FEGReG Working Paper 08/03

Corporate governance and the theory of the firm: a re-assessment of shareholder primacy in the light of limited liability and the position of creditors

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Acknowledgements

An earlier draft of this paper was presented, under a different title, at the Fourth Transatlantic Business Ethics Conference held at the Wharton School of the University of Pennsylvania in October 2006. The comments of participants – especially John Boatright, Norman Bowie, Nien-hê Hsieh and the late Tom Dunfee – are gratefully acknowledged.

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Abstract

The neoclassical theory of the firm presents an impressive analysis in which the primacy of owners' interests is asserted. It offers powerful insights into the contracting and monitoring challenges that arise when owners, as principals, delegate control to executive managers, their agents. This perspective has had a major impact on debates regarding corporate governance and upon programs of corporate governance reform, especially in the wake of various corporate 'scandals'. However, through an examination of the nature of the limited liability corporation and, in particular, the position of creditors, this paper argues that the abstract theory of the firm should not be taken to imply that shareholders are the only party whose interests currently count in conventional systems of corporate governance. In this way, the paper seeks to disturb the notion of shareholder primacy, pure and simple, thus opening up possibilities for other analyses of the limited liability corporation; and it also highlights for business ethicists the significance of trade creditors and finance creditors whose interests should be recognized and considered.

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Introduction

Any theory of the firm carries with it a set of assumptions, explicit or implicit, about the governance of the firm – perhaps in relation to how governance is to be practiced but, more fundamentally, about in whose interests it should be established and directed.

The upsurge of academic interest in corporate governance has tended to focus on the relationship between the company and its shareholders (stockholders), as have policy debates and initiatives. Public discourse on practical corporate governance is consistent with, and indeed has been influenced by, the neoclassical theory of the firm (Blair, 1998), in particular its identification and analysis of 'moral hazard' within an agency theoretic analysis (see Hendry, 2001, p.161).[1] However, as explained below, groups other than shareholders also have a strong claim to be recognized in discussions of corporate governance. While some have written about governance in the context of a multi-stakeholder theory of the firm (e.g. Freeman & Evan, 1990; see Hendry, 2001 for a critique of such attempts), this paper complements recent debates by examining the position of creditors in corporate governance as a means of disturbing current conceptions of shareholder primacy.[2] This has significant implications for business ethics, because certain positions antithetical to a 'fully formed' or thoroughgoing ethical analysis of business[3] are premised on what I seek to demonstrate is an ill-founded understanding of the nature of the position of shareholders with respect to the governance of the firm.

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[1] In doing this they are focusing on the divorce of ownership and control famously identified by Berle & Means (1932).

[2] At a basic level, creditors can be divided into *trade* creditors and *finance* creditors. Trade credit constitutes the single largest source of short-term funds for many companies (Rigby, 2002, p.75). Finance credit is, broadly speaking, the provision of funds in the form of loans etc, on which the borrower pays a rate of interest. What they have in common is that they have a *fixed* claim to the payment of the principal amount plus any associated interest. Unlike equity shareholders, whose rewards as residual claimants are variable with no entitlement to a return (Maitland, 2001), they do not receive extra rewards if the company does well; nor do they lose their right to payment if the company does badly. Furthermore, both are voluntary creditors. Generally speaking, the points I shall make apply to involuntary creditors too, such as many victims of torts committed by companies (Davies, 2002). However, some of the points, particularly where I discuss how creditors might protect themselves, apply only to voluntary creditors.

[3] Cf. writing on the so-called 'business case' for ethics, where congruence with the financial interests of shareholders is the focus of attention. (For a review of the empirical evidence see, for example, Orlitsky et al., 2003.)

The paper is structured as follows. The first section introduces the topic of corporate governance, highlighting features and issues of significance for the focus of this paper and reviewing some of the arguments in favour of the primacy of shareholders. The second section describes some of the ways in which the interests of the creditors of limited liability companies are protected, paying particular attention to the those features that relate to corporate governance. The third section then discusses the implications of a recognition of the position of creditors in relation to the governance of firms incorporated with limited liability. The fourth and final section presents the conclusions.

