why We Should Keep Teaching Dodge V. Ford Motor Co.' (2022) 48(1) The Journal of Corporation Law 77-119, 94.

[1096] 48 Ill. App. 445, 453 (Ill. App. Ct. 1892).

[1097] 170 NW 668 (Mich. 1919).

purpose of the company should be to maximise its profits to its shareholders. The powers entrusted to the management of the company should be exercised for that purpose alone, without any alternative aims.[1098]

It is worth noting that the court in the said case recognised the implied responsibilities of management to uphold humanitarian motives, meaning that shareholders' initial investment purpose should be given effect by the management.[1099] Bainbridge argues that the fact that Ford had abandoned shareholder value maximisation was essential to the court finding and this case provided a correct statement of the law of corporate purpose.[1100]

Lawyers seized this opportunity to advocate for the shareholder primacy norm in cases such as Dodge v. Ford, which subsequently became a seminal legal authority for shareholder primacy through the application of the Stare decisis principle in common law jurisdictions.[1101] Notable cases like eBay Domestic Holdings, Inc v Newmark[1102] and In Re Trados Incorporated Shareholder Litigation,[1103] further solidified this stance. For instance, in eBay Domestic Holdings, Inc v Newmark,[1104] the court stated that *directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization - at least not consistently with the directors' fiduciary duties under Delaware law.*[1105] In Re Trados Incorporated Shareholder Litigation,[1106] the court stated that *directors of a Delaware corporation owe fiduciary duties to the corporation and its stockholders which require that they strive prudently and in good faith to maximize the value of the corporation for the benefit of its residual claimants*.[1107]

Transitioning from these legal developments, it becomes evident how the concept of directors' fiduciary duties began to take form and solidify in corporate governance. In the early twentieth century, the legal landscape did not provide

[1098] ibid 684.
[1099] Lynn A Stout, 'Why We Should Stop Teaching Dodge v. Ford' (2008) 3 Virginia Law & Business Review 163, 168.
[1100] Bainbridge, 'Why We Should Keep Teaching Dodge V. Ford Motor Co.' (n 1095) 93.
[1101] See Revlon, Inc v MacAndrews & Forbes Holdings, Inc 506 A.2d 173 (Del, 1986); Unocal Corp v Mesa Petroleum Co 493 A.2d 946 (Del, 1985); Re Trados Incorporated Shareholder Litigation 73 A.3d 17 (Del Ch, 2013); Percival v Wright [1902] Ch 421; Regentcrest Plc v Cohen [2001] 2 BCLC 80. (Although the two latter United Kingdom cases mentioned here have considered the interests of the company, it could be contended that they implicitly uphold the principle of shareholder primacy).
[1102] eBay Domestic Holdings, Inc v Newmark (2010) 16 A.3d 1 (Del Ch) 31.
[1103] Re Trados Incorporated Shareholder Litigation 73 A.3d 17 (Del Ch, 2013).
[1104] eBay Domestic Holdings, Inc v Newmark (2010) 16 A.3d 1 (Del Ch) 31.
[1105] ibid 36.
[1106] Re Trados Incorporated Shareholder Litigation 73 A.3d 17 (Del Ch, 2013).
[1107] ibid 21.

sufficient protection to shareholders from potential opportunistic behaviours by managers.[1108] Richberg, who held a significant position in the US during the 20th century, argued that the primary objective of a business is the enrichment of its owner, with the secondary objective being to serve the public and other stakeholders.[1109] Thus, neoclassical economists argued that fiduciary duties should be vested in managers to ensure that they conduct the business affairs of the company in the interest of shareholders to generate profits. As a result, the doctrine of directors' duties was born, and the first agency principle facilitated remedies against such managers' opportunistic behaviours. During this period, the stakeholder approach was an unknown concept to economists.

5.2.3 Diverging views: shareholder wealth maximisation vs. broader responsibilities

Thereafter, the economists began to debate the purpose of the companies and in whose interest the directors should act. Adolf Berle worried about the managers' accountability towards shareholders after Dodge,[1110] began writing about managers' fiduciary obligations to act in the best interest of shareholders, marking the birth of the shareholder primacy norm in law and economics.[1111] In response, Merrick Dodd argued that managers should be fiduciaries for the company and not for shareholders.[1112] Dodd further noted that the duties of managers should be to act as custodians of all the interests that a corporation impacts, and not solely those of its shareholders.[1113]

Manne picked up the shareholder primacy idea from Berle and argued that the shareholders are only concerned about their profit maximisation and any departure from profit maximisation would be economically inefficient, selfish, and lead to a business failure.[1114] However, Berle opposed Manne's arguments on shareholder

[1108] Fenner Stewart Jr, 'Berle's Conception of Shareholder Primacy: A Forgotten Perspective for Reconsideration during the Rise of Finance' (2011) 34 Seattle University Law Review 1457, 1464.

[1109] Donald R. Richberg, 'Developing Ethics and Resistant Law' (1922) 32 Yale LJ 109, 117-118.

[1110] Dodge v Ford Motor Co., 170 NW 668 (Mich. 1919).

[1111] See Stewart Jr, (n 1108), Adolf A Berle Jr., 'Participating Preferred Stock' (1926) 26 Columbia Law Review, 303, 303, 305, 317; Adolf A Berle Jr., 'Corporate Powers as Powers in Trust' (1931) 44 Harvard Law Review, 1049, 1049.

[1112] Merrick E Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45 Harvard Law Review, 1145, 1154, 1160, and 1163.

[1113] ibid 1157.

[1114] Henry G Manne, 'The 'Higher Criticism' of the Modern Corporation' (1962) 62 Columbia Law Review, 399, 413.

profit maximisation for the reasons that Manne's profit maximisation would lead to unfair and greedy profit gains at the expense of the public interest and is incompatible with corporate sustainability.[1115]

Thus, it is evident that Berle advocated for the shareholder primacy norm, furthering public interest in law and economics.[1116] In this era, the prevailing perspective among law and economic scholars was that the objective of corporate law was to minimise agency costs (agency cost discussed in the first agency relationship in this research), with the understanding that shareholder primacy was crucial for achieving this goal.[1117] It is worth noting that during this era agency problems 2 and 3 which are discussed in this research were not known.

In the contemporary world, there has been increased awareness regarding corporate sustainability and academics are challenging shareholder primacy as the biggest misconception in corporate law and the main barrier to achieving corporate sustainability.[1118]

5.2.4 Contemporary perspectives on shareholder primacy

In today's context, Shareholder primacy can be defined as '*where the primary even the only – goal of corporations is to maximize returns for shareholders*'.[1119] Palladino states that in the United States context, shareholder primacy is *a legal and economic framework for corporate governance that claims that the sole purpose of corporate activity is to maximize wealth for shareholders; thus, executives and*

[1115] Adolf A Berle Jr., 'Modern Functions of the Corporate System' (1962) 62 Columbia Law Review, 433.

[1116] Stewart Jr, (n 1108) 1457–59; also see Sneirson, The History of Shareholder Primacy, from Adam Smith through the Rise of Financialism' (n 1092) 80.

[1117] David K Millon, 'Radical Shareholder Primacy' (2013) 10 University of St. Thomas Law Journal 1013, 1033.

[1118] Beate Sjåfjell and others, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' in Beate Sjåfjell and Benjamin J Richardson (eds), *Company Law and Sustainability: Legal Barriers and Opportunities* (CUP 2015) 79-147; also see Beate Sjåfjell, 'Redefining Agency Theory to Internalize Environmental Product Externalities. A Tentative Proposal Based on Life-Cycle Thinking' in, Eléonore Maitre-Ekern, Carl Dalhammar and Hans Christian Bugge (eds), *Preventing Environmental Damage from Products: An Analysis of the Policy and Regulatory Framework in Europe* (CUP 2018) ch 5, University of Oslo Faculty of Law Research Paper No 2017-31, Nordic & European Company Law Working Paper No 16-30 <https://ssrn.com/abstract=3031788> accessed 25 April 2023, 4.

[1119] Sjåfjell,'Redefining Agency Theory to Internalize Environmental Product Externalities. A Tentative Proposal Based on Life-Cycle Thinking' (n 1118) 3.

boards of directors should prioritize increasing share prices over all else.[1120] Rhee states that shareholder primacy is the law and not just a social norm.[1121] Rhee further argues that, in the Hartian tradition, shareholder primacy is a vital principle that carries a '*seriousness of social pressure*'. Though it is not enforceable, courts acknowledge and institutionalise it, and it is said to be fundamental to the operation of corporate law and governance.[1122] Rhee argues that shareholder primacy, in the corporate purpose context, instructs the board to manage the daily affairs of the company for the purpose of maximising shareholder wealth.[1123]

Comparative study in Chapter four shows that company law provisions directly and/or indirectly empower shareholder primacy in corporate governance. For instance, according to FCA 1:5 the primary objective of the company is to generate profits for its shareholders, unless otherwise stated in the company's articles.[1124] It is highly unlikely that investors would provide a different objective on the company's articles, unless the majority shareholding is owned by green funds controlled by environmentalists. Thus, Finnish company law unequivocally endorses the doctrine of shareholder primacy, enshrining it as a statutory obligation. The position of the Finnish company law regarding the shareholder wealth maximisation is discussed further in this chapter.

In other common law jurisdictions, the directors are obligated to always act in good faith in the best interest of the company. For instance, '*A director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.*'[1125] The duty to act in the best interest of the company has been traditionally interpreted to mean in the best interest of the shareholders collectively[1126]. For instance, in

[1120] Lenore Palladino, 'Financialization at work: Shareholder primacy and stagnant wages in the United States' (2021) 25(3-4) Competition & Change 382-400 <https://doi-org.ezproxy.utu.fi/10.1177/1024529420934641> accessed 11th May 2023, 383.

[1121] Robert J Rhee, 'A Legal Theory of Shareholder Primacy' (2018) 102 Minn L Rev 1951, 2016.

[1122] ibid 2006.

[1123] ibid 952.

[1124] Limited Liability Companies Act - Finland (624/2006; amendments up to 981/2011 included; *osakeyhtiölaki*).

[1125] Australian Corporations Act 2001, Section 181. Also see Section 187 of the Sri Lankan Companies Act No. 7 of 2007; Section 131 of the New Zealand Companies Act 1993; Section 122 of the Canada Business Corporations Act (R.S.C., 1985, c. C-44).

[1126] Darcy L Macpherson, 'Supreme Court Restates Directors' Fiduciary Duty - A Comment on Peoples Department Stores v. Wise' (2020) Alberta Law Review 383-405 <https://doi.org/10.29173/alr1257> accessed 12th May 2023; also see *820099* Ontario Inc. v. Harold E. Ballard Ltd., [1991] O.J. No. 266 (Gen. Div.), aff'd by [1991] O.J. No. 1082 (Div. Ct.).

Wesfair Foods Ltd v Watt[1127] it is stated that '*The phrase 'best interests of the corporation' has been judicially interpreted to mean the best interests of the shareholders taken as [a] whole*'.[1128] Similarly, in Cassimatis v Australian Securities and Investments Commission[1129] Thawley J held that '*It is, of course, relevant to the degree of care and diligence which s 180(1) requires to have regard to the fact that the corporation's interests include the interests of the shareholders….*'.[1130] Rhee argues that the directors have a dual obligation: duty to the corporation and shareholders, and it is a vertical relationship in which shareholder's interest is at the apex.[1131]

However, throughout the years the court has attempted to facilitate stakeholder interest in the corporate purpose in a way by supporting decisions taken in the long-term interest of the company will eventually support shareholder value maximisation. In Peoples Department Stores v Wise[1132] justices Major and Deschamps state that:

> Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase the 'best interests of the corporation' should be read not simply as the 'best interests of the shareholders'. From an economic perspective, the 'best interests of the corporation' means the maximization of the value of the corporation….[1133]

Moreover, Fisch has observed that '*no modern court has struck down an operational decision on the ground that it favours stakeholder interests over shareholder interests*'.[1134] Rhee further argues that courts have '*not imposed liability for breach of fiduciary duty on the specific reason that the board, in managing operational matters, failed to maximise shareholder profit….',*[1135] Greenwood stated that courts

1127 [1990] 4 W.W.R. 685, 699 (Alta Q.B.)

1128 Macpherson (n 1126) 388; also see other cases where best interest of corporation means best interest of shareholders in Canada: Greenhalgh v. Arderne Cinemas Ltd. (1951] Ch. 286, [1950] 2 All E.R. 1120 (C.A.); Palmer v. Carlmg O'Keefe Breweries of Can. Ltd. (1989), 67 O.R. (2d) 161,41 BLR. 128, D.I.R. (4lh) 128, 32 O.A.C. 113 (Div. Cl); Howard Smith Lid. v. Ampol Petroleum Ltd., [1974] AC. 821, [1974] 2 W.L.R. 689, [1974) 1 All E.R 1126 (PC.).

1129 (2020) 376 ALR 261; (2020) 144 ACSR 107; [2020] FCAFC 52.

1130 ibid 472.

1131 Rhee (n 1121) 1993; also see N Am Catholic Educ Programming Found Inc v Gheewalla (Del 2007) 930 A2d 92, 99; Mills Acquisition Co v Macmillan Inc (Del 1989) 559 A2d 1261, 1280; Polk v Good (Del 1986) 507 A2d 531, 536.

1132 [2004] 3 SCR. 461. 2004 SCC 68.

1133 ibid para 42.

1134 Jill E Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) 31 J Corp L 637, 651.

1135 Rhee (n 1121) 1961.

typically do not demand anything akin to a strong version of short-term profit-maximisation.[1136] Ibrahim suggested that 'even if the law necessitates that corporate managers aim solely for profit maximisation, it does not mandate that these profits be maximised in the short term.[1137] Kidd, on the other hand, argued that maximising the present value of profits does not necessitate a specific preference for long-term profits.[1138]

Rhee goes on to assert that the business judgment rule would defend the board's decisions aimed at the long-term interest of the corporation and shareholders on the basis of the shareholder maximising norm. An example Rhee provides includes decisions such as paying employees above the market wages or incurring higher expenses to meet regulatory safety standards. The Supreme Court in the Dodge case also recognised that directors should be free to pursue long-term plans.[1139] However, a question arises: is a decision taken for the benefit of stakeholders at the expense of shareholders defensible under the business judgement rule? In my opinion, such decisions can still be contested by dissatisfied shareholders who may argue that these decisions are contrary to the corporate purpose. For example, if directors make a decision to incur costs to address an environmental issue that is gradually worsening, at the risk of reducing dividends, can this be considered a proper business judgment to defend under the business judgment rule? The company may later face litigation and/or a decrease in brand value due to its decision to prioritise shareholders over the environment. Thus, there is clear uncertainty for directors when making decisions in certain circumstances that conflict with the interests of stakeholders. Furthermore, the decisions considering stakeholders are based on the end result of shareholder profit maximisation and as a result, long-term environmental or other stakeholder interests might be neglected in such decisions. For example, the gradual encroachment of the ecological ceiling, discussed under planetary boundaries in this chapter, can be overlooked.

Bainbridge in his recent article states that shareholder value maximisation has been in fact reconfirmed as the primary purpose of the corporation. For instance, in Murphy v Inman,[1140] the Michigan Supreme Court reaffirmed the shareholder value maximisation by stating that '*a corporation is carried on primarily for the profit of its shareholders, . . . the 'essence' of directors' fiduciary duties is to 'produce to*

[1136] Daniel J H Greenwood, 'Discussing Corporate Misbehavior: The Conflicting Norms of Market, Agency, Profit and Loyalty' (2005) 70 Brook L Rev 1213, 1235.

[1137] Darian M Ibrahim, 'A Return to Descartes: Property, Profit, and the Corporate Ownership of Animals' (2007) 70 Law & Contemp Probs 89, 105.

[1138] Jeremy Kidd, 'The Economics of Workplace Drug Testing' (2016) 50 UC Davis L Rev 707, 710 n.6.

[1139] Dodge v Ford Motor Co., 170 NW 668 (Mich. 1919) 684.

[1140] (Mich, No 161454, Apr 5, 2022) WL 1020127.

each stockholder the best possible return for his [or her] investment'.[1141] Thus, it can be seen that shareholder primacy has been integrated into interpreting the director's duties in the 'best interest of the company' in considering the 'best interest of the shareholders'.

5.2.5 Navigating legal ambiguities in corporate decision-making

The lack of a clear statutory definition for 'the best interest of the company' can leave directors uncertain when making business decisions.[1142] This uncertainty is particularly relevant in the context of decisions promoting sustainability, as reliance on the business judgment rule may not provide a strong defence due to the legal ambiguity surrounding the term. Consequently, it is crucial for the term 'best interest of the company' to be clearly defined in company law. Additionally, there needs to be a comprehensive understanding of how the business judgment rule relates to corporate sustainability within the realm of corporate governance. This is crucial because sustainability-oriented business decisions may sometimes entail short-term financial losses while contributing to the company's long-term welfare. For example, should directors opt to invest in community development or environmental projects, initial expenses may be high, but long-term profits could materialise (eg an increase in brand value and customer growth in the long run). In other words, if explained under the third agency problem, investments in community or environmental initiatives can reduce stakeholder costs mentioned in the context of the third agency problem between the firm and the environment/community, which in turn could promote the company's reputation over time and ultimately increase residual income.

Nevertheless, company law might contain ambiguities allowing shareholders, who are focused on short-term returns, to legally challenge directors for allegedly not acting in the company's best interest. In such instances, the business judgment rule might not safeguard the directors unless 'the best interest of the company,' especially concerning corporate sustainability, is clearly defined in company laws. Moreover, a decision framed as being in the long-term interest of the company might be a greenwashed business judgment, which could arise due to the influence of shareholder wealth maximisation on business judgements. Therefore, it is essential

[1141] Murphy v Inman (Mich, No. 161454, Apr 5, 2022) WL 1020127, quoting Thompson v Walker (Mich 1931) 234 NW 144.

[1142] Beate Sjåfjell, 'Sustainable Value Creation Within Planetary Boundaries—Reforming Corporate Purpose and Duties of the Corporate Board' (2020) 12 Sustainability 6245, 7 <http://dx.doi.org/10.3390/su12156245> accessed on 6th June 2023.

to scrutinise the business judgment rule and its implications for corporate sustainability.

5.3 Future perspectives: the business judgment rule and emerging sustainability norms

5.3.1 Foundations of the business judgement rule: an 18th-century perspective

In this section, the origins of the business judgment rule are explored, highlighting its importance in contributing to sustainability in corporate governance.

During the 18th century an English case, Charitable v Sutton[1143] played an important role in defining the directors' duties on their role in manging the affairs of the company. It characterised directors as agents who are employed in trust and thus, such a person is '*obliged to execute it with fidelity and reasonable diligence*'.[1144] Courts went on to define directors as fiduciaries who have a 'distinct legal relationship' with the company and its shareholders.[1145]

McMurray elaborated on this concept, arguing that the directors, as fiduciaries, must confirm their adherence to the duty of care and duty of loyalty.[1146] He further states that business judgment rule evolved concurrently with the duty of care. Many of the cases analysed the principles of the business judgment rule when determining directorial liability in breaches of duty of care. Specifically, they considered directors to be in violation of their duty of care if they made business errors that were 'so grossly negligent that an individual with common sense and ordinary attentiveness would not have committed them'.[1147] This view can be seen in cases such as Smith v Prattville Mfg. Co.,[1148] the court stated that directors are not liable for honest mistakes and errors of business judgment. This has been supported by several other

1143 (1742) 26 ER 642; 2 Atk 404.

1144 ibid 504-506, 26 Eng. Rep. 644-445.

1145 Lippitt v. Ashley, 89 Conn. 451, 463, 94 A. 995, 999 (1915); Babineaux v. Judiciary Comm'n, 341 So. 2d 396, 400 (La. 1976); Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939); also see Rudolph E Uhlman, 'The Legal Status of Corporate Directors' (1939) 19 B.U.L. Rev. 12, 12-15 and 16.

1146 Marcia M McMurray, 'An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule' (1987) 40 Vand L Rev 605, 606.

1147 Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829).

1148 Smith v. Prattville Mfg. Co., 29 Ala. 503, 509 (1857); also see Hun v Cary, 82 N.Y.,70; Hodges v. New England Screw Co., 1 R.I. 312, 348 (1850).

cases highlighting that directors are liable only for business judgements which are absorbed and ridiculous.[1149]

Early interpretations of the business judgment rule were established in cases such as Panter v. Marshall Field & Co.[1150] and Casey v. Woodruff.[1151] These cases emphasised key elements of the business judgment rule, indicating that in the absence of fraud, bad faith, gross overreaching, or abuse of discretion, directors could use their honest belief in acting in the best interest of the corporation as a defence against liability claims. Further, Arsht suggested elements including the absence of self-dealing, lack of personal interest, and the proper exercise of due care as integral to the application of the business judgment rule.[1152] Arsht and Cohn have argued that if a decision turns out to be faulty, yet the directors have demonstrated appropriate care in making it, the court should determine whether such a decision was rendered in good faith and with the genuine intention of furthering the best interests of the corporation.[1153] It can be observed that the 18th-century evolution of the business judgment rule emphasises the importance of directors' decisions being made in the best interest of the company.

5.3.2 Modern applications and defences under the business judgement rule

As we transition into contemporary times, it is evident that the modern interpretations of the business judgment rule continue to emphasise the importance of directors making decisions in the best interest of the company.

Bainbridge states that the plaintiff bears the burden of proof to demonstrate that the decisions were made out of self-interest, in bad faith, or in a grossly negligent manner, which includes failing to consider all reasonably available material facts. Most importantly, Bainbridge further asserts that if directors are shown to lack independence or to act in a way that cannot be linked to a rational business purpose, they can also be held accountable.[1154] Rhee mirrors this view, highlighting that the business judgment rule is a fundamental rule of corporate law. He argues that this

[1149] Godbold v Branch Bank, 11 Ala. (1847) 191, 200; see Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829), 78. But cf. Spering's Appeal, 71 Pa. 11, 24 (1872).
[1150] 486 F. Supp. 1168, 1194 (N.D. Ill. 1980).
[1151] 49 N.Y.S.2d 625, 642-43 (1944).
[1152] Samuel S Arsht, 'The Business Judgment Rule Revisited' (1979) 8 Hofstra L Rev 93, 111-112.
[1153] ibid 114, and Stuart R. Cohn, 'Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule' (1983) 62 Tex L Rev 591, 613.
[1154] Bainbridge, 'Why We Should Keep Teaching Dodge V. Ford Motor Co.' (n 1095) 91.

rule can operate as a defence for directors, assuming their decisions — though resulting in company losses — were made in good faith and can be justified by the rationale of shareholder maximisation. Rhee goes on to argue that Delaware law indeed encourages the pursuit of shareholder wealth enhancement, even if this involves undertaking risks that may incur losses to the company, as long as the actions taken are in the company's best interest.[1155]

Keay and Loughrey, through a comparative study of English, Australian, and United States (US) case law, offer an interesting perspective by suggesting that the term 'judgment' has been interpreted in two ways: as an ability and as a decision by directors. They argue further that *'business judgment' in both senses can be linked to Knight's concept of entrepreneurial judgment and the wealth creation function of directors.*[1156]

5.3.3 Codification and adaptation of the business judgement rule in global jurisdictions

Some jurisdictions have taken the initiative to codify the business judgment rule. For instance, Australian jurisdiction has codified the business judgment rule as a defence in connection to a scenario when the directors are alleged to have failed to exercise that authority with appropriate care and diligence. Du Plessis argues that the common law business judgment rule was very poorly developed by courts because of their reluctance to interfere with internal company decisions.[1157] As a result, the Australian government codified the business judgement rule but most importantly, the Australian statute applies only to cases relating to the duty of care.

