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# BEYOND SHAREHOLDER PRIMACY: THE LEGAL TRANSFORMATION OF CORPORATE PURPOSE IN THE ERA OF STAKEHOLDER GOVERNANCE

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## ABSTRACT

This paper discusses the way in which the orthodox notion of companies existing to serve shareholders is being challenged and slowly redefined. The shareholders have long been the focus in the decision-making process of the corporation as presented by company law. Increasing apprehension regarding environmental degradation, social inequalities and long-term sustainability has resulted in a wider consideration that companies can also consider the interests of employees, consumers, creditors, communities and the environment. The paper discusses the question as to whether this is simply an aspirational shift to stakeholder-oriented thinking or whether it is actually finding real expression in legal systems. It examines shifts in company law, codes of governance, and regulatory practices in terms of how the responsibilities of directors are being construed in the face of these changing expectations. Although a lot of jurisdictions such as India have now implemented clauses in respect of corporate social responsibility and an increase in the disclosure requirement there is still a question of whether these measures are really altering the very purpose of the corporation or simply creating more layers of compliance. The conflict between flexibility and accountability is one of the main points of the paper. Expanding corporate purpose can enable companies to implement a more balanced and responsible approach but also raises the issue of dilution of responsibility where the obligations towards stakeholders are not clearly enforceable. The paper raises the question as to whether the law has been keeping up with this change or whether the law itself remains embedded in the old systems in which shareholders primacy was the order of the day. By examining legal trends, as well as practical issues, the paper will argue that to effect any meaningful change to corporate purpose, it is important to better articulate the duties of the directors and better mechanisms of ensuring that the interests of the stakeholders are not neglected. It finds that, although the stakeholder governance language is, increasingly, gaining traction, the successful integration of the stakeholder governance language into corporate law has not yet been achieved and needs a more coherent and enforceable approach.

**Keywords:** Corporate Governance, Shareholder Primacy, Directors' Duties, ESG, Corporate Accountability.

## **1. Introduction**

Corporate law over the decades has been based on the premise that firms are being founded with the sole purpose of serving shareholders. This methodology supported by legal doctrine and judicial logic dictated the manner in which the duties of directors would be interpreted, and in what way the success of corporations would be measured. But even this narrow thinking has been stretched to a greater and greater degree. The rising issues of climate change, rising social inequality, and corporate failures have revealed weaknesses of a completely profit-oriented model. In reaction, a greater expectation has been formed: that of seeing corporations not as just economic participants but as institutions with obligations to its employees, consumers, creditors, communities and the environment.

Although this change in attitude toward stakeholders may sound substantial, the real question is whether the law has been actually changed in any substantial way. In other countries such as India, visible steps that include a mandatory spending on CSR, sustainability reporting and clauses that require directors to make decisions in the broader interest of the company are visible. However, in reality, these changes and modifications tend to override a system where the shareholder remains a priority. Stakeholders concerns are considered but not necessarily supported by good legal rights or enforcement legislation. This brings about the scenario whereby companies discuss responsibility, yet are not necessarily legally liable to it.

## **2. Doctrinal Foundations of Shareholder Primacy in Corporate Law**

The classical fiduciary duty framework, judicial interpretation, and economic theory have deep roots in the doctrinal underpinnings of shareholder primacy in corporate law. Instead of being, as it is often portrayed as, a simple theoretical construct, shareholder primacy has been firmly strengthened through case law and doctrinal development making any change to a stakeholder-oriented model both complicated and incremental. Fiduciary duty is considered to be at the heart of corporate law as the directors owe the company fiduciary duty. Historically, this obligation has been stated as having to act in the best interest of the company. The judicial interpretation has historically conflated the company with its shareholders, thus incorporating the primacy of shareholders into the very fabric of corporate governance. When discharging their obligations of care and loyalty, the directors in question are thus expected to prioritize the maximization of the stockholder wealth often taking the other stakeholder interests as secondary or instrumental.

