

The Purpose of the Corporation Project

Concept Note

“The capitalist system is under siege. In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems ... a narrow conception of capitalism has prevented business from harnessing its full potential to meet society’s broader challenges ... 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

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.

Corporate purpose and the question of trust

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.

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 global business. In essence, this is often interpreted to mean pursuing only shareholder wealth as reflected in current stock price.

For example the 2012 Kay review of the United Kingdom equity markets heard evidence from company directors who erroneously equated their duty to promote the success of the company with maximising current share price.¹ This problem was exacerbated by the fact that the majority of shareholders were passive and often focused on short-term profits, as noted by the European Commission in its 2011 review of corporate governance.²

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.

But 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 Lynn Stout has shown that not only is the business world

misunderstanding and misapplying the law that underpins shareholder primacy, but that, as a concept, it “stands on the brink of intellectual failure”.³ 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”.⁴

The reason why this notion is so problematic is concisely set out in the work of another Law Professor, Joel Bakan who 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”.⁵

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 ... 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)”.⁶

Publicly listed companies are under tremendous pressure from activist shareholders, takeover threats, and general market dynamics to generate short-term value by spinning off parts of the company, buying back shares, and laying off staff.

External pressure is compounded by executive compensation schemes that are heavily weighted towards stock options. In theory, incentive compensation systems should reduce agency costs so that managers will act in the interests of shareholders.

In practice, they create perverse incentives to extract value from the company at the expense of customers, employees, organizational health, the community in which the business operates, and ultimately society as a whole. **A number of unintended consequences result, including:**



Firm mismanagement through stock manipulation, insider trading and tax evasion, with a number of associated firm-level and macroeconomic risks including treating employees as disposable; undermining investment, research and development; hollowing out whole organisations; turning executives into caricatures of self-interest and greed powered by narrowly focused remuneration schemes; focusing talent in the corporate world on systematically extracting value rather than creating it; stock price manipulation; and fueling market failure and economic crash.



Erosion of trust between society and the corporate sector, including the role of corporations in shaping public policy, which in turn leads to a loss of trust in democratic processes



The failure of companies to adequately consider and respond to societal challenges, such as environmental damage and climate change, due to the perceived cost



Inequality has greatly increased in the last twenty years, in part due to the failure to translate corporate profits into increased salaries across the firm. Even as worker productivity has continued to rise, real worker wages have essentially flat-lined. At the same time, executive compensation has markedly increased due to the aforementioned stock option schemes.

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 and by the European Commission’s 2011 communication on corporate social responsibility (CSR)⁷. An initiative to improve workplace safety, for example, will only be justified if it can be shown that this will result in litigation costs falling by more than the cost of the safety improvements.

This would mean 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, is an adequate measure 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 these risks.

This use of corporate groups also facilitates aggressive transfer pricing arrangements that can see large brand name firms paying little or no tax in countries where they have significant operations.⁸

Revisiting corporate purpose

What is needed is to revisit 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”.⁹ 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.¹⁰ 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.¹¹

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.¹²

There is now ample evidence that the shareholder value paradigm is flawed economically, legally and socially.

The paradigm shift

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 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.

This new paradigm must be translated into the existing framework of incentives and regulations for corporate governance and accountability. It needs to be reflected in market mechanisms, in particular in the way that financial markets interact and influence companies.

The role of shareholders in corporate governance will have to be rethought in order to protect their role in ensuring management accountability, whilst freeing companies from the imperative to maximise the stock price as at all costs.

In order to achieve transparency and accountability, companies will need to provide an accurate accounting of their environmental and social impacts. Boards of directors will also need to revise their decision-making process to consider the effect of the company on the environment and society, systemic risks, and ability of the company to achieve success in the long-term. Well-run companies should develop long-term plans charting their way towards environmental and economic sustainability.

It will be necessary to devise holistic measures for measuring corporate success in the long-term, reflecting their ability to create value in a responsible manner. These metrics should be reflected in incentives for corporate executives as well as for institutional investors.

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. He 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”.¹³

Framing the discussion

The Purpose of the Corporation Project has launched a global roundtable series on corporate governance bringing together experts from business, academia, regulators and civil society to discuss the future of big business. The first event was held in September 2014 at Cass Business School in London and it has been followed by discussions at New York University Stern School of Business and subsequent events in Zurich, the Netherlands, and Brussels. Frank Bold has also partnered with other organisations such as CORE, Future Agenda and ACCA to deliver workshops and debates on corporate governance.

A key challenge, in this process of consideration, is to avoid 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 needs 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 include:

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 is an apolitical and collaborative platform for the relevant actors to explore these important issues.

The first step has been to engage with the academic community 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.

To address this problem, the Modern Corporation Project run by Prof. Hugh Willmott and Dr. Jeroen Veldman at Cass Business School,

City University invited leading international academics from the fields of Company Law, Economics, Accounting, Management and Politics to prepare succinct and authoritative statements on different aspects of corporate governance which are now available on-line.¹⁴

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 investigation¹⁵ into this area in the United States has raised real concerns in that regard. It suggests that some students are being taught an inaccurate 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"

This is consistent, of course, with Professor Bakan's observations that the current paradigm makes managers do things that they otherwise would not do.

The Purpose of the Corporation Project reaches out to business and policy makers 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.

Who is behind the project

The Purpose of the Corporation is an initiative of Frank Bold, a purpose-driven law firm using the power of business and non-profit approaches to solve social and environmental problems.

With six branches in three EU countries, Frank Bold provides legal expertise in corporate accountability to the European institutions as well as to NGO's in many countries. Frank Bold has been working on corporate responsibility 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. 

Visit our website:

www.purposeofcorporation.org

Connect with us on twitter:

[@purposeofcorp](https://twitter.com/purposeofcorp)

For further information please contact:

paige.morrow@frankbold.org
filip.gregor@frankbold.org

References

- 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** Green Paper: The EU corporate governance framework Brussels, 5.4.2011 COM(2011) 164 final, at p.3. Available at: http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf
- 3** Stout, L. (2012). *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations And The Public*. San Francisco. Berrett-Koehler Publishers. P.115.
- 4** Quoted in Stout, L. (2012) p.5.
- 5** Bakan, J. (2005). p. 50.
- 6** Bakan, J. (2005). *The Corporation*. London: Constable & Robinson. p. 35.
- 7** COM (2011) 681.
- 8** See for example Robe, J.F. (2011). *The Legal Structure of the Firm. Accounting, Economics, and Law*. Vol.1: Iss. 1 p. 50-52.
- 9** Stout, L. (2012). p. 11.
- 10** Martin, R. (Jan-Feb 2010). *The Age of Customer Capitalism*. Harvard Business Review. p. 58-65.
- 11** 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.
- 12** See <http://consciouscapitalism.org/purpose>
- 13** Tricker, R. (2012). *Corporate Governance: Principles, Policies, and Practices*. Oxford University Press: Oxford. p.7.
- 14** See <http://themoderncorporation.org>
- 15** 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