180 Care and diligence—civil obligation only

Care and diligence—directors and other officers

(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

[1155] Rhee (n 1121) 1994.
[1156] Andrew Keay and Joan Loughrey, 'The Concept of Business Judgment' (2019) 39 Legal Studies 36.
[1157] Jean J Du Plessis, 'Open Sea or Safe Harbor? American, Australian and South African Business Judgment Rules Compared (Part 1)' (2011) 32(11) Company Lawyer 345, 347.

(a) were a director or officer of a corporation in the corporation's circumstances; and

(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

Business judgment rule

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

(a) make the judgment in good faith for a proper purpose; and

(b) do not have a material personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the **judgment is in the best interests of the corporation**.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence)—it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:

> **business judgment** means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.[1158]

In Australian Securities and Investments Commission v Rich,[1159] Austin J acknowledges that the Australian business judgment rule has been influenced by the business judgment rule developed by US courts and particularly by the American Law Institute.[1160] However, scholars have identified differences between the US business judgment and Australian business judgment, eg section 180 (2) proposes that the scope of the term 'business judgment' should be limited to exclude decisions to knowingly cause the company to break the law[1161] and also, proposes a reasonable director test rather than the gross negligent test.[1162] Most importantly, it has been codified that it is mandatory that the directors rationally believe that the judgement is in the best interests of the corporation.[1163] However, Legg and Jordan critically examine that the objective of accountability is not achieved through section 180 (2) specifically because the wording 'rationally believe' can overly protect the directors and thus, suggest revisiting the said section.[1164]

Similarly, US's the Model Business Corporation Act (MBCA) has codified elements of the business judgment rule.[1165] Section 8.31. (2) (ii) (A) of MBCA specifically states that a party can challenge a decision taken by directors if the director did not reasonably believe such a decision to be in the best interests of the corporation. The MBCA commentary highlights the significance of the decision being in the best interest of the company, indicating that a judgment falling outside the purview of the business judgment defence will not sustain under the business judgment defence. For instance, '*In the rare case where a decision respecting the corporation's best interests is so removed from the realm of reason (eg corporate waste), ……, the director's judgment will not be sustained*'.[1166]

[1158] Section 180 of the Australian Corporation Act 2001 (emphasis added).

[1159] (2009) 75 ACSR 1; 236 FLR 1.

[1160] Wesley Bainbridge and Tim Connor, 'Another Way Forward? The Scope for an Appellate Court to Reinterpret the Statutory Business Judgment Rule' (2016) Company and Securities Law Journal 34(6): 415-437, 426.

[1161] ASIC v Fortescue Metals Group Ltd (2011) 81 ACSR 563.

[1162] ibid 418.

[1163] Section 180(2)(d) of the Australian Corporation Act 2001.

[1164] Michael Legg and Dean Jordan, 'The Australian Business Judgement Rule after ASIC v Rich: Balancing Director Authority and Accountability' (2014) 34 Adel L Rev 403, 426.

[1165] § 8.31. Standards of Liability for Directors Model Bus. Corp. Act Ann. (5th ed. 2020).

[1166] ibid.

In addition, Edward observes that commentaries pertaining to section 8.31 MBCA explicitly clarify that the section does not contain a rigid codification of the business judgment rule but leaves room for the court to interpret it according to the unique characteristics of individual factual scenarios.[1167] The official commentary provides '*The elements of the business judgment rule and the circumstances for its application continue to be developed and refined by courts. Accordingly, it would not be desirable to freeze the concept in a statute*'.[1168] The commentaries further state that certain principles of the business judgment rule relating to personal liability issues are reflected in Section 8.31.[1169] The comments further observe that the judiciary has characterised good faith as a triad of fiduciary duties in Cede & Co. v Technicolor, Inc.,[1170] it is not a standalone fiduciary duty like the duties of care and loyalty. Good faith is a subsidiary element of the duty of loyalty.

Importantly, the comments emphasise that the duty of loyalty is confirmed by the director's actions being guided by good faith belief that these actions are in the corporation's best interests. Comments further observe that the ruling in Re Walt Disney Company[1171] (derivative litigation case) clarified that acting 'grossly negligently' does not mean that the director had bad faith or a lack of good faith. Instead, the courts emphasise the meaning of bad faith as decisions taken with an intent to harm the corporation, or where intentional actions are undertaken that do not advance the best interests of the corporation. The comments further state that this could involve an intentional failure to act when there is a known duty to act.[1172] Thus, one can argue that a decision not furthering shareholder maximisation can be tainted as a decision taken in bad faith. Accordingly, the MBCA underlines the critical role of the best interest of the corporation as a guiding principle in a director's decision-making process.

[1167] Edward B Rock, 'The ALI's Restatement of the Law of Corporate Governance: A Reply to Professor Bainbridge' (2023) 78(2) The Business Lawyer 451, 453 <https://www.proquest.com/trade-journals/alis-restatement-law-corporate-governance-reply/docview/2803538817/se-2> accessed 18th May 2023.

[1168] ibid.

[1169] ibid.

[1170] 634 A.2d 345 (Del. 1993).

[1171] 906 A.2d 27 (Del. 2006).

[1172] § 8.31. Standards of Liability for Directors Model Bus. Corp. Act Ann. (5th ed. 2020).

5.3.4 The nexus between company purpose and directors' duties in EMCA

A similar approach can be seen in the European Model Companies Act (EMCA), a model law drafted by a group of European academics. Section 10.01(3) (Directors' liability) of EMCA stipulates that:

> (3) A director who makes a business judgement in good faith fulfils the duty under this Section if he or she:
>
> (a) is not interested in the subject of the business judgement;
>
> (b) is informed with respect to the subject of the business judgement to the extent that the director or managing director reasonably believes to be appropriate under the circumstances;
>
> (c) **rationally believes that the business judgement is in the best interests of the company.**[1173]

The comments under Section 1.06 (Purpose of the Company) of the EMCA specifically state that there is a clear connection between the purpose of the company and the powers and duties of the directors. They further stipulate that directors must exercise the powers conferred upon them for a proper purpose. Directors are bound by a duty of good faith to act in the company's best interest.[1174] The purpose of the company is defined under Section 1.06 as '…unless otherwise provided in the company's articles, it is to increase the company value.[1175] The comments further clarify that while the company's usual objective is to maximise its value, this should be pursued with a focus on long-term sustainability in its investments and management. Additionally, they argue that promoting a long-term perspective among shareholders by merely focusing on the duration of their investment might not be the most effective approach. This could lead to a lock-in effect, which could be detrimental to the company. The underlying rationale is that liquidity pressures directors to operate efficiently to avoid potential takeovers, which could ultimately risk their positions. Thus, comments discourage rewarding the shareholders

1173 Section 10.01(3) (Directors' liability) of European Model Companies Act (emphasis added).
1174 Section 1.06 (Purpose of the company) of European Model Companies Act.
1175 ibid.

(shareholders only) specifically stating that it can be a disservice to the company.[1176] The comments suggest remedying the situation by encouraging corporate social responsibility (CSR), promoting transparency, fostering active ownership, and developing legal strategies that support a constructive dialogue between shareholders and companies while taking into account the interests of stakeholders.[1177]

5.3.5 Exploring the risks of tunnelling and self-dealing by directors

Enriques and Gilotta argue in their recent article (although they did not directly use the term 'business judgment rule') that this principle can be used by directors to defend acts of tunnelling against minority-co-owned groups (MCOGs). They contend, for instance, that '*minority shareholders may encounter undue difficulties in recovering damages related to harmful transactions for which ex-post compensation is lacking, as directors may still avoid liability by proving that it was nonetheless reasonable, ex-ante, to expect compensation*'.[1178] This defence could potentially apply not only to the entire group of shareholders in standalone companies but also to the company itself. Directors might tunnel the value of the company to themselves (self-deal) or their benefactors, and later justify their actions by arguing that the decisions were made with the company's long-term perspectives in mind. Furthermore, minority shareholders could face high costs in trying to prove that directors acted in self-dealing, while the statute concurrently provides safeguards for decisions made in consideration of the long-term perspectives of the company.[1179] In such a circumstance, it is possible to find legal strategies through the agency principles to hinder the risk of tunnelling and self-dealing and on the other hand to foster sustainability in corporate governance. These legal strategies could be incorporated into company law to hinder such risks. For example, the company law can fashion laws to identify tests which can be guidelines for directors to foster a specific stakeholder such as the environment and not categorise a decision as mere long-term decisions.

As we move beyond the traditional perspectives on director's duties and explore the evolving legal landscapes, it becomes evident that some jurisdictions are

1176 Paul K Andersen and others., 'European Model Company Act (EMCA)' (2017), 29 <https://ssrn.com/abstract=2929348> accessed 18th May 2023.

1177 ibid 30.

1178 Luca Enriques and Sergio Gilotta, 'The Case Against a Special Regime for Intragroup Transactions' (2023) Eur Bus Org Law Rev 1-36, 6 <https://doi.org/10.1007/s40804-023-00285-3> accessed 18th May 2023.

1179 ibid.

explicitly rejecting the shareholder primacy norm. Edward notes that Pennsylvania's statute explicitly rejects shareholder primacy. For instance, Section 1715 of Pennsylvania Business Corporation Law specifically states that:

> The board of directors, committees of the board, and individual directors shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor.[1180]

Sjåfjell and others state that the Albanian company law has arguably narrowed the scope of its Business Judgment Rule when it comes to matters pertaining to environmental protection. It mandates that the board must make decisions that serve the best interest of the company as a whole, with a special focus on the impact of its operations on the environment.[1181] Albanian company law may be an interesting perspective in protecting the environment from corporate harm.

5.3.6 A Critical analysis of the shareholder wealth maximisation doctrine

LoPucki argues that in the modern world, owing to the extreme nature of the shareholder wealth maximisation doctrine only a few companies follow it in practice and in fact, recent courts are unwilling to enforce it through the business judgement rule.[1182] LoPucki argues further that the business judgement rule presumes that directors' actions — gifts to the managers' favourite charities, net-zero greenhouse gas campaigns, corporate jets, CEO compensation of hundreds of million dollars a year — are all for the purpose of maximising long-run profits and thus unless directors openly announce their lack of intention to pursue shareholder wealth maximisation, legal procedures prevent shareholders from rebutting the presumption.[1183]

[1180] Rock (Nominees) Ltd v RCO (Holdings) Plc [2004] EWCA Civ 118, 457.
[1181] Sjåfjell and others, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' (n 1118) 118.
[1182] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2019 and 2020.
[1183] See eBay Domestic Holdings, Inc v Newmark (2010) 16 A.3d 1 (Del Ch) 31. and Dodge v Ford Motor Co., 170 NW 668 (Mich. 1919). (In both eBay and Dodge cases, the directors publicly showed their lack of interest to prioritise shareholder wealth maximisation. In the eBay case, Jim and Craig expressed their personal belief that Craigslist's primary concern should not be the enhancement of stockholder wealth, neither currently nor in the future. Meanwhile, in the Dodge case, Henry Ford's testimony showed that he believed the Ford Motor Company had generated excessive

Similarly, Millon observes that under the business judgment rule that the court would not second guess if a decision is taken prioritising the long-term best interests of the company, even if certain decisions appear to favour stakeholders over shareholders in the short term. He argues that as long as there is a plausible connection between the decision and the corporation's long-term best interests, such actions can be justified.[1184] Bainbridge, agreeing with a similar view, state that Shlensky v. Wrigley[1185] offers an upgraded version of the Dodge case[1186] because the latter elaborates on that proposition by ensuring '*that directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long term value even at the cost of immediate value maximisation*'.[1187]

Further, in eBay v Newmark,[1188] Chandler explained that the business judgment rule will not question directors' rational decisions that favour interests beyond the shareholders, such as charitable donations or employee benefits, provided these decisions can be logically connected to an ultimate increase in shareholder value. Chancellor Chandler further noted that the Dodge case established an important guideline, demonstrating that directors could face personal liability if their decisions diverge from the ultimate aim of shareholder value maximisation.[1189] In an interesting view, Rühmkorf argues that in German company law only promoting the long-term interests of the company (ie economic sustainability) shows a narrow conception of what sustainability means.[1190] This concurs with the view that specific long-term decisions do not facilitate corporate sustainability and a common definition and method of achieving sustainability is needed in corporate governance.

profits, and despite the potential for earning large profits, the company should consider sharing these with the public by reducing the price of the output of the company).

1184 David K Millon, 'Two Models of Corporate Social Responsibility' (2011) 46 Wake Forest L Rev 523, 527.

1185 237 N.E.2d 776, 780 (Ill. App. 1st Dist. 1968).

1186 Dodge v Ford Motor Co., 170 NW 668 (Mich. 1919).

1187 Stephen M Bainbridge, *The Profit Motive Defending Shareholder Value Maximization* (Cambridge University Press 2023) 49 <https://doi.org/10.1017/9781009025799> accessed 17th May 2023> accessed on 7th July 2023.

1188 eBay Domestic Holdings, Inc v Newmark (2010) 16 A.3d 1 (Del Ch) 31.

1189 ibid 33.

1190 Andreas Rühmkorf, 'Stakeholder Value Versus Corporate Sustainability: Company Law and Corporate Governance in Germany' in Beate Sjåfjell and Christopher M Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press 2019), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3383447> accessed 17 April 2023, 245.

5.3.7 Finnish corporate law: the evolution and critique of the business judgment rule

Pönkä argues that according to FCA 1:8, the company's management is obligated to act with due care and advance the company's interests. When legal actions claim a breach of this duty of care by the directors, the courts rely on a concept known as the business judgment rule to evaluate the case. This term is referred to as '*liiketoimintapäätösperiaate*' in Finnish. He further contends that this rule evolved from Delaware court practices and was recognised in Finland, stating that directors' business decisions should not be invalidated or punished as long as they can demonstrate a rational and informed basis for their decisions.[1191] Similarly, Bainbridge contends that this rule attempts to strike a case-by-case balance between authority and accountability, granting directors decision-making autonomy while also holding them accountable for their actions.[1192] Pönkä notes that the problem with this rule is that it offers no specific guidance about the level of diligence and competence shareholders can rightfully demand from their agents, namely the company directors. He further argues that in Finland, where legal precedents on director accountability are inadequate, shareholders are in a particularly vulnerable situation if their defence against management's opportunistic behaviour is based primarily on an 'empty' transplant rule borrowed from another jurisdiction.[1193]

Airaksinen, however, offers a different interpretation of the Finnish company's purpose in relation to the business judgment rule in his recently published doctoral thesis.[1194] He contends that the wording of FCA 1:5 should clarify that 'profits are to be generated (or value maximised) on a long-term basis, and its preparatory works should state that 'generating profits for shareholders' means maximising the present value of the company's future cash flows'. He further states that the company purpose implies an obligation to take socially responsible actions where these align with the long-term value maximisation goal, and an obligation to abstain from socially responsible actions where such actions would breach this goal. Thus, the

[1191] Ilkka Hannu Ville Pönkä, 'The Convergence of Law: the Finnish Limited Liability Companies Act as an Example of the So-Called 'Americanization' of European Company Law' (2017) 14(1) European Company Law 22, 32; also see Jukka T. Mähönen and Seppo Villa, *Osakeyhtiö I. Yleiset opit* (Talentum 2015) 61; Marika Salo, *Hyvä liiketoimintapäätös ja johdon vastuu* (Talentum 2015) 43, 45-49.

[1192] Stephen M Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vanderbilt Law Review 83 <https://ssrn.com/abstract=429260> accessed 20th May 2023; also see Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press 2008).

[1193] Pönkä (n 1191) 33.

[1194] Manne Airaksinen, *Osakkeenomistajakeskeisyys, sidosryhmät ja yhteiskuntavastuu osakeyhtiöoikeuden järjestelmässä* (Alma Talent 2023).

company law indirectly requires the directors not to prioritise environmental or socially responsible actions fostering sustainability when these actions breach the goal of maximising profits for shareholders. Nonetheless, Airaksinen states that the board has wider discretion under the business judgment rule such that the company's purpose of SWM would not prevent it from taking socially responsible action. It should be noted that the directors' decisions would not be interfered with until a shareholder challenges or questions them. In a situation where a shareholder challenges, the directors will not have a legal instrument to rely on to support their decision to foster sustainability.[1195]

5.3.8 The underlying principles of business judgment rule

Interestingly, Bainbridge argues that the business judgment rule is an abstain doctrine meaning that it prevents the court from invoking the underlying substantive doctrine – in a typical business judgment rule the underlying principle is the duty of care. Bainbridge argues further that it is unquestionable that such an underlying principle exists. Similarly, the fact that the business judgment rule usually prevents the court from determining whether directors violated the shareholder-wealth-maximisation norm does not imply that this norm is not the underlying principle. Bainbridge agrees with Yosifon in arguing that it can be inferred that 'despite the challenges in enforcing shareholder primacy through lawsuits, it still represents the prevailing law of corporate governance in Delaware', and, arguably, in other jurisdictions as well.[1196] For example, Bainbridge argues that the shareholder primacy norm is the dominant norm regarding the purpose of the corporation, and it is not merely a *dicta*. He differentiates that in Dodge, the primary reason the judges ruled against Ford was that he specifically testified that he would not carry on the corporation's business affairs 'primarily for the benefit of the stockholders'. Thus, the court might have allowed decisions aimed at increasing stakeholder value under the business judgment rule if Ford had not specifically testified as above because the court expressly confirmed that they will not interfere with the business judgment of directors.[1197]

Further, Stout suggests that during the 1970s and 1980s, the theory of shareholder primacy started to gain traction as it was taught and accepted by professors in law and economics, and business schools. These educators imparted the shareholder wealth maximisation norm to their students, who have since risen to

[1195] ibid 461.

[1196] David Yosifon, *Corporate Friction: How Corporate Law Impedes American Progress and What to Do About It* (Cambridge University Press 2018) 60–95, 93.

[1197] Bainbridge, 'Why We Should Keep Teaching Dodge V. Ford Motor Co.' (n 1095) 93.

influential roles as CEOs, board members, investment managers, policymakers, and regulators. These individuals now approach decision-making with shareholder primacy as their guiding principle. Over time, this doctrine has become deeply rooted and universally accepted in modern corporations. It is so entrenched that many of its followers might not even be able to articulate the empirical evidence supporting it over other theories.[1198] In essence, shareholder primacy has become an integral part of how business is conducted in today's corporate world. This suggests that shareholder primacy, or the norm of shareholder wealth maximisation, holds a dominant or paramount position in the sphere of corporate law.

5.4 Scholarly arguments on the detrimental effects of shareholder primacy on the public interest

In this section 5.4, the discussion navigates through various scholarly debates, highlighting the potential negative implications of a staunch focus on shareholder wealth maximisation, particularly in terms of public welfare. In section 5.4.1, a critical analysis is presented on how this shareholder-centric approach affects creditors. Moving on, section 5.4.2 delves into the balance that board-centric governance seeks to achieve, managing the expectations of shareholders while addressing the requirements of other stakeholders. Section 5.4.3 brings forth LoPucki's critique, challenging the predominant emphasis on maximising shareholder wealth.

Following this, section 5.4.4 questions the conventional view of directors as mere agents of the shareholders, suggesting a more comprehensive understanding of their responsibilities. In section 5.4.5, the focus shifts to re-evaluating how stock prices and director accountability are intertwined, advocating for a seamless integration of sustainability into financial decision-making. Section 5.4.6 introduces a critical perspective on using stock prices as a measure of managerial performance, adding another layer of complexity to the discourse. Finally, in section 5.4.7, the ambiguity surrounding long-term profitability and the company's best interests is addressed.

Collectively, these sections contribute to discussion, challenging established norms, specifically based on shareholder wealth maximisation in corporate governance.

[1198] Lynn A Stout, 'The Toxic Side Effects of Shareholder Primacy' (2013) 161 U Pa L Rev 2003, 2010.

5.4.1 Sustainability, shareholder primacy, and creditor impacts

Several studies support the assertion that companies adhering to sustainable principles and social responsibility ultimately create greater value for shareholders. For example, Eccles, Ioannou and Serafeim present empirical evidence demonstrating that highly sustainable companies significantly outperform their counterparts over the long term.[1199] El Ghoul and others find a stronger market reaction in companies committed to climate change initiatives compared to those that are not.[1200]

Hawn and Ioannou propose that a business's symbolic ESG actions enhance its intangible assets, such as a strong brand or valuable patents, thereby positively impacting the company's market value.[1201] Similarly, Goss and Roberts' work on borrowing costs reveals that companies with minimal CSR efforts incur higher financial costs.[1202] Plumlee and others suggest that superior CSR performance enables companies to access cheaper equity financing.[1203] These examples indicate that companies adopting strategies that consider environmental and social aspects, instead of solely focusing on shareholder wealth maximisation, will experience a long-term value increase. On the other hand, those failing to embrace such sustainable changes may face negative repercussions.[1204]

Transitioning from the realm of sustainable business practices and their positive impacts, we now turn our attention to the concept of shareholder primacy, exploring how this prevailing norm influences the financial and operational aspects of a company, with a specific focus on its effects on creditors. In terms of shareholder primacy and its effects on creditors, several studies shed light on the dynamics. For

[1199] Robert G Eccles, Ioannis Ioannou and George Serafeim, 'The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance' (2012) SSRN Electronic Journal <10.2139/ssrn.1964011> accessed on 9th July 2023.

[1200] Sadok El Ghoul and others, 'Does corporate social responsibility affect the cost of capital?' (2011) 35 Journal of Banking & Finance 2388 <https://doi.org/10.1016/j.jbankfin.2011.02.007> accessed on 16th June 2023.

[1201] Olga Hawn and Ioannis Ioannou, 'Do Actions Speak Louder than Words? The Case of Corporate Social Responsibility (CSR)' (2012) SSRN Electronic Journal <10.2139/ssrn.2101775> accessed on 17th June 2023; Academy of Management: Briarcliff Manor, NY, USA 14137.

[1202] Allen Goss and Gordon S Roberts, 'The impact of corporate social responsibility on the cost of bank loans' (2011) 35(7) Journal of Banking & Finance 1794<https://doi.org/10.1016/j.jbankfin.2010.12.002> accessed on 17th July 2023.