The most widely known example of illustrating this doctrinal position is the example of *Dodge v. Ford Motor Co*<sup>1</sup>. Here, Henry Ford was trying to reinvest corporate earnings into increasing production and enhancing employee welfare instead of paying dividends to the shareholders. The Michigan Supreme Court did not approve this practice, as it is the role of a corporation to make its shareholders earn a profit. The Court made it clear that the directors cannot subordinate the shareholder interests to larger social goals, thus establishing the principle according to which the maximization of profits is the primary purpose of corporate enterprise. The case still remains a canonical authority to the suggestion that the discretion of directors is not coaxial when it is no longer beneficial to the shareholders.

Similarly, the English case of *Percival v. Wright*<sup>2</sup> enforces the doctrinal isolation of the duties of directors in the corporate entity and not in their personal capacity as shareholders. The Court ruled that directors are not obligated to fiduciary duties to any one shareholder when acquiring their shares with the emphasis that their obligation is owed to the company as a whole. Although this case seems on its face to restrict direct claims by shareholders, it ironically confirms the primacy of shareholders by confirming that the interest of the company to which directors owe their duties is ultimately aligned with the common good of the shareholders and not other stakeholders such as employees or creditors.

The economic justification for this doctrinal stance is most prominently articulated through agency theory.<sup>3</sup> This theory imaginatively conceives the corporation as a nexus of contracts where shareholders are the principals and directors are their agents. With the practice of ownership and control separation, there is an inherent risk of managers operating in their self-interest, as opposed to maximizing shareholder value.<sup>4</sup> Shareholder primacy is then seen as an efficiency based approach to this agency problem to give a clear measurable goal of profit maximization on which the performance of the managers can be evaluated. By shifting the management incentives towards the interests of the shareholders, the corporate law is aimed at reducing the agency costs and optimal resource distribution.

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<sup>1</sup> *Dodge v Ford Motor Co* 170 NW 668 (Mich 1919).

<sup>2</sup> *Percival v Wright* [1902] 2 Ch 421.

<sup>3</sup> Jensen MC and Meckling WH, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

<sup>4</sup> Adolf A Berle Jr and Gardiner C Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932).

This apparently coherent code also demonstrates its shortcomings. The single-minded approach to shareholder wealth tends to neglect other stakeholders whose interests are part of the long-term sustainability of the corporation. Regardless of this doctrinal entrenchment of shareholder primacy through both fiduciary principles and authoritative case law generates a strong inertia against change. Judicial bodies have been in general reluctant to entertain more expansive visions of corporate purpose that drift away of shareholder interests which has led to a sluggish and path-dependent development of the law.

### 3. ESG, Sustainability, and the Rise of Stakeholder Governance

The contemporary pressure of the shareholder primacy is not an accident, or a purely ideological phenomenon; it is the outcome of a combined regulatory and market pressure, and the pressure of the society, which has redefined the expectations of a corporation. The advent of the Environmental, Social, and Governance (ESG) considerations are a turning point in this transformation that makes stakeholder governance not an abstract ideal but a practical response to the systemic risks and changes in the economic reality. ESG has been diffusing both ways into the market, both through formal intervention of the regulations, and intense market signaling. In the regulatory front, availability of disclosure regimes is increased.

As an example, the European Commission by means of the Corporate Sustainability Reporting Directive.<sup>5</sup> has required comprehensive sustainability reporting in thousands of companies integrating ESG in binding compliance regimes. In the same manner, in India Business Responsibility and Sustainability Reporting (BRSR) has been operationalized by the Securities and Exchange Board of India.<sup>6</sup> Listed entity requirements which are indicative of an increased convergence of corporate governance and sustainability indicators. These trends suggest that ESG is moving beyond a voluntary reporting process to an emerging element of regulatory framework.

Much stronger agent of this change is found in capital markets. Large asset managers and institutional investors in particular have re-programmed ESG as a material risk factor as opposed to an ethical add-on. Firms such as BlackRock<sup>7</sup> have clearly associated sustainability performance with long-term shareholder value with climate risk as one of the investment risks.

