

The ethics of corporate governance

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How should corporate directors determine what is the 'right' decision? For at least the past 30 years the debate has raged as to whether shareholder value should take precedence over corporate social responsibility when crucial decisions arise. Directors face pressure, not least from 'ethical' investors, to do the 'good' thing when they seek to make the 'right' choice. Corporate governance theory has tended to look to agency theory and the need of boards to curb excessive executive power to guide directors' decisions. While useful for those purposes, agency theory provides only limited guidance. Supplementing it with the alternatives – stakeholder theory and stewardship theory – tends to put directors in conflict with their legal obligations to work in the interests of shareholders. This paper seeks to reframe the discussion about corporate governance in terms of the ethical debate between consequential, teleological approaches to ethics and idealist, deontological ones, suggesting that directors are – for good reason – more inclined toward utilitarian judgments like those underpinning shareholder value. But the problems with shareholder value have become so great that a different framework is needed: strategic value, with an emphasis on long-term value creation judged from a decidedly utilitarian standpoint.

Introduction

Whenever a board of directors needs to take any action, its individual members face a decision: what is the right thing to do? Most of the time, choosing the right course is a matter of business judgment on what ethicists call non-moral issues. In a few instances, the choice is a narrow, legal one, where compliance with a specific statute or regulation is at stake. But in some cases – and in particular for major decisions like mergers, acquisitions, downsizing or large investments – neither the law nor business judgment may be sufficiently clear. These decisions often involve conflicting versions of what's *right* in a moral sense. Important decision-making in the boardroom is, in short, a matter of ethics. While directors will choose to act on individual decisions from different theoretical perspectives, their tough calls are likely to be based on more fundamental and often unspoken assumptions about the nature of what is right. The lobby for ethical investment brings with it similarly unspoken assumptions about the ethical basis on which its recommendations are made. This paper explores how ethical frameworks underpin theories of corporate governance to give guidance to directors, in particular to those independent, non-executives who increasingly act as the moral compass for the enterprise. It suggests, moreover, that the ethical approach that sits most

comfortably with the purpose of most corporations is one that rejects important aspects of both stakeholder theory and shareholder value.

Concern about corporate governance has developed historically in response to major crises of confidence, fraud and market failure, and with it advances in our thinking about the role that corporations play in the economy and society. The 1929 stock market crash formed at least part of the recognition of just how different the economic and moral imperatives of large listed companies and institutional investors were, compared with the Victorian concept of the company (Berle and Means, 1932/1991). The 1930s also saw recognition of the way that the corporation could be a vehicle for economising effort through the reduction of transaction costs and freeing resources for productive use elsewhere (Coase, 1937; Williamson and Winter, 1993). The focus of what we now call the economic institutions of capitalism (Williamson, 1985) lay in showing how capitalism created social wealth, and was not merely a vehicle for the exploitative power of the capitalist.

Another surge of interest came in the early 1990s from what was perhaps a less dramatic string of events but ones which still reverberate in the news more than 15 years later: the near-simultaneous collapse of Polly Peck, the Bank of Commerce and Credit International and, perhaps most importantly, Robert Maxwell's collection of enterprises (see Wearing, 2005 for a detailed discussion). Those events threw into doubt the principles-based, self-moderating system of accounting, the gentlemanly approach to financial regulation and the cosy, patrician ways in which directors were selected and boards did their work. The result was the Cadbury Report (1992) and eventually what became the Combined Code of corporate governance, which was then emulated in other jurisdictions. A third wave came from the excesses of the dotcom era of the late 1990s and the subsequent collapse of Enron in 2001 and WorldCom in 2002. There were other cases, too, which might have seemed just as dramatic had they not been preceded by egregious lapses that had rocked the confidence in US financial markets and led to the implosion of the global accounting practice of Arthur Andersen. The byproduct was a new, stringent law on corporate responsibility commonly known as the Sarbanes-Oxley Act (Library of Congress, 2002), which led to a spurt of legislative, regulatory and self-regulatory actions around the world to clean up the mess and reduce the risk of a systemic infection.

The collapse of the German Herstatt Bank in the 1970s and of IBH Holding in the 1980s demonstrated that continental European countries were not immune from the problem. Those cases had been dealt with largely by tapping the hidden reserves of the German banking system. In Switzerland, Credit Suisse had similarly made its governance fiasco (known as Chiasso) disappear by tapping into shareholder funds it had hidden from view. But in the early years of the 21st century that was harder to do. In 2003, lapses and frauds at the Italian food producer Parmalat and the Dutch supermarket group Ahold were reminders that corporate governance was an issue for all. What lay behind these episodes was a sense of moral hazard associated with the accumulation of financial resources and power in the hands of corporations and the sense that the directors of these corporations, entrusted with society's wealth, were unaccountable and open to corruption. While there were issues about the

personal morality of individuals, these episodes raised questions about the ethics of the corporate system as a whole. These ethical concerns took on four main questions:

- Were managers in distant corporations draining the resources of shareholders for their private use, as Berle and Means had described?
- Was the private use of corporate wealth actually contributing to broader social wealth, as Coase had maintained, or damaging it owing to market failure?
- What assumptions were the directors of corporations using – consciously or unconsciously – when those excesses occurred under their noses?
- What might they have done differently if they had focused on the examining those assumptions?

