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The impact of financialisation on international corporate governance: the role of agency theory and maximising shareholder value

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The phenomena of financialisation has had a universal and pervasive impact upon economies and societies in recent decades. Global finance is now typified by a more international, integrated and intensive mode of accumulation; a new business imperative of the maximization of shareholder value; and a remarkable capacity to become an intermediary in every aspect of daily life. The finance sector has progressively increased its share of GDP, and even for non-financial corporations the pursuit of interest, dividends and capital gains outweigh any interest in productive investment. As non-financial corporations have become increasingly drawn into a financial paradigm they have less capital available for productive activity. These financial pressures are translated into the operations of corporations through the enveloping regime of maximising shareholder value as the primary objective. Agency theory has provided the rationale for this project, prioritising shareholders above all other participants in the corporation. This article seeks to discover the origins of the financialisation of corporations in the early development of agency theory and shareholder value in Anglo-American corporations. The enduring myths of shareholder primacy are examined. The article concludes with a consideration of how the reform of corporate law might serve to strengthen the recognition and pursuit of the wider purposes of corporations and longer-term investment horizons.

A. Introduction: the universal and pervasive impact of financialisation

The development of finance is often considered synonymous with the advance of economic activity, and by imputation the growth of wealth – as Niall Ferguson suggests "money is the root of most progress".[1] Ideally, finance exists to serve the productive economy; however, it is hard not to acknowledge that each stage in the origin and development of new financial institutions and systems was punctuated with some form of self-interested excess. At the origins of capitalism Frentrop graphically records how greed, speculation, deceit and frequent bankruptcy punctuated the fortunes of the earliest of the great trading companies beginning with the Dutch East India Company.[2] Goetzmann *et al* in *The Great Mirror of Folly* consider how the first global stock market bubble burst, destroying the fortunes of investors in London, Paris and Amsterdam.[3]

Financial innovations and financial cycles have periodically impacted substantially on economies and societies ever since, most notably in the recent global financial crisis.[4] However, the new global era of financialisation is qualitatively different from earlier regimes. Global finance is now typified by a more international, integrated and intensive mode of accumulation, a new business imperative of the maximisation of shareholder value, and a remarkable capacity to become an intermediary in every aspect of daily life. Hence finance as a phenomenon today is more universal, aggressive and pervasive than ever before.[5]

The costs and benefits of the rapid financialisation of advanced industrial economies have been debated for some time.[6] Competing definitions of "financialization" highlight different dimensions of the problem:

- the growing dominance of capital market financial systems over bank-based financial
- systems;
- significant increases in financial transactions, real interest rates, the profitability of financial firms and the share of national income accruing to the holders of financial assets;[7]
- the explosion of financial trading with a myriad of new financial instruments;
- the "pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production";[8]
- the ascendancy of "shareholder value" as a mode of corporate governance;[9]
- the increasing role of financial motives, financial markets, financial actors and
- financial institutions in the operation of the domestic and international economies.[10]

These dimensions are extremely wide ranging, causing Dawe to comment "Financialization is a bit like 'globalization', a convenient word for a bundle of more or less discrete structural changes in the economies of the industrialized world."[11] Multiple changes in the structural transformation of finance are occurring at three levels: financial markets and institutions increasingly displacing other sectors of the economy as the source of profitable activity; the insistent financialisation of non-financial corporations through a regime of maximising shareholder value and the emphasis on financial metrics; and the penetration of finance into every aspect of life as people are increasingly incorporated into financial activity.[12]

The international expansion of financial markets and institutions amounts for Krippner to a new "pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production".[13] The finance sector has progressively increased its share of GDP, and even for non-financial corporations the pursuit of interest, dividends and capital gains outweigh any interest in productive investment. As non-financial corporations have become increasingly drawn into a financial paradigm, they have less capital available for productive activity despite increasing profits from financial activity.[14] A combination of the accumulation of debt and the volatility of asset prices has increased systemic risk, leading to the increasing intensity of boom–bust cycles.[15]

These financial pressures are translated into the operations of corporations through the enveloping regime of maximising shareholder value as the primary objective. Agency theory has provided the rationale for this project, prioritising shareholders above all other participants in the corporation, and focusing corporate managers on the release of shareholder value incentivised by their own stock options. In turn this leads to an obsessive emphasis on financial performance measures, with increasingly short-term business horizons. However, as financial gains are realised they are not reinvested in advancing the corporation's productive activity, but distributed to shareholders in dividend payments and share buy-backs.[16] While enriching executives and shareholders, corporations' innovative and productive future is threatened by the increasing impact of financialisation.

Finally the overwhelming embrace of finance is experienced in the increasing dependence of people on financial services and transactions in everyday life. The increasingly universal significance of defined contribution superannuation schemes, property mortgages, credit cards and mass-marketed financial services has created a world in which the apparent "democratisation of finance" has led to a convergence of finance and lifestyles.[17] However, in contrast to the public welfare and savings regimes of the past which were intended to mitigate lifecycle risks, the contemporary immersion in a profoundly financialised personal world acutely exposes individuals to the recurrent risks of the financial markets.

This accumulation of an unrelenting international expansion of financial markets, the insistent financialisation of corporate objectives and values, and the subordination of whole populations to financial services exploded in the 2008 global financial crisis.[18]

This article seeks to discover the origins of the financialisation of corporations in the early development of agency theory and shareholder value in Anglo-American corporations. The enduring myths of shareholder primacy are examined. The article concludes with a consideration of how the reform of corporate law might serve to strengthen the recognition and pursuit of the wider purposes of corporations and longer-term investment horizons.