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<sup>5</sup> European Commission, *Corporate Sustainability Reporting Directive* (Directive (EU) 2022/2464).

<sup>6</sup> Securities and Exchange Board of India (SEBI), *Business Responsibility and Sustainability Reporting (BRSR)* (SEBI Circular, 10 May 2021).

<sup>7</sup> BlackRock, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance* (2020).

The tangible impact of this repositioning has been the growth in recent years of global sustainable investment assets to over \$30 trillion,<sup>8</sup> demonstrating that investing in ESG concepts is no longer a marginal but a mainstream matter. As a result, corporations are not only reacting to their regulatory requirements but they are also responding to their strategic requirements which are the requirements imposed by their capital providers.

One such symbolic expression of this change is the 2019 declaration by the Business Roundtable<sup>9</sup> that re-established corporate purpose to encompass employee, customer, supplier and community commitments in addition to shareholders. Although the statement does not have the force of law, its meaning is in the fact that it is the reflection of the changing elite consensus in corporate leadership. It is an indication that reputational legitimacy and value-creation over long-term is more and more conditional upon stakeholder engagement. The fact that ESG-related financial instruments such as green bonds and sustainability-linked loans have rapidly increased in size demonstrates that markets are rapidly pricing non-financial performance. Simultaneously, the systemic risks of limited shareholder-focused decision-making have been revealed by high-profile corporate failures ranging all the way to environmental disasters and governance collapses.

#### 4. Legal Recognition of Stakeholder Interests

The process of gradual integration of stakeholder interests into corporate law is one of the greatest changes in the modern corporate regulation. Although there are jurisdictions which formally acknowledge the existence of the broader set of interests other than shareholders which corporations must take into account, these jurisdictions operate within a strictly delimited legal framework. A comparative analysis shows that a consistent pattern is evident: the interests of stakeholders are more and more *recognized*, but are seldom implemented, thus resulting in what can be described as a structured, but limited, inclusivity.

The Companies Act, 2013 in India is a resounding change to the traditional (shareholder-centric) approach to governance in companies. Section 166(2)<sup>10</sup> explicitly mandates that directors act “in good faith to promote the objects of the company in the best interests of the company, its employees, the shareholders and the community and in the best interests of the

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<sup>8</sup> UN Principles for Responsible Investment, *Global Sustainable Investment Review* (2020).

<sup>9</sup> Business Roundtable, *Statement on the Purpose of a Corporation* (19 August 2019).

<sup>10</sup> Companies Act 2013, s 166(2) (India).

environment.” There are two important reasons why this statutory language is important. First, it officially broadens the area of fiduciary duty to non-shareholder constituencies. Second, it can integrate the stakeholder issues into the core responsibility of directors in contrast to making it an incidental responsibility.

But this doctrinal growth is checked by the fact that it can not be directly enforced. The liability as stated in Section 166 is applicable to the company, but not to the individual stakeholders. Communities, environmental groups or employees have no right to undertake any action about this breach of this duty. As such, although players in stakeholder interests are not disregarded, they are mediated through the corporate entity that restricts their practical legal effect.

A similar dynamic is evident in Section 135<sup>11</sup> of the same statute that brings about a compulsory CSR model. Firms that have certain financial requirements must pay part of their profits to activities that are socially beneficial. Although this provision is commonly hailed as a ground breaking legislative innovation, its design has a compliance-oriented nature, as opposed to a rights-based framework. Moreover, the BRSR regime through the Securities and Exchange Board of India requires detailed disclosures of ESG by listed entities hence enhancing transparency and enabling the market to hold entities accountable. Once again the engine of action is the exposure of information as opposed to rights of substance. Stakeholders are educated and not given the powers to in still compliance outside the market forces.

The United Kingdom offers a parallel approach through Section 172 of the Companies Act 2006.<sup>12</sup> This is a provision reflecting the principle of “Enlightened Shareholder Value” that requires directors to promote the success of the company to the benefit of its members and considering factors such as employee interests, supplier relationships, community impact, and environmental considerations. The principle tries to balance the primacy of shareholders with the sensitivity of stakeholders by conceptualizing the stakeholder interests as a means to long-term shareholder value. Regardless of how progressive this may be articulated, it is limited by the enforcement restrictions. The responsibility of directors is to the company and litigation is normally sought by use of derivative actions, which are under the control of the shareholders.