On corporate governance and the primacy of shareholders

Corporate governance clearly raises ethical issues and, particularly when discussed in response to perceived ethical failures or 'scandals', entails an ethical agenda of some sort. However, as a public policy issue is a comparatively recent phenomenon, dated by many to the establishment in May 1991 of The Committee on the Financial Aspects of Corporate Governance (Cadbury, 1993). This was set up by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in the UK in response to 'some well-publicized major scandals involving fraud and the sudden collapse of a number of companies shortly after receiving clean audit opinions' (Rutteman, 1993, p.57).[4] The publication of the Cadbury Report in 1992 represents a landmark in modern corporate governance, not only in the UK[5] but internationally,[6] prompting widespread use of a term – even in languages other than English (Wymeersch, 1993) – that previously had little currency.[7] Academics are often criticized for ignoring real-world concerns, but research on corporate governance has increased dramatically, and the last decade of the twentieth century 'saw the emergence of corporate governance as a growing field of study and research in universities and business schools around the world' (Stiles & Taylor, 2001, p.v).

[4] Enron and its well known successors represent just the most recent in a succession of waves of concern (or moral panic) about business corporations which can be traced at last as far back as the nineteenth century.
[5] Fisher & Lovell (2006) – a business ethics text – provides a useful overview of developments in corporate governance in the UK subsequent to the Cadbury Report.
[6] Along with the OECD Principles it has influenced many corporate governance codes across the world (Mallin, 2004).
[7] Midgley (1982) and Tricker (1984) are rare examples of pre-Cadbury books that contain the term in their title.

Not surprisingly, particularly given its relatively recent emergence as a focus of attention, corporate governance has been defined in a variety of ways (Keasey et al., 1997), some of them not altogether satisfactory. Sternberg (1998) argues, for example, that the term itself has broader application than that to which it is generally taken to refer. She makes the point that corporate governance is about corporations and hence is not about all businesses and, more important, is about enterprises other than businesses too, since the corporate form is used more widely, for example by charities. As Davies (2002) notes, the company is one of the mechanisms made available by the state for the carrying on of business, but not all companies need to be formed with a view to making a profit.[8]

However, even though it is clear from their discussions that they have in mind business corporations, the definitions proffered by some authors do not themselves fall foul of Sternberg's criticism. For example, Cadbury (1993, p.46) writes that corporate governance 'in its broadest sense takes in the whole framework within which companies operate'; and Monks & Minow (2001, p.1) define corporate governance as 'the relationship among various participants in determining the direction and performance of corporations'. Nevertheless, for the purposes of this paper I will deal with Sternberg's point by simply making explicit what is implicit in the corporate governance debates to which she refers; when I refer to corporate governance, I have in mind business corporations.

Having delineated the scope of the application of the term for this paper, it is appropriate to comment a little more on the content of corporate governance. Perhaps unsurprisingly, attempts at definition are marked by difference and vagueness. As Keasey et al. (1997) comment, different writers draw very different boundaries of the subject. However, a useful distinction, applicable to most if not all definitions of corporate governance, is made by Tricker, who distinguishes governance from the management of a company: 'If management is about running business; governance is about seeing that it is run properly' (Tricker, 1984, p.6). This simple contrast nicely brings out the 'oversight' aspect of corporate governance, the responsibility for which in the case of a particular company might be taken to fall most obviously to the board of directors, but which also – in a more general sense – lies with other parties,

[8] This applies especially, but not exclusively, to companies limited by guarantee.

including the authorities responsible for setting and administering the framework within which companies operate.

This begs the question of in whose interest the oversight is exercised, particularly by directors. Occasionally, approaches to corporate governance appear to be quite flexible about this, perhaps reflecting differences of emphasis internationally. For example, Prentice (1993, p.25) states that the debate above corporate governance 'at its broadest level involves the issue of the relationship between the *stakeholders* in a company and those who manage its affairs (the board of directors)' (emphasis added). In their well known text on corporate governance, Monks & Minow (2001, p.1), without using the term 'stakeholder', seem to be similarly disposed, for they begin by defining corporate governance as 'the relationship among various participants in determining the direction and performance of corporations'. They mention, *inter alia*, employees, customers, suppliers and creditors – the latter being the focus of this paper. However, they also refer to the three 'legs' of the corporate 'tripod' of 'primary' or 'direct' participants as the shareholders, the management (led by the CEO) and the board of directors; and it is this 'tripod', particularly the agency relationships within it, that forms the focus of their book, with other participants, such as employees and creditors, subsequently neglected.

