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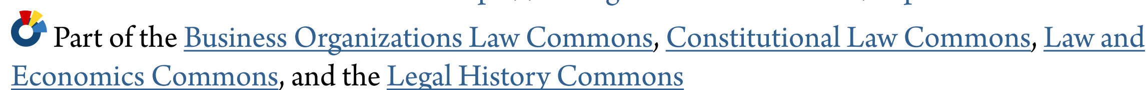
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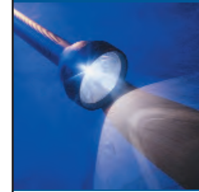

New principles for company law

By **Professor Kent Greenfield**, Boston College Law School and Distinguished Faculty Fellow at the Center on Corporations, Law and Society, Seattle University

- *Because companies operate in a wider framework than simply earning profits and producing goods and services, shareholders are not their only stakeholders*
- *Corporate directors and manager already balance disparate obligations from corporate and other types of law and also the market itself*
- *We value pluralism and diversity of thought in other aspects of public life and there is no reason to think that corporate administration should differ*

The success of business in modern society depends on not only the ethics of individual executives and managers, but on the legal framework that empowers and constrains the corporation itself. For businesses to flourish in a sustainable fashion, the legal infrastructure must encourage the creation of wealth, while simultaneously constraining the inevitable excesses brought about by an unrelenting drive to increase profits. The American and British legal traditions address this tension between empowerment and constraint by establishing corporate law as the province of shareholder and managerial prerogatives and leaving the regulation of corporate excesses to 'external' regulation, such as environmental law, employment law and the like. The duties within company law are straightforward — the managers should look after the interests of the shareholders, and they need concern themselves with the interests of other stakeholders of the firm only when required to do so by external law or when doing so is conducive to shareholder interests.

This bifurcation of interests — shareholder interests are the concern of corporate governance, while the interests of non-shareholder stakeholders are addressed elsewhere — is increasingly under attack. Not only does the parsing of interests seem artificial, but inefficient as well. A growing number of business leaders, scholars, and leaders of NGOs are calling for changes in the legal framework to allow corporations to create wealth while addressing the concerns of all their stakeholders.

If company law were to be released from its shareholder/management focus, what would it look like? This article proposes five new principles for company law. If adopted, these new principles and proposals would provide the basis for positive change in the way we govern corporations.

Principle One: The ultimate purpose of corporations is to serve the interests of society as a whole

Imagine a situation in which a corporation is thriving economically, but that it spins off more external costs than external benefits, so that society as a whole is worse off. Such a situation would be unsustainable and untenable. The corporation's prerogatives do not depend on any natural or human right. Instead, the corporation is a state-created entity whose purpose is to serve the collective good, broadly defined, and if it ceases to serve the collective good, it should not be allowed to continue its operation, at least not in the same way. If all corporations, or corporations of a certain type, or even an individual corporation created more social harm than good, no society in its right mind would grant incorporation to those firms.

Of course, both 'social value' and 'social cost' are difficult to define, but it is crucial to define them broadly. Benefits include not only profit to the shareholders but also workers' earnings, the stability a company brings to communities in which it does business, the quality and importance of the company's products or services,

and more. Costs include pollution, depletion of scarce resources, harmful effects of the company's products or services, mistreatment of employees, and even more abstract externalities such as the company's reinforcement of harmful stereotypes.

Ultimately, we cannot assess the social value of a company simply by looking at its financial disclosures. We must know about the company's product or service, how it treats its workers, and whether it is a good 'citizen' in the community. Even though a company's narrow-gauged financial reports are often popularly cited as a measure of the company's worth, they of course do not come close to reporting a business's true value. Instead, companies should be measured on more than their finances — because externalities count, we must try to count them. The type of broader information about a company is important not only to citizens interested in knowing the true impact of a company, but also to the decision makers within the company itself.

Principle Two: Corporations are distinctively able to contribute to the societal good by creating financial prosperity

One cannot go very far in a discussion about guiding principles for the regulation of corporations without noting what is special about them: they are especially able to create financial prosperity. They are able to do so because of a number of characteristics: the easy transferability of shares, limited liability, specialised and centralised management, and a perpetual existence separate from their shareholders. These characteristics are creations of law. Society establishes the framework of corporate law in order to create the space in which large public corporations can be one of the engines of wealth creation in the economy. If they stop creating wealth, they are failures.

Importantly, the wealth that matters includes not only monetary gain by shareholders but also gains to other stakeholders as well. We must also include the value to employees of their jobs and the social worth of the goods or services sold, as well as the multiplier effect on other businesses that provide raw materials, transport the end product to market, or sell sandwiches to the employees at lunchtime.

