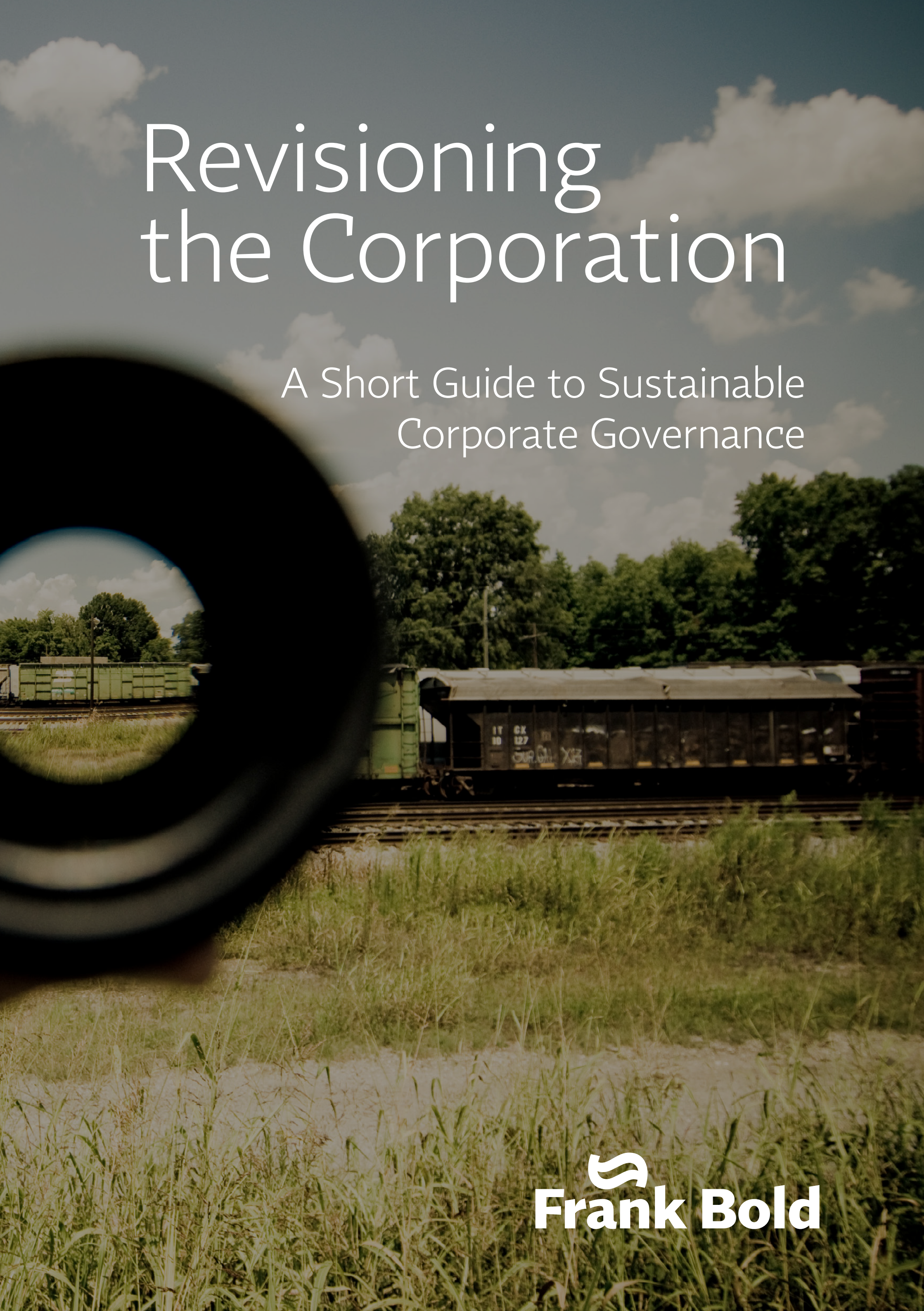
Revisioning the Corporation

A Short Guide to Sustainable Corporate Governance



Frank Bold

Authors:
Paige Morrow (Head of Brussels Operations at Frank Bold), Filip Gregor (Head of the Responsible Companies Section at Frank Bold) and Jeroen Veldman (Senior Research Fellow at Cass Business School, City of London).

Editor:
Sandrine Brachotte

Design and layout:
Susanna Arus, Communications at Frank Bold.
(CC) Icons designed by Freepik
(CC) Cover picture by Andy Ciordia

Citation:
This guide may be cited as: Morrow, P., Gregor, F., and Veldman, J. (2015) *A Short Guide to Corporate Governance*. Brussels: Frank Bold. Comments may be directed to Paige Morrow (paige.morrow@frankbold.org).

Acknowledgments
The authors would like to thank the following people for their comments and contributions to the handbook: Jay Cullen, Natasha Dyer, Chris Halburd, Andrew Johnston, Martin Rich, and Beate Sjafjell.

Who we are

The Purpose of the Corporation Project (an initiative of Frank Bold) provides a strategic, open source platform for leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed companies through business management and public policy. The Project works with academics and practitioners to develop new options for corporate governance models. We also liaise with business, policymakers and civil society organisations to foster an open discussion with all stakeholders on the purpose of the corporation.

Frank Bold is a purpose-driven law firm using the power of business and non-profit to solve social and environmental problems.

The Purpose of the Corporation Project and the publication of this guide are kindly supported by the Charles Leopold Mayer Foundation for the Progress of Humankind, the Friends Provident Foundation, the Joseph Rowntree Charitable Trust, and the Wallace Global Fund.

Objective

The objective of this publication is to provide civil society organisations and responsible businesses with the following:

- An overview of corporate governance, and its implications in terms of corporate impact on civil society concerns;
- An overview of existing and alternative corporate governance models; and
- Some food for thought about the corporate governance rules that could help build a responsible corporate governance model.

Table of contents

Introduction to Corporate Governance

1.1 What is corporate governance?

Corporate governance has been described as the procedures and processes according to which a business is directed and controlled.

Corporate governance may be broadly understood as the way the modern capitalist corporation is 'governed':

how are corporations administered and structured
by whom (the issue of corporate control)
for whom: for which purpose

Overall, corporate governance structures relations between the company and different groups of stakeholders: shareholders, creditors, boards, managers, workers, communities, trade unions, and the state.