These questions lie at the heart of what have become the four main theoretical perspectives on the problem of how directors can best control corporate wealth and power: agency theory, shareholder value, stakeholder theory and stewardship theory and at the heart of the claims that ethical investors are making on directors. This paper argues, however, that there is a sixth stance available to the individual board member – sometimes confused with the concept of shareholder value – that lies at the heart of the work of independent, non-executive directors, i.e. decisions based upon perceived strategic value.

Theories of corporate governance

The workings of the boardroom are, as a matter of necessity, largely hidden from view and therefore from detailed examination. From conversations and public statements of individual directors we've seen emerge several theories that *describe* how boards operate and seek to *prescribe* the basis on which directors should make decisions. Stiles and Taylor (2001) outline six theories of corporate governance, though perhaps only three have a useful normative character. First, the *legal* view is a narrow one, which reflects what some directors might see as their role – fulfilling the obligations of company law – but which provides little worthwhile guidance for their actions. While directors may have *de jure* responsibility for the company, *de facto* control rests with management.

Two other theories – *class hegemony* and *managerial hegemony* – are almost entirely descriptive, though what they describe provides implicit but salutary advice to boards: all too often boards either act to perpetuate a ruling elite or exist as a legal fiction disguising the reality of managerial power. More interesting from an ethical perspective is the *organisational economics* approach, which uses agency theory to suggest the board's role is to control abuses in managerial power, and transaction-cost theory to lead decision-making. A *stewardship* approach assumes a psychological stance: managers, and by extension directors, will be motivated by things other than narrow self-interest, to be good stewards, to do a good job. The *resource-dependence* approach sees outside or non-executive directors as having the role of

facilitating access to funds, people and other resources. This can, of course, be seen as a subset of a transaction-cost approach. Having directors with the right contacts means cheaper loans, better terms on supply contracts and the first pick of new business school graduates.

The approach of Stiles and Taylor draws on the analysis of Zahra and Pearce (1989), who describe four perspectives. They share with Stiles and Taylor *legal*, *resource dependence* and *class hegemony*, but Zahra and Pearce focus on *agency theory* while leaving out direct reference to transaction-cost economics. They do not mention *stewardship theory* at all. These surveys of theories of governance, however, leave out perhaps the two most important and conflicting ones: the competing cults of stakeholder theory and shareholder value. Owing to their prescriptive nature and their influence on decisions made by directors, the article will look in greater detail into agency theory, stakeholder theory and stewardship theory to see what ethical assumptions lie behind each, and then elaborate the virtues and drawbacks of shareholder value.

Agency theory

The origins of agency theory in corporate governance are usually traced to the groundbreaking work of Adolf Berle and Gardiner Means (1932/1991). Agency theory, a term they never used, came to be seen as a way to examine the issue of individual greed. As Jensen and Meckling (1976) argued, putting managers in charge of wealth that is not theirs creates, in economic terms, a cost – one they call agency cost. This cost doesn't exist in a business owned by its manager, which is why the problems of governance in a private company are different from those in public companies. In what Berle and Means call the *modern corporation*, however, the problem cannot be eliminated, but it can be controlled. Since this realisation, public companies around the world have developed incentives that seek to align the interests of managers with those of shareholders. Controlling agency costs lay behind the growth of the use of stock options and other equity-based pay systems, rather than relying solely on salary and bonuses to motivate managers. Rational managers will see that it is not in their interests to divert the company's resources to their private use when they have so much more to gain from taking actions that benefit shareholders as well as themselves. In large public companies, a second layer of potential problems arise. Shareholders employ directors to watch over the work of managers, creating a second moral hazard; or put another way, a second layer of agency costs. From an ethical perspective, the focus on economics in both instances changes the moral choice from one of 'right' or 'wrong' into one of 'better' or 'worse'.

Stakeholder theory

The stakeholder view of corporate governance is often associated with Japanese and continental European practice, and perhaps most closely with Germany, where law has required that half the seats on supervisory boards go

to representatives of the workforce and where custom has long mandated that a company's bankers and large-block shareholders have seats as well. The term 'stakeholder' is recorded as early as 1708, when it meant a neutral party holding the stakes of the contestants in a wager. But over the past quarter of a century, it has developed another layer of meaning. 'Stakeholder' has deliberate echoes of 'shareholder' and even more of 'stockholder', the more common American term. This rhetorical device boosts employees, suppliers, customers and outside interests to a linguistic status with something approaching the same claim to rights over a company's activities. Its origins in the theory of corporate governance are somewhat difficult to trace.

