The Purpose of the Corporation

ENVIRONMENTAL LAW SERVICE

"The capitalist system is under siege. In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community ... A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation which has emerged over the past few decades ... Companies must take the lead in bringing business and society back together. The recognition is there among sophisticated business and thought leaders, and promising elements of a new model are emerging. Yet we still lack an overall framework for guiding these efforts, and most companies remain stuck in a "social responsibility" mind-set in which societal issues are at the periphery, not the core ... a narrow conception of capitalism has prevented business from harnessing its full potential to meet society's broader challenges. The opportunities have been there all along but have been overlooked. Business acting as business, not as charitable donors, are the most powerful force for addressing the pressing issues we face. The moment for a new conception of capitalism is now; society's needs are large and growing, while customers, employees, and a new generation of young people are asking business to step up ... The purpose of the corporation must be redefined as creating shared value, not just profit per se."

Porter, M.E. & Kramer, M. R. (Jan-Feb 2011) Harvard Business Review. P.64

Corporate Purpose and the Question of Trust

In earlier times corporations were not just about profit per se. They were often established to undertake such public works as supplying water to cities or building canals to facilitate transport. They were established for finite periods. They were limited in size. They did not enjoy limited liability. They could not own shares in other corporations. In short, corporations, as we know them today, are very different creatures from their forbears. Whilst some of the privileges that they now enjoy may have changed, what remains true is that they enable society to achieve feats which would not be available to it without some way of aggregating capital and managing risk. They are important organs of society and ones that society cannot afford to simply take for granted.

The question of the purpose of the corporation has always been with us. It is the basis from which everything else flows when we come to discuss the corporation. Yet it is not something that most of us spend a lot of time thinking about. We should. We are at a moment in history when we need our corporate businesses more than ever to help us cope with the challenges ahead. We, as a society, though, need to be clear in our understanding of the basis upon which society grants the privileges that now accompany the modern corporate form. Those that manage corporations also need to be clear on what society expects from the corporation. It is only by having a full, and fully informed, discussion about these issues that the bond of trust between business and society can be re-established. Without that trust we will remain locked in a vicious cycle where the level of governmental regulation ebbs and flows, often in proportion to the number and intensity of corporate scandals that populate our televisions and newspapers. A cycle which sees vast amounts of corporate resources being needlessly wasted on lobbying policy makers just to ensure that there is no new regulation. A cycle which sees non governmental organisations (NGOs) expending part of their scarce resources on naming and shaming those involved in corporate misbehaviour which serves to further undermine trust in business.

In the wake of the recent financial crises, society has also lost faith in government. The 2012 Edelman Trust Barometer, which was based on a survey of 25,000 respondents across 25 countries, shows that, in a majority of countries, respondents did not trust their governments to do what is right. In fact, in almost all countries surveyed, respondents trusted government leaders less than business leaders when it comes to telling the truth.

On the other hand, for the fifth year in a row, the survey found that the most trusted institutions in the world are NGOs. It is incumbent upon these institutions to reward that level of trust by helping to mediate between business and government. NGOs are ideally placed to bring together representatives of all stakeholders in order to further the important and neglected discourse around what society expects the purposes of the corporation to be in the future.

Trust is founded on communication and the credibility of communication is, accordingly, a fundamental element in the successful creation of trust. The Edelman survey found that the most credible spokespeople were academics or other accepted experts. The discussion of the purpose of the corporation has a long history in academia. Perhaps most famously in the debate waged, in part, in the Harvard Law Review in the early 1930's between Adolf Berle from Columbia, who argued that corporations exist for the benefit of their shareholders, and Merrick Dodd from Harvard, who maintained that the corporation had a social, as well as a profit making, function. Despite the fact that Berle later changed his mind and agreed with Dodd, by the end of the twentieth century shareholder primacy came to dominate thinking. Today the concept of maximising shareholder value is pervasive in world business.