B. The financialisation of Anglo-American corporations

The origins of shareholder value and agency theory lie within the deeper development of the financialisation of the Anglo-American corporation in the later decades of the twentieth century. The modern corporation that had emerged in the early part of last century was typified by Berle and Means as manifesting a separation of ownership and control, where professional managers were in a position to determine the direction of the enterprise and shareholders had "surrendered a set of definite rights for a set of indefinite expectations".[19] After the New Deal and the end of the Second World War many US corporations in the 1950s and 1960s increased massively in scale and market domination, achieving pre-eminent positions in world markets.

A new managerial and corporate mode of co-ordination of enterprise based on organisation and planning had arrived as analysed by Coase[20] and later Chandler,[21] transcending the market. This was an era celebrated in Galbraith's *New Industrial State*[22] in which corporate growth and brand prestige apparently had displaced profit maximisation as the ultimate goals of technocratic managers, as planning and administration in close co-operation with government had displaced market relations as the primary corporate dynamic.[23] In this technocratic milieu shareholders were "passive and functionless, remarkable only in [their] capacity to share without effort or even without appreciable risk, the gains from growth by which the technostructure measures its success".[24]

The Galbraithian idyll began to disintegrate with the severe recession of 1973/75, the incapacity of US corporations to compete effectively with Japanese and European products in key consumer market sectors, and the push towards conglomerate formation by Wall Street which was interested in managing multiple businesses by financial performance. Subsequently, in successive waves, US corporations were subjected to further financial imperatives: tight monetary and fiscal policy suppressed growth; wages were constrained to raise profits; and competition facilitated by international deregulation.[25] As Doug Henwood graphically and extensively portrays: "Over time purely financial interests have increasingly asserted their influence over hybridized giant corporations."[26]

A fertile scene was set for Michael Jensen, his colleagues in the Business and Law Schools at Harvard, and the Chicago School of economics, as enthusiastic advocates of the financialisation sweeping through corporate America, to develop a finance-based theory of corporate governance that was to envelop Anglo-American policy and practice. While agency theory and shareholder value were the most enduring principles of the Jensen legacy, they were preceded and accompanied by other financial innovations that disrupted the stability and often damaged the substance of corporate America. The series of wrecking-balls of leveraged buy-outs (LBOs), junk bonds and free cash flow directed at US corporations were impelled by the frequent enthusiastic exhortations of Jensen.[27]

Jensen was an early convert to the LBO in which a group of investors, and incumbent senior management, would take a company private by going deeply into debt: "The discipline of debt and the potential vast rewards from holding the stock would inspire managers to heroic feats of accumulation."[28] In this new market for corporate control alternative managerial teams compete for the rights to manage corporate resources.[29] However, it is clear that the resources the new management teams were particularly focused upon was the cash flow of the corporations concerned. Jensen neatly translated this investor avariciousness into "disgorging free cash flow", which he defined as:

> "Free cash flow in excess of that required to fund all projects that have net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial cash flow. The problem is how to motivate managers to disgorge the cash rather than investing at below the cost of capital or wasting it on organization inefficiencies."[30]

Yet as Henwood persuasively argues:

> "Jensen's definition sounds more precise than it really is, while cash flow and cost of capital are possible to figure out, though different analysts will come up with different measures for each, it is judging future projects that is difficult. It assumes firms know how much money a project can earn. Of course they never can. In practice, one can do little more than extrapolate from the past, but that's not really the same thing."[31]

For Jensen "the stock market is always axiomatically the ultimate arbiter of social good".[32] However, the result of eliminating the free cash flow of companies in LBOs (which disappeared in fees to investment banks and lawyers, and in huge incentives paid to management and former shareholders), and in loading up companies with debt, while facing increasing interest rates in the inflationary times of the 1970s and 1980s, was to leave US companies without capital to invest in research and development at a time of increasing competition from overseas companies engaged in continuous product development.[33] Meanwhile Jensen was more impressed by the financial innovation of boutique LBO firms such as KKR, and the inventor of the low rated/high-risk/high-return junk bonds Drexel Burnham Lambert, suggesting these financial engineers could readily replace corporate entrepreneurs:

> "With all its vast increase in data, talent and technology, Wall Street can allocate capital among competing businesses and monitor and discipline management more effectively than the CEO and headquarters staff of the typical diversified company. KKR's New York offices and Irwin Jacobs' Minneapolis base are direct substitutes for corporate headquarters."[34]

This amounted, to Jensen, as the eclipse of the public corporation, something he proclaimed in a celebrated *Harvard Business Review* article, which received a robust response. Peter Róna, head of Schroder Bank in New York, maintained that by exclusively privileging shareholder interests Jensen pre-empted "thoughtful analysis of the very question that is at the heart of the issue – what *should* be the rights and privileges of shareholders?"[35] Róna questioned Jensen's assumption that shareholders are better judges of capital projects than managers and corporate boards as "an ideologically inspired assertion that lacks empirical support".[36]

Extensive evidence assembled by Henwood suggests that Jensen's confidence was unfounded that "all-knowing financial markets will guide real investment decisions towards their optimum, and with the proper set of incentives, owner-managers will follow this guidance without reservation".[37] The impact of the restructuring of assets in the increasingly aggressive market for corporate control in the 1970s and 1980s was not primarily efficiency-enhancing as Jensen maintained, and there is little support for the "inefficient management displacement hypothesis".[38] While acquisitions may benefit some private interests, there is little productivity gain and frequent losses from mergers.[39] Any returns from hostile acquisitions came from other sources including reductions in employment, tax savings, cuts in investment, and possibly, with mergers within industries, increasing their market power to control prices. Moreover management buyouts and hostile takeovers were not a new permanent organisational form, but a temporary reallocation of assets, before they were transferred back to large public corporations.[40] In this process the large US corporation was not eclipsed, but was usually badly bruised and often left eviscerated.

