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Comparative Corporate Governance Distinguished Lecture Series

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Corporate Social Responsibility, Profit Maximization and the Stakeholder Board

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CLE COURSE MATERIALS

This series, co-sponsored by The Corporate Law Center and The Fordham Law Office of International and Non-J.D. Programs, was established in 2010 and invites distinguished international scholars to present current research in global financial law.
### CORPORATE SOCIAL RESPONSIBILITY AND PROFIT MAXIMIZATION

*Say H Goo*

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“If one can always remember where he started (his original heart), he will definitely realize his wish in the end”. – Bai Juyi (772-846 AD)

“Risk takers need backers, good ideas need evangelists, and forgotten community needs advocates” Bill Gate

“Take the first step in faith. You don’t have to see the whole staircase, just take the first step.” (Martin Luther King, Jr)
Abstract

Despite voluminous law and regulations to look after stakeholders’ interests, corporate actions that harm stakeholders’ interests continue to occur on a daily basis, particularly in the areas of environmental and consumer protection. Why? Christopher Stone in his pioneering work in 1975 outlined the reasons most of which are still applicable 40 years later. Most of them relate to problems with inadequacy of the law and enforcement. But at the heart of the problem is the notion of profit maximization as the sole purpose of a corporation and directors’ duty to shareholders to do that. This paper seeks to find the true purpose of corporation and explains the development of corporate purpose through historical, legal, doctrinal, economics, and political lenses and concludes that corporations should be formed for the benefit of society, not solely for profit maximization, and that it would be more efficient for corporations to do that than to focus on profit maximization. It draws on the idea, made in the 70s, of having stakeholders (especially consumers and the environment) on the board to help corporations to act for the interest of the society. Workers and creditors can negotiate for their welfare, so do not need stakeholder directors to represent them. The main stakeholders that need protection are consumers and society and the environment as they do not have inside information about pollution caused by manufacturing process and materials used for products and cannot contract with the corporations.

INTRODUCTION

Corporations were first allowed to be formed for public interest, and corporate law left it to the corporations and their directors and management to decide how to protect public interest, occasionally insisting that some stakeholder directors in the form of government appointed public interest directors sit on the board, eg the Union Pacific Railroad Co, to protect public interest.1 But as history shows, investors pushed their interest, and economists keen to protect the interest of investors, argue that corporations should be run for the interest of investors by profit maximization.2 No one else pushed strongly enough for the interest of stakeholders at the time until the 1950s, by which time profit maximization had become the received wisdom. So other stakeholder interests are protected through other laws, not corporate law.3 And as factories moved to China and other developing countries in the late 70s, and the US economy transitioned to service industries and environmental pollutions in the US eased (check data???) reducing the pressure on corporations in the US to act for the interests of the environment. But these social problems are unresolved but simply moved abroad, and with pollution now threatening the world,4 and the source of the problems – where decisions are made, in the boards (especially those of Global 500 in the US), it is time to reexamine the issue of how to protect stakeholder interests. This paper revisits the idea of stakeholder board as a possible solution, proposed by others5 but rejected by Hansmann and Kraakman.6

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1 Stone, at 130.
2 Hansmann and Kraakman, at 451-3
3 Hansmann and Kraakman, at 442.
4 See World has reached critical point on global warming, SCMP.
5 Ralph Nadar et al??
Many economists, and even law and economic scholars, have argued that it is not the business of corporations to worry about their social impact; it would not be economically efficient for them to do so, so they argued. Another view is that profit maximization for shareholders (or the shareholder-oriented model) is the most efficient model to attain public welfare. This paper argues that these arguments do not hold in practice, and it is not in the interest of market efficiency or public welfare for corporations to focus solely on profit maximization because of externalities. It is also not consistent with the original idea and purpose of corporation and the original intent of the law, which is that corporations exist for the benefit of society, and this idea still serves a very valuable purpose today. It was the political power of the entrepreneurial and middle class that caused the economists and even some judges to accept that the meaning and purpose of ‘corporation’ is to serve the interest of the investors and shareholders rather than its original purpose of serving the society.

We need a ‘system change’ to tackle the source of the problems (See Eric Nee, Stanford Social Innovation Review). This paper argues that one of the root causes of the problems is the perceived duty of directors to maximize profits for corporations. To solve this problem, this paper argues that the law should be clarified and affirmed that corporations be run for its original purpose which is to serve the interests of the society (ie all other stakeholders in the corporation), not just for the shareholders, and there should be governance mechanism to protect these interests, whilst effort to improve law and regulations and their enforcement should continue to internalize externalities. This paper argues that stakeholder board is one such mechanism. And stakeholder directors’ duty will be to act for the stakeholders they represent with an overarching duty to act bona fide in the interest of the company as a collective whole.

The idea of stakeholder directors will solve the problem of irreconcilable conflict between directors’ duty owed to shareholder verses their duty to other stakeholders as I explained elsewhere. Secondly, it does not make sense to make it possible for board to cause harm by externalizing costs and then to have law to punish breach to internalize them. Stakeholder board will solve this problem by preventing the harm in the first place.

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7 Friedman
8 Hansmann and Kraakman, at 441
9 eg judicial decisions interpreting directors’ duty to act in the interest of the company as being in the interest of shareholders (see Michigan Supreme Court case in Dodge v Ford Motor Co: directors cannot consider interests of other stakeholders. Here, the Michigan Supreme Court held that Henry Ford could not reduce consumer prices and increase employee salaries. “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes...”
10 Hansmann and Kraakman, at ???
11 See Goo, AJLS.
12 Hart & Zingales pointed out “Consider the case of Walmart selling high-capacity magazines of the sort used in mass killings. If shareholders are concerned about mass killings, transferring profit to shareholders to spend on gun control might not be as efficient as banning the sales of high-capacity magazines in the first place.” (at 3, Hart & Zingales). They also argue that in non-separable activities, where profit and damage are inextricably connected, the company has the technology to create both profit and damage and individuals do not have the technology (costlessly) to undo this, Friedman’s conclusions do not hold: shareholder welfare is not equivalent to market value. (at 3-4).
Third, stakeholder board will allow company’s CSR, which appeared in 1950 literature and reappeared in recent years increasingly on a global scale, to be implemented more effectively. Hart & Zingales said, “it may be very difficult to write a regulation that specifies, say, that companies should treat their workers with dignity. It might be better to leave the implementation of this goal to shareholders.”¹³ As will be explained later, even leaving this to shareholders may not always work to protect stakeholders. I would suggest that this should be left to stakeholder directors. The point from Hart & Zingales, however, is that this is not something that can be done by regulations, but in my view can be negotiated in stakeholder board.

Fourthly, stakeholder board will bring company’s purpose back to its original root which is to benefit the society.

This paper will be divided into five parts. Part I states and explains the problems and the root causes in some details. Part II reviews literature that is specifically related to the research questions, and discusses sources, including theories and principles, from which the problem conceptualization is derived, including any studies that have been done or can be related to the problem conceptualization. It explains the methodology and states and explores the research questions in some details. Parts III and IV analyze the received views, observations and arguments made in the literature and data. Part V concludes and makes recommendations.

