

# The Choice of Values Behind Corporate Law: A Critique of Shareholder Primacy and a Response to China's Proposal

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**Abstract:** The theory of shareholder primacy, as an important value judgment in the U.S. corporate law on corporate governance model, has influenced the shaping of legal rules of corporate governance in different countries and regions of the world, as well as the revision of China's corporate law. The theoretical lineage of shareholder-centrism has its own peculiar soil of existence and should not be regarded as a universal value behind the norms of corporate law. Even in the U.S., shareholder primacy is highly controversial, and the direction it advocates is contradictory to the reality of corporate governance practices. China has not been affected by the shareholder primacy debate in the current revision of its corporate law, but has adopted a corporate power allocation model with Chinese characteristics, so as to achieve a balance between the efficiency of corporate governance and the protection of shareholders' interests.

**Keywords:** Shareholder Primacy; Corporate Governance Model; Corporate Law Revision; Chinese Approach.

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## 1. Formulation of the Problem

China's company law has completed its second overhaul in the history of company law, and the issue of how power is distributed in corporate governance has once become a hot topic of debate during the revision process of the company law. After the official launch of the revision of the Company Law in 2019, scholars in the field of corporate law have also begun to focus on such grand systemic issues as the distribution of power in corporate governance, and Jiang Daxing believes that, although mainstream scholars believe that China should move from "shareholders' meeting primacy" to "board of directors primacy", the board of directors resides between the shareholders' meeting and the managerial level, but the board of directors is not the only one. Jiang Daxing believes that although mainstream scholars believe that China should move from "shareholders' meeting primacy" to "board of directors primacy", the board of directors resides between the shareholders' meeting and the managerial level, and this kind of mezzanine mechanism leads to many decision-making levels and inefficiency. Instead of "director primacy", "manager primacy" should be recognized. [1] According to Zhao Xudong, China's corporate governance model presents a special state of statutory director primacy and de facto managerial primacy or controlling shareholder primacy in some companies, and the Chinese model is not a multiple choice, but rather gives the governance model norms to the arbitrariness of the law. [2] Liang Shang Shang believes that the text of China's company law to see, the company's shareholders' meeting and the board of directors each have their own exclusive power to take the authority of the statutory doctrine, not the general theory advocated by the shareholders' meeting primacy, the company's power vested in the board of directors of the company is the norm of corporate governance, the use of exceptions to the legislative techniques to regulate the authority of the company's shareholders' meeting. [3] According to Liu Junhai, the jurisprudential basis of shareholder centrism stems from the ideas of corporate

profitability, equity capital, residual claims and popular sovereignty. Reconceptualizing and insisting on the development of shareholder primacy can help build a shareholder-friendly society and promote sustainable corporate development. [4]

Shareholder primacy and director primacy involved in the issue of distribution of corporate power have actually been influenced by the trend of shareholder primacy in the United States. Although the specific system level and value orientation of the doctrine of the dispute is not the same, but can be seen that the shareholder primacy as an important part of the U.S. corporate law theory of the "problem and doctrine" has profoundly affected the theory of corporate law and corporate governance practices in other countries and regions, so it is necessary to from the source of the U.S. corporate law theory of shareholder centrism trend to do a summary combing, which will help China in the process of corporate law revision in the face of shareholder primacy. Therefore, it is necessary to summarize the shareholder primacy in the American corporate law theory from the source, which will help our country to critically deal with the ideological content of the shareholder primacy theory in the process of the revision of the company law.

## 2. The Development of Shareholder Primacy and Theoretical Controversies

### 2.1. The Origin and Development of the Theory of Shareholder Primacy

The core concern of the shareholder primacy concept is the purpose of corporate existence, i.e., whether the purpose of corporate existence is to create value for the maximization of shareholders' interests, or to create value while focusing on the interests of others, and to create wealth for the society at the same time. The clarity of the concept of shareholder primacy came from the 1930s when American academics explored the nature of the corporation as a business organization.

