ENVIRONMENTAL LAW SERVICE

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Briefing: Beyond Maximising Shareholder Value

This briefing relates to the UK government's Department for Business, Innovation and Skill's Company Ownership Transparency and Trust Discussion Paper, Q.39: The merits of strengthening responsibilities of banking directors by amending the directors' duties in CA06 to create a primary duty to promote financial stability over the interests of shareholders.

<u>About the Environmental Law Service (ELS)</u>

The Environmental Law Service (ELS) is a public interest law firm with offices in the Czech Republic, Poland and Brussels. Since 1995 ELS has been using the law to protect and strengthen democracy and to help people to uphold their rights. ELS is involved in the development and promotion of legal frameworks for corporate accountability aimed at bridging the governance gaps which have resulted from globalisation. ELS is a steering group member of the European Coalition for Corporate Justice (ECCJ) which brings together over 250 civil society organisations from 15 European countries in order to promote corporate accountability, making it the largest such group in Europe.[1]

<u>Summary</u>

Strengthening directors' duties in the manner proposed would promote a more appropriate balance between the market and the public interest. It would have the effect of removing shareholder primacy, as suggested by the Parliamentary Commission on Banking Standards (PCBS). It would effectively change the purpose of the corporation from simply being to maximise shareholder value. This would be a welcome step. Indeed we submit that the government should consult on amending S.172 CA06 simpliciter, not just in relation to banks and "other key sectors" as referred to in the discussion paper.

<u>The current situation</u>

S.172 (1) of the Companies Act (2006) presently reads as follows:

A director of a company 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, 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.

The need for consultation on S.172

The necessity for such a consultation is highlighted in the discussion paper itself where at 8.9, in the context of directors' competing duties under what is termed "enlightened shareholder value", it is noted that "[t]he concern expressed by the PCBS was that in the banking sector, shareholders' interests appeared to prevail over the other duties". One stark example of that is captured in evidence given to the PCBS by Professors Black and Kershaw in the following terms;

> For managers who are required to promote the success of the company for the benefit of the shareholders they comply with their duties if they increase the banks risk profile at the expense of the ultimate no-adjusting creditor - the state.[2]

This prevailing of duties to shareholders over other duties is hardly surprising. Despite being termed" enlightened shareholder value" S.172 (1) only requires directors to consider the other factors enumerated in the sub-sections in the context of promoting the success of the company for the benefit of the members. When the Companies Act was being debated in the House of Lords, the then Attorney General Lord Goldsmith said:

> the government's intention is that the duty to have regard to these other factors should be subordinate to the overriding duty to act in what the director considers, in good faith, would be most likely to promote the company's success (Hansard HL, 9 May 2006, col 845)[3]

In other words whilst the section requires a consideration of the mentioned constituencies, beyond shareholders, once they have been considered it does not really matter whether a given decision will be a good result for them because the ultimate concern is the benefit of the members as a whole.[4] Enlightened shareholder value is but little different from the classic shareholder value approach.[5]

Having noted that S.172 preserves shareholder primacy Mayson, French & Ryan sum up the effect succinctly noting that the directors are required to act to promote the success of the company as a separate entity for the benefit of the members while having regard to the matters in paragraphs (a)-(f) amongst other things: "It is the members who have the benefit while other constituencies have only regard".[6]

Shareholder primacy, shareholder value and maximising shareholder value (MSV) are different names for the same idea. Their effect is that corporations are deemed to "exist for one purpose only, to maximise shareholders' wealth. Shareholder wealth, in turn, is typically measured by share price-meaning share price today, not share price next year or next decade."[7] For example the Kay Review heard evidence from some company directors who equated their duty under S.172 with maximising current share price.[8]

Recent comments by Bank of England Governor Mark Carney help to illustrate the problem with shareholder primacy in the banking context.[9] Mr Carney called on banks to "focus on the real economy and help businesses invest and create jobs". When "asked whether people working for banks should sell a product to a customer to make a profit, even if they know the product was bad for the customer, Carney said: "Absolutely you shouldn't sell it.'" In relation to culture he said "the cultural issue is fundamentally important. There has to be a change in the culture of these institutions". He noted a need for banks to reconnect with society. These are all laudable goals but they are all impeded by the present purpose of the corporation, as set out in S.172, being effectively MSV.

For example:

- Under MSV, if a bank can make more money out of dealing in financial products than it can by financing the real economy through, for example, lending to small business, then the directors are required to ensure that finance prevails.
- In the event that a bank is satisfied, having regard to such things as litigation risk and reputational risk, that it will still be profitable to sell products to clients that they know not to be good for them, MSV argues in favour of doing just that.
- It is uncontroversial that corporate culture and corporate purpose are closely linked. Ideally they should be aligned. If the purpose of the corporation is MSV it is very difficult for any culture other than MSV to survive.
- In short, after having had regard to the societal factors in S172 (1) (a) to (f), a director who, none the less, concludes that MSV is best achieved by causing harm to society is under a duty to do just that. As Professor Joel Bakan puts it, MSV compels executives "to prioritize the interests of their companies and shareholders above all others and forbids them from being socially responsible - at least genuinely so".[10]

A recent European Corporate Governance Institute Working Paper notes:

> The financial crisis has demonstrated serious flaws in the corporate governance of systemically important financial firms. In particular, the Shareholder Value norm, which has guided corporate governance reform for a generation, proves to be a faulty guide for managerial action in systemically important firms.[11]

<u>An alternative provision</u>

A new section could be along the following lines:

A director of a company, which carries on the business of a bank, must act in the way he considers, in good faith, would be most likely to promote the financial stability of the company for the benefit of society as a whole, and in doing so have regard (amongst other matters) to-

(a) the need to promote the success of the company for the benefit of its members as a whole.

