THE CORPORATE LAW DILEMMA AND THE ENLIGHTENED SOVEREIGN CONTROL PARADIGM: IN SEARCH OF A NEW LEGAL FRAMEWORK

Abstract

This article is centred on the proposal of a new model of corporate decision-making: the enlightened sovereign control paradigm. In revisiting the long-standing academic debate on the corporate objective, typically enshrined in the dichotomy between shareholder value and stakeholder theory, a critique of these existing models is put forward. It questions in particular the existing theories' ability to take account of the complex and multidimensional risks that are created by the company but affect different constituencies both inside and outside it. While the global financial crisis re-ignited the urgency to further define an appropriate legal framework for decision-making in large public firms, there have not been substantial changes in the way this problem is treated in legal and business circles.

The paper is grounded on the recognition of the historical quest to find a legitimisation of corporate power and in particular to create a system of public accountability that could justify managerial decision-making. These tasks have become ever more central in the wake of the many scandals that exploded from the early 2000s to the present day, showing that many constituencies can suffer from the externalities of corporate activities.

While much has been written on this topic, more recent events illustrate the need to find an alternative approach to the question of the corporate objective. This is because of its centrality in defining legal strategies to control managerial behaviour, but also because of the shortcomings related to the application of existing paradigms. The asserted urgency to find a new theoretical model to govern managerial actions and coordinate them with the interests of different corporate constituencies leads to the proposition of a new theory. The enlightened sovereign control paradigm flows from a pluralistic theoretical foundation and provides a novel framework for the balancing of different interests that are affected by the behaviour of large public corporations.

> *"…the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself. That, in its essence, is Fascism – ownership of Government by an individual, by a group, or by any other controlling private power. … Among us today a concentration of private power without equal in history is growing".*
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> —F.D. Roosevelt[1]

> *"The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state"*
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> -A.A.Berle[2]

Introduction

This paper revisits the long-standing academic debate on the corporate objective, typically enshrined in the question of in whose interest large public corporations should be run. This has been traditionally addressed by two main theoretical paradigms: shareholder value and stakeholder theory. The global financial crisis (GFC) and events after it have re-ignited the urgency to firstly, further define this theoretical debate beyond the above dichotomy, and secondly, find an appropriate legal framework to address the fundamental question of corporate decision-making. Neither of these questions has however resulted in substantial changes in the way the problem of the corporate objective is treated in business and legal circles.[3]

Post-crisis regulation has not addressed the fundamental issue of the corporate goal and it has also failed to recalibrate at the higher level the question of the purpose of regulatory intervention. This is very central to the debate because it involves inter alia defining the rationale for public intervention in corporate affairs and more generally the degree to which private corporate interests should be subservient to social priorities.[4] The question of public interest has recently come to the fore in the context of the attempted hostile takeover of UK pharmaceutical giant AstraZeneca by its US counterpart Pfizer. Pfizer's bid sparked heated political debates because of the consequences that the takeover would have on research and development in the UK pharmaceutical sector. The widespread perception was that the Pfizer's strategy was

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[1] F.D. Roosevelt "*Message to Congress on Curbing Monopolies*", April 29 1938. Available at http://www.presidency.ucsb.edu/ws/index.php?pid=15637#axzz1Ze7GRv3W.

[2] A. Berle and G. Means "*The Modern Corporation and Private Property*", 2nd edition Harcourt, Brace and World, New York 1967 (first edition published in 1932), p.313.

[3] Despite interesting and thought-provoking proposals brought forward for instance by A. Keay "Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model", *Modern Law Review*, Vol.71 No.5, 2008; D. Attenborough "Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle", *Legal Studies*, Vol.32 No.1, 2012.

[4] On this J. O'Brian "Back to the Future: James M. Landis, Regulatory Purpose and the Rationale for Intervention in Capital Markets", in *Integrity Risk and Accountability in Capital Markets – Regulating Culture*, edited by J. O'Brian and G. Gilligan, Hart 2013.

aimed at breaking up AstraZeneca and eventually selling off its assets.[5] While a high bid could have met target shareholders' favour, the socio-political concern shifted to the long-term impact that the transaction could have had on the UK science and research environment, with losses of jobs and infrastructures following the acquisition of the largest British drug-maker.[6] This in particular led Labour representatives to invoke a public interest test on sensitive takeovers in order to block transactions that have a negative impact on the national economy.[7] At the time of writing, Pfizer's final offer has been rejected by AstraZeneca's board, despite pressure from its shareholders to reconsider the final bid.[8] This situation exemplifies the above mentioned friction between the private interest of shareholders, concerned with reaping the benefit of their investment (mostly in the short-term), and the broader public interest, reflected in this case by issues of science and research development. It is in the context of these highly topical junctures that this article contributes with a new approach to the problem of balancing diverging interests in the decision-making of large public corporations.

In the first part (section I), this article defines the importance and the difficulty of directing decision-making processes in large public corporations. This is followed in section II by a critique of the two main models of corporate management (shareholder value and stakeholder theory) which highlights each theory's assumptions and the impact that they have on the running of large public firms. While much has been written on the topic, the unfolding of events within the GFC shows that there remains the need to find an alternative approach to the issue of the corporate objective, mainly because of its centrality in defining legal strategies to control and direct managerial behaviour, but also because of the shortcomings of the above models.

The asserted urgency to find a new theoretical model to govern managerial actions and align them with the interests of a broader range of constituencies leads to the proposition of a new framework. The enlightened sovereign control (ESC)

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[5] M. Wolf "AstraZeneca is more than investors' call", *Financial Times*, 8 May 2014, available at http://www.ft.com/cms/s/0/6fe31054-d691-11e3-b251-00144feabdc0.html#axzz33PqNE3d6.

[6] See J. Kollewe "Labour threatens to block AstraZeneca takeover bid if it wins 2015 election", *The Guardian*, 16 May 2014, available at http://www.theguardian.com/politics/2014/may/16/labour-threatens-to-block-astrazeneca-deal-if-it-wins-election.

[7] Ibid.

[8] See R. Neate "AstraZeneca tells shareholders to stop pressuring it to reconsider Pfizer", *The Guardian*, 20 May 2014, available at http://www.theguardian.com/business/2014/may/20/astrazeneca-chairman-leif-johansson-shareholders-pressure-pfizer.

paradigm is put forward, in section III, as an alternative model to shareholder value and stakeholder theory. In proposing a pluralistic theoretical foundation, it provides the background for more specific measures to regulate managerial behaviour and channel decision-making in boards of directors. Section IV provides some concluding remarks.

I – Defining the problem

A – The importance of decision-making in large public corporations

The economic crisis that is ongoing since 2008 has re-evoked memories of the 1930s Great Depression and more surprisingly of the regulatory and policy concerns that emerged at that time. The quotes at the beginning of this paper reflect striking similarities with some of the issues that are currently faced both within academic and political circles. While President Roosevelt pointed in more general terms to the concentration of private power as a threat to the functions of a democratic state, Berle had framed the problem by identifying public corporations as the vehicle that elicited the concentration of private power, which could supersede the democratic state and escape regulation.[9]

This section provides a background to the article's main theme as it introduces and explains why it is important to establish sound mechanisms of decision-making in large public corporations.

Large public corporations[10] have today reached a new zenith. In the age of globalisation, their position within society has become increasingly central because they stand as catalysts of financial, economic and social changes. While this was already recognised by Berle, the magnitude of corporate power has today reached a new dimension. One reason for this is the much augmented interplay between corporations and capital markets that has taken place since the 1980s in the UK and the US. The liberalisation and then the progressive deregulation of financial centres (chiefly London and New York, but this process extended globally) created new opportunities for multinational corporations to diversify sources of capital and

[9] Ibid.

[10] Large public firms are referred to in this article as listed corporate entities that, because of their size and activities, create externalities on a varied range of constituencies. Examples of this category are represented by financial institutions, multinational corporations, or companies involved in the extraction of natural resources. This categorisation will be discussed in more detail in the second part of this article. For an explanation of what is meant by "large corporations", see J. Parkinson "*Corporate Power and Responsibility*", Clarendon Press Oxford, 2002, p.4.

enhance their returns through innovative corporate finance strategies.[11] The increased interdependence with corporate finance logics accentuated the alignment of corporate decision-making with the pursuit of increases in share value (i.e. shareholder wealth maximisation) which has also become the main metric to gauge corporate success. Even though this specific goal is not prescribed by the law – both in the UK and in the US[12] – it has come to represent the chief priority of corporate management, often to the detriment of other constituencies that are also vital components of corporations.[13]

The process just described, referred to as "financialisation" of corporate law, has extended beyond the UK and the US.[14] Even though there are reasons to believe that there is no "end of history" in sight for corporate law[15], the business model based on shareholder value (which could also be referred to more broadly as shareholder capitalism[16]) has been widely exported over the last three decades[17], giving rise to similar legal issues and socio-economic questions across a variety of jurisdictions.[18] Some of these legal issues have surfaced repeatedly through a number of crises and scandals that occurred over the last decade and the GFC has proposed them with new vigour. Generally speaking, corporate governance problems can be encapsulated in the failure to establish sound mechanisms of control over managerial behaviour. This pertains to both internal governance mechanisms, represented most prominently by the function of non-executive directors (NED) on the board, and to external

[11] This was already epitomised in the Enron-type scandal where the company's core business became subservient to financial and accounting techniques for the purpose of profitmaking. See J.N. Gordon "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", *Columbia Law School, Centre for Law and Economic Studies*, working paper no. 203/2002.