Writer R. Edward Freeman links it most directly to the Stanford Research Institute in the early 1960s, though he accepts he couldn't quite pinpoint it (see Freeman, 1984; p. 49). Freeman defines stakeholders as "any group or individual who can affect, or is affected by, the achievement of a corporation's purpose" (1984, p. 6). SRI and other strategic thinkers used stakeholder concept mainly as a tool for strategic analysis. It was in part a result of the growing recognition of the complexity of strategy – that the company wasn't simply a production system, where strategy was based primarily on products and the means to produce them, as it had been seen for first half of the 20th century. Gradually, strategists had come to appreciate that corporations created value through the complex interaction of various networks of relationships. Examples of that approach range from Igor Ansoff's thinking in the 1960s through to Michael Porter's conceptions of industry analysis in the 1980s, the balanced scorecards of the 1990s and current work on customer relationships and their lifetime value (see Porter, 1980; Ansoff, 1987; Kaplan and Norton, 1992; Bell *et al.*, 2002; Rust *et al.*, 2004). But considering the interests of stakeholders in strategy doesn't imply stakeholders should be regarded as *the* or even *a* purpose of corporate activity. Indeed, Ansoff argued forcefully against the stakeholder approach, drawing a distinction between a corporation's "responsibilities" to a wide range of interested parties and its "objectives", which guide management to fulfilling the company's purpose (Ansoff, 1987; p. 53).

Strong versions of stakeholder theory challenge the assumption that directors (and by extension managers) have their sole duty to the company's owners. Indeed, Freeman even defends exploiting the word 'stakeholder' precisely because it sounds like 'stockholder'. Words, he writes, "make a difference in how we see the world. By using 'stakeholder' managers and theorists alike will come to see these groups as having a 'stake' (1984, p. 45). Stakeholders have legitimacy because they can affect the direction of the company; it is legitimate for management to spend time and resources on stakeholders", he argues. That is, however, still some way from arguing that these people and groups are 'ends' of corporate purpose, to which corporate boards owe a duty, rather than just a 'means' to the end of shareholder value. The usual argument against the strong versions of stakeholder theory is that shareholders have their entire investment at risk, while suppliers, customers and employees in general receive benefits from the corporation contemporaneously, and enjoy the added protection of prior standing in contract if things go wrong. But Freeman, writing with William Evan and using examples

based on US law, pointed out that shareholders, managers, customers, suppliers and employees all have their contractual rights protected by one or another aspect of law. “Another way to look at these safeguards is that they force management to balance the interests of stockholders and themselves on the one hand with the interests of customers, suppliers and, other stakeholders on the other” (Freeman and Evan, 1990; p. 347).

Can we find guidance in company law? In many jurisdictions the matter is quite clear: directors are responsible and accountable to shareholders. But that legal accountability is only a narrow sense of the ethical issues directors face, and with mounting public pressure – from corporate governance scandals and environmental concerns – even the legal context is subject to change. An example was the eight-year long debate in the UK over revising company law that finally ended with the law reform of 2006. The business lobby beat off attempts from the more leftwing elements of the Labour Party to amend the duty-of-care provisions. Business interests even successfully lobbied to get government to repeal a requirement for large listed companies to provide a detailed narrative account of the business in an Operating and Financial Review taking specific heed of employees, suppliers, customers and the environment. But the final version of the law nonetheless retained a degree of accountability to stakeholders in the Business Review (UK Parliament, 2006) mandated under European Union law. Around the same time another branch of government the Department for Environment, Food and Rural Affairs, issued guidelines concerning annual disclosure for all substantial businesses – public and private – of key performance indicators for environmental affairs (DEFRA, 2006). While not carrying the force of law, these guidelines carry the threat of affecting a business’s ability to contract with government. A narrow legal definition is, therefore, subject to change.

Most arguments for a stakeholder approach to governance aren’t based on a narrow legal claim, but appeal instead to a larger moral purpose. Freeman declared that the ordinary view of corporations – with shareholder value at the centre – “is or at least should be intellectually dead” (Freeman, 1994; p. 14) That view doesn’t go undisputed, either in its method of argument (see Child and Marcoux, 1999 for an example) or its conclusions about the appropriateness of stakeholder theory. Indeed, John Hendry declared that the normative stakeholder theory and Freeman in particular had overshot. “To the extent that they have their sights too high they have also undermined their own position by sacrificing credibility and introducing major problems” he wrote (Hendry, 2001; p. 159). Not only was the emphasis on stakeholder rights wrong in theory, they were falling out of practice, he said. Stakeholder concerns had “become increasingly marginal to the corporate governance debate” not just in the US but also in such “stakeholder oriented societies” as Germany, Japan and South Korea (p. 173). Hendry was, of course, writing before the next big crisis in governance was to occur – the collapse of Enron, which robbed employees of pension rights and led to the biggest changes in public accountability of executive directors since the creation of the US Securities and Exchange Commission in the 1930s. Stakeholder theorists seem to be representing two different ethical perspectives. The Freeman and Evan approach was, in some ways, making the argument on the devil’s own terms.