In essence, this is often interpreted to mean pursuing only shareholder wealth as reflected in current stock price. For example the Kay review of the United Kingdom equity markets, concluded in 2012, heard evidence from some company directors who erroneously equated their duty to promote the success of the company, under S.172 of the Companies Act, with maximising current share price.[1]

The Problem of a Corporate Purpose to Maximise Shareholder Value

The problem is that this way of thinking has been linked, as a causative factor, to the recent financial crises. It has been blamed for some of the worst excesses in corporate behaviour, and academics are now broadly questioning the basic tenets upon which it was built. Policy makers are alive to one of its manifestations, short-termism, and are seeking ways to mitigate that type of thinking. A problem in that regard is that they often simply seek to fix the problem by deploying solutions which serve to further entrench shareholder primacy. They never think to ask the fundamental question: *"Does this paradigm, which has dominated corporate governance for several decades, actually work?"*

Cornell Law School Professor, Lyn Stout, has expressed the view in her recent book "The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public" that, as the name of the book implies, it does not work. She shows that, not only is the business world misunderstanding and miss-applying the law that underpins shareholder primacy, but that, as a concept, it *"stands on the brink of intellectual failure"*.[2] She also makes the point that this type of thinking is not limited to academia quoting former shareholder value early adopter and GE CEO Jack Welch who said in the Financial Times, in relation to the 2008 financial crisis, that *"strictly speaking shareholder value is the dumbest idea in the world"*.[3]

The reason that the notion that the purpose of the corporation is to create wealth for shareholders is so problematic is concisely set out in the work of another Law Professor, Joel Bakan. Professor Bakan argues that:

"Corporations are created by law and imbued with purpose by law. Law dictates what their directors and managers can do, what they cannot do, and what they must do. At least in the United States and other industrialized countries the corporation, as created by law, most closely resembles Milton Friedman's ideal model of the institution [one in which the only social responsibility of business beyond obeying the law is to increase its profits]: it compels executives to prioritize the interests of their companies and shareholders above all others and forbids them from being socially responsible-at least genuinely so".[4]

Bakan also argues that maximising shareholder value constrains managers (the term "managers" includes company directors) in such a way as to make them do things that they otherwise would not do. He says:

"People who run corporations are, for the most part, good people, moral people. They are mothers and fathers, lovers and friends, and upstanding citizens in their communities, and they often have good and sometimes idealistic intentions ... Despite their personal qualities and ambitions, however, their duty as corporate executives is clear: they must always put the corporations best interests first and not act out of concern for anyone or anything else (unless the expression of such concern can somehow be justified as advancing the corporation's own interests) ".[5]

Corporate Purpose, Human Rights and Corporate Groups

We can use the area of respect for human rights to illustrate the problem. Under shareholder value thinking, it is perfectly acceptable for the managers of a corporation to create shared value, as is proposed both by Porter & Kramer in the passage above, and by the European Commission's most recent communication on corporate social responsibility (CSR)[6], by a measure, such as improving safety in the workplace, if it can be shown that this will result in litigation costs falling by more than the cost of the safety improvements, because this means that a benefit is being delivered to society at the same time as the corporate bottom line is being improved. This does not hold true for the situation where the cost of the improvements is more than the saving. In that instance, setting aside the question of reputational risk, maximising shareholder value, either in the short-term or in the long-term, requires that no improvement be made. This is the reason why neither shared value nor CSR, as it is traditionally understood, are adequate measures to address risks to society such as corporate human rights abuses.

The problem is amplified by the fact that large modern firms are made up of multiple corporations, acting as a corporate group, incorporated and operating in different jurisdictions around the world. These corporations often own other corporations in the corporate group, sometimes they even own shares in corporations that own shares in them. In each case the shareholder company ordinarily enjoys limited liability with respect to the acts of its subsidiaries. This limited liability insulates the parent corporation from the risk taking behavior of the subsidiary corporation. Unfortunately no such insulation is provided to protect society and the environment from such risks. This use of corporate groups also facilitates the sorts of aggressive transfer pricing arrangements which can see large brand name firms paying little or no tax in countries where they have significant operations.[7]

Re-visiting Corporate Purpose

What is needed is to re-visit the purpose of the corporation so as to explicitly recognise a corporate purpose which extends beyond simply making as much profit as possible within the law regardless of whether that is expressed as being in the short-term or the long-term. This can be thought of as re-incorporating society into corporate purpose. Once that is done company law and corporate governance will naturally change to reflect this purpose. This change would reflect, in legislation, corporate and director responsibility, which has broad ranging implications for all corporate behaviour and frees the mostly good managers, that Bakan describes, to do the right thing, without fear of being sacked or sued for not delivering a quarterly share price that is quite as high as it might otherwise have been.