[12] See V. Bavoso "The Global Financial Crisis, the Pervasive Resilience of Shareholder Value and the Unfulfilled Promises of Anglo-American Corporate Law", 6 *International Company and Commercial Law Review* 213, 2014.

[13] In this sense: M. Jensen "Value Maximization, Stakeholder Theory and the Corporate Objective Function", 12(2) *Business Ethics Quarterly* 235, 2002.

[14] See L. Mitchell "*Corporate Irresponsibility – America's Newest Export*", Yale University Press New Haven 2001.

[15] See H. Hansmann and R. Kraakman "The End of History for Corporate Law?", 89 *Georgetown Law Journal* 439, 2001 which discusses the emergence of shareholder-value ideology; and D. Kershaw "No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance", 2 *Journal of Corporate Law Studies* 34, 2002, which provides a different perspective.

[16] See K. Williams "From Shareholder Value to Present-Day Capitalism", *Economy and Society*, Vol.29, No.1, Feb.2000, p.6. It is observed that shareholder value is not a viable principle for industrial and commercial companies which would have to compete for product market supremacy rather than capital market supremacy, prioritising therefore a different set of interests, namely product innovation vs returns on equity holders.

[17] Supra Mitchell "*Corporate Irresponsibility*", 2001, Introduction.

[18] See for a reflection on European and Nordic Company Law: B. Sjafjell "Regulating Companies As if the World Matters: Reflections from the ongoing Sustainable Companies Project", 47 *Wake Forest Law Review*, 113, 2011, 129-130.

mechanisms, which rely on market forces (chiefly the employment of stock options, or the market for corporate control) and on the role of gatekeepers. At a higher level, a more deep-seated corporate governance problem is represented by the unresolved dilemma of the corporate objective, which has become more urgent because of the widespread employment of shareholder value as parameter of corporate success.[19]

It is worth stressing that identifying the corporate objective with the interest of one constituency, shareholders, proves more problematic in the context of large corporations, because these entities are the offspring of the cooperation between different stakeholders[20], and more importantly because their actions can create externalities on a very broad range of corporate and societal constituencies. In this context, the corporate governance problems just highlighted are exemplified by the failure of boards of directors (BoDs) to weigh different interests at stake and to understand the long-term risks related to certain activities. Relevant illustrations in this sense are provided by the BP oil spill in 2010 and by the behaviour of most banks involved in the GFC.[21] Arguably these BoDs' failures were all underscored by the intellectual bias flowing from shareholder value rhetoric and from the short-term goals embedded in it.

Notwithstanding the lessons from recent and past crises, corporate law has remained anchored to a legal form that is very close to that of its initial modern codifications.[22] Despite reviews and law reforms, it has been observed that the current form of company law shows increasingly its inefficiency to face the ever-changing challenges that are posed by new corporate structures and by the ubiquitous influence of capital markets on corporate strategies.[23] This is the case especially in the context of leveraged financial institutions where the risk-bearers are not the shareholders but a broader range of stakeholders.[24] However, while large public corporations play a prominent role in society, their actions vis-à-vis societal stakeholders have remained

[19] This is discussed in A. Johnston "Reforming English Company Law to Promote Sustainable Companies", *European Company Law*, 11 No.2, 2014, pp.63-66.
[20]See M. Blair and L. Stout "A Team Production Theory of Corporate Law", *Virginia Law Review*, Vol.85 No.2, 1999, where the interplay between different corporate groups is analysed.
[21] See V. Bavoso "Sustainable Companies through Enlightened Boards: Combining Private and Public Interest in the Decision-Making of Large Public Firms", *European Company Law*, 11 No.2, 2014, pp.90-93.
[22] The UK Companies Act 1862 (which followed from the Joint Stock Companies Acts of 1844 and 1856) is widely recognised as the first comprehensive set of rules governing companies.
[23] This has been argued by S. Deakin "Corporate Governance and Financial Crisis in the Long Run", Centre for Business Research, University of Cambridge, working paper 417 2010, p7.
[24] Ibid.

unregulated or neglected by company law. This is largely due to the narrow framework that is widely accepted as being the mandate of company law, focusing chiefly on the relationship between shareholders and directors (i.e. the agency problem), and giving way to the shareholder primacy assumption.[25] Under this view, the regulation of other relationships, namely those affecting social stakeholders or the environment, should be left to contractual negotiations or to specific regulation external to company law.[26]

The GFC represents an ideal case study to support the contentions made in this article. Firstly, that the process of corporate decision-making has been flawed and it has failed to correctly appreciate issues of risk-taking.[27] Secondly, that corporate decision-making can impact on a wide range of constituencies both within and outside the corporate vehicle. In most cases though these constituencies – namely consumers, employees, creditors – have no say on how the company should be run and are not empowered by company law mechanisms to hold the board accountable.[28] Environmental disasters have also demonstrated the impact of corporate externalities on society and the long-lasting legacies that communities are left to bear. The BP oil spill in 2010 is a clear testament of the damages that can be caused to the ecosystem by corporate decision-making that is myopically geared to the maximisation of share value to the detriment of other long-term concerns.[29] The proposal put forward in this paper will provide a more inclusive mechanism to corporate decision-making that encompasses the balancing of different interests at stake.

B – Legitimacy and public accountability in large public corporations

[25] Supra Johnston "Reforming English Company Law to Promote Sustainable Companies", 2014. Johnston argues that this assumption is flawed and policy-making should consider broadening the scope of company law in order to take into account the interest of a wider range of stakeholders.

[26] M. Moore "*Corporate Governance in the Shadow of the State*", Hart Publishing Oxford 2013, p.64.

[27] In the financial sector risk-management is a central task of the board because of the systemic risk attached to certain products; these risks however were repeatedly ignored or misstated in the years prior to the crisis. See House of Commons, Treasury Committee "*The Run on the Rock: Fifth Report of Session 2007-08*", Volume 1, London, The Stationary Office Limited, 2008; and US Financial Crisis Inquiry Commission "*The Financial Crisis Inquiry Report*", January 2011, ch.3.

[28] Under UK and US law, the board of directors is delegated managerial power over all but the most important issues (where shareholders' consent is needed) and is accountable to shareholder.

[29] In the case of BP, the observation of environmental laws and corporate social responsibility was subordinate to the pursuit of shareholder value and other stakeholders were not adequately represented on the board. See M.A. Cherry and J.F. Sneirson "Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster", *Tulane Law Review*, Vol.85:983, 2011, p.114.

The questions raised in the previous section lead to the fundamental task of finding sources of legitimacy to the decision-making process in large public corporations. Before providing in the next sections a critique of the two guiding criteria of corporate management, this section will delineate the difficulties associated with directing and controlling BoDs' decision-making.

Traditionally, the central concern with UK and US corporate law has been related to the regulation of the agency problem.[30] This flows directly from the delegation of managerial powers to the board and the resulting separation of ownership and control.[31] The divorce of the two main components of corporations (equity ownership and the relating management) triggered the necessity to find a model of corporate governance that provided legitimisation of the decision-making process within large public corporations. The resulting problem of managerial hegemony was initially identified by Berle who recognised that the modern corporate form epitomised by large public firms with dispersed ownership gave rise to a control void. While this was considered an intrinsic feature of the modern corporation, it posed questions of accountability and legitimacy.[32] It is useful to appraise here how the pioneering work conducted by Berle approached the problem that is today persisting in contemporary corporate governance.