I. THE PROBLEMS

The problem, simply stated, is that our laws that seek to regulate corporate behavior have failed, resulting in many environmental and social problems. What contributed to this problem? In 1975, Stone in his pioneering book, Where the Law Ends, lamented how more and more it is corporations, and indeed an increasingly small number of them, that are effectively actors in our society, who are our most evident producers, distributors, land managers, taxpayers, polluters, investors, investments, service providers, and even farmers.¹⁴ “Corporations have long since become, for better or for worse, the most effective “private” forces to do both widespread good and widespread harm.”¹⁵ He said to solve the society’s problem is, in no small measure, to come to grips with the corporation problem. In 2017, over 40 years after the publication of the book, the ‘corporation problem’ appears to have gone worse, despite many law and regulations in that time to control the problem. To the question how is the corporation problem to be dealt with, he answered “Nothing in society is a continuing problem because of itself, per se; something becomes and remains a problem because of shortcomings in the institutional arrangements we rely on to deal with it”.¹⁶ To come to grips with the ‘corporation problem’ he said one must make a simultaneous inquiry into two directions: (i) exactly what is it about corporations, and (ii) exactly what is it about the institutions we have available to control them, that so often seems to leave the one so frustratingly outside the grasp of the other?¹⁷ “What is so fundamentally

¹³ Hart & Zingales, at 4.
¹⁴ Stone, at xi-xii.
¹⁵ Stone, at xii.
¹⁶ Stone, at xii.
¹⁷ Stone, at xii.
wrong about the measures we have adopted to control corporations? In the light of these shortcomings, what can be done to improve existing measures? What sort of new controls can be, and must be, designed?"18 It is along these lines that I will be making my inquiry.

“It is not an oversimplification to claim that the problems we face in controlling corporations today have their roots in legal history; they are a legacy of the law’s failure to search out and take into account special features of business corporations as actors that make the problem of controlling them a problem distinct from that of controlling human beings”.19

As mentioned in the Introduction above, in my view the problem is caused and worsen by the idea that corporations are to serve the interest of the shareholders; to maximize profit for shareholders, and not to worry about the interest of other stakeholders. Proponents of such an idea believe that stakeholders are adequately protected by other laws. The following flaws in our legal system have, however, rendered such protection ineffective:

A. Law designed for persons not corporations

The problem is that the law does not develop measures designed to deal with corporation problems specifically. “Instead, corporations were generally assimilated into the pre-existing general legal system by deeming them “persons”… and should be treated indiscriminately like any other person.”20 A model of law built upon notions of human behaviour and motivation was transferred as a body with a minimum reconsideration to corporations.21 “This was the simplest way to deal with corporations. But not … the wisest or most effective.”22

As corporations are only a legal fiction with “no pants to kick or soul to damn”,23 the law should concern itself simply and directly with the corporation’s constituent human beings.24 But we cannot analyze the decision of each human being, but can only focus on the institution – the decision making body, that comprises the human beings. Nor should we treat its decision as the aggregate sum of all the human beings within it. “The law ought constantly to be searching out and taking into account the special institutional features of business corporations that make the problems of controlling them (and of controlling men-in-them) a problem distinct from that of controlling human beings in ordinary situations.”25

The earliest corporations, called “proto-corporations” were ecclesiastical organizations, municipalities, guilds, and universities. They were very different from the giant corporations today. They were a passive devise to hold property and special privileges.26 Wrongs committed by these proto-corporations, similar to modern

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18 Stone, at xiii.
19 Stone, at 1.
20 Stone, at 2.
21 Stone, at 10.
22 Stone, at 2.
24 Stone, at 3.
25 Stone, at 7.
26 Stone, at 11.
problems of consumerism and environmentalism were all easily ascribed to, and gave rise to actions against, the individual townsman or guildsman.27 Whilst the government could have traced specific social wrongs to specific features of the corporation (eg the guilds), and exercised continuing direct influence over these critical institutional features so as to stave off wrongdoing preventively, rather than just lend its court system to repair the harm afterward, the government did not do that at this stage, as the law that deal with individual human beings as actors, rather than institutions, was not strongly at odd with the social facts, or cause injustice.28

The early regulated companies that began to spring up in the sixteenth century – the great trading companies – did not change this pattern, as the members did not place their capital in the hands of the agents to invest or run the business; membership in a company, like membership in a guild, gave them a right to exercise the exclusive trading privileges held by the company “on their own bottom” either alone or jointly with other members.29 Under this arrangement, any legal liabilities the operation would incur would give rise to actions against the members individually under the ordinary principles of law.30 However, by the early seventeenth century, this pattern changed. To provide protection from pirates, it was necessary to have synchronized sailings of fleets with armed escorts, the cost of adventures grew to a scale that was beyond the financial capacities of one man or several men.31 In 1612, the East India Company decided that only the corporation could trade.32 Each member would subscribe to a common fund to be placed in the hands of the governor or committees (like directors today) for management on behalf of the members.33 This then provided a model for the modern corporations; the supplier of capital and the managers of the enterprise were now separate persons. There were doubts as to who would be responsible for wrongs. The officers would obviously prefer the company to bear the liability, whereas the investors would want the management to bear the liability since they have control over the day-to-day operation of the company.34

By the early eighteenth century, unchartered joint-stock companies - a hybrid of corporations and partnerships, appeared and in 1719, the South Sea Company collapsed, after a breathtaking rise in the price of its stock.35 The UK Parliament passed the South Sea Bubble Act in 1720 to eliminate unchartered joint-stock companies, but failed to stop them as the Act was poorly drafted and consequently not enforced.36

The Industrial Revolution and the demands for vast pools of centralized capital caused the demands for charters to increase.37 State charters gave way to general incorporation and charter mongering.38 The courts also began to interpret charter provisions more

27 Stone, at 12.
28 Stone, at 13.
29 Stone, at 14.
30 Stone, at 14.
31 Stone, at 14.
32 Stone, at 14.
33 Stone, at 15.
34 Stone, at 16.
35 Stone, at 17.
36 Stone, at 17.
37 Stone, at 19.
38 Stone, at 20-21.
broadly. The administrative structure also changed, giving rise to managerial control and discretion.

Because of the complexity in attributing responsibility to individuals when something goes wrong, and even when you can identify the individual concerned, he/she is not worth suing, law responded by holding corporation liable. However to ameliorate the increased investment risk, limited liability was granted to corporation to shield investors from unlimited loss. The law did not respond to the changes brought about by corporation by specially adapted law, except in the area of shareholder-management relations, not in the areas of corporation’s customer, its neighbour, or its fellow citizen. “In those areas there already existed a body of law addressed to “persons”, and the corporation was eased into this body of law in the simplest way possible” by ignoring the earlier qualms about whether the corporation could be a person. “As a result, many possible approaches to controlling corporations that would have taken special account of their special institutional natures were not developed as they might have been.” That is not to say that the law never saw the problems created by corporate growth that demanded special treatment. Many new laws were indeed passed, eg the federal legislation Interstate Commerce Act 1887, Sherman Anti-Trust Act 1890, Federal Trade Commission Act 1914 etc were attempt to fill the gap.