In so identifying the three 'legs' of their 'tripod', Monks & Minow are acting in accordance with the advice of Klein & Coffee (1988, p.118) that the 'formal structure for control and operation of a corporation can best be described by reference to three basic groups – shareholders, directors, and officers'. Moreover, this is consistent with most conventional views of corporate governance where, whatever the particular definition chosen, it is taken for granted to be about the relationship between shareholders and the company or, more commonly, between shareholders and directors.[9] In interviews in the UK, Stiles & Taylor (2001, p.123) found, perhaps not surprisingly, that directors themselves 'claimed that they acted in the interests of shareholders'.

However, as Boatright (1999) notes, notwithstanding the confidence of the directors whom Stiles & Taylor interviewed, debate rages – at least in some quarters – over the

[9] Sternberg, whose argument about the applicability of the term 'corporate governance' was mentioned earlier, writes that it refers exclusively to 'ways of ensuring that corporate actions, assets and agents are directed at achieving the corporate objectives established by the corporation's *shareholders*' (Sternberg, 1998, p.20, emphasis added).

nature of the corporation. The primacy of the interests of shareholders, usually interpreted as the pursuit of profits or (in more modern parlance) 'shareholder value', is taken for granted by many business people and other commentators; and finance textbooks, for example, rarely, if ever, argue for the claim that the objective of the firm is to maximize shareholder wealth (Boatright, 1999). However, there are significant debates over whether shareholders should be accorded primacy.[10] There are also different arguments for why they should. Both legal and economic arguments tend to be drawn upon when the issue is discussed.[11]

Perhaps the commonest justification for an exclusive shareholder orientation in corporate governance is that the shareholders are the owners. This opinion may at best be useful 'shorthand', but as an argument it has serious deficiencies. It is certainly not the case that a shareholder owns some proportion of the net assets of the business, nor even that the shareholders as a group own them; 'as a matter of law a shareholder (even the sole shareholder) of a corporation does not own the assets devoted to the business of the corporation … the corporation owns the assets' (Klein & Coffee, 1988, p.108; see also Iwai (2007) for an extended analysis). In this understanding is embodied the notion that the company is a legal person separate from its shareholders, which 'is fundamental to the conceptual structure of company law' (Davies, 2002, p.9). Instead, the shareholders own only shares of stock of the corporation (Klein & Coffee, 1988).

However, property rights theory, which says that the corporation is the private property of the stockholders (Boatright, 1999, p.170), can be built on the basis of shareholder ownership of stock. For example, Sternberg (1998, p.21) writes that 'the reason why corporate governance refers solely to shareholders, and not to stakeholders, is because corporations are the property of their shareholders in aggregate; corporations are owned by, and are created to service the objective of, their shareholders'. However, although the rights that shareholders possess might make them look like owners, according to the law 'strictly speaking, shareholders do not

[10] E.g normative stakeholder theory.

[11] Where legal matters are referred to in this paper, they will tend to refer to British or US law. Although US law depends, to some extent, on which state is being considered, company law developments in the US followed the British path more closely than did countries in mainland Europe (Tricker, 1984), and the parallels in the economic and legal systems of the UK and US mean that there are still significant resonances. These parallels or resonances are sufficient for the level of argument of this paper.

own their company' (Lucas, 1998, p.65), 'despite frequent statements to the contrary by corporate managers' (Kay, 1996, p.11).

An alternative line of reasoning which has similar implications to those of property rights theory, but which avoids its legal weaknesses,[12] is contractual theory. This holds that 'the firm results from the property rights and the right of contract of every corporate constituency and not from those of shareholders alone' (Boatright, 1999, p.171). Thus a firm, including a corporation, is sometimes held to be a 'nexus of contracts'. In itself, this does not lead to the primacy of shareholders. There is a further argument that depends on the nature of the shareholders' relationship with the company. Participants such as creditors have a 'fixed claim' upon the corporation, whereas the position of shareholders is by its very nature 'residual'. It is this that forms the basis for claiming their primacy and not, for example, their role as a capital provider.