(b) the likely consequences of any decision in the long term,

(c) the interests of the company's employees and the need to mitigate negative impacts on them,

(d) the need to foster the company's business relationships with suppliers, customers and others,

(e) the impact of the company's operations on the community, including customers, and the environment and the need to mitigate negative impacts on them,

(f) the desirability of the company maintaining a reputation for high standards of business conduct,

(g) the need to act fairly as between members of the company.

Such a formulation recognises that corporations exist to advance societal goals and that banks, in particular, are fundamentally important organs of society. It provides some much needed balance with regard to the need to promote the success of the company for the benefit of shareholders and notes the need to not only have regard to employees, community and the environment but also have regard to the need to mitigate negative impacts on these constituencies.

The need for a consultation on S.172 simpliciter

As noted above S.172 equates with MSV and applies to all entities covered by the Companies Act, not just banks. Writing in the European Financial Review in April Professor Lynn Stout, of Cornell Law School, notes that the consensus around MSV is crumbling. As just one example she points to the fact that " in the past year no fewer than three prominent New York Times columnists have published articles questioning shareholder value thinking".[12] In July, in a Financial Times article entitled "MBA teaching urged to move away from focus on shareholder primacy model", journalist Sarah Murray noted the "growing consensus that focusing on short-term shareholder value is not only bad for society but also leads to poor business results".[13] In August it was the turn of the Washington Post to join in the criticism making the point that "it used to be a given that the interests of corporations and communities… were closely aligned. But no more".[14]In a subsequent piece the same newspaper likened MSV to a straightjacket.[15] Perhaps the most famous quote of all about the problem of MSV was also published in The Financial Times in 2009 when former MSV advocate and General Electric CEO, Jack Welch, in the context of the financial crisis, referred to MSV as "the dumbest idea in the world".[16]

Professor Stout concludes that "conventional shareholder primacy stands on the brink of intellectual failure".[17]

It also seems clear that there is confusion over what directors need to do to comply with S.172. For example Professor John Kay recently noted, in the Financial Times, that directors have a duty beyond enriching shareholders and that accordingly they are not required to engage in tax minimisation through aggressive tax planning.[18] The first part of this proposition does not sit well with the fact noted above that Professor Kay took evidence from some directors who did equate their duty under S.172 with maximising current share price. If that is what you think your duty is as a director, then surely you would also consider legally paying less tax as a duty. It seems that there was even a lack of agreement on the effect of S.172 on required director behaviour among some of those closely connected with the process of the Company Law Review which led to its inclusion in the Act.[19]

In 2011 the Association of Chartered Certified Accountants published a report commissioned from a team of academics on the process and thinking that led to S.172 in its present form. We respectfully commend this report, entitled 'Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and the Evidence', to the government. It included interviews with 15 individuals, most of whom were directly involved in the Company Law Review (CLR).[20] This report recommends that the question "in whose interests should companies be run?" be revisited. It notes firstly that the under-mentioned matters justify a re-examination, and secondly, sets out the wider evidence which should be taken into account in any examination.[21]

- A number of participants in and close observers of the CLR argued strongly that there was no serious opportunity to discuss alternatives to shareholder primacy. Nor was there any meaningful discussion of it in the media.
- Interviews with directors and an evaluation by BIS suggest that there has not been any change in corporate behaviour as a result of S.172.
- MSV is implicated in financialisation which, in turn, is implicated in short-termism and the pursuit of financial reward at the expense of social stability and sustainable value creation.
- Shareholder primacy is an identifying characteristic of Anglo-American countries and that these have a case to answer "in regard to their consistently poor measures of social well-being relative to those of [other] developed economies, which typically pursue a 'stakeholder', rather than a 'shareholder', model of capitalism".
- The link between the poor social indicators noted above and objectives pursued by large companies need to be seriously considered. Inequality as a driver of social ills should be borne in mind in this context.

