PIONEER
ACADEMIC PUBLISHING LIMITED

Studies in Law and Justice
ISSN 2958-0382
www.pioneerpublisher.com/slj
Volume 2 Number 1 March 2023

Risk Analysis from a Stakeholder First Perspective

Baoqi Yuan[1]

[1] University of Leeds
Correspondence: Baoqi Yuan, University of Leeds.

doi:10.56397/SLJ.2023.03.08

Abstract

The widely held belief that corporate executives should only prioritize shareholders' interests is eroding. However, there are risks involved if directors of the business are asked to concentrate on broad objectives that serve the interests of all of the company's stakeholders. Therefore, this paper focuses on the risks arising under the broad objective that company directors are required to focus on serving all stakeholders of the company, including the risk of litigation that may arise from the actions of company directors, the moral hazard of infringement of stakeholders' interests and the creation of risks such as damage to the company's interests, based primarily on section 172 of the Companies Act 2006 and the relevant provisions of the Insolvency Act 1986 Overall, therefore, the conclusions of this paper provide some insight into the risks arising from the view that all stakeholders are paramount.

Keywords: corporate law, primacy of all stakeholders, risk analysis

1. Introduction

Corporate directors have a broad scope of action focused on serving all stakeholders in the company, which will create new risks for multiple parties while benefiting stakeholders. The traditional understanding of 'shareholder primacy' has reached its peak and is in decline (Stout, L. A., 2012). Thus, the emergence and codification of a view of the primacy of all stakeholders will inevitably lead to a series of problems, namely the risks that arise in the process of realization. Risk identification is a prerequisite for risk avoidance, and the existence of risk is a key impediment to the implementation of stakeholder primacy by directors, and the analysis of the risks that may arise plays a key role in enabling directors to better serve all stakeholders in the company. This paper, therefore, seeks to identify the risks arising from the 'all-stakeholders first' perspective, building on the work of Allen, Macey, Jensen, and others.

The article is structured as follows. The next section, which forms the main body of the article, discusses some of the risks arising from the broad objective that company directors are required to focus on serving all stakeholders in the company from three perspectives, including the risk of litigation against company directors, the moral hazard of infringement of stakeholder interests and the risk of damage to the company's interests, in accordance with the provisions of section 172 of the Companies Act 2006 relating to directors' duties. three areas. What specific risks will be faced by each of these three categories of subjects and why the risks arise are discussed separately, and an attempt is made to explain the positive effects that exist under the risks. Finally, there are some concluding remarks to conclude the text.

2. Analysis of Risks

Analysis of the risks that may arise from three perspectives: directors, stakeholders and the company

2.1 Litigation Risks Arising from the Actions of Directors

The Companies Act 2006 introduces a completely new concept compared to the Companies Act 1985, namely the duty of directors to "promote the successful operation of the company in the interests of all members of the company as a whole". In this provision, what constitutes "the success of the company" is not clearly defined in the Act or in case law, making the concept unclear and making it difficult for directors to determine what decisions are necessary to promote the success of the company in particular circumstances, such as when the company is facing a merger or bankruptcy. This obligation also requires directors to consider and balance the interests of all stakeholders and the long-term consequences of their actions before making decisions, thus making the directors' obligations even less clear. As such, a vague definition of the duty may create a greater risk of litigation for directors.

Where a company is operating well, the directors may face derivative actions brought by shareholders. Under the relevant provisions of the Companies Act 2006, the right of action would be in favour of the company if the directors acted inconsistently with the terms of their duties. (Keay, A., 2007) As a result, shareholders have the right to sue the directors on behalf of the company in a derivative action[1]. Firstly, according to Macey and O'H derivative (Macey, J. R., & O'Hara, M., 2003), O'Hara requiring directors to focus on all stakeholders and thus balance the relevant interests is a very cumbersome decision-making process. It is difficult for directors to consider all interests at the same time in this process and may make poor decisions, so if the interests of the company are harmed, shareholders will likely sue on behalf of the company and directors will be at risk of litigation. However, even though directors are exposed to the risk of a derivative action, they are still only liable to the company under the law, meaning that only the company has the right to hold the directors liable for their misconduct. At present, however, under the relevant case law, it is rare for a company to bring an action against a director for breach of duty. The risk of a director being sued is not always present because the test for determining whether a director's actions "promote the success of the company" is subjective and depends on whether the director himself believes that his actions are reasonable. (Keay, A., 2014)