These definitions clearly recognise the importance of groups other than shareholders and broader interests, including the planet. However, there are different ways to do corporate governance, which are called corporate governance models. In practice, the current mainstream corporate governance models often favour shareholders' interests.

This Guide shows how and why other corporate governance models that better take into account other stakeholders' interests, based on another vision of the purpose of a corporation, will govern corporations in the future.

1.2 How is corporate governance relevant to social justice?

Engaging with corporate governance is relevant to many critical social issues.

Inequality

The current corporate governance model puts strong incentives and constraints on publicly listed companies to maximize short-term value creation and to increase the payout ratio to shareholders. As a result, award compensation packages for executive managers are heavily weighted towards stock options, which increases inequality both within companies and across society. Moreover, the demand to produce shareholder value is linked to the way global value chains are structured, notably producing pressure to engage in tax evasion, transfer pricing, and segmentation of liabilities (e.g. in special purpose vehicles). This effect extends further to firms' relationships with suppliers and drives the exploitation of workers throughout value chains, for example in off-shore manufacturing sites. Corporate governance in the way it is currently structured is, therefore, an important background to the persistence of global inequaliti

Sustainability

Companies face tremendous pressure from investors to justify investments in more sustainable operations that do not pay off in the short-term. This may also extend to addressing human rights risks, for example in overseas supply chains. Corporate governance in the way it is currently structured is, therefore, an important background to the externalization of costs that pertain to 'intangibles', such as long-term relations with workers, suppliers, local communities, and the state.

Poverty

The financial crisis showed that existing checks and balances in how companies were being run failed to create sound business practices, leading to a large number of corporate and personal bankruptcies, entrenched unemployment, mortgage defaults, and pervasive poverty

1.3. How to engage with corporate governance?

The current default is to regulate corporate behaviour through external regulations, relating to the environment, human rights, tax, accounting, etc. While these external regulations are crucial to mitigate acute environmental and social problems, such as water pollution and worksite safety, they are often criticised for being bureaucratic, complicated, expensive to monitor and enforce, adversarial, ineffective at addressing root causes and for having a tendency to stifle innovation.

Furthermore, external regulations as they currently exist do not necessarily encourage companies to consider the broader rationale of those regulations, i.e. why and how their business activities could be structured to dramatically reduce or eliminate negative impacts, or conversely why and how companies could contribute positively to the welfare of workers, the communities in which they operate, and society .

Revisioning corporate governance is not an alternative to the regulation of externalities, such as pollution, waste, and impacts on human rights. It rather enhances regulation by focusing on the structural and regulatory conditions that push companies to prioritise short-term profits and produce negative externalities. Furthermore, responsible corporate governance should be distinguished from corporate social responsibility (CSR), which relies on voluntary measures and soft law to improve corporate conduct

1.4. Why engage with corporate governance?

It is now generally accepted that designing corporate governance in a way that takes on board these considerations can help a company to be sustainable in the long-term. There is, then, a shared interest between civil society, business, and states to reform corporate governance in a way that allows for business to be conducted differently.

Today we face complex challenges that cannot be addressed by governments or civil society alone because they are intrinsically connected with the economy, such as climate change; doing business within the limits of the planet's resource boundaries; and negotiating the complicated relationship between economic globalisation, development, and human rights.

Responsible corporate governance offers the possibility of forging a vision for business that sees corporations providing benefits to the communities in which they are situated. Reforming the corporate governance framework can make this possible by complementing existing regulation that seeks to promote responsible corporate behaviour.

Revisioning corporate governance is not an alternative to the regulation of externalities, such as pollution, waste, and impacts on human rights. It rather enhances regulation by focusing on the structural and regulatory conditions that push companies to prioritise short-term profits and produce negative externalities.

The eventual formulation and recognition of a new understanding of the purpose of the corporation is a first step to start a discussion on the construction of a new system that sets different conditions and possibilities for companies to take on board and engage with these negative externalities. Launching this discussion is essential for a change of our economic system as a whole.

1.5. Corporate Governance and the Purpose of the Corporation

The purpose of the corporation is emphatically not to maximize shareholder value in the short-term. While a corporation serves to generate profits, this might be on a very long-term time horizon. Furthermore, the purpose of the corporation is whatever its founders wish it to be, as long as it is legal. Thus, it might be to make innovative products, develop cutting edge technology, build a spaceship, create the next penicillin, foster a great working environment for employees, satisfy their customers or one of many other objectives.

A corporation may also decide to maximise quarterly profits and short-term share price - the key here is that it is a permitted objective, not one that is required by law.

When the public limited liability corporate form was made available for general purposes during the 19th century, the law essentially left a vacuum allowing companies to decide what their purpose should be. By the end of the 20th century, the socially constructed norm of shareholder value had expanded to fit the vacuum. Very few conventional companies were founded with the narrow objective to maximise shareholder value. Rather, these companies became profitable and generated shareholder value as the result of delivering a product or service that addressed a specific societal need. Over time, the pursuit of shareholder value as measured by share price has become an objective in itself.

The eventual formulation and recognition of a new understanding of the purpose of the corporation is a first step to start a discussion on the construction of a new corporate governance model that sets different conditions and possibilities for companies to take on board and engage with various stakeholders' interests. Launching this discussion is essential for a change of our economic system as a whole.

1.6 Corporate Governance and Myths about the Corporation

Current corporate governance rules rely on several misguided beliefs. Busting those myths is another preliminary step towards the construction of a new corporate model.

Fact 1

Shareholders do not own corporations.

Busting the myth

Many incorrectly believe that shareholders own corporations. This is not true under the law of any known country. Shareholders only own shares of stock, which give shareholders certain rights in the company. In law, corporations are legal persons or entities, which means they have an independent personality and cannot be owned by anyone.

Treating a corporation as a legal person means that the corporation has certain rights and obligations, including especially the rights to own property, enter contracts, and be held accountable in its own name for any harm it causes to others.

It is important to be clear that the idea of shareholders as 'owners' is fundamentally incompatible with the corporation as we know it today. Right now, the financial risk to investors when they buy shares is limited to the amount of money that they have invested in the corporation or paid for their shares. If a corporation was owned by its shareholders, they could be held financially responsible for any wrongdoing or money owned by the company (as is true for other forms of companies, such as sole proprietorships and partnerships).

