IS STAKEHOLDER GOVERNANCE A GOOD CORPORATE STRATEGY

In December 2020, Harvard Professor Lucian A. Bebchuk and Roberto Tallarita published a paper entitled: *The Illusory Promise of Stakeholder Governance*. (See Harvard Law Discussion Paper No. 1052 Dec. 2020) The authors define "Stakeholderism" as the "non-shareholder constituencies of the corporation including employees, customers, suppliers, committees and the environment." The authors trace the history of Stakeholderism back to pre 1800's when 75% of corporate charters were for public services, so the corporate charter was a privilege bestowed on companies to address public benefit needs. Once the system switched from a privileged charter, to a general incorporation construct for any company business, the main purpose of a company evolved basically to simply making a profit, which became the predominant position in the early 1900's.

The 1900s became known as the age of managerialism because managers held the power in corporate entities. Things went along as such until the 1970s when Milton Friedman introduced the so-called "shareholder primacy" construct that evolved into free market capitalism by the end of the 20th century. But when the hostile takeover deals exploded in the late 20th century, the public calls for anti-hostile takeover regulation grew louder. Given these two contrasting constructs, the question became, from a broader context, what is an "efficient and effective" way to operate a modern corporation? The author bluntly concludes that "the illusory purpose of stakeholderism should not be allowed to advance a managerialist agenda and to obscure the critical need for external interventions to protect stakeholders via legislation, regulation, and policy design." The new construct, known as "Stakeholder Capitalism," has officially arrived. Whether it's the Business Roundtable ("BRT") annual letter to investors, or the Davos Manifesto calling for revisiting the purpose of a corporation and stakeholder interests, the authors cite Martin Lipton (i.e., partner at WLRK) as describing 2019 as a "watershed year in the evolution of corporate governance." The co-authors of this Article's response to the evolution is that Stakeholderism should be rejected, including and especially by, those who take stakeholder interests seriously.

So which is the right path for corporations to go down? The authors say that shareholder governance should not be pursued at this time because there are several open questions. First, what counts as being affected by a corporate decision in order to be included in the definition of a stakeholder? Second, once the stakeholder group is defined, the next question to be resolved is how to weigh and balance (i.e., tradeoffs) the various decisions of the corporate directors and officers will have on various stakeholders. Until these two criteria are met, the construct of stakeholder capitalism is just an idea, or worse, just done for show so because it creates an "illusory promise." Why? The authors state that "[o]nce we recognize the critical dependence of stakeholderism on the discretion of corporate leaders, we must conclude that any evolution of stakeholderism, and any support for it, should be based on a prior analysis of how corporate leaders should be expected to use their discretion." The co-authors then provide their analysis of how it will all play out.

To prove their skeptical position on stakeholder capitalism, the authors cite as evidence the most recent BRT 2019 and 2020 statements. They conclude that (i) the directors of most of the corporations never requested their board of director to approve the BRT Statement for same, and (ii) executive compensation packages are not geared towards stakeholder-centric corporate operations. Ergo, they conclude that the position is just a theory. Even worse, the authors say it's counter-productive, because it allows directors to decide what is an appropriate stakeholder capitalism governance construct, versus legislation that makes certain fundamental conduct legal or not legal. So the BRT is the "straw man" target that these authors create to show that stakeholder governance is just more talk than action. In summation, they call stakeholder capitalism counterproductive and harmful when compared to more promising approaches of legislation making certain behavior illegal. They list their concerns as follows:

(a) Stakeholderism would make corporate leaders more insulated and less accountable to shareholders.

(b) Stakeholderism would "impede, limit, or delay policy reforms that could offer effective protection to stakeholders."

Given these two major conclusions, they assert that regulating corporate governance is the only way to address the sense of urgency we have today. This conclusion raises some serious questions. So is this a fair assessment of a so-called co-determinacy of a modern corporation, or is their assessment merely a classic false choice? Put another way, is their skepticism merited, or is it simply, as the old adage goes, "to a man with a hammer everything looks like a nail." Do Bebchuk and Tallarita present a false choice by choosing between major regulatory reform of corporate misbehavior versus directors creating a new corporate purpose to address a more inclusive group of constituencies (i.e., not just managers and shareholders). Why can't a positive sum solution be used instead of their zero-sum model to account for externalities and non-represented constituencies?

