Rethinking the Purpose of the Corporation

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In 1976 two economists at the University of Rochester, Michael Jensen and William Meckling introduced the concept of "agency costs"—the costs incurred by shareholders of public corporations to get corporate management to act on their behalf.[1] In the Jensen-Meckling view, shareholders were the "principals" in an economic relationship with professional corporate managers who were the "agents." Principals delegated decision-making authority over a corporation to agents act in their interests. Inevitably, the financial interests of principals and agents differed at least slightly, hence the various possible agency costs borne by shareholders including salaries, incentive compensation, inefficiency, suboptimal decision-making, and corporate empire-building.

In legal and finance theory, agency costs came to be understood as a bundle of cash costs and opportunity costs involved in trying to align the incentives of different corporate actors. This characterization of the mission of corporate law has led to a 40 plus year search for an organizational Holy Grail—how to align the interests of shareholders and managers (and of controlling and minority shareholders) through a series of techniques, including regulatory standards, independent directors, take-overs and activist shareholders.

The advent of the "Efficient Market Hypothesis" (EMH) during the same era reinforced the focus on market pricing as the arbiter of corporate performance and of maximizing shareholder wealth as the purpose of the corporation.[2] Increases and decreases in a company's share price were considered, respectively, objective affirmations or repudiations of firm decisions. If share prices reflected all public information about a company's operations and future plans, then good corporate governance was simply that which gave corporate management strong incentives to increase shareholder wealth at reasonable shareholder cost.

Or, so went the "conventional wisdom" at the time.

We have learned, painfully, over the last four decades, that proper corporate governance requires more than just faith in efficient equity markets and strong managerial incentives. Much more thinking is needed than simply deciding to award large numbers of stock options to senior managers. Despite apparently powerful economic incentives to "do the right thing," numerous bankruptcies and accounting scandals followed both the high-tech boom of the late 1990s and the real estate-related financial boom of the 2000s. Aggregate shareholder and taxpayer losses were tremendous, banks and accounting firms went out of business, and a few CEOs and other senior executives went to prison.[3]

This led to a reassessment of the previous corporate governance orthodoxy. By the turn of the century, Michael Jensen had become an advocate for what he referred to as "Enlightened Stakeholder Theory"—a focus on maximizing total long-term market value, although he still argued that, "Enlightened stakeholder theory specifies long-term value maximization or value seeking as the firm's objective and therefore solves the problems that arise from the multiple objectives that accompany traditional stakeholder theory."[4]

That single firm objective concept has become challenging in a world in which change—technological and otherwise—is quicker and more pervasive than ever before. Consider, for example, that only 53 companies have remained on the Fortune 500 list over the last 65 years. Only two of those (Exxon and Johnson & Johnson) have stayed in the top 10.

In the meanwhile, corporate law—the language of our statutes—has been overwhelmed by the advent of "corporate governance"—various governance codes have effectively become global legal norms. This in turn, spawned an active governance industry and a variety of new analytical models for corporate law.

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1. Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, October 1976, V. 3, No. 4, pages 305-360.

2. The efficient market hypothesis was developed in a series of papers in the 1970s by University of Chicago Professor (and future Nobel laureate) Eugene Fama and others. Fama and his co-authors argued that stocks always trade at their "fair value," reflecting all publicly available information at the time, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.

3. For a revisionist view on the desirability of strong incentives, particularly in the banking field, see John McCormack and Judy Weiker, "Rethinking 'Strength of Incentives' for Executives of Financial Institutions," *Journal of Applied Corporate Finance*, Vol. 22, Issue 3, pp. 65-72, Summer 2010. Available at SSRN: https://ssrn.com/abstract=1684897 or http://dx.doi.org/10.1111/j.1745-6622.2010.00291.x

4. Michael Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function (October 2001)" *Unfolding Stakeholder Thinking*, eds. J. Andriof, et al, (Greenleaf Publishing, 2002). Also published in *JACF*, V. 14, N. 3, 2001, *European Financial Management Review*, N. 7, 2001 and in *Breaking the Code of Change*, M. Beer and N. Norhia, eds, HBS Press, 2000. Available at SSRN: https://ssrn.com/abstract=220671 or http://dx.doi.org/10.2139/ssrn.220671

Despite the inevitable desire for standardization and theoretical elegance, there is no one "right" governance model. Governance is highly contextual, depending on what a particular company does, its ownership structure and the markets and political frameworks in which it operates. Corporate governance is messy and complicated because that is life. The move from corporate law to corporate governance reflects a move from a simple legal view of the corporation to one that has become increasingly complex and dynamic, constantly responding to societal expectations.

Ron Gilson and Reiner Kraakman, two leading US legal scholars, have characterized the tension between the simple and complex views as similar to the virtual debate "across the years" between the late 18th century English parliamentarian and philosopher Edmund Burke and the 20th century Austrian-American economist Joseph Schumpeter.[5] Burke was a philosophical conservative whose default position was to distrust most proposed change. What change he approved of was of the evolutionary, rather than revolutionary, sort. Schumpeter, by contrast, is best known for having developed the concept of "creative destruction" in business and industry.