Interestingly, despite acknowledging the development of capital markets as a means of capital allocation, Berle remained dismissive of the powers of the market as a discipline mechanism over managerial behaviour. This stemmed from Berle's doubts on the informational efficiency of capital markets, which he argued were reflected in the irrationality of investors' decision-making and in their incentives to choose strategies often not aligned with the long-term interest of the firm.[33] As Berle was also cognisant of the increasingly externalised (and arguably residual) role of shareholders in the governance of corporations[34], the main source of direction over corporate decision-making rested on professional managers who were tied to the

[30]See E. Fama "Agency Problem and the Theory of the Firm", *Journal of Political Economy,* 1980 vol.88.
[31] See E. Fama and M. Jensen "Separation of Ownership and Control", 26 *Journal of Law and Economics* 301, 1983.
[32]See A. Berle and G. Means "*The Modern Corporation and Private Property*", Harcourt, Brace & World 1967, chapter 1 book 2.
[33]Ibid, introduction.
[34] This is thoroughly discussed by M. Moore and A. Reberioux "Corporate Power in the Public Eye: Reassessing the Implications of Berle's Public Consensus Theory", 1109 *Seattle University Law Review,* Vol.33 No.4, 2010 p.1116-17.

company through trust and property law mechanisms.[35] While this did not solve the accountability deficit and if anything it further exacerbated it, Berle also developed a theory of "public consensus" based on the existence of a set of values endorsed by the community, and often by the corporation too. In Berle's rather optimistic view, the company's decision-makers would not disregard the interest of the community due to citizens' increasing influence on corporate affairs.[36] Moreover, under this design the public consensus would be enforced on managers because of a "corporate conscience", represented by managers' perception of the public consensus.[37] This is close to what is recognised today as firms' reputation, described as "loss of prestige, public standing and popular esteem", which would undermine the public trust towards the corporation.[38] This represented a first level of informal constrain over corporate decision-making according to Berle and it would be supplemented by more forcible measures in the shape of regulation, which reflected the democratic force of the state reacting to a violation of the public consensus.[39]

The idea that management would not act in a way that is contrary to what is perceived as "public good" represented probably an overvaluation of the democratic mechanisms available to the general public. Enforcing the lack of consensus against corporate power (the board) was and remains today prerogative of shareholders, both in the UK and in the US.[40] In this sense then, the control void identified by Berle remained legally unresolved, especially given his lack of faith in shareholders to be able to bring about accountability in a wider context. This argument is even stronger today, because institutional shareholders (representing a large slice of the shareholder population in the UK and the US) are increasingly identified with hedge funds and similar investment vehicles. These entities hold stock for short periods of time averaging eight months and therefore tend to have little interest in the company's long-term success, with their main concern being represented by quarterly gains.[41] Ultimately, the solution to the accountability problem envisaged by Berle seemed to

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[35] Supra Berle and Means "*The Modern Corporation and Private Property*", 1967, chapter 7 book 2.
[36] The idea of public opinion was initially introduced in "The Modern Corporation and Private Property" and was later expanded in A. Berle "*Power without Property: A New Development in American Political Economy*", Harcourt Brace, 1959.
[37] Supra Berle "*Power without Property*", 1959, p.91.
[38] Ibid, p.92.
[39] Ibid, p.114,115.
[40] Supra Bavoso "The Global Financial Crisis" *ICCLR* 2014, p.215.
[41] A. Keay "The Global Financial Crisis: Risk, Shareholder Pressure and Short-Termism in Financial Institutions", 2011, available at
http://ssrn.com/abstract=1839305, p.10,11.

be a "least bad" scenario, with corporate power held by professional managers, only theoretically accountable to a community consensus.[42] As already stated, finding new forms of legitimacy to the decision-making process of large public corporations remains an open task in corporate law scholarship.

The question has been reprised by Parkinson who in more recent times stressed the importance to find a public interest justification of corporate power.[43] The central argument of Parkinson's work was the recognition of public corporations as a force capable of shaping society. As such, the public outcome of private (internal) decision-making needed to be legitimised so that modern corporations could provide some form of public or social purpose to the wealth they created. In essence, he viewed large public firms as forms of social enterprises.[44] This line of thought has been supported by both legal and political theory. In particular, it has been maintained that the possession by private companies of decision-making power which has a social dimension is legitimate only if decisions are taken in the public interest. It follows that society is entitled to ensure that corporate power is exercised in a way that is consistent with the public interest.[45] Parkinson's argument was ultimately not aligned with the conventional wisdom prevailing over the last three decades, that pursuing shareholder value would bring about benefits for all other stakeholders and more generally that profit maximisation was conducive to public interest goals.[46]

At this stage of the discussion it needs to be specified that the problems so far debated are originally related to the Anglo-American corporate ownership structure and its model of corporate governance. However, it has been argued by Professor Mitchell that this model has been exported globally, together with the process of "financialisation" of corporate governance[47], which inevitably attenuated the

[42] Supra Berle "*Power without Property" 1959, p.109 where Berle defined management as "community of best minds".*
[43] J. Parkinson "*Corporate Power and Responsibility*", Clarendon Press Oxford, 2002.
[44] Ibid, p.23.
[45] M. Eisenberg "Corporate Legitimacy, Conduct and Governance – Two Models of the Corporations", 17 *Creighton Law Review* 1, 1983.
[46] Supra Parkinson 2002, p.41, 42. Parkinson contended that there was no conclusive evidence suggesting that profit maximisation is consistent with public interest.
[47] Supra Mitchell "*Corporate Irresponsibility*", 2001, p.7. Mitchell observes that globalised consulting accounting and law firms sell advice based on shareholder value to companies in Europe and globally, and they sell the US way of doing business; moreover legal and business consultants have contributed to drafting Corporate Governance codes in developing countries and imposed a model of Corporate Governance based on shareholder value.

difference between shareholder and stakeholder orientations.[48] The global integration of financial markets that occurred from the 1990s was mainly prompted by ideological developments from the UK and the US. These were grounded on the undisputed reliance on market discipline and shareholder value, and similarly global financial institutions promoted the application of the shareholder-oriented model across many different jurisdictions.[49] However, as discussed earlier, there has been no end of history in corporate law. Scandinavian countries, as well as Germany or France have maintained a more balanced approach to corporate governance and financial development by prioritising issues of social stability and welfare.[50] This argument is important for the present discussion because it shows that a different model to control and direct corporate decision-making is possible and it is eventually rooted in different ways to regulate corporate relationships.[51] This fundamental differentiation originates from a different idea of corporation that emerged in Germany and other northern European countries, and is still reflected today in a process of decision-making that allows greater centrality to employees' interests.[52]

Early German companies were already concerned with general welfare interests and were geared to social goals rather than simply the pursuit of profits for shareholders, which characterised their UK counterparts.[53] German companies were the product of a different regulatory framework which reflected a type of capitalism centred on cooperation and pluralism, where the state retained a central and at times intrusive role in steering market players' behaviour towards these goals.[54] Similarly, German financial markets were traditionally characterised by the overwhelming role of large banks vis-à-vis securities markets, which entailed a more limited access for corporations to disintermediated sources of finance and less interdependence with market logics.[55]

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[48] See S. Lutz and D. Eberle "On the Road to Anglo-Saxon Capitalism? German Corporate Governance and Regulation between Market and Multilevel Governance", *CLPE* Research Paper 4/2007, Vol.3 No.3.
[49] Supra Hansmann and Kraakman 2001, p.451
[50] Supra Williams 2000, p.12. This also entailed that the interplay between corporate decision-making and capital market logics remained lower.
[51] ibid.
[52] See K. Pistor "*Codetermination: A Sociopolitical Model with Governance Externalities*" in "Employees and Corporate Governance", by M.M. Blair and M. Roe, 1999 p.163.
[53] J. Micklethwait and A. Woolridge "*The Company: A Short History of a Revolutionary Idea*", Random House 2003, p.80.
[54] Ibid, p.90-93.
[55] See H. Siebert "Germany's Capital Market and Corporate Governance", *Kiel Institute for World Economics*, Working Paper No. 1206, 2004.

The challenges of directing decision-making processes in a more inclusive way seems thus to be traditionally related to the Anglo-American model of corporate governance, based on large public companies with dispersed shareholding, driven by the pursuit of profits for shareholders.[56] The following section will clarify this contention by illustrating the shortcomings of the two main models of corporate governance: shareholder value and stakeholder theory.

II – A critical view of the existing models of corporate management

Since the 1930s, corporate law scholars have strived to address the fundamental question of the corporate objective and clarify what constituency should be identified as main beneficiary of corporate decision-making. This debate originated at Harvard, around the contrasting views of professors Berle and Dodd. The crux of the dispute was reflected in the dichotomy between a minimalist and a maximalist stance on corporate governance.