The 1980s ended with disillusionment about the role of LBO firms to serve other than their own interests,[41] with an extensive series of defaults by over-leveraged firms amounting to the largest insolvency boom since the 1930s, and with the imprisonment of Michael Milken of Drexel Burnham for fraud. Those who wished to discipline corporations needed to find a more pliable tool than the market for corporate control in order to do so. The organisation of shareholder activism provided a new form of investor assertiveness. Ironically among the most influential of the new shareholder activists was T Boone Pickens an oil industry corporate raider. He organised the United Shareholders Association (USA):

> "From its 1986 founding to its 1993 dissolution, USA tracked the performance of large public corporations and compiled a Target 50 list of losers. The USA would try to negotiate with the underperformers, urging them to slim down, undo anti-takeover provisions, and just deliver their shareholders more 'value.' If satisfaction wasn't forthcoming, USA would ask its 65,000 members to sponsor shareholder resolutions to change governance structures. USA-inspired resolutions were often co-sponsored by groups like the California Public Employees Retirement System (Calpers), the College Retirement Equities Fund (CREF), and the New York City Employees Retirement System (Nycers)."[42]

In 1995 a new organisation, Relational Investors, was founded to invest to act as a "catalyst for change" with similar backing from a number of large institutional investors. These were pension funds of public-sector workers, adopting an anti-management rhetoric aimed at big business, though focusing on governance reforms such as more independent directors, and linking executive pay to stock performance.[43] Unfortunately these performance improvements would often be achieved by downsizing and investment cutbacks, and heralded an increasing short-termism in the obsession with quarterly results. The rationale for these interventions was that higher share prices benefited society at large; however, the loss of growth and employment through reduced investment involved considerable social costs, and the benefits in share price gains were distributed to a much narrower section of the community with the extreme concentration of all forms of shareholdings, including pension funds investing in equities, since all forms of superannuation are themselves highly unequally distributed.[44]

It was in this hollowing-out of the social responsibility of business that the US business corporation emerged as primarily a *financial* instrument. In this new financialised, dematerialised, and dehumanised corporate world agency theory could be purveyed as the primary theoretical explanation, and shareholder value as the ultimate objective with impunity. In turn these new conceptions of the theory and objective of the firm became vital ingredients in the further financialisation of corporations, markets and economies.[45]

C. The hegemony of agency theory

Agency theory has become "a cornerstone of ... corporate governance".[46] Agency theory is often regarded not only as the dominant current interpretation, but as an eternal and universal explanation of corporate governance. In fact agency theory is of recent origin, and is very much a product of the Anglo-American world. Rooted in finance and economics, it has somehow managed to penetrate not only policy and practice but the essential understanding of corporate law regarding directors' duties. In classical agency theory the central role of the board of directors is to monitor managers (the agents) to ensure their interests do not diverge substantially from those of the principals (the shareholders), and to devote the company to maximising principals return.[47] Yet, despite its pre-eminence, agency theory is not only profoundly simplistic, but deeply flawed:

- Agency theory focuses on an oversimplification of complex financial and business reality.
- Agency theory damagingly insists upon the single corporate objective of shareholder value.
- Agency theory misconceives the motivations of managers.
- Agency theory ignores the diversity of investment institutions and interests.
- Agency theory debilitates managers and corporations, and ultimately weakens economies.
- Agency achieves the opposite of its intended effect.

As Didlier Cossin, Professor of Finance at IMD, Switzerland has recently observed:

> "Most financial models taught today rely on false mathematical assumptions that create a sense of security even as failure approaches. … The list of flawed theories (including agency theory) … are all finance models based on over-simplifying complex choices. This pretence that mathematical models are the solution for human problems is dangerous and is not only at the core of finance theory but is also in the heads of many corporate and financial managers. Given the tremendous changes in financial systems, these theories must be scrutinised and then abandoned as models for the future."[48]

Not only does agency theory dangerously oversimplify the complexities of business relationships and decisions, but it damagingly demands a focus on a single objective. Agency theory asserts *shareholder value* as the ultimate corporate objective which managers are incentivised and impelled to pursue: "The crisis has shown that managers are often incapable of resisting pressure from shareholders. In their management decisions, the short-term market value counts more than the long-term health of the firm."[49]

Agency theory, which does not dare to enter the "black box" of the firm itself, from a distance hopelessly misconceives the motivations of managers, reducing their complex existence to a dehumanised stimulus–response mechanism:

> "The idea that all managers are self-interested agents who do not bear the full financial effects of their decisions[50] has provided an extraordinary edifice around which three decades of agency research has been built, even though these assumptions are simplistic and lead to a reductionist view of business, that is, comprising two participants – managers (agents) and shareholders (principals)."[51]

Agency theory tends to ignore the diversity of investment institutions and interests, and their variety of objectives and beneficiaries. As Lazonick has argued, institutional investors are not monolithic and different types of institutional investors have different investment strategies and time horizons.[52] Corporate governance becomes less of a concern if a share holding is a very transitory price-based transaction, and much share trading today is computer generated, with rapid activity generated by abstract formulas. While life insurance and pension funds do have longer-term horizons, and often look to equity investments to offer durable and stable returns, the behaviour of other market participants is often focused on the shorter term, and more interested in immediate fluctuations in stock prices than in the implications of corporate governance for the future prospects of a company:

> "Pension fund managers can generally take a longer-term perspective on the returns to their portfolios than can the mutual-fund managers. Nevertheless even the pension funds (or insurance companies) are loath to pass up the gains that, in a speculative financial era, can be made by taking quick capital gains, and their managers may feel under personal pressure to match the performance of more speculative institutional investors. The more the institutional investors focus on the high returns to their financial portfolios needed to attract household savings and on the constant restructuring of their portfolios to maximize yields, the more their goals represent the antithesis of financial commitment. Driven by the need to compete for the public's savings by showing superior returns, portfolio managers who invest for the long term

> may find themselves looking for new jobs in the short term."[53]

US information technology companies, which led the world in innovation in the 1990s (Microsoft, IBM, Cisco, Intel, Hewlett-Packard), "spent more (much more except Intel) on stock buybacks than they spent on R&D in 2000–2009".[54] In the 2007/08 global financial crisis,

> "many major US financial firms (including Citigroup, Merrill Lynch, Lehman Brothers, Wachovia, Washington Mutual, Fannie Mae), many of whom subsequently failed, had previously used up precious reserves in order to fund stock buybacks, which in turn made already over-compensated executives even wealthier."[55]

Lazonick asks why senior executives willingly diminished the financial strength and resilience of major corporations in this reckless way:

> "The ideology of maximizing shareholder value is an ideology through which corporate executives have been able to enrich themselves. The economists' and corporate executives' mantra from 1980 until the 2007–2008 meltdown of shareholder value and the need to 'disgorge … free cash flow'[56] translated into executive option grants and stock buybacks, and resulted in increasing dramatically those executive options' value."[57]

The power of the shareholder value model

> "has been amplified through its acceptance by a worldwide network of corporate intermediaries, including international law firms, the big accounting firms, and the principal investment banks and consulting firms – a network whose rapidly expanding scale give it exceptional influence in diffusing the ... model of shareholder-centered corporate governance".[58]

The self-interest and irresponsibility inherent in the practice of pursuing shareholder value reached its zenith with the reckless excesses of the global financial crisis. William Bratton and Michael Wachter relate the activities of financial sector firms in the years and months leading to the financial crisis of 2007/08:

> "For a management dedicated to maximizing shareholder value, the instruction manual was clear: get with the program by generating more risky loans and doing so with more leverage. Any bank whose managers failed to implement the [high-risk strategy] got stuck with a low stock price. … Unsurprisingly, its managers labored under considerable pressure to follow the strategies of competing banks."[59]

This behaviour has been widely recognised in post-crisis inquiry reports, and regulatory reforms across most jurisdictions now recommend that executive remuneration systems should be redesigned to take into account risk strategy and promote long-term performance and responsibility.[60]

In the latest manifestation of the reckless pursuit of self-interest at the heart of shareholder value, the dangers of massive high-frequency trading are becoming increasingly clear in equity markets. Regulators around the world are very concerned about the systemic risk of high-frequency trading. Already we have experienced a flash crash on the New York Stock Exchange (NYSE) on 6 May 2010 when US$1 trillion was wiped off share values in a matter of minutes only to be largely restored later in the afternoon,[61] and the bail-out of Knight Capital hedge fund due to a high-frequency trading algorithm that went wrong leading to a US$440 million trading loss; and there have been frequent incidents in other major markets as well. Algorithmic and high-frequency trading is sometimes manipulative or illegal, but it is often simply predatory on other investors. In response there is the proposal to mandate computer "kill" switches that stop trades which appear to be out of control. In addition, regulators are concerned about the increase of trading taking place in "dark pools" and are encouraging trades back out on to exchanges.

There is an intense irony in the huge divide between the sage call for long termism in investment horizons by the representatives of the institutional investors, and the acute explanation of the increasing prevalence of high-frequency trading provided by the trading arms of investment banks, which starkly highlights the complexities of contemporary finance markets. The immense divide between the 20-year time frame of fund managers to provide retirement benefits to the public, and the frantic high-velocity trading in which microseconds are critical demands further investigation.

Firstly there is a profound distinction between investing and trading. These are very different activities and deserve to be regulated, supervised and taxed in different ways. *The Kay Review of UK Equity Markets and Long-Term Decision Making*, published in July 2012, analysed this distinction.[62] High-frequency traders are driven by short-term market trends, and turn their portfolios over rapidly. Underlying performance is of less interest than immediate opportunity. In contrast, investors intent on holding assets for the long term will analyse a companies' prospects and underlying performance. Kay concludes "Equity markets work effectively for the corporate sector when they encourage, and do not impede, decisions which enhances the long-term competitive capabilities of the business."[63] The concern is that the short-term emphasis of equity markets may have encouraged unproductive value extraction at the expense of sustainable value creation.