In 1932, The American economists Berle and Means, in their famous book "The Modern Corporation and Private Property", described the public corporation as a new economy. They pointed out that the public corporation system had not just evolved into a conventional form of running a business, but that there was a gravitational pull that sucked wealth into ever-expanding pools, while at the same time vesting control in fewer and fewer hands. [5] At the same time, the public corporation is increasingly becoming an industrial unit that must be involved in the economic, social, and political life of the United States.

Berle and Means focus on the separation of ownership and control of the company in the modern economy due to the specialization of the division of labor, and the dispersion of equity determines that it is not very interested in paying attention to the internal situation of the company or going to participate in voting, i.e., the creation of shareholders' rational indifference. Another consequence of equity fragmentation is the creation of agency costs in the firm.

Despite the academic arguments for shareholder primacy, Berle and Means also refer in their book to this new conception of corporate activity, in which the leader of a corporation proposes a plan that includes fair wages, employee security, reasonable service to the public, business stabilization, etc. .... "Control" of large corporations should develop into purely neutral technological domination that balances the demands of different groups in society and distributes income to each group on the basis of public policy rather than individual self-interest. "Control" should evolve into purely neutral technological domination, balancing the demands of the different groups in society, and distributing the company's income to each group on the basis of public policy rather than individual self-interest. [6] Taking into account the interests of shareholders while also taking into account the interests of employees, consumers, and the state, this model of stakeholder corporate governance is also known in economics as managerial capitalism.

Shareholder primacy related views continued to be refined in the 1970s. In the early 1970s, the corporate economy in the United States began to go downhill. The most challenging period was the bear market from 1973 to 1974, when the Dow Jones Industrial Average slumped by almost 50% of its market capitalization. The main reason for this may not be attributable to strategies in corporate governance practices, but rather the answer should be sought at a more macro level of the U.S. economy. Another perspective on the U.S. economy's entry into recession emphasizes that its important cause was the inflation triggered by Nixon's decision to abandon the gold standard in 1971, which led to the OPEC oil embargo campaign of 1973, resulting in a doubling of the price of oil from 1973 to 1974, which was fundamental after the U.S. economy began to go into stagnation and decline. [7]

Nonetheless, the misconceptions were not dispelled, and the poor stock market performance in the early 1970s led to increasing skepticism about the validity of the traditional model of corporate governance. Outside of the U.S. corporate law community, some influential financial scientists have begun to prepare critiques of the managerial capitalism of traditional corporate governance. [8]

In 1976, economists Jensen and Meckling co-published an article that has since become widely cited in the field of corporate governance and management, "The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structures" which focuses on the issue of agency costs in the

context of corporate governance. In this article, Jensen and Meckling did not express the same cautious optimism about the "separation of ownership and control" as Berle and Means did in their article published more than 40 years earlier. [9] The two scholars believe that the passivity of individual investors (individual shareholders) in listed companies is fraught with problems, such as external professional managers pursuing their own interests at the expense of shareholders, managers shirking their responsibilities, and even engaging in behaviors that are seriously detrimental to the interests of the company. The problem of agency costs lurks like a ghost in public companies and has been haunting many financial and corporate governance experts and corporate law scholars in the theoretical world. Less than a decade after the publication of Jensen and Meckling's article, shareholder primacy made its official debut. Shareholder primacy is the theory that the only legitimate purpose of a corporation is to maximize the interests of its shareholders, and that the best way to achieve this is to make corporate managers as accountable as possible to the shareholders, for example by giving shareholders greater control over the board of directors or by linking the income of corporate managers to the price of the shares. [10] This idea is similar to that of Friedman, a well-known economist, who published an article in The New York Times in 1970, stating clearly his core idea that corporations have one and only one social responsibility, which is to generate profits, and that by generating profits, they fulfill their social responsibility.

## **2.2. The Maturation of the Theory of Shareholder Primacy and its Practical Implications**

After decades of development of the shareholder primacy trend in the 1980s, in 2001, the renowned scholars of corporate law in the United States, Hansmann and Kraakman jointly published "The End of History of Corporate Law", arguing that the corporate governance model has been converged in the world, and that this converged model is guided by shareholder-centrism, and the two scholars summarize the values of shareholder primacy as the academic community, the business community, governmental circles can accept as a practical philosophy: that is, the ultimate control of the corporation should depend on the shareholder level; and that the managers of the corporation are obligated to be accountable to the interests of the shareholders. Other groups, such as creditors, employees, suppliers, and consumers, also have a right to have their interests protected. This protection needs to be realized through contractual and regulatory means, rather than through participation in corporate regulation. The measurement of shareholders' interests needs to be realized through the share prices of public companies on the stock market. [11] This article has been widely discussed around the world and is seen as the classic expression of the corporate governance paradigm finally coming to a definitive conclusion.