The legal environment in the United States is more devolved, with state innovations (such as benefit corporations and constituency statutes) prevailing. Benefit corporations clearly and

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<sup>11</sup> Companies Act 2013, s 135 (India).

<sup>12</sup> Companies Act 2006, s 172 (UK).

openly address social and environmental goals in their corporate goal and requires their directors to think about the effects of their actions on various stakeholders. Equally, constituency laws in a number of states allow the directors to take into account the interests of non-shareholders. All these are indications of a formal abandonment of strict shareholder primacy.

On the supranational front, the European Commission has developed a progressive agenda on sustainable corporate governance. Mandatory sustainability disclosure, and proposed directives on due diligence initiatives are aimed at making corporate behaviour incorporate human rights and environmental concerns.<sup>13</sup> These initiatives are a more interventionist effort, but the translation of these efforts into a set of enforceable stakeholder rights is still pending. Although due diligence obligations can imply a liability in connection with some harms, they do not fundamentally reorganize fiduciary obligations to establish a direct responsibility in relation to stakeholders as right bearing entities.

The comparative analysis therefore indicates a uniform type of doctrines in jurisdictions. Stakeholder language is being introduced into legal frameworks, disclosure obligations are being extended and sustainable practices are being promoted. But they do not go so far as to give stakeholders enforceable rights, or direct standing in the corporate governance framework. This produces what can be called a legal illusion of inclusiveness a system where the interests of stakeholders are accepted in principle but are subordinated in practice.

### **5. Directors' Duties in Transition: Between Flexibility and Accountability**

Corporate law is now at a silent yet deep crossroads. The position of directors seemed to be quite established over decades: they were fiduciaries entrusted with advancing the “best interests of the company,” a term which, in practice was given a meaning more or less based on the welfare of the shareholders. That clarity of orientation provided the courts, investors and managers with a common language of accountability. But, as the architecture of corporate purpose has become more and more inclusive of stakeholders, the previously stable building has begun to shake giving way to a more complex and at times unsettling legal narrative.

Think of a contemporary boardroom. Directors sit around the table not only with financial

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<sup>13</sup> Ministry of Corporate Affairs (India), *National Guidelines on Responsible Business Conduct* (2019).

projections but also with ESG reports, measures of employee welfare, community impact measures, and climate disclosures. Any document is a valid contention over corporate attention. But none of them offers a definite priority list. What now arises to mind is no longer what will maximize shareholder value but *what will best serve the best interest of the company in a world of competing stakeholder claims*. It is on this widened ground that the role of a director is being redefined and possibly extended.

The law has not moved with equal clarity. In *Regentcrest plc v. Cohen*,<sup>14</sup> the court stated a very deferential standard: whether directors had in good faith believed that their decision was in the best interests of the company. The subjective good faith test was created with the intention of upholding managerial discretion and to avoid the courts imposing their judgment on that of business decision-makers. Such deference in a shareholder-centric model was moderated by a relatively recognizable benchmark profitability and shareholder return. However, in the modern stakeholder-focused environment, the same criterion gets a much more expansive and indeterminate scope.

A similar narrative unfolds in *Shlensky v. Wrigley*,<sup>15</sup> in which the decision of directors not to play night baseball games was affirmed by the court, in part on the basis of community welfare. The decision did not imply that directors had to prioritize profit in all their decisions but it only reaffirmed that they were free to consider non-economic factors. This might have seemed at the time as an exception even a curiosity. It nearly reads today as a prelude to the stakeholder governance, of a time when the law had come to some silent consensus that there is no such thing as corporate decisions.