Advances in financial, computing and communications technologies have facilitated the dramatic reduction of the average holding period of equity: on the NYSE this has diminished from seven years in the 1950s to six months today. More worryingly as much as 70% of trading volume on the NYSE is measured now in milliseconds, and other exchanges are similarly overwhelmed:

> "Over the past decade, trading in financial markets has undergone a technological revolution. The frontier of this revolution is defined by speed. A decade ago, trade execution times were measured in seconds. A few years ago, they were measured in milliseconds. Today, they are measured in microseconds. Tomorrow, it will be nano-seconds or pico-seconds. For technologists, this is a 'race to zero' – the promised land of zero latency where execution times converge on the speed of light. For social scientists, this is a financial arms race, a sub-second game of leapfrog. In their quest for speed, a number of firms are also engaged in a positional race. … Accompanying this shift in speed has been a dramatic change in the composition of trading

and market-making. During this decade, so-called High Frequency Trading (HFT) has come to dominate. It now accounts for anywhere between a half and three-quarters of trading volume on the world's major equity markets and a rising share of futures and other derivative markets. In some markets, HFT firms have become the de-facto liquidity providers or market-makers. Historically, designated market-makers were often granted privileges in return for agreeing to ensure trade and price continuity. No longer: the sleek have inherited the earth."[64]

The more impact short-term traders have in the market, the more volatile prices will be as these become less rooted in the fundamentals of the value of corporations traded, as Andrew Haldane of the Bank of England has documented, citing a Chartered Financial Analyst (CFA) 2006 Symposium which concluded "The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance."[65]

Present financial wisdom, and the securities regulation that has been developed within the same paradigm, suggests there is no such thing as too much liquidity, too much volatility or too much trading as Fox and Lorsch argue in the August 2012 issue of the *Harvard Business Review.*[66] Yet this creates very hazardous financial seas in which to navigate any corporate vessel. Michael Porter once warned the US Council on Competitiveness of the problems for business created by a too fluid capital market.[67]

More recently the consequences for corporate America in 2012 were revealed by Lazonick: US corporations have hoarded trillions of dollars, and they will only spend money on dividends, share buy-backs and executive options – all designed to enhance their share price.[68] Disastrously, investment in innovation, product and skill development has collapsed in US industry (with the large corporation exceptions of Apple and Google). Last year America had a US$60 billion trade deficit in high-tech goods according to the US Department of Commerce.[69] Business innovation is fuelled by investment. Innovation trajectories are shaped not simply by new knowledge and technical capability, but the rates and criteria by which financial markets and institutions will allocate resources to innovative business enterprise. Long-term innovation and investment performance requires attention to more than short-term financial metrics to satisfy the most transient of shareholders.

D. The enduring myths of shareholder primacy

Yet the concept of shareholder primacy, and the concomitant insistence that the only real purpose of the corporation is to deliver shareholder value, has become an almost universal principal of corporate governance, and often goes unchallenged. This self-interested, tenacious and simplistic belief is corrosive of any effort to realise the deeper values companies are built upon, the wider purposes they serve, and the broader set of relationships they depend upon for their success.[70] The obsessive emphasis on shareholder value is an ideology that is constricting and misleading in business enterprise, and is intended to crowd out other relevant and viable strategies for business success:

> "The idea that shareholders alone are the *raison d'être* of the corporation has come to dominate contemporary discussion of corporate governance, both outside and (in many cases) inside the boardroom. Yet the 'shareholder primacy' claim seems at odds with a variety of important characteristics of US corporate law. Despite the emphasis legal theorists have given shareholder primacy in recent years, corporate law itself does not obligate directors to do what the shareholders tell them to do. Nor does it compel the board to maximize share value. To the contrary, directors of public corporations enjoy a remarkable degree of freedom from shareholder command and control. Similarly, the law grants them wide discretion to consider the interests of other corporate participants in their decision-making – even when this adversely affects the value of the stockholders' shares."[71]

From the mid-1980s a majority of states in the United States (but not in Delaware, the seat of incorporation of many major US corporations) amended their corporate law statutes to permit (but, typically, not to require) directors to take into account in decision-making the interests of other stakeholder constituencies and community interests beyond shareholders. Approximately, half of these constituency statutes (as they are called) grant the licence only in the context of a hostile takeover or other corporate control transaction; indeed, the licence has principally been invoked by directors in response to an unsolicited takeover bid. Generally, the statutes do not give non-shareholder stakeholders standing to take enforcement action against directors and they make no provision for representation in governance of non-shareholder interests.[72]

Lynn Stout explains how the Chicago School economists strongly influenced the debate over shareholder primacy to the point where, in the 1990s, most scholars and regulators accepted shareholder wealth maximisation as the proper goal of corporate governance.[73] Hansmann and Kraakman's 2000 paper "The End of History for Corporate Law" marked the peak of this theory.[74] Stout's view is that this was the zenith of the shareholder primacy view which is now "poised for decline". She explains very clearly that furthering shareholder value is only one interpretation of directors' duties: "American law does not actually mandate shareholder primacy."[75]

Despite these developments, the primacy traditionally accorded to shareholder interests is most often justified on the basis that it is the means by which corporate law can most effectively secure aggregate social welfare.[76] This view was perhaps most clearly and familiarly expressed by the economist Milton Friedman, who declared that "the social responsibility of business is to increase its profits".[77] However, the question of whose interests should shape corporate operations and strategy has become contested under the corporate social responsibility movement. Is it, and should it be, the collective interest of shareholders exclusively or should it also include other interests and wider social claims in their own right?