Burke cast the tension as what we would today call the "long-term versus short term" debate. He was dismissive of the leaders of the French revolution as short-term in orientation. In contrast, he had great respect for the French aristocracy who were threatened:

Of my best observation, compared with my best inquiries, I found [the French] nobility for the greater part composed of men of high spirit, and of a delicate sense of honour, both with regard to themselves individually, and with regard to their whole corps, over whom they kept, beyond what is common in other countries, a censorial eye.[6]

Schumpeter's response to the Burkean fear of chaos is well known:

The opening up of new markets and the organizational development from the craft shop to such concerns as US Steel illustrate the same process of industrial mutation—…that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact about capitalism.[7]

This frames the two issues I propose to consider.

First, the irony that corporate law and regulation have tended to frustrate dynamic adaption and have led to governance systems that underperform. A related problem is the tendency to oversimplify governance issues. I will consider the gap between rhetoric, reality and relevance that tends to predominate in thinking about corporate governance.

The second is to consider whether there might be more constructive ways to think about corporate purpose and governance. Drawing on scholarship in another field, but also that of two corporate law scholars (the late Lynn Stout and Tamara Belifanti), I'll suggest that systems theory may be instructive.[8]

Focussing on Issues that Matter

One of the most striking features of corporate governance politics is that there are new controversies and consequential regulatory proposals every year. We have spawned a governance reform industry that has become incredibly adept at feeding itself. A related oddity is the fact that many of the regulatory initiatives are "symbolic"—they certainly cannot be explained by their relevance to improving corporate governance or performance.

To take a current example, think of "say on pay." We now have 7 years of data concerning the legal ability of shareholders to cast an advisory vote on executive compensation. Shareholders have typically approved compensation with votes in favor exceeding 90%. It is striking that shareholder support for executive pay appears to be highly correlated with a company's short term stock performance. To the extent that say on pay votes have heightened incentives to focus on short term stock price at the potential expense of creating sustainable value, this regulatory initiative is surely misguided.

There are many examples of issues that clearly matter, but that no one seems to want to address in a meaningful manner. For example, the Canadian Securities Administrators are still unable to agree on even a "comply or explain" climate risk disclosure regime, after over a decade of studying the issues.

In theory, securities law should already address this disclosure concern—the legal concept of materiality should define the line where sustainability issues become public disclosure obligations. Yet not only are companies avoiding effective metrics for disclosure, but regulators are accomplices to their inaction. The suggestion that issues are contingent or speculative doesn't make them immaterial. Likewise, the absence of evidence is not evidence of absence. We know it is feasible to assess the materiality of a company's exposure to climate-related financial impacts. In fact, a majority of industry-leading companies are already doing so—most often using metrics which lack comparability across industry peers or, worse, boilerplate language which is of little use to investors.

5. Ronald Gilson and Reiner Kraakman, "Takeovers in the Target Boardroom: Burke vs. Schumpeter," 50 *Business Law* 1419 (2005).

6. Edmund Burke, *Reflections on the Revolution in France*, 115 (Frank M. Turner ed 2003) (original published in 1990).

7. Joseph Schumpeter, *Capitalism, Socialism and Democracy* 82-83 (1942).

8. See Tamara Belinfanti and Lynn A. Stout, "Contested Visions: The Value of Systems Theory for Corporate Law," *University of Pennsylvania Law Review*, Forthcoming; Cornell Legal Studies Research Paper No. 17-17. (March 29, 2017). Available at SSRN: https://ssrn.com/abstract=2942961

It is unlikely that the explanation for this lies in false perceptions—we are talking about some of the most sophisticated and influential actors in our society. A more likely explanation is that governance is often viewed as a moral crusade—tapping into broader public sentiment without regard for materiality or the challenge of effecting fundamental change. The exercise becomes largely symbolic and, ironically, as a result it is often conservative. While governance reforms maintain the appearance of solving problems, they often have opposite or at best, very limited effects. One systemic danger is that such reforms deflect attention from, and dull the desire for, deeper introspection.

This account of the gap between rhetoric and reality suggests taking governance reform with a grain of salt. Understanding the exaggerated rhetoric of corporate governance should generate a healthy skepticism about who are the "good guys" and the "bad guys." These issues involve many more shades of grey than clear black and white distinctions. In this respect, the politics of corporate governance reform shares much in common with politics generally.

The Relevance of Systems Theory

This leads to my second theme—whether there might be a more nuanced and constructive way to think about corporate purpose. Let us start with some basic principles of systems theory. The first is that systems are more than the sum of their parts. Another is that systems are fractal—that is they are comprised of subsystems which in turn are comprised of other subsystems on so on.[9] A third principle flows from the first two—that the overall health of the system depends on the continued health of each of its essential subsystems, as well as of the larger systems in which it is embedded. Think about how each of these principles applies to your organizations.