[1203] Marlene A Plumlee and others, 'Voluntary Environmental Disclosure Quality and Firm Value: Further Evidence' (2015) 34(4) Journal of Accounting and Public Policy 336 <https://doi.org/10.1016/J.JACCPUBPOL.2015.04.004> accessed on 18th June 2023.

[1204] Rodrigo-González, Grau-Grau and Bel-Oms (n 1082).

instance, expanding upon the foundational arguments presented by Adler and Kahan, Stout argues that the norm of shareholder primacy can negatively impact creditors' welfare as stakeholders in business decisions. According to Stout, business decisions driven by this norm can lead to numerous adverse effects on creditors' welfare, including increased risk, reduced cash reserves, asset stripping, a short-term focus, and the amplified influence of shareholders.[1205] Under the shareholder primacy norm, the board may be inclined to take on increased risks, particularly when influenced by shareholders with diversified portfolios. These shareholders limit their potential losses if a strategy fails due to their diverse investment portfolios, while creditors bear the downside risk alone.[1206]

In addition, the shareholder primacy norm can encourage directors to distribute excess cash as dividends or use it for share buybacks, rather than retaining it as a cash reserve. This practice, however, contradicts the preference of creditors who favour maintaining robust cash reserves to mitigate bankruptcy risks. Directors might also engage in asset stripping to inflate share prices in the short term, an action that can detrimentally impact creditors by reducing the assets available to them in the event of bankruptcy.[1207]

The short-term focus encouraged by shareholder primacy can jeopardise the company's long-term stability, adversely affecting creditors who have extended long-term credit facilities to the company. The reason is that certain short-term business decisions could adversely affect the long-term value increase of the company and thus, indirectly affect long-term creditors.[1208] Lastly, the emphasis on shareholder primacy can motivate shareholders to take a more active role in company affairs in their self-interest. This increased influence can lead to extreme shareholder-centric decisions that may have severe repercussions for creditors.[1209]

5.4.2 The dynamics of board-centric governance: balancing shareholder wealth and stakeholder contributions in sustainable finance

Stout argues that the Dodge case was primarily applied to closed corporations, and modern Delaware courts have only applied it only in that context. She further argues that in modern public corporations, the business judgment rule leaves plenty of room

[1205] Stout, 'The Toxic Side Effects of Shareholder Primacy' (n 1198) 2019; John R Graham, Campbell R Harvey and Shiva Rajgopal, 'Value Destruction and Financial Reporting Decisions' (2006) 62 (6) Financial Analysts Journal 27.
[1206] ibid 31 fig.4.
[1207] Stout, 'The Toxic Side Effects of Shareholder Primacy' (n 1198) 2020.
[1208] ibid 2020.
[1209] ibid 2019.

to pursue stakeholder objectives even at the expense of stockholder wealth.[1210] The reason is that the shareholder primacy principle discussed in Dodge case does not apply to public companies and the court should not look at the shareholder primacy norm or shareholder wealth maximisation norm in terms of the company's best interest.

Stout concurring with Blair, argues that board-centric governance motivates nonshareholder stakeholders to make nonfinancial investments in corporate functions. These contributions, which cannot be entirely protected by law or contract, may come in forms such as extra efforts from employees, extended credit from suppliers during cash flow shortages, customers dedicating time and effort to learning product usage, or local communities constructing specialised infrastructure to support the company needs.[1211] These stakeholders make these investments not because they are fully protected by law or contract, but out of trust that the board will value and consider their contributions in decision-making. According to Stout and Blair, these stakeholders view the corporation as a socio-economic entity. Their argument on board-centric governance proposes that the board should metaphorically 'put on a socio-economic hat', meaning they should adopt a socio-economic perspective when making decisions. Conversely, stakeholders often distrust dispersed shareholders, who could personally profit by threatening to devalue or destroy stakeholders' investments. This distrust makes it harder for companies primarily focused on shareholders to attract dedicated employees, loyal customers, cooperative suppliers, and community support. The shareholder-centric model may result in a short-term increase in 'shareholder wealth', but it could significantly compromise the corporation's long-term profitability. This argument further highlights the potentially detrimental effects of an excessive focus on shareholder primacy.[1212]

Moving on to consider how shareholder primacy influences sustainable practices within the financial sector, it is vital to emphasis its substantial impact on corporate finance. The ethos of shareholder primacy, rooted in the goal of maximising shareholder wealth, has profoundly shaped efforts to promote sustainability in corporate financing. This influence manifests in various ways, including socially responsible investing and the implementation of transparency measures like sustainability reports that disclose ESG factors. However, these influences are not practically effective due to the deep-seated issues associated with shareholder primacy thinking. For example, Cash states that cultivating environmental and social

[1210] Stout, 'Why We Should Stop Teaching Dodge v. Ford' (n 1099) 168-72.
[1211] Margaret M Blair and Lynn A Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Va L Rev 247, 253.
[1212] Stout, 'The Toxic Side Effects of Shareholder Primacy' (n 1198) 2016.

principles is essential to successfully achieving the objectives encapsulated within the Principles of Responsible Investments (PRI).[1213] Nonetheless, a major obstacle to achieving sustainability is the significant variance in the quality of ESG information published by companies. This discrepancy impedes investors' ability to differentiate between genuine sustainable initiatives that create value and practices known as 'greenwashing'. This form of greenwashing frequently stems from directors' pursuit of short-term profits for their shareholders, a motivation rooted in the principle of shareholder primacy. Zeidan argues that unless such issues are addressed, the future success of sustainable finance will be jeopardised.[1214] Thus, as Weber clearly indicates, there is a lack of a cohesive, overarching strategy to encourage the financial sector to contribute to sustainable development.[1215]

5.4.3 LoPucki's critique on shareholder wealth maximisation

In a recent article, LoPucki debunked six theories which are foundational to the existence of shareholder primacy. LoPucki argues that shareholder wealth maximisation is detrimental to the corporation's future success. He bases his arguments on a review of legal scholars' articles, discrediting six theories that support the reasoning of shareholder primacy advocates, namely that '*abandoning SWM will somehow impair corporate efficiency remains the principal barrier to reconceptualising the public corporation*'.[1216] The six theories supporting this reasoning are:

1. Corporate law does not require shareholder wealth maximisation,
2. Shareholders are the owners of the company,
3. Shareholders are the residual claimants of the company,
4. Directors are the agents of the shareholders,
5. Shareholders have an implied contract for shareholder wealth maximisation, and

[1213] Daniel Cash, 'Sustainable finance ratings as the latest symptom of 'rating addiction'' (2018) 8 Journal of Sustainable Finance & Investment 242 <https://doi.org/10.1080/20430795.2018.1437996> accessed on 14th July 2023.

[1214] Rodrigo Zeidan, 'Obstacles to sustainable finance and the covid19 crisis' (2020) Journal of Sustainable Finance and Investment 525 <https://doi.org/10.1080/20430795.2020.1783152> accessed on 14th July 2023.

[1215] Olaf Weber, 'Finance and Sustainability' in H Heinrichs and others (eds), *Sustainability Science: An Introduction* (Springer 2015) 119–129.

[1216] Stout, 'The Toxic Side Effects of Shareholder Primacy' (n 1198) 2017.

6. Shareholder wealth maximisation enables shareholders to monitor directors via the stock price.[1217]

In addition, he contends that in the US context, three circumstances assure that the threat of impaired efficiency resulting from abandoning shareholder wealth maximisation is unfounded. These are: 1) corporations incorporated in jurisdictions that do not follow the shareholder wealth maximisation doctrine are competitive with U.S. corporations; 2) recent statistics show that the number of U.S. public companies has been decreasing in recent decades, while the number of foreign domestic corporations has been increasing, and 3) recent cases show that Delaware law does not enforce a director's duty to maximise shareholder returns, thus directors are free to ignore it. These US examples can be utilised as an example for other jurisdictions to abandon shareholder primacy norm. This shows that companies not adopting shareholder primacy norm are doing well taking a lead compared to other companies.

LoPucki specifically states that corporate law requiring SWM cannot be necessary to corporate financial performance. He further argues that shareholders' claim to the ownership of the company is weak,[1218] and the ownership theory makes no claim that treating shareholders as owners improves the corporation's financial performance.[1219] Moreover, LoPucki attacks the core of the reasoning that shareholder wealth maximisation maximises social wealth[1220] by concurring with Choper, Coffee Jr and Gilson, and Lucian, Bebchuk and Tallarita who argue that shareholder wealth maximisation ultimately contributes to a wide array of societal problems including environmental ills.[1221]

[1217] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2065.

[1218] ibid 2037.

[1219] Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (n 1134) 650.

[1220] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2040. (SWM advocates argue that SWM maximizes social wealth. The argument's premise is that shareholders are the corporations' residual owners. The argument proceeds in four steps: (1) because the shareholders' status as residual owners gives them the strongest incentives to maximize corporate wealth, shareholders should control the corporation, but (2) shareholders cannot control the corporation, so (3) to maximize corporate wealth, the directors who control the corporation should SWM, and (4) that SWM will maximize both corporate wealth and social wealth.)

[1221] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2048. And also see Jesse H Choper, John C Coffee Jr, and Ronald Gilson, *Cases and Materials on Corporations* (8th edn, 2013) 40 ('Virtually everyone recognizes that corporate profit maximisation can sometimes inflict a greater harm on society than the gain it creates for shareholders'); Lucian A Bebchuk and Roberto Tallarita, 'The Illusory Promise of Stakeholder Governance' (2020) 106 Cornell Law Review 91, 168; Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (Free Press 2004), 61

Additionally, a recent study conducted by Shapira point outs that once you calculate the time value of money, the decision to pollute becomes rational from the point of view of shareholder wealth maximisation.[1222] On this premise, LoPucki argues serious concerns about shareholder wealth maximisation that:

> Other externalized social costs include the release of microplastics and other pathogens, the generation of financial crises, the social effects of child and slave labor, violations of human rights, the monopolization of the water supply, the movement of populations for temporary employment, the abandonment of older employees, and the release of greenhouse gases that may render the planet uninhabitable.[1223]

Most importantly, LoPucki argues that the most efficient strategy for reducing the government's clean-up cost, which is greater than the pollution avoidance cost borne by the corporation, is to eliminate the shareholder wealth maximisation norm in company law. Additionally, lobbying activities by private corporations demonstrate that efforts to regulate and compel companies to adopt necessary regulations are hindered by corporate agents who benefit from the shareholder maximisation norm. Thus, it suggests that shareholder maximisation does not necessarily lead to the maximisation of social wealth.[1224]

5.4.4 Directors as agents: a misconception

Several scholars, including LoPucki, contend that directors do not function as agents of shareholders within the framework of corporate law. Stout argues that the hallmark of the agency is that the principal has full control of the agent's behaviour which in this case between the shareholder and director is not the case.[1225] Additionally, Millon asserts that one of the fundamental aspects of an agency relationship which is the principal's right to control the actions of the agent is lacking.[1226] In corporate law, the behaviours of directors and managers are self-directed, not externally controlled. Fisch elucidates that corporate managers, distinct

('[T]he corporation's built-in compulsion to externalize its costs is at the root of many of the world's social and environmental ills.')

1222 Roy Shapira, 'The Challenge of Holding Big Business Accountable' (2022) 44 Cardozo Law Review 203, 233.

1223 LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2048.

1224 ibid 2049.

1225 Stout, 'The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public' (n 467) 42.

1226 Millon, 'Radical Shareholder Primacy' (n 1117) 1022.

from conventional agents, are not directly under the control of their principals; instead, their power largely emanates from statutory provisions.[1227] Grounded in these assertions, LoPucki concludes that, as directors are neither agents in law nor in practice, agency arguments supporting the theory that directors' maximisation of shareholder profits ultimately enhances corporate performance are not accurate.[1228] The enforcement of criminal liabilities on directors in corporate law further highlights that directors carry personal responsibility for their actions, whereas shareholders are not personally accountable.

In Beth Isr. Med. Ctr. v Horizon Blue Cross & Blue Shield of N.J., Inc.[1229] it was stated that '*The terms of an implied-in-fact contract turn on the conduct of the parties*',[1230] meaning that directors obligations and expectations are inferred from their actions and not explicitly stated in a written contract. LoPucki assert that none of the facts specifically basing on the findings by Bebchuk, Kastiel and Tallarita support the fact that directors have to act in maximising the shareholders wealth.[1231] In fact, the findings support in contrary - *Most of the policies Bebchuk and Tallarita classified as supporting shareholder primacy merely said that the board's role was to represent or promote the interests of the corporation's shareholders. Nearly all the policies studied are consistent with an unstated board intention to also serve the interests of other stakeholders.*[1232] This means the shareholder primacy in 'fact' is not shareholder wealth maximisation but serves the interest of stakeholders. This finding in my opinion is strong evidence that there is a necessity to redefine the meaning of shareholder primacy to reflect the overall purpose of the company, which is sustainable value creation, because as it is now it is misleading to reflect shareholder wealth maximisation. In addition, LoPucki asserts that proponents of team production and stakeholder theory persuasively suggest that the benefits public companies offer stakeholders, which can substantially be more or less than their legal entitlements, imply that stakeholders, not shareholders, have implicit contracts,

[1227] Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (n 1134) 649.
[1228] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2051.
[1229] 448 F 3d 573 (2d Cir 2006).
[1230] ibid ('The terms of an implied-in-fact contract turn on the conduct of the parties'.)
[1231] Lucian A Bebchuk and Roberto Tallarita, 'Will Corporations Deliver Value to All Stakeholders?' (2022) 75 Vand L Rev 1031, 1060; also 1055 ('I do not read that language as requiring maximization of shareholder value. It is consistent with an intention to also act solely in the best interest of the other stakeholders').
[1232] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2053.

thereby challenging the notion of implied contracts for shareholder wealth maximisation.[1233]

5.4.5 Rethinking stock prices and director accountability: integrating sustainability in financial decision-making

Proponents of shareholder wealth maximisation argue that if directors are allowed to serve the interests of other stakeholders, they may use this discretion to serve their own interests, making it difficult for shareholders to monitor the corporation's efficiency.[1234] Interestingly, Hart and Zingales propose that companies should replace market value maximisation with shareholder welfare maximisation.[1235] This means that directors should consider the socially conscious preferences of shareholders. For example, investment funds often advertise that they invest in environmentally friendly companies. The ordinary citizens, seeing this description, buys units from the funds. The fund managers then have a duty to invest in companies according to this description. The ultimate shareholders of these companies are ordinary citizens who have ethical and social concerns. Hart and Zingales explain that these citizens often internalise externalities to some extent, eg they might buy an electric car instead of a gas-guzzler due to concerns about pollution or global warming, or they might buy fair-trade coffee even though it is more expensive and not necessarily better than regular coffee.[1236] In their view,

[1233] ibid 2054; also see Lynn A Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 S Cal L Rev 1189, 1194-95; Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (n 467) 40; Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (n 1134) 660.

[1234] Stephen M Bainbridge, 'The Bishops and the Corporate Stakeholder Debate' (2002) 4 Vill. J.L. & Inv. Mgmt. 3, 21 ('There is a very real risk that directors and managers given discretion to consider interests other than shareholder wealth maximization will use stakeholder interests as a cloak for actions taken to advance their own selfish interests.'); Harry G Hutchison, 'Choice, Progressive Values, and Corporate Law: A Reply to Greenfield' (2010) 35 Del. J. Corp. L. 437, 462 ('The claim that expanded stakeholder governance leads to diminished accountability of corporate managers is not new'.); Jonathan R Macey, 'Corporate Law as Myth' (2020) 93 S. Cal. L. Rev. 923, 953 ('If corporate directors and corporate managers stop believing in the myth that they are supposed to maximize value for shareholders, there would be precious little, if anything, to constrain them from simply pursuing their own, idiosyncratic notions of what is 'best' for whatever group of corporate constituents they idiosyncratically and serendipitously happened to prefer at a particular moment in time.').

[1235] Oliver Hart & Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (2017) 2 Journal of Law, Finance, and Accounting 247, 270.

[1236] ibid 248.

companies and asset managers should pursue policies consistent with investor preferences, which can be determined through voting.

They further argue that if investors vote against prosocial policies, the company will follow the Friedman outcome, where shareholders favour value maximisation.[1237] In such a case, there would be two types of companies: prosocial and antisocial. As said above, advocates of shareholder wealth maximisation argue that stock prices would be a reliable measure of managerial performance, but this may only hold true in antisocial companies, not in prosocial ones. Hart and Zingales point out that efficiency requires shareholder utility maximisation, not just shareholder wealth maximisation.[1238] Accordingly, profit maximisation is not the only metric for measuring stock value; internalising externalities also plays a crucial role. Thus, Hart and Zingales' findings challenge the position of shareholder wealth maximisation proponents who believe that stock prices can be used to monitor directors' performance. Hart's and Zingales's arguments suggest that stock prices can only serve as a reliable metric when directors internalise externalities.

Building on these insights, integrating sustainability into financial decisions emerges as a pivotal aspect of contemporary corporate strategy. Similarly, the study by Fatemi and Fooladi demonstrates that it is indeed possible to incorporate this new conception of sustainable value into the traditional Net Present Value (NPV) approach.[1239] NPV, a financial concept widely used by decision-makers, specifically investors, helps ascertain whether an investment is worth pursuing. The adaptation of the NPV approach to include sustainable value will take into account incremental cash flows generated as a result of the company's sustainability efforts. For example, such efforts might increase brand value, enhance customer loyalty, and attract pro-social customers. Additionally, sustainable initiatives can reduce future costs through decreased water and energy consumption, and, importantly, lower the cost of capital due to improved risk management practices in socially and environmentally responsible companies.[1240] This perspective reinforces the proposed third agency problem discussed in the chapter three and encourages the internalisation of social and environmental considerations into corporate decision-making affairs.

[1237] ibid 271.
[1238] ibid 271.
[1239] Fatemi and Fooladi (n 1084).
[1240] Rodrigo-González, Grau-Grau and Bel-Oms (n 1082) 9.

5.4.6 Critique on using stock prices as a measure of managerial performance

LoPucki disputes the notion that stock prices, based on the norm of shareholder wealth maximisation, can be a reliable measure of managerial performance. He provides three reasons to support his argument. Firstly, stock prices reflect several factors related to the company's performance, not limited solely to managerial performance.[1241] Secondly, concurring with Stout, Stevelman, Haan and the supreme court decision in Smith v Van Gorkum[1242] LoPucki highlights that a corporation's value cannot be measured accurately by the performance of stock prices.[1243] Thirdly, there are possibilities for managers to manipulate the stock price. For instance, raising share price without improving real economic performance,[1244] costly price-boosting manipulation, massive corporate trading in the corporation's own shares,[1245] artificially increasing profits through 'earnings management',[1246]

[1241] Others include stock market conditions, product market conditions, labour market conditions, stakeholder cooperation, government policies, wars, path dependencies, and technological changes. Additionally, analysts of stock prices strive to account for factors that are beyond the control of the directors.

[1242] 488 A.2d 858 (Del. 1985).

[1243] Faith Stevelman and Sarah C Haan, 'Boards in Information Governance' (2020) 23 U Pa J Bus L 179, 208 ('The shocking drop and then stunning climb of stock market prices after the spring of 2020 has not enhanced faith in stock market efficiency.'); Lynn A. Stout, 'The Mechanisms of Market Inefficiency: An Introduction to the New Finance' (2003) 28 J Corp L 635, 667 ('the evidence at this point does not support the close correlation between price and value predicted by orthodox efficient markets theory.') and 636 ('In the Spring of 2000, the Standard & Poors 500 Index of 500 leading companies topped 1,500. By October 2002, the S&P Index was hovering near 775, a nearly fifty percent decline in value.'); Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985), overruled by Gantler v. Stephens, 965 A.2d 695 (Del. 2009) ('The parties do not dispute that a publicly-traded stock price is solely a measure of the value of a minority position and, thus, market price represents only the value of a single share. Nevertheless . . . the Board assessed the adequacy of the premium over market . . . solely by comparing it with Trans Union's current and historical stock price'.)

[1244] Stout, *The shareholder value myth: How putting shareholders first harms investors, corporations, and the public* (n 467) 67-68.

[1245] Jesse M Fried, 'The Uneasy Case for Favoring Long-Term Shareholders' (2015) 124 Yale L J 1554, 1561 ('Short-term shareholders, on the other hand, may benefit when managers engage in what I call 'costly price-boosting manipulation' — actions that boost the short-term stock price at the expense of the pie generated over the long term.').

[1246] James J Park, 'From Managers to Markets: Valuation and Shareholder Wealth Maximization' (2022) 47 J Corp L 435, 477 ('Company managers that deliver predictable earnings prove that they can accurately forecast earnings growth and follow through on their plans. There is evidence that companies that meet market expectations are rewarded with a higher stock price.'); also see Graham, Harvey and Rajgopal (n

misstating their profits,[1247] exercising GAAP-permitted 'judgment',[1248] and taking 'one-time' charges that analysts will ignore.[1249] Based on this premise, it can be concluded that one of the main objectives of shareholder wealth maximisation, which is to monitor the performance of directors, is flawed.[1250] Furthermore, corporate law does not provide any specific statutory tools for monitoring directors' performance in the daily affairs of the company, apart from at the Annual General Meeting. During this meeting, shareholders can ask questions directly to the directors and cross-check the financial returns to see if they accurately reflect the financial reality of the company.

One of the main arguments for the foundational pillars of shareholder wealth maximisation is that ending the policy may adversely affect the corporation and the economy. This argument has been supported by several scholars advocating for the importance of shareholder wealth maximisation norm in corporate governance. Bainbridge argues that '*the basic rule that shareholder interests come first… has helped produce an economy that is dominated by public corporations, which in turn has produced the highest standard of living of any society in the history of the world*'.[1251] Rock strongly states that if the shareholder maximisation norm is replaced as the objective of the corporate purpose, it will result in *disrupting the coherence of the corporate form, a form that has been one of the great wealth-generating innovations of the last 150 years.*[1252] Romano argues that if the company pursue other objectives than share value maximisation, *the market's allocative efficiency will be*

1205) 33 (Fig. 4.) ('80% of survey participants report that they would decrease discretionary spending on R&D, advertising and maintenance to meet an earnings target.')

[1247] Sharon Hannes and Avraham D Tabbach, 'Executive Stock Options: The Effects of Manipulation on Risk Taking' (2013) 38 J Corp L 533, 557 ('Inaccurate accounting and earnings management came at a huge cost to the firms involved and to the U.S. market as a whole'.).

[1248] William O Fisher, 'Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis' (2004) 39 Gonz L Rev 29, 37-38 ('Indeed, two companies in the same industry can undergo virtually the same economic experience in a quarter yet report GAAP numbers that differ dramatically.').