B. Two types of harm
Stone points out that there are two types of harm: (i) “absolutely disfavoured conduct” (conduct that is so inherently objectionable that we want to eliminate entirely eg murder, price fixing etc) and (ii) “qualifiedly disfavoured conduct” (conduct that law feels cannot eliminate absolutely without risking social losses that could exceed the gains, eg pollution, industrial accidents). For the first class, we make it unlawful and threaten the corporation with the damages triple the amount of loss plus criminal fines, as in price fixing. Most corporate harms fall into the second class, however. For this class, a wide range of factors should be taken into account: the damage that the harmful activity is causing, the value to society of the things that the corporation is producing, the cost to the company and the society of various measures that can be taken to reduce harms. We make corporations compensate for the damage caused, no more no less. If they cannot bear the damages and continue, so be it. If they can continue, it means that although their behaviour have bad aspects, an unqualified elimination would make society suffer more than it gains.

However, to reduce disfavoured conduct, “the law must be capable of bringing about certain systematic changes within the organization”. If botulism bacilli appear in a company’s soup, or automobile accidents due to some faulty design or defect, there is an institutional weakness that will not go away until the root cause is identified and

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39 Stone, at 21-22.
40 Stone, at 23.
41 Stone, at 27.
42 Stone, at 28.
43 Stone, at 28.
44 Stone, at 30-31.
45 Stone, at 31.
46 Stone, at 32.
47 Stone, at 32.
48 Stone, at 32.
removed. This may include the company's purchasing standards, its cooking (or manufacturing) procedures, its quality-control requirements, improved information systems, improved role definitions, improved authority structures, improved technical programs, improved corporate allocations of human and other resources etc. Information has to be sourced not only from within its own plants, branches and task forces, but also from relevant external parties. Not only would this information system have to be designed to draw data from the right places, internally and externally, but the information has to be channeled to the right desks for action: the company’s design engineers, its quality-control staff, its test drivers, and perhaps the board of directors. Cost has to be taken into account in so doing to allow company to balance social resources appropriately and to prevent over-regulation. Stone concludes that the key questions are: (i) for qualifiedly disfavoured conduct, is the law adequate to make the corporation institute the most effective internal organizational changes to the extent that the cost does not exceed what doing so saves the society; (ii) for unqualifiedly or absolutely disfavoured conduct, is the law getting the corporation to do whatever most effectively and economically brings the conduct to an immediate halt?

The problems, as Stone sees them, are that: (i) the law currently does not build into corporation itself mechanisms that play the function of guilt, shame and a sense of responsibility found in human beings that prevent human beings from committing crime or do wrong; (ii) some of the major sanctions applicable to control human beings are not applicable to corporations, eg imprisonment and death penalty.

Given the above limitations, the current strategy of the law, in the case of qualifiedly disfavoured conduct, has been to impose an amount of damages that is more or less equal the amount of loss, believing that the company, being a “rational economic man” will respond by changing its optimal internal institutional configurations. If the company ceases to effect changes, that means changes are not warranted on a social cost basis. However, Stone points out that company, once passes the survival stage and can maintain satisfactory level of profits to stave off shareholder insurrections, is not always a profit maximizer, therefore such strategy does not always work.

Another factor that renders the strategy ineffective is that contingent legal liability is only one of the many challenges that corporation faces, eg uncertainties in acquiring and losing personnel, dealing with suppliers, anticipating the moves of competitors, opening new markets, developing improved methods of production, securing new sources of capital etc. And often workers at the lowest level for their own interests are not willing to pass “bad news” to the top level of the corporation. And it is not

49 Stone, at 32-33.
50 Stone, at 32.
51 Stone, at 33.
52 Stone, at 33.
53 Stone, at 33-34.
54 Stone, at 34.
55 Stone, at 35-36.
56 Stone, at 37-38.
57 Stone, at 38-39. See also Robert Anthony, The Trouble of Profit Maximization, at ??
58 Stone, at 40.
59 Stone, at 45.
always easy to identify who is at fault to have follow-up action as one group will always put the blame on someone else.  

C. The limit of law  

A further reason is that the threat of liability does not always stop corporation from bad behavior. First, shareholders and company are shielded by limited liability. Secondly, “the calculations that will maximize the profit of the corporation do not coincide with the calculations that encourage and constrain the key personnel who have the most influence over corporate policies”. Because of the separation of ownership and control, and dispersed shareholders, even with reconcentration of share ownership in institutional investors, management is tempted to take higher risks than is suggested by the “rational economic corporation/free market” model.  

“Salaries of top management, as well as their positions, are relatively buffered from the financial ups and downs of the corporation from whatever cause – and certainly seem to be independent of the most major damage awards the law has ever meted out.” (For example, compensation of CEO of failed financial institutions were not affected by the Global Financial Crisis even though they have contributed to their institutions’ failure??). Even if the management’s shareholdings are so significant, as a result of incentive adopted to align the interest of the management with the interest of the shareholders, there is still a lack of congruence between the interest of the management and shareholder, and other stakeholders, (such as the bondholders, trade creditors, employees and others). For example, if the choice is whether to market a new drug that can make the corporation millions, but if it is defective cost it millions in damage suits, the bondholder who will only get a fixed rate of interest, or the employees who will likely get the same salaries even if the drug is successful but will likely lose the entire investment or job respectively if the drug turns out to be a huge liability, the bondholders and employees are more likely to be risk adverse than the shareholders and management and would prefer to delay the marketing pending further research but not the managers and shareholders. There is therefore no reason to suppose that a threat of legal liability reasonably calculated to make lawbreaking a poor bargain for the corporation will change management’s calculation in the direction the society desires. There are other doctrinal limitations in the law in imposing civil or criminal liabilities and damages on corporations. There are also problems with imposing potential liability on the people at the very top of the corporate hierarchy who are more likely to effect a change in corporate direction. The people at the top often do not know the details of the day-to-day operation that was causing harm, and there are ways to indemnify them, eg by D&O insurance. There is also the corporation’s rules for

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60 Stone, at 45.  
61 Stone, at 46.  
62 Berle and Mean.  
63 Gordon.  
64 Stone, at 46-47.  
65 Stone, at 47.  
66 Stone, at 49.  
67 Stone, at 49.  
68 Stone, at 49.  
69 For details see Stone, at 50-57.  
70 See stone, at 58-69.
advancement and reward, its customs, conventions, and morals that may actually encourage law breaking.\textsuperscript{71} (eg wells fargo fictitious accounts).