We should also remember that, as social values go, the creation of wealth is not at the top of the hierarchy. Wealth is an instrumental value, not an end in itself. This is not to say that money is unimportant, but there are many things we cherish that have little or nothing to do with how monetarily valuable they are. We strive to end racial injustice, even if such efforts cost us in terms of financial wealth. We protect pristine wilderness areas not because of their financial value but because we enjoy walking in deep forests, or value the idea that deep forests exist, even if we never get to walk in them. We prohibit companies from discriminating against potential employees on the basis of their disability, even if such disability is costly to accommodate. We collectively value justice, fairness, equality, and human rights even though it costs money and resources to protect them.

All this is to say that corporations should be appreciated for their special ability to create wealth but should be treated warily because of their inability (absent regulation) to take into account values far more important than wealth. We should be persistent in our monitoring of corporations to make sure they are moving us in a positive direction, given the form and powers we have bestowed upon them. The ability to create wealth is a very important power of corporations. As any powerful force, it must be constrained and regulated to ensure it does not careen out of control. The guiding standards for this regulation are the focus of Principle Three.

Principle Three: Company law should further Principles One and Two

This principle is simply the concept that *law* is necessary to ensure the first two principles are satisfied. If corporations are to serve the interests of society (Principle One) and do so primarily by creating wealth (Principle Two), we need to use law to make sure those principles are met. Corporations will not, through their own generosity, internalise the external costs of their decisions or keep an eye on the social harms they produce. Ironically, we use law to grant corporations the characteristics that make them capable of generating profit, but we need to constrain them using other areas of law and regulation.

The problem, however, is the fact that existing company law routinely makes the simultaneous generation of wealth and societal benefits less likely, by requiring management to look after the interests of shareholders first and foremost. If management knowingly makes a decision that benefits employees but imposes real, long-term costs on shareholders, such a decision would violate their duties to shareholders (under US law).

Shareholder primacy is traditionally based on three arguments:

1. Advancing shareholder wealth advances societal wealth
2. Broadening managers' responsibilities to include other stakeholders in fact releases them from any real responsibility

3. It is more efficient to regulate corporations from the outside than from the inside.

Each of these claims can be answered.

The first claim is that we need not worry about non-shareholder interests, since looking after shareholders will inevitably help other stakeholders as well. At one level, this claim is true. A company that is losing money is not much good to anyone with any sort of investment in the firm, whether that investment be in the form of labour, money, or infrastructural support. But beyond that, the claim becomes much more tenuous — the 'trickle down' is not inevitable. Without a mechanism within the corporation to force it to absorb externalities or to share profits among all stakeholders, there is no inevitable gain on the part of workers or society even when the company is making lots of money. Indeed, shareholder profit could result from a transfer of wealth *from* the company's employees or from society generally to the shareholders.

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The second argument in favour of shareholder primacy is that a broadening of corporate responsibilities actually makes it easier for managers to avoid individual responsibility. If corporate managers have more than one 'master', they can play masters off of one another, much like a child might play parents off one another.

This argument is overblown and dubious. There is little reason to fear that managers cannot handle increased responsibility or that it would be impossible to know whether managers are doing their jobs well. People routinely have more than one responsibility, some of them even conflicting, and we do not helplessly throw up our hands. Corporate directors and managers, in actual practice, regularly balance a number of obligations, some arising from corporate law, some from other areas of law, and some from the market itself.

The only way that having more and broader responsibilities would make it easier for managers to avoid responsibility is that they could use one obligation as a defence to a claim that they failed meeting another. But this is not a function of the number and scope of responsibilities but how they are *enforced*, and corporate law duties are simply not enforced in a way that would allow managers to play one duty off the other.

So the traditional contention that company law should focus on shareholders alone reduces to the third and final claim that it is more efficient to regulate corporations from the 'outside' than from the 'inside.' This is simply an empirical question: if we want to regulate corporations to ensure they consider the interests of non-shareholding stakeholders but still allow them to generate wealth, are we better off using corporate law along with other regulatory mechanisms or just those other mechanisms alone? Here, there is reason to believe that corporate law is an untapped resource with significant potential. If more economic fairness is a social objective, it is likely to be more efficient to have that goal be included among the corporation's own objectives rather than having government redistribute the wealth after corporations create it. Also, corporate managers may have expertise in areas that government bureaucrats do not, and a broadening of corporate responsibilities would allow corporations and their management to be proactive in addressing issues of social concern, which in turn might be more efficient than relying on the mostly reactive power of government regulation. Finally, progressive changes in corporate governance would affect the corporation wherever it does business, whereas regulatory reforms largely stop at the state or national border.

Principle Four: A corporation's wealth should be shared fairly among those who contribute to its creation

Corporations are collective enterprises — they require a multitude of inputs, all of which are essential to the creation of its wealth. The firm needs financial capital, labour, infrastructure, and depends on a social fabric of laws and norms that create and sustain the marketplace and enable a stable society in which the company can operate. The collective nature of the firm should be recognised through an equitable sharing of the corporate surplus.