> The crux of the financial argument is that shareholders differ from other constituencies by virtue of being residual risk-bearers and that as such, they have peculiar problems of contracting that are best met by having control. (Boatright, 1999, p.170)

This might look like an ethical argument, and it can certainly be propounded as one; the vulnerability of shareholders, given their 'residual' position, entitles them to control. However, whatever the merits of this argument, Klein & Coffee (1988, p.42) note that shareholders, because they hold the residual, 'are more likely to be interested in and to have control of the firm than are the holders of the debt, or fixed claim'. In other words, it is more worthwhile to shareholders for them to have control than it is for creditors, since creditors are entitled to no more than their fixed claim. The structure of the game or implicit bargaining between different parties is such that overall control falls almost naturally to the shareholders. Because of the incentives and risks they face as residual claimants, they will be, in effect, the 'highest bidders' for voting rights (Maitland, 2001, p.132) and so governance structures and mechanisms will be set up in their favor.

Such an outcome might be argued to serve the public interest too, not just shareholders'. Assuming that maximum wealth creation is the goal of business activity (Boatright, 1999), the corporation should be governed in the interest of the

[12] Given the current state of company law.

group with the strongest incentives for wealth-maximizing decisions, which in turn should be to the benefit of society as a whole (Mallin, 2004).[13]

However, contractual theory does miss one essential feature of corporate law. Davies (2002, pp. 6-7) writes that:

> it is of the utmost importance to note that the law treats shareholders not just as a group of people with contractual rights of various sorts against the company but also as its 'members'…. To the Victorian drafters of the companies legislation it was as natural to vest ultimate control of the company in the shareholders (members), at least as the default rule, as it is still to us to think that the members of a cricket club or a students' union should be the ultimate repository of authority in those organizations.

As Tricker (1984) notes, under British company law the primary duty of the directors is to the company and, since the company is made up of the members, this duty lies to the body of shareholders as a whole – and, as a primary duty, nowhere else.[14] While demonstrating the limited strength of some other arguments for shareholder primacy, this might appear to rule out other stakeholder groups from serious consideration in terms of corporate governance. However, as shown below, it does not, on its own, do justice to the position of creditors at least.

In conclusion, although there are some definitions of corporate governance that appear to take a stakeholder viewpoint,[15] most approaches quickly, or without any apparent consideration, concentrate upon shareholders and the protection of their interests vis-à-vis the board of directors (and executive management). This has been the focus of virtually all recent debate and action with regard to corporate governance reform. However, upon examination, the arguments for this exclusive focus are, as shown earlier in this section, of variable quality. In particular, simplistic notions or slogans about ownership ride roughshod over the legal subtleties of the corporate arena and risk erroneously closing down legitimate areas of debate. Indeed, when it comes to governance, Davies (2002) reminds us that company law[16] has historically

[13] Equating wealth maximization with shareholder wealth maximization clearly involves subsidiary arguments, e.g. in relation to issues such as the efficiency of markets (and hence welfare significance of prices), externalities, and whether shareholders are really the only residual claimants (cf. employees who make firm-specific investments, for example – see Blair, 1998).

[14] This notion of shareholders as members is perhaps a somewhat neglected one that would reward, in the context of business ethics, some further consideration. However, that is beyond the scope of the current paper.

[15] In which case creditors would be part of the corporate governance agenda.

[16] He is referring to the UK but, by extension, it applies to similar regimes.

been concerned with more than just shareholders and the board; it has dealt with the activities of three main groups:

- the shareholders (or members) of the company;
- its directors and, to a lesser extent, its senior managers (whether they are directors or not); and
- its creditors.

The law seeks to regulate relations between and within the three elements of what he refers to as the "traditional trinity" (Davies, 2002, p.6).[17] The next section considers the usually ignored third element of this trinity, the creditors. It begins by looking at the historical origins of limited liability companies and their regulation.

