What is the purpose of a corporation?

By Christopher Halburd*, Solicitor and member of the Purpose of the Corporation Project advisory group

- Current thought leadership is questioning the purpose of the corporation generally and critiquing shareholder primacy in particular.
- This article examines the purpose of the corporation through a variety of lenses: law, management, politics, accounting, economics and sustainable companies.
- The Purpose of the Corporation Project roundtable series is in train to identify the desired outcomes of corporate governance through discussions with investor, business, academic, regulatory and NGO communities.

Governance Institute's recently released discussion paper *Shareholder primacy: Is there a need for change?*[1] is a timely piece of thought leadership which deserves to be widely read as it both takes the, perhaps central, question of modern corporate governance beyond an academic discussion and firmly grounds it in real world decision-making contexts and also because it brings what is becoming an increasingly important conversation in global governance and management circles to Australia.

At about the same time as Governance Institute's Governance Advisory Panel was deciding to explore the issue of shareholder primacy in Australia, a European public interest law firm, Frank Bold, was developing a project to explore the same issue but in a slightly different way and from a global perspective. This project was recently described in an article in the *Financial Times* in London as 'an ambitious attempt to get back to first principles' and as providing 'a welcome boost to clear thinking'.[2] This project, the Purpose of the Corporation Project, was launched in February 2014 in the European Parliament in Brussels hosted by the parliament's long standing CSR Rapporteur, Richard Howitt MEP. The launch event brought together over 120 representatives from academia, business, civil society and policy makers who spent a day hearing from leading international experts as well as brainstorming ideas for next steps. The expert presentations are available along with a written synopsis and numerous other resources on the project website.[3] As the name implies the project asks the fundamental questions 'What is the purpose of the corporation?' 'Is it to maximise shareholder value (MSV) or is it something more?'.

Sitting at the heart of this project is a series of collaborations with and between an extraordinary array of knowledgeable, passionate and generous senior academics from multiple disciplines and countries. Working together they have produced succinct and accessible statements critiquing shareholder primacy[4] through the lens of their particular academic disciplines. These statements are freely available.[5] To understand why this is so crucial, it helps to consider Bob Tricker's metaphor of corporate governance as a stage illuminated by a series of spotlights. Each spotlight represents one theory of corporate governance. The spotlights illuminate different areas of the stage but none illuminates the whole stage. Tricker observes that a variety of academic disciplines have contributed to these

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theories. They include economics, law, accounting, management and politics.[6] The Purpose of the Corporation Project collaborations have resulted in statements covering each of these disciplines along with one, cited in Governance Institute's discussion paper, which considers the issue through a sustainability lens. The disciplinary statements allow for appropriately qualified academics to add their endorsements making them living documents whose persuasive power grows as the weight of informed opinion increases.

In the words of Lynn Stout, one of the drafters of the company law statement, in her award winning book, *The Shareholder Value Myth: How putting shareholders first harms investors, corporations, and the public*. The situation at the turn of the millennium was that:

> Most scholars, regulators and business leaders accepted without question that shareholder wealth maximization was the only proper goal of corporate governance. Shareholder primacy had become dogma, a belief system that was rarely questioned, seldom explicitly justified, and had become so pervasive that many of its followers could not even recall where or how they had first learned of it.[8]

By the time of the publication of her book in 2012, however, Stout asserted that conventional shareholder primacy stood on the brink of intellectual failure.[9] Even former shareholder value champion Jack Welch had famously declared it 'the dumbest idea in the world'[10]. A consideration of the academic statements illustrates why this is the case.

The dumbest idea in the world: Law

It is an unfortunate fact that a number of widely held beliefs about corporations and company law relied upon by business experts, the financial press and economists who study firms are legally incorrect. For example, contrary to popular belief there simply is no general duty for directors to maximise profits for shareholders. Shareholders do not own corporations or the assets of corporations. They 'only own shares of stock-bundles of intangible rights, most particularly the rights to receive dividends and to vote on limited issues'. Managers, directors and officers, are not the agents of the shareholders. Since most shareholders purchase on the secondary market the notion that shareholders contribute capital to corporations is, in the great majority of cases also wrong. Wrong too is the idea that the shareholders are the sole 'residual claimants' when the company is operating normally.[11]