They said that seeing the corporation as a contracting mechanism, as Coase (1937) and Williamson (1985) had done, provided a way of showing the stakeholder theory was about tangible costs and benefits, a means of reducing the economic burden of the social contract, the weak version of the theory, where the ethical determination is based on the consequences of the action. This is far from a typical stakeholder argument, which holds that businesses are accountable to larger aims than profit maximisation (Evan and Freeman, 1993; Donaldson and Preston, 1995; Crowther and Caliyurt, 2004).

John Hasnas says: "When viewed as a normative theory, the stakeholder theory asserts that, regardless of whether stakeholder management leads to improved financial performance, managers should manage the business for the benefit of all stakeholders" (Hasnas, 1998; p. 26). This is just the type of conclusion that is sure to raise the hackles of many business people, and led Milton Friedman to pen his famous retort that the social responsibility of business is to make money (Friedman, 1970). It's not surprising to see how stakeholder theory became conflated with corporate social responsibility, though we can argue that there is a difference. Indeed, the devil's argument (e.g. Freeman and Evan, 1990) might well be making an argument that treating suppliers, customers and employees well reduces transaction costs, thereby contributing to profits. But the more common view of stakeholder theory is that advanced by these authors and a host of followers, i.e. that respect for individuals is a greater good that businesses cannot ignore (Evan and Freeman, 1993). The discussion of an even broader theory of social contract for business (Donaldson and Dunfee, 1994) lies behind more contemporary notions, including that of the UK think tank Tomorrow's Company: businesses require a "license to operate" from society (Hampson, 2007). This approach forms the basis of what we call legitimacy theory (e.g. Guthrie and Parker, 1989; Lindblom, 1994; Deephouse and Carter, 2005).

Stewardship theory

As a description of board practice, stewardship theory suggests that a directive will be motivated by some larger than personal wealth. Drawing on organisational psychology, it suggests that self-esteem and fulfillment loom large in their decision-making, as Abraham Maslow (1943) had suggested in his hierarchy of needs. As a prescription, however, it contends that individual directors should look after the interests of someone or something larger than their personal self-interest. Some may be guided by a code of conduct or statement of corporate purpose, like the charitable aims of the foundation that owns 90 per cent of the German manufacturing giant Robert Bosch GmbH, the credo of Johnson & Johnson or the trust principles that have protected the editorial integrity of the news operations of Reuters Group plc. In other cases, a legalistic approach would look at their fiduciary obligations as described by company law. But on many decisions, the law is silent and the director needs to look elsewhere to find the guiding principle. Some directors see their roles as being stewards of a particular interest. When a major shareholder secures a seat on the board, its director will understandably be tied to that shareholder's

aims, whatever company law might say. That's why we saw new emphasis on the role of independent, non-executive, outside directors in the governance reforms introduced with, say, the Sarbanes-Oxley Act in 2002, the Higgs Review and subsequent revision of the UK Combined Code in 2003 or the New York Stock Exchange's listing rule changes that same year. Independent directors, these reforms hoped, would be stewards of some greater good. But what?

An ethical framework for governance

These theories of corporate governance encompass what in ethics are known as consequential (sometimes called teleological) and idealistic (also called deontological) approaches. Deciding the 'right' course of action can be based on an assessment of the benefits arising from it (morality based on the *consequences* of the action) or by obeying some more general rule or ideal state (some ethical principle) irrespective of the outcomes of the action. The former is probably best known in its 18th and 19th century incarnation – utilitarianism, embracing John Stuart Mill's notion of the greatest good for the greatest number (Mill, 1863) – which underpinned much of the development of economics. But there is another strand of consequential thinking that also plays a role in corporate governance, ethical egoism, in which the individual decides on the basis of what is best *for himself*,¹ irrespective of the consequences for others. Among its proponents were Epicurus, Hobbes and Nietzsche, philosophers who no longer have the great fan clubs they once enjoyed, except perhaps among CEOs (for a crystalline exposition of ethical theory, including the distinctions between act and rule utilitarianism, see Frankena, 1963).