The maturation of the shareholder primacy concept for the development of the theory of corporate law and the economy of the firm in the United States.

First of all, shareholder primacy has led to individual changes in corporate laws and institutions, so that directors and managers of listed companies have always taken the share price as their guiding light. In the field of corporate law system, in order to meet the market development, the relevant system design of the U.S. corporate law is based on the model

of "bottomward competition" of each state's corporate law, oriented by "pursuing efficiency and responding to practice", with the concept of "deregulation and trusting the market", and with the concept of "empowering type". Believing in the market" as the concept, and "empowering rules" as the mainstream corporate governance model, the U.S. Trafalgar State Corporation Law has become the winning target. For the protection of corporate shareholders' interests, the Delaware Corporate Law has a series of relevant institutional designs. For example, Section 141 of the Delaware General Corporation Law provides for a staggered board of directors, under which only a certain percentage of board members can be re-elected each year. If the board of directors of a corporation is divided into three classes, A, B, and C, with each class comprising approximately one-third of the total number of directors, then the term of office of the elected Class A directors shall be from their initial term to the first annual meeting of stockholders following the election, the term of office of the Class B directors shall be from their initial term to the second annual meeting of stockholders, and the term of office of the Class C directors shall be from their initial term to the third annual meeting of stockholders.

### **3. Reflection on and Critique of Shareholder Primacy**

#### **3.1. Shareholder Primacy Lacks the Necessary Theoretical Self-consistency**

Because the shareholder related debate is generated in the large structure of the U.S. economic cycle of change and fluctuation, and mixed with the product of different disciplines mixed and blended information, its own theoretical system is not self-consistent, only in the sense of communication science has been widely discussed, and do not think that it can be used as a universal values to guide the construction of the norms of corporate law. American scholars have also reflected on the theoretical legitimacy of shareholder primacy from the academic level.

First, the theory of shareholder primacy is shaped more by its communication value than its normative value. From the perspective of academic communication, shareholder primacy provides a simple story about the structure and purpose of corporations, which can be easily accepted by laypeople without any foundation in jurisprudence when they ask questions such as, "What is a corporation for? or what is the purpose of creating a corporation," the story can be readily accepted by these groups. For some academics seeking tenure, particularly in the field of law, shareholder primacy provides a succinct, scientific explanation of corporations that is highly communicative in the classroom. As a result, beginning in the 1980s, the shareholder primacy trend began to flourish at a number of top, prestigious law schools in the United States. For researchers of the empirical approach, shareholder primacy provided an extremely simple way to test corporate performance (through rising or falling stock prices), which provided what appeared to be a very solid foundation for a series of so-called empirical approaches to corporate governance research. [12] In contrast, journalists or columnists in the media world, as disseminators of ideas from another quarter, also prefer this simple, eye-catching and communicative line of explanation.

Second, the theoretical formation of shareholder primacy lacks a practical factual basis in the corporate economy. Corporate governance practices at the real level are pluralistic

and integrated, and the concept of shareholder primacy did not evolve from the needs of the real business world itself: corporate promoters do not put an overemphasis on shareholders' rights into the company's articles of incorporation because they believe that doing so will allow the company to operate in a more efficient manner. At the same time, from an investor's perspective, which does not severely criticize the management structure of the company, the over-emphasis of shareholder rights is not recognized by enthusiasts of shareholder value first. [13] In the real business world, entrepreneurs, company executives, company employees, external creditors of the company and most investors, how they decide how to hold stocks and the corporate governance structure in their business practices have their own business logic, which is not compatible with the narrow concept of shareholder primacy. Some American scholars have criticized the theory of shareholder primacy as an intellectual game devised by a group of academics, and the architects of this philosophy have been influenced and abetted by journalists, hedge fund managers, and some corporate executives who see in the wording of shareholder value maximization an opportunity to grow their personal wealth. [14]

