Shareholder Control in the Context of Corporate Social Responsibility — A Fundamental Challenge to the Modern Corporation

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Shareholders are entitled to participate in the corporate decision-making and internal governance when it comes to determining corporate leadership or/and fundamental corporate changes. Accordingly, any discourse of corporate social responsibility (CSR) without a serious discussion on shareholders' role will be incomplete at best and misleading at worst. This article is one of the first articles contributing to the CSR literature by critically examining shareholder vote in CSR activities, a subject that has not received the attention it deserves. The article finds that when shareholders vote against CSR, it would result in significant difficulties for companies to engage in CSR due to the shareholder control; when shareholders support CSR on the other hand, it would be equally problematic considering the rationale behind shareholder voting in modern corporations reliant on capital markets. The fundamental incompatibility of shareholder control and CSR activities exhibited in this article can serve as a new premise for future studies aiming for a more workable CSR framework.

1. Introduction

Corporate social responsibility (CSR) is no longer a new topic. Increasingly more corporations around the world have been either proactively or passively engaging in CSR activities. In academia, the concept of CSR has also been vigorously examined during the past seven decades since Howard Bowen's *Social Responsibilities of the Businessman*.[1] CSR is generally seen as corporation's concern for its stakeholders' moral rights and social welfare that extend beyond economic and legal requirements.[2] This to some extent determines the voluntary nature of CSR and the effort to seek a

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[1] Howard R Bowen, *Social Responsibilities of the Businessman* (New York: Harper & Row, 1953).
[2] Archie B Carroll, "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders" (1991) 34 *Business Horizons* 39–48.

business case to justify and promote CSR from an instrumental aspect.[3] Accordingly, a significant body of existing research attempts to examine the correlation between CSR engagement and corporate financial performance. Tremendous efforts have been made to establish or empirically test the business case for CSR — that is to demonstrate whether engaging CSR would increase or decrease shareholder value, if at all.[4]

While shareholder value remains in the spotlight, there are not many articles directly discussing shareholder control in the CSR literature.[5] Pursuant to the mainstream law and economics theory, shareholders as residual proprietary claimants have an important role in both corporate management and governance mechanisms.[6] Despite the fact that corporation comprises more than shareholders,[7] only shareholders are entitled to participate when it comes to determining the leadership of corporation[8] or fundamental corporate changes like amendment of the corporate constitution, merger, sale of all or substantially all of the corporate assets and voluntary dissolution.[9] In other words, although non-shareholding stakeholders like employees, creditors, suppliers and consumers can also be materially affected by corporate decisions, they would rarely be invited for formal participation similar to

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[3] See Min Yan, "Corporate Social Responsibility *vs*. Shareholder Value Maximization: Through the Lens of Hard and Soft Law" (2019) 40 *Northwestern Journal of International Law and Business* 47–86.

[4] See Michael L Barnett, "Stakeholder Influence Capacity and the Variability of Financial Returns to Corporate Social Responsibility" (2007) 32 *Academy of Management Review* 794–816; Paul Min-Dong Lee, "Review of the Theories of Corporate Social Responsibility: Its Evolutionary Path and the Road Ahead" (2008) 10 *International Journal of Management Reviews* 53–73; David J Vogel, "Is There a Market for Virtue? The Business Case for Corporate Social Responsibility" (2005) 47 *California Management Review* 19–45; Elizabeth C Kurucz, Barry A Colbert and David Wheeler, "The Business Case for Corporate Social Responsibility" in Andrew Crane, Dirk Matten, Abagail McWilliams, Jeremy Moon, and Donald S. Siegel (eds), *The Oxford Handbook of Corporate Social Responsibility* (Oxford: Oxford University Press, 2008) pp 85–92; Michael E Porter and Mark R Kramer, "The Link between Competitive Advantage and Corporate Social Responsibility" (2006) 84 *Harvard Business Review* 78–92.

[5] There are very few empirical studies on the shareholder proposals. For example, see Giovanna Michelon and Michelle Rodrigue, "Demand for CSR: Insights from Shareholder Proposals" (2015) 35 *Social and Environmental Accountability Journal* 157–175; Erwin Eding and Bert Scholtens, "Corporate Social Responsibility and Shareholder Proposals" (2017) 24 *Corporate Social Responsibility and Environmental Management* 648–660.

[6] To be fair, there is also a large body of literature debunking such residual claimant argument. For example, see Ewan McGaughey, "Democracy in America at Work: The History of Labor's Vote in Corporate Governance" (2019) 42 *Seattle University Law Review* 697–753.

[7] In fact, the continuing participation of other stakeholders like employees, creditors, suppliers and consumers among others is key to the success or survival of a firm.

[8] Namely, the election of the board of directors; see, for example, Delaware General Corporate Law (DGCL) s 141(k).

[9] DGCL ss 109(a), 242(b), 251(c), 271(a) and 275(b). Similarly, in the UK, shareholder approval is required for amendments to articles, allotment of shares, disapplication of pre-emption rights, a variation of class rights, voluntary winding up and transactions with directors.

shareholder voting.[10] The primary normative justification for such an institutional arrangement is shareholder primacy,[11] where the governance norm determines the corporate law system, as well as the leadership of the firm, to place shareholder interests at the centre.[12] Of course, there is a distinction between liberal market economies like the United States and the United Kingdom and coordinated market economies like Germany which may put less emphasis on shareholder primacy.[13] But such distinction caused by different institutional frameworks becomes increasingly less obvious as discussed next. Accordingly, it would be incomplete to discuss a company's CSR policy and/or activities without looking into the important role played by its shareholders.

There are in general two scenarios after involving shareholders, namely, they may either object or support CSR. Both scenarios would be problematic. First, if shareholders, as the *de jure* controller of the firm, vote against CSR, it would be theoretically and practically difficult for a company or say its directors of the board, to engage in CSR. Second, if shareholders vote in favour for CSR, it would be contradicted to the very reason they are entitled to vote in the modern corporation, ie, the economic foundation for the allocation of corporate power between shareholders and non-shareholding stakeholders. The conventional wisdom holds that shareholders as the residual proprietary claimant will be affected by the outcome of the corporate leadership election and corporate decisions more than any other stakeholders and thereby have best incentive to exercise their discretion for maximising the residual

[10] The dual-tier board structure in countries like Germany may be the only salient exception on the ground that employee representatives, who are elected by employees, are able to directly monitor the leadership of the corporation.

[11] Under shareholder primacy, the board of directors and their delegates of daily management, executive officers, are as a result expected to serve for shareholder value. Providing better employee welfare, improving customer service and contributing more to communities among other things, are not considered proper for managers to pursue unless these activities can serve as a means to maximise shareholder value in due course. By the same token, when conflicts arise between shareholders and non-shareholders, directors and corporate officers are only required to address the interests of the former and take actions to produce the highest possible returns for them even at the expense of non-shareholder groups' interests. For more discussion, see Min Yan, *Beyond Shareholder Wealth Maximisation* (London: Routledge, 2018) p 31; also see D Gordon Smith, "The Shareholder Primacy Norm" (1997) 23 *Journal of Corporation Law* 277, 278.