Thinking differently, one construct that might have some answers, is a 1995 Law Review Article entitled: *Incompletely Theorized Agreements* by Cass R. Sunstein (108 HLR 1733). The author states, in a nutshell that, "Participants in legal controversies try to produce "Incompletely Theorized Agreements" ("ITAs") on particular outcomes as, for example, Delaware case law demonstrates. So what does the author mean by an ITA? He states that deciders "need not agree on a fundamental principle. . . . The distinctive feature of this construct is that it emphasizes agreement on (relative) <u>particulars</u> rather than on (relative) <u>abstractions</u>. This is an important source of social stability." Ideally, most case law review of an outcome to a legal dispute would have a completed theory behind it that the deciders agree upon to justify same. An alternative is that the deciders can agree on low-level principles that account for the outcome, but not the higher level proposition or abstraction. The beauty of ITAs is that they have the important advantage of allowing large degrees of openness to new facts and perspectives. As Sunstein writes, "There is a large advantage [to ITAs] over more arbitrary methods since ambitious thinkers, in order to reach horizontal and vertical coherence, will probably be forced to disregard many decided cases. . . ."

For example, in the Maryland Law Review Article entitled: *A Decision Theory Approach to the Business Judgment Rule: Reflection on Disney, Good Faith, and Judicial Uncertainty,* (2007), the author, Andrew S. Gold, writes that “The business judgment rule [“BJR”] is an example of an “incompletely theorized agreement.” By that he means that “it’s presumption produces a doctrinal result in which courts and commentators can roughly agree, even though the higher level theories that support this convergence are in conflict.” So all parties agree to disagree, so to speak, in that they agree to the BJR, but disagree as to its “premise”. Simply put, it works, but we don’t agree on why.

So can this theory of ITA’s in case law apply to stakeholder governance? Conversely, what if stakeholder capitalism can be premised on ITAs at some higher level principle, but not at a lower level of execution of same? The author of the Article concludes that “. . . [T]heories may be treated as search lights that illuminate particular judgments and show them for what they really are. . . . [T]heories are simply the (human constructed) means by which people make sense of their ethical and political worlds.” So is stakeholder capitalism too non-specific at this time, or is it simply an ITA in process?

If the latter, is the construct of stakeholder capitalism “good enough’ to begin the harder dialogue on how to implement same? Or is it, as the authors suggest, mostly show with no real teeth, or worse, counter-productive? Let’s now take a look at those writers who are beginning to shape the hard conversation on how to implement a stakeholder capital construct, using various tools already in place albeit incomplete. The question is, can the <u>future</u> hold both horizontal and vertical coherence in shared principles and if so, how do we go about it? So what are these current ESG issues worldwide?

In an Article in the Fast Company Magazine (dated 4/21/21) by Tim Mohin entitled, *5 Things You Need To Know About The Future of ESG Reporting*, he wrote that financial regulators are facing “the lack of common reporting standards about environmental, social, and governing issues.” He listed five (5) key issues that are shaping ESG reporting that can impact a company in the future. They are:

1. Universal disclosures, recently touted by the International Business Coalition and the WEF, that have 20 topics using International Financial Reporting Standards (“IFRs”).

2. Sector standards containing the core philosophy of the SASB as tailored to individual companies.

3. “Materiality,” (i.e., what companies report on), as determined by regulators to help with comparability purposes. (The test of materiality is based on “what could affect investors in the company.”)

4. Regional laws, (e.g., California) and various city codes, as an impetus to create more consistent cross border global disclosure standards.

5. Convergence of existing Regulatory Standards will be one of the harder and key issues to resolve. The key players are Europe, the U.S.A., and China. The ESG

regulators may have to deal with 3 standards of doing business until these three standard bearers agree on a uniform system of ESG reporting.

So are we trapped in a dangerous trend of "illusory promises," or are we in the nascent stage of positive change? Two recent ABA articles that address ESG and its impact on corporate governance are the following: (1) *For Whom is the Corporation Managed in 2020*? The Debate Over Corporate Purpose" by Edward B. Rock, (The Business Lawyer; ABA Spring 2021; Vol. 76, No. 2) and the response thereto by Leo E. Strine, Jr. entitled *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy* (The Business Lawyer; ABA Spring 2021, Vol. 76, No. 2.)