Lynn Stout argues that the debate is not a simple contest between shareholders and stakeholders but that the idea of shareholder value as a stand-alone concept does not make any sense. Indeed she comments that "a relentless focus on raising the share price of individual firms may be not only misguided but harmful to investors".[78]

> "If we stop to examine the reality of who 'the shareholder' really is – not an abstract creature obsessed with the single goal of raising the share price of a single firm today, but real human beings with the capacity to think for the future and to make binding commitments, with a wide range of investments and interests beyond the shares they happen to hold in any single firm, and with consciences that make most of them concerned, at least a bit, about the fates of others, future generations, and the planet."[79]

She argues convincingly that each of the basic assumptions behind shareholder primacy are false and that shareholders do not own the company, "Corporations own themselves, and enter contracts with shareholders exactly as they contract with debt holders, employees, and suppliers."[80] Once it is conceded that directors are allowed to pursue the success of the company in meeting all of its contractual relationships, and that they are not required to simply maximise the value of the corporation's shares, the question then becomes: what ultimate objectives should they pursue?[81] If the answer to this question is that the corporate objective is to pursue a long-run goal to satisfy wider corporate interests, it is difficult to implement this prescription without adopting a more explicitly stakeholder orientation in practice, as even Michael Jensen, the arch-priest of agency theory, has conceded:

> "In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders – customers, employees, managers, suppliers, and local communities. Top management plays a critical role in this function through its leadership and effectiveness in creating, projecting, and sustaining the company's strategic vision. … Enlightened value maximization uses much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders."[82]

As Margaret Blair contends, in the US directors have both the authority and the responsibility, without any change in corporate law, to consider the interests of all of the participants in the corporate enterprise in order to try to find the outcome that creates value for all parties.[83] In contrast "the ideology and practice of maximizing shareholder value – or more accurately shareholder wealth – is not a triumph of economic efficiency. Instead it reflects and reinforces the growing power of an increasingly assertive financial elite."[84]

E. Modern company law reform

Historically, since the origins of contemporary capitalism, the wider purposes and interests of the corporation have been recognised and valued. Berle and Means were the first to explore fully the structural and strategic implications of the separation of ownership and control.[85] Berle wrote in the preface to *The Modern Corporation and Private Property* that "it was apparent to any thoughtful observer that the American corporation had ceased to be a private business device and had become an institution".[86] In their monumental work Berle and Means searched for a new conception of the corporation that embraced the wide constituency of corporate interests and responsibilities (a concern tragically abandoned by most contemporary financial economists):

> "Neither the claims of ownership nor those of control can stand against the paramount interest of the community. … It remains only for the claims of the community to be put forward with clarity and force. Rigid enforcement of property rights as a temporary protection against plundering by control would not stand in the way of the modification of these rights in the interests of other groups. When a convincing system for community obligations is worked out and is generally accepted, in that moment the passive property right of today must yield before the larger interests of society. Should corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to the their public and stabilisation of business, all of which would divert a portion of the profits from the owners of passive property and would the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way. Courts would almost of necessity be forced to recognise the result, justifying it by whatever of the many legal theories they might choose. It is conceivable, indeed it is almost essential if the corporate system is to survive, that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income streams on the basis of public policy rather than private cupidity."[87]

As Olivier Weinstein authoritatively sets out, the clear features of the new form of corporate enterprise advanced by Berle and Means, "underlying its capacity to serve as a support to the accumulation of capital and to an unprecedented concentration of material, human and financial resources", included three essential dimensions:

- The separation between investors and the enterprise, the status of the corporation making the corporation an autonomous entity, involving the strict separation between the assets of the enterprise and the assets of the investors.
- Incorporation required governance rules legally separating business decision-making from the contribution of finance capital, and giving discretionary powers to directors and officers, recognising their managerial rights to allocate corporate resources.[88]
- The freedom in a public corporation for shareholders to sell their stock with the development of capital markets. This signified a radical change in the relationship of the investors and the enterprise.[89]

These dimensions are integral to the investment, operation and development of corporations, and the workings of capital markets, and are the foundation on which Berle and Means built their theory of the implications of the separation of ownership and control. Integral to this theorisation is a realisation that there is a distinction between the corporation as a legal entity and the firm as a real organisation. The corporation is both a legal entity, and a collective, economic set of activities, that cannot be simply reduced to a series of contracts. It is this latter existence that gives the corporation an existence independent from the changing shareholders. [90] This gives rise to the enduring question of in whose interests the corporation should be managed.

Berle and Means could never have imagined that 80 years later corporations, managers, shareholders and lawyers would remain mired in the controversial issues raised by their ideals. And however undermined and marginalised the idealism of Berle and Means became in the work of financial economists in the later twentieth century who reasserted shareholder primacy with a purity and intensity not witnessed since the early nineteenth-century origins of industrial capitalism, nevertheless the resonances of good sense of the original Berle and Means statement continued in the minds and actions of practical managers and corporations. Blair and Stout have portrayed a convincing alternative view of the essentially collaborative basis of corporate wealth generation across an array of involved and skilled stakeholders.[91] This understanding of the business enterprise resonates closely with the approach of European and Asian business.[92] While in need of further elaboration, the idea of a participative engagement of all stakeholders in a common productive effort is far closer to the perceived reality of business activity than the abstracted and rarefied academic speculation of the agency theorists. Indeed the arrival of the new knowledge-based economy added a powerful boost to the early conceptions of the essentially social basis of industry, as Charles Handy highlighted:

> "The old language of property and ownership no longer serves us in the modern world because it no longer describes what a company really is. The old language suggests the wrong priorities, lead to inappropriate policies and screens out new possibilities. The idea of a corporation as the property of the current holders of shares is confusing because it does not make clear where power lies. As such, the notion is an affront to natural justice because it gives inadequate recognition to the people who work in the corporation, and who are, increasingly, its principal assets."[93]

Ironically during explosion of the knowledge economy in the 1990s, the Anglo-Saxon shareholder-value-based approach to corporate governance became reinvigorated in the US, UK, Australia, New Zealand and other countries that adopted this model (though the original high-tech companies of Silicon Valley would never have got started without venture capitalists and employee stock options, and often maintained majority ownership until the companies were well established, and ultimately became the servants of equity markets). The shareholder value model also began to have a strong influence in European and Asian economies, which formerly sustained more stakeholder or collective conceptions of corporate governance. In the context of global competition, international investment patterns, and the aggressive growth of international mergers and acquisitions, assuming the primary objective of releasing shareholder value often seemed the only sure way not only for international business success, but for corporate survival itself.