Professor Berle's approach was grounded on the configuration of managerial powers as powers held in trust, whereby the beneficiaries of that trust should have been the shareholders as owners of the firm. This minimalist position was grounded on Berle's view of property law mechanisms as tools to protect shareholders by creating legal safeguards against management's deviation from the ultimate profit goal.[57] Professor Dodd advocated what was defined a maximalist vision of corporate governance, whereby the powers held by management were not to be conceived only for the pursuit of shareholders' wealth, but for the benefit of other social groups too.[58]

The seeds of this quest have flown in more recent times into what has substantiated the corporate objective dilemma. As already announced, this is reflected in two models of corporate management that provide diverging approaches to the problem of controlling and directing decision-making: shareholder value and stakeholder theory. As will be explained in the following sections, these two paradigms originated from very diverging politico-economic assumptions developed in the 1970s and it is fair to say that the recent GFC has contributed to reassessing their appropriateness. A critique of both models will be useful to better understand the

[56] Supra Johnston 2014. It is observed that smaller companied tend to be subject to greater social control and are naturally constrained by social norms with respects to the effects that their decision-making create.
[57] See A.Berle "For Whom Managers are Trustees: A Note", *45 Harvard Law Review* 1365, 1932.
[58] See E. Dodd "For Whom are Corporate Managers Trustees?", *45 Harvard Law Review* 1145, 1932.

difficulty to channel corporate activities and provide sound mechanisms of accountability. This critique will also pave the way for the proposal of a new paradigm, the enlightened sovereign control (ESC), as an alternative model of corporate decision-making.[59]

A –A critique of shareholder value

The foundation of shareholder value lies in the emergence of financial-economic theories in the early 1980s, which in turn stemmed from the strong Neoliberal consensus that occurred in the same period, chiefly in the UK and the US.[60] In the context of corporate governance, this translated into the development of "contractarian" theories of the firm by law and economic scholars, which identified the company as a nexus of contracts among different constituencies, with shareholders recognised as owners and residual claimants.[61] This economics-centric approach advanced the concept of efficiency that justified the corporate goal of maximising returns for shareholders as the best possible allocation of resources.[62]

It is worth repeating that the prioritisation of shareholders ahead of other stakeholders became more critical in the last twenty years due to the increasing influence of capital markets on corporate strategies.[63] Deep and liquid stock markets were relied upon as sources of information as regards the value of stock[64] and as monitoring mechanisms.[65] This was exemplified more typically by the employment of stock options and other forms of market-based compensations which were envisaged as an ideal tool to align the interest of management and shareholders.[66]

The assumptions that justified the application of shareholder value have however become unpopular in recent years. The corporate scandals that occurred

[59] This is based on the proposal made in V. Bavoso "*Explaining Financial Scandals: Corporate Governance, Structured Finance and the Enlightened Sovereign Control Paradigm*", Cambridge Scholar Publishing Newcastle 2013, chapter 7.

[60] J. Parkinson "*Corporate Power and Responsibility*", Clarendon Press Oxford 1994, ch.4.

[61] F. Easterbrook and D. Fishel "*The Economic Structure of Corporate Law*", Harvard University Press, 1991, p.36-39.

[62] M. Friedman "The Social Responsibility of Business is to Increase its Profits", *NY Times Magazine*, Sept. 13 1970, p.32-33.

[63] L.E. Mitchell "Financialism: a (very) brief history", in the "*Embedded Firm"*, edited by C.A. Williams and P. Zumbansen, CUP 2011, p.42.

[64] See M. Moore and A. Reberioux "Revitalizing the institutional roots of Anglo-American corporate governance", *Economy and Society*, 40:1, 2011, p.89

[65] Supra Easterbrook and Fishel, 1991. Financial markets were seen as a way to counter "managerialism".

[66] See L. Bebchuck and J. Fried "Pay Without Performance: Overview of the Issues", *Journal of Applied Corporate Finance*, Volume 17 Number 4, 2005.

during the last decade and the GFC have contributed to provide greater strength to the critics of shareholder value.[67] This section lays out the arguments brought against the shareholder value paradigm.

The first strong argument made by legal scholars is that the economic conception of shareholders' ownership is misguided. It overlooks the fact that by law shareholders are merely owners of the shares they hold and not of the company.[68] This entails that rights and expectations are limited by law to what flows from their shares (typically a right to vote, and receive dividends) and this automatically defies the rhetoric of ownership that has essentially redefined the property rights of one constituency in the corporation.[69]

Similarly, the identification of shareholders as residual claimants has been strongly refuted. The rationale for the assumption was that unlike other constituencies who have a right to a fixed claim (such as employees, managers, creditors) shareholders rely on whatever remains after the company has paid its fixed claims.[70] Law and economic scholarship argued that as ultimate risk-bearers shareholders have the greatest stake in the company and should benefit from it being run for the purpose of maximising the value of stock.[71] This construction however, is based on an incorrect proposition because shareholders are treated by corporate law as residual claimants only when the company is insolvent.[72] Outside insolvency, shareholders are entitled by corporate law mechanisms to receive payments only if the company has retained sufficient profits, and if the board declares dividends to be paid.[73]

Together with the above two points, shareholder value rests on another assumption that derives from the economic (rather than legal) configuration of the company, namely the principal-agent model. This is closely linked to the contractarian view of the company advocated by Jensen and Meckling in the late

[67] Primarily reflected in the many works of Andrew Keay, Lynn Stout, Margaret Blair, Lawrence Mitchell.
[68] See L. Stout "*The Shareholder Value Myth*", Berrett Koehler San Francisco 2012, p.37. This legal stance can also be drawn from the legal definition of shares provided by courts in England, see *Short v. Treasury Commissioners* [1948] 1 K.B. 122.
[69] M. Blair "Shareholder Value, Corporate Governance, and Corporate Performance. A Post-Enron Reassessment of the Conventional Wisdom", in "*Corporate Governance and Capital Flaws in a Global Economy*", by P.K. Cornelius and B. Kogut, OUP, 2003, p.57.
[70] Supra Easterbrook and Fishel 1991, p.36.
[71] Ibid p.37.
[72] Supra Stout 2012, p.40. Stout observes that outside bankruptcy, it is wrong to suggest that shareholders are entitled to whatever is left once the company's obligations are paid.
[73] Ibid. This leads to concluding that shareholders are just one of several groups that can be described as residual claimants in the sense that they can enjoy benefits beyond those provided in their explicit contracts.

1970s and then consolidated in more recent scholarship.[74] The principal-agent model has however been strongly criticised for failing to capture the essence of large public firms. The economic structure of these entities is based on many fractional shareholders and different organisational layers of management, which go clearly beyond the simplification proposed by the principal-agent model.[75]

One of the presumed advantages associated with the shareholder model is the direct accountability that it creates because shareholders would be motivated to monitor the board. This assertion has become contentious for two reasons. Firstly, because the degree of accountability is not evident in large public corporations, where the effective powers of shareholders to control the board and shape its decision-making is not substantial enough.[76] Secondly, it is observed that shareholders are not a monolithic category as they encompass different categories and types of investors. Beyond having different preferences and interests in the company, their involvement in the company's affairs will also vary.[77]

Much of the criticism against shareholder value in the last ten years has revolved around the increased interplay of corporations with financial markets. In particular, the belief that share prices are a reliable measure of the value of the company has been contradicted. While deep and liquid stock markets do respond quickly to new information, it has become evident that share prices deviate substantially from their value through periods of boom and bust.[78] This has a number of explanations, primarily identified with the complexity of financial information that is transmitted to the market and the difficulty to process it correctly.[79] Behavioural explanations are also put forward because markets tend to overreact leading to investors' herding behaviour and other socio-pathological phenomena. This translates

[74] M. Jensen and W. Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", Vol.3 N.4 *Journal of Financial Economics* 305, 1976; F. Easterbrook and D. Fischel "*The Economic Structure of Corporate Law*", Harvard University Press Cambridge 1991; H. Hansmann and R. Kraakman "The End of History for Corporate Law", 89 *Georgetown Law Review* 439, 2001.
[75] In this sense, supra Stout 2012, p.36.
[76] See A. Keay "Company Directors Behaving Poorly: Disciplinary Options for Shareholders", *Journal of Business Law* 656, 2007. Keay notes that shareholders powers vary and are more effective in the UK than in the US, but still they do not amount to a reliable accountability mechanism to hold directors responsible if they fail to maximise share value.
[77] See A. Keay "Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model", *The Modern Law Review*, vol.71, no.5 2008, p.672.
[78] See L.A. Stout "Stock Prices and Social Wealth", *HLS Discussion Paper* No. 301, 2000.
[79] See S.L. Schwarcz "Regulating Complexity in Financial Markets", 87 *Washington University Law Review* 2, 2009.

into stock prices going out of line with their real value before investors can react.[80] More generally, share price can be misrepresented by market or industry fluctuations which do not necessarily reflect the real value of the company.[81]

In essence, share price has been tainted as an unreliable index of corporate success. This became evident after Enron, which showed how manipulated and misleading information could be released into the market. The pressure to maximise shareholders' wealth led executives to pursue short-term strategies finalised at inflating the company's share value, mainly through plain accounting manipulations or complex off-balance sheet transactions.[82] In other words, pursuing the quarterly growth of share price became the main goal of management, regardless of the company's fundamentals.

This problem was accentuated by the application of stock options, employed as corollaries of shareholder value to guarantee a strong link between firm's performance and managers' remuneration, whose interests would become aligned with shareholders.[83] The main problem of stock options is the incentive they create to pursue risky strategies. This is due to the intrinsic moral hazard they involve, because option-holders win big if the option goes up but are not penalised if the stock price plunges.[84] Shareholders' limited liability allows benefiting from high risks and high levels of leverage because they can reap the gains of the investment, while the underlying risks are borne by other stakeholders.[85] In highly leveraged financial institutions in particular, the opportunity for rapid expansion of financial assets and short-term returns on equity has led to excessive risk-taking.[86] Stock options have

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[80] Supra Blair 2003 p.59 and E. Avgouleas "The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy", 23 *Journal of Corporate Law Studies*, Vol.9, 2009.

[81] See T. Clarke "Accounting for Enron: Shareholder Value and Stakeholder Interests", *13(5) Corporate Governance 598*, 2005.