[1249] Fisher (n 1248) 38 ('For instance, if you decide at some point to discontinue a particular line of business, you may take a 'restructuring' charge to record, at the time the line is discontinued, the costs that you anticipate the discontinuation will create. This, too, is an estimate').

[1250] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2060.

[1251] Stephen M Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 Wash & Lee L Rev 1423, 1446.

[1252] Edward B Rock, 'For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose' (2021) 76 Bus L 363, 394.

compromised.[1253] However, LoPucki points out four circumstances that demonstrate the aforementioned claims are unfounded.

Firstly, the competitiveness of foreign corporations which are not subject to the shareholder wealth maximisation norm in numerous markets suggests that the absence of SWM is not fatal. Secondly, the decline in the number of American-origin public companies over the past several decades, contrasted with the increase in foreign-origin companies worldwide, implies that American companies subject to the SWM norm may be less efficient than those not subject to this norm. Thirdly, a significant minority of American public companies are incorporated in states with constituency statutes, allowing their boards to consider the interests of non-shareholder stakeholders without the obligation to maximise shareholder wealth. These corporations remain competitive despite not prioritising SWM. Fourthly, there is little evidence to suggest that American companies consistently follow the SWM norm.[1254] Additionally, Macey highlights that directors have considerable discretion within the framework provided by corporate law.[1255] Even under the 'hard candy shell - Tootsie Pop' example proposed by Bainbridge, which suggests that the SWM norm is a protective shell that directors can operate within until challenged by a shareholder, directors have significant discretion.[1256]

LoPucki further asserts that 'Corporations in all U.S. jurisdictions are pursuing objectives other than SWM, and the sky has not fallen'. Several scholars have concurred with the same view that it is possible for directors to pursue any other objective as long as they do not openly critique the SWM norm. For example, Strine quoted Chancellor Chandler's assertion that Delaware law does not permit directors to openly disregard shareholder value maximisation, a statement he described as 'rather expected'.[1257] Therefore, at least in the American context, where the shareholder primacy norm originated, there is confusion about its purpose and application.

[1253] Roberta Romano, 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 Emory LJ 1155, 1165.

[1254] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2061 - 2063.

[1255] Macey, 'Corporate Law as Myth' (n 1234) 950.

[1256] Bainbridge, 'Why We Should Keep Teaching Dodge V. Ford Motor Co.' (n 1095) 115. ('Likewise, the fact that the business judgment rule typically precludes a court from deciding whether directors breached the shareholder-wealth-maximization norm does not mean that the norm is not the underlying doctrine.')

[1257] Leo E Strine Jr., 'Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit' (2012) 47 Wake Forest L Rev 135, 146–149.

5.4.7 Ambiguity in the meaning of long-term profitability and best interest of the company

LoPucki argues that 'removing the remaining legal and normative pressures to SWM would tend to reduce corporate externalisation of social costs'.[1258] Moreover, as previously stated, Hart and Zingales' findings suggest that internalising social costs could enhance corporate efficiency.[1259] LoPucki further contends that discarding SWM would eliminate the hypocritical presumption in corporate law that directors calculate the long-term profitability of each decision, a practice widely acknowledged to be unrealistic. Accordingly, long-term profitability cannot be achieved if the SWM norm is present in the decision-making process.

However, in the Nordic context, Hansen argues that '*the central characteristic of the Nordic model is the prevalence of dominant shareholders and an accompanying view of shareholders as beneficial and entitled to run their companies within the limits set by statutory law as they see fit*',[1260] a perspective that has shown good results. He further argues that '*The outcome of that power struggle is yet uncertain, but should investors cum shareholders prevail, it does not necessarily signify the end of ESG or the Green Transition*'.[1261] This uncertainty itself creates ambiguity in the true meaning of 'long-term profitability' and the 'best interest of the company' when the shareholder dominant (which is synonym for SWM) is prevailing. For example, it remains unclear how a legal framework that permits shareholders to act freely can promote adherence to planetary boundaries and thus, stay within the just space for humanity without perusing self-interest which is profit maximising.

Accordingly, it raises the following questions: Can companies run by shareholders within statutory legal boundaries efficiently mitigate stakeholder costs, such as liability risks? Can shareholder-dominant models effectively comply with environmental legislation, as was shown with contrary results in the Finnish case KKO:2016:58?[1262] Therefore, is it more likely that achieving long-term profitability is better facilitated by internalising stakeholder costs in company law, rather than relying on statutory law external to company law, or on shareholders running their companies as they see fit within legal constraints? The potential for internalising

[1258] LoPucki, 'The end of shareholder Wealth Maximisation' (n 1079) 2061 - 2065.

[1259] Hart and Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (n 1078) 271.

[1260] Jesper Lau Hansen, 'The Nordic Approach to Corporate Governance and ESG' (Nordic & European Company Law Working Paper No 23-03, 13 June 2023) <https://ssrn.com/abstract=4486977> accessed 2 July 2023, 27.

[1261] ibid.

[1262] KKO 2016:58 (Supreme Court of Finland, 2016) <https://finlex.fi/fi/oikeus/kko/kko/2016/20160058> accessed on 20 July 2013.

stakeholder costs could act as a proactive mechanism to prevent the company from incurring such costs.

This research supports the position that sustainable value creation, as advocated by Sjåfjell and others, could serve as a replacement for the SWM norm and facilitate the achievement of the realistic long-term profits.[1263]

5.5 Shareholder-stakeholder dichotomy and prominence of shareholder primacy in jurisdictions

5.5.1 The Shareholder-stakeholder debate and the emergence of sustainable corporate governance initiatives

Sjåfjell and Mähönen assert that the shareholder-stakeholder dichotomy is misleading and that it reinforces the drive for shareholder primacy. They elaborate on this dichotomy as a debate among European scholars between the societal approach and the efficiency-based approach, both of which should be integrated into the Sustainable Corporate Governance initiative launched by the European Commission in 2020.[1264] They advocate for redefine the corporate purpose *within a research-based concept of sustainability,* which they describe as *securing the social foundations of humanity now and for the future while staying within planetary boundaries.*[1265] Porter and Kramer assert that the current challenges faced by the European Union have put pressure on the business community to adopt more stringent sustainable business practices.[1266] This implies that companies should aim to create value not just for themselves and their beneficiaries, but for the benefit of society as a whole, whether in the short-term or long-term.[1267] Villiers, Sjåfjell and Tsagas question the current concept of value creation, citing its significant

[1263] Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (n 30).

[1264] Beate Sjåfjell and Jukka Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (21 February 2022) University of Oslo Faculty of Law Research Paper No. 2022-43, <https://ssrn.com/abstract=4039565> or <https://dx.doi.org/10.2139/ssrn.4039565> accessed on 15th July 2023.

[1265] Charlotte Villiers, Beate Sjåfjell and Georgina Tsagas 'Stimulating Value Creation in a Europe in Crisis' in Sjåfjell B, Tsagas G and Villiers (eds), Sustainable Value Creation in the EU: Towards Pathways to a Sustainable Future through Crises (Cambridge University Press 2022) 7.

[1266] Michael E Porter and Mark R Kramer, 'Creating shared value' in Gilbert G Lenssen and Craig N Smith (eds), Managing Sustainable Business (Springer 2019) 327-350.

[1267] ibid.

detrimental impacts on various areas, including environmental degradation, labour exploitation, and deepening wealth and income inequalities to an alarming extent.[1268]

The concept of value creation can be interpreted in both short-term and long-term contexts, including through the lens of enlightened shareholder value creation. Various elements within the corporate domain, including scholars, judges, and even statutes, have identified long-term or enlightened shareholder value creation as a process that considers stakeholders as subordinates to shareholders in decision-making. This approach supports long-term value creation, which is gaining prominence in the modern corporate world.[1269] Sjåfjell and Mähönen probing deeper into the concepts of corporate purpose states that 'shareholder primacy' should be distinguished from the Angelo-American legal concept of 'shareholder value'.[1270] Sjåfjell and others argue that 'shareholder primacy' is a social norm, specifically in the European context, while 'shareholder value' is a legal requirement.[1271] Sjåfjell and Mähönen elaborate by stating that '*Shareholder primacy is a short form for a complex mix of perceived market signals and economic incentives, informed by path-dependent corporate governance assumptions and postulates from legal-economic theories*'.[1272] Moreover, they highlight that shareholder primacy empowers the corporate management to put shareholders' financial interest above all others.[1273] Sjåfjell and Mähönen opine that the 'interest of the company' can be positioned on a spectrum. At one end of this spectrum is a monistic approach, which equates the interest of the company with that of the shareholders, embodying the concept of shareholder value. On the other end of the spectrum is pluralism, where the interest

[1268] Villiers, Sjåfjell and Tsagas (n 1265) 2; and also see Porter and Kramer (n 1266); Benjamin J. Richardson and Beate Sjåfjell, 'Capitalism, the Sustainability Crisis, and the Limitations of Current Business Governance' in Beate Sjåfjell and Benjamin J Richardson (eds) *Company Law and Sustainability: Legal Barriers and Opportunity* (Cambridge University Press 2015) ch 1 (environmental degradation); Miguel Alzola, 'Decent Work: The Moral Status of Labor in Human Resource Management' (2018) 147(4) Journal of Business Ethics 835-853 (labour exploitation); and Thomas Piketty, 'Capital in the 21st Century' (Harvard University Press 2014) (deepened wealth and income inequalities to excessive levels).

[1269] Michael C Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2001) 14 Journal of Applied Corporate Finance 8-21.

[1270] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 10.

[1271] Sjåfjell and others, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' (n 1118) 147.

[1272] Beate Sjåfjell, 'Realising the Potential of the Board for Corporate Sustainability' in Beate Sjåfjell and Christopher M Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge Law Handbooks 2019), ch 49.

[1273] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 10.

of the company encompasses a broader set of interests, potentially including those of stakeholders and perhaps even the public at large.[1274] Sjåfjell and Mähönen suggest that, through the examination of case law and related legal materials, the concept of 'the interest of the company' in company law can be used to categorise jurisdictions along the aforementioned spectrum. They further contend that the pluralistic end of the spectrum can be subdivided into several categories, where the firm serves as a balancing point for various interests, such as those of shareholders and stakeholders. In these instances, the company's board has a duty to promote these interests in addition to those of shareholders.[1275]

5.5.2 Comparative perspectives on corporate purpose: analysing European jurisdictions

From the perspective of Finland, Sjåfjell and Mähönen state that the purpose of the company is understood as a long-term, inclusive shareholder value variant, inspired by the UK's legislated concept of 'enlightened shareholder value'.[1276] Similarly, Pönkä states that '*enlightened value maximization theory – which is the prevailing theory in Finland– claim that by promoting the interests of the shareholders' 'going concern' the interests of other stakeholders are concurrently satisfied*'.[1277]

Airaksinen states that the company's purpose inherently necessitates undertaking socially responsible actions, but only when they align with the objective of long-term value maximisation. He further brings attention to a secondary, potentially conflicting obligation - to refrain from socially responsible actions if they contradict this goal of long-term value maximisation. However, this presents a quandary: can long-term value maximisation achieved in this way actually lead to sustainability when the decisions are not socially responsible?[1278] Similarly, Sjåfjell and others emphasis that the Finnish case law '*emphasises the secondary nature of shareholders' right to profit in relation to the interests of the company*'[1279] and maintains that the purpose of the company should be further enhanced by mandating

[1274] Sjåfjell and others, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' (n 1118) 95.
[1275] ibid 92.
[1276] ibid 92.
[1277] Pönkä (n 1191) 8.
[1278] Airaksinen (n 1194) 461.
[1279] Sjåfjell and others, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' (n 1118) 92; also see Jukka Tapio Mähönen and Guðrún Johnsen, 'Law, Culture and Sustainability: Corporate Governance In The Nordic Countries' in Beate Sjåfjell and Christopher M Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press 2019) 218-231, 222.

that directors should have fiduciary duties to wider society rather than solely to their shareholders.[1280]

Norwegian Companies Act requires that if the companies do not include the purpose of making profits for the company in order to benefit its shareholders, the company should include a provision in their company's article about the distribution of their profits.[1281] Germany is commonly referred to as a 'stakeholder value system'[1282] and the main reason is that usually employees elect members of the supervisory board (*Aufsichtsrat*) under the system of codetermination.[1283] The management board is tasked with the direct responsibility for managing the daily affairs of the company and they are required to employ the care of a diligent and conscientious manager.[1284] Interestingly, shareholders cannot issue any instructions to the board members on their decisions, and they have the discretion to make their own independent business judgments.[1285] Scholars argue that such judgment should be oriented towards the interest of the company (*Unternehmensinteresse*).[1286]

However, German company law does not provide a definition for the meaning of 'interest of the company'. Koch, along with the majority of scholars, argue that '*the term is to be construed according to the stakeholder value concept, which means that the interests of all groups affected by a company (eg employees, shareholders, but also creditors and local communities) are to be taken into account by the board in its decisions*'.[1287] The German corporate governance code provision 4.1.1 highlights the phrase 'sustainable value creation' but it is not reflected in the German company law (*Aktiengesetz*). Sjåfjell and others argue that there is a Germanic-

1280 Beate Sjåfjell and Jukka Mähönen, 'Upgrading the Nordic Corporate Governance Model for Sustainable Companies' (2014) 11(2) European Company Law 58, 59 ('Nordic companies acts should include the statement that '(t)he purpose of a company is to create sustainable value through the balancing of the interests of its investors and other involved parties within the planetary boundaries').

1281 *Allmennaksjeloven* [the Norwegian Public Companies Act] (13 June 1997, No. 45) § 2–2 (2). (If the object of the company's business is not that of generating profit for the shareholders, the articles of association shall provide for the employment of any profit and of the capital in the event of liquidation.)

1282 Shuangge Wen, 'The Magnitude of Shareholder Value as the Overriding Objective in the UK: The Post-Crisis Perspective' (2011) 26 J Intl Banking L and Reg 326.

1283 Section 3.1 of *Aktiengesetz* (AktG).

1284 Section 76 (1) and 93 (1) of AktG.

1285 Rühmkorf (n 1190) 233.

1286 Gerald Spindler, Unternehmensinteresse als Leitlinie des Vorstandshandelns – Berücksichtigung von Arbeitnehmerinteressen und Shareholder Value (Gutachten im Auftrag der Hans-Böckler-Stiftung 2007) and ibid, 233.

1287 Rühmkorf (n 1190) 234 and J Koch in J Koch (ed), Hüffer/Koch: Aktiengesetz, 12th edn (C.H. Beck Verlag, 2016) § 76, para 28.

inspired concept of ‘company interest’, where the interest of the enterprise arguably is the balancing point around which a number of interests are to be considered.[1288]

Lauraitytė and Miliauskas argue that in Lithuanian company law profit seeking is the predominant factor when discussing the purpose of the company.[1289] Interestingly, at first glance, the UK’s enlightened shareholder value, as suggested by Section 172 of the UK Companies Act, appears to endorse stakeholderism. This seems to position it towards the pluralistic end of the spectrum previously discussed, giving the impression that considering stakeholders as subordinate to shareholder interests contributes to long-term value. Sjåfjell and others argue that this attempt to incorporate long-term value into the purpose of a company through stakeholder consideration is merely a codification of shareholder value, representing a clear departure from the pluralism previously discussed[1290] but it is a small step forward from the shareholder value end of the spectrum.[1291] Sjåfjell and others suggest that reformers in UK were influence by the agency cost theory and shareholder primacy to result in such a section to end on the shareholder value end of the spectrum.[1292] Villiers argue that the UK had an opportunity to move forward towards a more sustainable codification of company law.[1293]

5.5.3 Critiquing shareholder primacy: the Need for a societally inclusive approach to corporate governance

Accordingly, Sjåfjell and Mähönen argue that conflating shareholder value with shareholder primacy is misleading and viewing the UK’s Section 172 approach as the modern stakeholder approach is a misrepresentation when it comes to achieving

[1288] Sjåfjell and others, ‘Shareholder Primacy: The Main Barrier to Sustainable Companies’ (n 1118) 93.

[1289] Egle Lauraityte and Paulius Miliauskas, ‘Sustainable Companies under the Lithuanian Company Law’ (2013) University of Oslo Faculty of Law Research Paper No. 2013-10 <https://ssrn.com/abstract=2248591> accessed on 1st June 2023.

[1290] Sjåfjell and others, ‘Shareholder Primacy: The Main Barrier to Sustainable Companies’ (n 1118) 99; also see Department of Trade and Industry (DTI), ‘Modern Company Law for a Competitive Economy: Developing the Framework’ (Department of Trade and Industry, 2000) ch 2.

[1291] Johannes Heuschmid, ‘The protection of workers under EU company law: the current position and future prospects’, in Sigurt Vitols and Johannes Heuschmid (eds), ‘European Company Law and the Sustainable Company: A Stakeholder Approach’ (European Trade Union Institute 2012) 127.

[1292] Sjåfjell and others, ‘Shareholder Primacy: The Main Barrier to Sustainable Companies’ (n 1118) 100.

[1293] Charlotte Villiers, *Mapping Paper: Sustainable Companies UK Report* (Cambridge University Press 2015).

sustainability in practice.[1294] Sjåfjell and Tsagas assert that '…*a mere canvassing of 'stakeholder interests' and giving priority to the ones that make themselves heard the most is insufficient*'.[1295] Accordingly, Sjåfjell and Mähönen identify three faulty assumptions contributing to this misdirection: 1) that shareholder primacy is reflected in company law, 2) that the Anglo-American discussion on this topic is representative of all jurisdictions worldwide, and 3) that there are only two options: shareholder primacy or a shift towards stakeholderism.[1296] According to the said faulty assumptions, they argue that broader social problems have been externalised through the agency principles discussed by mainstream law and economic scholars. This could have serious repercussions, such as reinforcing the shareholder drive without a legal basis, shifting from shareholder primacy to stakeholder primacy without considering other options, and perpetuating the belief in corporate law that directors are responsible for shareholders, which is assumed to increase the firm's efficiency.[1297] On this backdrop, Sjåfjell, Häyhä and Cornell propose a research-based concept of sustainability.[1298]

As previously discussed, purpose of the company, or what is meant by the interest of the company, has influenced the direction in which directors steer the company within society. Specifically, shareholder primacy has shaped the discourse on how the corporate directors should make decisions,[1299] deviating from the original

[1294] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 11.

[1295] Beate Sjåfjell and Georgina Tsagas, 'Integrating Sustainable Value Creation in Corporate Governance: Company Law, Corporate Governance Codes and the Constitution of the Company' in Beate Sjåfjell, Georgina Tsagas and Charlotte Villiers (eds), *Sustainable Value Creation in the EU: Towards Pathways to a Sustainable Future through Crises* (Cambridge University Press, forthcoming 2022) University of Oslo Faculty of Law Research Paper No. 2022-09, 216.

[1296] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 11; also see Bebchuk and Tallarita (n 1221) and Colin Mayer, 'Shareholderism Versus Stakeholderism – a Misconceived Contradiction. A Comment on 'The Illusory Promise of Stakeholder Governance' by Lucian Bebchuk and Roberto Tallarita' (2020) European Corporate Governance Institute - Law Working Paper No. 522/2020, <https://ssrn.com/abstract=3617847> or <http://dx.doi.org/10.2139/ssrn.3617847> accessed on 5 August 2023.

[1297] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 12.

[1298] Beate Sjåfjell, Tiina Häyhä and Sarah Cornell, 'Research-Based Approach to the UN Sustainable Development Goals. A Prerequisite to Sustainable Business' (28 January 2020) University of Oslo Faculty of Law Research Paper No. 2020-02 <https://ssrn.com/abstract=3526744> accessed 18 May 2023.

[1299] Stefan Grundmann, 'Actors in Organizations' in Stefan Grundmann, Hans-W Micklitz and Moritz Renner (eds), *New Private Law Theory: A Pluralist Approach* (Cambridge University Press 2021) 369-90.

purpose of companies, which is to further the societal purpose of the company.[1300] Interestingly, a cursory examination of the issue often leads to the conclusion that shareholder wealth maximisation is the company's purpose. However, a more in-depth analysis of legal sources reveals a broader range of conclusions, from shareholder wealth maximisation to a more pluralistic purpose that considers various stakeholders. It should be noted, though, that this pluralistic purpose is only evident in certain jurisdictions and often bears a strong resemblance to shareholder wealth maximisation, which continues to hold a revered place in company law, as exemplified by Bainbridge's 'hard candy shell - Tootsie Pop' analogy.'

5.6 Redefining corporate purpose: sustainable value creation and the doughnut economy model

5.6.1 Introducing sustainable value creation and its legal implications

Sustainable value creation, a research-based concept was introduced to the corporate world by Nordic scholars specifically lead by Beate Sjåfjell and Jukka Mähönen through the Smart project. Sjåfjell and Mähönen have argued that the corporate purpose should move away from the existing shareholder primacy and stakeholder debate. Sjåfjell state that *'The goal of creating 'sustainable value', as a redefinition of corporate purpose, must reflect the multifaceted and interconnected environmental, social, cultural, economic and governance aspects of securing the social foundation for humanity*'.[1301] The scholars' position is that this should encompass '*questions of justice and inequality relating to global patterns of consumption and production, resource allocation, benefit distribution, and so on.*[1302]

[1300] Otto von Gierke, *Die Genossenschaftstheorie und die deutsche Rechtsprechung* (Weidmann 1887); Peter Muchlinski, 'The Development of German Corporate Law Until 1990: An Historical Reappraisal' (2013) 14 German Law Journal 339-79; Leonardo Davoudi, Christopher Mckenna and Rowena Olegario, 'The historical role of the corporation in society' (2018) 6 (s1) Journal of the British Academy 11-47.

[1301] Sjåfjell, 'Realising the Potential of the Board for Corporate Sustainability' (n 1272) 706.

[1302] Louis J Kotzé and Rakhyun E Kim, 'Earth system law: The juridical dimensions of earth system governance' (2019) Earth System Governance 1.

or in other words, securing a just space for humanity.[1303] The scholars propose that the '*the purpose of the undertaking is defined in law as creating sustainable value within planetary boundaries*'.[1304] In this EU-funded project, it was specifically highlighted that relying on the compartmentalisation of laws to protect the environment, product safety, and labour, as well as relying on reporting, social norms, self-regulation, or voluntary improvements, would not be sufficient to achieve the aforementioned purpose. This suggests that the protection of stakeholders, specifically the environment, should be internalised into company law. In light of this, it is essential to explore the meaning of 'within planetary boundaries'.