It would also provide space for a proper policy debate across a range of issues. It is difficult for the voice of the rest of society to be heard by policy makers while ever the prevailing law and/or thinking is that the sole or dominant purpose of the corporation is to maximise profit.

As Professor Stout puts it *"many and perhaps most of our corporate problems can be traced not to flawed individuals but to a flawed idea- the idea that corporations are managed well when they are managed to maximise share price"*.[8] She argues that the present model also represents a threat to investors and to corporations themselves. Roger Martin, writing in the Harvard Business review in 2010, makes the point that returns to shareholders have actually declined since maximising shareholder value became the dominant paradigm. Martin describes the paradigm as "tragically flawed" and advocates instead focusing on the interests of customers.[9] Of course that approach does little for other stakeholders.

Dissatisfaction with shareholder value thinking is not just confined to the academic world. A number of states in the USA now allow corporations to be registered which specifically do not have maximising shareholder value as a purpose. These so called "benefit corporations" are, generally, required to have a corporate purpose to create a material positive impact on society and the environment. They provide for directors to have fiduciary duties to consider non-financial interests and they have an obligation to report on social and environmental performance assessed against an objective standard.

Former US Vice-President Al Gore speaks of "sustainable capitalism" which *is "a framework that seeks to maximise long-term economic value by reforming markets to address real needs while integrating environmental, social and governance (ESG) metrics throughout the decision making process"*.[10] There is a growing movement around "conscious capitalism" which while advocating "entrepreneurship, competition, freedom to trade, property rights, and the rule of law" recognises that business has a higher purpose that goes beyond mere profit maximisation.[11]

There is now ample evidence that the shareholder value paradigm is flawed economically, legally and socially. What is lacking is a platform for the development of a coherent vision for a new paradigm of corporate governance which will be more beneficial for society than the present one but which will still allow corporations to remain profitable, to provide jobs and innovative solutions to society's growing needs. In order for such a beneficial paradigm shift to occur in this area there will need to be collaboration between academics (across a number of disciplines), business leaders, policy makers and civil society. At present there is no mechanism for bringing these groups together in a meaningful way, so that the mental models that underlie thinking in this area can be properly considered.

The reason why such a consideration of these models is needed is neatly captured by the man often described as "the father of corporate governance", Bob Tricker. Tricker observes that we still think about company law and corporate governance using a model of the corporation as it existed in the 19th century. This, he says, *"bears about as much relationship to reality as a hang-glider does to a fleet of jumbo-jets."*[12]

Framing the Discussion

A key challenge, in this process of consideration, will be avoiding the exercise simply dividing along political/ideological lines. This is an area that is easily politicised but this needs to be avoided if we are to reach the best possible understanding of the role of corporations in the 21st century. Among the first of the issues that will need to be considered is the fundamental question of why we have corporations in the first place, what is it that they are designed to do from a societal point of view? Other issues will doubtless include such things as:

1. How have the mental models that we use to understand the corporation developed over the years and do they still make sense?

2. How did we get to the current paradigm? What exactly does it entail? Does it still make sense? If not, what are the reasonable alternatives? What are the risks associated with these?

3. How do we ensure that our companies will continue to have access to capital and continue to provide innovative solutions to meet society's needs? How do we ensure shareholders, and potential shareholders, retain trust in corporations to build wealth, in the new paradigm?

4. How do we balance the necessity for corporations to be profitable with their impacts on society?

5. What do we understand fundamental concepts such as "competitiveness", "stakeholder", and "value" to mean in this context?

6. For whom are corporate managers trustees?

7. How might this be reflected in corporate governance provisions and company law?

The Goals of the Project

The Purpose of the Corporation Project aims to create a safe and apolitical space for the relevant actors to explore these important issues. The first step will be to engage with the academic community in an attempt to assemble a range of new options for corporate governance models. There is already a great deal of excellent work being done on this in academic circles, but we need to find a way to make this readily accessible from both a physical and intellectual point of view. The value of academic work to society is limited if it is contained within separate virtual silos, either because outsiders don't know about it, can't engage with it, or are unable to appreciate its relevance without, themselves, having an academic background in the relevant area.