[82] W.W. Bratton, "Enron and the dark side of shareholder value", *Tulane Law Review, Public Law and Legal Theory* Working Paper n.035 2002 p.8.

[83] See M.M. Blair and L.A. Stout "A Team Production Theory of Corporate Law", 85 *Virginia Law Review* 247, 1999, p.249.

[84] S.L. Gillian "Option-Based Compensation: Panacea or Pandora's Box?", *Journal of Applied Corporate Finance* 14, 2001, p.116.

[85] S.M. Sepe "Making Sense of Executive Compensation", *Arizona Legal Studies* Discussion Paper No. 10-42, 2010, p.5.

[86] This is explained in E. Avgouleas and J. Cullen "Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship", 22 March 2014 at http://ssrn.com/abstract=2412869.

exacerbated executives' incentives to speculate through risky transactions because the options are more valuable the more risky is the underlying investment.[87]

The criticism towards executives' pay is often associated with more general concerns over the suitability of market mechanisms to control managerial behaviour and direct decision-making towards the long-term interest of the company. Much scholarship has been dedicated in the past to clarify whether the market for corporate control (in the shape of hostile takeovers) could represent a valid corporate governance tool. While no conclusive evidence has been produced in this sense[88], shareholder value proponents supported the assumption that the threat of takeovers would constitute a sufficient discipline mechanism on the board and that liability rules and statutory mechanisms would be superfluous.[89] Against this proposition, it has been argued that hostile takeovers often have detrimental effects on employees and other stakeholders[90] and they exacerbate short-termism when executives engage in "empire-building" strategies[91], something that has been feared in the context of the recent AstraZeneca's attempted takeover. Despite providing an allocative function of corporate resources, hostile takeovers' role as a corporate governance mechanism has been largely redefined as a residual one whereas other internal tools should provide the necessary control of managerial decision-making.[92]

B – A critique of stakeholder theory

The stakeholder theory originated from social-democratic ethos that were developed in the post-war years and were later channelled into a communitarian philosophy. This envisaged a more inclusive and multidimensional approach to corporate law.[93] The ideology was more clearly defined in the 1980s when the concept of stakeholder was integrated within organisational behaviour studies.[94] It posited that beyond shareholders, other constituencies contribute to the corporation and their interests too

[87] On the distorting effect of leverage, see M. Blair "Financial Innovation, Leverage, Bubbles and the Distribution of Income", *Vanderbilt University Law School* WP, 10-31 2010, p.12.
[88] Supra Parkinson 2002, p.113.
[89] Supra Parkinson 2002, p.132-134. It was suggested that the effect of implementing legal regulation on top of what is already provided by the market would be an inefficient distortion of managerial behaviour.
[90] Supra Deakin 2005, p.15,16.
[91] A. Singh "Take-overs, Economic Natural Selection and the Theory of the Firm", 1975 *Economic Journal* 497, p.497-515.
[92] J.C. Coffee Jr "Regulating the Market for Corporate Control: a Critical Assessment of the Tender Offer's Role in Corporate Governance", (1984) 84 *Columbia Law Review* 1145, p.1221.
[93] J. Gray "*False Dawn*", Granta 2009, p.94.
[94] See E. Freeman "*Stakeholder Management: A Stakeholder Approach*", Boston Pitman, 1984.

deserve consideration, particularly because they are often not covered by contractual provisions.[95]

Traditionally, German corporate law epitomises a typical stakeholder approach with its codetermination system. This grants employees certain powers in the management of the company by allowing employees' representatives to sit on the supervisory board.[96] In essence, the fundamental feature of stakeholder theory consists in having boards that undertake the function of balancing the interests of different constituencies.

The pluralistic foundation of stakeholder theory has been often pointed to as its main problem. This line of criticism became recurrent in the 1990 in connection with the stagnation of social-democratic economies in continental Europe.[97] It was then suggested that the theory could lead to inefficiency because it did not provide guidelines as to how the board should balance different (possibly conflicting) interests and it did not even define the concept of stakeholder, leaving therefore a problem of subjectivity in the identification of these interests.[98] The enforceability of stakeholders' rights was also seen as a problem because courts would find it problematic to interfere with subjective boards' policies, trying to impose objective standards.[99] The enforceability of stakeholders' rights is further hindered by the procedural barriers that in most legal systems do not permit all stakeholders to initiate derivative actions.[100]

Another problem associated with the stakeholder theory is the lack of standards to evaluate corporate performances. Departing in fact from shareholder value entails that share price is not relied on as the main metric of corporate success. The absence of equivalent stakeholder standards upon which the management can be evaluated leaves an accountability gap, also because there is no specific constituency that can hold the board accountable. From a different perspective, it would be unlikely

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[95] Ibid, p.97. The argument was that the board has a duty to create value for all the actors who are affected by the company's decision-making.
[96] M.J. Roe "German Codetermination and Securities Markets", 5 *Columbia Journal of European Law 3* 1999, p.9.
[97] Supra Hansmann and Kraakman 2001, p.451.
[98] E. Sternberg "The defects of shareholder value", 5(1) *Corporate Governance* 3, 1997 p.4,5.
[99] S. Kiarie "At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?", *International Company and Commercial Law Review, 17 (11) 329,* 2006 p.9.
[100] Supra Keay 2008 p.676. In the UK for instance only shareholders on behalf of the company are allowed to bring a derivative claim. Keay observes that unless they are also members of other stakeholding groups, they will be reluctant to bring an action that will entail costs.

that any group will perform an efficient monitoring function on the board for fear of other groups' free-riding.[101]

The above arguments have led to strong criticism relating to the competitiveness of corporations organised under the stakeholder model. The underlying objection is that departing from shareholder primacy would affect firms' ability to maximise their value because of the impossibility to balance conflicting claims and operate beyond a mono-dimensional (shareholder) goal.[102] Shareholder value proponents argued that this dilemma would be most clearly reflected in the context of takeover bids where the interest of employees is likely to conflict with shareholders and may induce directors to frustrating bids.[103]

This last critique carries also a normative dimension. Stakeholder theory would inevitably broaden the narrow framework that has so far characterised the mainstream Anglo-American approach to corporate law, because it would encompass and directly regulate the social costs created by the company (currently dealt with by external regulation or market mechanisms).[104] Moreover, this approach would be less competitive according to shareholder value proponents because of its less facilitative normative framework.

III – The need for a new model of corporate decision-making

A – Why a new model?

Much of the critique laid out in the previous sections is supported by corporate scandals that occurred throughout the last fifteen years. In particular, corporate and financial failures have coincided with the breakdown of shareholder value mechanisms: this was true for the Enron-type scandals, for the failures of financial institutions in the UK and in the US during the GFC, and for the environmental disasters epitomised by the BP oil spill.[105] The corporate governance dimension of these failures can be identified, inter alia, with flawed systems of decision-making. In

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[101] J. Salacuse "Corporate Governance in the new century", 25 *Company Lawyer* 69, 2004, p.75.

[102] See M. Jensen "Value Maximization, Stakeholder Theory, and the Corporate Objective Function", 7 *European Financial Management* 297, 2001, p.300.

[103] Supra Kiarie 2006, p.10; see also City Code on Takeovers and Mergers 2009.

[104] Supra Johnston "Reforming English Company Law to Promote Sustainable Companies", 2014.

[105] See W.W. Bratton, "Enron and the dark side of shareholder value", *Tulane Law Review, Public Law and Legal Theory* Working Paper n.035 2002; L. Stout "*The Shareholder Value Myth*", Brett-Koehler Publishing 2012; M.A. Cherry and J.F. Sneirson "Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster", *Tulane Law Review*, Vol.85:983, 2011; V. Bavoso "Sustainable Companies through Enlightened Boards: Combining Private and Public Interest in the Decision-Making of Large Public Firms", 2014.

particular risk-management and control functions were not adequately conducted by boards whose priorities remained geared towards the increase of share value to the detriment of long-term objectives.[106] This approach to corporate management resulted in the failure to take account of different societal interests that were heavily affected by corporate behaviours.

A more specific manifestation of this unfair societal arrangement is provided by recent events in the financial and environmental industries. In the banking sector the recent crisis unveiled a business model conceived to maximise rates of return on equity (essentially shareholder value) through aggressive asset growth, excessive leverage and minimisation of capital and funding risk.[107] This model contributed to increase short-term profits for shareholders by externalising the business risk onto other stakeholders (creditors and employees) and society (taxpayers). Environmental disasters provide an even clearer picture. The Deepwater Horizon oil spill illustrated BP's behaviour in the very critical supervision of high-risk activities. BP's board repeatedly ignored environmental legislation in favour of pursuit of short-term profits from oil extraction.[108] The board's focus was primarily on profitability and the company acted in a socially responsible manner only when this could contribute to its "green image" without hindering profitability.[109] This behaviour was the result of flawed decision-making where the board understated the importance of environmental laws and risks in order to pursue increases in share value. Ultimately, the many stakeholders' interests affected by BP's operations were not adequately represented on the board.