There are other problems with the law, even if the company follows the law:

(i) “the time-lag problem” – it always takes a long time before law is enacted long after the problem (eg that the drugs their corporations are about to produce can alter consciousness or damage the gene pool of the human race, that they are on the verge of multinational expansion that will endow them with the power to trigger worldwide financial crises in generally unforeseen ways etc) is or could have been anticipated by the corporate engineers, chemists, and financiers.\textsuperscript{72} Until the law is passed, “a great deal of damage – some perhaps irreversible – can be done”.\textsuperscript{73}

“There is something grotesque – and socially dangerous – in encouraging corporate managers to believe that, until the law tells them otherwise, they have no responsibilities beyond the law and their impulses (whether their impulses spring from the id or from the balance sheet)… And the dangers to society seem all the more acute where corporations are concerned.”\textsuperscript{74}

(ii) Problems with the making of law\textsuperscript{75} - There is the problem that the law is usually an acknowledgement of rules established by the industry players, the regulatees. The regulator is considerably outstaffed and relatively uninformed compared to the regulatees, so it does not want to set higher standards that it will always have to fight to enforce. Often the regulator is staffed with industry personnel, eg having industry representatives on the board of the regulator. Corporations can manipulate public opinion about the nature and seriousness of the problem by “bamboozling” the public or engaging in “opinion-framing” activities. The regulator is not as informed as the regulatees.\textsuperscript{76} “Even the specialized regulatory agencies, much less the Congress, cannot in their rule-making capacities keep technically abreast of the industry”.\textsuperscript{77} The society often lacks consensus as to the values we want to advance, eg value of clean environment, of human life, luxuries verses sustainability of resources, value of present verses future generations etc.\textsuperscript{78} It is also increasingly difficult to be confident about the real causes of a problem and the real effects of a solution, making it difficult to know what to do.\textsuperscript{79} Even if we can all agree on the value and what to do, we may not be able to translate it into viable legal rules.\textsuperscript{80} If the law is vague, parties will be more likely to contest in court, and corporations prosecuted will feel personally and arbitrarily selected for prosecution, resulting in friction

\textsuperscript{71} Stone, at 67-69.
\textsuperscript{72} Stone, at 94. See also Goo & Klinger, at ???
\textsuperscript{73} Stone, at 94.
\textsuperscript{74} Stone, at 94.
\textsuperscript{75} Stone, at 94-103. See also Goo (Conv); A Ogus.
\textsuperscript{76} See Goo, Regulating sale of off-the-plan property; Ogus, Rethinking self-regulation; Cheffins, Company Law: structure etc…
\textsuperscript{77} Stone, at 96.
\textsuperscript{78} Stone, at 97.
\textsuperscript{79} Stone, at 97-98.
\textsuperscript{80} Stone, at 99.
between industry and government with regrettable ramifications.\textsuperscript{81} The law will also be less effective in face of other more definite competing demands on the corporation eg need to return profits, increase price-earnings ratios etc.\textsuperscript{82} Making finer rules is not necessarily the answer and creates its own problems; rules can become cumbersome, frustrating, pointless, and missing the values they were originally designed to advance.\textsuperscript{83} With cumbersome and detailed rules, corporations might also abdicate their independent responsible judgment treating them as “bright line” they can tread on without compunctions.\textsuperscript{84} Law is more appropriate as a tool for minimum standards of conduct rather than to force from each person what he is fully capable of.\textsuperscript{85} Many of the corporate problems fall into the latter category, eg American automobile manufacturers not doing all they can to develop cleaner engines, creating not only environmental problems, but also balance of payments and unemployment among US auto workers as well.\textsuperscript{86} A stakeholder board will more likely enable the board to do the best they can over and above the minimal standards required by law.

(iii) Problems in implementing the law \textsuperscript{87} – It can be very difficult if not impossible to know or establish the cause or source of harm and to prove the extent of injuries and the injuries attributable to the harm, eg the product may contain chemicals that are killing us slowly or reducing our life expectancy.\textsuperscript{88} The administrative and regulatory cost of enforcing the law compared to the benefits may prevent enforcement.\textsuperscript{89} The law can be counterproductive too in that it may discourage people from developing information that would help improve the system as the same system can be used to attribute liability.\textsuperscript{90} Whilst the law can keep harmful products, eg bad drugs, off the market, it can also delay non-harmful products (eg valuable medicine preventing deaths) from reaching the market depriving consumers of the benefit of such products.\textsuperscript{91} There is also the evidential difficulty of identifying and proving causative factor where many companies are involved in a harm or accident.\textsuperscript{92} Courts are ill-suited to resolve complex “polycentric” issues and offer cost effect solutions. Whilst special agencies or regulators should have the flexibility and expertise compared to Congress to make regulations and enforce them, the evidence suggests that they tend to be captured by the regulated industries; they tend to protect the industries they are supposed to regulate.\textsuperscript{93} They may be incapable of developing consistent policies, often ineffective, may be corrupt or subject to influence peddling, sometimes over-regulate or over-

\textsuperscript{81} Stone, at 100.  
\textsuperscript{82} Stone, at 100.  
\textsuperscript{83} Stone, at 100.  
\textsuperscript{84} Stone, at 101.  
\textsuperscript{85} Stone, at 101.  
\textsuperscript{86} Stone, at 101.  
\textsuperscript{87} Stone, at 103-110.  
\textsuperscript{88} Stone, at 103.  
\textsuperscript{89} Stone, at 104.  
\textsuperscript{90} Stone, at 104-05.  
\textsuperscript{91} Stone, at 105.  
\textsuperscript{92} Stone, at 105-06.  
\textsuperscript{93} Stone, at 106. See also Goo (Conv), Ogus, Cheffins
They may suffer from staffing problems, lack of budget, failure of appropriate congressional oversight and other transient and remediable problems.

If the law and the agencies were effective, it would be proper to brush aside the calls for corporate social responsibility, but “the weakness of the agencies are simply a further argument that trust in our traditional legal machinery as a means of keeping corporations in bounds is misplaced – and that therefore something more is needed.”

II. LITERATURE REVIEW, RESEARCH QUESTIONS AND METHODOLOGY

As mentioned above, in my view, the main problem lies in the idea of profit maximization for shareholders. However, given that there are strong proponents who took the opposite view, this will be the main research question that this paper seeks to address. This paper seeks to answer this question by examining two related questions: (i) whose interest should corporation serve? (ii) does profit maximization for shareholders achieve the most efficient outcome?

To answer question (i), I review the literature to trace the historical root of corporation to find out how it came into being, whose interest was it to serve, and how it had changed over time and why, and demonstrate that the original purpose of a corporation, which is to benefit society and profit for shareholders is only secondary or ancillary, is still relevant in modern time. I also review the law and economics literature to see what lawyers and economists think corporation is for, and the literature on political economy to understand how politics led to the change in its perceived purpose, and to demonstrate that the perception is misconceived and should be restored.

To answer question (ii) I examine the arguments in the literature for and against from law and economics perspective. I conclude that profit maximization is not efficient from the societal perspective. To understand the difficulty in any reform in this direction, I review the literature on corporate social responsibility and the development in the shareholder versus stakeholder debate in the US and the UK from a political economy perspective to predict which way the debate might go in the US and the UK. I conclude by predicting that there is optimism that stakeholder board will prevail, but the challenge is to find a workable mechanism.