Fact 2

Boards of directors do not have a legal duty to maximize shareholder value by focusing on short-term stock price or quarterly returns.

Busting the myth

Directors have a fiduciary duty to act in the best interest of ‘the company’. The best interest of the company is difficult to ascertain but it cannot be equated with maximising shareholder value, and especially not in the short-term. Directors are free to instead choose to invest in innovation, research and development, employee training, improvements to sustainability or other areas if that will ensure the long-term vitality of the firm. On a sufficiently long time horizon, the interests of the company are inseparable from societal well-being.

Furthermore, even if directors wish to maximise shareholder value, it is difficult to determine what this means in practice. It may be impossible to identify all major shareholders and determine their interests. Certain investors have very short-term time horizons (e.g. hedge funds) whereas others are interested in long-term returns (e.g. pension funds and sovereign wealth funds). Focusing only on quarterly earnings may lead a company to make decisions that will have a negative impact on the future health of the firm, e.g. laying off workers or failing to invest in research and development. It is therefore impossible to argue that maximizing short-term profits or raising the share price in the short run is in the interests of all investors, let alone in the interest of ‘the company.

Fact 3

Directors are not the agents of shareholders

Busting the myth

It is often said that directors are the ‘agents’ of shareholders; this is not true under the company law of any jurisdiction. Directors have a duty to act in the best interests of ‘the company’. While shareholders should and normally will benefit from a company’s success, directors do not as a matter of law act on behalf of shareholders.

The myth originates in the principal-agent theory of corporate law widely held by institutional investors and legal scholars, particularly in the United States. Under this theory, directors are the agents of shareholders and are responsible for acting in shareholders’ best interests rather than their own in managing the corporation. This is one theory of the firm among others (which will be explained further in the next chapter) and does not reflect the obligations of directors to non-shareholder stakeholders, which is an important feature of corporate law in much of Europe.

Furthermore, the decisions of directors are typically protected by the business judgement rule (or a functional equivalent), which is a legal principle that gives directors the benefit of the doubt provided that they can show that they acted in good faith, with proper care and in a way that the directors reasonably believed was in the best interests of the corporation.

Fact 4

Corporations do not earn any capital when their shares are trade

Busting the myth

Many believe that companies profit from their shares being bought and sold on securities markets. In fact, companies only receive money from the first sale of security to the public in the primary market, which is often referred to as an initial public offering (IPO). When the initial investors resell their shares on the secondary market (commonly known as the 'stock market'), the sale proceeds and any increase in stock price go to the seller. The company that issued the stock does not receive any part of the profit or loss.

Fact 5

Shareholders have certain limited rights because they invest capital in the corporation… but other groups have rights, too.

Busting the myth

Shareholders own shares, which give them a number of organisational, control and economic rights in relation to the company, such as the right to receive dividends and to vote on certain matters. Shareholders do have special rights, but these cannot be justified on the basis of their relationship with the company, which is analogous to the relationship between the company and other stakeholders, including employees, creditors and bondholders.

Fact 5

Shareholders have a residual interest in the corporation in the event of bankruptcy… but so do other stakeholders.

Busting the myth

The principal-agent theory of corporate law says that the interests of shareholders should be prioritised because they are the 'residual claimants', meaning that they have the sole remaining claim on the company's cash flows after the deduction of preceding agents' claims (e.g. wages, outstanding debts and tax) and therefore also bear the residual risk.

This claim is hotly debated, with many legal scholars arguing that employees are also residual claimants because they invest time and money to acquire special skills of benefit to a specific company. When a company goes bankrupt, employees must invest in retraining and finding new employment.

Furthermore, many external stakeholder groups are dependent upon, or affected by, company decisions but their contracts might be incomplete or they might not be in a contractual relationship with the corporation at all, and so have no opportunity to protect their interests. For example, a local community might be indirectly reliant on the company for the economic benefits that it provides. Such a community or the state might also have a more direct claim because it has provided material or immaterial means, such as subsidies, tax breaks, or infrastructure to the company.

1.7 What does 'bad' corporate governance look like?

Perhaps the most famous example of a company where internal decision-making processes went terribly wrong is Enron – whose top executives lied about financial results for years to inflate the value of their personal stock options, with the complicity of the board of directors and auditor. The actions went undetected by US regulators, rating agencies or media for years until the firm spectacularly imploded into bankruptcy in 2001.

There are numerous other examples of publicly listed companies with dysfunctional governance structures that led to egregious misconduct:

Tax avoidance - in the Panama Papers and LuxLeaks scandals it emerged that European companies had structured their business operations to reduce their tax burden. Boards of directors often believe that they have an obligation to reduce their companies' liability to taxation as part of their duty to produce shareholder value. This is disputed. For example, in the UK, a leading law firm published a legal opinion that concluded: "It is not possible to construe a director's duty to promote the success of the company as constituting a positive duty to avoid tax." Indeed, aggressive tax minimisation can have harmful effects on financial performance due to reputational brand damage. It is one of the key reasons for the collapse of trust between business and broader society.

Short-term cost cutting - The Deepwater Horizon oil spill showed how BP's culture of cost-cutting reduced safety oversight and resulted in the largest accidental marine oil spill in the history of the petroleum industry. Similarly, Shell has been accused of lax oversight over its Nigerian subsidiary, leading to immense ecological damage in the Niger Delta. The foreign subsidiary was ordered to pay compensation to a Nigerian farmer because the company had neglected its duty of care.

Irresponsible supply chain management, particularly in the garment and electronics industries – The drive to reduce labour costs has led to the outsourcing of production. This, coupled with the failure to oversee and guarantee the health, safety and equitable pay for workers, has led to a pattern of human rights violations in several low wage countries. The most notable recent example is the collapse of Rana Plaza in Bangladesh, which occurred despite the instability of the building structure having previously been identified.

1.8 What does 'good' corporate governance look like?

It is harder to identify good governance than to point to bad corporate governance. One way to define good governance would be to say that it captures the ways in which the company makes sure that it creates the conditions to serve its stated purpose in the long run. In a broader sense, we may say that the purpose of a corporation is not only framed by its own purpose, but by the way it relates to and is embedded in the purpose, culture and values of the community in which it operates in a long-term perspective.

We might say that a well-run company is sustainable, is managed in a transparent way and accountable to robust standards that govern its performance in all applicable areas, including environment, human rights, labour, and tax.