5.6.2 Planetary boundaries: scientific foundations and legal incorporation

Planetary boundaries were discovered by a consortium of eminent scientists from around the globe. The term 'Planetary Boundaries' implies that societal activities should not exceed certain thresholds. Villiers, Sjåfjell and Tsagas argue that it is essential to incorporate the concept of planetary boundaries, grounded in scientific evidence, into the fashioning of company laws.[1305] Research conducted by Rockström and others, Steffen and others, and Richardson and others has demonstrated that life and its physical environment co-evolve, leading to the realisation that human activities are significantly altering environmental processes. [1306] In response, these researchers have developed a framework that identifies critical sustainability pillars, which are nine processes and systems that maintain the stability and resilience of our planet. Each pillar is monitored by specific control variables that act as both indicators and potential points of intervention. These critical pillars include climate change, ocean acidification, stratospheric ozone depletion, biogeochemical flows (focusing on phosphorus and nitrogen cycles), changes in freshwater use, alterations in land systems, shifts in biosphere integrity, atmospheric

[1303] Sjåfjell, 'Sustainable Value Creation Within Planetary Boundaries—Reforming Corporate Purpose and Duties of the Corporate Board' (n 1142) 5.

[1304] Beate Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (2019) University of Oslo Faculty of Law Research Paper No 2019-63, Nordic & European Company Law Working Paper No 20-05 <https://ssrn.com/abstract=3503310> accessed on 11 October 2023.

[1305] Charlotte Villiers, Beate Sjåfjell and Georgina Tsagas, 'Pathways to Sustainable Value Creation' in Beate Sjåfjell and others (eds), *Sustainable Value Creation in the European Union: Towards Pathways to a Sustainable Future through Crises* (Cambridge University Press 2022) 301-314.

[1306] Katherine Richardson and others, 'Earth beyond six of nine planetary boundaries' (2023) 9 (37) Sci. Adv. <https://www.science.org/doi/10.1126/sciadv.adh2458> accessed on 11 October 2023, 6.

aerosol loading, and the emergence of novel entities in the environment. A recent study by Richardson and others concluded that six out of the nine planetary boundaries have already been transgressed. Furthermore, they discovered that both novel entities and genetic diversity, within the context of biosphere integrity, are currently beyond safe limits. However, the precise quantification of novel entities remains uncertain, and the current state of genetic diversity loss is known only with significant uncertainty.

Transgressing one or more of these boundaries could be detrimental to humanity and the environment. They assert that operating within these planetary boundaries is of utmost importance for sustainability,[1307] but currently, according to the recent findings by Richardson and others humanity is placing unprecedent pressure on Earth system.[1308] Franco states that '*Theory and practice inspired by ecological neo-narodnism constitute an alternative to overcome the social and environmental challenges of the 21st century,* ie *tackling inequality and complying with planetary boundaries that impose limits on human activity*'.[1309] This concept paves the way for a shift in global governance and management, moving away from sectoral analyses of growth limits aimed at minimising negative externalities, towards estimating the safe space for human development. Such global governance should aim for a '*paradigmatic shift, in which social justice dictates that minimum living standards should be granted for all, while ecological thresholds enforce a ceiling to the scale of economic processes vis-à-vis those of natural processes*'.[1310]

As significant societal actors with legal standing, firms, along with all other societal actors (including governments, international institutions, universities, and individuals), bear the responsibility to respect these planetary boundaries and undertake measures to operate within these limits without transgressing them. For example, in the 1990s, the boundary for ozone depletion was exceeded. However, thanks to collective actions initiated by societal actors through the Montreal Protocol, this boundary is no longer transgressed.[1311] This serves as an example of

[1307] Johan Rockström and others, 'Planetary Boundaries: Exploring the Safe Operating Space for Humanity' (2009) 14 Ecology and Society < https://www.researchgate.net/publication/284146060_Planetary_Boundaries_Exploring_the_Safe_Operating_Space_for_Humanity_Internet> 4th June 2023; Will Steffen and others, 'Planetary boundaries: Guiding human development on a changing planet' (2015) 347 Science <https://www.researchgate.net/publication/270898819_%27Planetary_Boundaries_Guiding_Human_Development_on_a_Changing_Planet%27> 4th June 2023.

[1308] Richardson and others (n 32) 11.

[1309] Marco Vianna Franco, 'Ecological neo-Narodnism and the peasant economy: history and contemporary relevance' (2021) 28 Journal of Political Ecology 416, 429.

[1310] ibid 429.

[1311] Richardson and others (n 32) 7.

how policymaking and collective actions can help bring planetary boundaries back within safe limits. Franco states that the 'proposed systemic change is predicated on principles of communality and cooperation, as well as on the harmonious coevolution of humans and nature, safeguarding the equilibrium between natural and economic processes and the survival of humanity itself'.[1312] Therefore, this research suggests that amendments to company law should be made in the public interest to prevent the transgression of planetary boundaries.

5.6.3 The doughnut economy model: a paradigm shift for corporate sustainability

Sjåfjell defines corporate sustainability as:

> when businesses (or, more broadly, economic actors) in aggregate create value in a manner that is (a) environmentally sustainable in the sense that it ensures the long-term stability and resilience of the ecosystems that support human life, (b) socially sustainable in the sense that it facilitates the respect and promotion of human rights and other basic social rights as well as good governance, and (c) economically sustainable in the sense that it satisfies the economic needs necessary for stable and resilient societies.[1313]

Interestingly, diving into this definition it can be seen that three concepts have been taken into account, namely, the planetary boundaries, human rights, and social foundation stipulated in the doughnut economy model proposed by Kate Raworth in her book 'Doughnut Economics: Seven Ways to Think Like a 21st-Century Economist'.[1314]

Villiers, Sjåfjell and Tsagas argue that the concept of planetary boundaries, which defines sustainability as securing the social foundation for humanity, should be encapsulated in the goal of a 'safe and just space for humanity'.[1315] Raworth designs an economic model shaped like a doughnut, tailored to meet the future needs of humanity. She emphasises that an excessive focus on Gross Domestic Product (GDP) as the measure of success is a significant pitfall for sustainable progress.

[1312] ibid 429.

[1313] Beate Sjåfjell, 'Redefining the Corporation for a Sustainable New Economy' (2018) 45 Journal of Law and Society, 29–45, 36.

[1314] Kate Raworth, *Doughnut Economics: Seven Ways to Think Like a 21st Century Economist* (Random House Business Books 2017).

[1315] Villiers, Sjåfjell and Tsagas (n 1265) 6.

Instead, she advocates replacing GDP with an alternative goal: a 'safe and just space for humanity' within a regenerative and distributive economy.[1316]

Raworth contends that these planetary boundaries should incorporate governments' social priorities outlined at Rio+20. These priorities can be grouped into three clusters:

Wellbeing: characterized by food security, adequate income, improved water and sanitation, and healthcare.

Productive: achieved through education, decent work, modern energy services, and resilience to shocks.

Empowered: denoted by gender equality, social equity, and political voice.[1317]

These clusters form the basis for Raworth's Doughnut Economics model, which guides societal actors towards a sustainable future. The inner circle of the doughnut represents these social priorities - a social foundation or the basic needs for humanity within a sustainable economy. The outer circle signifies planetary boundaries (an ecological ceiling) concerning issues like climate change, air pollution, and land conversion.

Raworth argues that governance and management should strive to keep economic activities within these two boundaries to secure a safe and just space for humanity. If economic activities exceed the planetary boundaries by overusing natural resources, it could result in severe repercussions for both the economy and humanity – a clearly unsustainable option. On the other hand, if the economy fails to reach the inner circle, individuals may struggle to meet their basic needs. Hence, Raworth proposes replacing GDP with the balance between these two boundaries as a measure of success.

[1316] Raworth (n 1) 44.
[1317] UN High-Level Panel on Global Sustainability, Resilient People, Resilient Planet: A Future Worth Choosing (Report for the 2012 Rio+20 Earth Summit, United Nations, New York, 2012).

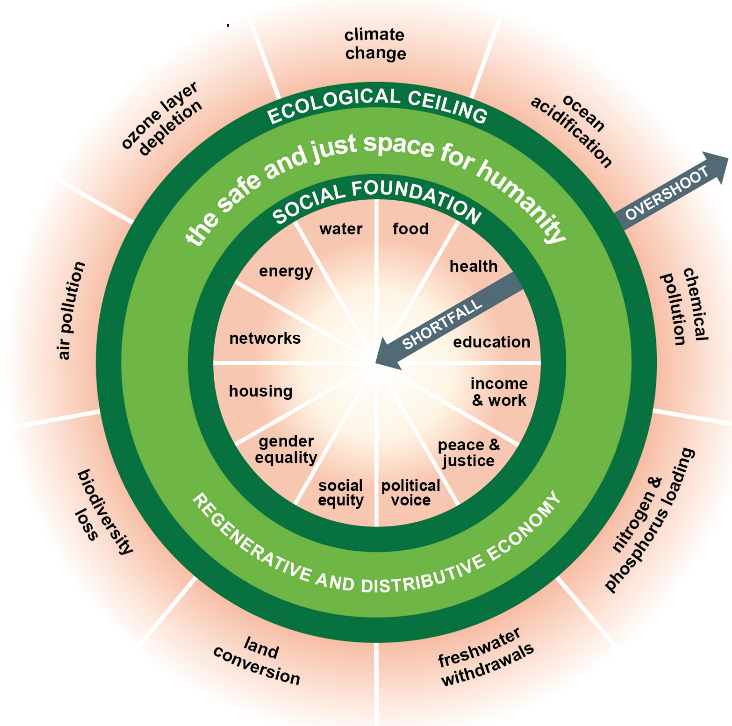

Figure 4 - Doughnut Economics model by Kate Raworth[1318]

Additionally, Raworth proposes six changes to the existing economic structure. She advocates for a holistic perspective that does not solely focus on financial aspects, embedding the economy within larger systems such as society, the Earth, and even the solar system, with the ultimate aim of serving life. She emphasises the importance of nurturing human nature by fashioning economies that cater to all human beings. She critiques the current focus on Homo Economicus, which instils self-interested traits in future economists, suggesting a shift from self-interest thinking to socially reciprocating thinking. This shift could facilitate humanity's movement into the safe and just space of the doughnut model.

Raworth's fourth proposed change is to deepen our understanding of the systems constituting the world, such as economic, social, and ecological systems, and navigate through them to comprehend their interconnections and the needs of individuals, communities, and societies. This understanding would better inform decisions promoting sustainability and equality. As such, she proposes moving away

[1318] Kate Raworth, 'A safe and just space for humanity: Can we live within the doughnut' (2012) 8 Oxfam Policy Pract. Clim. Change Resil; Raworth (n 1).

from overly complex economic models based on equilibrium and embracing systematic thinking to better understand economic dynamics. She further emphasises the vital role economists can play in creating a more just and sustainable world.[1319] Raworth suggests that '*economists should act not as engineers controlling the economy, but as gardeners nurturing and shaping it*'.[1320]

Raworth also challenges the Kuznets curve - a concept suggesting that market forces initially increase and subsequently decrease economic inequalities as an economy develops.[1321] She argues that this model is not only inaccurate but also potentially detrimental when applied to environmental issues. In particular, she refutes the assertion that environmental pollution must first increase before economic growth can mitigate it, citing a lack of substantive evidence to support such a hypothesis. As an alternative, Raworth advocates for the creation of a regenerative economy, whereby business models are transformed to convert waste into valuable commodities. Furthermore, she contends that wealth distribution mechanisms are not confined to the framework of the Kuznets curve. Raworth emphasises that wealth, whether derived from land ownership, companies, technologies, or money creation, should be distributed equitably in conjunction with incomes.[1322]

Importantly, Raworth highlights the necessity of being agnostic about economic growth and acknowledges that economic growth must not exceed its limits by exploiting resources. She suggests striving to satisfy our needs and those of our planet in a manner that maintains harmony with the environment. Environmental disasters, such as tsunamis, earthquakes, and floods, can pose significant risks to humanity.[1323]

Raworth has outlined seven approaches for thinking like a 21st-century economist and has formulated a framework in the form of the Doughnut Economics model to guide policymaking. In shaping corporate law, adherence to her seven principles and the incorporation of the Doughnut Economics model can be instrumental. Similar to the judicial obligation of adjudicators to mitigate losses for both parties by striking a balance, policymakers must also strive to establish an equilibrium when fashioning laws. Specifically, public interest should be paramount in policymaking, and harmonising the social foundation with ecological ceiling boundaries serves this interest optimally. It is advantageous for companies to operate

[1319] ibid 14.
[1320] ibid; Florian Ross, 'Kate Raworth - Doughnut Economics: Seven Ways to Think Like a 21st Century Economist (2017)' (2019) 11(2) Regional and Business Studies 81, 83
[1321] Gene M Grossman and Alan B Krueger, 'Environmental Impacts of Economic Growth' (1991) 81(2) The American Economic Review 253-257.
[1322] Raworth (n 1) 144.
[1323] ibid 35.

within planetary boundaries, as deviation could lead to detrimental repercussions including environmental restoration costs, diminution of brand value, and potential insolvency due to consumer loss.

Consequently, this research suggests a paradigm shift from an exclusive focus on shareholder interests to the realisation of the objectives outlined in the Doughnut Economics model via corporate laws. A growing body of research, including this study, recommends supplanting shareholder value with sustainable value creation, reflecting that the primary aim of a corporation should be to strike a balance between the social foundation and ecological ceiling in its operations. In doing so, according to the third agency principle discussed in chapter three, shows that this will benefit the company in the long term and, thus, ultimately increase shareholder value in the long term. Furthermore, empirical evidence supports the premise that firms engaging in socially responsible and environmentally considerate practices ultimately reap financial benefits.[1324]

For example, Fatemi and Fooladi, drawing on empirical evidence, argue that there is *robust support for the proposition that firms are rewarded for focusing on sustainability*. They also state that a *growing body of evidence indicates that the market's valuation of firms is increasingly reflecting expectations for improved societal and environmental performance*. They suggest that this evidence, coupled with the exponential rise in the costs associated with addressing social and environmental damage (both the ex-post and ex-anté), indicates that sustainable value creation is the only viable path forward. They further opine those early adopters of this framework (ie those that move away from the traditional short-term focus and embrace a sustainable value creation model) will reap the benefits of a market value premium, while firms that fail to adopt this model will lag behind in creating value for shareholders.[1325]

Thus, the integration of the Doughnut Economy Model into corporate governance laws will likely generate profits for companies in the future. This integration represents a strategic shift, acknowledging that sustainability and environmental responsibility are not merely ethical imperatives but also core drivers of long-term profitability and shareholder value. It can be argued that if companies align their business practices with the need to address the escalating crises resulting from the breach of planetary boundaries, those that adjust their operations to meet the ecological limits and social foundations stipulated in Raworth's model can gain a competitive advantage.

For example, public awareness and stakeholder expectations are shifting, and firms operating within these sustainable parameters are not only avoiding the

[1324] Fatemi and Fooladi (n 1084) 111.
[1325] ibid.

increasing costs associated with harmful environmental impacts due to their operations but also enhancing their market valuation, as indicated by the research of Fatemi and Fooladi. Other elements that can contribute to increasing a firm's profitability due to the integration of the Doughnut Economy Model result from direct or indirect effects of strengthening the social foundation. For instance, enhancing the social foundation can provide a better base for non-stakeholders such as employees, potentially leading to improved performance and loyalty toward the firm, and encourage consumers from the local community to contribute to the firm's survival, such as through increased purchases.

Consequently, this research advocates for the internalisation of environmental impacts, supported by the third agency principle discussed in Chapter three, which emphasis the long-term benefits to companies, manifesting in increased shareholder value. The Doughnut Economy Model, with its emphasis on a 'safe and just space for humanity', offers a clear framework for this internalisation. Therefore, the adaptation of corporate laws to embed these principles is not just recommended but I believe an essential for sustainable value creation, guiding companies to operate within a system that acknowledges the interdependence of economic performance, human well-being, and environmental health.

CHAPTER SIX – CONCLUSION

6.1 Introduction

The SMART project advocates for a significant redefinition of corporate purpose. It proposes that company law should not only counter shareholder primacy but should also direct companies towards a sustainable future.[1326] This transformative proposal aims to redefine business and finance operations in alignment with the principles of the circular economy, changing how products are produced and consumed. The project promotes a comprehensive shift in business practices, alleviating the pressure on directors to maximise shareholder profits and instead requiring them to pursue sustainable value within planetary boundaries. This objective is to be integrated throughout their global value chains. In addition to these changes, the SMART project also recommends encouraging sustainable financing and transitioning away from unsustainable investments. It advocates that products sold in the EU must adhere to circular production and consumption principles.[1327]

Sjåfjell and Mähönen provide a roadmap for boards to achieve corporate sustainability. They recommend integrating the proposed overarching purpose into the 'corporate business model, strategy, and risk management - all fundamental elements of the board's duty - and require mandatory sustainability due diligence…'.[1328] The SMART project also calls for external verifications of due diligence reports submitted by companies to prevent greenwashing, and it argues for coherent and forceful legislation to enforce these mandatory measures. This

[1326] Beate Sjåfjell and Jukka Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (21 February 2022) University of Oslo Faculty of Law Research Paper No. 2022-43, <https://ssrn.com/abstract=4039565> or <https://dx.doi.org/10.2139/ssrn.4039565> accessed on 15th July 2023, 16; also see Beate Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (2019) University of Oslo Faculty of Law Research Paper No 2019-63, Nordic & European Company Law Working Paper No 20-05 <https://ssrn.com/abstract=3503310> accessed on 11 October 2023.

[1327] Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (n 30).

[1328] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264) 20.

approach aims to mitigate the risk of unsustainability and create a level playing field for businesses transitioning to sustainability.[1329] The project further suggests, inter alia, changes to directors' duties and the company's articles to further sustainable value creation.

This research focuses on identifying ways to increase firm efficiency and achieve corporate sustainability concurrently, using the three agency models discussed previously in Chapter three as a framework. Moreover, it provides alternative methods for companies to achieve the goals of the Doughnut Economics model. The research findings are based on innovative amendments to existing company law legislation. These findings are further detailed in two subheadings: Subheading 6.2 discusses findings on the second agency problem, while subheading 6.3 focuses on the third agency problem. A concise summary of the findings, presented in bullet form, can be found in subheading 6.4 under the synopsis.

6.2 Findings on the Second Agency Problem

In sections 6.2.1 to 6.2.4, this research presents a detailed analysis and potential solutions to address the second agency problem in corporate structures through the means of arbitration.

Section 6.2.1 highlights the importance and potential benefits of addressing issues related to prosocial investors. In section 6.2.2, the research provides a comprehensive overview of monitoring mechanisms discussed in the comparative part of this research.

Section 6.2.3 provides a comprehensive overview of the *Rationes decidendi* and *obiter dicta* both in favour and against arbitration in common law jurisdictions. By comparing the differing legal stances across these jurisdictions, the section offers a detailed global perspective on arbitration's role in mitigating the second agency problem. This section further discusses potential amendments to company law to facilitate the resolution of disputes related to the second agency problem through arbitration. By proposing a set of conditions under which disputes could be arbitrated, it aims to streamline legal proceedings, thereby reducing the costs and complexities inherent in corporate disputes.

Finally, in section 6.2.4, the research proposes legal strategies specifically aimed at resolving disputes arising from the second agency problem. It introduces legal strategies as guidelines in general for jurisdiction's to fashion a *sui generis* shareholder remedy provision that allows for arbitration in cases of oppression, mismanagement, and unfair prejudice, thereby offering an efficient solution for

[1329] Sjåfjell and others, 'Supporting the Transition to Sustainability: SMART Reform Proposals' (n 30) s 5.2.3.5.

managing intra-corporate disputes and facilitating prosocial investors to further sustainability.

Taken together, these sections of the conclusion chapter synthesise the research's findings on the second agency problem, provide a comparative analysis of legal stances across different jurisdictions, and propose legal strategies to address this issue. By doing so, they pave the way for more effective and efficient dispute resolution within corporate structures.

6.2.1 How Could Sustainable Investments and Shareholder Remedies Drive a Paradigm Shift?

In the heart of this thesis lies a complex yet crucial interplay between investor protection and sustainable development within the modern economic landscape. This thesis aims to unravel how legal safeguards for investors (especially for prosocial), particularly for non-controlling shareholders, are not merely vital for the integrity of the capital market or for the business development by closely-held companies, but also serve as a stepping-stone for sustainable business practices. The key to finding solutions for the second agency problem is in the recognition that protecting shareholders, especially in private companies, act as a significant catalyst for innovation and sustainable business expansion.

Fatemi's and Fooladi's study suggest that there has been a significant growth in socially responsible investments (SRI). For example, in the US, SRI grew from $639 billion in 1995 to over $3 trillion in 2009, which accounts for one out of every eight dollars invested. In Europe, the SRI under management surpassed $7 trillion in the same year, with nearly half of each dollar invested being socially responsible.[1330] Moreover, recent reports by Deloitte indicate that by 2024, assets mandated by Environmental, Social, and Governance (ESG) criteria are expected to constitute half of all professionally managed global assets. This surge in ESG can be because of the adoption of new disclosure regulations in the European Union[1331] and the growing demand from clients for sustainable investment products.[1332]

[1330] Ali M Fatemi and Iraj J Fooladi, 'Sustainable finance: A new paradigm' (2013) 24 Global Finance Journal 101 <https://doi.org/10.1016/j.gfj.2013.07.006> accessed on 4 August 2023, 110.

[1331] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088> accessed on 17 June 2023.

[1332] Tania Lynn Taylor and Sean Collins, 'Ingraining Sustainability in the Next Era of ESG Investing' (Deloitte Insights, 5 April 2022) <https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-and-sustainability.html> accessed 17 June 2023.

Despite enduring macroeconomic pressures such as rising interest rates, inflation, and an impending recession, a report by Morningstar suggests that global sustainable funds experienced only a temporary dip in inflows and product development in the first quarter of 2023. By the end of March, they recovered, bolstered by higher valuations. The report also highlights a significant push for new sustainable funds globally, with Europe leading the initiative by holding 84% of global sustainable fund assets.[1333]

Moreover, investors have begun to recognise and capitalise on the opportunities presented by the transition to cleaner energy sources as a strategy to combat climate change. These investors, who fall under the category of 'prosocial investors' as aptly termed by Hart and Zingales,[1334] play a crucial role in advocating for sustainable corporate actions including climate action. This thesis asserts that these prosocial investors should be equipped with the necessary legal tools to steer corporate affairs in this green direction. Morningstar's recent reports further concur with the key role of investors in the fight for climate action.[1335]

It is crucial to emphasise the importance of investor protection in the healthy development of the capital market.[1336] Protecting shareholders and/or owners of private companies can be paramount in encouraging entrepreneurs to develop new business ideas and start a business. For example, in Raynolds v. Diamond Mills Paper Co.,[1337] a suit brought by non-controlling shareholder of a closely held corporation for demanding dividends, the court held that it is equally important to

[1333] Hortense Bioy and others, 'Global Sustainable Fund Flows: Q1 2023 in Review' (Morningstar Manager Research, 25 April 2023) <https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/bltefc96189f40e7a3f/6489ebdd48a8ff3e794767d7/Global_ESG_fund_flow_report_Q1_2023_FINAL(1).pdf> accessed 17 June 2023.

