IoD CENTRE FOR CORPORATE GOVERNANCE PAPER

Shareholders or Stakeholders
For whom do directors govern the corporation?

The following is the text of a speech delivered by Dr. Roger Barker at the NEXT Corporate Governance Conference, Seoul National University, 22 September 2023.

A common feature of company law in most countries is that directors have a legally defined duty to promote the success of the company.

But what does the success of a company actually mean? Is it just the generation of profit for shareholders. Or can a company have some other purpose?

The answer to that question depends on your conception of what a company is, and what it exists to do.

There are various definitions of a company, most of which emphasize its role as a vehicle for team (rather than individual) commercial activity. Legal definitions stress that a company has an identity that is distinct from any of the individuals involved with it.

A possible starting point for conceptualising the success of a company is to consider what success means for human beings.

What is a company?

Etymology

The word 'company' derives from the Latin word, companio ("one who eats bread with you")

Definitions from the Oxford English Dictionary

- "A business organization that makes money by producing or selling goods or services"
- "A group of people who work or perform together"
- "The fact of being with somebody else and not alone"

Legal definitions

- "An artificial person, invisible, intangible, and existing only in contemplation of the law. It has neither a mind nor a body of its own." Chief Justice John Marshall (1819)
- A company is a legal entity representing an association of people, whether natural, legal or a mixture of both, with a specific objective

For the ancient Greeks, a successful life was encapsulated in the concept of **eudaimonia**, which approximately translated means happiness or, more precisely, flourishing.

One can argue that the goal of a company is to flourish, to prosper, to sustain itself as a holistic entity for the benefit of the various actors (or stakeholders) involved with it, with the directors exercising their business judgement to deliver this happy state of affairs.

In that sense, a successful company can be seen as an end in itself. The company's flourishing, as the team effort of a group of stakeholders, is its own reward.

Of course, the company needs to remain commercially viable. It must fulfil the demands of the marketplace by supplying useful goods and services at a profit.

But beyond that, it can define a distinctive purpose for itself which promotes the sustained flourishing of itself and its stakeholders.

However, there is another influential way to conceive of a company, which is more narrowly defined.

According to this view, the company's only purpose is to provide investors with a legal vehicle through which they can generate financial returns. The company is not an end in itself. Its role is subservient to the interests of one specific category of investor, its shareholders.

This view was famously expressed through the words of the American legal scholar, Adolf Berle, in the 1930s.

All powers granted to a corporation or to the management of a corporation, or to any group within the corporation... [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.

Adolf Augustus Berle

How a company is conceived has major implications for how the directors govern it.

If the directors see the company as primarily shareholder oriented, its long-term survival will be conditional on the ongoing success of shareholders.

According to this perspective, if things aren't working out for shareholders, then the capital invested in the company should be reallocated. The various stakeholders involved with the company can be released.

For employees in particular, this process may be personally disruptive in the short term – especially if their skill set is company specific rather than transferable.

But from a shareholder perspective, it is better if they are redeployed within the labour market so that they end up working for companies which can generate a better outcome for shareholders.

Which of these models of the company should society choose? The shareholder or the stakeholder approach?

The reality is that most systems are a hybrid between the two. Each approach has strengths and weaknesses. One may fit better into the context of a specific society, with its particularities in terms of history, culture, politics and social relations.

A recent survey by ecoDa/Allen & Overy found that European jurisdictions take differing approaches to shareholders/stakeholders in their definition of directors' duties. For example, German and Dutch corporate law is more stakeholder oriented, whereas the UK and Belgium prioritise the interests of shareholders.

Source: ecoDa/Allen & Overy (2023)

Germany

In German corporate law, the legal responsibilities of directors are towards the company as a legal person. The directors are directly committed only to the company, not to the shareholders or specific groups of shareholders.

Examples of where this is legally defined include Section 93 the German Stock Corporation Act and Section 43 of the German Limited Liability Companies Act.

Netherlands

Dutch corporate law is based on the stakeholder approach as opposed to the shareholder approach.

According to case law, and on the basis of the provisions of Section 2:8 of the Dutch Civil Code, directors must exercise care with respect to the interests of all stakeholders who are involved with the company.

UK

The Companies Act 2006 specifies that a director "must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole". For a commercial company, this means a long-term increase in shareholder value.

Directors must also have regard to certain other factors, including the company's employees, business relationships and the impact on the community and the environment, but only to the extent that they are relevant to long-term shareholder value.

Belgium

The Belgian Supreme Court has defined the interest of the company as the collective profit interest of all current and future shareholders.

The interests of other stakeholders can be taken into account by directors, but only to the extent that these could impact the collective profit interest of all current and future shareholders.

Also, there is a degree of historical cyclicality in terms of societies favouring a shareholder or stakeholder approach.

For example, in the 1920s, the shareholder approach was embedded in the US business system and in legal statutes. This was reflected in the famous 1919 judgement of the Michigan Supreme Court against Henry Ford, where the court admonished Ford for focusing too much on the interests of employees and customers, and not sufficiently prioritising the generation of profits for shareholders.

By the 1970s, a more stakeholder-oriented approach had become the conventional wisdom in corporate circles on both sides of the Atlantic. But by the 1980s, this was once again being rejected – being seen as an excuse for management inefficiency and inadequate shareholder accountability. This incarnation of the shareholder value movement probably reached its peak at the end of the 1990s.

Since then, and especially since the 2008 financial crisis, we have seen a swing back towards stakeholderism. This time it is allied with advocacy for a broader purpose for business which goes beyond generating shareholder returns. Business should also make a positive social impact.

The 2018 statement by Larry Fink, CEO of the world's largest asset manager BlackRock, is an example of this trend. It is all the more notable given that it comes from the leader of an institution that, in theory, is a vehicle for shareholder interests.