In the first Article *For Whom is the Corporation Managed in 2020*, the author Edward B. Rock, states that the question is, "one of the oldest questions in corporate law," and rightfully so. He then proceeds for analysis purposes, to break the topic into four separate questions, namely;

1) What is the "best theory" for corporations as a legal entity?

(2) How should academia finance understand the "properties" of the corporate legal form?

(3) What constitutes "good management practices"?

(4) What are the "social roles and obligations" of large publicly traded firms?

Given the above 4 questions, the author takes the reader on a journey from the Business Roundtable Statement of 1997 and compares it to the current statement in 2019 and 2020. He then compares these to various political solutions being proposed in the U.S. Senate, such as the S3348 Accountable Capitalism Act, 115th Cong (2018), the Davos Manifesto, Attorney Martin Lipton's "New Paradigm," and finally Common Sense Corporate Governing Principles (as set forth on their website). He then frames the debate about "corporate purpose" by bluntly stating, "If non-shareholder stakeholders are not adequately protected by regulation (or contract), and the structure unjustly favors stakeholders over all other stakeholders, then perhaps a "stakeholder" focused corporate law system is the only way to preserve a market economy against the threat of Warren/Sander's type legislation." He then lists the 4 questions mentioned above, as the best way to break down the debate into manageable points of discussion.

Regarding the first question posed by Prof. Rock, namely, <u>the "Legal Debate"</u>, he states that, like it or not, "as a matter of Realpolitik, you work for whomever can fire you. . . ." Given that shareholders have the power to control directors, the shareholder primacy construct governs, despite the fact that the law in Delaware does not state as such. (He states parenthetically that Delaware is also "deeply board-centric with regard to the management of the firm.") Notwithstanding the above, the author compares this classic view of shareholder primacy with Attorney Martin Lipton's "New Paradigm" that espouses the theory that the purpose of the corporation (and the duty of the board of directors) is to promote a long-term value creation (versus short-term stock price monetization). So what is his solution? Prof. Rock asserts that, "the board of directors may consider the interests of other stakeholders, so long as there is <u>some rational relation</u> (emphasis added) to shareholder value, citing <u>Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.</u>, 506 A.2d 173, 183 (Del. 1986).

With respect to the second question posed by the author, "<u>The Finance Debate</u>," he asserts that finance school textbooks and the typical company, all are geared to the assumption of shareholder primacy where investors seek the highest net present value projects. Financial scholars seek actual practices of current corporations, not normative or aspirational goals. Basically, their focus is to stay tethered to current practices, not theory. But that conclusion has resulted in the very problems we face today. Some of the more notable authors mentioned by the Financial Times include Mariana Mazzucato, author of the book "The Value of Everything", and Kate Raworth, author of "Doughnut Economics". Both conclude that what constitutes real value has to be revised to address the damages caused by past practices.

With respect to the third question, "<u>The Management Debate</u>," Prof. Rock compares two prominent goals by stating that the tension is over the balance of power "between short-term price maximization and the cost of long-term firm value" (as well as what metrics would be used in furtherance of broader goals of corporate purpose). He contrasts this view with the famous quote by Jack Welch, former CEO of General Electric, who once said, "on the face of it, shareholder value is the dumbest idea in the world . . . Shareholder value is a result, not a strategy . . . Your main constituency are your employees, your customers, and your products." (Financial Times, March 13, 2009.) Ultimately the author concludes that, because Delaware law does not require short-term value maximization, then, practically speaking, "why battle over the legal description of the corporate form."

With respect to the fourth question, "<u>The Political Debate</u>," the author summarizes the core issue by stating that "shareholder primacy theory presents an externality problem to the sustainability of the private enterprise system. Productive business firms are valuable to the U.S. to an extent far beyond their net present value to shareholders." As such, society expects "a level of business investment in fixed assets that cannot be adequately explained by the shareholder primacy theory." Having said that, the author reverts to the Milton Friedman argument that "free markets" are the only way to ensure the future of capitalism, and that business leaders that make grand pronouncements regarding social responsibility undermine the legitimacy of the market system. The author concludes by stating that he believes the proposed cures are worse than the perceived illness. He rationalizes same by asserting that "[I]t is thus implausible to think that the short-sightedness of misbehavior of large-scale business enterprises is a consequence of the organization form in which they choose to conduct business. So the form of the corporation, "as applied" is not the issue because shareholder primacy is simply a theory, not a requirement. But the key issue is precisely how the corporate form is being applied when given the choice. He then produces a long list of why we should not tinker with the corporate structure, mostly based on "what if" things don't work out? If that does not suffice to put a brake on corporate governance change, Professor Rock states that "we should never forget that many of our problems require regulatory solutions" so revising corporate objectives is no substitute. Put another way, he is asking us to picture a rather negative sum scenario. Grim indeed, and fear-based at its core. But can there be a positive sum solution where there is both regulatory reform and corporate governance reform? The next author, Leo Stine, Jr. thinks we can do both.