In finding data and information to answer the above research questions, I adopt a combination of approaches: Analytical - relevant published literatures are studied to discern and explicate principles or theories that might guide action; comparative - similar situation in two or more places are studied to determine and explicate their likenesses and differences to draw comparative lessons; developmental - the changes over time in one or more observable factors, patterns, or sequences of growth or decline (e.g., use of corporate form, royal charter and state charter, number of factories, and

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94 Stone, at 107. See also Goo, Ogus, Cheffins
95 Stone, at 108. See also Goo, Ogus, Cheffins
96 Stone, at 110 (emphasis added).
degree of pollution) are traced or charted and reported; and historical -history of incorporation is studied to reconstruct the past accurately and without bias in order to ascertain, document, and interpret their influences and to check the tenability of hypothesis.

III WHOSE INTEREST DID CORPORATION SERVE ORIGINALLY?

Stone made a compelling case for making corporations more socially responsible. But critics claim that corporations are there to make profits for shareholders. But are they? Why were corporations invented historically?

A. Historical Perspective

What is the original purpose of corporation? Does it still serve a useful purpose? Has it changed over the years? If so, should we go back to the original purpose? These are important questions as they provide insights into how corporations should be regulated today, and what kind of governance structure we should develop.

The evolution of corporations can be traced back to the temples of ancient Mesopotamia, nearly four millennia ago at the time of the Code of Hammurabi, which were in some respects like corporations.98 Vikramaditya S Khanna (2006) claims that corporate entities, the “sreni” – a complex organizational entity that shares similarities with corporations, guilds, and producers’ cooperatives – existed in India from around 800 B.C. until the advent of the Islamic invasions around 1000 A.D.99 It was widely used in virtually every kind of business, political and municipal activity. It has a separate legal personality separating the assets of the sreni and those of its members; it facilitates asset partitioning or entity shielding). [SG: any limited liability?] This was ahead of the Roman’s protocorporations, the “societates” in the seventh century BC, which were often used to do business with the state.100 Vinogradoff claimed there was evidence of corporate entities in ancient Athens in the sixth century BC. There were partnership companies in Venice and Amalfi in the ninth century of the Christian era to finance voyages, apparently modeled on the legal form of Islamic muqarada.101 Partnership companies emerged in Florence and Genoa in the twelfth century.102 These Italian-style partnership companies were imitated in parts of Northern Europe, but did not have perpetual existence and were vulnerable to the death and exit of one of the partners. In the twelfth and thirteen centuries, new legal systems were developed in England, France, Germany, Sweden, Poland and the Netherlands under the new canon law of the church and the discovery of Justinian Roman law, which recognized “corporate persons” that could exist in perpetuity and survived the death and exit of individual member.103 Towns, charities, religious communities, universities, and guilds became corporations, set up by royal charter and regulated by the state, with privileges and immunities.104 Most of these were not for business and did not evolve

99 See Khanna (2006)
104 Hodgson, at 225.
into modern business corporations.\textsuperscript{105} It was not until the sixteenth and seventeenth centuries that the first chartered business corporations first appeared in England, for example the Muscovy Company (1555), The East India Company (1600), the Hudson’s Bay Company (1670).\textsuperscript{106} The Dutch East India Company was formed in 1602,\textsuperscript{107} whilst the first business corporation, the Honor dels molis del Bazacle, in France was formed in the fourteenth centuries. As the sections below show, these corporations were originally allowed by the state to serve the interests of the state and the community, not the interest of individual business peoples. However, this changed in the course of history from mid-19\textsuperscript{th} century with recognition of limited liability in England in 1855.

(check Hodgson, how economics forgot history)

1. France - The Origin of Corporation

France is not a jurisdiction this paper looks at, but for this section we take a look at France because it is where the earliest corporation could be traced back today.\textsuperscript{108} Contrary to popular believe, corporations existed long before, in the fourteenth century in at least one major city in Occitania in the south of France, to finance profitable economic infrastructure, ie the construction of large-scale water mills and dams along the Garonne River.\textsuperscript{109} The Honor dels molis del Bazacle, dating from 1372, is believed to be the oldest known corporation.\textsuperscript{110} It was created to serve the interest of residents in the city.

“The medieval Toulousain investor between the twelfth and fifteenth centuries who bought mill shares was not acting exactly like the modern-day capitalist, eager to draw the greatest pecuniary profit possible from his resources. Since the dividends were distributed in the form of grain, the shareholder did in fact intend to increase his revenue, but also sought to feed his family and to protect himself from shortage. Generally, he only bought the share necessary to satisfy this need. Hence the explanation of a fact surprising to the modern mind: the mill shares were distributed among numerous hands without the number of shares bearing any relation to the total fortune of the shareholders.”\textsuperscript{111}

The first corporation was different from its cousins today. It evolved gradually over time. Shareholder decision by majority rule began in 1372.\textsuperscript{112} From 1387, a new entity, the mill honor, distinct from its shareholders was born to represent the company.\textsuperscript{113}

Sicard explains how corporation came about, why it was recognized as judicial person, who were shareholders, how was corporate decision made etc. These all bear the

\begin{itemize}
  \item \textsuperscript{105} Hodgson at 225 citing Hessen (1979, 1987)
  \item \textsuperscript{106} Hodgson at 225.
  \item \textsuperscript{107} It was also the first corporation that had its shares listed on the Amsterdam Stock Exchange.
  \item \textsuperscript{109} Ibid, at p.x.
  \item \textsuperscript{110} Ibid, at xiii. It existed until 1946 when it was nationalized when the French public national electricity company EDF was created, and some of the shares of EDF have been listed on the Paris Bourse since October 2005: ibid, at xiii.
  \item \textsuperscript{111} Ibid, at xxiii.
  \item \textsuperscript{112} Ibid, at 201.
  \item \textsuperscript{113} Ibid, at 206.
\end{itemize}
characteristics of a modern corporation. So it grew organically for the purpose of serving each member of the society and each member was a shareholder.

Will research into the question whether the Dutch and the English use the same concept of corporation? How did the Dutch and English East India company come about? What was it for? Who were shareholders?

2. The UK

(To write up)

3. The US

Corporations existed in the US from the early colonial period. At the time, the established doctrine was that only the king in Parliament could create corporations by royal charters. They were created to bestow a de facto monopoly on the corporations to undertake the range of public functions such as setting up local governments and conducting negotiations with the indigenous peoples of a colonial territory. From the early days, “English law has sought to constrain the use of the corporate form in order to preserve the political authority of the Crown to grant charters”. Corporations by royal charters were established to serve the interest of the Crown, not individuals’ private interest.

The Virginia Company (the Virginia Company of London and Virginia Company of Plymouth), the two joint stock companies chartered under James I on 10 April 1606 to establish settlements on the coast of North America with self-governance, were probably the first corporations in the US. Corporations in the US were uncommon before 1800. They were mostly churches, charities, cities or boroughs. Very few were business corporations; they were banks, insurance companies, water companies, and companies organized to build and run canals, turnpikes, and bridges providing public services, with even less for manufacturing purpose.

Early charters had many peculiar characteristics, eg corporations did not have perpetual existence as they do today; charter terms of five, twenty, or thirty years’ duration were quite common before 1823. Shareholders did not enjoy one share one vote until after 1819.