Admittedly, the failure of shareholder value to provide a valid model of corporate management has become evident since the early 2000s. This was recently confirmed by a EU Green Paper that acknowledged a number of problems in the governance of financial institutions.[110] It noted that a presumption of effective

[106] This is explained by R. Posner "*A Failure of Capitalism*", Harvard University Press 2009, p.80, where it is explained that risk managers' activity is not conducive to profit-making and therefore is often overlooked by the board.
[107] M. Onado "Northern Rock: Just the Tip of the Iceberg", in "*The Failure of Northern Rock: A Multi-Dimensional Case Study*", edited by F. Bruni and D.T. Llewellyn, The European Money and Finance Forum, 2009, 107.
[108] M.A. Cherry and J.F. Sneirson "Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster", *Tulane Law Review*, Vol.85:983, 2011, 114.
[109] Ibid, 115.
[110] EU Commission Green Paper "*Corporate Governance in Financial Institutions and Remuneration Policies*" COM (2010) 284.

shareholder control in financial institutions is misguided because shareholders will be concerned with short-term financial goals instead of the entity's long-term viability.[111]

However, this view has not translated in substantial reforms or shifts in policy directions. On the contrary, despite much criticism (particularly within academic circles[112]) shareholder value has remained the widely accepted criterion of corporate decision-making[113] and policy responses to the GFC have not departed from a shareholder-centric agenda.[114] This tendency shows that, notwithstanding the lessons drawn from recent events, the Neoliberal theories advancing shareholder supremacy are still very central to policy-making and law reforms in the area of corporate law.[115] In the UK, both the Stewardship Code 2010 and the Corporate Governance Code 2010 promoted wider shareholder participation in corporate governance. The former followed the recommendation of the Walker Review[116] and set out monitoring responsibilities on shareholders, and recommendations for institutional investors to act collectively to that end and on voting policies.[117] The Corporate Governance Code also promoted enhanced shareholder power specifically with regards to pay-setting procedures.[118]

As noted earlier, this approach is misguided in the context of large public corporations. It has been observed that fragmented ownership and foreign investments are not conducive to shareholders' enhanced participation[119] because the interest of this type of shareholders is largely geared to short-term quarterly gains[120] and active engagement in corporate governance represents costs that would reap economic benefits only in the longer term. This assertion is confirmed by shareholders' votes in

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[111] Ibid, p.8. The report specified that this attitude reflected shareholders' excessive risk-taking which is in turn encouraged by performance-related incentives for managers.

[112] This emerges from a number of initiatives, among which the "*Sustainable Companies Project*" promoted by Professor Beate Sjafjell at Oslo University.

[113] Supra Bavoso "The Global Financial Crisis" *ICCLR* 2014

[114] In the UK this is exemplified by the UK Corporate Governance Code 2010 and by the Stewardship Code 2010 (including its revised version of 2012), while in the EU similar views emerged from the EU Commission Green Paper "*The EU Corporate Governance Framework*" 2011.

[115] See L. Talbot "Why Shareholders Shouldn't Vote: A Marxist-Progressive Critique of Shareholder Empowerment", *The Modern Law Review* Vol.76 No.5, 2013 p.809-10.

[116] D. Walker "*A Review of Corporate Governance in UK Banks and Other Financial Industry Entities*", July 2009.

[117] Financial Reporting Council "*The UK Stewardship Code*", 2010, p.7,8.

[118] Financial Reporting Council "*The UK Corporate Governance Code*", 2010, p.22.

[119] See B.R. Cheffins "The Stewardship Code's Achilles Heel", *The Modern Law Review* 73:1004-1025, 2010.

[120] Supra Keay "The Global Financial Crisis: Risk, Shareholder Pressure and Short-Termism in Financial Institutions", 2011, p.11.

300 annual general meetings in 2012 where on average, vote against remuneration reports reached only 7.64 percent.[121]

One of the reasons for the resilience of shareholder value over the last fifteen years is the absence of an alternative model, given the mistrust in the US and the UK for stakeholder-based theories which are regarded as fundamentally impractical.[122] The flaws associated with shareholder-based decision-making processes however can no longer be neglected. Putting one constituency at the centre of very complex and multidimensional organisations has proven unjustified[123] and socially destabilising. The corporate governance failures, of which mention has been made, have created externalities on a number of constituencies whose interests were not adequately considered by BoDs, notably: employees, taxpayers, consumers, local communities, the environment. Notwithstanding the potential harm to large sections of society, complex risks (such as environmental or financial) in large public firms were consistently understated by executives who were kept myopically focused, due to perverse market incentives, on the pursuit of short-term goals.

The question as to why risks were not properly gauged is a complex one. Assessing and managing risks is among the most critical aspects of the decision-making process of large public firms. While this delicate process has resulted in unsatisfactory outcomes, it needs to be explained that in many circumstances warning signs were raised by risk-managers within firms. Posner has argued that BoDs driven by shareholder value goals are more likely to ignore red flags, chiefly because the function of risk-managers is not aligned with the overarching profit-making objective.[124] Boards on the other hand tend to rationally follow traders who pursue short-term profits driven by market-based incentives.[125]

The way in which risks have been underestimated in large public firms can also be explained through the mechanics of risk perception in boards. Behavioural studies have examined how psychological and cultural forces alter risk perception in large firms and thus affect decision-making. Langevoort has observed that overconfidence in periods of boom leads to persistence, effort and enhanced risk-

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[121] Supra Talbot 2013 p.814.
[122] A. Keay "Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model", *Modern Law Review* 2008, Vol.71 No.5, p.679.
[123] It is worth reiterating that the law does not mandate so in both the UK and the US. Supra Bavoso *ICCLR*, 2014.
[124] Supra Posner 2009, p.80.
[125] Ibid.

taking, which will outperform more realistic and cautious strategies.[126] Overconfidence, especially in times of boom, becomes embedded in the corporate culture and will result in common bias in the organisation, which also risks affecting the perception of those who conduct external assessments.[127] It is correct to say that the way risk is perceived within an organisation becomes institutionalised because of psychological and cultural forces that will make individuals believe that there is no risk big enough to worry about.[128] In the context of decision-making processes, overconfidence towards risk can become a self-fulfilling prophecy in times of good fortune. It is also true that overconfidence before the crisis was fuelled by the availability of risk modelling and risk mitigation techniques that further affected individuals' cognitive bias and led to institutional underestimation of risk.[129]

Boards' decision-making was also driven by investors' expectations. Keeping the stock price inflated required firms to keep "dancing"[130] because this form of behaviour was deemed functional to maintaining a competitive edge over other firms (especially in the financial sector) and satisfy investors' demands for quarterly gains.[131] This suggests that beyond the behavioural explanation of investors' irrational exuberance, stock prices were fundamentally mispriced because firms failed to disclose information to allow the accurate assessment of risk.[132] In other words, if share price remains the metric for corporate management, the distorted reactions of the stock market will likely produce biased behaviour among investors and affect in turn boards' decision-making.[133]

The brief behavioural explanations of corporate decision-making show that risk-management functions have been hindered by cultural and organisational factors.

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[126] D. Langevoort "Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk-Taking", 96 *Cornell Law Review* 1209-1246, 2011. See on this also G. Akerlof and R. Shiller "*Animal Spirits: How Human Psychology Dives the Economy*", Princeton University Press 2009.

[127] Ibid. the inside bias will influence non-executive directors and also gatekeepers because they will tend to believe in the inaccurate disclosure produced by those who have inside knowledge.

[128] Ibid, p.1242, the institutionalised perception therefore overrides the individual one and defies the assumption that managers act rationally.

[129] Ibid p.1221. Posner however argued that excessive risk-taking was primarily due to wrong incentives and moral hazard rather than psychological factors. Supra Posner 2009.p.80.

[130] This term is borrowed from the sentence used by Citigroup CEO Chuck Prince who stated at the outset of the 2008 crisis that "you've got to get up and keep dancing". This refers to strategies at firm level that would positively affect the stock price, hence the wilder the dancing, the higher the stock price.

[131] Supra Langevoort 2011, p.1231.

[132] See W. Bratton and M. Wachter "The Case against Shareholder Empowerment", 158 *University of Pennsylvania Law Review* 653, 2010.

[133]Supra Langevoort 2011 p.1233.

This means that the cognitive dimension of this fundamental function has been dominated by profitability instead of an objective assessment of risks.