But this thinking – when other actors invoke governance mechanisms like contract and the force of law to constrain the actions of the egotists – lies at the heart of the assumptions we see at work in agency theory. The CEO, indeed any self-interested actor, will seek to maximise personal gains. The role of corporate governance is, therefore, to constrain his actions without dampening his drive to succeed. In agency theory the board uses negotiation with the CEO and pay policies for the rest of senior management to channel energy toward common outcomes, albeit with different specific goals: we assume the CEO will attempt to maximise his wealth. If the way to do that also maximises shareholder wealth, then *job well done*. This ethical stance underpins nearly all the traditional corporate governance literature, as Hendry's conclusions infer (Hendry, 2001). Business culture breeds people who seek to maximise profits, personal or corporate. If the means to that end differ depending on whether we are looking at the personal or corporate, greed is widely thought to take precedence over the sense of corporate purpose. Nor is this approach confined to the boardroom. Much management literature and the 'how-to' approach to

¹ For convenience, the masculine form will embrace both genders. The current custom in polite English speech of pluralising to escape gender bias (e.g. "the person themselves") jars especially badly here. We are speaking of (1) *individual* actions and (2) in the context of corporate governance lapses, overwhelming *male* perpetrators.

organisational change are about aligning personal goals and incentives with corporate aims.

Stakeholder theory, in its strong form, approaches corporate decision-making from a deontological perspective. This is especially true among proponents of what we have come to call corporate social responsibility, around which we see developing an industry of ‘socially responsible’ or ‘ethical’ investors (though one suspects that many of the managers of SRI funds take a rather more ethically egotistical approach). There have been many attempts to demonstrate that what’s good for society (in a deontological sense) is also good for financial performance (in a utilitarian sense). The evidence to date, however, is less than entirely convincing. This lack of empirical support for the (financial) value of corporate social responsibility hasn’t silenced its proponents, giving greater evidence that their stance is fundamentally deontological and idealistic in the philosophical sense.

Indeed, much of the academic literature in support of stakeholder theory comes overtly from this perspective. Donaldson and Preston (1995), for example, see stakeholder theorists drawing support mainly from the normative aspects of its ethical foundation – a nod, at least, toward deontology. The philosophical tradition for stakeholder theory draws most directly from Immanuel Kant (for examples, see Evan and Freeman, 1993; Donaldson and Dunfee, 1994; Hasnas, 1998), whose notion of the “categorical imperative” – an *a priori* obligation – formed the heart of what John Stuart Mill, his utilitarian predecessors and his followers set out to dislodge. There is some greater good, in Kant’s view, that “is not derived from the goodness of the results which it produces” (Kant, 1785; p. 17). When extended to embrace an obligation upon business owners to respect some larger and largely unwritten contract with society for their license to operate, we hear echoes of other philosophical traditions: Rousseau’s social contract and Marx, which contribute to the scepticism of business people, reared in capitalism and steeped in the thinking of Adam Smith, whose thinking in part informed Mill’s version of utilitarianism.

Stewardship theory arises as well from deontological roots. Though not nearly so well explored in the academic literature, it has an intuitive appeal to many people in business. In the corporate governance literature it’s more associated with the governance of charities, where by definition actors – in management or among the trustees – are presumed not to be seeking to maximise profits but rather working for some greater good. But stewardship is not confined to the charities, either. Peter Weinberg, a partner at the boutique investment bank Perella Weinberg Partners and former Goldman Sachs executive, wrote of what a privilege was to join the board of a public company. “Serving on a board is like taking on a position in public service” he wrote in the *Financial Times*. “It is not (and should not be) a wealth creation opportunity but a chance to play a role in the proper workings of our marketplace” (Weinberg, 2006). Boardroom pay has improved markedly since the scandals of 2001 and 2002 and the resulting demands for more non-executive directors who must spend more time on their mandates. Indeed, it is difficult to see how personal profit maximisation would lead many of the current crew of serving independent, non-executive directors at public

companies to take up those roles when there was much better money to be in private equity.

This is not necessarily true for all outside directors of public companies, however. Despite the move in recent years away from the deep entanglement of German banks with the equity of German industry, many bankers still sit on supervisory boards of German companies, taking those roles not for personal gain, nor out of a sense of what Weinberg (2006) called *public service*. They are, however, serving at least in part to serve a *different* higher purpose – that of looking after the interests of their bank’s loan portfolio. Like the lawyers, bankers and accountants who so often populated American company boards over decades, this, too, is stewardship, but of a different kind than that envisaged in the calls for ‘independence’ of mind and purpose invoked in the Higgs review of the role of non-executive directors in the UK (Higgs, 2003), the NYSE listing rule changes (New York Stock Exchange, 2003) and the German government-backed code (German Kodex, 2002/2007), among other governance regulation and principles. But it is still deontological in nature, as there is a greater good that guides those directors’ decisions – just not one that Rousseau or Marx might have cherished. Nor is stewardship theory limited in use to the boardroom. Muth and Donaldson (1998) point out that stewardship, unlike agency theory, recognises non-financial motives of managers, such as the need for advancement and recognition, intrinsic job satisfaction, respect for authority and the work ethic. But these three broad theories of corporate governance – one rooted in utilitarian ethics, the others in deontological – miss out the key area most on the minds of corporate directors: shareholder theory.

Shareholder value

The mantra of corporate management at least since the 1980s in what is often called Anglo-Saxon capitalism has been ‘shareholder value’. It’s a measure of the financial rewards delivered to shareholders through the combination of cash (dividends and share buy-backs) and the capital gains achieved on public or private equity markets.