In his reply to Professor Rock's "textured" essay above, Leo E. Strine, Jr. penned the essay *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy* published in the same ABA Journal (see citation above) (Vol. 76, Forthcoming Spring 2021). His primary position is that fixing the woes of the corporate form is not a "revolution" as much as it is instead a "restoration" of how corporate governance has worked in past years, and should work going forward if we are to move forward in a sustainable manner in the 21st century. Far from being the result of "populist" pressure of the Business Roundtable in more recent times, the author traces the debate back to the sustained debate by legal and academic scholars over the past two decades, or longer. He discusses the first two questions posed by Prof. Rock as "largely hobby horses of law and finance professors," while the third question is the focus of business school courses. As such, they are far narrower than the general public's view of same, and it is the public that is affected most by corporate governance getting it right or not. So Strine boils his disagreements down to Prof. Rock's question #4, viz.; <u>The Political Debate</u>. He then poses the question that, given the current spate of financial and environmental damage, that has occurred since the advent of "Milton Friedman and Ronald Reagan-style thinking: it is far past time to address how corporations "use their power in a sustainable manner." And because the current structure allows economic elites to use corporate power to decrease the effectiveness of the political process to protect stakeholders, it is time corporate governance better aligns with "our society's well-being and equity"? With his reframed question, the author creates a roadmap for how he would do so.

Simply put, Strine shifts the focus of the current policy debate to the issue of the standard of legal review known as the business judgment rule, and the importance of the standard of conduct of fiduciary obligations of directors (i.e., "normative obligations"). Why? Strine believes that the results of focusing on these two key constructs can provide more promise, and be less threatening, than skeptics would think is possible. The results can be "evolutionary" and positive sum, such that both sides of the debate would benefit. So is this possible?

In order to prove his theory, the author cites the famous case of <u>Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc</u>., 506 A.2d 173, 176 (Del. 1986) where the court stated that "while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some <u>rationally related benefit</u> accruing to the stockholders." [Emphasis added] In the *Revlon* case, the court held that because the sale of the company was for cash, protecting the value of the corporation note holders was not a rational relationship to the best interest of the stockholders, so to do so constituted a violation of the duty of loyalty by the directors (i.e., preferring the interests of the note holders). To Strine, Delaware case law is clear on shareholder primacy in M&A corporate matters, especially in this case.

The first target of Strine's reply to Prof. Rock's characterization of the 4 questions he posed in his essay is the question of "What is the best theory of the legal form we call the corporation"? He reframes what he considers this narrow academic question of Prof. Rock into a broader real world question of "what structure of regulation or governance will produce the most socially desirable outcome" because such a reframed question has the most promise for sustainable results in society today.

The next question the author targets is The Finance Debate. The author goes to the source of the issue where, once the legal academics create the narrative of the shareholder primacy model, the financial academics use the "properties of the legal form" to create the formulas for the value of a corporation. Once these two building blocks merge, the lock on the discourse of the corporate form becomes complete when stock price, or Tobin's Q, becomes the "proxy for the value of a company to just one constituency - stockholders." As the author states, "this method of measuring value has long had a distorting effect on the purpose debate." Such "framing of the debate" "tilts the debate by making advocates of stakeholder governance play uphill and against the wind," when using such simplified financial models where corporate value equals equity value.

To Strine, such construct is summarized by saying "[a] simpler intellectual compound has perhaps never been conceived when addressing the residual claimant theory of a corporation." First, he writes, "This is not the way the world works." Second, a corporate equity value is simply the collective view of traders only, as to what stockholders can get out of their investments. As such, it represents merely a trading or equity value, not the overall value that a corporation provides to society. Ultimately, the result is "corrosive" as the author states, in that it is a "drag on overall economic growth and social welfare." Equity value as a proxy for overall value needs to go, if we are ever to move forward in a sustainable way.