Again, the theoretical formation of shareholder primacy lacks a normative basis in corporate law. There is a considerable amount of support for the shareholder community in U.S. academia from economists who believe that shareholders are the ultimate owners of the corporation and the sole claimants to the corporation's residual profits. Thus the process by which corporate directors and executives maximize shareholder wealth (as measured by stock price) is also the process by which the company generates economic benefits. [15] In practice, however, this conclusion rests on erroneous legal assumptions. [16] Because "the Law and Economics Movement" was so powerful, economics imperialism invaded the social sciences too deeply in the United States in the late 1970s. [17] The conflation of social and legal rules by economists has contributed to the confusion in the discussion of corporate governance models, and to the weakness of the theoretical foundations of shareholder primacy.

From the perspective of company law theory, shareholders cannot own the company, shareholders through capital contribution to obtain the qualification of shareholders, and the company because of shareholders' capital contribution to obtain the company's independent property. Since the company is a legal entity with independent personality, in essence the relationship between the shareholders and the company is a legal contract.

On the contrary, corporations, not shareholders, are their own claimants to residual profits, and corporate directors have sufficient legal authority to decide to retain profits or to distribute them to different interests, which include not only shareholders, but also creditors, employees, consumers and some public communities.

In other words, from the perspective of the practical foundation of the formation of the theory of shareholder primacy, the internal argumentation of the rules of corporate law and the path dependence in the formation process, the theory of shareholder primacy is not a perfect concept to promote the benign order of corporate governance, but as one of the long-term alternatives in the model of corporate governance, the theoretical framework of shareholder primacy necessitates theoretical corrections under the system

of corporate law.

### **3.2. Shareholder Primacy is not a Universal Value of Corporate Governance**

Shareholder primacy in the United States corporate law in fact there are large theoretical differences within the legal profession, as the United States corporate law theory to support the most important case system, for the support of shareholder centrism cases, in fact, there is also a large divergence, which means that the theory of shareholder primacy is only one of the doctrines in the theoretical system of the company law, as the mainstream values or even universal values is obviously a cognitive error.

In the case of *Dodge v. Ford* in 1919, the Michigan Supreme Court stated: "A business corporation is organized and operated primarily for the benefit of its stockholders. The powers of the board of directors are to be used for that purpose." In that case, Henry Ford owned 85% of Ford and served as the company's president and a member of the board of directors. The Dodge Brothers held a 10% interest in Ford, and the Dodge Brothers neither served on Ford's board of directors nor were employed by Ford. Beginning in 1911, Ford paid an average of \$1.2 million per year in fixed dividends to shareholders, and between 1913 and 1915, Ford also paid special dividends of \$1-110,000 per year. In 1916, however, Henry Ford announced that Ford would no longer pay special dividends and that a portion of the profits would be invested in new factories, which would enable Ford to expand its production capacity, double the wages of its employees, and lower the selling price of its automobiles. As a result, the plaintiffs sought an injunction to restrain the defendant from constructing the plant; to require the distribution of 75% of the company's accumulated surplus, and to apply all of the company's profits to dividend distributions in the future, unless there was a valid reason, such as an emergency. This case forms the core basis of the argument that the purpose of a for-profit corporation is to maximize shareholder value.

Further support for shareholder primacy was provided by the Delaware Superior Court in the 1985 *Revlon* case (*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*). In that case, the CEO of Pantry Pride approached the CEO of Revlon and offered Revlon \$40-\$42 per share, or \$45 if it had to be a hostile takeover. The two CEOs had a personal disagreement, which the court noted was a potential motivation for Revlon to move elsewhere. Revlon's directors met and decided on a poison pill plan to buy back 5 million shares of Revlon. Pantry Pride countered with a bid of \$47.50, which prompted Revlon to repurchase 10 million shares with senior subordinated notes. Pantry Pride continued to raise its bid, and Revlon decided to look for another buyer in Forstmann. Revlon offered \$56.25 and promised to raise its bid further if another bid exceeded that price. Instead, Revlon reached an agreement for Forstmann to pay \$57.25 per share, subject to certain restrictions, such as a \$25 million cancellation fee on Forstmann and a no-purchase clause. Plaintiff MacAndrews & Forbes Holdings, Inc. sought to enjoin the agreement because it was not in the best interests of shareholders. Defendants argued that they also needed to consider the best interests of the company's shareholders. The Superior Court of Delaware held that a board of directors faced with a change of control must obtain "the highest price consistent with the interests of the shareholders."