The dumbest idea in the world: Management

Not only is the notion that the purpose of the corporation is to maximise shareholder value legally wrong but it results in bad management practices. It has, perhaps counter-intuitively, actually destroyed shareholder value and has seen a drastic reduction in the life span of corporations over the last 30 years. Many managers now operate under a 'folk wisdom' of shareholder primacy which has led to a race to the bottom in both the quality and quantity of employment and has encouraged the use of corporate restructuring efforts such as mergers and acquisitions ostensibly to create value but the vast majority of which fail to deliver long-term productive capability. This folk wisdom has led to increases in both within-firm and within-country inequalities whilst at the same time threatening firms' ability to innovate. When combined with limited liability the notion that the purpose of the corporation is to maximise shareholder value leads to systemic risk. An obvious example being banks which create short-term financial gain for shareholders by creating toxic assets which threaten the entire financial system in the long run.[12]

The dumbest idea in the world: Politics

This statement differs from the others to the extent that it has a primary focus on the European Union and concludes that there is an inbuilt bias toward maximising shareholder value for corporate governance and EU policy. Of concern for Australia are the observations that MSV has resulted in an 'ongoing privatisation of gain and socialisation of loss' and that policies around corporate governance shape the conditions for politics itself. This process involves a significant element of international influence through the global economy and value chains as well as international actors such as the World Bank, G20 and the Financial Stability Board all of which reinforce MSV. A specific consideration of these issues from an Australian perspective would be a most welcome addition.[13]

The dumbest idea in the world: Accounting

For most of the 20th century financial accounting was seen has having the purpose of holding managers accountable to stakeholders with a strong focus on correct valuation of assets with a view to protecting creditors. There has been a gradual move away from this in the International Accounting Standards Board to 'more narrowly focus on financial reporting as a corporate tool for providing absentee investors and creditors with information to support their decisions to invest or not in the corporation's securities'. This new understanding of the purpose of financial accounting with its focus firmly on the capital markets combines with the expanding number of corporate governance codes to support MSV. This 'can result in insidious changes whereby a highly contestable accounting-based measure of business success can become an end in itself at the expense of more pluralist and socially accountable stewardship of companies'.[14]

The dumbest idea in the world: Economics

Just as in the realm of accounting, there was a shift in economics during the 20th century away from a broader stakeholder perspective to a focus on the shareholder. Economics saw the triumph of MSV by about the 1990s but 'far from promoting economic efficiency, MSV is a core factor in growing macroeconomic imbalances, instability and the erosion of innovative capability'. It erodes the tax bases of the jurisdictions which create the environments in which corporations can successfully operate in the first place. It reduces the overall time horizon of strategic thinking, encourages short-termism generally and threatens innovation. MSV contributes to within-country inequality, the ideology of MSV has resulted in a situation where 'from the early 1980s, productivity growth has been outstripping real wage growth, leading to a declining factor share of labour in national income in almost all western countries over the last thirty years'.[15]

The dumbest idea in the world: Sustainable companies

This statement summarises some of the findings of a three year international project involving over 40 legal scholars who mapped the law in 26 jurisdictions across the globe, including Australia. It finds that even though 'no company law system requires directors to pursue shareholder profit maximisation at all costs, the social norm of shareholder primacy provides incentives and pressures to do just this.' This creates the main barrier to companies being sustainable from an environmental perspective. The social norm has been allowed to dominate because there simply is no legal norm. A prerequisite to achieving sustainable companies is accordingly 'reform of core company law, both at the level of broad principle, and at the level of its more detailed structure'.[16] The scholars at the Sustainable Companies project are already well advanced as to what these reforms should be in the Nordic countries and at the EU level.

Time for some not so dumb ideas

Frank Bold is continuing to advance the Purpose of the Corporation Project through a series of roundtables on corporate governance to be held with partners around the globe. The first roundtable was held in September 2014 at Cass Business School in London, the new home of the Modern Corporation Project, with other events currently under development.

The purpose of the roundtable series is to identify the desired outcomes of corporate governance through unique discussions that gather together thought leaders in the investor, business, academic, regulatory and NGO communities. The result will be a discussion that is global in scope but tailored to the unique characteristics of each region.