After the American Independence in 1776, state charters – a special bill adopted by state legislature, replaced royal charters. At the beginning of the 19th century, the Jeffersonians were reluctant to encourage industrialization because of fear of the consequences of larger amounts of capital assembled in any private enterprise. Thus, there were many restrictions and checks and balances against the corporate purposes and powers in corporate charters. There were restrictions on the size of the capital,

114 See also Stone, chapter 4.
116 CCG, at 18.
117 See Adam Winkler, We the Corporations: How American Businesses Won Their Civil Rights, p???
118 Lawrence Friedman, A History of American Law, (2d ed, 1985), at 188.
119 CCG, at 19.
maximum value and location of property the company could own, indebtedness etc.\textsuperscript{120} The special charter system, continuing the tradition of the English Royal charters, was a strong mode of corporate control.\textsuperscript{121}

However the demand for charters was too great that the state legislatures would have been swamped if incorporation had not become so routine under state corporate statutes. Thus, between 1800 and 1850, the nature of corporations changed from a unique, \textit{ad hoc} creation, vesting exclusive control over a public asset or natural resource in one group of favourites or investors, to a general form of organizing a business, legally open to all, and with very few restrictions on entry, duration, and management.\textsuperscript{122} Incorporation by specially tailored bills for state charters gave way to standard clauses in State corporate statute law and case law of corporations. New York was the first state to enact a corporate statute in 1811, The Act Relative to Incorporations for Manufacturing Purposes of 1811, for free incorporation with limited liability but only for manufacturing businesses,\textsuperscript{123} with New Jersey and Connecticut followed suit in 1816 and 1837 respectively. Delaware enacted its first corporation law as late as 1883. So by about 1830s, state enactment of corporation laws was becoming more common. However, due to the restrictive nature of state corporation laws at the time as a result of the Jeffersonian period of hostility against private power, many companies continued to seek a special legislative charter for incorporation to attain privileges or monopolies until the late nineteenth century.

After the civil war, to meet the need to seek the help of entrepreneurs to rebuild the country, from the end of the 19th century, there was a rapid transition in state corporation statutes from explicitly regulatory to largely enabling.\textsuperscript{124} With New Jersey enacting a largely enabling corporation statute in 1888, and Delaware followed suit in 1899, there was a ‘race to the bottom’\textsuperscript{125} or dubbed “charter mongering”\textsuperscript{126} ending substantive state regulation of corporate behaviour. One consequence of this race is that it ‘minimized constraints that interfered with shareholder wealth maximization’.\textsuperscript{127} The corporation could do anything it wanted, operate where it wanted to, grow to whatever size it wanted, manufacture any products and provide any service it chose.\textsuperscript{128}

However, despite the change from incorporation by special charter to free incorporation under state corporate statute, one feature remains constant: ‘only the state can create a corporation and confer limited liability on its shareholders’.\textsuperscript{129} Furthermore, even with the enabling state corporate statutes, the state or indeed the federal government has never given up control over corporations. Thus, whilst proposal for a federal corporate

\textsuperscript{120} Stone, at 20.
\textsuperscript{121} Friedman, at ???.
\textsuperscript{122} Friedman, at ??? check 188-192, 194-198.
\textsuperscript{124} CCG, at 25.
\textsuperscript{125} Justice Brandeis’s famous words in Liggett v Lee 288 US 517, 557-560 (1933).
\textsuperscript{126} Stone, at 21.
\textsuperscript{127} Ralph Winter, Government and the Corporation (1978); Daniel Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s corporation Law, 76 Nw U L Rev 913 (1982).
\textsuperscript{128} Stone, at 22.
\textsuperscript{129} CCG, at 18.
law has never taken off, at periodic intervals, Congress had responded to special crises by enacting laws regulating particular aspects of corporate behaviour, for example the federal Securities Act of 1933, Securities and Exchange Act 1934, the Williams Act 1968, the Foreign Corrupt Practices Act 1977, Sarbanes-Oxley Act 2002 and Dodd-Frank Act 2010.

In the early days, the court was equally restrictive in its control over corporations. Even after the US Supreme Court held in 1819 in *Trustees of Dartmouth College v. Woodward* that corporate charters are "inviolable" and not subject to arbitrary amendment or abolition by state governments, the Supreme Court also said that the state could reserve a power in the corporate charter to amend the charter if it so wished. Here, the state of New Hampshire tried to turn the college into a public institution after its President was deposed by its trustees, so that the governor of New Hampshire could reinstate the college’s President. The Supreme Court held that the original charter granted by the British crown in 1769 was a contract protected by the contract clause in the US Constitution and the charter was not dissolved by the American revolution. The Charles River Bridge decision held that charters were to be construed strictly to keep the corporate powers within narrow boundaries. Similarly, the court in *Wood v Drummer* case was against shareholders declaring dividend out of capital to protect creditors.

4. Conclusion

Historically, a state charter allowed distinct corporate entities to undertake a (very limited) range of activities, such as building roads or canals, that were assessed to yield substantial public benefit. As Henry Carter Adams said in his presidential address to American Economic Association, Economics and Jurisprudence:

“Corporation originally were regarded as agencies of the state. They were created for the purpose of enabling the public to realize some social or national end without involving the necessity of direct governmental administration. They were in reality arms of the state, and in order to secure efficient management, a local or private interest was created as a privilege or property for corporation. A corporation, therefore, may be defined in the light of history as a body created by law for the purpose of attaining public ends through an appeal to private interest.”

Many of the potentially problematic effects of corporations, especially their capacity to concentrate wealth and power, have been acknowledged and guarded against since the early 13th century. As a result, as we have seen in the US and the UK mentioned above, the corporate form was held under sovereign control until the late 18th

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130 17 U.S. 518 (1819).
131 https://books.google.com/books?id=FkUQAAAAYAAJ&pg=PA1#v=onepage&q=corporations%20originally&f=false, at p 16
132 Post, 1934; Micklethwait, 2005, cited in Veldman and Wilmott, at ??
century. Whilst chartered business corporations were permitted to make a private profit for those who invested in it, they were fewer and the liabilities for its investors were unlimited.

However, “Pressures to expand and fund imperialist geopolitical ambitions (Neocleous, 2003) slowly divorced the corporate form from direct political control. In the 19th century, political restrictions were further questioned and subsequently relaxed. Further relaxations and occasional tightening of these state-mediated political restrictions have ebbed and flowed in the 20th and 21st centuries (Bowman, 1996).”

