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Corporate Governance

In a brilliant must-read article in the May-June 2017 issue of the *Harvard Business Review*, Joseph L. Bower and Lynn S. Paine show the fallacies of the economic theories and statistical studies that have been used since 1970 to justify shareholder-centric corporate governance, short-termism and activist attacks on corporations. They demonstrate the pernicious effect of the agency theory promoted by Milton Frenchman (1970) and Michael Jensen and William Meckling (1976), a theory still endorsed today by a majority of academic economists and lawyers who write about and teach corporate governance. The Bower and Paine rejection of hedge fund activism is telling.

> The activists' claim of value creation is further clouded by indications that some of the value purportedly created for shareholders is actually value transferred from other parties or from the general public. Large-sample research on this question is limited, but one study suggests that the positive abnormal returns associated with the announcement of a hedge fund intervention are, in part, a transfer of wealth from workers to shareholders. The study found that workers' hours decreased and their wages stagnated in the three years after an intervention. Other studies have found that some of the gains for shareholders come at the expense of bondholders. Still other academic work links aggressive pay-for-stock-performance arrangements to various misdeeds involving harm to consumers, damage to the environment, and irregularities in accounting and financial reporting.
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> We are not aware of any studies that examine the total impact of hedge fund interventions on all stakeholders or society at large. Still, it appears self-evident that shareholders' gains are sometimes simply transfers from the public purse, such as when management improves earnings by shifting a company's tax domicile to a lower-tax jurisdiction—a move often favored by activists, and one of Valeant's proposals for Allergan. Similarly, budget cuts that eliminate exploratory research aimed at addressing some of society's most vexing challenges may enhance current earnings but at a cost to society as well as to the company's prospects for the future.
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> Hedge fund activism points to some of the risks inherent in giving too much power to unaccountable "owners." As our analysis of agency theory's premises suggests, the problem of moral hazard is real—and the consequences are serious. Yet practitioners

> continue to embrace the theory's doctrines; regulators continue to embed them in policy; boards and managers are under increasing pressure to deliver short-term returns; and legal experts forecast that the trend toward greater shareholder empowerment will persist. To us, the prospect that public companies will be run even more strictly according to the agency-based model is alarming. Rigid adherence to the model by companies uniformly across the economy could easily result in even more pressure for current earnings, less investment in R&D and in people, fewer transformational strategies and innovative business models, and further wealth flowing to sophisticated investors at the expense of ordinary investors and everyone else.

To counter short-termism and activism, Bower and Paine embrace the corporation-centric/constituency theory of governance. They argue that the corporation and its board of directors have a fiduciary duty not just to its shareholders, but to its employees, customers, suppliers and to the community. This is the theory I argued in *Takeover Bids in the Target's Boardroom* (1979) and regularly since in a lone series of articles and memoranda. While Bower and Paine say:

> The new model has yet to be fully developed, but its conceptual foundations can be outlined. . . . [T]he company-centered model we envision tracks basic corporate law in holding that a corporation is an independent entity, that management's authority comes from the corporation's governing body and ultimately from the law, and that managers are fiduciaries (rather than agents) and are thus obliged to act in the best interests of the corporation and its shareholders (which is not the same as carrying out the wishes of even a majority of shareholders). This model recognizes the diversity of shareholders' goals and the varied roles played by corporations in society. We believe that it aligns better than the agency-based model does with the realities of managing a corporation for success over time and is thus more consistent with corporations' original purpose and unique potential as vehicles for projects involving large-scale, long-term investment.

in fact the corporation-centric theory—that the directors have a fiduciary duty to the corporation and all of its stakeholders—is reflected in a number of state corporation laws. Perhaps the most cogent example is the Pennsylvania Business Corporation Law which provides:

> A director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care,

> including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.
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> In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:
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> The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.
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> The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.
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> The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.
>
> All other pertinent factors.

While wider adoption and strengthening of laws like the Pennsylvania statute would provide some more ability to boards of directors to temper short-termism and resist attacks by activist hedge funds, voting control of corporations will remain in the hands of the major institutional investors and asset managers. To achieve a truly meaningful change and effectively promote long-term investment, corporations and institutional investors and asset managers will need to endorse and adhere to *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* (2016) promulgated by the World Economic Forum or *A Synthesized Paradigm for Corporate Governance, Investor Stewardship, and Engagement* (2017) based on it and on *The Principles of the Investor Stewardship Group* (2017). The alternative would be legislation, something that both corporations and investors should assiduously avoid.

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