In the event that a company becomes insolvent and goes into administration or liquidation, the directors may be exposed to relevant action by the administrator or liquidator, such as an action for wrongful trading by the liquidator[2]. Normally, the directors would only have a duty to the company, but if the company has gone into administration or liquidation, the directors would become liable to the creditors.[3] When a director knows or should know that the company is on the verge of insolvency and unable to pay its debts, the director may take extreme risky actions in a desperate attempt to save the interests of all stakeholders of the company, including shareholders and employees, and still continue with the relevant business activities. Just as the UK government enacted the Corporate Insolvency and Governance Act 2020 (CIGA 2020)[4] in 2020 to avoid consideration of improper trading by directors during the new crown epidemic, the aim is also to protect and save the interests of the company and its stakeholders by providing directors with an exemption from liability and thereby. Nevertheless, it is generally accepted that a breach of duty occurs if a reasonable director believes that the exercise of the relevant powers is not in the interests of the company (In the event of insolvency of the company, for the benefit of creditors). (Ahern, D., 2011) Therefore, if such decisions end in failure and the interests of creditors are further harmed, then the directors can become defendants and be held liable. Fundamentally, the purpose of a director is to save the interests of the company's stakeholders, so once the director is required to focus on serving all stakeholders, the risk of litigation against the director in the event of the company's insolvency is further increased. In addition, according to the communitarian theory (Al-Barashdi, S., & Yeung, H., 2018), the insolvency of a company requires attention to all stakeholders rather than just creditors, but in any insolvency situation there are considerable community and potential interests, and there may be some conflict in the choice of interests to be protected, so over-protection of stakeholders' interests in the case of insolvency will inevitably be to the detriment of creditors, which increases the risk of litigation by creditors. This increases the risk of creditor litigation.

In normal circumstances, even if derivative proceedings are commenced, a director can state that he or she believes that he or she has acted in good faith, in the interests of all stakeholders in the company, and has given due consideration to all matters specified. If the court does not fully believe the director's declaration, there are options to help the director avoid the risk of litigation, such as the Charterbridge Corporation test[5].

2.2 Moral Hazard of Compromised Stakeholder Interests

The requirement for directors to be accountable to all stakeholders of the company protects stakeholders while providing an excuse for directors to indirectly harm stakeholders, exacerbating directors' propensity for moral hazard and thereby increasing the potential risk of damage to the interests of certain stakeholders.

In the existing discussion on stakeholder management, I agree more with Jensen's main point (Jensen, M. C., 2002) that directors have unconditional discretion in protecting the interests of their stakeholders and that this power increases the more stakeholders there are in the stakeholder group. At the same time as directors have to aim broadly at the different interests of all stakeholders, they are likely to avoid being held accountable for this, in other words, directors can be held accountable for no one. In reality, not only is there a risk of directors' misconduct in the operation of a company, but there is also a moral risk of shareholders with only limited liability infringing on the interests of stakeholders, such as abuse of power, deliberate deception, and so on.

According to s. 172(1) of the Companies Act 2006, directors need to consider a number of situations that have been listed, but are not exhaustive, when fulfilling their duty to promote the company towards success, including consideration of the interests of the company's employees; business relationships with suppliers, customers, etc. The group of stakeholders involved in this provision is quite large and there are different conflicting and differing interests between different stakeholders, and it is clear that such differences and conflicts provide a possible scenario for directors to ostensibly actively protect the interests of one stakeholder while in fact infringing on the interests of another stakeholder. In the case of a bank, for example, the lender and the bank depositor are both stakeholders in the bank, but the interests of each are arguably completely opposed. If the directors of a bank reduce the interest rate on deposits in the name of protecting the interests of the lenders, then the interests of the depositors of the bank will be infringed; conversely, the directors of the bank may increase the interest rate on loans in order to protect the interests of the depositors, but this would be to the detriment of the relevant interests of the lenders. Clearly, in this case, the directors become the biggest beneficiaries of the broad objective of the service company for all stakeholders, and the risk of harm to the interests of stakeholders is greatly increased.