The shareholder value view upholds a property conception of the company.[94] In its most extreme form, as developed by the Chicago School of law and economics, the company is treated as a nexus of contracts through which the various parties arrange to transact with each other. This theory claims the assets of the company are the property of the shareholders, and managers and boards of directors are viewed as the agents of the shareholders with all of the difficulties of enforcement associated with agency relationships. Though the shareholder value orientation is assumed to be an eternal belief, firmly rooted in law, with strong historical foundations, little of this is anything more than a recent ideological convenience. Shareholder value in its current manifestation was a construct of financial economists in the 1980s, and meant to deal with the *lack* of shareholder value orientation widely apparent in US industry at the time.

Historically, US corporations have demonstrated a broad conception of the committed orientation towards a wide constituency of stakeholders necessary in order to build the enterprise. Over time and with the increasing market power of large corporations, managements' sense of accountability might have become overwhelmed by complacency and self-interest. However, to attempt to replace self-interested managers with managers keenly focused entirely upon delivering value to shareholders is to replace one form of self-interest with another. Any broadening of the social obligations of the company was dangerous according to the shareholder value school of thought: "Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[95]

The difficulty is whether in trying to represent the interests of all stakeholders, company directors simply slip the leash of the one truly effective restraint that regulates their behaviour – their relationship with shareholders. These views were expressed with vigour by liberal economists, and enjoyed the support of leading business leaders and senior politicians. More practically, such views reflected how US and UK companies were driven in the period of the 1980s and 1990s, with an emphasis upon sustaining share price and dividend payments at all costs, and freely using merger and takeover activity to discipline managers who failed in their responsibility to enhance shareholder value. It was the economic instability and insecurity created by this approach that was criticised in the report by Porter.[96]

Meanwhile, efforts were made to clarify the law on directors' duties. In 1979 the UK company legislation was amended to provide that the matters to which directors "are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members". The duty is owed to "the company (and the company alone) and enforceable in the same way as any other fiduciary duty owed to a company by its directors" (section 309(2)). There was a widespread sense that UK company law was in need of reform:

> "[T]he state of directors' duties at common law are often regarded as leading to directors having an undue focus on

> the short term and the narrow interests of members at the expense of what is in a broader and a longer term sense the best interests of the enterprise."[97]

These issues were extensively considered for several years in the deliberations of the UK *Modern Company Law for a Competitive Economy* review (1998-2000).[98] Two approaches were considered:

- a pluralist approach under which directors' duties would be reformulated to permit directors to further the interests of other stakeholders even if they were to the detriment of shareholders;
- an enlightened shareholder value approach allowing directors greater flexibility to take into account longer-term considerations and interests of various stakeholders in advancing shareholder value.

In considering these approaches, the essential questions of what is the corporation, and what interests it should represent, are exposed to light, as Davies argues:

> "The crucial question is what the statutory statement says about the interests which the directors should promote when exercising their discretionary powers. The common law mantra that the duties of directors are owed to the company has long obscured the answer to this question. Although that is a statement of the utmost importance when it comes to the enforcement of duties and their associated remedies, it tells one nothing about the answer to our question, whose interests should the directors promote? This is because the company, as an artificial person, can have no interests separate from the interests of those who are associated with it, whether as shareholders, creditors, employers, suppliers, customers or in some other way. So, the crucial question is, when we refer to the company, to the interests of which of those sets of natural persons are we referring?"[99]

F. Options for change

What should be the legal rule with respect to directors' duties? Should company law *require* directors and senior managers to act by reference to the interests of all stakeholders in the corporate enterprise, according primacy to no particular interests including those of shareholders (*mandatory pluralism*)? Or should company law *permit* (but not require) directors and senior managers to act by reference to the interests of all stakeholders, according primacy to no particular interests including those of shareholders (*discretionary pluralism*)?

The most radical of these models is the mandatory pluralist model creating a multifiduciary duty requiring directors and managers to run the company in the interest of all those with a stake in its success, balancing the claims of shareholders, employees, suppliers, the community and other stakeholders. The claims of each stakeholder are recognised as valuable in their own right and no priority is accorded shareholders in this adjustment; their interest may be sacrificed to that of other stakeholders. (Stakeholders are variously defined as those with an interest in or dependence relationship with the company or, alternatively, as those upon whom it depends for its survival.) The discretionary pluralist model would permit, but not require, directors to sacrifice shareholder interests to those of other stakeholders. Either of these models would formalise earlier managerialist practice that has been displaced by the current shareholder value culture. As a member of the Corporate Law Review Steering Group, Davies goes on to defend the enlightened shareholder value view, suggesting the pluralist approach produces a formula which is unenforceable, and paradoxically gives management more freedom of action than they previously enjoyed.[100] However, John Parkinson, another member of the Corporate Law Review Steering Group, argued strongly for the viability of a pluralist conception that maintained a broader sense of corporate purpose; but sadly Parkinson died during the period the steering group was meeting.[101]

G. How enlightening is englightened shareholder value?

The UK Company Law Review Steering Group, following its comprehensive review of company law, recommended a recasting of directors' duties to give effect to its notion of "enlightened shareholder value" ultimately contained in the Companies Bill 2006 (UK) which received Royal Assent on 8 November 2006.