Society is demanding that companies, both public and private, serve a social purpose ... Companies must benefit all of their stakeholders, including shareholders, employees, customers and the communities in which they operate.

Larry Fink

Fink's statement has been echoed by prominent reports from the British Academy and the World Economic Forum. And In 2019, the US Business Roundtable of leading CEOs also came out in favour of a stakeholder approach – revising their 1997 statement which had emphasized shareholder value creation.

US Business Roundtable - Statement on the purpose of a corporation

- In 1997, the Business Roundtable issued a statement emphasizing the importance of shareholders: "the principal objective of a business enterprise is to generate economic returns to its owners."
- In recent years, an increasing number business leaders began to argue that the 1997 language did not mirror their view of how a well-run company operates.
- In 2019, nearly 200 CEOs of America's largest companies adopted a new Statement on the Purpose of a Corporation. It declared that companies should deliver long-term value to all of their stakeholders - customers, employees, suppliers, the communities in which they operate, and shareholders.

Some commentators view these recent claims about the purpose of the corporation with scepticism. They argue that bosses are using stakeholderism as a cover to fend off shareholder accountability – particularly from aggressive activists and hedge funds.

Also, they note that the bosses aren't proposing any fundamental changes to corporate law which might give stakeholders other than shareholders more power.

There may indeed be an element of opportunism in some of these declarations. However, they appear to have caught the zeitgeist of the time – which increasingly rejects the previously dominant pro-shareholder narrative.

What explains this recent shift towards more of stakeholder orientation? There's no doubt that it is linked to the rise of ESG as an investment approach, which in turn is underpinned by the current debate around climate change and demands for companies to be socially responsible.

Specifically, there is increasing awareness that the current economic system has a tendency to generate externalities – namely costs imposed on wider society from business activities which are not taken account of by market prices or the resource allocation mechanisms of the free market. Greenhouse gas emissions are an example of such an externality.

Some argue that a business system is more likely to generate such externalities if it is narrowly focused on one KPI – namely shareholder value creation – rather than viewing business success from a broader, more holistic perspective.

The narrowness of previous business thinking prompted Jack Welch, former boss of GE and at one time one of the most ardent advocates of shareholder capitalism, to renounce shareholder value maximisation at the end of his career.

On the face of it, shareholder value is the dumbest idea in the world.

Shareholder value is a result, not a strategy… Your main constituencies are your employees, your customers and your products.

Jack Welch

It seems that shareholder advocates find it increasingly difficult to persuade the public, as they did so effectively in the 1980s and 1990s, that the success of shareholders is fully aligned with that of wider society.

Where do directors stand in this debate? Well to a large extent, we are neutral agents. Our job is to fulfil our legal duties to the company which are defined in corporate law. These are, in turn, the outcome of legislative decisions which, in a democratic system, reflect the perspectives of society.

However, many directors have their own personal preferences based on their own values and experiences.

It is understandable that if you have served for a long time as a director of a shareholder-oriented company, and have built your reputation on delivering shareholder returns, you may well have an alignment with that approach.

Also, shareholders still have the crucial power to appoint and dismiss directors. Some directors may feel under pressure to prioritise the shareholder perspective, especially if they are targeted by hedge funds or PE investors, who tend to pursue shareholder returns in a particularly single-minded manner.

But directors are also subject to other pressures which are pulling them towards stakeholderism. Many business activities only succeed through the cooperation of committed and effective teams consisting of multiple stakeholders. If directors fail to prioritise stakeholder interests, then sufficient collaboration may be lacking.

Also, there is increasing pressure to fulfil the expectations of Generation X, who are emerging as customers, employees and the future pipeline of senior managers and directors. Compared to earlier generations, younger cohorts tend to have different expectations around appropriate corporate behaviour.

In the UK, historically a bastion of shareholder governance, there are efforts (supported by the IoD) to reform director's duties in section 172 of the Companies Act 2006 to reflect these changing attitudes.

Purpose of the company... and the UK's Better Business Act campaign

The Better Business Act would:

- Establish a new principle of fiduciary duty within Section 172 of the Companies Act.
- The change would require directors to exercise their judgement in weighing up and advancing the interests of all stakeholders, not just shareholders.
- Directors would be tasked with pursuing a purpose which both promotes the interests of shareholders and benefits wider society and the environment.

betterbusinessact.org

My observation is that directors are already adopting many elements of a stakeholder approach, regardless of the current status of company law. Otherwise, they simply wouldn't be able to manage their businesses effectively.

Furthermore, as directors, we do not operate in a social vacuum. If societal expectations for business change, then so must we. Only if directors are trusted will they retain their role as key economic decision makers at the top of major organisations.

As with everything, the sweet spot will never lie at the extremes. A pure shareholder or a pure stakeholder approach is likely to be equally dysfunctional. Shareholders are still key players, and an essential source of investment capital in many sectors. Directors must continue to offer an attractive investment case for shareholders.

But the balance is changing. We are moving towards a situation in which company direction is more complex than simply maximising shareholder value.

This is a challenge that directors are aware of, and many are eager to embrace it.

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Dr. Barker is a well-known speaker on governance issues, and the author of four books and numerous articles on corporate governance and board effectiveness. A former investment banker, Dr. Barker spent almost 15 years in a variety of equity research and senior management roles at UBS and Bank Vontobel, both in the UK and Switzerland. He has a doctorate from Oxford University and taught politics at Merton College, Oxford.

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum – from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies.

The IoD was granted a Royal Charter in 1906, instructing it to "represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation."

The Charter also tasks the Institute with promoting "for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors", which the IoD seeks to achieve through its training courses and publications on corporate governance.