[12] For example, providing better employee welfare, improving customer services, contributing more to communities and the like are not seen as proper ends for managers to pursue unless these activities can serve as a means to maximise shareholder value in due course. When conflicts arise between shareholders and non-shareholders, directors are only required to address the interests of shareholders and take actions to produce the highest possible returns for them, even at the expense of non-shareholder groups. For more discussions, see Min Yan, "The Corporate Objective Revisited" (2017) 38 *Business Law Review* 14, 16.

[13] See Peter A Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

profits of the company. Consequently, this article contributes to the CSR literature by displaying the fundamental incompatibility between shareholder control and CSR to serve as a new premise for future studies aiming for a more workable CSR framework.

The remainder of the article is organised as follows: Section 2 discusses the corporate control in the hands of shareholders as well as its rationale to set the foundation of the argument. On the ground that a most important way for shareholders to participate in corporate decision-making is through their vote, this section also critically discusses the essence of shareholder voting rights, in particular the principle of the so-called proportionate voting. Section 3 then challenges the premises of shareholder control and shareholder voting in the context of shareholder heterogeneity. In other words, due to the untenable assumption of shareholder homogeneity, assigning voting power based on shareholders' economic stakes along with shareholder primacy would turn out to be problematic. Shareholders' rational apathy and the conception of the fictional shareholder are discussed as potential mitigation of the problem. Section 4 looks into shareholders' role in CSR and finds that CSR, as opposed to shareholders' economic interests, is a significant deviation from the conventional rationale for corporate voting. Section 5 continues the analysis of the challenge brought by CSR to the fundamentals of modern corporate law and governance. The conclusion is provided in Section 6.

2. Shareholder Control

2.1 Shareholder Primacy

While non-shareholding stakeholders are increasingly required to be considered during corporate decision-making, shareholder interests remain in the centre. For example, the enlightened shareholder value approach adopted by the UK Company Law requires directors to have regard to stakeholders' interests, but when the stakeholder consideration is in conflict with shareholder interests, the latter will prevail.[14] Just like Paul Davies argues, non-shareholder interests would not be taken into consideration unless "it is desirable to do so in order to promote the success of the company for the benefit of its members".[15] In other words, it might be acceptable

[14] See s 172(1), UK Companies Act 2006.
[15] Paul Davies and Sarah Worthington, *Principles of Modern Company Law* (London: Sweet & Maxwell, 9th ed., 2012) p 542.

under certain circumstances to impair non-shareholders' interests for the sake of shareholder primacy. In the United States, although the constituency statues which explicitly authorise "corporate boards of directors to consider the interest of constituencies other than stockholders" in the sale of their firm,[16] empirical evidence has shown that directors and executives made little of their discretionary power to secure stakeholder interests.[17] In other words, while company is now assuming more responsibility to stakeholders and society, shareholders remain in the centre.

Employee participation as evidenced in the co-determination in many EU countries traditionally provides an exception for shareholder primacy. However, things have also changed in these countries. Take Germany as the most conspicuous co-determination country for example. *KonTraG 1998* (Corporate Sector Supervision and Transparency Act) deliberately lacks any reference to the stakeholder view of the corporation in order to put the shareholder value front and centre, which represents a departure from the long tradition that focuses on the interests of the employee and the company as a whole rather than merely shareholders.[18] Similarly, in contrast to the earlier *Aktiengesetz* (German Stock Corporation Law), stakeholder and society view is no longer mentioned in *Aktiengesetz 2009* or *Aktiengesetz 2016*. Corporations have shifted a large part of their added value from the public and society to the shareholders. For instance, whilst business taxes paid by German joint stock companies declined by 9 per cent per year from 1996 to 2000, dividends distributed in 2001 had nearly doubled compared with 1996.[19] Furthermore, employee voting has been blamed to produce inefficient decisions, paralysis or weak boards due to their too heterogeneous interests.[20] As a result, shareholder primacy has not become a history, especially in the Anglo-American jurisdictions. Instead, it remains the normative drive for the modern corporate law and governance arrangement. Providing better employee welfare, improving customer services, contributing more to communities and the like are not seen as proper ends for managers to pursue unless

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[16] Lawrence E Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 *Texas Law Review* 579, 579–580.
[17] Lucian A Bebchuk and Roberto Tallarita, "The Illusory Promise of Stakeholder Governance" (2020) 105 *Cornell Law Review* (upcoming).
[18] Jurgen Beyer and Martin Hopner, "The Disintegration of Organised Capitalism: German Corporate Governance in the 1900s" (2002) 26 *West European Politics* 179, 191.
[19] Stefanie Hiss, "From Implicit to Explicit Corporate Social Responsibility: Institutional Change as a Fight for Myths" (2009) 19 *Business Ethics Quarterly* 433, 436.
[20] Henry B Hansmann and Reinier H Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439–468.

these activities can serve as a means to maximise shareholder value in due course. That is to say, when conflicts arise between shareholders and non-shareholders, directors are only required to address the interests of shareholders and take actions to produce the highest possible returns for them, even at the expense of non-shareholder groups.[21]

With the development of law and economics discipline in the 1970s, the contractarian theory offers the modern theoretical foundation for shareholder primacy.[22] Contractarians see a company as a "legal fiction, which serve as a nexus for a set of contracting relationships among individuals".[23] As an artefact of continuously renegotiated contracts, the conception of *ownership* becomes irrelevant. Shareholders are seen as input owners of equity, similar to input owners of labour, credit, raw materials and others. All input owners cooperate within the firm. Nonetheless, ascertaining and allocating rewards would be difficult as the final output is usually not separable. This means that each individual's contribution to the output is difficult to be numerically identified. To stimulate higher productivity, it is of the essence to accurately relate the rewards with productivity.[24] Nevertheless, owing to information asymmetry and the cost of monitoring, it is not workable to observe the behaviour of individual input owners to ascertain their contribution. Meanwhile, there is always the same incentive for *monitors* to shirk because the new substitute "still bears less than the entire reduction in team output for which he is responsible".[25] The solution is to entitle the ultimate monitor the *net earnings of the team, net of payments of other inputs*, namely, let the ultimate monitor become the residual proprietary claimant to earn:

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[21] Yan (n 12 above) pp 14–20.

[22] Nevertheless, it should be noted that the theoretical foundation of shareholder primacy remains controversial. For example, the positional circularity is that whether shareholder primacy made shareholders the only group who participate in corporations or does shareholders' participating power (ie, vote) result in shareholder primacy?

[23] Michael C Jensen and William H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305, 310. Similarly, Professor Fama argues: "[T]he firm is just the set of contacts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs." Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *Journal of Political Economy* 288, 290.

[24] As Alchian and Demsetz pointed out, when productivity and rewards are highly and accurately related, then the productivity will be enhanced; otherwise productivity will become smaller if there is only a loosely correlated relationship. See Armen A Alchian and Harold Demsetz, "Production, Information Cost, and Economic Organization" (1972) 62 *American Economic Review* 777, 780. Moreover, if one can shirk without being punished, the incentive to shirk would be great.

[25] *Ibid.*, p 781.