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Given the difficulty of identifying what is truly good corporate governance, beyond mere code compliance, the participants discuss the key outcomes of corporate governance towards which they believe we should be moving. In the words of Professor Colin Mayer of University of Oxford we 'should start at the other end and determine what we want firms to do and then establish the metrics by which we evaluate their performance'.[17]

Subsequent to the events, several senior academics will place the discussion within the broader context of existing academic theory and put forward concrete proposals for changes to business practice and regulatory reform that could be used to work towards these outcomes. Rather than advancing one single proposal for change, the goal is to foster an educated debate by considering each of the options available. The ultimate objective of the roundtable series is to move towards building corporate governance that goes beyond mere code compliance and box ticking in order to deliver what the world needs from its corporations.

Time for a re-consideration of shareholder primacy in Australia?

Much has happened since the last major consideration of these issues in Australia including the global financial crisis, which some have argued was caused or exacerbated by the ideology of shareholder primacy. Non-financial reporting criteria in the USA and EU have moved forward. The International Integrated Reporting Council is guiding the development of Integrated Reporting which may become a global standard. French economist Thomas Piketty, has ensured that inequality is firmly on the international policy agenda. Aggressive tax transfer pricing and so called 'inversions' driven by MSV ideology are receiving increasing attention at national and international levels. Employees are increasingly interested in working for organisations with a purpose beyond merely making money and senior business thinkers are recognising that through initiatives such as the Global Drucker Forum, Inclusive Capitalism, Conscious Capitalism and the Benefit Corporation movement. If we fail to reconsider shareholder primacy in Australia using all of the evidence available to us we risk being left behind.

Chris Halburd can be contacted on 0497 946 662 or by email at halburd@gmail.com.

**Formerly Head of Brussels Operations for Frank Bold.*

Notes

1 www.governanceinstitute.com.au/media/695936/govinst_shareholder_primacy_disc_paper_october2014_web.pdf

2 Stern S, 2014, 'Transcend 'shareholder value' for all our sakes', *Financial Times*, 23 October 2014.

3 www.purposeofcorporation.org/cs

4 The statements frame the critique as 'maximising shareholder value'.

5 http://themoderncorporation.wordpress.com/

6 Tricker B, 2012, *Corporate Governance: Principles, and Practices*, Oxford University Press, Oxford, pp 74–75.

7 Sjåfjell B, Johnston A, Anker-Sorensen L, & Millon D, 2014, *Shareholder Primacy: The Main Barrier to Sustainable Companies*, www.jus.uio.no/ifp/english/research/projects/sustainable-companies/news/sustainable companies2pagesummarycompanylaw.pdf

8 Stout L, 2012, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, Berrett-Koehler, San Francisco, p 21.

9 ibid, p 115.

10 Guerra F, 2009, 'Welch condemns share price focus' *Financial Times*, 12 March 2009.

11 The Modern Corporation Statement on Company Law www.purposeofcorporation.org/dokumenty/project_outputs/modern-corporation-statement-on-company-law.pdf

12 The Modern Corporation Statement on Management, www.purposeofcorporation.org/dokumenty/project_outputs/modern-corporation-statement-on-management.pdf

13 The Modern Corporation Statement on Politics, www.purposeofcorporation.org/dokumenty/project_outputs/modern-corporation-statement-on-politics.pdf

14 The Modern Corporation Statement on Accounting, www.purposeofcorporation.org/dokumenty/project_outputs/modern-corporation-statement-on-accounting.pdf

15 The Modern Corporation Statement on Economics, www.purposeofcorporation.org/dokumenty/project_outputs/modern-corporation-statement-on-economics.pdf

16 Sjåfjell B, Johnston A, Anker-Sorensen L, & Millon D, 2014, *Shareholder Primacy: The Main Barrier to Sustainable Companies*, www.jus.uio.no/ifp/english/research/projects/sustainable-companies/news/sustainable companies2pagesummarycompanylaw.pdf

17 Mayer C, 2013, *Firm Commitment: Why the Corporation is failing us and how to restore trust in it*, Oxford University Press, Oxford, p 159.