Section 172(1) of the UK Companies Act 2006 imposes a duty upon a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

Not only in the UK but in the US also this controversial new clause was trumpeted as a remarkable innovation in company law, the UK government claiming that the provision "marks a radical departure in articulating the connection between what is good for a company and what is good for society at large".[102] How the government interpreted the new clause was elaborated in the 2005 White Paper:

> "The basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely. The Government strongly agrees that this approach, which [is] called 'enlightened shareholder value', is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all."[103]

Just as debate continued on the precise intentions of the government during the long period of the company law review process, and throughout the drafting of the White Paper and subsequent Companies Act 2006, so the purpose and intentions of the Act were keenly considered by the academic and legal community. One authority stated:

> "The purpose behind s 172, within the framework just discussed, was primarily to emphasise the fact that directors should not run a company for short-term gains alone, but to take into account long-term consequences. The policy intention is to encourage decision-making based upon a longer-term perspective and not just immediate returns. Also, the section, together with the Business Review (required by s 417 of the Act), was to make the process of management more enlightened and it did this so as to ensure that directors would consider a much wider range of interests, with the hope that there would be more responsible decision-making."[104]

However, the practical influence of the new legislation has proved modest compared to the ideals that inspired it. A survey of law firms at the time of legislation discovered that most were agnostic concerning whether section 172 might alter the outcomes of directors' decisions in the course of doing business.[105] Directors might have a new and more inclusive duty enshrined in the Act, but they remained entirely immersed in a political economy of financial institutions, relationships and expectations which they normally feel impelled to respect. These influences continuously shape and form directors values and behavior, as Lipton, Mirvis and Lorsch argue,

> "Short-termism is a disease that infects American business and management and boardroom judgment. But it does not originate in the boardroom. It is bred in the trading rooms of the hedge funds and professional institutional investment managers who control more than 75% of the shares of most major corporations."[106]

Indeed it can be argued that the key players in corporate governance, the institutional investors and the executives and directors running companies, are now so financially committed to the short term that there is little chance of section 172 changing their behavior, as Keay argues:

> "While s 172 provides an entreaty, in s 172(1)(a), to manage whilst having regard for the long-term effects of an action, it is questionable whether it will in fact happen across the board. First, it is going to be difficult to enforce the long-term requirement, especially where directors resolutely maintain that they have acted in good faith. Second, managing for the long term is often antithetical to the interests of the company's managers. Managers could favour the short term because they only have a temporary interest in the company, primarily limited to their time in the job. Managers get no or little benefit from planning for the long term as it is likely to be their successors who will receive the plaudits, and benefit from rents that come to the company under that approach. In fact planning for the long term could make the performance of today's managers look decidedly average, as the share price might not increase and higher dividends would not be paid as quickly as if short-term plans were implemented."[107]

In this context, despite the high aspirations of some involved in the early work of revising UK company law, it is possible that section 172 and the accompanying business review in section 417 of the Act will simply amount to a directors' commentary that is a "self-serving and vacuous narrative rather than analytical material which is of genuine use".[108] In short, we are at a stage where directors are permitted to take different stakeholder interests into account but only to the point that this can be argued to be good for long-term shareholder wealth.[109] It would be hard for directors to make decisions that treat the well-being of employees or the environment as the primary cause for action (unless based on other legal obligations under employment or environmental law). As Marshall and Ramsay state, "the extension of *duties* of directors has not been attended by the extension of *rights* for stakeholders".[110]

H. Conclusions

The instability and short termism of both the financial economy and corporations is likely to continue in an ongoing financialisation regime. While the tenets of agency theory and maximising shareholder value have been questioned, they remain firmly in place as central impulses of the corporate economy. Any further legislative efforts to provide for a more balanced assessment of corporate purpose and to pursue longer-term productive horizons will need to be accompanied by a wholesale change in investment relationships and executive incentives. To achieve this will require a more fundamental questioning of the systemic risk associated with the existing investment values and practices, and corporate purpose and objectives than has so far occurred. ■

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109 See P Redmond, "Directors Duties and Corporate Social Responsiveness" (2013) Forum 18(1) *UNSW Law Journal*; S Marshall and I Ramsay, "Stakeholders and Directors Duties: Law, Theory and Evidence" (2013) Forum 18(1) *UNSW Law Journal*; R Williams, "Enlightened Shareholder Value in UK Company Law" Forum 18(1) *UNSW Law Journal*; B Baxt, "Future Directions for Corporate Law: Where Are We Now and Where Do We Go From Here? The Dilemmas of the Modern Company Director" (2011) 25 *Australian Journal of Corporate Law* 213; A Klettner, T Clarke and M Adams, "The Changing Roles of Company Boards and Directors: The Impact of Legal Reform" (2010) 24 *Australian Journal of Corporate Law* 148; P Redmond, "The Reform of Directors' Duties" (1991) 15(1) *UNSW Law Journal* 86; RW Parsons, "The Director's Duty of Good Faith" (1967) 5 *Melbourne University Law Review* 395.

110 S Marshall and I Ramsay, "Stakeholders and Directors' Duties: Law, Theory and Evidence" (Centre for Corporate Law and Securities Regulation, 2009), available at http://cclsr.law.unimelb.edu.au/go/centre-activities/research/research-reports-and-research-papers/index.cfm.