> "his residual through the reduction in shirking that he brings about, not only by the prices that he agrees to pay the owners of the inputs, but also by observing and directing the actions or uses of these inputs".[26]

Accordingly, the lower the cost of managing, the greater is the residual value. So, the monitor with residual proprietary claims would no longer shirk as before with this enhanced incentive.

In the corporate context, shareholders are chosen to be such monitor and residual proprietary claimant, entitled to claim the residual profits. Maximising shareholders' return is thereby equated to maximising overall team productivity, which is seen as ultimately beneficial to society as a whole. The economic foundation for the power allocation between residual claimants and others is also highlighted by Easterbrook and Fischel at the end of 1980s.[27] The right to residual proprietary claims against incomes generated by the company provides shareholders with a very different incentive compared to holders of the so-called fixed claims such as monthly salaries, interest payments and the like. Shareholders as residual proprietary claimants are entitled to "every penny of profit left over after the firm's contractual obligations to creditors, suppliers, and employees have been met".[28] Put differently, shareholders can "reap the marginal dollar" of corporate profits and "suffer the marginal dollar" of corporate losses.[29] Thus, in a solvent company, shareholders are expected to have the greatest impetus to maximise the corporate wealth because they could receive the entire surplus (or at least most of it) after all fixed claims have been satisfied.[30]

The fact that shareholders are entitled to receive whatever is left from the income stream tightly ties their personal interests to the financial performance of the firm. It is believed that the wealth of residual proprietary claimants would be maximised in the event that corporate wealth is maximised by virtue of their residual nature. As

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[26] *Ibid.*, pp 782–783.

[27] Frank H Easterbrook and Daniel R Fischel, "The Corporate Contract" (1989) 89 *Columbia Law Review* 1416, 1446–1447.

[28] Margaret M Blair and Lynn A Stout, "Specific Investment: Explaining Anomalies in Corporate Law" (2006) 31 *Journal of Corporation Law* 719, 728 referred to Robert Clark, *Corporate Law* (London: Little Brown, 1986) pp 594–602.

[29] Lynn M LoPucki, "The Myth of the Residual Owner: An Empirical Study" (2004) 82 *Washington University Law Quarterly* 1341, 1343–1344.

[30] For example, see Jonathan R Macey, "Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective" (1999) 84 *Cornell Law Review* 1266, 1267. In the meanwhile, as Professor Stephen Bainbridge argued, if directors just "siphon some portion of the corporation's free cash flow into their own pockets", the stakeholders' interests may not readily be harmed, but the shareholders as residual claimants would apparently be damaged. Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (New York: Oxford University Press, 2008) pp 68–69.

residual proprietary claimants, shareholders would receive higher dividends and share values when the corporation is run well, receive less or even lose all their investment when the corporation is run badly. In particular, their position in the profit allocation sequence underlines shareholders' incentive to pursue the success of the company. Contrary to the so-called definable and fixed returns, the residual risk-bearing nature could stimulate those residual claimants into choosing and wholeheartedly supporting decisions and projects for the best interest of the company.

In short, the shareholder primacy theory insists shareholder interest can be aligned with the interest of the company and therefore maximising their interests would also be equivalent to maximising corporate interests and ultimately the maximal social utility. Shareholders as residual proprietary claimant have the best incentive to exercise discretion and oversight in an optimal way.[31] Such an incentive could then justify shareholders' participation in the context of neoclassical economics.[32] As a result, only shareholders can elect directors of the board to lead the company,[33] and only shareholders can approve or disapprove those most fundamental corporate changes including amendment of corporate constitution, merger, sale of (substantially) all of the corporate assets and voluntary dissolution.[34]

2.2 Corporate Voting

As known, the most important way for shareholders to participate in corporate management and governance is through voting. The right to vote, which defines a baseline of power relations,[35] is the right to make all decisions not otherwise provided by the contract.[36] The control right also includes the right to delegate. Despite the fact

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[31] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991) p 68.
[32] For more discussion, see Yan (n 12 above) pp 17–20.
[33] Even under German dual-tier board structure, only shareholders could elect representatives of the management board. Meanwhile, directors are not expected to manage the company themselves on a daily basis; they will select a management team including CEO and other top executives, and shape their incentive by compensation arrangement and monitor their performance. See Lucian A Bebchuk, "The Myth of the Shareholder Franchise" (2007) 93 *Virginia Law Review* 675, 680.
[34] See DGCL in the United States and Companies Act 2006 in the United Kingdom. Also, see the discussion in Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 3rd ed., 2017) pp 172–174.
[35] Colleen A Dunlav, "Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights" (2006) 63 *Washington & Lee Law Review* 1347, 1351.
[36] Frank H Easterbrook and Daniel R Fischel, "Voting in Corporate Law" (1983) 26 *Journal of Law & Economics* 395, 402.

that directors of the board are responsible for the management of corporate businesses, for which purpose they may exercise all powers of the corporation,[37] these discretionary powers are delegated to directors by shareholders.[38] And such delegation can also be revoked by shareholders. In addition to vote to elect representatives into the board, shareholders can also vote to remove directors, which provides the elected further incentives to focus on shareholder interests.[39] Moreover, shareholders can vote to approve or disapprove those fundamental corporate changes after exercising their discretion. Put differently, shareholders can not only use their voting power to elect corporate management but also influence decision-making.[40]

The theoretical underpinnings of the voting right involve (1) the right to cast a vote and (2) the vote casted is not diluted either quantitatively or qualitatively.[41] Regarding the first and the most fundamental issue about who shall have the ability to vote, the primary consideration is the degree to which a potential voter is affected by the outcome.[42] Only those who have a strong stake in the outcome are more likely to make optimal decisions compared with those who are not similarly affected by the outcome. In the corporate context, due to the residual proprietary claim discussed earlier, shareholders will be affected by the outcome of the election of the corporate leaders and their decisions more than any other corporate stakeholders;[43] therefore,

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[37] For example, see art 3 of Schs 1–3 in *The Companies (Model Articles) Regulations 2008* (UK). Similarly, s 141(a) of DGCL (US) explicitly stipulates "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." Moreover, from the perspective of economic efficiency, allocating the decision-making to the hands of a central place is seen as the only optimal choice when information is widely dispersing and speed is needed. Kenneth J Arrow, *The Limits of Organization* (New York: Norton, 1974) p 68. In the context of (large) corporations with scattered information, a centralised authority is required to deal with the information to make informed decisions for the sake of organisational efficiency. Lynn A Stout, "The Mythical Benefits of Shareholder Control" (2007) 93 *Virginia Law Review* 789, 792–793.

[38] Directors are then expected to delegate ongoing management decisions to the company's officers and especially to the CEO.

[39] Even in large public corporations where shareholdings are essentially dispersed, shareholders do have "real power" to vote to elect or replace directors. Bebchuk (n 33 above) p 682. Of course, there will be some impediments such as costs, staggered boards to the effectiveness of shareholders' exercising of their vote. *Ibid.*, pp 683–694.

[40] In fact, the argument of shareholder empowerment does also focus on one or both of these two sides. See Lucian A Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 *Harvard Law Review* 833, 836; Lucian A Bebchuk, "Letting Shareholders Set the Rules" (2006) 119 *Harvard Law Review* 1784, 1784.