The next step is to describe the essential focus of systems theory—addressing questions of sustainability and relevance. This suggests mechanisms such as redundancy (i.e., devoting more resources to some purpose than is necessary under current conditions), homeostasis (i.e., information and feedback loops that allow a system to adjust to disturbances in its environment and stay within the parameters necessary for its continued functioning), self-organization (i.e., the ability of a system to learn, diversify and evolve in response to shifts in its environment that might otherwise threaten its survival) and resilience. Each of these mechanisms are common features of well governed organizations.

Consider a topical example. While acknowledging that a company could have too much debt, the general conclusion reached by financial economists and shareholder value advocates was that more leverage was probably desirable. First, because interest costs (as opposed to dividends on shares) are tax-deductible in many tax jurisdictions. Second, and perhaps even more importantly, debt was believed to impose discipline on otherwise lax and self-serving corporate managers.

Systems thinking and highly levered capital structures often don't go well together. I find it interesting that economic arguments implying that much less leverage would be optimal for many companies, even for many old and well-established industrial companies, are now coming from the same quarters that most strongly reinforced the "debt is cheaper than equity" and "debt is good for discipline" presumption[10] not too many years ago.

Finally, in systems multiple purposes are the rule, not the exception. What we observe about a system's apparent purpose will depend on our level of analysis. Indeed, the purpose and functions of a system are often the least obvious parts of the system, especially to outside observers who pay attention to only a few events or stated goals. What systems-thinking has to say about corporate purpose is that the overall goal of a corporate system should not be subordinated to the goals of any one of its subsystems such as the share-ownership subsystem. As the Canadian Supreme Court has observed in the BCE decision, a critical role of governance is to mediate these tensions.[11]

Consider, for example, the potential risks of extremes of income inequality from a corporate "systems" perspective. There is pretty compelling evidence that these include risks to economic growth and financial stability, risks of political polarization and the erosion of social cohesion and risks of destabilizing nationalism and populism at both ends of the political spectrum. The likelihood that we are, at least temporarily, losing our political "center" in current political elections is but one of many warning signals. These risks clearly impact long term corporate and investment performance.

Conclusion

Where does this thinking lead? First, systems theory counsels against focusing on any single metric (and in favor of the need for new ones—the relevance of metrics inevitably run down over time). To take the obvious example, short term profitability is not so much an objective as a constraint a firm may have to meet in order to remain in business. Metrics such as profits, employee turnover, and customer satisfaction are not ends in themselves. Rather, they are a source of information about whether the corporation is relevant, resilient and sustainable.

9. For a general overview of fractals as they apply to business and markets, see Benoit Mandelbrot and Richard L. Hudson, *The Misbehavior of Markets: A Fractal View of Financial Turbulence*, annotated edition, Basic Books, 2004.

10. See Stephen V. Arbogast and Praveen Kumar, "Financial Flexibility and Opportunity Capture: Bridging the Gap Between Finance and Strategy," *Journal of Applied Corporate Finance*, Winter 2018, Volume 30, Issue 1.

11. In *BCE Inc. v. 1976 Debentureholders* [2008] 3 SCR 560 the Supreme Court of Canada held that the directors' fiduciary duty is owed to the corporation viewed as a good corporate citizen rather than to any particular constituency.

A second lesson from systems theory is that, given multiple purposes and the complexity inherent in systems analysis, it will be difficult for academics, lawmakers or the corporate governance industry to identify "one size fits all" reforms that can reliably improve the performance of all companies. Attempts to impose such "silver-bullet" solutions are more likely to result in what an academic colleague, Roberta Romano, has described as "quack corporate governance" that often does more harm than good.[12]

The systems challenge is to bring about a paradigm shift that restores connectivity between investors, employees, management, other corporate stakeholders and governments. This will require thinking differently about how the constituent elements interact and produce results. Many of us have participated in such paradigm shifting before—think of the last three decades of the 20th century when an underlying shift took place focused on maximizing short-term returns to shareholders. It's time to flip that switch.

Change is hard. People dislike it, especially when it may affect them adversely. Enlightened self-interest obliges us to avoid the "governance trap" and to focus on meaningful change—restoring the connectivity within systems.

In 1921, the poet T.S. Eliot described what was then already a worrisome social phenomenon but which is now an even more severe challenge:

> *The vast accumulations of knowledge—or at least of information—deposited by the nineteenth century have been responsible for an equally vast ignorance. When there is so much to be known, when there are so many fields of knowledge in which the same words are used with different meanings, when everyone knows a little about a great many things, it becomes increasingly difficult for anyone to know whether he knows what he is talking about or not. And when we do not know, or when we do not know enough, we tend always to substitute emotions for thoughts.*[13]

I hope that practical business leaders will take a longer view, being rigorous in analysis while assuming positive intent, encouraging adaptive responses rather than calling for more rigid and formal compliance requirements.

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12. See Roberta Romano, "Quack Corporate Governance," *Regulation,* Vol. 28, No. 4, pp. 36-44, Winter 2005. Available at SSRN: https://ssrn.com/abstract=875370

13. See T.S. Eliot, "The Perfect Critic," *The Sacred Wood*, Alfred A. Knopf, New York, 1921. https://archive.org/details/sacredwoodessays00elio; http://www.bartleby.com/200/sw2.html