While it may seem that the courts have upheld the judgment

that shareholder primacy should be upheld in the operation of corporations, there are a few views that hold other views on such cases. Among these views is the argument that incorporating the broad requirements of shareholder primacy into corporate law falls into the category of going a bit too far. First, other Delaware takeover cases have explicitly recognized the potential power of corporate decision makers to consider stakeholder interests. In *Unocal v. Mesa Oil Company* (*Unocal v. Mesa*), the Delaware Supreme Court held that when a board of directors acts defensively against the threat of a takeover, it must have "reasonable grounds for believing that corporate policy and effectiveness are at risk." *Unocal* does not identify shareholders as the only group in the corporation whose interests should be defended. In *Paramount Communications, Inc. v. Time, Inc.*, the Delaware Supreme Court stated that a board of directors "has no duty to maximize shareholder value in the short term, even in the context of a takeover". Some scholars have also argued that the so-called maximization of shareholders' interests actually reflects the obligation of controlling shareholders to "refrain from oppressing minority shareholders". Interpreted as limiting the ability of controlling shareholders to pursue particular objectives at the expense of minority shareholders, this concern is more suited to the duty of loyalty framework than to the realm of shareholder primacy.

From the academic discussion of the U.S. corporate law case system, shareholder primacy is merely one of the values to explore the direction of corporate governance, and is not a mainstream or universal corporate law value. It should be reasonably discerned when making normative changes.

## **4. The Revision of Shareholder Primacy and Options in Chinese Corporate Governance**

### **4.1. Response of the U.S. Corporate Law System to the Shareholder Primacy Trend**

The concept of extreme shareholder primacy will lead to a series of behaviors detrimental to the long-term value of the company in order to excessively pursue short-term economic benefits, such as short-termist behaviors catering to the market, the moral hazard of controlling shareholders (to the detriment of the interests of other small and medium-sized shareholders), as well as behaviors detrimental to the public interest. The U.S. corporate law system in fact provides a necessary response to extreme shareholder primacy.

First, the rule of fiduciary duty of the majority shareholders of a corporation has been developed. In the traditional U.S. corporate law, the framework of fiduciary duty only exists between the company's executives and the company and shareholders, because in the state of separation of ownership and control, the company's executives may, on the contrary, engage in moral hazard behaviors that are detrimental to the interests of the company and shareholders, which is the so-called agency cost problem discussed above, and in order to solve the agency cost problem, it is necessary for the management of the company, who actually hold the control right of the company, to diligently perform their duties. In order to solve the agency cost problem, it is necessary for the management of the company who actually holds the control of the company to be diligent and responsible, and at the same time not to engage in activities that conflict with the interests of the company in the course of the company's operation.

However, it is obviously not enough to control the behavioral norms of corporate executives only through fiduciary duty, because the shareholder group of a company does not fully follow the state of corporate democracy of "one share, one right" and "same share, same right", and the reality of the corporate practice is often divided into different interest groups, and the heterogeneous structure of shareholders leads to the infringement of the interests of the controlling shareholders against the minority shareholders. The heterogeneous structure of shareholders leads to the infringement of the interests of minority shareholders by controlling shareholders. In order to satisfy the need to protect minority shareholders from the oppression of controlling shareholders, in legal practice, the courts have established through case law that controlling shareholders have fiduciary obligations to other shareholders, and that in the face of abuses of control by controlling shareholders, the minority shareholders can sue controlling shareholders for breach of fiduciary obligations directly. The classic case establishing the fiduciary duty of controlling shareholders is the 1975 Rodd case, which centers on the idea that a closed company can be described as a corporate partnership, and that shareholders of a company owe each other an enhanced fiduciary duty similar to that owed by partners to each other. Although in the application of the rules of different courts there are different degrees of disagreement, but in the company for the controlling shareholders of the other small and medium-sized shareholders of the fiduciary obligations of this issue of cognition, the United States of America different states of the company law is highly consistent. Controlling shareholders' fiduciary duty to other small and medium-sized shareholders can help to avoid shareholder-centrism in corporate governance practice, in extreme cases, the interests of controlling shareholders against small and medium-sized shareholders oppression.