[41] Grant M Hayden, "The False Promise of One Person, One Vote" (2003) 102 *Michigan Law Review* 213, 214.

[42] Grant M Hayden and Matthew T Bodie, "One Share, One Vote and the False Promise of Shareholder Homogeneity" (2008) 30 *Cardozo Law Review* 445, 452. Also see Hayden (n 41 above) pp 251–261.

[43] That is why it is argued that "[t]he right to vote (that is, the right to exercise discretion) follows residual claim." Easterbrook and Fischel (n 36 above) p 404.

they have "the right incentives"[44] to exercise their control rights through voting to make optimal decisions, namely, those that can maximise residual profits. That is also why the UK Company Law Review Steering Group (CLRSG) concluded that shareholders have the greatest exposure to the residual risk as a consequence of mismanagement could serve as an economic justification for the shareholder-oriented approach.[45] More recently, Bebchuk and Tallarita have summarised the severe problems of letting stakeholders other than shareholders to elect directors of boards from a perspective of dysfunctional decision-making process and deadlocks.[46] Thus, in contrast to the fixed claimants, namely, those non-shareholding stakeholders, shareholders as residual proprietary claimants have the strongest stake in the outcome of the corporate leadership election and alike.

The mere ability to vote is certainly insufficient to ensure meaningful participation. It is also essential to ensure these votes are not diluted. According to Hayden, while quantitative dilution occurs when votes receive unequal weighing, qualitative dilution occurs when a voter has less opportunity to elect a representative of his choice.[47] It is, therefore, essential to make sure one's vote carries "an appropriate numerical weight" especially when the voters are not equally affected.[48] This is to reflect the varying degrees to which voters cared about the outcome of the election.[49]

In *Salyer Land Co v Tulare Lake Basin Water Storage District*,[50] a statute provided that only landowners were qualified to cast their ballots to elect the district's board of directors to be in charge of acquiring, storing and distributing water for farming in the district of Tulare Lake Basin. Besides, the votes were apportioned according to the assessed valuation of the lands owned by these landowners. The US Supreme Court rejects the challenge by appellants and upholds the statute that limited the franchise to landowners. Regarding the ability to vote, as we can find from this case, the district's board decision would disproportionately affect landowners compared to district residents owning no land themselves, since the primary services

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[44] *Ibid*., p 403.
[45] CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (London: DTI, 1999) p 34.
[46] Bebchuk and Tallarita (n 17 above).
[47] Hayden (n 41 above) p 215. One typical example of qualitative dilution in the political setting is gerrymandering district lines to dilute a group's voting power. As qualitative dilution is not common compared with quantitative dilution in the corporate context, so this section primarily focuses on quantitative dilution.
[48] Hayden and Bodie (n 42 above) p 451.
[49] *Ibid.*, p 456.
[50] 410 US 719 (1973).

of the water storage district in the *Salyer* directly benefit only landowners.[51] The fact that landowners have the greatest stake in the outcome of the election of the district's board entitles them the right to participate in the election. Those landowners with strong interests in the outcome are more likely to make optimal decisions. Second, with regard to the weighing of the vote, the degree to which landowners are affected by the outcome is not identical. It is upheld by the Supreme Court that "the benefits and burdens to each landowner . . . are in proportion to the assessed value of the land".[52] Therefore, the weighing of landowners' votes is determined on the basis of the assessed value of their land. In other words, the assessed valuation of the land owned by each voter determines the degree to which he would care about the election outcome.

In the context of corporate voting, it is believed that the degree to which shareholders would be affected by the corporate elections along with corporate decisions made by the elected directors is largely in proportion to their residual proprietary claims against the company. Therefore, the general corporate voting rule apportions power among shareholders according to their equity investment. The dominant corporate governance rule allocates shareholders voting power:

> "in proportion to their economic interest by mandating a single class of voting common stock that has both a residual interest in corporate profits and one vote per share".[53]

The rule of "one share, one vote" as the default voting arrangement nowadays seems perfectly matching voting power with economic incentives and allows shareholders to cast ballots based on their financial stakes in the corporation.[54] In other words, the voting power is tailored to the corresponding level of the voter's (economic/financial) interest.[55]

Furthermore, in addition to elect directors, shareholders can also shape their interests in a way to align with shareholder interests. The equity-based and performance-based compensation that is widely adopted in large public companies is

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[51] "*Salyer Land Co v Tulare Lake Basin Water Storage District*: Opening the Floodgates in Local Special Government Elections" (1974) 72 *Michigan Law Review* 868, 887. Also, see Hayden (n 41 above) p 254: "Landowners have a greater interest in, and care more about, the storage and distribution of water in the Tulare Lake water district, and the strength of their interest roughly corresponds to the amount of land that they own."

[52] 410 US 719, 734 (1973).

[53] Bernard S Black and Reinier H Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 *Harvard Law Review* 1911, 1945.

[54] *Ibid*.

[55] Hayden (n 41 above) p 263.

explicitly designed to align the interests of directors with that of shareholders.[56] The incentives produced by directors' compensation practice form strong reasons for directors and top managers to pursue higher shareholder value.[57]

3. Shareholder Heterogeneity

3.1 False Assumption of Shareholder Homogeneity

Apart from exercising control right, another important aspect of voting is to aggregate individual preferences in a democratic manner.[58] Instead of letting one decide for the rest, voting is the preferred method to translate individual preferences into group choices.[59] An important premise for shareholder voting, rather than empowering other stakeholders to vote, is the shareholder homogeneity, which holds all shareholders have homogeneous interests in maximising residual profits in order to get benefited from such maximisation.[60] If shareholders have heterogeneous interests, they will then have different preferences in corporate decision-makings.[61] The dissimilar incentives held by shareholders as voters would make it difficult, if not impossible, to aggregate their individual preferences into a consistent system of choices.[62] And lack of consistent choices for a corporation would be self-destruct.[63]

That is also why Easterbrook and Fischel insisted that most shareholders in a given company at a given time are a reasonably homogeneous group with an analogous objective.[64] Reinier Kraakman and his co-authors also commented that those investors of pecuniary capital have or at least are able to be induced to have relatively homogeneous interests.[65] In Anabtawi's words:

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[56] Bebchuk and Tallarita (n 17 above).
[57] *Ibid*.
[58] Hayden and Bodie (n 42 above) p 450.
[59] Daniel A Farber and Philip P Fricke, *Law and Public Choice: A Critical Introduction* (Chicago: The University of Chicago Press, 1991).
[60] Hayden and Bodie (n 42 above) p 476.
[61] It may well be wider than maximising residual profits.
[62] In fact, another important reason for not allowing stakeholders other than shareholders to vote is that their interests are so diverse and impossible to aggregate their preferences into a consistent system of choice.
[63] See Frank H Easterbrook and Daniel R Fischel, "Voting in Corporate Law" (1983) 26 *Journal of Law & Economics* 395, 405.
[64] Easterbrook and Fischel (n 31 above) p 70.
[65] Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 3rd ed., 2017) p 13. Interestingly, in the previous edition, the authors use the phrase "*highly* homogeneous interests". See Reinier Kraakman, Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda and Edward Rock, *The Anatomy of*

> "most observers of corporate governance law nevertheless regard divergences in the interests of shareholders as either insignificant or checked by the corporate law voting principle of majority rule."[66]

All these are to demonstrate that inconsistent choices are likely to be avoided (thanks to the shareholder homogeneity).