Good corporate governance allows a company to look well into the future, anticipate challenges and opportunities, build capacity to create value on an ongoing basis, embrace the creation of real value for customers and wealth for shareholders as mutually reinforcing objectives, and recognize societal and environmental sustainability as essential conditions for delivering on these objectives in the long run.

Good corporate governance embraces these objectives and implements them in business strategy through evaluation, monitoring and incentive mechanisms. Companies that are run in this way are more likely to act according to sound ethical principles even in the absence of a clear business case.

There are significant advantages to strong corporate governance, including better relations with stakeholders, less litigation and fewer costly disputes, and reduced interference from regulatory authorities. Good corporate governance results in superior performance on the market for products and services as well as on capital markets - at least in the long-term. It also puts companies in a position to shape new standards, both regulatory and with respect to customers' expectations.

Furthermore a well-run company with a great reputation is better placed to attract talented employees. Overall, it provides the conditions for successful long-term business operations and reduces the chance of insolvency.

Further reading about good corporate governance:

Richardson, B. and B. Sjåfjell, B. (2015). Capitalism, the sustainability crisis and the limitations of current business governance. In Richardson, B. and B. Sjåfjell, B. (Ed.) Company Law and Sustainability: Legal Barriers and Opportunities. Cambridge: Cambridge University Press.

International Corporate Governance Network (ICGN) (2015). Human rights through a corporate governance lens. London: Author. Retrieved from https://www.icgn.org/policy/viewpoints/human-rights

Prevalent systems of corporate governance

Speaking broadly, corporate governance experts tend to talk about three systems of corporate governance that may be found in Europe and North America.

- the Shareholder Wealth Maximisation-Oriented Model (the Anglo-Saxon model); and
- the Stakeholder-Oriented Model (the German model)

Countries with an Anglo-Saxon legal tradition, including the United Kingdom, United States, Canada and Australia, have a corporate governance model that tends to focus on shareholders. Countries with a German legal tradition, on the other hand, are considered to be stakeholder-oriented industrial systems, meaning that business decisions tend to take into account the needs of employees and other stakeholders. Countries with Scandinavian and French legal traditions do not entirely fit into either category but generally fall into the non-shareholder-oriented model.

Within each system, there is considerable variation and the systems have influenced each other. For example, the rising importance of American activist investors in France has led to pressure on French companies to reform their governance in line with the US model.

Below is a brief outline of these models along with an analysis of their strengths and weakness

2.1 The Shareholder Wealth Maximisation-Oriented Model

At its core, the shareholder value maximisation-oriented model perceives the sole or primary purpose of the corporation to be to maximise its value for shareholders. This belief has been developed only since the 1970s.

American economists such as Friedman and Jensen and Meckling argued that publicly traded companies suffer from an incentive problem: the people who run companies (management) are different from the people who 'own' the company (shareholders) or who are otherwise affected by its success or failure (stakeholders). To fix this perceived problem, various mechanisms should be used to try to align the interests of management with shareholders, such as stock-based executive pay and allowing hostile take-overs. Since the 1970s, companies have made stock options an increasingly significant part of executive pay in an effort to ensure that executive managers make decisions that benefit shareholders. As a result, this model has introduced a strong focus on quarterly earnings and short-term share price as the main basis for strategic decisions by company executives.

Contrary to widespread belief, corporate directors generally are not under a legal obligation to maximize profits for their shareholders.
Modern Corporation Statement on Company Law

▶ 2.1 (A) What are the weaknesses of this model?

Lack of legal basis

The immediate challenge to the shareholder model is that the maximisation of short-term profits is not required under any legal system.

Lack of efficiency

Furthermore, it is impossible to speak of 'shareholders' as a homogenous group with a coherent set of interests.

Short-termism, or myopic behaviour, is the natural human tendency to make decisions in search of immediate gratification at the expense of future returns, decisions which we subsequently regret.
John Kay 2012: 1

While certainly shareholders expect to earn profits, both their expectations for financial returns and their time horizons vary significantly. For example, institutional investors like pension funds and sovereign wealth funds may have extremely long time horizons because they seek to provide a return to their members and citizens over the course of their entire lifetime, or indeed over the course of many lifetimes.

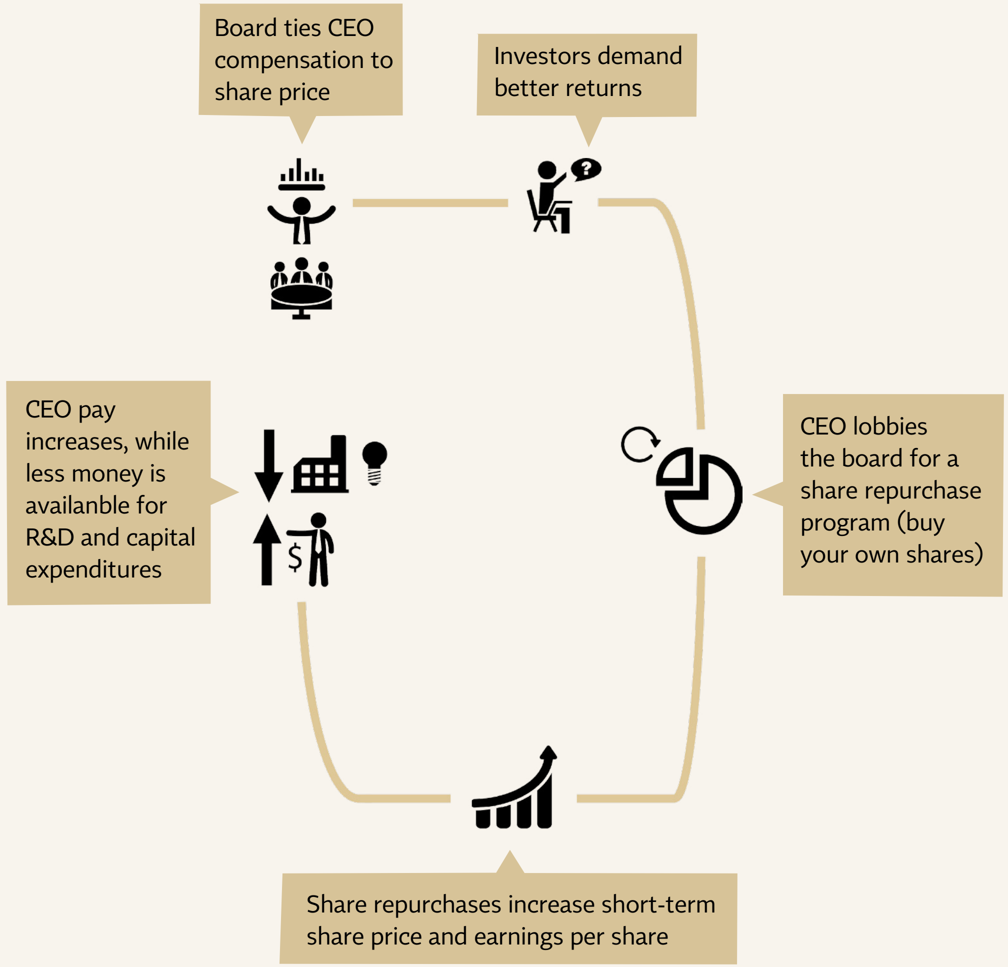
As a result, they may be patient investors prepared to invest in research and development to promote long-term innovation (such as new technology, which may take 10-20 years to be profitable) or invest in sustainability measures that are costly in the short-term (e.g. the transition to clean energy or upgrading factory equipment).