Another goal of engaging with the academic community is to ensure a balanced approach to teaching in law and business schools so that maximising shareholder value is placed in its proper historical, legal and economic context. The graduates from these schools will go on to lead our society and manage our businesses so it is vital that they start their careers understanding all of the issues associated with the core question of corporate purpose. A recent investigation into this area in the United States has raised real concerns in that regard. It suggests that some students are being taught an innacurate version of the law on the topic and that there seems to be too much focus on maximising shareholder value. It found that MBA students leave business school erroneously thinking that they are required to maximise shareholder value. This investigation also revealed that if it were up to them to choose *"more students are likely to say they would emphasize employees and social and environmental considerations and fewer indicate they would stress shareholder value."*[13] This is consistent, of course, with Bakan's observations that the current paradigm makes managers do things that they otherwise would not do.

The Purpose of the Corporation Project will reach out to business and policy makers, initially with a European focus, to encourage them to engage in an open public discussion with all stakeholders to properly consider the question of the purposes of the corporation. The European Commission has undertaken, in its CSR Communication, to *"Initiate an open debate with citizens, enterprises and other stakeholders on the role and potential of business in the 21st century, with the aim of encouraging common understanding and expectations…"*. The question of the purpose for which corporations exist is fundamental to this exercise.

An important part of this discussion flows from another feature of which Professor Bakan reminds us and that is that corporations are creatures of the law. The media is fond of making comparisons between corporations and countries along the lines *"if XYZ Ltd were a country it would be bigger than country A"*. Of course a corporation is not a country, and cannot exist at all without a country to allow it to incorporate. Incorporation is not a right, it is a privilege, one for which there has always been a price. Part of that price needs to be adherence to the purposes for which society grants the privilege of incorporation. Those purposes cannot be dictated by any one interest group. They must be co-created by society as a whole, thus re-establishing the bond of trust between business and society. It is toward helping to facilitate this process of co-creation that the Purpose of the Corporation Project works .

The Purpose of the Corporation Project is an initiative of the Environmental Law Service which is a public interest law firm established in 1995 with four offices in the Czech Republic as well as offices in Krakow and Brussels. The Environmental Law Service has been working on corporate accountability issues since its inception and was one of the earliest members of the European Coalition for Corporate Justice, an organisation with which it continues to work closely.

For further information or to become involved please contact c.halburd@elseurope.org or visit www.elseurope.org.

[1] The Kay Review of UK Equity Markets and Long-Term Decision Making: Full Report. July 2012 at p.17. Available at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

[2] Stout, L. (2012). *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations And The Public*: San Francisco. Berret-Koehler Publishers. P.115.

[3] Quoted in Stout, L. (2012) p.5.

[4] Bakan, J. (2005). *The Corporation.* London: Constable & Robinson. p. 35.

[5] Bakan, J. (2005). p. 50.

[6] COM (2011) 681.

[7] See for example Robe, J.F. (2011). The Legal Structure of the Firm. *Accounting, Economics, and Law.* Vol.1: Iss. 1 p. 50-52.

[8] Stout, L. (2012). p. 11.

[9] Martin, R. (Jan-Feb 2010). The Age of Customer Capitalism. *Harvard Business Review*. p. 58-65.

[10] Gore, A., & Blood, D. (2012). A Manifesto for Sustainable Capitalism: How business can embrace environmental, social and governance metrics. *Sustainability: The Journal of Record.* 5(2) p.66.

[11] See http://consciouscapitalism.org/purpose

[12] Tricker, R. (2012). *Corporate Governance: Principles, Policies, and Practices.* Oxford University Press: Oxford. p.7.

[13] West, D. (2011). *The Purpose of the Corporation in Business and Law School Curricula.* The Brookings Institution. Available at http://www.brookings.edu/~/media/research/files/papers/2011/7/19%20corporation%20west/0719_corporation_west.pdf