[1334] Oliver Hart & Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (2017) 2 Journal of Law, Finance, and Accounting 247, 270.

[1335] Hortense Bioy, 'Investing in Times of Climate Change 2023' (Morningstar, 2 May 2023) <https://www.morningstar.com/funds/investing-times-climate-change-2023> accessed 17 June 2023.

[1336] Ashwini K Agrawal, 'The impact of investor protection law on corporate policy and performance: Evidence from the blue sky laws' (2013) 107 J Financ Econ 417; Frederick S Ahiabor and others 'Shareholder protection, stock markets, and cross-border mergers' (2018) 171 Econ Lett 54; Mark DeFond, Mingyi Hung and Robert Trezevant, 'Investor protection and the information content of annual earnings announcements: International evidence' (2007) 43 J Account Econ 37; Jamal Ibrahim Haidar, 'Investor protections and economic growth' (2009) 103 Econ Lett 1; Di Song and others, 'How Does a Regulatory Minority Shareholder Influence the ESG Performance? A Quasi-Natural Experiment' (2023) 15 Sustainability 6277 <http://dx.doi.org/10.3390/su15076277> accessed on 15th June 2023.

[1337] 60 A. 941 (N.J. Ch. 1905).

expand the business for it to be profitably and advantageously operated, without keeping the shareholders in starvation.

In scenarios where companies must retain profits for sustainability and long-term benefits, certain shareholders might perceive these decisions as oppressive or unfair to their interests. Particularly in closely-held companies, these shareholders have the option to exit the company by invoking unfair prejudice or oppressive remedies, even where constraints such as the difficulty in finding a purchaser for a minority share exist. Consequently, the business judgments made by directors to promote sustainability may not be seen as breaching the corporate purpose or shareholder primacy norm.[1338] Indirectly, this approach upholds the shareholder primacy norm, as shareholders not aligned with sustainability objectives can choose to exit the company and invest elsewhere, in companies whose strategies align better with their preferences. However, if the situation were reversed - if the company is making decisions that disregard the interests of prosocial shareholders - the prosocial shareholders may even choose to exit the company at a loss, lacking a remedy to steer the company in a sustainable direction. Therefore, this research proposes a third limb to protect prosocial investors rights as an amendment to sections similar to unfair prejudice/oppression/mismanagement remedies among other amendments to foster sustainability. This research supports the position that this unorthodox approach enables the company to achieve long-term profits, as discussed in chapters three and six, which highlights that ESG measures are beneficial for the company in the long term and aid in increasing capital by attracting prosocial investors.

This unorthodox method of utilising an unfair prejudice-like remedy will foster market sustainability and liquidity to attract investments to financial markets. Such pro-sustainable legislative intervention will level the playing field for all companies to advance sustainability, compelling non-prosocial investors to adhere to sustainable initiatives undertaken by companies. This will facilitate the hindrance of greenwashing by fund managers because funds marketing themselves as pro-sustainable will be clearly labelled as unsustainable if they fail to adhere company's sustainable initiatives. In the context of closely-held companies, where non-prosocial investors utilise the unfair remedy to exit the company, these companies could be highlighted as prosocial enterprises and attract investments from green venture capital firms, supported by the public at large. Similarly, in publicly-listed companies, acts of oppression or unfairly prejudicial conduct against a prosocial shareholder will reflect in the dilution of the company's brand value and may lead to the company being labelled as unsuitable for investments, resulting in difficulties in attracting small-scale investments. Thus, this unorthodox method of utilising an

[1338] Findings under the third agency problem discuss strengthening the directors' powers to take decisions to promote sustainability in corporate decision-making.

unfair prejudice-like remedy will proactively operate as a proactive mechanism for management to foster sustainability and avoid a takeover due to a devaluation of shares – in fear of losing their jobs.

Furthermore, incorporating sustainable initiatives will make the business community and investors, such as existing shareholders, get adapted to the sustainable landscape in businesses to achieve the Doughnut Economics model goals. Thus, sustainability will become a norm in financial markets and venture capital markets. The overall achievement of the Doughnut Economics model globally is good for humanity and indirectly good for the long-term existence of the business of the company.

Interestingly, it can be argued that an unfair prejudice remedy could serve as an alternative to protect prosocial shareholder rights derived from the shareholder primacy norm. A legal strategy such as an unfair prejudice-like remedy can deter directors from engaging in self-dealing and oppressing non-controlling shareholders. If directors engage in self-dealing, such attempts will become evident in the company's future financial performance, enabling shareholders to take necessary actions – be they criminal charges. In such situations, well-drafted clawback provisions will facilitate the punishment of directors and hold them personally liable. These provisions will provide proactive measures to ensure stricter responsibility for directors to manage the daily affairs of the company prudently.

Moreover, Smith argues that Dodge[1339] is best viewed as a minority oppression case and not reflecting a corporate purpose case.[1340] Similarly, Miller argues that Dodge is not about shareholder value maximisation but rather the protection of minority shareholders.[1341] Also, Elhauge argues that the case is really one about the conflict of interest between controlling and minority shareholders.[1342] Interestingly, Stout claimed that Dodge sets out not the law of corporate purpose, but rather the law governing efforts by a controlling shareholder to oppress minority shareholders.[1343] These academic comments further reveal that the shareholder primacy norm can be addressed through legal strategies such as shareholder remedies because directors are, in most circumstances, especially in closely-held corporations, controlled by controlling shareholders of the company. The idea behind shareholder primacy, which is to protect the shareholders, can be executed through legal strategies such as a *sui generis* unfair prejudice remedy or oppressive and

[1339] Dodge v Ford Motor Co., 170 NW 668 (Mich. 1919).

[1340] Gordon D Smith, 'The Shareholder Primacy Norm' (1998) 23 J Corp L 277, 320.

[1341] Geoffrey Miller, 'Narrative and Truth in Judicial Opinions: Corporate Charitable Giving Cases' (2009) Mich St L Rev 831, 835.

[1342] Einer Elhauge, 'Sacrificing corporate profits in the public interest' (2005) 80 NYU L Rev 733, 774.

[1343] Lynn A Stout, 'Why We Should Stop Teaching Dodge v. Ford' (2008) 3 Virginia Law & Business Review 163, 4.

mismanagement remedy. Thus, it can be argued that the second agency problem can tackle the issues related to the modern shareholder primacy norm-related rights to protect shareholders by fashioning legal strategies according to the second agency principle. In this law and economics method, traditional company law is not ignored to protect shareholders but is enhanced through non-controlling shareholder remedies, which play a key role in curbing corporate control opportunism.[1344] Traditional company law combined with unconventional legal strategies as statutory tools can be utilised to combat unsustainable practices and enable green activists to urge companies toward sustainability.

This thesis, based on its discussions in Chapter three (law and economic theories on shareholder cost) and legislative examination in Chapter four (Comparative analysis on shareholder remedies) proposes a *sui generis* mechanism that enables these prosocial investors to achieve their objectives via shareholder remedies. Simultaneously, this thesis further proposes a proactive framework that allows shareholders to resolve disputes in a cost-effective manner. This framework, which is informed by the economic theories outlined in Chapter three, proposes that the company should bear the shareholders' costs as monitoring cost to increase its residual interests.

Importantly, this draft framework deviates from the traditional doctrinal approach entrenched in shareholder remedies rooted in shareholder primacy thinking. The details of the findings on the deviation of shareholder primacy thinking are further discussed in the subsequent sections under the findings on third agency problems.

6.2.2 Analysis of the comparative study on Shareholders' Rights as proactive monitoring mechanisms

The analysis shows that all the selected jurisdictions are empowered with the principle of freedom of contract, meaning that the Companies Acts have provided greater flexibility for investors to govern their business affairs through articles of association. Accordingly, shareholders can agree on their rights and obligations through the company's articles. Thus, this thesis suggests that the company's articles can play a pivotal role in reducing the agency costs between the controlling and non-controlling shareholders. The main objectives of the company's articles should be to avoid disputes, to act as a *sui generis* dispute resolution mechanism, to facilitate efficiency in daily business affairs and to advance sustainability. According to the stakeholder theory and sustainable value creation discussed in connection to the third

[1344] Jukka Mähönen, 'Shareholder Activism: A Driver or an Obstacle to Sustainable Value Creation?' (2021) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3806011> accessed 17 April 2023.

agency problem promoting sustainability is an important element in corporate governance. Thus, it is important to consider stakeholder sustainability matters in the company's articles. The provisions in the company's articles, therefore, play a pivotal role as proactive and monitoring mechanisms to reduce agency costs in all agency relationships.

In Germany, the company's articles enable investors to agree on certain matters, such as the purpose of the company and the definition of the duty of loyalty (*Treuepflicht*), which is an important proactive measure to reduce the agency costs in the agency relationship. Further, the jurisdictions analysed in the comparative study in chapter four shows that company law is mainly based on the principle of freedom of contracting, allowing investors to self-regulate the rights and obligations of the company's shareholders. The provisions of these Companies Acts allow investors to agree on the company's articles, deviating from what is originally provided in the statutory provisions, ie subject to Articles.[1345] However, each jurisdiction has its own deviations on what statutory provisions are subject to the company's articles, ranging from, eg matters relating to dividends or share purchase to the exercising of voting power and the management of company affairs.

The important principles identified through the chapter four comparative study in increasing cost-efficiency are as follows: the 'fiduciary duties of the directors and controlling shareholders to act in the best interests of the company', the 'German doctrine of duty of loyalty (*Treuepflicht*)', the 'independence of directors and auditors', 'transparency in corporate affairs', 'proactive dispute resolution', 'shareholder (minority) economic rights protection' and 'corporate sustainability'. Accordingly, this thesis suggests that fashioning company law and the company's articles based on the above identified principles in such a manner that they operate as a proactive and monitoring mechanism can facilitate to reduce agency costs. Already fashioned laws and provisions based on these principles include, eg directors' duties, pre-emptive rights, the minority shareholder exit right and the solvency test. Directors' duties and pre-emptive rights fall under the fiduciary duty and shareholder economic rights protection, respectively.

Additionally, this research argues that considering stakeholders' interests is of paramount importance to the long-term best interests of the company. Exit rights and the solvency test fall under proactive dispute resolution and corporate sustainability, respectively. Ultimately, the comparative study and their analysis of the function of the law in reducing agency costs in agency problems shows that 'proactive provisions' and 'monitoring mechanisms' are key areas in improving cost-efficiency.

[1345] See - FCA 13: 6 (4).

6.2.3 Cost-efficient dispute resolution mechanism based on second agency problem

This thesis explores avenues for utilising arbitration as a solution to reduce agency costs, which the company can incur during shareholder disputes based on the second agency problem. Arbitration is widely utilised in the commercial world to resolve disputes, primarily due to its cost-effectiveness, privacy, speed, and party autonomy. Notably, the topic of cost-effectiveness in arbitration has drawn significant academic attention. Several steps have been taken by arbitral institutions to control these costs, eg the International Chamber of Commerce has issued a report on techniques for controlling time and costs in arbitration.[1346] Mistelis and Lew state that the cost of representation constitutes the highest percentage of the total cost of arbitration, ranging from 81% to 94%.[1347] A survey conducted by PricewaterhouseCoopers (PwC) and the Queen Mary University of London School in 2013 reveals that corporations are hiring lawyers with dispute resolution expertise to enhance their in-house capabilities, thereby reducing representation costs and increasing cost-effectiveness in arbitration.[1348] The responsibility for cost reduction in arbitration largely rests with the State and arbitral institutes. Nordic states, among others, are taking measures to enhance the cost-effectiveness of arbitration, including the use of third-party and insurance funding. While this research does not delve deeply into the cost efficiency of arbitration, as this is an ongoing issue being addressed by relevant stakeholders specifically with the help of digitalisation, it proposes the integration of arbitration into corporate governance to enhance cost efficiency and, consequently, increase residual interest. The initial costs associated with establishing an arbitration framework within corporate governance can also be classified as shareholder costs in terms of transaction cost theory and monitoring costs in the context of the agency problem, as discussed in Chapter three.

[1346] International Chamber of Commerce, 'ICC Commission Report: Controlling Time and Costs in arbitration' (2018) <https://iccwbo.org/wp-content/uploads/sites/3/2018/03/861-2-ENG-Techniques-for-Controlling-Time-and-Costs-in-Arbitration.pdf> accessed on 19 June 2023.

[1347] L Mistelis and DM Lew (eds), *Time and Money: Pervasive Problems in International Arbitration* (Kluwer Law International 2006).

[1348] Raphael Ng'etich, 'The Current Trend of Costs in Arbitration: Implications on Access to Justice and the Attractiveness of Arbitration' (2017) 5(2) Alternative Dispute Resolution 111 <https://ssrn.com/abstract=3644333> accessed on 11th June 2023, and also see Queen Mary University of London School of International Arbitration and PricewaterhouseCoopers (UK), 'Corporate choices in international arbitration: Industry perspectives' (2013 International Arbitration Survey) accessed 17 June 2023 <https://arbitration.qmul.ac.uk/media/arbitration/docs/pwc-international-arbitration-study2013.pdf> accessed 17 June 2023.

Integrating arbitration into company law has its own benefits, such as 'privacy', which allows the company to maintain its share value on the public stock market while the current dispute is being resolved. However, certain disputes that may affect the internal affairs of the company can be reflected in the financial markets. Additionally, arbitration provides an efficient mechanism for resolving internal disputes between shareholders and managers. Together with punitive provisions against wrongdoers, an efficient arbitration mechanism would help to increase cost-efficiency by avoiding unnecessary litigation.

In this light, it is important to examine and analyse the court's approach to the arbitrability of such company disputes, which has been extensively considered in the comparative analysis. For instance, the Indian position includes court judgments that highlight several *rationes decidendi* and *obiter dicta* in favour and not in favour of referring the company dispute to arbitration, specifically on oppression and mismanagement remedies.

The *rationes decidendi* and *obiter dicta* in favour of arbitration, inter alia, are as follows:

- The court is vested with a discretionary power to stay the proceedings and refer the matter to arbitration;[1349]
- On the basis that the dispute resolution clause satisfies the requirements of Section 8 (which highlights the prerequisite of an arbitration agreement and the mandatory nature of referring such a dispute to arbitration) and the issues raised in the petition are covered by the four corners of the arbitration agreement;[1350]
- Considering the **mandatory nature** of Section 8, the oppression and mismanagement disputes must be referred to arbitration.[1351]

Rationes decidendi and *obiter dicta* that are not in favour of referring the dispute to arbitration, inter alia, are as follows:

1349 *O P Gupta v Shiv General Finance (P.) Ltd*. (1977) 47 Comp Cas 279 (Del).

1350 *Pinaki Das Gupta v Maadhyam Advertising (P.) Ltd.* (2002) 49 CLA 9: (2002) 4 Comp LJ 318: (2002) 38 SCL 170 (CLB): (2003) 114 Comp Cas 346 (CLB).

1351 *Vijay Kumar Chopra v Hind Samachar Ltd.* (2001) 2 CLC 867: (2001) 40 CLA 313: (2002) 108 Comp Cas 115: (2001) 2 Comp LJ 133: (2001) 30 SCL 80 (CLB); see *Enercon Gmbh v Enercon (India) Ltd*. (2008) 143 Comp Cas 687 (CLB).

- The shareholders have a **statutory right** to invoke the oppression and mismanagement statutory provisions;[1352]
- The court cannot refer the matter to arbitration if the prerequisites stipulated in Section 8 are not satisfied;[1353]
- On the basis that a party to the dispute is not a party to the arbitration agreement and the subject matter does not fall under the arbitration agreement;[1354]
- On the basis that issues raised in the court are separate to the grounds urged in the arbitration application;
- On the basis that the reliefs sought in the court are not connected to the arbitration agreement;
- On the basis that the equitable powers vested in the court to adjudicate issues cannot be exercised by an arbitrator, eg *acts of non-service of notice of meetings, financial discrepancies, and non-appointment of Directors.*[1355]

The common law jurisdictions' position (including that of the UK in the nature of unfair prejudice remedy) on the arbitrability of disputes instituted in terms of the aforesaid statutory provisions is similar to the Indian position. The *Rationes decidendi* and *obiter dicta* in favour and not in favour of referring such disputes to arbitration in the common law jurisdictions are discussed below.

Rationes decidendi and *obiter dicta* in favour of arbitration are as follows, inter alia:

- The unfair prejudice disputes are arbitrable if the remedies sought do not affect any third party, the dispute is covered by the four corners of the arbitration agreement and the arbitral tribunal has the authority to grant remedies sought in the application (English case);[1356]
- The purpose of oppression or unfair prejudice remedies is to protect the commercial expectations of the parties; if the parties have chosen to resolve

[1352] *Re Kare P. Ltd. Surendra Kumar Dhawan v R. Vir* (1997) 47 Comp Cas 276 (Del).

[1353] *V. L. S. Finance Limited v Sunair Hotels Limited* (2001) 4 Comp LJ 321: (2001) 44 CLA 207: (2002) 110 Comp Cas 772: (2001) 33 SCL 475 (CLB).

[1354] *Dr. G. L. Purohit v Dr. S. S. Agarwal* (2011) 163 Comp Cas 205 (CLB).

[1355] Dhananjay Mishra v Dynatron Service P. Ltd. and others Company Appeal (AT) No. 389 of 2018 <https://nclat.nic.in/Useradmin/upload/1610476525cadb92e6423b.pdf> accessed on 3rd January 2022, 18-19.

[1356] Fulham Football Club (1987) Ltd v Sir David Richards and The Football Association Premier League Ltd. [2010] EWHC 3111 (Ch).

such disputes through arbitration, this should be given effect subject to certain conditions, eg it is not contrary to public policy to arbitrate (Singaporean case);[1357]

- On the basis that minority oppression claims are generally arbitrable under certain conditions (Singaporean case);[1358]
- Under Section 5 of the *Sri Lankan Arbitration Act*, a party can object in a court proceeding on certain types of oppression and mismanagement disputes arising out of a joint venture agreement, if the subject matter of the dispute is covered by the arbitration agreement (Sri Lankan case);[1359]
- On the basis that there cannot be a blanket rule that oppression and mismanagement disputes cannot be resolved by arbitration (Sri Lankan case).[1360]

Rationes decidendi and *obiter dicta* not in favour of arbitration are as follows, inter alia:

- On the basis that an arbitration agreement cannot oust the right of a party in a company dispute to invoke statutory remedies, specifically the right to apply for a winding-up order (Australian case);[1361]
- On the basis that the statutory right conferred on the members of the company to seek statutory reliefs at any stage is inalienable (English case);[1362]
- The subject matter of the unfair prejudice dispute falls outside of the arbitration clause owing to the reason that the arbitration clause in the shareholder agreement did not cover disputes arising out of the Companies Act and the company's articles (English case);[1363]

[1357] Tomolugen Holdings Ltd. and another v Silica Investors Ltd. and other appeals [2015] SGCA 57.
[1358] L Capital Jones Ltd v Maniach Pte Ltd. [2017] SGCA 03.
[1359] Heung in Enterprises Company v Alumex (Pvt) Ltd and others HC/Civil/06/2005(02).
[1360] Mahenthiran Subranabiam v Mascons (Pvt) Ltd and others HC/Civil/ 31/2018/CO.
[1361] A. Best Floor Sanding Party Ltd v Skyer Australia Party Ltd. [1999] VSC 170.
[1362] Exeter City Association Football Club Ltd v Football Conference Ltd. [2004] 1 WLR 2910.
[1363] Dickson Holding Enterprise Co Ltd. v Moravia CV and Others [2019] HKCFI; HCMP 2665/2017.

- On the basis that the court is vested with an extraordinary and summary equitable jurisdiction, and such powers cannot be exercised by an arbitral tribunal in relation to the case in hand (Sri Lankan case);[1364]
- On the basis that an arbitral tribunal has no power to address complex issues and complicated situations, as in the case at hand (Sri Lankan case);[1365]
- On the basis of giving regard to the nature and circumstances of the disputes, eg continuing and urgent disputes of serious financial mismanagement and fraudulent acts are not arbitrable (Sri Lankan case).[1366]

Most importantly, Patten LJ in the *Fulham case* stated that it is possible for the arbitral tribunal to first decide on the subject matter and go through the facts to see whether a lesser remedy can be granted by the Tribunal. Additionally, Patten LJ stated that it is possible for the Tribunal to summon any third party and seek their views before deciding on the terms of the award that may affect such a third party. Thus, in my opinion, it is possible to amend company law to resolve certain disputes in arbitration as a proactive step. Statutory arbitration of corporate disputes can increase the efficiency of the company by providing privacy on disputes, solving problems efficiently and imposing proactive economic deterrence on the losing party by bearing the arbitration costs.[1367]

However, it is important to note that not all disputes related to the aforementioned remedies can be arbitrated, as arbitrability largely depends on the circumstances of the specific dispute in question. Therefore, this research systematically explores the potential for arbitration in disputes relating to oppression, mismanagement, and unfair prejudice remedies. This systematisation is accomplished by scrutinising case law through comparative analysis in Chapter four. Consequently, this research proposes that disputes can be resolved through arbitration if the following five conditions are met:

1. The dispute at hand is covered by the four corners of the arbitration agreement;
2. The dispute is within the powers vested in the tribunal to grant at least a lesser remedy;

[1364] Aitken Spence v Garment Group Ltd & others CHC 02/2003/(2), SC CHC APPEAL 08/2005, and SC CHC APPEAL 08/2005 judgment dated 5.7.2018

[1365] Sumith Chandrasiri Galamangoda Guruge v Serene Pavilions (Pvt) Ltd & others HC/Civil/41/2013/CO.

[1366] Mahenthiran Subranabiam v Mascons (Pvt) Ltd and others HC/Civil/ 31/2018/CO.

[1367] Mitsubishi Motors Corp. v Soler Chrysler-Plymouth, Inc. 473 U.S. 614; Fulham case (n 892).

3. The tribunal is vested with the power to summon third parties who may be affected by the dispute at hand;
4. The tribunal consists of experts capable of examining the dispute; and
5. The tribunal is vested with the power to adjudicate the dispute.

Amending company law to accommodate these five conditions would enhance legal certainty, thereby encouraging disputes to be arbitrated before resorting to court proceedings. This shift could help reduce the backlog of cases in courts, as disputes may have already passed through the evidential stage during arbitration. Additionally, the certainty of the arbitrability of disputes would reduce agency costs in the second agency problem, thereby increasing cost-efficiency.

6.2.4 Proposed legal strategies relating to cost reduction in the second agency problem

This research proposes seven legal strategies to consider for fashioning statutory provisions to address the second agency problem and to create a function, especially for prosocial shareholders, to resolve disputes effectively in order to direct the company in a sustainable direction. These proposals are general, and jurisdictions are free to implement these suggestions as they see fit in their own way. These seven legal strategies are 1) broader grounds for shareholder arbitration, 2) enhanced arbitral authority for efficient dispute resolution, 3) limited rights to appeal, 4) a dispute resolution manager to oversee the dispute, 5) broader remedial measures for shareholder disputes, 6) efficient resolution and cost reduction, and 7) protection of prosocial investors' interests.