At the other extreme, hedge funds and activist investors may seek to 'unlock' shareholder value by pressuring boards to buy back stocks, layoff employees, buy other companies in order to acquire their innovations (rather than investing in risky explorative research) or engage in financial engineering to increase stock price. In some places, the pressure to raise share price is simply driven by business culture, management reacting to demands from shareholders or seeking to increase the value of their own shareholdings, or a misinterpretation of the legal obligations of directors.

As a consequence, high profile advocates of shareholder primacy such as Michael Jensen (one of the economists who developed the theory), Jack Welch (ex-CEO of General Electric), and Lucian Bebchuk (Harvard law professor) have backed away from the idea that maximizing share value always and everywhere has the effect of maximizing the total social value of the firm or society more broadly.

Although the shareholder-centric model is generally perceived to be effective in terms of streamlining decision making in order to generate profits, they now recognise that specific types of shareholders may dominate the process, leading executive managers to become incentivised to take on too much risk. This may lift the immediate market valuation of the firm, but does so by reneging on implicit contracts and by imposing costs on creditors, employees, taxpayers, and the economy as a whole.

Investor - CEO feedback loop



Critiques of the current model:

Serious environmental and social implications

The use of the corporation as a legal form has had tremendous advantages in the past due to its ability to stimulate risk-taking and innovation. At the same time, it has passed along many costs to the broader society - what economists call negative externalities - due to its failure to properly account for its impacts. The problem is particularly acute for climate change, where rapid and deep change is needed to avert impending crisis.

Growing inequality

In the 20th century, the incomes of middle-class individuals consistently rose despite economic recessions, wars and other upheaval. That is no longer the case. Recent research has shown that a very large part of global wealth increase is captured by the the top 1%. The primary causes for this capture are the increase in the share of company proceeds going to shareholders, notably in the form of dividends and share buybacks and the rise of top executive compensation in large U.S. corporations, which is now largely based on stock options. At the same time, the wages of lower and middle-class workers have essentially flatlined. Rising inequality within large companies has contributed, along with other factors, to increasing societal inequality on a global scale

Economic growth without job creation

As we begin the 21st century, we have witnessed an unprecedented situation where increased corporate profitability has not translated into job opportunities. There are numerous reasons for this, not least the rising role of automation and outsourcing. Yet, the fact remains that companies are not reinvesting their returns into research and development (R&D) and/or employment but rather maintaining significant cash reserves, buying other companies, paying out dividends to shareholders and buying back shares.

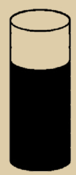
Real consequences

Pay Gap (USA) :
CEO pay in 2014 was 204 times that of an average worker

Dividends to shareholders (UK)

In 1970
£10
of every
£100

Today
£70
of every
£100



Stock Holding Period
(S&P 500)

In 1960 the average was **8 years**

Today the average is **4 months**

▶ 2.1 (B) The Enlightened Shareholder Value Model

Certain jurisdictions have adopted a concept called ‘enlightened shareholder value’, meaning that boards of directors must consider the needs of other groups beyond shareholders.

The UK is the foremost example, where directors are explicitly required to make decisions that are in the best interests of the members as a whole (meaning, all present and future shareholders), taking into account the interests of stakeholders, including employees, creditors, the environment and broader society. In Canada, directors must make business decisions that are in the best interest of the company as an ongoing entity, in other words ensure that the company is able to continue operating into the future.

A central issue with these approaches is the lack of an enforcement mechanism, meaning that concerned citizens or civil society groups are unable to bring a claim alleging the failure of directors to pay appropriate attention to the interests of stakeholders. This is a corollary of the business judgement rule. In this system, the law’s unwillingness to interfere allows the pressure to maximise shareholder value in the short-term to remain dominant

2.2 The Stakeholder-Oriented Model

In the mid-1980s, business models that placed a number of groups at the centre of decision-making, first began to achieve prominence. These models saw stakeholders as “any group or individual who is affected by or can affect the achievement of an organisation’s objectives”, meaning a broad range of interest groups including employees, creditors, customers, and extending to society and the environment - as well as shareholders.

The most well-known example of a stakeholder model is Germany, which has adopted a pluralistic governance structure called co-determination. Companies with more than 2,000 Germany-based employees allow workers to elect one-half of the members of the supervisory board, which in turn appoints the managing board, monitors its performance and approves major business decisions. Austria has a form of co-determination similar to that in Germany.

Other European countries have forms of employee representation, including Denmark, Luxembourg, Hungary, Slovenia and the Czech Republic, and require companies to allow workers to elect or nominate a portion of the board’s membership. France reserves board seats for labour representatives. The only EU states without formal worker representation are Belgium, Italy, Portugal, and the UK.

The stakeholder model is generally associated with improved working conditions and enhanced productivity. There is also tentative evidence to suggest that it is associated with improved environmental sustainability. In Germany, for example, many of the largest corporations disclose information about environmental and social matters, often using the Global Reporting Initiative’s reporting standards, and 29 German corporations have agreed to comply with a voluntary Sustainability Code created by the German Council for Sustainable Development. A study of publicly traded German companies (DAX-30) concluded that in nearly all cases environmental and social activities had been initiated by employees, typically through their representatives on supervisory boards. Furthermore, companies with board level employee representation tend to be more equal because employees have a say in deciding the salaries of the CEO, in addition to lower-ranking employees.