There are two related arguments for such an arrangement. First, corporate law should make fair allocation of the corporate surplus the norm because this would be better for firms over time. Many of the stakeholders in the firm make firm-specific 'investments' — whether of capital or labor or infrastructure — meaning that their contributions are much more valuable in the particular firm than they would be generally. Firm-specific investments

are great assets for the firm because it can then take advantage of and build on the knowledge and expertise of their investors, suppliers, communities and employees over time. The problem is that the more an individual stakeholder makes investments that are firm-specific, the greater the risk the stakeholder is taking that the firm will collapse, violate some implicit or explicit contract with the stakeholder, or extort concessions from the stakeholder. As the stakeholder becomes more valuable to the company, he or she also becomes more vulnerable. This risk makes the stakeholder less willing to dedicate themselves to developing the firm-specific ability in the first place.

The answer to this dilemma is that a fair allocation of the profit created by the firm will help ensure that all stakeholders will be willing to make firm-specific investments. Because corporations are a collective effort, the key to sustainability is for those who contribute to the firm to receive the benefits (or suffer the costs) of the firm in rough proportion to their contributions. Stakeholders who believe they receive a fair allocation of the corporate surplus will be more willing to 'invest' in the firm. Over time, the firm will be more successful if the various stakeholders are willing to make such investments.

Additionally, a fair allocation of the corporate surplus will inure to the benefit of the firm over time because the various stakeholders will be more dedicated to the firm's success. Human beings are reciprocators — we tend to treat others the way that others treat us. Workers who believe they are treated fairly tend to work harder, be more productive, obey firm rules more often, and be more loyal to their employers. This in turn likely makes those firms more profitable than they would have been absent such fair treatment.

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Even if one is not convinced that more parity among stakeholders is better for firms themselves, there is an additional reason to push for a fair allocation of the corporate surplus. When we take society's interest as our ultimate guidepost, society is not concerned exclusively with the maximisation of aggregate wealth. Rather, the fairness of the allocation of society's wealth is an important principle. As a society, we look not only at the total social wealth, but at the equality of its distribution.

Principle Five: Participatory, democratic corporate governance is the best way to ensure the sustainable creation and equitable distribution of corporate wealth

A fair distribution of the corporate surplus is essential, but allocative decisions are extremely difficult, especially before the fact. So instead of trying to reach agreements beforehand about substantive fairness, corporate governance should instead focus on *procedural* fairness. Because the stakeholders cannot be expected to decide ahead of time who should get what, they need to decide instead *how* to decide who gets what. The crucial objective of corporate governance, then, is to create methods of decision making that offer procedural fairness among the various stakeholders.

The best way to do this would be to require some mechanism for non-shareholder stakeholders to elect their own representatives to company boards. The best way to have the board make fair allocative decisions is to have the important stakeholders represented in the board room. The specifics will be challenging but not impossible: employees could elect a proportion of the board; communities in which the company employs a significant percentage of the workforce could be asked to propose a representative for the board; long-term business partners and creditors could be represented as well.

Again, the specifics do not matter as much as the notion that the board itself should be a place where more than just a shareholder perspective will be heard. As they participate on the board, each stakeholder representative will have the incentive to build and maintain profitability in order to sustain the company over time. Moreover, the board will be the locus of the real negotiations among the various stakeholders about the allocation of the corporate surplus. Even though board members might be selected for their positions in different ways and from different constituencies, each would be held to fiduciary duties to the firm as a whole. Decisions that affect major stakeholders would no longer be made lightly, without someone on the board

being able to anticipate and articulate the likely impact such a decision would have on the workers, creditors, and other interested stakeholders.

One might argue that board pluralism would be inefficient and unnecessary. But no constituency would have an incentive to hurt the company in order to gain a larger piece of the pie, and doing so would violate their fiduciary duties to the firm as a whole. A pluralistic board would actually retard selfish impulses, because any behaviour that benefits one stakeholder at the expense of the firm must be done in full view of the others.

Making the board less homogeneous may make decisions less tidy, since more views will have to be taken into account and since the board will be forced to compromise so that decisions are acceptable to a majority or plurality of stakeholders. But we routinely consider such pluralism worth the effort in other areas of our lives — we widely accept the notion that decisions brought about after dialogue and compromise are better than those made unilaterally by a uniform group of individuals. We recognise in legislative bodies, administrative agencies, school faculties, and NGOs that diversity of viewpoints and people increase the likelihood that dissent will be welcomed, important perspectives will be heard, and decisions will be more fully vetted. As a matter of institutional dynamics, more and more studies show that good decision making requires diversity of viewpoints.

These principles of good decision making are not new. They are just systematically ignored in corporate governance. The key contention is that corporate boards — now among the most homogeneous decision making groups in society — would stand to benefit from a greater openness and diversity. Such openness would not only make for fairer decisions but better decisions as well.

This article has been adapted from Kent Greenfield's book The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities *(2006), published by Chicago University Press.*

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