Limited liability and the protection of creditors

'The joint-stock company, with limited liability for its shareholders was an elegantly simple and eminently successful development of the mid-nineteenth century.' (Tricker, 1984, p.2). In the UK, prior to the Joint Stock Companies Act 1844, introduced by William Ewart Gladstone when he was President of the Board of Trade' (Davies, 2002, p.1), the creation of a corporation required an act of Parliament, but the 1844 Act provided aspiring promoters with a cheap and easy means of incorporation (Edwards, 1989, p.101). It is conventionally understood that it was not until the Limited Liability Act 1855 that shareholders in companies were granted the protection of limited liability, with the privilege not extended to banks and insurance until 1858 and 1862 respectively (Page, 1982). However, the Winding Up[18] Act of 1844 had provided for the first time that remedies of creditors of companies only extended to company property and not that of shareholders (Keay & Walton, 2003).[19] Moreover, as Klein & Coffee (1988, p. 139) point out, limited liability is a corollary of the concept of the corporation as an entity – it is the corporation that incurs the debt, not the shareholders. Indeed, strictly speaking the 'limited liability company' is a misnomer (Davies, 2002, p.11), since creditors' rights can be asserted to the full

[17] This 'trinity' can be contrasted with Monk & Minow's (2001) 'tripod' of shareholders, management/CEO and board of directors, mentioned earlier.
[18] Winding up of companies is often called liquidation.
[19] After 1862 such provisions were incorporated in companies legislation (Keay & Walton, 2003).

against the company's assets, even if they cannot be fulfilled. It is the liability of the shareholders that is limited, not that of the company.

The crucial feature for creditors is that doing business with a limited liability company increases the risk of non-payment when compared, *ceteris paribus*, with an unincorporated business such as a sole trader or a partnership, because the creditor does not have recourse to the personal assets of the people involved in the business of the company– the members (shareholders) and the directors (except in exceptional circumstances).

The widespread availability of incorporation with limited liability can be argued to have had an enormous impact on the mobilization of risk capital and hence economic growth. However, in response to the risks brought about by limited liability, legislatures have attempted to provide some degree of protection for creditors, to reduce the likelihood of companies not paying their debts. The frameworks or templates of 'default' rules (Maitland, 2001) vary from country to country (or from state to state, within the US) and have changed over time, but, in terms of the provisions of company law, they can be divided broadly into financial and informational measures.[20]

The financial protection of creditors could involve requiring companies to put aside a sum of money to cover what they owe, but, if significant, that would 'make the corporate form very unattractive for business' and undermine some of the benefits of both limited liability and a credit-based financial system (Davies, 2002, p.84). Instead, attempts have been made using capital maintenance rules to prevent the assets being run down inappropriately, by restricting payments to shareholders. So, for example, until relatively recently UK law prohibited a company from purchasing its own shares, and even now re-purchases are subject to a prescribed procedure which aims to safeguard creditors' rights (Davies, 2002). Similarly, capital reduction schemes are 'hedged about' with protections for the creditors (Davies, 2002, p.91).

Dividends have been restricted in a related fashion, with the general rule in the UK being that dividends may only be paid out of profits. Creditors are not the only intended beneficiaries of this, for one of the aims in the nineteenth century was to prevent investors being fooled into thinking that a company was doing better than it

[20] If protection proves insufficient and creditors find themselves in trouble with an insolvent company, bankruptcy/insolvency law is available – see below.

was.[21] However, the convention of prudence or conservatism in financial accounting and reporting was developed to place a restraint on the declaration of profits and hence the distribution of dividends to shareholders, thus – other things being equal – providing for greater capital maintenance to the potential benefit of creditors. One of the challenges is to ensure that the definition and hence calculation of profit is sufficiently robust to give the rule some purchase on company finances. In nineteenth century Britain, for example, when it was common practice to distribute as dividend 100% of the current year's profits, the profit might be calculated to equal the intended dividend; varying – or even eliminating – the depreciation charge was one method of achieving this (Edwards, 1989).

Dividend rules have varied over time and from place to place. The law of dividend is very divided in the US, 'with some states requiring only that the dividend not render the corporation forseeably [sic] insolvent and others that it come out of a carefully defined fund on the corporation's balance sheet' (Klein & Coffee, 1988, p.142).

Although it is not entirely satisfactory, the 'doctrine of capital maintenance' (Davies, 2002, p. 87) can plausibly be argued to protect creditors, at least to some extent. However, it is only a partial solution. Not only is it difficult to find an appropriate method of putting it into practice, but it does little or nothing to prevent a company's capital being eroded by a succession of losses (Edwards, 1989).