Europe considered adopting the stakeholder model at the regional level but eventually decided against it due to significant opposition.

Further reading on different corporate governance models:

Tricker, B. (2015). Corporate Governance: Principles, policies, and practices. Oxford: Oxford University Press.

Lynn Stout, L. (2012)The Shareholder Value Myth. Oakland: Berrett-Koehler Publishers. (2012)

The Future of Corporate Governance: which corporate governance model

A change of corporate governance models to one that balances the interests of investors, workers, consumers, communities, and the environment would allow businesses to thrive in a climate of sustainability. For this to happen, it is essential that we shift the policy discussion from a single-minded focus on shareholders to a broader understanding of their role in the firm.

The debate needs to be reframed **from** 'how do we make investors more responsible?'

to 'how do we integrate the needs of all stakeholders and the long-term needs of the company itself into core business decision-making?'

This section briefly sets out **four alternative models** of corporate governance and reviews the strengths and weaknesses associated with the adoption of any of these models.

3.1 Team Production Model

Rather than focusing on conflict between a company's management and shareholders, law professors Margaret Blair (Vanderbilt) and Lynn Stout (Cornell) argue for a 'team production analysis' of corporate structures. This analysis starts from the assumption that everyone associated with the company (employees, management, shareholders, creditors, local communities, etc.) has an interest in its success and should benefit from it.

> What if power weren't a zero-sum game? What if we could create organisational structures and practices that didn't need empowerment because, by design, everybody was powerful and no one powerless?
> **Frédéric Laloux, Reinventing Organisations**

Directors should therefore seek to "maximise the joint welfare of all the firm's stakeholders".

The conceptual appeal of the team production model is its emphasis on collaboration rather than the presumption that only one narrow set of interests should dominate. While some argue that it does not appear to be a viable alternative model at this time, it has received interest in Anglo-American jurisdictions and could provide the basis for a deeper discussion of a new corporate governance theory.

3.2 Trust Firms Model

Colin Mayer (Oxford) has proposed a new variation on an old form of company, the trust firm, that would grant voting rights on shares proportional to the remaining length of a holding period that the shareholder commits to at the time of share purchase. During the holding period, shares could not be transferred. Transferable shares would not have any voting rights.

Trust firms would have a Board of Trustees that is obligated to uphold the corporation's values. These values should be disclosed publicly to allow potential stakeholders to evaluate and decide whether to invest or otherwise engage with the company. Mayer argues trust firms would embed long-termism into their corporate structure and reduce the financial engineering that companies engage in to artificially inflate their share price or prevent a hostile takeover.

The idea behind this proposal is to reduce the incentives for excessive risk-taking by prioritising long-term shareholders, which should indirectly increase corporate responsibility. However, this proposal does not foresee any direct means to integrate environmental, social or labour issues into business decisions. Furthermore, trust firms are not immune to corporate scandals. For example, Germany foundation-controlled ThyssenKrupp was forced to pay more than 100 million euros in fines for price-fixing and was caught treating journalists to lavish press junkets. Perhaps Mayer's most convincing argument is for a plurality of corporate forms, which would include but not be limited to trust firms.

3.3 B Corp Model

The B Corp model attempts to imbed the ingredients of corporate responsibility within corporate structures and broaden directors' fiduciary duties to include the consideration of societal -- not just shareholder -- interests. This is done through a private certification process that assesses the company's impact on the communities where it operates, its relationship with employees, its impact on the environment, and the company's governance. In some jurisdictions, hybrid corporate forms have been created to allow businesses to anchor their social responsibility within a binding legal framework.

If you want to attract more pro-social investors, it's like hanging a sign around your neck: Nice people invest here.
Lynn Stout, professor of corporate and business law at Cornell Law School

The business' constitution must be amended to say that the legal obligation of the directors is to run the business for all the stakeholders, not simply to maximise financial returns for shareholders. Boards of directors are required to consider the impact of their decisions on specific corporate constituencies, including shareholders, employees, suppliers, the community, as well as on the local and global environment. Although shareholders are generally listed first, it is left to the board to decide what weight should be given to the interests of each affected group. As has been explained in this handbook, however, it is already open to the directors of any corporation to consider a range of interests.

Whilst until now B Corps have been predominantly small startups, the certifying body B Lab (a global non-profit organisation) is developing performance standards and a verification process for multinational and publicly traded companies. There are already several publicly traded companies with B Corp status, including e-commerce site Etsy and cosmetics maker Natura. They may soon be joined by consumer goods multinational Unilever.

B Corps and other hybrid organisations are often very innovative but may have trouble scaling their activities and face the possibility of 'mission drift', meaning a gradually increasing focus on profits at the expense of social good. B Corps have also been criticised for further entrenching the myth that traditional corporations are required to maximise shareholder value by suggesting that businesses should adopt a special status to reflect their dual profit-purpose mission. Although the B Corp movement should not be considered a coherent theory of corporate governance for existing publicly listed companies, it is an innovative business model that provides some answers to the question of how to govern a business responsibly.

3.4 Creating Shared Value (CSV) Model

The idea of "Creating Shared Value" (CSV) was launched by Michael Porter and Mark Kramer in the Harvard Business Review. According to Porter and Kramer, shared value is created when corporate policies and practices enhance the competitiveness of the business while simultaneously helping to solve social or environmental challenges.

They suggest that there are three ways to create shared value

1. by reconceiving products and markets
2. by redefining productivity in the value chain
3. by building supportive industry clusters at the company's locations

What CSV offers is a vision for business strategy that shifts the focus from profit maximisation to one that integrates the needs of all stakeholders. Thus, a pharmaceutical company might decide that rather than developing only expensive and inaccessible medical treatments and donating a small percentage of those

The purpose of the corporation must be redefined as creating shared value, not just profit per se. This will drive the next wave of innovation and productivity growth in the global economy.
Porter and Kramer, HBR

drugs as part of its CSR programme, it will instead focus on producing reasonably priced drugs that are sold at affordable prices.