However, shareholder interest may mean substantially different things to different types of shareholders. Assuming one shareholder is keen on certain environmental or social causes, then increasing share prices and dividends by ignoring or damaging these causes is certainly not in accord with the interest of this shareholder. Similarly, certain institutional investors such as labour union funds may care more about labour interest than a quarterly return. After a comprehensive review of recent literature, Goranova and Ryan summarised shareholders' investment horizons, business relationships with the firm, portfolio considerations and discrepancies between cash flow rights and voting rights may cause substantially different preferences.[67]

To take one step back, even though the ultimate goal of shareholders could be roughly categorised into making economic interests in general, they could have substantially dissimilar timeframes and/or risk preferences. First, it is not uncommon for shareholders to have different expected holding periods. While short-term shareholders tend to focus on immediate profits from fluctuations in the share market by buying and selling shares with high frequency, long-term shareholders tend to focus on long-term development by buying and holding shares regardless of the rise and fall of share prices.[68] Thus, shareholders with different expected holding periods

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Corporate Law: A Comparative and Functional Approach (Oxford: Oxford University Press, 2nd ed., 2009) p 15.

[66] Iman Anabtawi, "Some Skepticism about Increasing Shareholder Power" (2006) 53 *University of California Los Angeles Law Review* 561, 577–578.

[67] Maria Goranova and Lori Ryan, "Shareholder Activism: A Multidisciplinary Review" (2014) 40 *Journal of Management* 1230, 1249.

[68] Consider hedge funds, for example. They are typically only concerned with short-term performance and share price instead of long-term success. When a hedge fund invests in a company, it may then force directors of that company to seize the maximum possible earnings in a short period due to its *relatively short life span*. Division of Investment Management, "Implications of the Growth of Hedge Funds" *Staff Report to United States Securities and Exchange Commission* (September 2003), available at www.sec.gov/news/studies/hedgefunds0903.pdf (visited 1 September 2020). If some other shareholders in that company take a long-term view, for instance a pension fund, then unavoidably they will have fundamentally different opinions on corporate strategies, such as attitudes toward R&D, especially in an inefficient stock market. As well-known, it is hard for the market to tell the long-term from the short-term strategy. Even though sophisticated investors or shareholders may identify which is which, it by no means implies that the market as a whole can benefit from such a discovery and thereby

would unavoidably have divergent preferences over corporate decision-making. The former may be more likely to pressure directors to adopt policies/actions which would maximise short-term share prices, such as axing employees, reducing R&D expenses or selling corporate assets at the expense of long-run value,[69] whilst the latter may be more willing to sacrifice immediate profits for long-term development. Indeed, short-term and long-term interests are quite difficult to reconcile or integrate. Long-term development, by training employees, investing in technology and improving customer service for example, requires a non-negligible upfront cost. Such an upfront cost would be considered as a negative factor under short-termism because the immediate profit would be impaired as a consequence. Conflicts between shareholders with different expected holding periods are inevitable.

It is also not uncommon for shareholders to have different risk preferences depending on their level of diversification. While a diversified shareholder cares much less about firm-specific risks, an undiversified shareholder would be very sensitive to such risks. Put differently, diversified and undiversified shareholders may have contrasting preferences regarding risks and the like. Further, the differing expectations between inside shareholders and outside shareholders, hedged shareholders and unhedged shareholders also demonstrate shareholders may have very different interests, thereby making it impossible to be aligned. For example, inside shareholders like directors with shares may be more concerned about job security and prefer to maintain the status quo when facing a hostile takeover, even though the offer may be in the best interests of the company as a whole. Or in the context of golden parachutes, inside shareholders who happen to be directors would have a greater incentive to facilitate the merger even it is not in the best interests of outside shareholders.[70] In short, different shareholders may well have different specific requirements.[71]

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it cannot serve as a reliable criterion. Also, see Lynn A Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) 28 *Journal of Corporation Law* 635, 667.

[69] According to Professor Michael Jensen, it is not impossible for directors to: "increase this year's profits at the expense of future year's profits by moving expenses from this year to the future (by delaying purchases, for example) or by moving revenues from future years into this year by booking orders early (by announcing future price increases or by giving special discounts this year or guaranteeing to repurchase goods in the future, and so on)." Michael C Jensen, "Paying People to Lie: The Truth about the Budgeting Process" (2003) 9 *European Financial Management* 379, 387.

[70] Anabtawi (n 66 above) pp 583–593.

[71] Tax consideration should be taken into account as well. For instance, shareholders in different tax brackets may have different views on dividends, reinvestment and the like. Stephen M Bainbridge, "Director Primacy and Shareholder Disempowerment" (2006) 119 *Harvard Law Review* 1735, 1745.

3.2 Heterogeneous Interests and Shareholder Apathy

The foregoing discussion shows the assumption of shareholder homogeneity is untenable, and shareholders as voters in the corporation do have heterogeneous interests. Now the question becomes why the control remains in the hands of shareholders. In other words, shareholder heterogeneity indicates shareholders may legitimately have interests other than maximising residual profits, which clashes with the very rationale behind shareholder control and voting as discussed earlier.

One explanation would be shareholders' rational apathy, which in turn results in ineffective usage of shareholder voting power and thereby mitigates the *impact* of shareholder heterogeneity. Widely dispersed shareholders can be rationally apathetic. In particular, by adopting diversified and balanced portfolios, shareholders including institutional investors can be less concerned about the success of any particular company than their overall portfolios. Moreover, as observed by Berle and Means as early as in the 1930s, dispersed shareholders in large modern companies are both unable and uninterested in exercising control.[72] Dispersed information, the costly transmission of information as well as collective action problems are almost insurmountable, especially in large US or UK public companies where shares are usually dispersing. Shareholders would then lack both information and incentive to actively participate in corporate decision-making. Even those institutional investors are likely to be rationally apathetic as well.[73] Just as Cahn and Donald argued that most shareholders "either do not want to manage the company or do not have the necessary skill" to exercise effective decision-making.[74]

To begin with, shareholders are normally not active participants in the corporate governance system. They may either lack resources, skills or willingness to be involved. Institutional shareholders, who manage a large pool of assets and become a major part of shareholder classes nowadays, also prefer to be rationally apathetic with few exceptions of activist groups. Even assuming institutional shareholders'

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[72] Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (New Brunswick: Transaction Publishers, 1991, originally published 1932).

[73] Stephen M Bainbridge, *Corporate Governance after the Financial Crisis* (Oxford: Oxford University Press, 2012) pp 243–244.