Although there are signs of significant and rapid global convergence, not all jurisdictions have equally stringent accounting and disclosure demands in return for the privilege of limited liability. However, company law does provide some help to creditors when it comes to losses, in the sense that there are financial reporting requirements laid upon companies that do not apply to, say, sole traders. Creditors can obtain that information and act accordingly, choosing either not to trade with the company or to adjust their terms of trade – perhaps even trying to deal only on a cash basis. Accounting information is not perfect – it may be somewhat out of date for example – but it is not the only source of information available; creditors can also look to credit rating agencies, their own experience of the company, or take account of views 'on the grapevine'. The essential point is that creditors can, at least to some extent, look after themselves. At the very least, the law puts them on notice by

[21] Dividends can act as informational signals, as highlighted by modern finance theory.

requiring incorporated businesses to append ‘ltd’, ‘plc’, ‘inc.’ or some other such suffix to their name to warn of the presence of limited liability.

Thus, although the law attempts to provide a certain level of protection, creditors can – if they decide to do business with the company, which is their option – attempt to obtain greater protection, if they think it is worth having.[22] There are various methods of doing this, including the following:

- In the case of a potential trade creditor, retaining ownership, i.e. effectively allowing the company use of goods but without giving up title on delivery. Thus goods might be supplied to a retailer on consignment (effectively ‘sale or return’) or a reservation of title clause (a so-called ‘Romalpa clause’) might be included in the contract of supply. In effect, the supplier reduces or eliminates the period of trade credit.

- Finance creditors (e.g. banks) often wish to secure their loan against company assets (sometimes referred to as ‘collateral’), so that if the company goes into liquidation (see below), there is an asset or assets specially identified to meet their claim (hopefully in full). Alternatively, a creditor might take a floating charge. Without such security, a bank might be unwilling to provide a loan, or only at a higher rate of interest. This move is also open to, but less commonly employed by, trade creditors. Secured creditors have not only a contractual right against debtors, but also a proprietary right in relation to some or all of the debtor’s assets (Keay & Walton, 2003, pp.12-13).

- A creditor might ask for a personal guarantee from directors. This pierces, at least in part, the veil of limited liability, and is likely to be used in the case of small or medium-sized owner-managed companies.[23] Again, it is quite common for banks to ask for this, but it can also be used by trade creditors.

- Creditors, particularly banks, might seek to place various restrictions on the company’s activities for the period that the credit is outstanding. For example, there might be covenants to limit the company’s subsequent borrowing, or a contractual clause might restrict the ability to pay dividends, in a tighter and clearer manner, than the general provisions of the law.

[22] Greater protection, whatever form it might take, is likely to cost something in some way.
[23] Even if such guarantees effectively removed the benefits of incorporation with limited liability, there might still remain tax advantages from using that form (Klein & Coffee, 1988).

- Trade creditors can sell, or 'factor', their debts to a third party – though if the customer is perceived as risky they might be able to do so only at a deep discount.
- Finally, creditors might simply reflect the perceived risk of extending credit to a particular company in the prices or interest charged (Maitland, 2001). Mention was made earlier of the levying of higher interest on unsecured than on secured loans. Similarly, trade creditors might charge higher prices to customers perceived to entail greater risk of non-payment (Ross et al., 2007).

Creditors can thus help themselves, using commercial law and other means, to supplement the protection afforded by company law. However, sometimes a company is unable to meet all its obligations to creditors. In such circumstances the law of bankruptcy – or 'insolvency' as it is called when referring to corporations in the UK – comes into play.

Insolvency law is generally very complicated, but for the purposes of this paper its intricacies are of limited significance.[24] It is generally invoked when a corporate debtor is in serious financial difficulty. Sometimes an attempt will be made at reorganization (or "rehabilitation") of the company, but in cases of "straight" bankruptcy or insolvency the company will be liquidated and the cash fund thus raised distributed in accordance with strict procedures. Creditors, of course, rank before shareholders (who are likely to receive nothing) in the distribution, and secured creditors generally have their claims met before unsecured creditors, though in some countries the legislature has given 'certain unsecured debts (mainly employees' claims to wages – to a modest extent – and certain claims of the public authorities) statutory priority over the floating, though not the fixed, charge' (Davies, 2002, p.76). However, whatever the complications, in essence it is the case that 'When corporations are in distress, creditors take control from shareholders and the creditors' interests become primary until the firm recovers.' (Boatright, 1999, p.178).[25]