However, CSV has been roundly criticised for failing to address the real trade-offs that are present when the 'business case' is insufficient to justify investments in workplace safety or basic human rights protections. Furthermore it fails to acknowledge the serious ethical dilemmas that business often face, such as how to address corruption or decide what it means to pay a fair share of taxes.

Further reading on hybrid business models:

Bauer, J. and Umlas, E. (2015). Making Corporations Responsible: The Parallel Tracks of the B Corp Movement and the Business and Human Rights Movement. SSRN Electronic Journal. Retrieved from http://ssrn.com/abstract=2650136 or http://dx.doi.org/10.2139/ssrn.2650136.

Liao, C., (2014). Disruptive Innovation and the Global Emergence of Hybrid Corporate Legal Structures. European Company Law 11(2).

IV Responsible corporate governance: opportunities for engagement

As a first step towards the implementation of a more responsible corporate governance model, two main strands of work should be tackled: reframing the debate and proposing policy reforms.

4.1 Reframing the debate

Why?

Reframing the debate about the corporation and its role in society, which involves a new vision of corporate governance, would have three major implications.

First, the move to a new paradigm of corporate governance could result in less need for external regulation of business conduct as business leaders would consider the effects of their operations on a number of groups and factor that into all strategic decisions.

Secondly, it would be easier to advocate for the regulation of negative externalities, such as pollution, if key stakeholders agreed that the purpose of the corporation was not limited to advancing the interests of its shareholders. This is an attainable objective because the long-term interests of society and the company both favour sustainability, innovation, and a strong social licence to operate. In other words, there is a 'business case' for corporate governance reforms that look beyond the narrow interests of shareholders. Conversely, it is much harder to argue the business case in the current debate on externality regulation because the shareholder-centric model of corporate governance tends to perceive any new regulation of business activity as detrimental to the interests of shareholders. Sustainable companies may be more competitive over the long-term, but it is nearly always more profitable to pursue unsustainable business activities in the short-term.

Third and finally, reframing the debate on responsible business could provide an opportunity for civil society to counterbalance and distance itself from the corporate social responsibility (CSR) discussion. That is, to move away from the fixation on voluntary corporate initiatives and market forces that currently characterises the CSR debate. It would also allow for the articulation of a positive vision for the role of corporations in society that rejects the existence of a conflict between the economic benefits for society and environmental and social concerns.

How?

Civil society could reframe the debate on corporate responsibility based on a new vision of corporate purpose and the role of corporations in society. One of the objectives of this handbook is to provide material for this debate.

This strategy could be put in practice by holding conversations and conferences with business leaders and policy makers, clearly distinguishing the new vision from the CSR concept. This would refocus the debate and build relationships with new allies.

The communication strategy could be further implemented by responding in the media (e.g. through opinion editorials and letters to the editor) to economic, environmental and social crises, explaining how they are connected to the dysfunctional behaviour of business and capital markets.

Sustainability and corporate responsibility should be integrated into new standards in corporate governance, such as the UK Stewardship Code and the OECD Principles for Corporate Governance, to ensure policy coherence. Civil society organisations (CSOs) may argue that CSR as well as business and human rights policies should be directly integrated into corporate governance frameworks.

Further reading on frames and how they can be integrated into civil society strategy:

Lakoff, G. (2014). Don't Think of an Elephant!: Know Your Values and Frame the Debate. Chelsea: Chelsea Green Publishing.

Matthews, A. and Matthews, L. (27 February 2015). Five Ways that People Frame Climate Change Debates. Retrieved from http://www.theguardian.com/sustainable-business/2015/feb/23/five-ways-that-people-frame-climate-change-debates

Public Interest Research Centre (PIRC) (2011). Common Cause Handbook. London: PIRC. Retrieved from http://valuesandframes.org/

4.2 Proposing policy reforms

When engaging in corporate governance policy-making processes, such as reforming the UK Stewardship code, civil society could promote the integration of corporate responsibility objectives, and also concrete measures to counterbalance the short-term influence of capital markets, embedding incentives for long-term strategy by companies and investors alike, tying shareholders' influence in corporate governance to long-term commitment, and limiting harmful practices such as financial engineering by stock buy-backs. This discussion would further contribute to reframing the debate on the role of corporations in society.

CSOs could advocate for the integration of corporate governance elements into policy plans and standard-setting instruments in the sustainability and business and human rights areas, for example in the National Action Plans on Business and Human Rights. Similarly the importance of reforming corporate governance can be voiced at major conferences and stakeholder meetings.

Ultimately, CSOs could argue that the definition of corporate purpose in company law as well as associated directors' duties should be changed to reflect broader societal purpose and environmental responsibility.

This broadly formulated objective needs to be stated in precise terms and have concrete monitoring and enforcement mechanisms that are available to civil society and affected groups.

Further reading on advocacy for systemic change:

Michael Narberhaus, M. and Sheppard, A. (2015). Reimagining Activism: A Practical Guide for the Great Transition. Berlin: Smart CSOs Lab / Michael Narberhaus. Retrieved from <http://smart-csos.org/images/Documents/reimagining_activism_guide.pdf>

Broadbent, A. and Omidvar, R.(2011). 'Impacting Public Policy' in Five Good Ideas: Practical Strategies for Non-Profit Success. Toronto: Coach House Books.

V Which corporate governance rules for a responsible corporate governance model?

This section presents for discussion a number of concrete mechanisms for fostering long-termism and sustainability within publicly traded companies that may be implemented within existing corporate governance frameworks. They should not be taken as the recommendations of the authors but rather **promising avenues to explore** and further refine.

5.1 Specify corporate purpose

Company law could specify more clearly the societal purpose of companies generally.

A clear statement of purpose would

- Clarify what audiences and matters company directors consider material for the company[47]
- Introduce legal clarity
- Create a level playing field for companies that wish to contribute to a sustainable and innovative economy.

EU company law could require all Member States to allow companies to specify long-term purposes in their constitutional documents. These statements of purpose might cover environmental, social or scientific goals. In addition, company law could require that companies be able to lock-in those purposes against opportunistic change by short-term shareholders (perhaps by requiring a supermajority to amend the purpose clause) (Segrestin and Hatchuel 2012).

The inclusion of long-term (social, environmental or scientific) purposes, either within the corporate constitution or in national companies legislation (as appropriate), would facilitate informed shareholder engagement. It would also prevent the reduction of corporate purpose to the shareholder interest in short-term financial returns.