The first proposed legal strategy, which is broader grounds for shareholder arbitration, emphasises providing extensive protection to shareholders' rights by broadening the grounds upon which shareholders can initiate a dispute resolution process within the company. The proposed grounds for such extensive protection, which are already discussed in this research, include protecting shareholders from unfair prejudicial acts, acts or omissions detrimental to shareholder interests, and actions harmful to the environment or community. Protection against acts of unfair prejudice is a ground that provides a wider basis for shareholders to protect their rights. Examples of its application can be seen in the discussion in the comparative study under the Sri Lankan and UK comparative studies (see Chapter four, section 4.3.2.4 and 4.4.2.4.). This ground allows arbitration to be initiated if the affairs of the company are being conducted in a manner that is unfairly prejudicial to all or some of its shareholders. 'Unfairly prejudicial' is a broad term that can encompass a range of actions, such as abuse of power by majority shareholders, mismanagement of company resources, or decisions that disproportionately benefit certain

shareholders over others. This legal strategy is particularly important as it acknowledges the potential for internal company practices or decisions to harm its shareholders and provides recourse for those aggrieved parties. Acts or omissions detrimental to shareholder interests ground offers a proactive application for shareholders to react to protect their rights. This part proposes extensive grounds for interim arbitration measures against any act or omission (whether proposed or actual) by the company that is or would be prejudicial. This proposal is significant because it is not limited to actions already taken but includes proposed actions, allowing shareholders to proactively address potential issues before they come to fruition. The term 'prejudicial' in this proactive context is broad and could relate to any decisions or failures to act that could harm shareholders' interests, not just financially but potentially in terms of reputation, future business prospects, or other forms of harm. Furthermore, this research contributes based on the said legal strategy by introducing a third ground: 'actions harmful to the environment or community'. Such a ground can be drafted as for example, 'that an actual or proposed act or omission by the company, including an act or omission on its behalf, is or would be harmful to the environment, the local community, or the company's social license to operate'. This progressive suggestion aims to extend protection to the interests of prosocial investors, emphasising a commitment to environmental and social responsibility. This reflects an evolving understanding of corporate responsibility that extends beyond shareholder profit and into the realm of social and environmental accountability. Arbitration under this ground could be based on actions that, for instance, cause pollution, exploit communities, or otherwise harm the company's ability to operate sustainably.

The second proposed legal strategy, which is enhanced arbitral authority for efficient dispute resolution, should empower the arbitral tribunal to adjudicate matters and decide if a lesser remedy is suitable, enhancing the flexibility and responsiveness of the process. However, it should also acknowledge the limits of an arbitral tribunal's power, allowing for the transfer of cases to the appropriate courts when necessary. Further, it is suggested to establish a fast-track court with digital capabilities to deal Awards emanating from the intra-shareholder disputes.

The third proposed legal strategy, which is limited rights to appeal, should emphasise the parties' right to appeal the arbitral award in court, which ensures that the arbitration process does not deny parties the right to judicial review and maintains a system of checks and balances. However, the right to appeal should be based not on the facts already dealt with in the arbitral proceedings but on limited grounds such as public interest.

The fourth proposed legal strategy, which is dispute resolution manager oversight, emphasises the importance of appointing a dispute resolution manager from the beginning of the dispute to oversee it. The dispute resolution manager's

main duties are to continuously observe the dispute and direct it at any stage for efficient resolution to reduce costs. Further, the rationale is that while executing these duties, the manager will calculate the economic losses and benefits of the dispute and bring them to the attention of the parties at all stages.

The fifth proposed legal strategy, which is broader remedial measures for shareholder disputes, emphasises that the Award should contain remedies which the court has the power to enforce, and the Award itself will not be subject to challenge. In that way, the court can directly enforce the Award if a party does not voluntarily adhere to its content.

The sixth proposed legal strategy, focusing on efficient resolution and cost reduction, emphasise the importance of incorporating tools for efficient dispute resolution and cost management into statutory provisions. This is particularly crucial in corporate arbitration, where financial stakes are often high, and disputes have the potential to drag on for extended periods. Examples of such efficient resolution and cost reduction management tools could be mechanisms similar to Part 36 of the Civil Procedure Rules 1998 in the UK. Essentially, if a party does not accept a sensible Part 36 offer made by the opposing side, they risk facing penalties related to legal costs and interest at the conclusion of the case. Therefore, making such an offer is a legitimate strategy to exert pressure on the other side to settle, and it should not generally be interpreted as a sign of weakness.

The seventh proposed legal strategy, which is protection of prosocial investors' interests, emphasises the rights of prosocial investors to initiate proceedings based on harm to the environment or local community. This proposal recognises the growing importance of planetary boundaries and importance of prosocial investors. This aspect of the legislation is particularly forward-looking and acknowledges the expanding role of corporations in society as active players in achieving the targets of the doughnut economy model discussed in this research.

This research suggests that the proposed legal strategies for fashioning statutory provisions could effectively mitigate agency costs associated with the second agency problem, given the potential threat of legal action by affected non-controlling shareholders. Notably, Section 994 of the CA 2006, which addresses unfair prejudice, is primarily invoked in closely-held companies within the UK. Esser and Loughrey have stated that intra-corporate litigation—namely, litigation initiated by shareholders against the company and/or its directors, or by the company against its directors—is practically non-existent in dispersed shareholder-owned and listed public companies.[1368] They argue that shareholder litigation is more feasible in

[1368] Irene-Marie Esser and Joan Loughrey, 'Stock corporations: corporate governance and external and internal controls' in Andrea Vicari and Alexander Schall (eds), *Company Laws of the EU: A Handbook* (Beck/Hart 2020) 1534.

smaller companies where personal relationships between directors and individual shareholders are present.[1369] The logic behind this is that shareholders in dispersed share-ownership companies have access to a liquid market for their shares, providing a straightforward and less costly means of responding to unfair prejudicial actions by directors.[1370] As Hannigan points out, shareholders might even choose to sell their shares at a loss to evade entanglement in litigation,[1371] thus rendering Section 994 of the CA 2006 practically ineffective in dispersed share-ownership and listed companies in the UK.

The proposed amendments to the unfair prejudicial remedy could provide a less expensive litigation option through arbitration, known for its cost-effectiveness. Furthermore, litigation through arbitration could impose considerable costs on wrongdoers as they would be expected to shoulder the cost of the arbitral proceedings. However, these costs could be reduced through the proposed amendments, which introduce in-house mechanisms, such as a dispute resolution manager, to decrease these expenses.. Therefore, shareholders are unlikely to bear hefty litigation costs under the proposed new unfair prejudicial remedy.

Hannigan further asserts that disputes in public companies typically centre around the business direction, management standards, and investor returns.[1372] The proposed amendments to the unfair prejudicial remedy, particularly the aforementioned third ground, could provide prosocial investors with a cost-effective dispute resolution mechanism to guide businesses towards sustainability. This could help companies avoid unnecessary greenwashing litigation instigated by environmentalist groups, potentially leading to substantial liability costs for the company, among other costs outlined in Chapter three.

Accordingly, this research proposes that the drafted provision could be used to reduce costs arising from the second and third agency problems outlined in Chapter three. The second agency problem generates monitoring costs to mitigate the costs arising from disputes between controlling and non-controlling shareholders, such monitoring costs are defined as 'shareholder costs' within the context of transaction cost theory (see - discussion in Chapter three). The third agency problem results in reputational costs, relocation costs, litigation costs, and the potential risk of insolvency due to customer loss. Monitoring costs to mitigate these costs are referred to as 'stakeholder costs' in the context of transaction cost theory (see - discussion in Chapter three and six). Costs arising from the said agency problems can be proactively mitigated through the proposed legal strategies. Although the firm would

[1369] ibid 1535.
[1370] ibid.
[1371] Brenda Hannigan, *Company Law* (6th edn, Oxford University Press 2021) 432.
[1372] ibid.

face initial monitoring costs to establish this mechanism, these costs would be minimal compared to the potential risk of incurring the previously mentioned costs stemming from agency problems.

6.3 Findings on the third agency problem

This comparative study in Chapter four scrutinises the stakeholder protection legal strategies of selected jurisdictions. While the primary emphasis of this thesis lies in environmental considerations, it concurrently highlights other stakeholder protection legal strategies, thereby reinforcing the significant role that various stakeholders play in addressing the third agency problem.

Section 6.3.1 unveils findings, embarking on an exploration of stakeholder costs and their implications for corporate governance and sustainability. It highlights a necessity of a balanced approach to ensure long-term stability and success. Subsequently, this section introduces findings from the comparative analysis in chapter four in respect of proactive monitoring mechanisms to curtail stakeholder costs, with a special focus on environmental considerations. It evaluates various legal strategies implemented to mitigate potential conflicts between the firm and its diverse stakeholders. Accordingly, the legislative frameworks of the UK Companies Act 2006 and the UK Stewardship Code are evaluated for their efficacy in promoting sustainability and addressing the third agency problem.

In addition, Section 6.3.2 provides a critical assessment of the company's purpose, advocating for a reorientation of corporate objectives to more closely align with public interest and environmental sustainability. Section 6.3.3 proposes draft legal strategies aiming to mitigate the costs associated with the third agency problem, suggesting novel solutions like sustainability tests and a business classification system based on environmental impact. Lastly, Section 6.4 discusses the role of European Union's Directive on Corporate Sustainability Reporting, Corporate Sustainability Due Diligence, and Equality Treatment in Employment and Occupation in tackling the third agency problem.

This comprehensive investigation offers novel insights into enhancing corporate governance by integrating environmental sustainability into decision-making processes, thus effectively addressing the third agency problem.

6.3.1 Findings on the Stakeholder costs and existing legal strategies to reduce such costs

Finding on the stakeholder costs are one of the highlights of this research. This thesis proposes that addressing the third agency problem, as discussed in Chapter three, can contribute to a significant reduction in stakeholder costs such as liability risk,

one of the most substantial costs a company can incur. Further, this research proposes that addressing the problems in the third agency problem discussed in chapter three of this thesis simultaneously addresses corporate sustainability. Stakeholder costs, such as liability risk, are one key factor which can result owing to the company's unsustainable activities.[1373] The recent and growing number of cases filed against environmental harm and greenwashing are prime examples of actual risks of liability. These cases include the famous Dutch Shell climate case,[1374] Statnett SF et al. v. Sør-Fosen sijte, [1375] De Conto v. Italy and 32 other States,[1376] and a recent case on greenwashing filed by FossielVrij NL against KLM.[1377] The rising litigation globally indicates that companies should prepare to take proactive measures to reduce liability risks. This thesis proposes that legal strategies fashioned to address identified problems in the third agency problem can be utilised to reduce such stakeholder costs such as liability costs.

The comparative study shows that jurisdictions already utilise legal strategies to protect their stakeholders. For example, most of the common law jurisdictions utilise the solvency test, issuing shares to employees, the indoor management doctrine, good governance principles (such as ESG reporting) and considering environmental interests in decision-making. However, it is important to note that Finnish company law also resembles a similar solvency test to common law jurisdictions.

The comparative study in the chapter four show that the level of protection provided to stakeholders depends on the circumstances and that currently, I believe that creditors are afforded higher protection compared to other stakeholders. For example, creditors are provided with a higher level of protection in a situation of the winding-up of the company and also when making a distribution such as dividend payments. The solvency test plays a pivotal role here in protecting creditors, and it can be considered the golden thread that runs through the entire fabric of the

[1373] Sjåfjell and Mähönen, 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' (n 1264).

[1374] The Hague District Court, Milieudefensie and Others v. Royal Dutch Shell PLC and Others, case number C/09/571932, Judgment of 26 May 2021.

[1375] Supreme Court of Norway, Statnett SF et al. v. Sør-Fosen sijte, HR-2021-1975-S, Judgment of 11 October 2021.

[1376] ECHR, De Conto v. Italy and 32 other States, application no. 14620/21, submitted on 3 March 2021.

[1377] Marlies Hesselman, 'A new frontier in (Dutch) climate litigation: Greenwashing advertisements on CO2 compensation' (Columbia Law School Climate Law Blog, 12 July 2022) <https://blogs.law.columbia.edu/climatechange/2022/07/12/guest-commentary-a-new-frontier-in-dutch-climate-litigation-greenwashing-advertisements-on-co2-compensation/> accessed 24 June 2023.

Companies Acts in several common law jurisdictions.[1378] The reason for this is that directors must consider the solvency of the company in most situations, eg before making a distribution and reducing the stated capital. This protection is further tightened by clawback provisions that support the recovery of irregular distributions made contrary to the solvency test and penal provisions to imprison irresponsible and dishonest directors.[1379] In the Finnish company law, FCA 13:2 provides for creditor protection in the case of the company being insolvent or if a decision will make the company insolvent. Thus, solvency is an important condition to be satisfied prior to making a distribution in Finnish companies, which is similar to other common law jurisdictions.

The comparative study shows that employees are also given incentives and statutory protection, but the level of protection can vary depending on the situation and jurisdiction.[1380] For example, German law provides higher protection to employees compared to the other jurisdictions examined in the comparative study. For instance, in Germany, co-determination law requires companies comprised of more than 100 employees to form an economic committee (*Wirtschaftsausschuss*).

The comparative study specifically finds that the main protection measures for stakeholders are transparency (eg disclosure requirements), stringent statutory provisions imposing mandatory requirements reinforced with clawback provisions (eg solvency test), punitive provisions, voluntary codes on the basis of 'comply and explain', and statutory provisions on the mandatory consideration of stakeholder interests (eg Section 172 conditions). Additionally, the comparative analysis shows that the courts are strict in respect of climate change and climate-related disputes including greenwashing claims; accordingly, statutory provisions vesting stakeholder responsibility would facilitate the reduction of unexpected consequences of court cases and adverse effects on the company on the part of environmental interest groups.[1381] However, the comparative study shows that company law does not provide stronger legal strategies to protect the environment for non-listed companies. This thesis highlights that it is crucial for private companies to be regulated to internalise environmental protection. The legal strategies discussed

[1378] See Section 57 (1) of the CA 2007, Section 4 of the NZCA of 1993, 643 of the UKCA 2006, and FCA 13:2.

[1379] See Section 61 of the CA2007 and 643 (5) of the UKCA 2006 respectively.

[1380] Shares provided with restrictions on voting and transferability.

[1381] *Bundesverfassungsgericht* (BVerfG), 24.03.2021 - 1 BvR 2656/181 BvR 78/20, 1 BvR 96/20, 1 BvR 288/20 <https://www.bundesverfassungsgericht.de/e/rs20210324_1bvr265618en.html> accessed on 25th February 2022; also see The State of the Netherlands (Ministry of Economic Affairs and Climate Policy) v Stichting Urgenda ECLI:NL:HR:2019:2007.

above would facilitate the reduction of agency costs that can arise from the third agency problem.

In this light, the comparative study shows that many jurisdictions lack proactive company law provisions to reduce the costs that can arise as a result of direct or indirect impact on the environment by the company's business. In most cases, the company itself will suffer from the negligent or irresponsible decisions of its directors. However, as discussed in Chapter six company law provisions currently favour protecting directors on the basis of the business judgment rule.[1382] In other words, the company itself will incur costs if its directors decide to maximise the profits of shareholders at the expense of the environment, which can have a long-term effect on the company as per the third agency problem discussed in Chapter three.

The UK company law has made it mandatory for boards to consider other stakeholders in their corporate decision-making: the UKCA 2006 introduced such proactive statutory provision in the form of Section 172. As a result, the board's primary duty towards the shareholders is subject to three conditions, including Section 172 requirements.[1383] In this way, the UK has introduced proactive provisions to make directors responsible for their decisions by mandating considerations of the environment as part of the decision-making process.[1384] This provision also operates as a screening process for the decisions taken by the directors, which will indirectly reduce the costs that can arise in the third agency problem. Moreover, the directors cannot rely on the business judgment rule if the conditions stipulated in Section 172 are not satisfied, while the *Companies (Miscellaneous Reporting) Regulations 2018* makes it mandatory for listed companies to issue a public statement on how the board has given due regard to non-shareholder stakeholders. This influences the board to act responsibly in discharging their duties to comply with Section 172. Thus, Section 172 together with the required 'Section 172 statement' provides a barrier for businesses to negatively impact the environment for the company's benefit. In other words, this will directly increase the firm's cost-efficiency as per the third agency problem over the long term.

Section 172 indeed assigns to boards the duty to adhere to laws related to corporate governance. As previously mentioned, if the board fails to provide a statement as required by the Companies (Miscellaneous Reporting) Regulations

[1382] FCA 1:5 - the purpose of the company is to generate profits for the shareholders, unless otherwise provided in the Articles of Association.

[1383] Tom Rose and Dominic Sedghi, 'UK: Corporate Governance Laws and Regulations 2020' (ICLG 14th July 2020) <https://iclg.com/practice-areas/corporate-governance-laws-and-regulations/united-kingdom> accessed on 21st August 2021.

[1384] Section 172 of the UK CA2006.

2018, they could be held accountable under Section 172 of the UKCA 2006. Furthermore, a prosocial shareholder would have the option to invoke a statutory remedy, tailored according to the newly proposed legal strategies mentioned earlier. This remedy could be fashioned to specifically address violations of the Section 172 conditions and statement, operating as a unique prosocial shareholder remedy under the proposed seventh legal strategy.[1385]

However, as discussed in Chapter five Section 172 does not provide a clear pathway for UK companies to achieve sustainable value creation. This is mainly owing to the reason that shareholder primacy is still reflected in section 172 because the directors should give priority to shareholders and then to their stakeholders. However, this thesis highlights that section 172 is a good starting point towards sustainable value creation if the priority from shareholder profit maximisation is replaced by placing the planetary boundaries.

The UK Stewardship Code fosters long-term value through, inter alia, the responsible allocation of resources to benefit the economy, the environment, and society sustainably.[1386] Additionally, the business community's eagerness to interact with stakeholders is evident in the guidance issued by the GC100 and companies' recent activities following the COVID-19 outbreak.[1387] The UK government has also taken steps to enhance sustainability by promoting climate-related disclosure rules for listed companies.[1388] These actions by the UK government and the business community underline the importance of stakeholders for sustainable development. They also demonstrate that addressing such considerations within the context of the third agency relationship can boost cost efficiency and, in the long term, increase shareholder value. However, it is worth noting that climate-related disclosure rules for listed companies are a minor step towards respecting the planetary boundaries, as there are eight other boundaries to consider.[1389] Moreover, these disclosure requirements are not relevant for non-listed companies.

[1385] See section 6.2.4 (proposal on the seventh legal strategy).

[1386] The Stewardship Code 2020 <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf> accessed on 26th August 2021, 4.

[1387] GC100 guidance on section 172: focus on directors' duties <https://uk.practicallaw.thomsonreuters.com/w-017-7364?transitionType=Default&contextData=%28sc.Default%29> accessed on 25th August 2021; also see 953).

[1388] Financial Conduct Authority, 'FCA consults on further climate-related disclosure rules' *FCA* (London, 22nd June 2021).

[1389] These issues encompass climate change, ocean acidification, stratospheric ozone, biogeochemical cycles (nitrogen and phosphorus), global freshwater use, land system change, and the rate of biodiversity loss. Two additional boundaries, chemical pollution

This situation echoes findings by Hardman and Santos, who argue that UK company law (and, I believe, most of the global jurisdictions) tends to address listed companies first, even though the majority of businesses are private, non-listed companies.[1390] Similarly, in Finland, the number of publicly listed companies is small compared to registered non-listed companies.[1391] Hence, it is crucial to address sustainability issues at a foundational level. I believe amendments to company law that promote sustainable value creation could have widespread applicability across all companies.

6.3.2 Findings on the purpose of the company

It is clear that the principle of shareholder primacy, which remains the prevailing social norm underpinning corporate governance, continues to impose significant constraints on the achievement of sustainable value creation.[1392] The comparative study examines that in most jurisdictions the default interest of the company in terms of company law can be placed on a spectrum[1393] – one end being the one end of this spectrum reflects a monistic approach, which aligns the interest of the company with that of its shareholders, mirroring the concept that shareholder value is fundamentally rooted in the maximisation of shareholder wealth.

Even though some jurisdictions seemingly attempt to shift away from this monistic approach towards a more pluralistic end of the spectrum, they are often pulled back towards the monistic paradigm due to the strong embedding of SWM instilled in company law. Given the protective shell that SWM provides for directors, as demonstrated by the ‘hard candy shell - Tootsie Pop’ metaphor proposed by Bainbridge, directors can operate with significant discretion within the bounds of the business judgment rule until challenged by a shareholder. This is because in most jurisdictions the purpose of the company is interpreted as maximising the value of shareholders and the business judgment operate as a defence for directors if directors

and atmospheric aerosol loading, have been considered but have not yet been quantified.

1390 Jonathan Hardman and Guillem Ramírez Santos, ‘Empirical Evidence for the Continuing Need to ‘Think Small First’ in UK Company Law’ (2023) 24(1) European Business Organization Law Review 117, <https://doi.org/10.1007/s40804-022-00258-y> accessed 25 June 2023.

1391 See ‘Company Statistics’ (Finnish Patent and Registration Office 2023) <https://www.prh.fi/en/kaupparekisteri/tilastot/lkm.html> accessed 27 June 2023.

1392 Christopher M Bruner and Beate Sjåfjell, ‘Corporate Law, Corporate Governance and the Pursuit of Sustainability’ in B Sjåfjell & C Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press 2019) 716.

1393 See chapter six for more details on the company interest spectrum.

have taken the decision in that context rather than furthering environmental protection. Further, according to Section 172 of the UKCA 2006 shareholders' interest should be given priority but should consider the environment is a good example where it is pulled back towards the monistic end of the spectrum.[1394] Accordingly, this research compellingly argues for a rearrangement of the company's priority order when making decisions. To facilitate this, directors should be provided with a firm legal anchoring point, much like the business judgment rule currently offers for shareholder interests. As discussed in Chapter five, the ultimate purpose of the company - which shapes the company's interests - serves as this strong legal hold that directors can latch onto. Consequently, the prevailing company purpose, which is shareholder-centric, needs to be realigned towards what this thesis proposes - the 'public interest'. Such a shift is imperative to achieve a balance between the economic ceiling and social foundation, as proposed in the Doughnut Economics model. This model highlights the need for a sustainable future where humanity can continue to thrive within a 'safe and just space'.

Furthermore, this thesis suggests that the current company purpose, centred on SWM, is indeed detrimental to the company itself, as examined in Chapters five and six. This study offers preliminary evidence that the externalisation of environmental costs similarly harms the company. Notably, the comparative study reveals that stringent laws aimed at environmental protection exist in most jurisdictions. For instance, the National Environmental (Amendment) Act, No. 56 of 1988 (NEA) in Sri Lanka serves as the overarching law safeguarding the environment, while a host of key legislations provide a framework for Finnish companies to make environmentally conscious decisions.[1395] Academics argue that such external legislation acts as a barrier, limiting companies from inflicting environmental damage.