This brings in structural imbalance of flexibility and accountability. On the one hand, Flexibility allows the directors to respond to long-term risks in order to include ethical considerations as well as struggle with the reality of the contemporary enterprise. But flexibility, in not being regulated by definite accountability, runs the danger of becoming opacity. When it is possible to justify every decision by appeal to some stakeholder interest whether in the environmental sustainability or the well-being of employees or the impact of a business on the community then the very concept of fiduciary constraint will start to lose its disciplining effect.

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<sup>14</sup> *Regentcrest plc v Cohen* [2001] 2 BCLC 80.

<sup>15</sup> *Shlensky v Wrigley* 237 NE 2d 776 (Ill App Ct 1968).

This brings up an uncomfortable yet needed issue, namely, does stakeholder governance in its current legal form indeed limit directors, or does it expand the vocabulary of justification of decisions? The current response seems to be skewed towards the latter. The protective barrier of the doctrines like that of the business judgment rule and the subjective good faith standard is that the courts remain hesitant to inquire into the content of the boardroom decisions. In the meantime, stakeholders regardless of their increasing rhetorical visibility are mostly exempted by enforcement mechanisms.

The move towards stakeholder governance has increased discretion of directors without corresponding increase in accountability that would create space of managerial opportunism in which stakeholder concerns can be invoked selectively to justify decisions. This is not a total change, but a process of incomplete change that has yet to be completely resolved in corporate law. Although there is a growing tendency to see directors as agents of a wider corporate purpose, the lack of clear legal standards and mechanisms of enforcement still serve to blur the boundaries of their responsibilities. Thus, the conflict between flexibility and accountability has been at the center of contemporary corporate governance.

## **6. Corporate Social Responsibility and ESG: Compliance, Reality, and the Risk of Symbolism**

Paper-wise, India seems to be one of the most liberal jurisdictions as far as corporate responsibility is concerned. The Companies Act, 2013, has introduced a mandatory CSR framework which requires eligible companies to spend not less than 2% of their average net profits on socially beneficial activities. This has over the years been translated into huge financial investment. According to government statistics, over the last few years, the annual CSR expenditure in India has topped ₹25,000 crore with cumulative spending since 2014 amounting to several lakh crores. On first observation this indicates that there is a high degree of coordination between the corporate and social development.

The reality on the ground tells a more intricate story in the sense that a part of the CSR expenditure is still concentrated on a few sectors like education and healthcare usually in regions where companies already operate.<sup>16</sup> Despite the value attached to these initiatives, there are still concerns that the initiatives are too superficial to be consistent and have a long-term

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<sup>16</sup> Government of India, *Report on CSR Expenditure* (Ministry of Corporate Affairs).

effect. Numerous undertakings are short-lived, visibility-oriented, or through third parties with minimal observation. The outcome is that spending objectives are achieved but transformative outcomes are not even. Compliance risks in most situations become an end in and of itself.

The same trend is evident in the emergence of the ESG disclosures. BRSR has been required by the Securities and Exchange Board of India of the top 1,000 listed companies a significant step towards being more transparent. Today, an immense majority of these companies post elaborate ESG reports indicating how swiftly companies have begun speaking the language of sustainability. Indeed, India has become one of the quicker implementers of ESG reporting frameworks among the emerging economies. Nevertheless, disclosure does not necessarily imply the substantive change.

Organizations tend to make properly formatted reports that focus on their commitments to reduce carbon emissions, diversity and ethical governance but more quantifiable results are difficult to verify. As an example, companies can report their emissions data or set sustainability targets but independent reviews often show that these are measured in different ways, that there are no consistent standards and that they are not generally outside audits. This allows itself to be subject to what is commonly referred to as greenwashing, where the claims of sustainability go beyond what is being actually done.

The disconnect between the reported and what actually occurs is further amplified by the manner in which these frameworks work. In large part, ESG reporting is based on self disclosure, where little or no checks are made on the quality or actual impact of the information disclosed. Organizations can emphasize positive data, minimize negative data and work towards long term objectives that are more of aspirations rather than reality. This complicates the process of investors and regulators to distinguish between real sustainability initiatives and good management of the image.