Table 1: Theories of governance

	<i>Personal</i>	<i>Corporate</i>
Consequentialism (teleology)	Agency theory	Shareholder value
Ethical idealism (deontology)	Stewardship theory (in the main)	Stakeholder theory (in the main)

Overtly utilitarian, shareholder value guides directors to decide what’s in the greater interest of the holders of the greatest number of shares outstanding. Mapping the ethical approach to the interest served gives us a map of governance theories like those in Table 1 above. With the inclusion of shareholder theory, our faith in the economic purpose of the corporation is

restored and the sound economist sitting on a board of directors has an ethical framework to guide decisions. End of story? Not quite.

The problems with shareholder value

Discerning what is in the interests of shareholders has never been an easy task. Founders and their families have different interests from venture capitalists looking for an early exit; both have different interests from the institutional investor who has just purchased shares during an initial public offering from either of them. Do you set strategy for the investor who holds the shares today, or the one who is likely to hold them tomorrow? Or in three years time? In the comparatively relaxed days of the 1980s, when all directors had to worry about was corporate raiders and vulture capitalists, delivering shareholder value was a pretty safe ethical bet. In Germany, where the tax system, accounting conventions and company law requiring *Mitbestimmung* (worker co-determination of corporate policy) constrained the efforts of supervisory boards to deliver profits, yes, even in Germany shareholder value became the vogue. Shareholder-value rules-of-thumb grew from the broad patterns of share ownership. In the US, shareholders of large public companies were mainly domestic. About half were private individuals, the rest institutional investors of a conventional sort. In the UK, ownership was also domestic but perhaps less so than in the US. Institutions made up a large majority of the holdings, though they were, again, largely of a conventional nature: domestic insurance and pension funds. In continental Europe, however, even in the early 1980s, a large proportion of shares – a quarter to half, depending on the country – were held by foreign institutions, many of them in the UK. The globalisation of capital markets, the introduction of new instruments and the development of fast, electronic trading platform was about to change all that.

By the start of the new century, derivative markets, short-selling, hedge funds and cross-border trading made the task of understanding the interests of shareholders not just difficult, but impossible and even perverse. Consider the simplest of these developments: collective investment tools like mutual funds or what in the European Union are fetchingly called as UCITS. Their growth has accelerated the concentration of corporate share ownership in the hands of institutional investors. Some are index-tracking or passively managed funds, where the interests of the fund lay in overall performance of the market. The owners' economic interests are, therefore, different from those of the company in its competitive marketplace. A case in point is the takeover battle between Barclays and a consortium led by Royal Bank of Scotland for control of the Dutch bank ABN-Amro. The antagonists shared many of the same shareholders, whose greater interests might lie more in preventing bidding war than in winning or even losing. Deciding what to do *in the interests of shareholders* might be deciding to do nothing at all, because doing anything might damage a competitor that your owners also own. Even the managers of active funds, however, can see their economic interests diverge from those of their beneficiaries, introducing another level of agency relationship, and with it another agency problem. The competition between them for short-term

financial performance led to rapid portfolio turnover. Even in 2002, a dull year for equity markets, the average duration of an equity investment by a US mutual fund was a mere eleven months (see Bogle, 2003), which raises the question of what interest it would have in the long-term performance of the company. Nor was this short-term focus merely a US phenomenon. Actively managed UK funds turned over their portfolios about every two to three years. The pressure to deliver short-term fund performance – and with it the focus on delivering share price appreciation earnings announcements – lies at the heart of what a lot of people, including many corporate managers, feel is wrong with the Anglo-Saxon model of financial markets (Tonello, 2006; Aspen Institute, 2007; CED, 2007).

But their interests were still easier for a corporate director to discern than those of the other players in the equity market. Hedge funds using high-octane, heavily leveraged strategies have become a large force, not just in the volume of their trading activities but in the absolute numbers of shares they hold. Moreover, many used instruments known as ‘contracts for difference’ to create an economic interest in the company’s performance which don’t involve the quaint, old-fashioned notion of owning the shares. The UK Panel on Takeovers and Mergers modified its disclosure requirements to inclusive derivatives (The Takeover Code, 2007) and the London-based Investor Relations Society called on the Financial Services Authority to demand daily disclosures of such positions as well (“Disclose derivatives if you want transparency – IRS”, 2007). If that weren’t enough, hedge-fund activity supercharged the practice of stock-lending, in which a traditional institutional investor – even a passively managed index-tracker – might lend shares from their portfolios for a fixed period of time in exchange for a payment of interest from the hedge fund. Stock-lending gives the hedge fund temporary ownership, creating two types of trading strategies. One involved short-selling – selling shares today in the expectation of buying them back later at a lower price. This means the economic interest of the (temporary) owner of the shares is in seeing the company perform badly. In the cases of some small companies, we’ve even seen the short interest – the number of share sold in this fashion – represent a majority of the voting stock. For a brief period, therefore, it was, in a utilitarian sense of greater value to shareholders for the company to go bust. The second trading strategy of hedge funds has been to join the ranks of shareholder-activist fund managers. This approach involves taking control of the shares for the sake to effecting a change of direction on the company, to pursue a particular acquisition or to change the chief executive. The high profile case in 2006 of the actions of The Children’s Investment Fund and its investment in the German stock exchange operator Deutsche Börse AG provoked a political storm that included the German Social Democratic Party chairman Franz Müntefering, then a member of the German government, referring to hedge funds as “locusts”. Just how profitable of this approach can be was demonstrated in a large quantitative study of the shareholder activism of the Focus Funds of the UK asset management firm Hermes (Becht *et al.*, 2006).