From the above general overview of the debate, and the response to Prof. Rocks first two questions, Strine rewrites the more academic questions #3 and #4 posed by Prof. Rock, namely; what are good management strategies for building valuable firms <u>and</u> what are social roles and obligations of larger firms. Strine then asks the question of what are the "sources" of the debate raging today. To Strine, those scholars who focus on the results of the current corporate form, in terms of it overall impact to society, and not just to the equity price, were the ones who "kept an eye on the bigger picture consequences of corporate governance." The effects on inequality and the environment have been devastating in the past several decades, and for Strine the time for change is past due. The Great Recession and infamous corporate bailout of 2008 by taxpayers, should have been the final blow to casino capitalism, but it still staggers forward. With public cynicism at an all time high, from CEO pay inflation, hedge fund activism, tax havens, etc., it's time for real change especially in the corporate model. Of particular note to Strine is that Prof. Rock fails to address how "Milton Friedman and his acolytes have also engaged in a relentless campaign to eviscerate the rules of the game that protect workers and other corporate stakeholders." This has resulted in a massive distortion of our political process. (In a footnote he cites Mary R. Wilson's work *Lobbying Top 50: Who's Spending Big*, The Hill [2017]) Her data shows 49 of the top 50 spending lobbying interests were business or business-related. So corporations are experts at converting ideology into action. The question is, how can this narrowly focused, one constituency centric model shift to a broader model, that protects and promotes all parties that are impacted, not just the "elites" as he calls them.

Strine concludes on an optimistic note (unlike Prof. Rock's essay). He cycles back to the two part standards as espoused in the fiduciary duty of care, viz., the standard of conduct for a director, and the standard of legal review by the courts, as set forth in the business judgment rule. The normative duty in the former, as spelled out in detail in the seminal case of Caremark Intl., Inc. Derivative Litigation, 698 A.2d. 959 (Del. Ch. 1996) and its progeny, have made corporate compliance rules more transparent and articulated to address the argument of overly powerful managers and the weak position of its shareholders according to Milton Friedman. So Strine asserts that the age old conflict of managerialists versus financial investors roles needs to be revisited in the new financial capitalism reality today. According to the author, the balance needs to shift to address the complexity of the multi-faceted impact in stakeholders to the corporation, not just the elite few. Simply put, the reality is that "stockholders have little to fear from a "may" regime . . ." (i.e., no-prohibitory corporate statutes). Furthermore, "stockholder advocates also ignore that most stockholders are not long on one company, but rather long the entire economy, and thus suffer economically if externalities are rewarded instead of sustainable wealth creation." In summation, Strine states that "governance focused on stakeholders is not an authorization for management to do what it wants, it is a mandate for management to run a profitable company in a way that respects all stakeholders and benefits, not harms, society." This recognition of a realistic framework of the business world ecosystem is long overdue by the public. So a sense of urgency is needed, especially with regard to inequality and environmental harm.

Stone concludes his essay by addressing the fourth (4th) question posed by Prof. Rock, namely, "what were the social roles and obligations of large publicly traded firms?" To answer same, he proposes the following recommendations. First, Strine believes that the current "may" type corporate statutes allow for more robust solutions to individual corporate operations in keeping with the narrative duties of directors and officers, and the business judgment rule and duty of good faith as set forth in the *Caremark* case. Second, Strine believes the Delaware public benefit corporation model ("PBC") is a good alternative. Third, he believes that "private companies be subject to mandatory employee, environmental, sound, and governance or EESG reporting that would be focused on how these companies treat their workers, the environment, consumers, and society, so that they are more accountable. . . ." Fourth, he recommends a heightened focus on institutional investors to address their "standards of stewardship around EESG." Simply put, "codetermination creates successful market economies by avoiding the corrosive effects of a blinkered, sole-constituency oriented, shareholder primacy model.

So where are we today? Simple solutions are out. We need complex solutions to solve complex problems. There is a sense of urgency now more than ever, and the adage of "that's the way we have done it for years" is no longer acceptable. Stakeholder governance is a good strategy.

[7/21]