It becomes evident a more refined image. The CSR and ESG models in the Indian market have helped in increasing the visibility of corporate responsibility and as a result, companies are now contributing funds towards corporate responsibility and the change in the way companies discuss sustainability. But at the same time they also exhibit a certain underlying tension: how easily compliance can be traced versus how hard the actual impact can be evaluated. It is possible to measure spending and generate reports but the only way to achieve actual social and environmental change is to keep working on it, stay accountable, and adequately verify.

## **7. Turning Commitments into Real Accountability**

Corporate purpose in India has now gone beyond where the stakeholder interest is considered, but rather the real question is enforcement. The current discourse of sustainability, inclusion, and responsibility used by companies today in practice, most enforcement power of a company is still vested in shareholders. This leaves a notable disparity between what the companies promise and what they can actually be held liable to. In a practical point of view, what the India of tomorrow will be is not a scenario of adding more rules but rather of making the current rules more significant.

The directors are already required to put into consideration employees, communities and environmental impact as per the Companies Act, 2013. The issue is not that there is no law but that there is no clarity and enforceability. The initial step in a positive direction would be to provide more explicit regulatory guidance as to how directors are to balance competing interests. This would save on ambiguity and misuse of broad terms such as best interest of the company.

Second, India needs to cautiously introduce the stakeholder access to accountability. It does not mean that it should have unlimited litigation but should have organized platforms such as allowing complaints to regulatory bodies or sectoral authorities in situations where there is severe environmental or social damages. Even low status can be an excellent deterrent to the nominal conformity.

Third, the ESG reporting must not be based on disclosure oriented but must be based on outcome oriented. BRSR is already a forceful initiative by the Securities and Exchange Board of India but the next step ought to be standardised steps and independent certification. When businesses claim to be cutting down on carbon or making social impact there have to be a way of measuring and auditing these claims. This will reduce greenwashing and establish the real trust in the system.

The other reform which is helpful is to rectify the way incentives work. These are the obvious advantages that the companies that actually perform well in ESG should get such as faster approvals, easier access to funding or recognition by the society. In the meantime, the companies which give false information should receive a heavier penalty. Such a mix of incentives and penalties can be used to influence the behaviour of companies more than by

merely working on compliance.

## **8. Conclusion**

The history of corporate law does not indicate a shift but a gradual change. It has always been the situation with enterprises and an apparent focus on profit and shareholder value came first. Nowadays that concept is being questioned. Businesses are currently debating responsibility, sustainability and stakeholder inclusion and the legislation has also started to reflect this in its provisions in the Companies Act, 2013 and in the development of ESG frameworks. Despite this change of linguistic approach, the main pillar of accountability has not changed much.

One would only have to walk into a modern boardroom to see the difference. Environmental risk, staff welfare, and social impact as well as financial performance have become the subject of discussions. However, as these decisions are put to the test, the legal lens, nevertheless, continues to emphasize shareholder outcomes. This brings a disconnect that companies are being encouraged to think big but are being judged in a small manner. Hence the actual problem is not that of introducing new ideas but of putting them into practical use. Stakeholder governance can not be confined to the disclosures, policies or well-written reports. It must lead to clarity of roles, elevated directorial standards and mechanisms that enable them to be scrutinized. In its absence, there is indeed a genuine risk that the corporate purpose will be more about the presentation form than the actual realisation of the presentation form.

India is at a critical juncture of this transition. It has already made significant strides in acknowledging the wider corporate roles and responsibilities. The second step will be to make sure that these responsibilities have weight in practice. Corporate purpose and legal reality should be aligned to reduce the gap between what companies say they do and what they can be held responsible to do. Only in that case will the transition out of shareholder primacy change its status of being merely intended to actually taking place. Proper enforcement, through stricter rules, enhanced surveillance, and regular enforcement must now be of concern. Directors ought to show how the interests of the stake holders come into play in reality in making real decisions and reporting must reflect the quantifiable and verifiable results. Exposing it to a greater extent and providing harsh punishment in the event of false statements are the key to the creation of accountability. Should it be done, then India can develop a prototype of profit and responsibility hand in hand.