[24] Klein & Coffee (1988, p.219), for example, refer to US federal bankruptcy law as 'exceedingly complex'. In the UK, the law relating to the insolvency of companies used to be part of the companies legislation but is now to be found mainly, though not entirely, in the Insolvency Act 1986. This brings it together with personal bankruptcy (Davies, 2002). However, notwithstanding the complexity, it is the intentions and general principles that matter for the argument of this paper.
[25] This is broadly in accordance with creditors' bargain theory, which argues that the goal is to maximize the amount that creditors receive (Keay & Walton, 2003).

Discussion

The modern corporate form has enabled the growth of large organizations with widely dispersed shareholdings, in which the agency issues that arise from the divorce of ownership and control per the neoclassical theory of the firm are likely to loom large. To that extent, the focus of corporate governance debates and policy initiatives on shareholder interests – particularly in the wake of corporate scandals such as Enron, WorldCom and Tyco, in which managerial hubris and greed loomed large – is entirely reasonable and appropriate. However, a review of the nineteenth century origins of joint stock companies and the development of an associated body of law demonstrate that this is not the only issue of significance in relation to corporate governance. Not only for large corporations, where there might be a divorce of 'ownership'[26] and control per Berle & Means (1932), but also in relation to the smallest of incorporated businesses, there is the issue of limited liability. Many stakeholders are protected by particular branches of law (e.g. consumer law, labor law), but it is noteworthy that creditors – who can also make use of commercial law and practises to safeguard their interests – are protected by company law itself.[27] Davies (2002) similarly notes that the relations between companies and their creditors are covered by general commercial law because it makes no difference that a company, as opposed to an unincorporated business, is involved, but he goes on to state:

> Company law addresses only creditor issues which are unique to companies. In the main, such issues arise out of the adoption of 'limited liability' or because the taking of security by creditors gives them a potential role in the governance of companies. (Davies, 2002, p.8) [28]

In effect, a degree of protection for creditors is effected by regulating the relationship between the company and its members, for example by restricting the circumstances in which shareholders can be paid a dividend and, when the company is insolvent, removing control from them and those who are deemed to act in their interest (the board of directors). As explained at the end of the previous section, when a company becomes insolvent, the focus for corporate governance shifts from shareholders to creditors.

[26] See the earlier comments on shareholders as 'owners'.

[27] Notwithstanding the UK Insolvency Act 1986, I am continuing to bracket corporate insolvency law with company law, which is where its origins lie.

[28] Coffee (2006) argues that the corporate governance debate has also ignored the professional agents of the board and the shareholders, who inform and advise them. However, his interest is in the responsibilities of these parties in relation to the bilateral relationship that dominates the current governance literature, rather than in the legitimate interests of a third principal party, the creditors.

This analysis suggests that there is not one but two possible modes of governance for a limited liability company. First, in what I term 'normal' mode, shareholders' interests are paramount, which – subject to agency problems and the objectives of the particular shareholders concerned – will involve a focus upon the firm's positive residual or financial return.[29] However, to operate in this normal mode, creditors' fixed claims need to be capable of being met, failing which a company can be placed in what I term 'distressed' governance mode, where there is a prospect of a negative residual. In this mode the company is governed in the interests of creditors, with shareholders hoping that there might be something left for them or that the company might eventually return to viability and hence normal governance mode.

In distressed mode, the shareholders still own their shares and they are still members of the company, but governance is not oriented in their interests. This implies that arguments for the primacy of shareholders in governance, when based on notions of ownership or membership, are inadequate or even erroneous. According to this analysis, the residual claim arguments are more convincing; when the company is insolvent, there is not – at least as constituted according to legal definitions – a positive residual equity interest, and the creditors are bearing the risk because their fixed claims are vulnerable. The focus for governance therefore becomes their interests. A further implication of this argument is that Davies' (2002) corporate governance trinity is superior to Monks & Minow's tripod.[30]

Of course, if – and only if – creditors' fixed claims have been satisfied or adequately dealt with, a distressed company that has the prospects of being a going concern can once again be governed in the interests of shareholders. It might then be argued that the satisfaction of creditors' claims is itself in the interests of shareholders so that they can 'get the company back', and so there is a sense in which their interests might still be considered primary. However, there are at least two problems with this view. First, the decisions that are taken when a firm is in administration are first and foremost made in the interests of the creditors; they are not aimed at maximizing the long-term expected value for shareholders, and there is likely to be a shift towards a

[29] I note that there are legal cases in the UK and the US which some commentators argue mean that companies do not have to maximize profits. I also note that, in a closely held corporation, where there in no divorce of ownership by shareholders and control by executive management, non-financial goals may have an important part to play, as Friedman (1970) acknowledges.