Moreover, in the face of increasingly destructive shareholder activism and short-termist behavior in the U.S. markets. The dual-class structure has gradually become an area of focus in the governance practices of listed companies in the U.S. Beginning in 1994, the Chairman of the U.S. Securities and Exchange Commission (SEC) sent an initiative to the three U.S. stock exchanges to adopt a consistent policy on permitting two-tier shareholding companies to be listed and traded. NASDAQ, AMEX and NYSE accepted the initiative one after another. As a result, the regulatory policy of the United States on the two-tier shareholding structure tends to be unified and mature. As the double-layer shareholding structure doubles the voting rights of the company's founder group, the company's founder class can be free from the danger of the company being maliciously acquired in the capital market and changing the company's long-term business strategy, which is conducive to the company's long-term and stable development from the result, and also maintains the interests of all shareholders of the company.

As of 2009, more than 8% of companies opted for a dual class structure at the time of listing, and as of 2012, this percentage had risen to 12%. Public investors have also proven to be willing and expectant to buy shares in such companies and are optimistic about their prospects. [18] Even unlisted non-public companies prefer to adopt a two-tier shareholding structure as a class system to meet the company's long-term stability and its own good governance needs.

## 4.2. Options for the Distribution of Rights in Corporate Governance in China

The flux of shareholder primacy conceptual polemical thinking is hugely linked to the cyclical development of the U.S. economy, which itself is in a constant state of change and revision and refinement, and shareholder primacy cannot be held up as a theoretical classic that transcends the times and is beyond reproach, nor can it be held up as a universal value of corporate governance.

China's company law has been enacted at the end of 2023, and during the process of revision and final publication of the company law, China's company law has taken the shareholder primacy thinking into consideration for the power distribution scheme of corporate governance, but still ultimately chose to choose the solution with Chinese characteristics.

For example, in terms of power distribution in corporate governance, the antithesis of shareholder primacy is director primacy, which is a commonly adopted corporate governance scheme in the U.S. However, director primacy was mentioned but ultimately not adopted during this revision of China's Company Law. Article 46 of the 2018 Chinese Company Law demonstrates the powers and functions of a company's board of directors through eleven provisions in the Article 62 of the First Revised Draft of the Company Law, which draws on board-centrism in U.S. corporate governance, emphasizes that "the board of directors is the executive body of the company, exercising the powers and functions other than those belonging to the powers and functions of the shareholders' meeting as stipulated in the present Law and the articles of association of the company." However, in the Second Review Draft of the Revised Company Law, the Third Review Draft of the Revised Company Law, and the newly revised Company Law, the director primacy approach has not been implemented to the end, but rather, after deleting some contents, the statutory approach of the board of directors' powers and functions, which is characteristic of our country, has been adopted.

In addition, China also pays more attention to the demands and expression of employees' interests and has strengthened the role played by employees in the board of directors, which can still be regarded as a corporate governance element very much with Chinese characteristics, despite the gaps that still exist in Germany's system of democratic decision-making by employees. In the 2018 Chinese Company Law, Article 44 states, "A limited liability company invested and established by two or more state-owned enterprises or two or more other state-owned investment entities shall have representatives of the company's employees on its board of directors; other limited liability companies may have representatives of the company's employees on their boards of directors."

It can be seen that the power allocation scheme of corporate governance in China has not been influenced by the trend of shareholder primacy, but has adopted the path of power allocation of corporate governance with Chinese characteristics, which suggests that the choice of values behind the norms of corporate law in the Chinese context should be combined with the national situation, and that the traditionally ecumenical values of corporate law in today's environment are worth reviewing.

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