Finally, it would allow enterprises to pursue long-term strategies (especially those involving R&D which entail a high degree of uncertainty), and so contribute to long-term economic, social and environmental sustainability. For this to be possible, it will require numerous changes to the legal and regulatory framework, as well as improvements to business practice and culture. More specifically, the statement of purpose could be supported by a new director/board duty to develop long-term plans specifying how this purpose will be met. Plans could also include reference to planetary boundaries, international law and other external standard

5.2 Clarify fiduciary duties

Regulators or courts could clarify or expand the principle of fiduciary duty, or comparable duties. For example, it might create an explicit duty for directors to pursue sustainable value.

This has two important aspects

- the duty of directors/trustees to act in the best interests of the company
- the duty of investors to invest in beneficiaries' best interests

Each of these duties is often misinterpreted. In the case of directors, the duty is often misunderstood to be owed to the shareholders, not to the company. Similarly, the duty of investors is often misstated as being to maximise short-term returns and used to justify ignoring environmental or social risk factors, such as climate change.

5.3 Require companies to take into account the long-term interests of all stakeholders

Company law could encourage or require companies to take into account the long-term interests of all stakeholders, including workers, creditors, communities and shareholders, as well as broader social costs and harm to the environment arising out of their operations. This might be facilitated through provisions which allow these different stakeholder and affected groups to express their views to corporate management and shareholders.

Employees make illiquid, non-diversifiable investments in the companies for which they work, and so have a longer-term perspective than many shareholders. If policy-makers were to allow them to express that perspective in corporate governance processes, the problem of short-termism would be significantly reduced.

There need not be a binary choice between leaving corporate governance in the hands of boards alone or empowering shareholders. They may be counterbalanced by meaningful legal requirements of stakeholder participation in various aspects of corporate governance.

Together, the articulation of long-term purposes and the introduction of a plurality of voices into corporate governance would allow a better alignment of corporate decision-making with the common good, and operate as a brake on the current systemic tendency towards short- termism.

5.4. Measures to promote long-term shareholding

In theory, institutional investors with long-term liabilities should purchase and hold shares for the long-term, free from short-term pressures. In practice, many do not do this.

A number of techniques have been proposed and experimented with to discourage speculative trading and instead foster patient capital. These include time-weighted dividends that do not pay out full until the shareholder has held the shares for a pre-determined length of time, e.g. two years. Both Italy and France have introduced laws relating to increased voting rights for shares held longer than two years.

Alternatively, changes to accounting regulation and prudential norms might be used to encourage institutional investors to hold shares for periods that match their liabilities.

Outside of corporate governance, the imposition of financial transaction taxes have been hotly debated as a means to reduce short-term trading by imposing a small charge on each trade. In fact at least 40 jurisdictions currently use them, including England and Hong Kong. North American and European regulators have discussed the use of such a tax. The EU tax is expected to come into effect in 2017. Research about the effectiveness of financial transaction taxes in reducing market volatility is still inconclusive.

5.5. Dual-class share structures

A dual-class share structure allows public companies to designate one class of shares as having voting rights while the second class of common shares typically has no or limited voting rights. This allows companies to retain control over business strategy and vision, and resist takeover bids by allotting these shares to the founders, employees or other limited groups of stakeholders.

Dual-class share structures are common in the US with technology companies such as Google and Facebook, as well as in Scandinavia. For example, the Danish pharmaceutical company Novo Nordisk publicly trades common shares without voting rights while a foundation retains control over the voting shares. On the contrary, in the UK dual-class shares are considered problematic because they violate the ‘one share, one vote’ principle. They have been banned by the Singapore and Hong Kong stock exchanges.

5.6. Review executive pay rules

Other ways of governing executive pay in pursuit of long-termism are conceivable. Restrictions might be imposed on variable pay (including stock options), by, for example, following the EU Capital Requirements Directive and capping bonuses relative to fixed pay in all listed companies. This would continue to provide incentives to executives, but would reduce their short-sighted focus on share price.

Additionally, pay policies could measure performance against both financial and non- financial criteria to capture a range of issues often ignored by stock price, including innovation; and environmental, social and governance matters. This could be done by referencing existing standards such as the Integrated Reporting Framework or the Global Reporting Initiative (GRI) Guidelines.

Related Initiatives

The Modern Corporation Project

The Modern Corporation Project is an academic project led by Dr. Jeroen Veldman and Prof. Hugh Willmott, both at Cass Business School, City University, London, which studies how political economy conditions corporate governance theory and practice. The Project has invited leading academics to prepare memos on the framing and effects of maximizing shareholder value from their respective fields.

https://themoderncorporation.wordpress.com

Aspen Institute Business and Society Program

The BSP program is conducting a series of off-the-record and public dialogues among scholars, business leaders, and investors to broaden thinking about the corporate objective function beyond shareholder wealth maximization.

http://www.aspeninstitute.org/policy-work/business-society

B Corporation

An international community of certified companies that aim to create public benefit as part of their business mission.

https://www.bcorporation.net

Blueprint for Better Business

An initiative launched by the Church in the UK, rallying business leaders to explore the business need for change and how a rediscovery of corporate purpose and a focus on personal values might best be brought together in the service of society.

http://www.blueprintforbusiness.org

Drucker Institute

Carrying on the legacy of management expert Peter Drucker, Drucker Institute is on a mission of strengthening organizations to strengthen society.

http://www.druckerinstitute.com

Sustainable Market Actors for Responsible Trade (SMART)

Sustainable Market Actors is a global research network involving scholars from universities all over the world, wishing to contribute to research that will promote global, sustainable development within a circular, low-emission economy compatible with the planetary boundaries and in line with the international development goals.

http://www.jus.uio.no/english/research/areas/companies/Networks/sustainable-market-actors

Responsible corporate governance is a cornerstone of sustainable companies. Together, the articulation of long-term purposes and the introduction of a plurality of voices into corporate governance would allow a better alignment of corporate decision-making with the common good, and operate as a brake on the current systemic tendency towards short- termism.

Responsible corporate governance offers the possibility of forging a vision for business that sees corporations providing benefits to the communities in which they are situated and creative solutions to the complex challenges we face that cannot be addressed by governments or civil society alone, such as climate change.