In both Sri Lankan and Finnish jurisdictions, the 'duty to act in the best interests of the company' and, in the Finnish context, the 'duty of management', indirectly confine directors within the framework of environmental legislation.[1396] Any infringements can hamper the company's economic growth through the imposition of detrimental costs (ie stakeholder costs), thereby leading to long-term adverse effects on the company, as discussed in Chapter three. Yet, under the SWM principle, directors can potentially shield themselves given that the business judgment rule protects directors who base their decisions on maximising shareholder returns. This

[1394] See Chapter six for more detail on this discussion.

[1395] See Mika Alanko and Robert Utter, 'Environmental law and practice in Finland: overview' (Thomson Reuters 16 September 2013) <www.practicallaw.com/environment-mjg> accessed 26 June 2023.

[1396] See comparative studies on Sri Lanka and Finland.

protective shell indirectly allows companies to incur damages, including reputational losses, due to their detrimental impact on the environment and other externalities, resulting in long-term losses for shareholders.

Thus, this research suggests the implementation of stringent, company law-specific provisions that mandate management to adhere to stakeholder protection. For example, the comparative study examines already existing laws such as the solvency test for creditor protection. Simultaneously, it recommends a redefinition of the company's purpose, grounded in the public interest, to curtail costs arising from the third agency problem. Further, it suggests that aligning the company's goal with the public interest - achieving a balance between socio-economic prosperity and environmental sustainability - is not only in line with recent findings on planetary boundaries but also critical for humanity's survival if these boundaries are breached. The German statutory law, which already prohibits shareholder resolutions that violate public interest among other things, serves as a precedent.[1397] Therefore, a shift in how we conceptualise and operationalise the company's purpose is both necessary and beneficial for sustainable value creation.

6.3.3 Proposed draft legal strategies relating to cost reduction in the third agency problem between the firm and the environment

Based on this thesis's exploration of redefining a company's purpose to balance the economic ceiling with the social foundation, in line with the Doughnut Economics model's vision for a sustainable future, a 'safe and just space for humanity', it recommends the following amendments to company legislation. Specifically, these changes aim to guide directors onto a sustainable pathway, helping companies contribute to a safe and just space for humanity.

Foremost, the thesis proposes a hierarchy of decision-making priorities. Topping this list is the imperative to steer the company to respect the planetary boundaries. This necessitates regulatory changes across jurisdictions worldwide, underlining the crucial need for all governance systems to internalise these planetary boundaries. While this might be the most challenging step, given the existing diverse national interests and potential conflicts, it is not impossible. International organisations, such as the United Nations, World Trade Organisation and International Monetary Fund, can raise awareness about planetary boundaries and emphasise the importance of integrating these boundaries into governance systems.

[1397] Carsten van de Sande and Sven H Schneider, 'Germany' in Willem J L Calkoen (ed) *The Corporate Governance Review* (Law Business Research Ltd 2020) 95.

Additionally, it should be noted that the principles of the Doughnut Economics model — integrating planetary boundaries and maintaining a safe and just space for humanity — apply not just to businesses, but to all entities, including individual global citizens. Protecting the planet and operating within its boundaries is a collective responsibility, due to the wide-reaching and long-term effects of our actions on present and future generations. This thesis offers recommendations for private companies to contribute to this global effort to protect humanity.

Therefore, this thesis suggests that a company's primary purpose should be in the public interest, followed secondarily by the interests of its shareholders. Shareholder interests are already safeguarded through various company law provisions, such as pre-emptive rights, the right to dividends, and other rights examined in the comparative study in Chapter four. As highlighted in Chapter five, equating a company's purpose with shareholder interest does not necessarily bolster shareholder value. However, defining a company's purpose in terms of the public interest can serve as a proactive legal strategy to reduce stakeholder costs. This strategy can enhance shareholder value in the long run while simultaneously protecting the environment, local community, and other stakeholders. Most importantly, it supports the overarching goal of staying within the planetary boundaries.

An example of integrating public interest — alongside considerations of planetary boundaries — into company law could be fashioned in a potential amendment to the Purpose provision in Companies Act. For instance, an existing purpose of a company can be articulated in a typical company law provision as follows: 'The purpose of a company is to generate profits for the shareholders, unless otherwise provided in the Articles of Association'. This thesis suggests the following amendment to such a purpose of the company:

> The primary purpose of a company is to conduct business in the public interest whilst staying within the limits of planetary boundaries and the social foundation, in accordance with the Doughnut Economics model. The secondary purpose is to generate profits for its shareholders, unless stipulated otherwise in the Articles of Association.

Consequently, this thesis suggestion on prioritising the public interest — by planning company affairs with a focus on adhering to planetary boundaries and the social foundation, and secondarily generating profits for shareholders — would enhance the firm's cost-efficiency, ultimately benefiting shareholders over the long term. While the directors' position against shareholders remains protected by company law provisions.

A pivotal finding of this research, through the lens of the third agency problem, is the need to internalise stakeholder costs, specifically environmental costs. It underscores legal strategies that protect the environment through company decision-making as a proactive means to promote sustainability. As discussed in Chapters three and four, most jurisdictions have already integrated stronger creditor and employee protection into their company law. However, the protection of other stakeholders — particularly the environment — is an area of company law still in development. Certain jurisdictions like Albania stand out, where the board is mandated to make decisions in the best interest of the company as a whole, paying 'particular attention to the impact of its operations on the environment' to uphold the business judgment rule defence.[1398]

This thesis, therefore, highlights the importance of legal strategies that protect stakeholders for the sustainable development of a company. The protection required for different stakeholders may vary depending on the circumstances. For example, in the event of a company's liquidation, creditors are currently given greater consideration compared to other stakeholders, notably shareholders. Nevertheless, considering the crucial need to protect the ecological ceiling, the environment should be given priority even during liquidation, especially if the liquidation has environmental implications, although such occurrences are rare.

Furthermore, this thesis advocates for regulatory mechanisms that classify businesses based on their environmental impact, with factors such as greenhouse gas emissions (GHG) being key considerations. Such a classification scheme would aid in the precise quantification and auditing of a business's environmental footprint, thereby ensuring adherence to planetary boundaries. This system would provide a practical tool for data collection and monitoring, enabling businesses to align their operations with the 'safe and just space' encapsulated in the Doughnut Economics model.

Interestingly, Lynch in 1914 proposed classifying corporations by their type and size to provide a more realistic approach to governing the standard of care for directors. His suggested classifications included '(a) ordinary manufacturing, mining, or trading corporations; (b) monied corporations, as banks or insurance companies; (c) public service corporations; [and] (d) charitable, educational, or

[1398] The standard enables the court to consider all aspects of a business decision. This includes the long-term advantages of a group decision, even if it presents short-term disadvantages. These factors are likely to influence the decisions of independent directors of subsidiary companies, who must acknowledge their company's embeddedness in the group, as stipulated in the Albanian Companies Act, Article 98.; see Janet Dine, 'Jurisdictional arbitrage by multinational companies: a national solution?' (2012) 3(1) Journal of Human Rights and the Environment 68.

religious corporations'.[1399] A similar classification can be considered in relation to the ecological ceiling of planetary boundaries. Given that all planetary boundaries have been quantified,[1400] an accounting method resembling to the greenhouse gas Kyoto Protocol should be established for these boundaries.[1401]

The proposed business classification would guide businesses to navigate within a safe and just space for humanity. Therefore, directors should be entrusted with a duty of care to monitor and direct the business in accordance with the planetary boundary limits allocated under the business classification. The duty of care of this nature is further strengthened legally when the purpose of the company is aligned with the public interest in connection to a safe and just space between the ecological ceiling and social foundation. Consequently, this research recommends the following amendments to company law, obligating all businesses to report and adhere to climate change limitations.

Draft provision for the company's sustainable tests (Directors' duty to promote sustainability):

1) Purpose and Application

This provision applies to the board of directors/management of a company. Its purpose is to ensure that directors take into account the company's and its global value chains' impact on the ecological ceiling and human rights when making decisions.

2) Standard of Care on planetary boundaries

The board of directors/management, when exercising powers and discharging duties, must act in good faith and in the best interests of the company. This includes the company's obligations towards achieving a safe and just space for humanity according to the Doughnut Economics model, and adhering to due

[1399] Michael C Lynch, 'Diligence of Directors in the Management of Corporations' (1914) 3 Calif L Rev 21, 28-29.

[1400] Rockström and others (n 32) and Steffen and others (n 32).

[1401] See Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC 1998) <https://unfccc.int/resource/docs/convkp/kpeng.pdf> accessed 27 June 2023; World Resources Institute and GHG Protocol Initiative Team, 'A Corporate Accounting and Reporting Standard: Revised Edition' (World Resources Institute and World Business Council for Sustainable Development) <http://www.ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf> accessed 27 June 2023.

diligence requirements concerning the company's value chain operations, the operations of their subsidiaries, and any adverse environmental and human rights impacts.

3) Sustainability tests

Before making a decision that could significantly impact the ecological ceiling, the directors must comply with the following tests:

a) Greenhouse Gas Emission Test (GHG Test):[1402]

1. Directors must make an honest, diligent, and informed assessment of whether the decision will help the company achieve its net-zero emissions goal within its value chain;

2. Consider the company's current carbon footprint and the potential impact of the decision on this footprint; and

3. Take reasonable steps to mitigate any negative impact on the company's and its global value chains' carbon footprint,

This thesis suggests that similar tests should be fashioned and inserted into this draft provision for relevant classified businesses. For the sake of clarity, the remaining tests are termed as the Biodiversity Loss Test, the Stratospheric Ozone Depletion Test, the Ocean Acidification Test, the Biogeochemical Flows Test, the Land-System Change Test, the Freshwater Use Test, the Atmospheric Aerosol Loading Test, and the Introduction of Novel Entities Test.

4) Liability

If the board of directors/management fails to comply with the Greenhouse Gas Emission Test, the Biodiversity Loss Test, the Stratospheric Ozone Depletion Test, the Ocean Acidification Test, the Biogeochemical Flows Test, the Land-

[1402] The proposed Greenhouse Gas Emission Test is an initial concept aimed at integrating environmental responsibility into directors' duties. It is based on greenhouse gas accounting and reporting standards, but requires further refinement and study. The goal is to incorporate these standards into company law, making environmental consideration a legal obligation for directors. However, this is a complex process that requires expert input from, inter alia, environmental science field. Thus, the current test should be seen as a starting point for further development rather than a final solution.

System Change Test, the Freshwater Use Test, the Atmospheric Aerosol Loading Test, or the Introduction of Novel Entities Test, they may be held personally liable for any damage caused to the company or any third party as a result of this failure.

5) Reporting

The board of directors must include in their annual report a statement confirming that they have complied with the standard of care on planetary boundaries. They must also provide details of the actions taken to stay within the safe and just space for humanity, including adherence to the company's global value chains and any measures taken to mitigate adverse human rights and environmental impacts in the company's value chain.

This test would provide a safety net for any action taken by the company that could have an adverse effect on the environment. This should be expanded in the future to incorporate other planetary boundaries or similar provisions should be drafted in connection to other planetary boundaries. The suggested test should be applicable to companies regardless of their sizes for reporting their greenhouse gas emissions. This provision is designed to ensure that directors are held accountable for the environmental impact of their decisions and that companies take active steps towards reducing their greenhouse gas emissions and other environmentally harmful substances/activities.

The establishment of a sustainability-focused governance framework can impose significant initial costs, which can be particularly challenging for start-up companies. As discussed in Chapter three, these expenses can be categorised as 'stakeholder costs' under the transaction cost theory, necessary for setting up the mechanisms to comply with sustainability tests. It is suggested that governments should intervene to offset these costs by providing financial aid, along with access to requisite knowledge and information. Moreover, from the perspective of agency cost theory, these initial expenditures can be seen as monitoring costs that, despite their immediate impact, contribute to enhancing residual interest in the long term. Therefore, notwithstanding the immediate financial burden, the long-term benefits to the company and its stakeholders could be substantial. Further, these tests would level the playing field, allowing all companies to compete and grow under the same conditions.

Furthermore, I believe that such tests would facilitate the achievement of the Paris Agreement goals and the United Nations Sustainable Development Goals for a sustainable environment.

6.3.4 Insights from European Union's directive on corporate sustainability reporting, corporate sustainability due diligence, and equality treatment in employment and occupation in tackling the third agency problem

The European Commission's initiatives such as the Corporate Sustainability Reporting Directive (CSRD),[1403] Corporate Sustainability Due Diligence Directive (CSDD),[1404] and Equality Treatment in Employment and Occupation (ETEO)[1405] attest to the prevalence of the third agency problem in corporate governance, as discussed in earlier chapters.

The CSRD, which originated from the European Green Deal, mandates companies to incorporate sustainability measures and internalise stakeholder costs. This directive aims to transform the European Union into a modern, resource-efficient, and competitive economy, producing no net emissions of greenhouse gases by 2050. The CSRD facilitates investors' and stakeholders' access to vital information required to assess risks associated with climate change and other sustainability issues. By harmonising disclosure requirements, it reduces companies' long-term reporting costs. Notably, the CSRD mandates the audit of reported sustainability information and encourages the digitalisation of such data. Companies are also required to adhere to the European Sustainability Reporting Standards (ESRS),[1406] facilitating public actors and researchers in monitoring sustainability progress and formulating effective strategies for its achievement.

The CSDD also fosters sustainability by mandating companies to incorporate human rights and environmental considerations into their operations and governance, thereby broadening its applicability to global value chains. As articulated in the third agency problem, companies are required to bear the costs of establishing and maintaining due diligence procedures to alleviate long-term losses, including expenses related to modifying their operations to fulfil due diligence

[1403] See CSRD - Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Text with EEA relevance) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464> accessed on 27 June 2023.

[1404] See Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071> accessed on 30 June 2023.

[1405] 'Council Directive 2000/78/EC of 27 November 2000 establishing a general framework for equal treatment in employment and occupation' <https://eur-lex.europa.eu/legal-content/EN/LSU/?uri=celex:32000L0078> accessed on 30 June 2023.

[1406] For more information on ESRS <https://efrag.org/?AspxAutoDetectCookieSupport=1> accessed on 27 June 2023.

requirements according to CSDD.[1407] These additional compulsory obligations for large and non-listed companies demonstrate the difficulty of circumventing stakeholder costs, a point highlighted by the third agency problem in Chapter three when a company expands and prepares for listing on the stock market. Moreover, the abrupt transition costs companies currently incur to align with sustainability reporting standards and due diligence can markedly affect their financial stability. For example, once sustainability information is digitised and publicly accessible, companies could potentially face greenwashing litigation, as illustrated by the current lawsuits against European Union airlines due to their alleged misleading claims.[1408] The amendments proposed to company law in this research, which demand all firms adhere to sustainability due diligence directive requirements, could help minimise such transition costs as a company plans to list on the stock market during its growth timeline.

CSDD highlights a growing trend among EU companies adopting value chain due diligence as a mechanism to identify risks within their value chains and build resilience against sudden changes. However, the CSDD also notes several challenges faced by companies seeking to integrate value chain due diligence into their operational frameworks. These challenges include a lack of legal clarity around corporate due diligence obligations, the complexity of value chains, market pressures, informational deficiencies, and associated costs.

The draft proposal, as discussed in the aforementioned Section 6.3.3, addresses these issues, particularly the legal ambiguity surrounding corporate due diligence obligations, as well as market pressures, informational deficiencies, and costs. The standard tests stipulated in this research aim to resolve the legal ambiguity regarding the requisite legal obligations. The said provisions proposed as a mandatory provision within the Companies Act, requiring all companies to adhere to this test aims to create a level playing field, thereby alleviating market pressures. Furthermore, the mandatory reporting requirements incumbent upon companies, as per the said test, will contribute to a growing body of information over time. Establishing a level playing field and ensuring the availability of pertinent information is envisaged to reduce operational and compliance costs.

Additionally, this research proposes that the Sustainable Test should encompass the company's global value chain, a key aspect also highlighted in the CSDD. The

[1407] 'Corporate sustainability due diligence, fostering sustainability in corporate governance and management systems' (European Commission, February 2022) <https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en> accessed on 30 June 2023.

[1408] 'Consumer group files greenwashing complaint against Finnair and 16 other airlines' (Yle, 22 June 2023) <https://yle.fi/a/74-20038178> accessed 30 June 2023.

proposals made through the above draft provision will facilitate the implementation of Article 4 Section 1 of the CSDD, covering: (a) integrating due diligence into policies in accordance with Article 5; (b) identifying actual or potential adverse impacts in accordance with Article 6; (c) preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end and minimising their extent in accordance with Articles 7 and 8; (d) establishing and maintaining a complaints procedure in accordance with Article 9; (e) monitoring the effectiveness of due diligence policies and measures in accordance with Article 10; and (f) publicly communicating on due diligence in accordance with Article 11. For instance, the Sustainable Test, when considered by the board of directors in policy decisions, satisfies Article 4(1)(a). Moreover, the Sustainable Test addresses Articles 4(1)(b) and (c), as the board of directors will identify potential adverse impacts and are obligated to prevent and mitigate potential adverse impacts, end actual adverse impacts, and minimise their extent according to scientifically approved limitations. Additionally, an efficient complaints procedure, as per Article 4(1)(d), would enable board members to proactively operate in decision-making to satisfy the proposed sustainability test. Furthermore, the mandatory reporting requirement in the proposed provision addresses Articles 4(1)(e) and (f), as it obliges the company to monitor the effectiveness of their due diligence policy and measures and make this information publicly available in the annual report, which can also be published on the website.

While the CSDD suggestions contribute towards achieving sustainability it is not entirely sufficient to achieve a safe and just space for humanity according to the Doughnut Economics model. The environmental aspect of due diligence discussed in the CSDD will help address the climate change by limiting global warming to 1.5 °C in line with the Paris Agreement. However, it should be noted that recent findings by Richardson and others specifically state that there is increasing evidence suggesting the possibility of extreme Earth system impacts even at 1.5 °C warming, with risks increasing markedly above 1° warming. Thus, it is suggested that the CSDD be amended according to these new findings. On the other hand, a significant advantage of the proposed provisions is that they will mandate the board of directors to satisfy all the sustainability tests according to up-to-date scientific standards to achieve planetary boundary requirements.

The ETEO Directive, one of the earliest EU measures addressing the third agency problem, establishes a framework for equal treatment at the workplace, irrespective of religion, belief, disability, age, or sexual orientation.[1409] The benefits of this Directive to companies include fostering a diversified work environment,

[1409] See ibid.

which can support the emergence of new talents. However, non-compliance may lead to hefty fines and reputational damage, potentially reducing residual interests.

Notably, the CSRD and CSDD are primarily applicable to large and listed companies, which do not constitute the majority of companies in many jurisdictions, including the UK and Finland. This limited applicability can hinder the effectiveness of these directives, as non-listed companies might opt against growth or listing due to the potential transitional costs associated with sustainability compliance. Therefore, groundwork amendments to company law, as suggested in this research to 'first think small', are required to promote sustainability more universally and efficiently.

6.4 Synopsis of the findings

The essence of this research is captured in the following summary. It concisely details the main findings and recommendations pertaining to the second and third agency problems within corporate law. This brief overview stands as undeniable proof of the in-depth exploration and analysis conducted in this interdisciplinary law and economics study. It highlights the innovative solutions proposed, enriching our comprehension and paving the way for possible solutions to these widespread challenges in the contemporary world.

Findings on the second agency problem

- Introduces the concept of shareholder costs in the context of transaction cost theory.
- Highlights key principles for enhancing cost-efficiency in resolving the second agency problem, eg including the duty of directors and controlling shareholders to act in the company's best interest, the German doctrine of *Treuepflicht* (duty of loyalty), the independence of directors and auditors, transparency in corporate affairs, proactive dispute resolution, protection of shareholder (particularly minority) economic rights, and promotion of corporate sustainability.
- Proposes a cost-effective mechanism for resolving shareholder disputes through arbitration.
- Introduces a legal ground for prosocial investors to invoke their interests in the company, eg …….*that an actual or proposed act or omission by the company, including an act or omission on its behalf, is or would be harmful to the environment, the local community, or the company's social license to operate*.

- Systematises the application of arbitration for addressing disputes related to oppression, mismanagement, and unfair prejudice remedies.

Findings on the third agency problem

- Introduces the concept of stakeholder costs in transaction cost theory.
- Advocates that taking on stakeholder rights as monitoring costs can lead to long-term shareholder value increase.
- Redefines the company's purpose to align with the public interest, specifically balancing socio-economic prosperity with environmental sustainability. The secondary purpose is to generate profits for shareholders.
- Proposes a company law solution to achieve sustainability by introducing stringent sustainability tests, tailored to the 9 planetary boundaries, for businesses registered under specific environmental impact categories.
- Proposes regulatory mechanisms that classify and categorise businesses based on their environmental impact.
- Emphasises the necessity for firms to adhere to planetary boundaries and establish a robust social foundation.
- Proposes a level playing field for all companies to promote sustainability on the basis of the 'think small first' ideology, thereby compelling non-prosocial investors to conform to sustainable initiatives taken by companies.

Abbreviations

AI	Artificial Intelligence
CCSs	Corporate Constituency Statutes
CDB	Companies Disputes Board
CDS	The Central Depository Systems (Pvt) Ltd
CEA	Central Environmental Authority
CSDD	Corporate Sustainability Due Diligence Directive
CSE	Colombo Stock Exchange
CSR	Corporate Social Responsibility
CSRD	Corporate Sustainability Reporting Directive
ECMH	Efficient Capital Market Hypothesis
EMCA	European Model Companies Act
ESG	Environmental, Social, and Governance
ESMA	European Securities and Markets Authority
ESRS	European Sustainability Reporting Standards
ETEO	Equality Treatment in Employment and Occupation
FIN-FSA	Finnish Financial Supervisory Authority
GDP	Gross Domestic Product
GHG	Greenhouse Gas Emissions
ICASL	Institute of Chartered Accountants of Sri Lanka
IST	Instrumental Stakeholder Theory
MBCA	Model Business Corporation Act
MCOGs	Minority-Co-Owned Groups
NCLAT	National Company Law Appellate Tribunal
NCLT	National Company Law Tribunal
NPV	Net Present Value
PRI	Principles of Responsible Investments
RDL	Roman Dutch Law
SDGs	Sustainable Development Goals
SEC	Securities and Exchange Commission of Sri Lanka
SHRD II	Second Shareholder Rights Directive
SLO	Social License to Operate

SMEs	Small and Medium-sized Enterprises
SRI	Socially Responsible Investments
SWM	Shareholder Wealth Maximisation
TCFD	Taskforce on Climate-related Financial Disclosures

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