Whether stakeholders are at risk of compromised interests depends to a large extent on the way in which directors' discretion is used and on the fulfilment of their ethical obligations. As Bebchuk and Tallarita (Bebchuk, L. A., & Tallarita, R., 2020) state, it is also a good way to improve corporate performance if directors choose to use greater slack in decision-making to balance and expand the interests of all stakeholders, for example, by choosing low-challenge, low-intensity projects in a lower-stress work environment, allowing bottom-level employees to work easily under more lenient supervision. The theory of Hambrick and Finkelstein (Hambrick, D. C., & Finkelstein, S., 1987) also aptly illustrates that a manager who has greater discretionary power may make decisions that significantly enhance corporate performance, thus allowing the interests of stakeholders to be protected.

It follows that, due to the unconditional nature of directors' discretion and the directors' propensity for moral hazard, there is a real risk that the interests of various stakeholders will be invisibly infringed, but to a large extent depending on the subjective attitude of the directors, so that the impairment of interests is not absolute and in some cases, there may even be situations where the profits of the company increase and various stakeholders benefit from it.

2.3 Risk of Damage to the Company's Interests

In contrast to the theory that the interests of shareholders are paramount, a director's focus on the interests of all stakeholders in the company can incur high costs in terms of money and time in the corporate governance process, which in turn can be detrimental to the interests of the company as a whole. If the directors are only concerned with the interests of the company's shareholders and the maximisation of shareholders' interests is the ultimate goal of the company's production and management, then this goal is a single subject. If the director serves all stakeholders, the ultimate goal of the company is multiple, including social responsibility, economic profit and employee welfare. Tirol (Tirole, J., 2010) is negative about the desirability of such a stakeholder-based approach to the company's objectives. In a company where the interests of all stakeholders are united in a multiplicity of objectives, it is difficult for directors to focus solely on the company's earnings and this will inevitably lead to a loss of efficiency in the business. Furthermore, in the process of globalisation, there may be situations where different types of companies compete together, such as competition between companies that focus on the interests of shareholders and companies that focus on all stakeholders. According to Allen, Carletti and Marquez (Allen, F., Carletti, E., & Marquez, R., 2007) it is not difficult to find that companies that focus on all stakeholders, compared to companies that focus only on the interests of shareholders, the former benefit less from the softening of competition benefiting less and therefore being a manifestation of the damage done to the interests of the firm.

On the other hand, derivative actions may arise because directors are focused on the interests of stakeholders and may ignore or harm the interests of the company and its shareholders. If a shareholder brings a derivative action, then the company will have to bear the high costs of litigation in terms of money and time. Firstly, a derivative action brought by a shareholder against a director will incur significant time costs. A director's decision or action requires consideration of long-term consequences and requires time to verify, so a shareholder may bring an action without understanding the director's actions, and once the shareholder identifies the director's true intentions and may prove that the director's choice was correct or that the company has resumed normal operations, the time cost during the derivative action is a waste of time. At the same time, as a result of the new provisions of the Companies Act 2006 on the procedure for derivative actions, a great deal of preparation work is required prior to litigation, such as the plaintiff must prove at the time of litigation that the case is one in which a prima facie case already exists, the court may require the company to provide relevant evidence, and only in this case may the court accept it, and the cumbersome procedure further increases the company's time costs. Secondly, the high monetary costs incurred by companies during litigation. Unlike in the US, the UK rules require the losing party to pay both its own legal fees and those of the winning party. (Eisenberg, T., & Miller, G. P., 2012) This requirement undoubtedly increases the risk of damage to the company's interests when there is uncertainty as to whether the litigation will be successful. In addition, for larger companies, derivative litigation leads to a loss of shareholder confidence in the directors or even the company, which in turn leads to a serious impact on the company's reputation (Wilson, J. D., 1985), a fall in the value of the company's shares, damage to the company's interests and a number of other situations.

Although a focus on the interests of all stakeholders in the company may bring the risk of damage to the company's interests, it must be acknowledged that more attention to the interests of all stakeholders, such as employee welfare protection and attention to environmental protection, is also conducive to the stable development of the company and the improvement of its performance.