With the government as its midwife and guardian, the concession of limited liability became established in the mid-19th century, and shareholders allowed to retain their access to rewards but minimize the risks associated with the potential recklessness or incompetence of managers and with the turbulence of markets. The concession changed the cause of history and blur the original public benefit purpose of corporations, because it encouraged many investors to use corporations as a vehicle to conduct business with a selfish private interest of profit maximization, although as Adam Smith observed, this selfish pursuit of private benefit does also confer benefit on the public. By the 1860s after the American civil war, entrepreneurs became the leaders in the country who ‘built America’ and profit maximization by whatever means necessary became very much the ideal of business using corporations as vehicle to conduct business. This then led economists to believe and teach, in my view

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134 Veldman and Wilmott, at 9.
137 See The Men Who Built America.
138 In an article addressed to young and senior businessmen (see pp 126-127), Professor Robert Anthony of Harvard Business School, concluded that the reason why college graduates in economics were so ill equipped to handle real-life business problems, and why they, by applying what they avowed were sound analytical tools learned in college, often arrived at naïve solutions to the problems in business cases, was the assumption in most college economics texts and college classrooms that the objective of a business was to maximize profits. And unfortunately, this assumption was not confined to the campus; countless writers have taken it for granted that management’s purpose was to maximize profits; lawyers, labor union spokesmen, and government officials often indicated that they shares the same belief, and businessmen themselves sometimes said they operated on this assumption, Anthony observed. In 1960, when Antony wrote the article, he said in reality, profit maximization was not the dominant objective of American business, although they undoubtedly fit the profit-maximization pattern. Although leaders of the business community stressed the importance of a satisfactory profit, they also discussed “business responsibilities, the need for a fair division of income among the parties involved in a business, and other subjects that are incompatible with the profit maximization goal”. He quoted Donald K David as saying

“Business leaders, who wish to preserve and strengthen the kind of society in which we believe, must run a business organization which, beyond being competitive, is a satisfactory social entity for those who work in it and a constructive entity in the national whole. To this basic purpose there must be added the study of the responsibilities of management… [For the workers, the management must undertake to provide] not only the conditions essential to the effective performance of work but the realizing of their potentialities as persons so that freedom need not be futile or purposeless for any person. The community, which a company itself comprises, must be a healthy community, satisfying the non-economic as well as the economic needs of the individuals who make it up and enabling them to consider their work a way of life as well as a livelihood. But another responsibility, sometimes in apparent conflict with our human commitments inside our companies, extends to the businessman’s public responsibilities to the community, to the nation and the world comprised of all such communities.” (Address before the Transportation Association of America, January 20, 1954, cited at 127)
mistakenly, that corporations are there to maximize profit for the shareholders and investors, not for the society (the non-shareholder stakeholders), even though legally corporations by incorporation are subject to the same law and legal concepts as the original corporations chartered by the state for public purpose.

B. Legal Perspective

What is the original intent of the law? Has it changed? Should it change? From the legal doctrinal perspective, a corporation is a separate legal person from its shareholders. This was established as early as 1387 in the Mills of Toulouse in France, where a new entity, the mill honor, distinct from its shareholders was born to represent the company. Thus, it is the corporation, not the shareholders, managers, or creditors, that owns the assets of the corporation, whether they are corporations for public benefit or private benefit of shareholders. Nor are shareholders legally the primary residual claimants of corporate revenues or assets when the corporation is wound up; there are other government taxes, labours and creditors who have a claim in the wound up fund before the shareholders get their shares (if there is anything left especially in an insolvent winding up).

Since corporation is a separate legal person from its shareholders, directors’ duty to act “in the best interest of the company” is owed to the corporation, not to its shareholders. Thus, it has been argued that:

“[Directors’] legal duty is not to act on behalf of shareholders or to maximize shareholder value but, rather, to act ‘in the best interests of the company’ (Parkinson, 2003: 493) — a duty that extends to all those deemed to have an investment in the corporation.”

From the legal standpoint, this means that directors owe a duty to the company to maximize the stakeholder value (which includes shareholder value).

Why, then, are economics courses constructed on the assumption? Anthony said that its use permits a rigorous intellectual reasoning process; it was to make teaching the subject easier. Although often students are told that what they are studying is theoretical to be explored for its own sake, and not because it conforms to reality, this does not always sink in (at 128).

See also E. Merrick Dodd, Jr, For Whom Are Corporate Managers Trustees? 45 Harv L Rev 1145, 1148-50 (1932); Paul G Mahoney, Contract or Concession? A Historical Perspective on Business Corporations (University of Virginia School of Law, Working Paper, 1999) arguing that corporations exist by virtue of a state “concession” and therefore ought to be governed in the interests of society or all corporate constituencies, rather than in the private interest of shareholders alone. Whilst Berle championed shareholder interests in the 1930s (see Adolph A Berle, Corporate Powers as Powers in Trust, 44 Harv 1049, 1049 (1931): Adolph A Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv L Rev 1365, 1367-68 (1932)), by the 1950s, he seemed to have come around to Dodd’s managerial discretion as a positive virtue that permits managers to act in the interests of society as a whole (see Adolph A Berle, Jr, Power Without Property: A New Development in American Political Economy 107-10 (1959), and also John Kenneth Galbraith, The New Industrial State (1967): Hansmann and Kraakman, at 444. For an important collection of papers arguing on both sides see Edward Mason ed, The Corporation in Modern Society (1959).

139 Veldman and Wilmott, at 14-15.
Although shareholders are not the legal owners of corporations, admittedly they are the principal beneficiaries of the limited liability corporate form (which is justified by reference to its more productive, but also more risky, use of assets), but not the only beneficiaries. Thus, it has been said that:

“Contrary to what advocates of agency theory and shareholder value may assume or conjecture … , it is important to underscore the point that shareholders do not ‘own’ the corporation within the legal imaginary. The widely rehearsed wisdom that the corporate form is ‘owned’ or used to protect and promote the (exclusive) interests of its shareholders as a prioritized constituency, is a myth (Allen, 1992: 265; Crouch, 2011: 136). Qua entity, the corporate form can have multiple ‘owners’ or ‘stakeholders’; these stakeholders may have a variety of ‘investments’ in its formation, development, and continuation (Ireland, 2005, 2009, 2010; Robe, 2011; Stout, 2012). In the legal imaginary, the corporation is conceived as ‘having responsibilities to a range of constituents, including shareholders as well as employees [including managers], customers, creditors, and the general public’ (Ciepley, 2013: 147)"141

Although in Dodge v Ford Motor Co, the Michigan Supreme Court held that directors cannot consider interests of other stakeholders, it has been said that:

“Among non-experts, conventional wisdom holds that corporate law requires boards of directors to maximize shareholder wealth. This common but mistaken belief is almost invariably supported by reference to the Michigan Supreme Court’s 1919 opinion in Dodge v Ford Motor Co.”143

Henderson said:

“Dodge is often misread or mistaught as setting a legal rule of shareholder wealth maximization. This was not and is not the law. Shareholder wealth maximization is a standard of conduct for officers and directors, not a legal mandate.”144

1. Legal and economic theories

William Bratton traced the historical development of the legal and economic theories of the firm. From the early nineteenth century to 1850, as noted above, very few businesses took the corporate form, and corporate form was instituted only by the sovereign’s grant of a charter and only businesses that received state franchises, eg public utilities, transport concerns, banks, insurers, and water works were conferred charters.