[74] Andreas Cahn and David C Donald, *Comparative Company Law* (Cambridge: Cambridge University Press, 2010) p 299. It is also argued that many institutional shareholders indeed pursue short-term investment strategies. David Millon, "Shareholder Social Responsibility" (2013) 36 *Seattle University Law Review* 911, 913.

proportionate share of expected benefits can increase after their active participation in corporate decision-making and exceed all costs, institutional shareholders may still prefer to remain passive. It should not be ignored that any gains generated after active institutional shareholders' efforts would be shared by all shareholders, including other passive institutional investors, but only the activists bear the costs. This means rival institutional investors may free ride and benefit from the activist's successful intervention. Take fund managers for example. Passive fund managers can share the benefits from an active fund manager's successful intervention but not share any costs, so the activist's relative performance will not exceed his "free-riding" rivals. Indeed his position may be worse under the competitive environment due to the cost of activism.[75] When institutional investors are evaluated on their relative performance (namely, better than their competitors), it is not surprising that the majority would choose to remain passive even if expected gains can be larger than expected costs of engagement.

In fact, there is an unprecedented shift from active to passive investment strategies. Empirical evidence documents between 2008 and 2015 investors bought passively managed funds of approximately US$1 trillion, while during the same period sold holdings of actively managed equity funds worth roughly US$800 billion; and as of year-end 2015, passive index funds managed total assets invested in equities of more than US$4 trillion.[76] The three largest passive funds, ie, BlackRock, Vanguard and State Street combined constituted the largest shareholder in 438 of the 500 (87.6 per cent) S&P 500 companies, the most important American firms. A more recent analysis estimates the assets under the management of passive funds passed the assets under active fund by about US$25 billion on 31 August 2019, which makes passive funds representing 50.15 percent of the US equity markets.[77]

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[75] For more discussion, see Bernard S Black and John C Coffee, "Hail Britannia? Institutional Investor Behavior under Limited Regulation" (1994) 92 *Michigan Law Review* 1997, 2058–2059. Furthermore, activist sometimes may even be not able to internalise the potential benefits due to the dispersed shareholdings. See Bebchuk (n 33 above) pp 689–690.

[76] Jan Fichtner, Eelke Heemskerk and Javier Garcia-Bernardo, "Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk" (2017) 19 *Business & Politics* 298, 299.

[77] Kevin McDevitt and Gabrielle DiBenedetto, "Morningstar U.S. Fund Flows: Fed Rate Cut Doesn't Spur Inflows" *Morningstar Research*, 2, available at https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Fund_Flows_August2019_Final.pdf?cid=EMQ_&utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18776 (visited 1 September 2020). Just 10 years ago, active funds had about 75 percent of market share and over the past 10 years, active funds have had the US$1.3 trillion in outflows and their passive counterparts nearly US$1.4 trillion in inflows.

On the other hand, choosing alternative courses of action, eg exiting by selling shares rather than active engagement, may help to avoid collective action problems and secure gains that cannot be shared by competitors. This is also why institutional shareholders prefer to address the problem by seeking private benefits that cannot be shared.[78] In addition to the collective action problem, the demand for liquidity may further impede (institutional) shareholders from being active, as they prefer not to be "locked in". To become an active actor requires shareholders to spend adequate resources into investigating the investee companies and then challenge the incumbent management to effect a change. Shareholders would be locked in since the *voice* takes a significantly longer period, during which they may not freely liquidate their shares. This is much more costly and time-consuming than the *exit* strategy, which could deter investors who value liquidity highly. Indeed, the average holding period of shares has been considerably reducing,[79] reflecting activism an even less favoured option for most investors.

As a result, shareholders' inability or unwillingness to engage in corporate governance unintendedly mitigates the potential consequences of shareholder heterogeneity. Compared with active participants, passive and functionless investors concerned only with receiving "a return on their capital accruing with the mere passage of time".[80] Moreover, *fictional* shareholders, who are rational share-value maximisers, are developed to replace *real* shareholders to police the management and ensure managerial accountability.[81] By referring to the case *Pillsbury v Honeywell, Inc.*,[82] Daniel Greenwood concluded "[i]f the real people disagree with the fictional representation, the real people may simply be disregarded as not real shareholders" due to the lack of investment intent.[83] In short, both shareholders' rational apathy and the creation of fictional shareholder temporarily mitigate the impact brought by

[78] For example, see Bainbridge (n 71 above) pp 1754–1756.
[79] European Commission, "Green Paper: The EU Corporate Governance Framework" (2011) 164 COM final, p 12. The high trading frequency implies that institutional investors may hold shares for only seconds before selling them.
[80] Paddy Ireland, "Company Law and the Myth of Shareholder Ownership" (1999) 62 *Modern Law Review* 32, 42.
[81] Daniel Greenwood, "Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited" (1996) 69 *Southern California Law Review* 1021, 1052–1053.
[82] 191 NW2d 406, 411 (Minn 1971).
[83] Greenwood (n 81 above) p 1053.

shareholder heterogeneity as well as its collision with shareholder control.[84] The economic incentives of directors and management due to the executive compensation practice[85] would further encourage them to manage the company in a manner to maximise shareholder value.

4. Corporate Social Responsibility

4.1 Further Deviation from the Economic Rationale

Nevertheless, shareholder heterogeneity can go much further as their interests could encompass those other than economic profits. Some shareholders may be more concerned about environmental causes or community welfare. It is perfectly possible for individual shareholders choosing not to maximise residual profits regardless of the timeframe. That is to say, if creating fictional shareholders as a rational share-value maximiser might mitigate the conflict between shareholders' varying economic interests, it is perhaps insurmountable to strike a balance between economic and non-economic interests.

A good example of non-economic focus is the rapid growth of socially responsible investment (SRI) fund, where considerations other than pure economic utility (such as social and environmental concerns) are taken into account. These funds follow a non-financial screening and divest in socially irresponsible corporations regardless of their financial performance. Although SRI funds are arguably providing lower average returns than non-SRI counterparts,[86] by the end of 2017, the market size of SRI in the United States alone is over US$12.0 trillion, amounting to a quarter of all investment under professional management in the United States.[87] The increasing popularity of contemporary CSR across the world also reflects the belief that corporations have responsibilities beyond generating profits for shareholders.[88] Meanwhile, the

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[84] It is also noteworthy that the concern over managerial accountability also raises the necessity to establish an objective for directors and managers to pursue. So, shareholder primacy is to some extent a model to counterbalance management primacy or say management entrenchment.

[85] Bebchuk and Tallarita (n 17 above).

[86] The empirical findings of whether SRI funds perform better or worse than traditional investment funds remain largely mixed. For example, see Halil Kiymaz, "Performance Evaluation of SRI Funds: An Analysis of Fund Types" (2019) 8 *Accounting and Finance Research* 212, 214–219.

[87] US SIF Foundation, "2018 Report on US Sustainable, Responsible and Impact Investing Trends", available at https://www.ussif.org/trends (visited 1 September 2020). Also see Adam Connaker and Saadia Madsbjerg, "The State of Socially Responsible Investing" (2019) *Harvard Business Review*, available at https://hbr.org/2019/01/the-state-of-socially-responsible-investing (visited 1 September 2020).