Other criticisms of MSV include:

- Roger Martin, writing in the Harvard Business Review has made the point that returns to shareholders have actually declined since MSV became the dominant paradigm. A paradigm which he describes as "tragically flawed".[22]
- There can no longer be one single shareholder value because the range of shareholders in any given company have different and sometimes opposing interests. The most obvious being investors with a long investment horizon compared to those with a short-term horizon.[23]
- MSV is inconsistent with sustainability. Writing in the Worldwatch Institute's *State of the World* series in 2012 Allen White, senior fellow at the Tellus Institute, and Monica Baraldi, of the University of Bologna, made the point that "It is difficult, arguably impossible, to imagine a future of 9 billion people living sustainably in the absence of systemic change in the purpose and design of corporations."[24] This contention is supported by the preliminary research findings of the Sustainable Companies Project.The Sustainable Companies Project commenced in 2010. This project, led by Professor Beate Sjåfjell of the University of Oslo's Faculty of Law, is financed by the Research Council of Norway. The project has involved a team of more than 40 legal scholars and has been mapping the law in 26 jurisdictions across the globe including the UK and 10 other European Union Member States, the United States of America, Canada, China, Brazil and India. Professor Sjafjell notes that:

  > The tentative results of our cross-jurisdictional analysis indicate that shareholder primacy and the perceived overarching goal of maximizing shareholder profit present the most important barriers to the contribution of companies to environmental sustainability. Indeed, all tentative possibilities, all glimmerings of hope, are negated through the dominance of shareholder primacy and the short-term shareholder profit maximization drive.[25]

- Because MSV is based on agency theory it is largely responsible for disproportionately high executive salaries.
- MSV encourages both the exploitation of gaps in current regulation and the deployment of influence, such as "political donations, lobbying campaigns, sponsorship of directed research, revolving door employment opportunities for regulators and aggressive legal challenges to regulatory decisions".[26]
- MSV is inconsistent with respect for human rights. In his recent book *Just Business: Multinational Corporations and Human Rights*, Professor John Ruggie, the architect of the United Nations Guiding Principles on Business and Human Rights (UNGPs)[27]notes that the UNGPs would be reinforced by:

> Corporate law provisions that explicitly permit company directors, in fulfilling their fiduciary responsibility to the company, to consider its impact on other stakeholders and on society as a whole. That could encourage boards to establish more extensive oversight of company programs intended to manage social risks, including human rights, while also protecting directors from possible shareholder claims that they are breaching their duty to the company by straying too far from short-term profit maximisation.[28]

ENDS

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[1] http://www.elseurope.org This note reflects the position of ELS.
[2] EV 831.
[3] French, D., Mayson, S.W. & Ryan, C.L. (2012) *Mayson, French & Ryan on Company Law*. Oxford University Press. p.489.
[4] Keay, A. (2007). Section 172(1) of the Companies Act 2006: an interpretation and assessment. *Company Lawyer.* 28, 4, 106-110.

[5] Keay, A. (2007). Tackling the issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder value Approach'. *Sydney Law Review*, 29, 577-612.

[6] n. ii p.32.
[7] Stout, L. (2012). *The Shareholder Value Myth: How Putting Shareholders First Harms Investors Corporations, and the Public*. Berret-Koehler Publishers. pp.2-3.
[8] The Kay Review of UK Equity Markets and Long -Term Decision Making: Full Report. July 2012. p.17
[9] Mark Carney: banks need to reconnect with society. The Guardian * August 2013 available at http://www.theguardian.com/business/2013/aug/08/mark-carney-banks-need-to-reconnect-with-society
[10] Bakan, J. (2005). *The Corporation.* Constable & Robinson. p.35
[11] Armour, J., & Gordon, J.N. (August, 2013) Systemic Harms and Shareholder Value. *Law Working paper No. 222/2013.* ECGI available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2307959
[12] Stout, L. (2013). *The Shareholder Value Myth.* The European Financial Review. April 19 2013.
[13] Murray, S. Financial Times. *MBA teaching urged to move away from the focus on shareholder primacy model*. 7 July 2013
[14] Yang, J.L. The Washington Post. *Maximizing shareholder value: The goal that changed corporate America.* 27 August 2013.
[15] Pearlstein, S. The Washington Post. *Businesses' focus on maximizing shareholder value has numerous costs.* 6 September 2013.
[16] n. vi p.6.
[17] n. vi. p.115.
[18] Kay, J. Financial Times. *Directors have a duty beyond just enriching shareholders.* 5 June 2013.
[19] Collison, D., Cross, S., Ferguson, J., Power, D., & Stevenson, L. (2011) *Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence.*Certified Accountants Educational Trust.

[20] n. xv.
[21] n. xv. p44.
[22] Martin, R. (Jan-Feb 2010). The Age of Customer Capitalism. *Harvard Business Review.* pp. 58-65.
[23] See generally n.vi.
[24] White,A.L., & Baraldi, M. State of the World 2012: Moving Toward a Sustainable Prosperity. The Worldwatch Institute. p.88. Available at http://www.worldwatch.org/stateoftheworld2012
[25] Sjafjell, B. (2012) Regulating Companies As IF The World Matters: Reflections From The Ongoing Sustainable Companies Project. 47 Wake Forest Law Review 113. p.127.

[26] n. x p.19.
[27] Available at http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf
[28] Ruggie, J.G. (2013). *Just Business: Multinational Corporations and Human Rights.* W.W. Norton &Company. p.191.