Whatever the success of these trading strategies, they cause huge complication for directors pursuing an ethical stance based on achieving shareholder

value. Even more harshly than before, shareholder camps divide along the lines of what is in their *personal* self-interest. The voices from the traditional, long-only asset managers, especially those managing pension-fund assets with a long investment horizon, argue that directors should act in the interest of long-term investors, not short-term speculators, a phrase often spat out with the same disgust as Müntefering used with “locusts”. Some push for governance solutions giving greater voting power to long-term holders. Seemingly unaware of the irony, some of these same investors – wearing a different hat – argue against the disproportionate voting power afforded to a) founding-family shareholders, say, in Belgium, b) the beneficiaries of pyramids share structures in Italy, or c) super-voting rights of A-shares in Sweden. It’s easy to see how these shareholders themselves face conflicts of interest with their narrowly personal and utilitarian stance. [It’s worth noting, however, that an Oxford Union-style debate at the European Corporate Governance Institute in 2007 soundly defeated the motion that long-term investors should have double the voting rights. The vote was 13 in favour to 55 against with three abstentions (ECGI, 2007)].

Toward a new ethical stance in governance

This discussion suggests, from the vantage point of the independent, non-executive director, that an ethical system based on shareholder value is unworkable on a practical basis as well as having deep theoretical flaws. Stakeholder theory is flawed as well, but for different reasons. It fails in theoretical terms because it struggles with determining the difference between means and ends. It fails on a practical level because when everything is a goal then nothing is. Agency theory helps the director in finding solutions to the narrow problems of corporate governance: how to keep managers from diverting corporate funds for private purposes. Qualified by reference to transaction-cost economics, as in the organisational economics theory as outlined by Stiles and Taylor (2001), it can even help directors decide when it’s no longer worth trying to prevent managers from stealing shareholder funds, indeed why it might help shareholders to encourage what the British media like to call fat-cat pay. It was, after all, all those very fat-American-cat CEOs who delivered the disproportionately large gains in profits, share price appreciation and productivity while taking home large sums of cash pay and huge, unrealised gains on stock options. Stewardship theory helps explain why people might still want to serve on boards of directors of US public companies, despite the risk of federal prosecution under Sarbanes-Oxley or shareholder lawsuits so common in litigious America. Stewardship will help guide a director’s decision when the board faces authorising a questionable transaction or deciding when and how to report bad news. For a summary, see Table 2 below. What is missing, though, is the big picture, a theory to guide the large, *strategic* decisions, the ones that involve a substantial commitment of shareholder funds or the opportunity costs of abandoning one line of business for the sake of entering another.

Table 2: Perspectives of boards of directors

Dimension	Board's role	Directors' accountability	Theoretical origins	Ethical assumptions	Limitations
Class hegemony	Boards perpetuate power of ruling elite	Capitalist culture Themselves as a class	Marxist sociology	n/a	Descriptive, not normative
Managerial hegemony	Board is a legal fiction	CEO	Sociology	n/a	Descriptive, not normative
Legalistic	Fulfilling legal requirements	To the state As mere fiduciary of shareholders	Corporate law	Law = right	Not useful for decision-making beyond narrow compliance
Agency	Monitor agents (executives) to ensure efficient use of principal's (i.e. shareholders') funds	Shareholders	Economics and finance	Assumes ethical egoism on part of executives Act-utilitarian for outside directors	Narrow definition of board's role In public companies, directors are themselves agents, monitoring another agent's actions
Resource dependence	Co-operative mechanism to secure vital resources Boundary-spanning Create legitimacy	Each other and shareholders	Transaction-cost economics Organizational theory Sociology	Rule-utilitarian	Sees board in passive role, facilitating rather than setting direction
Stewardship	Trustee Representative of external principle(s)	Beneficiary of the 'trust' Self, one's conscience	Sociology	Idealism Rule-deontological	Without clear basis for trust, lacks a shared basis of decision-making
Stakeholder	Special case of stewardship with stated beneficiaries	Customers, suppliers, employees, competitors, society at large and shareholders	Sociology Trade unionism Religious belief, esp. Christian altruism	Idealism Rule-deontological	Useful only for easy decisions Confuses means and ends Temptation for director to act as trustee of one interest group
Shareholder value	Special case of stewardship	Shareholders	Economics and finance	Act- and rule-utilitarian	Susceptible to short-termism Derivatives markets compound difficulty of knowing who shareholders or what their interests are
Strategic value	Ensuring value maximisation over long-term	The enterprise	Strategic management Transaction-cost economics	Act- and rule-utilitarian	Unpredictability of future