[88] Min Yan and Daoning Zhang, "From Corporate Responsibility to Corporate Accountably" (2019) 16 *Hastings Business Law Journal* 47, 48.

considerable increase in the proportion of shareholder proposals on CSR issues also signals growing shareholders' concerns wider than mere maximisation of corporate residual profits.[89]

Corporate social responsibility advocates have tried hard to correlate CSR with shareholder value either intentionally or unintentionally.[90] Over one hundred empirical studies have focused on the correlation between engaging in CSR and corporate financial performance.[91] There is also a significant body of literature that aims to establish a positive contribution of CSR to corporate financial performance and shareholder value.[92] For example, based on Zadek's four general types of business case for CSR,[93] Kurucz, Colbert and Wheeler have argued engaging in CSR activities will (1) reduce firm's costs and risks; (2) gain a competitive advantage in the context of a differentiation strategy; (3) strengthen firm's legitimacy and reputation; and (4) create a win-win outcome by connecting stakeholder interests.[94] CSR in the context of "doing good to do well"[95] can be interpreted as a corporate strategy to reinforce corporate competitive advantages, which is ultimately for improving corporate performance.[96] These efforts are primarily aimed to preserve the shareholder primacy law and the residual proprietary claimant status of shareholders by providing an economic rationale for CSR.

It is argued that the incentive for shareholders to exercise or delegate the control power to engage in CSR activities is indeed to maximise the long-term residual of

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[89] Although those shareholders submitting CSR proposals could not represent other shareholders, they are at least representing a significant group of shareholders, especially in the context of growing SRI. Michelon and Rodrigue (n 5 above) p 158.
[90] See Yan (n 3 above) p 80.
[91] Andreas Georg Scherer and Guido Palazzo, "The New Political Role of Business in a Globalized World: A Review of a New Perspective on CSR and Its Implications for the Firm, Governance, and Democracy" (2011) 48 *Journal of Management Studies* 899, 904.
[92] For example, see Kevin T Jackson, *Building Reputational Capital: Strategies for Integrity and Fair Play That Improve the Bottom Line* (Oxford: Oxford University Press, 2004); Chris Laszlo, *The Sustainable Company: How to Create Lasting Value through Social and Environmental Performance* (Washington: Island Press, 2003); Sandra Waddock, *Leading Corporate Citizens: Vision, Values, Value Added* (New York: McGraw-Hill, 2002); Connie Van der Byl and Natalie Slawinski, "Embracing Tensions in Corporate Sustainability: A Review of Research from Win-Wins and Trade-Offs to Paradoxes and Beyond" (2015) 28 *Organization & Environment* 54–79.
[93] That is: (1) to defend reputation and avoid potential financial loss; (2) to achieve cost benefits; (3) for strategic business reasons; and (4) to help manage risks and promote innovation in learning in a dynamic and complex environment. See Simon Zadek, *Doing Good and Doing Well: Making the Business Case for Corporate Citizenship* (New York: The Conference Board, 2000).
[94] Kurucz, Colbert and Wheeler (n 4 above) pp 85–92.
[95] See Vogel (n 4 above) p 21.
[96] Porter and Kramer (n 4 above) p 83.

profits.[97] If this is the case, then shareholders' voting power remains commensurate with their (economic) interests in the corporation and more importantly, the foundation of the power allocation within the modern corporation may remain intact. When engaging in CSR arises from a profit motive, eg installing energy-saving or emission-reduction equipment can reduce management risk and increase shareholder return in due course, then undercutting CSR for ultimately higher corporate financial return and shareholder gain would become justifiable. In this regard, CSR activities/initiatives turn out to be merely another type of investment, which can then be dispensable for the ultimate end.

However, many commentators including economists and lawyers have in contrast insisted that activities only with profit-maximising motivation should not be defined as CSR.[98] Just as Kenneth Walters acutely noted, social responsibility refers to corporate goals, not corporate strategies — to ends, not means.[99] The essence of corporate responsibility is to expend corporate resources for socially beneficial purposes without any profit motive.[100] If CSR is an end itself, the focus on instrumentality warrants a thorough reconsideration. In other words, the impact of social performance on financial performance will be the limit of shareholders' interest in social performance. At least, the traditional economic utility rationale can no longer perfectly apply to the shareholder primacy theory or the justification for shareholder voting.

4.2 Shareholder Role in Corporate Social Responsibility

When shareholders are willing to exercise or delegate corporate control in a way to address social and environmental concerns beyond legal requirements that do not directly correlate with profits maximisation, it implies that their incentive to maximise residual profits of the corporation is diluted or at least no longer the sole priority. Subsequently, the correlation between shareholder interest and corporate interest as discussed earlier will be weakened if not completely disappeared. And when

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[97] See Archie B Carroll and Kareem M Shabana, "The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice" (2010) 12 *International Journal of Management Reviews* 85, 86.
[98] Kenneth J Arrow, "Social Responsibility and Economic Efficiency" (1973) 21 *Public Policy* 303, 303–309; Jerry L Mashaw, "Corporate Social Responsibility: Comments on the Legal and Economic Context of a Continuing Debate" (1984) 3 *Yale Law & Policy Review* 114, 115.
[99] Kenneth D Walters, "Corporate Social Responsibility and Political Ideology" (1977) 19 *California Management Review* 40, 41.
[100] Yan (n 3 above) p 82.

shareholders become indifferent to the corporate residual, participation through voting would become questionable.

From a law and economics perspective, shareholders' residual proprietary claims and their incentives to exercise discretions to maximise such residual are important premises for them to have the participatory right as opposed to the other corporate stakeholders such as employees, creditors, suppliers and alike. If shareholders are ready to exercise or delegate their control power to engage in CSR activities that do not maximise corporate residual, the economic foundation for the allocation of corporate power between shareholders and other corporate constituents, as suggested by Easterbrook and Fischel among others, will subsequently be shaken. In other words, requesting or expecting shareholders to be more active and voting for more CSR activities is fundamentally contradicted to the modern foundation of shareholder voting. Despite situations of shareholder proposing and voting for CSR activities do occasionally happen now,[101] when shareholders exercising their control in seeking values not related to their residual profits becomes the norm, the justification for shareholder participation (namely, their voting right) will not work anymore. Not surprisingly, shareholder voting under such context would also be a threat to the shareholder primacy norm.

Suffice it to say, the essential precondition for shareholder voting is that they are economically rational actors with substantially homogeneous preferences to maximise residual profits of the corporation. If shareholders' preferences become more socially or environmentally oriented rather than corresponding to their economic stake in the company, they may no longer have the *right* incentives to exercise their voting rights in a way that most likely to maximise the residual profits. Under such a situation, they will no longer be in the best place to monitor managerial performance to lower the agency costs. At the very least, the monitoring cost will be increased, as those shareholders would not be fully incentivised to exercise or delegate their control to achieve optional decisions in the sense of residual maximisation.