A final note needs to stress that the Anglo-American shareholder-centric model of corporate governance has relied since the 1980s on non-executive directors (NED) to bring an independent outside perspective in the company's decision-making. The collapse of financial institutions during the GFC unveiled however a systematic failure of banks' financial strategies. This included general breakdowns in executives' duties but more importantly in the risk-management function performed by NED who were not able to scrutinise the transactions entered into by the bank and their increasing level of leverage.[134]

One problem associated with NED is that they tend to lack industry or firm-specific expertise because of the "outside" position they have with the company. It has also been observed that their primary function in public corporation is to manage the stock price and its maximisation in the short term, which effectively makes them guardian of shareholders' interests.[135] This contention is supported by the fact that their independence is particularly valued for the ability to relate to inputs by securities analysts and institutional investors as regards the optimal firm's capital allocation. This explanation is corroborated by their full inception in the US in the 1980s, at a time characterised by the increase in debt finance and LBOs and the employment of off-balance sheet financing.[136]

The dilemma related to NED's independence is that while their objective and detached perspective is necessary to balance CEO's and executives' irrational exuberance, this function equally depends on a certain degree of knowledge of the company's strategies and culture, which however risks defying NED's independence.[137] As noted by Moore, this tension between independence and expertise has clearly shifted over the last ten years, with the former prevailing in the 2000s and the latter in the post GFC period. As these requirements can hardly coexist

[134] See R. Tomasic, "Corporate Rescue, Governance and Risk Taking in Northern Rock (Part 1)" 29 *Company Lawyer* 297, 2008.

[135] See M. Moore "The Evolving Contours of the Board's Risk-Management Function in UK Corporate Governance", 10 *Journal of Corporate Law Studies* 279, 2010.

[136] J. Gordon "The Rise of Independent Directors in the United States 1950-2005: Of Shareholder Value and Stock Market Prices", 59 *Stanford Law Review* 1465, 2007.

[137] Supra Moore "The Evolving Contours of the Board's Risk-Management Function", 2010 p.28; in this sense also D. Walker "*A Review of Corporate Governance in Banks and other Financial Industry Entities: Final Recommendations*", 2009 para 3.7; and W. Ringe "Independent Directors: After the Crisis", *European Business Organization Law Review*, Vol.14 Issue 03, 2013, p.415.

in NEDs, this may result in more specialised boards in industries that involve complex products and/or an element of public concern (such as financial services or utilities), while independence may prevail in contexts where the main corporate governance concern remain the conflicts of interests at board level.[138]

More general criticism has pointed to the lack of incentives for NED to provide objective assessments. This has a twofold explanation. Firstly, the same behavioural explanations apply to NEDs who are acquiescent to market conditions in times of boom.[139] Secondly, agency problems extend to independent directors too, and this translates in dangers of "groupthink" between executives and independent directors with the same industry background.[140] In essence, the natural solution to this problem would be to bring ex ante an expert outside perspective to work inside the firm. The next section will illustrate how this could happen.

B – The enlightened sovereign control paradigm

The arguments laid out in the previous section exposed the urgency to find a new model to govern decision-making processes in large public firms and provide legal certainty to the question of the corporate objective. To address this task, this paper puts forward the enlightened sovereign control (ESC) paradigm as an alternative to shareholder value and stakeholder theory.

The concept of ESC is developed on the back of a number of company law theories and scholarly reflections which are highlighted in the following pages. The work conducted by Professor Mitchell emphasised the nature of corporations as "externalising machines".[141] He observed that while at the individual level decisions have an impact on the decision-maker who will often directly feel the effect of its consequences and hence will have moral constraints, the result of the same process within a corporation is depersonalised because of limited liability and the interposition of the corporate vehicle between decision-makers and those affected by the decision.[142] The corporate structure also allows externalising costs related to

[138] Ibid p.34.
[139] Supra Langevoort 2011 p.1233, who argues that NED lack motivation and interest in objectivity because they also prioritise profitability over caution in times of growth, when market mechanisms become legitimate.
[140] In this sense, Walker Review 2009 para 2.17.
[141] L. Mitchell "*Corporate Irresponsibility – America's Newest Export*", Yale University Press 2001, ch.2.
[142] Ibid, p.40-43.

corporate profit-making activities onto other groups who are affected by the corporation but have no powers to shape its behaviour. Mitchell argues that as artificial legal entities, corporations lack the framework that allows a moral perspective of the choice, and thus they are naturally led towards behaviours that are irresponsible and unaccountable. This contributes to creating a more unequal society.[143]

This line of critique leads to questioning limited liability and its conceptual foundations. In particular, this has involved the reprisal of the old concession company law theory, developed firstly in the Victorian age. The theory viewed limited liability as a concession concurred by the state, flowing into the right of incorporation.[144] While under this construction the company was seen as a right granted by the state and thus derived from its power, contemporary scholarship has revisited the theory in a more socialised form. Professor Dine has argued that modern corporations are actually derived from society because they benefit from the cooperation and interplay of several social groups. This implies a bottom-up concession theory whereby society represents the foundation of corporations and communities would have the power to influence corporate decision-making.[145] This line of thinking entails that companies would not only be derived from society, but they would be responsible to a democratically represented community.[146]

A strong pluralist approach in this sense has been developed by Teubner who expanded the gist of the traditional stakeholder concept. He regarded corporations as entities that should advance the privileges of both internal (such as shareholders or employees) and external groups (such as communities and the environment). The board would therefore be called upon the task of embracing a more holistic approach to management.[147] Teubner's proposition rests on the hypothesis that a corporation

[143] Ibid, p.43,44. Mitchell observes that this is so because decision-makers in the company take the shape of the company and are absorbed by the corporate culture.
[144] The idea of limited liability as a right concurred by the state brings back to the restrictions of the Bubble Act 1720, which prohibited joint stock concerns for commercial purposes. See A.H. Miller "Subjectivity Ltd: The Discourse of Liability in the Joint Stock Companies Act of 1856 and Gaskell's Cranford", *ELH* 61.1, 139-157, 1994.
[145] See J. Dine "*The Governance of Corporate Groups*", Cambridge University Press 2000, ch.4. The structure would be from the bottom because there would not be in this case a monarch or a sovereign giving the concession, but it would come from society.
[146] In this sense, P. Ireland "Property and Contract in Contemporary Corporate Theory", 453 *Legal Studies* 2004, p.506.
[147] G. Teubner "Corporate Fiduciary Duties and their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility", in Hopt and Teubner*Corporate Governance and Directors' Liabilities*, De Greuter Berlin 1987, p.157.

does not only exist as a self-serving and self-realising entity, but it has to fulfill a broader social role. In order to achieve this, the organisational structure of the corporation and the way it is managed should be shaped to reflect the interest of society.[148] This entails a different determination of the corporate objective because different social groups would become relevant insofar as they represent social interests and are in a position to control fiduciary duties.[149]

The ESC is proposed as an alternative model of corporate management and it embraces the motives of the above theories to the extent that they offer greater recognition of social priorities vis-à-vis economic ones. It draws from the overarching belief that social and welfare interests should be embedded among the goals of those corporations whose activities impact on a wide range of constituencies. The ESC recognises however the importance of public firms for the creation of social wealth and therefore looks at measures that would not curtail entrepreneurship. The ultimate need to combine economic interests and social concerns pushes towards a balanced (indeed enlightened) intervention of the state (hence the use of the word sovereign) as guardian of social interests (which implies control).

The ESC is cognisant of the natural tension between economic and social interests and of the need to regulate corporate activities in a way that promotes the former while protecting the latter. These conflicting concerns pose a dilemma as to how corporations could be regulated in a way that is both economically viable and socially sustainable in the long term. The way in which this interest-weighing problem is addressed under the ESC is by creating a two-tiered classification of corporations, each attracting a different degree of state intervention.

The justification for state intervention in corporate affairs rests on the following argument. While the quasi-regulating powers of the market and the related financial-economic theories that developed from the 1970s have advanced the pre-eminence of firms' economic interests[150], a broader concept of corporate law

[148] Ibid, p.157.
[149] Ibid, p.165-167. This may entail a process of "proceduralisation" of fiduciary duties directed at the creation of organisational structures that allow the optimal balancing of corporate performance and function, taking into account at the same time the interest of the non-economic environment.
[150] Chiefly through "contractarian" theories of the firm centred around the agency relationship between shareholders and directors. See C. Bruner "Power and Purpose in the Anglo-American Corporation", *Virginia Journal of International Law*, Vol.50, N.3, 2010.

encompassing wider socio-economic interests has been understated.[151] The resulting narrow view of company law has hindered its role in regulating a number of legal relationships that give rise, inter alia, to social costs.[152] This has caused a democratic deficit in large public corporations, consisting in the lack of public legitimisation of managerial powers within society.[153] While the decision-making process in such entities has had effects on a broad range of social constituencies, it has remained anchored to the interests of a very narrow section of society, the stockholders. The model proposed in this article therefore aims at filling this democratic deficit by providing a legitimisation of corporate decision-making for entities whose activities impact on society.

The state is envisaged under the ESC as the natural custodian of different societal interests because of its democratic underpinning. It needs to be clarified that the inclusion of a democratic-based social interest in BoDs would be premised on the setting up of a permanent, state-based institutional/regulatory body[154], independent from both government and the market.[155] Independence would be achieved through an institutional design whereby the body is independent from political control, but at the same time accountable through procedural constraints.[156] The aim would be to create a permanent public institution that is not affected by problems of "time limit" which are typically associated with changes in governments and political fluctuations. At the same time the institutional body's public link would be preserved through accountability procedures established with relevant ministries, which would ensure consistency with broad social interests.