3. Conclusion

The purpose of this paper is to identify the various risks that arise when company directors adopt a 'all-stakeholders first' view. Firstly, there is the risk that directors may make poor decisions in the course of running a company that is difficult to balance between the interests of stakeholders, to the detriment of the company, and thus face derivative litigation; or that directors may risk wrongful trading actions by the liquidator in the event of the company's insolvency, where they risk aggressive trading to save the interests of stakeholders and the interests of creditors are infringed.

Secondly, although directors are required to serve all stakeholders, this requirement may still create risks for the stakeholders themselves. As directors' unlimited discretion allows them to avoid liability for unethical behaviour, it is possible that stakeholders' interests may be compromised by the directors' choices. In short, there is a potential moral hazard for stakeholders.

Finally, directors are accountable to the company and their implementation of the requirements will ultimately be reflected in the company's profits, so this requirement may also pose a risk to the company's interests. A director's excessive focus on stakeholders will inevitably lead to a reduction in operational efficiency, which will have a direct impact on the company's profitability. If a director enters into litigation, such as derivative litigation, due to his or her own failings, the company will have to bear the corresponding monetary, time and hidden social costs, all of which will indirectly affect the company's interests.

Overall, the conclusions of this paper provide some insight into the risks arising from the stakeholder primacy perspective. Unfortunately, the paper does not discuss in depth the opportunities that lie behind the risks. Despite its limitations, this paper has certainly added to my understanding of the types of risks that can arise.

References

Ahern, D. (2011). 'Nominee Directors' Duty to Promote the Success of the Company: Commercial Pragmatism and Legal Orthodoxy. *LQ REV, 127*, 118.

Al-Barashdi, S., & Yeung, H. (2018). An Assessment of Various Theoretical Approaches to Bankruptcy Law. *Journal of Arts and Social Sciences [JASS], 9*, 23.

Allen, F., Carletti, E., & Marquez, R. (2007). Stakeholder Capitalism, Corporate Governance and Firm Value. Corporate Governance and Firm Value. EFA 09.

Bebchuk, L. A., & Tallarita, R. (2020). The Illusory Promise of Stakeholder Governance. *Cornell L. Rev., 106*, 91.

'Charterbridge Corp v Lloyds Bank Ltd | Westlaw UK' (Practical Law). Retrieved January 10, 2023, from http://uk.practicallaw.thomsonreuters.com/Document/I862DFFF0E42711DA8FC2A0F0355337E9/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=6d79af65e3524e4c9857116e106167a4&contextData=(sc.DocLink)&comp=wluk

Eisenberg, T., & Miller, G. P. (2012). The English versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts. *Cornell L. Rev., 98*, 327.

Hambrick, D. C., & Finkelstein, S. (1987). Managerial Discretion: A Bridge between Polar Views of Organizational Outcomes. Research in organizational behavior.

Jensen, M. C. (2002). Value Maximization, Stakeholder Theory, and the Corporate Objective Function. *Business ethics quarterly, 12*(2), 235.

Keay, A. (2007). Section 172 (1) of the Companies Act 2006: An Interpretation and Assessment. *Company Lawyer, 28*, 106.

Keay, A. (2014). Directors' Duties and Creditors' Interests. *LQ REV, 130*, 443.

Macey, J. R., & O'Hara, M. (2003). The Corporate Governance of Banks. *Economic policy review, 9*.

Stout, L. A. (2012). New Thinking on Shareholder Primacy. *Accounting, Economics, and Law, 2*.

Tirole, J. (2010). *The Theory of Corporate Finance*. Princeton University Press.

Wilson, J. D. (1985). Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholders' Derivative Action. *Windsor YB Access Just., 5*, 142.

[1] The Rules of the Supreme Court (Amendment) 1994.

[2] Insolvency Act 1986.

[3] Companies Act 2006.

[4] Corporate Insolvency and Governance Act 2020—Interim report March 2022.

[5] Charterbridge Corp Ltd v Lloyds Bank Ltd [1970] Ch. 62. <http://uk.practicallaw.thomsonreuters.com/Document/I862DFFF0E42711DA8FC2A0F0355337E9/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=6d79af65e3524e4c9857116e106167a4&contextData=(sc.DocLink)&comp=wluk> accessed 10 January 2023.