5. Challenges to the Fundamentals of Modern Corporations

Hence, shareholders' preferences do matter. Shareholders are not merely *fictional* persons that are only concerning maximising their share value. Instead, their

[101] Or at a more indirect dimension, shareholders could shape directors' incentives by adding non-financial indicators in their compensation arrangement.

heterogeneous preferences become increasingly normalised as exhibited. The classical arguments against the stakeholder theory are equally applicable here. For example, the UK CLRSG concluded that:

> "[t]he trade off of interests of members and others (with whom the company is in some aspects in an adversarial bargaining relationship), would dangerously distract management into a political balancing style at the expense of economic growth and international competitiveness".[102]

Easterbrook and Fischel also voiced the concern that directors would be free and answerable to no one if they were required to take all stakeholders' interests into account.[103] By the same token, *real* shareholders with essentially heterogeneous interests would ultimately lead directors and their delegated executives to a similar outcome of trying to balance essentially heterogeneous claims. Clashes among diverse or even contradicting preferences are inevitable. Such heterogeneous interests would also lead to inefficiencies, similar to Hansmann and Kraakman's criticism against the employee voting participation under Germany's co-determination context.[104]

Some may quickly point out that if this is the case why chaos does not yet follow? Among the many possible explanations, there shall be two primary reasons. First, shareholder voting for CSR is not wholeheartedly. In other words, shareholders treat CSR strategically or cosmetically and only push directors to engage in CSR activities that could increase the residual of the corporation, as we can find in the foregoing business case argument. This theme of instrumental value-based arguments, which see CSR activities in a given manner would be useful for long-term shareholder value,[105] are not conceptually different from the old-fashioned shareholder primacy.[106] Seeing CSR as a mere investment or strategy to enhance competitive advantages determines such CSR is itself dispensable for ultimate corporate financial performance.[107]

The second explanation would be that shareholder voting mainly concerns vertical relations linking shareholders and management, rather than horizontal relations

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[102] CLRSG (n 45 above) p 44.
[103] Easterbrook and Fischel (n 31 above) p 38.
[104] Henry B Hansmann and Reinier H Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439, 445.
[105] See Porter and Kramer (n 4 above) p 83.
[106] Bebchuk and Tallarita (n 17 above); Yan (n 3 above) p 79.
[107] This is also why there is a school of scholars insists that genuine CSR is to expend corporate resources for socially beneficial purposes instead of profit-driven motives as discussed in the foregoing section. See notes 98-100 and accompanying texts above.

among shareholders.[108] The core concern of shareholder control is to deal with the principal-agent relationship between shareholders as a whole and directors/managers. The difference among shareholders is but secondary, which would not be surprising especially in the context of shareholder homogeneity. However, when the divergence among shareholders becomes more frequent, it is not impossible for directors or managers as agents to exploit such divergence and use the heterogeneous or even competing claims to shirk or engage in opportunistic, self-interested behaviour.[109] If it continues, the vertical power relations within the corporation will inevitably be affected in the end.

As a consequence, the foundation of shareholder voting will be shaken unless the CSR shareholders voted for is still largely aligned with profit maximisation, ie, not the *real* CSR that is purely for social benefits. While SRI funds do take social and environmental performance into consideration and divest in socially irresponsible firms, the crucial question is whether investors/shareholders would be ready to permit or encourage their investee companies to work on their social performance if it were to the companies' financial detriment. The collective action problem and conflicts of interest would inevitably lead to a general reluctance of institutional investors to intervene in their investee companies' internal affairs, though they are encouraged to be more actively involved. Alternatively, in case that shareholders' support for CSR is not strategic but wholeheartedly, the chaos may be avoided only if shareholder voting for CSR remains not frequent enough to fundamentally change the vertical power relations.[110]

When we return to the starting point of power allocation between shareholders and other stakeholders, the reason shareholders can obtain the control rights of the corporation is not merely because they would be affected by the corporate decisions. Other stakeholders such as employees, creditors and the like would also be affected by corporate decisions in one way or another, but they are normally not allowed to participate in corporate governance like shareholders. The conventional wisdom

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[108] Dunlav (n 35 above) p 1365. Such conception of "shareholder democracy", which initially occurred in the twentieth century, has persisted to the present day. *Ibid*., 1365–1366.

[109] Management can always choose to advance certain shareholders' interests that closely match their own. Or even worse, in order to escape the difficulty and potential liability, directors may choose to do nothing.

[110] In the capital market for example, ethical investment and SRI funds remain small compared to the size of the entire equity market, suggesting socially motivated investors/shareholders have not yet become a norm.

places the emphasis on shareholders' residual proprietary claim, which leads them to have the best incentive to exercise discretion and oversight, compared to other stakeholders as fixed claimant as previously discussed in Section 2. Such incentives largely ensure shareholders' preferences are homogeneous and can be aggregated into a consistent system of choices. On the other side, the heterogeneous nature of stakeholders determines their heterogeneous preferences would hardly be translated into a consistent group of choice. So even for those who strongly prefer pluralism and believe companies shall enhance the quality of life in their local communities, their environmental protection, the safety and security of their employees and workers, in their supply chains, and the health of their customers beyond increasing their share prices, they still believe directors should only be elected by shareholders,[111] as it is difficult to find a readily manageable and countable standard for the potential *stakeholder voting*. Nevertheless, the challenge brought by the non-economic preference of shareholders analysed earlier may result in the same outcome of lacking a consistent system of choices, which further challenges the foundation of shareholder control.

6. Conclusion

This article contributes to the CSR literature by critically examining shareholders' role in the context of CSR. As shown, shareholders' control and voting rights make it both theoretically and practically impossible for directors to engage in CSR if shareholders object it. In addition to the residual power of determining fundamental corporate changes, shareholders are able to elect directors of the board and remove them if they are displeased with these elected representatives' action. Shareholders can also shape directors' incentives by adding financial and non-financial indicators in the directors' remuneration arrangement. Thus, any CSR discourse without involving shareholder control would be incomplete at best and misleading at worst.

While it is generally believed that shareholders' voting power is, and shall be, based on their economic stakes in the residual proprietary claims against the corporation, shareholders may have heterogeneous interests. Shareholder homogeneity is proved to be a false promise. Reciprocal altruism and other values do

[111] Colin Mayer, "Shareholderism versus Stakeholderism — a Misconceived Contradiction. A Comment on 'The Illusory Promise of Stakeholder Governance' by Lucian Bebchuk and Roberto Tallarita" (2020) *ECGI Law Working Paper No. 522/2020,* available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3617847 (visited 1 September 2020).

sometimes reflect in human beings' decision-making,[112] and shareholders are not always economically rational actors. However, this article finds that if such decoupling of shareholder voting from their economic stakes in the corporation becomes normalised, then the conventional foundation for modern corporate governance will be shaken. In particular, the justification and basis for the allocation of corporate power within the corporation, ie, shareholder voting, will significantly be challenged. Put differently, the conception of CSR seems incompatible with shareholder control in modern corporations reliant on capital markets — when shareholders object CSR, it would result in difficulties for companies to engage in CSR; when shareholders support CSR, it would clash with the foundation of shareholder control.

In conclusion, it is essential for future CSR discourses to include the role of shareholders, especially institutional shareholders are presently encouraged to take more active role in corporate governance through voting and dialogue.[113] The incompatibility between shareholder control and CSR activities as discussed in this article shall not deter the focus on the relationship between the two, but instead stimulate future research on the potential solutions out of the old box, such as multi-stakeholder participation. At the very least, the challenge brought by CSR to the fundamentals of modern corporate law and governance must be squarely faced.

[112] Kent Greenfield, "Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool" (2002) 35 *University of California Davis Law Review* 581, 628–633.
[113] For example, see UK Stewardship Code.