[30] Davies brackets together management and the board, which are two of the separate 'legs' identified by Monks & Minow – who, of course, omit creditors, unlike Davies.

much more risk-averse and liquidity-friendly approach to decisions than would be in the interests of shareholders. Second, although it is in the interests of shareholders that creditors of a financially distressed company are satisfied or at least pacified – so that, in a sense, shareholders are 'in the wings', waiting to take governance 'center stage' again – so also it is the case that creditors are 'waiting in the wings' when shareholders' interests are apparently paramount, for when creditors' interests are threatened, the nature of the governance of the company can be switched in their favour.

Indeed, what determines which governance mode a company is in is, in essence, the issue of whether creditors' fixed claims are being, or are likely to be, met in full. Thus there is a case for arguing that not only do they have a significant position in governance, but they actually have a fundamental one, even if that does not usually involve their participation or active consideration. Moreover, the meeting of the fixed claims of creditors is, at least to some degree, a constraint upon the pursuit of shareholders' interests in normal governance mode, a constraint written into company law - and like any constraint, it can be viewed as a degenerate objective (Tocher, 1970) or overriding goal (Eilon, 1971). Even if company law is not completely effective in protecting creditors' fixed claims against the abuse or vagaries of incorporation with limited liability, the intention of the law is clear, particularly when the history of its development is considered.

Finally, the possible tension between shareholder primacy and a stakeholder conception of corporate governance was briefly mentioned earlier in this paper. Whatever the merits of a stakeholder conception might or might not be, this paper has argued that a shareholder-only approach is inadequate for conceptualizing the corporate governance of limited liability companies. Even within the conventional, 'Anglo-Saxon' corporate governance approach shareholders are not, even now, the only stakeholder considered. This is so – and justifiably so – because of the special privilege of general incorporation with limited liability vis-à-vis sole traders and partnerships. Furthermore, although a stakeholder conception would enable creditors to be brought into the corporate governance picture, creditors *qua* creditors already warrant their place in an adequate conception of corporate governance. They should not be forgotten, and the remembrance of them serves to place shareholders in a light different from that in which they are normally viewed.

Conclusion

In some respects the ambition of this paper has been a modest one. It has not sought, for example, to argue (as some have done) for a re-conceptualization of corporate governance in line with a stakeholder theory of the firm, which would involve arguing *for* such a theory. However, to the extent that defenses against a more thoroughgoing analysis of the firm in ethical terms, such as stakeholder theory would allow, rely upon shareholder primacy, the paper has opened the way for such ethical analyses and related prescriptions by showing the shortcomings of some of the arguments upon which defenses against them tend to depend. In particular, by paying attention to the position of creditors in the governance of conventional limited liability corporations (usually, if not always, forgotten by recent writers on corporate governance), it has shown that the institutional assumptions, upon which the neoclassical theory of the firm and the discourses it has influenced are based, are under-specified. Two things are particularly important to recognize. First, shareholders are not owners of a business in the way that sole traders or partners are; there are significant differences. Second, the position of creditors is fundamental to the origins and modern institutional form and regulation of the limited liability company. A recognition of these features of the economic world should form part of any attempt to apply the abstract, neoclassical theory of the firm, notwithstanding its intellectual achievements, to understanding the governance of the modern corporation.

The principal contribution of this paper is therefore not to replace shareholder primacy as such, but to *disturb* current conceptions of it and thus open the way for other analyses – though the paper has also developed arguments for seeing creditors, at least in some sense, as primary. A secondary contribution is to highlight for the scholarly business ethics community that creditors – whether as suppliers of capital or as suppliers of goods and services – are a stakeholder group worth recognizing and considering.

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