State intervention is premised on a two-tier classification of public corporations. The first tier is designed to comprise entities whose activities can create externalities on society. This classification categorises firms beyond size, ownership structure or industry sector. While financial firms for instance are today perceived as

[151] See G. Teubner "Corporate Fiduciary Duties and Their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility", in Hopt and Teubner "*Corporate Governance and Directors' Liabilities*", De Greuter Berlin, 1987.
[152] Supra Johnston 2014, p.3.
[153] J.E. Parkinson "*Corporate Power and Responsibility*", Clarendon Press Oxford 2002, ch.1.
[154] This institutional body is conceived as a new type of state regulator. A full discussion on its institutional design and modus operandi is provided in V. Bavoso "*Explaining Financial Scandals: Corporate Governance, Structured Finance and the Enlightened Sovereign Control Paradigm*", CSP 2013, ch.7.
[155] This is conceived as a very different entity from the Independent Regulatory Agencies that emerged, especially at EU level, after the 1980s. See on this G. Majone "The Regulatory State and its Legitimacy Problems", *West European Politics*, 22:1, 1999, p.2.
[156] Supra Bavoso 2013, p.256.

intrinsically dangerous for many social groups due chiefly to the systemic importance they bear, other corporate entities can equally cause harm to society because of the activities they conduct.[157] According to the ESC, the social interest needs to be factored into the regulation of these entities. More specifically, the type of supervision and control over boards' decision-making would guarantee that the social role of tier-one corporations is fulfilled and that costs created by the entity are internalised.

From a practical standpoint, the representation of the social, democratic-based interest on BoDs would occur by drawing professionals from the aforementioned institutional body to serve full-time on the board in a capacity similar to that of non-executive directors. While serving on the board, professionals would still be remunerated with public money by the institutional body from which they are drawn. This institutional arrangement would enhance the independent balancing of different interests at stake in the decision-making process of tier-one firms and avoid issues of groupthink. It would implement a corporate objective aligned with the multidimensional aspects of the business.

The second tier of public corporations would include firms that, regardless of size, pose only limited risks to society, either because their eventual failure would not threat social welfare to a considerable extent, or because their business does not affect the interests of a broad range of social groups and local communities. These entities would be subject to a regulatory framework typical of public companies, and their decision-making processes would not be shaped by social concerns beyond a voluntary approach. In other words, the corporate objective of tier-two corporations would remain aligned to the interest of shareholders as private corporate interests would prevail over social ones.

The classification proposed under the ESC is based upon five criteria that are designed to assess whether corporations can have a negative impact on society. In essence, the degree to which firms trigger the emergence of the five criteria will determine whether they fall under tier-one or tier-two regulatory framework. It is useful at this stage to provide a list of the five criteria employed under the ESC.

Firstly, the entity's size and number of employees at group level would provide an initial parameter to determine whether the business activity should attract

[157] Examples of environmental disasters made earlier serve to clarify this point, but other entities, like pharmaceutical corporations too may retain a social importance because of the public interest inherent in their activity.

sovereign control. A large workforce can shape decision-making particularly when a high number of jobs are at stake, as it is the case during takeovers for instance. Social concerns would also emerge when a city or a regional community rely on a large corporation for occupation and strategic industrial purposes.

The second criterion would also provide a means to quantify the entity's position in society and it looks at group turnover. A very high turnover should attract public scrutiny because of the fiscal and financial repercussions that this may have. In particular, the audit of such entities would need to draw specific attention to a range of financial and accounting issues, such as off-balance sheet liabilities and the entity's level of leverage.

The third criterion shifts the assessment onto another aspect of corporations' activity. It focuses on the geographical spread of the business and it is thus directed to a large degree at multinational firms. Multinational entities benefit from economies of scale that allow extracting value from society often due to decrease in competition. Their economic position also put them in an ideal position to exploit the benefit of regulatory arbitrage, particularly with respect to tax issues. A higher degree of public scrutiny over these entities would be needed to socialise the economic advantages that derive from this organisational pattern and direct it towards more inclusive goals (beyond profit-making for shareholders).

In connection with the geographical spread, the fourth criterion looks at the range and nature of business activities. This has a twofold significance because it firstly examines the degree to which firms embrace multiple areas of business, becoming therefore conglomerates. This has increasingly been the case within the financial services industry, where deregulation has allowed the proliferation of too-big-to-fail institutions. As in the previous criterion, the same rationale for sovereign control over the entity's decision-making would apply in this context. This criterion is also important because it refers to the nature of the activity conducted by the corporation (or the group). This in turn encompasses both a public interest test over those activities (whether they attract broader societal concerns as it is the case for instance for energy, pharmacy and media), and a test concerning the level of risk that the activities pose on society (example would be the environmental risks related to oil or mining extraction).

The final criterion looks at the externalities on social groups and it represents a synthesis of whether and to what degree corporate activities can have a negative impact on a wider range of societal groups, according to the first four criteria.

This article contends that the proposed institutional framework of tier-one companies would contribute to provide legal certainty to the unresolved question of the corporate objective. Firstly, it would impact on the dynamics of board decision-making. The passing of major board resolutions would be subject to the special powers vested in the professionals drawn from the institutional body described earlier. The majority of them would need to approve the resolution, ensuring that due regard is given to the social dimension of corporate strategies together with the economic one. Equally, a majority of the professionals would have powers of veto over high-risk activities, or alternatively they could refer specific resolutions raising higher concern to the professional body (examples would be transactions whose long-term effects impact on the firm's level of leverage and thus threat systemic stability, or takeovers within sensitive industries that impact on national interests). Most importantly, these powers would result in an ex ante gatekeeping function performed within the board of tier-one corporations. This is so because the judgement of state professionals would remain aligned to the social dimension of tier-one entities, also due to their compensation structure. Fixed salaries would more likely keep professionals averse to the high level of risk-taking that has been induced by perverse market incentives like stock options.

Secondly, the proposed design would bring intellectual and professional resources which are currently lacking from BoDs. It was argued earlier in the paper that NEDs have failed to provide an expert and independent perspective to curb the high-risk strategies (such as financial or environmental) implemented by their firms. State professionals would complement the expertise already available on BoDs because of their different independent background and this would allow them to depart from shareholder-oriented bias. Their powers would essentially impact on corporate decision-making by pursuing the corporate objective in a more balanced and contextual way. Drawing from some of the boards' failures that characterised the GFC, it can be argued that state professionals would be able to heed warning signs raised by risk-managers, whereas directors of financial institutions were incapable of doing so because they were hindered by shareholder value bias and followed the irrational exuberance of traders, motivated by lust for short-term profits.[158] In essence, the intrinsically truncated rationality of market actors would be complemented by a more socially responsible approach to business and a deeper awareness of its long-term implications.

IV – Concluding remarks

This paper has advanced the urgency to recalibrate the corporate objective of large public corporations towards more socially inclusive goals. The analysis conducted in the first part of this article reviewed the old-standing dilemma to find a public interest justification to the managerial power of large corporations. The quest of creating mechanisms of public accountability was already recognised by Berle who relied on the optimistic construction of his "public consensus" theory; more recently Parkinson further defined the problem by highlighting the void in democratic legitimacy characterising corporate management.

The difficulty to construct a viable model of corporate management, encompassing both business and social interests, is reflected on one hand by the ambiguous ubiquity of shareholder value, which has survived a number of crises and much criticism, and on the other hand by the reluctance (particularly in the UK and US) to adopt a stakeholder orientation to corporate governance. The critique provided in section II, shows that neither of the two models is suitable to deliver legal certainty in the process of decision-making and that problems of democratic legitimisation of managerial power have remained unresolved. The corporate scandals that occurred in succession from the early 2000s contributed to amplify this void and suggest that large public corporations need to embed wider societal interests among their objective.

This paper proposed a new model of corporate management, the enlightened sovereign control, to fill this void. In constructing a two-tier classification of public corporations, the ESC advocates a state-based democratic intervention in the decision-making process of tier-one companies. The priority of this model is to bring an external element of judgement in boards' management in order to counter the intellectual bias that persists within corporate and financial organisations. Behavioural explanations put forward in section III deconstructed the presumed rationality of

[158] Supra Posner 2009, p.80.

market-players' decisions chiefly because of the persistence of bias within corporate environments.[159] This justifies solutions that seek either an external regulation of the process of decision-making or a change in the environment in which decisions are taken. The ESC provides both the former insofar as it brings external non-market-based expertise on the board, and the latter, by shaping the environment in which decisions are taken.

In particular, the state professionals drawn from the institutional body described in section III would constitute a new "knowledge-based" profession[160] (by virtue of an ad-hoc educational path) capable to offer a deeper awareness of critical decision-making processes and thus bring about much needed balancing of different interests at stake.

[159] Supra Langevoort 2011.

[160] It is worth specifying that the different intellectual background of state professionals would be the result of a new profession that currently, despite similarities with academia or the bar for instance, does not exist.