Strategic value

This framework for the ethics of corporate governance wasn't, perhaps, quite complete. Instead of looking 'corporate' aims, we might better have formulated the notion as serving shareholder interests. The teleological, utilitarian stance remains shareholder value, with all the problems that entails, but the deontological focus becomes not that of stakeholder theory but of a narrower view: the one of socially responsible investors. A third and broader category of aims – collective ones – can be added to the framework to accommodate the deontological approaches of stakeholder theory and corporate social responsibility, involving the interests of those who aren't shareholders. That leaves a gap, in ethical terms utilitarian and in scope collective, which we shall call strategic value (see Table 3 below).

Table 3: Ethics of governance, expanded

	<i>Personal</i>	<i>Shareholder</i>	<i>Enterprise</i>
<i>Consequentialism (teleology)</i>	Agency theory	Shareholder value	Strategic value
<i>Ethical idealism (deontology)</i>	Stewardship theory	Ethical investing	Stakeholder theory; social responsibility

The shareholder perspectives are both problematic. Shareholder value still suffers from every director's inability to assess it in a meaningful way. Ethical investing operates on the hope that social responsibility will be profitable but on the conviction that even if it isn't, it is still the right thing to do. Stakeholder theory – especially in its guise as corporate social responsibility – carries over the confusion of means and ends. Strategic value, while not easy to determine, asks the director to take actions on the basis of what's best in a utilitarian sense for the viability and persistence of the enterprise. An example: faced with the decision between a takeover bid at a price that gives certainty of a 30 per cent gain over a six month period compared with an uncertain gain of 100 per cent over a three year period, how does the director choose? The incumbent CEO, conflicted as we know under agency theory, will vote for or against, depending on the size his severance package and what his next job outside the company might be versus what position and power he'll enjoy in the merged entity. The chairman, when it's not the same person, might act in his personal interest (a comfortable retirement, perhaps) or out of a sense of stewardship for the narrow interests of his close friends in senior management. A non-executive but bound director may feel obliged to vote in stewardship of the owners he represents, the founding family, the venture capital fund, the activist shareholder.

Under the governance model that the reforms this decade have promoted, the decision rests in the hands of the *independent, non-executive, outside* directors. They are now, supposedly, in a majority. They control all the key board committees. They are able to monitor performance through their control of the audit process, and to command the necessary data through their independent staffs. They already possess the requisite strategic knowledge

through their formal induction to the board and the company and their deepening knowledge of the business through the greater frequency and length of board meetings. On what basis do they decide? They assess what constitutes strategic value. That means judging sources of value – particularly the intangible ones – that might be lost in a takeover. If the company itself, using its own resources – its people, its customer relationships, its supply chain, its research and development – has a pretty good chance of matching the money on offer from a bidder, then it's better to stay independent – better, that is, in the sense that doing it oneself generates the psychological benefits we valued in aspects of stewardship theory as well as creating the options for further value creation through having succeeded ourselves. It recognises that it's better for wealth creation, for society, to *earn* a capital gain rather than just *make* one. If, on the other hand, the offer is clearly much better than what we can manage ourselves, it's better to let someone else manage the business. Basing decisions on strategic value involved considering the interests of stakeholders, yes, but in their strategic sense, for the options they generate in the creation of future wealth. The orientation of the independent, non-executive director should, therefore, be on the long term, regardless of what shareholders say. Its utility is limited by the unpredictability of the future, a shortcoming it shares with all other theories. And shareholders may be merely here today, gone tomorrow, but the enterprise remains.

Conclusion

Boards of directors face a wide variety of decisions that will involve invoking – consciously or otherwise – decision framework and ethical perspectives. The dangers of executive excess call out for non-executives to look to agency theory to guard against excesses and transaction-cost economics to know when it becomes counterproductive to stop here. In most cases they will see shareholder value as the governing framework for decisions, and in some instances, especially when the companies themselves have adopted sweeping statements of purpose, stewardship theory comes into play. Given the economic purpose of most corporations, it is not terribly surprising that directors might draw more on utilitarian ethics, using the expected consequences of their decisions as the basis for determining their 'rightness', than on deontological calls for a higher authority of an imperative beyond what is prescribed in law. As such, when crucial decisions arise, directors can be guided by their determination of what is likely to create strategic value, where the goals of stakeholders like employees, customers and suppliers may well be taken into consideration, but as means to purpose of wealth creation over the long term.

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