“The prevailing legal theories described the corporation as a legal fiction and an artificial entity… this means that the corporation was an entity, and that entity was a state-created reification. This operative ‘concession’ notion had been received from British law. With the special charter as the dominant mode

141 In conceptions of the corporate form which prevailed from the 1930s until the 1970s the legal imaginary led to the view of the corporate form as a ‘quasi-public’ type of representation (Berle and Means, 2007 [1932]) which implicitly incorporated a stakeholder conception of governance (Drucker, 2006 [1946], Kaysen, 1957).
143 Lynn Stout (2007).
144 Todd Henderson (2007).
146 Bratton, at 1484.
of corporate creation, this concession-based corporate theory accurately described American corporate practice.\textsuperscript{147}

At the same time, there were British lawyers who resisted the idea of sovereign’s authority to create new legal actors and maintained that only natural persons could exist in the legal world. They advanced contractual conceptions of the firm.\textsuperscript{148} It was claimed that “American law, with its “artificial entity” and “legal fiction” concepts, carried on this tradition of individualism, even as it conceded the existence of state-created juridical persons.”\textsuperscript{149} However, it was also acknowledged that despite the individualist claim, the legal foundations for later corporate collectivities were laid during this early period, and by 1850s the doctrinal provisions of free transferability and unlimited life were in place, and more importantly, the doctrine instantiated group values.\textsuperscript{150} So, traditionally, there were two competing legal theories - the “entity” theory and “concession” theory on the one hand, and “aggregate” theory and “contractual” theory on the other. As Bratton explained, “speculation about the reality of corporations, their entity and aggregate characteristics, and their origins in concession or contract was commonplace in legal theory until around 1930” when the management-centered conception of large corporate entities took hold.

Between 1850s to 1880s, the state enacted “general corporation laws” to allow equal access to the corporate form, which impaired the concession theory as corporations no longer seemed a product of sovereign grace.\textsuperscript{151} However, many still saw corporation as a reified entity. But as managers and investors, acting on behalf of corporations, became powerful economic actors, corporate doctrine developed restraints against corporate and managerial power.\textsuperscript{152}

From the 1880s to the turn of the Century, large corporations, termed “management corporations”, performing multiple tasks of production \textit{and} marketing replaced many small firms, producing an array of goods cheaply and in quantity.\textsuperscript{153} This was probably the beginning of the corporate social responsibility abuses, but no one saw the issue at the time. Managers’ powers grew stronger as managers were seen as having the expertise to coordinate production and marketing on a large scale, and investors withdrew from active participation in corporate management.\textsuperscript{154} This was the beginning of the separation of ownership and control; “corporate control of production partially displaced market control, causing power to flow from individuals to groups”.\textsuperscript{155} As Bratton points out, in the atomistic economy before the emergence of management corporations, economic actors did not exercise power against one another unilaterally; each actor decided what to produce or consume, and power relations were bilateral in that one could only affect another’s conduct indirectly by refusing to contract.\textsuperscript{156}

\begin{itemize}
\item \textsuperscript{147} Bratton at 1484.
\item \textsuperscript{148} Arthur J Jacobson, The Private Use of Public Authority: Sovereignty and Associations in the Common Law, 29 Buffalo L Rev 599, 662-63 (1980).
\item \textsuperscript{149} Bratton at 1484 citing Morton J Horwitz, Santa Clara Revisited: The Development of Corporate Theory, 88 W Va L Rev 173, at 181 (1985).
\item \textsuperscript{150} Bratton at 1485.
\item \textsuperscript{151} Bratton, at 1486.
\item \textsuperscript{152} Bratton, at 1486.
\item \textsuperscript{153} Bratton, at 1487.
\item \textsuperscript{154} Bratton, at 1487.
\item \textsuperscript{155} Bratton, at 1488.
\item \textsuperscript{156} Bratton, at 1488.
\end{itemize}
management corporations, “entities, rather than transaction between individuals, guided the flow of goods through the processes of production and distribution. Some of this management power was effectively unilateral – hierarchical superiors directed subordinates in the production and marketing processes. As to other economic actors – investors, suppliers, and consumers – management groups exercised varying degrees of dominance in the context of bilaterally structured relations.”

Management corporations were seen a success and state corporate law (e.g., New Jersey and Delaware) responded favourably by offering standardized corporate structures without ancillary regulation of business decisions.

“Although nineteenth century forms of shareholder participation stayed in the statutes, shareholders did not invoke them to challenge management arrangements. Judge-made corporate law changed too. Mid-nineteenth century fiduciary strictures on managers disappeared rather suddenly. The fiduciary principle survived in name, but, in practice, the system tolerated individual selfishness.”

During this period, individualism advanced a contractual theory of the corporation. It began to reject concession theory, replacing the sovereign with freely contracting individuals, taking an aggregate, rather than an entity, approach. On the other hand, the corporate realism theory treated the corporate entity as real, and management corporations as the classical profit maximizer in collective form. Horwitz argued that corporate realism better legitimized the practices of the management corporation than any other theory at the time.

From the twentieth century to 1980, management corporations continued their rise, and internal changes in corporate structure enhanced management discretion. After the First World War, multiple divisions appeared in some leading corporations, containing more than one operating unit and had a top management group responsible for all units. Top management became separate from operations management, and this type of structure became widespread after the Second World War and helped some corporations to grow into conglomerates in the late 1960s. Shareholdings became widely dispersed and there was an unspoken understanding until late 1970s between management and shareholders that for as long as the managers maintain stable dividends, they would be left to pursue growth. New Jersey and Delaware corporate law became the national norm supporting managerial discretion. The federal securities law of the 1930s requiring public disclosure of material information for the benefit of investors and the securities markets, only operated as a moderate constraint on management discretion. But traditional legal theory became influenced by economic theory of the firm. Berle and Means’s The Modern Corporation and Private Property published in 1932 marked the beginning of the new era which recognized the wide managerial discretion and advocated the use of incentive to align the management with the investors. But something else happened within economics: neoclassical microeconomics declined to theorize about the internal operations of the management corporation, but restricted their attention to the market explaining coordination of the

157 Bratton, at 1488.
158 Bratton, at 1489.
159 Bratton, at 1489.
160 Bratton, at 1490.
161 Horwitz, at 224.
162 Bratton, at 1492.
163 Bratton at 1493.
164 Bratton, at 1493.
use of resources and distribution of income by the price system. They employed the received model of the single-product firm operating in a static but highly competitive environment, treating the firm as owned by a single proprietor who strived to maximize profits, using only output and price as strategic variables. This approach reduced the firm to a “Production function” deemed to follow profit consideration exclusively and behave as an entity in rational patterns no different from those of human actors.

Berle and Means also encouraged the debate whether corporation was public or private in order to justify government regulation. Those seeking regulation argued that large corporations are similar to government, especially “public” firms which are like “political” entity. However, state corporate law remained substantially pro-managerial into the 1980s.

The managerialist affirms the legal doctrine that vested governing power of the corporate entity in the board of directors subject to shareholder vote, but recognized that the management in fact controlled the board, and that the financial community supported management.

“Management possessed hierarchical power ... First, management determined the processes of production and distribution. Second, management dominated enormous bureaucracies and exercised authority over the lives of all those lower down on the ladder. Third, management-dominated firms imposed externalities.”

This went on until the new economic theory, which was devised by economists in the 1960s, penetrated legal literature after 1980, raising concern about the nature of corporation among legal academics.

The new economic theory avoided direct discussion of hierarchies in management corporations. It describes all internal relationships as market transactions.

“The managerialist corporate entity almost disappears, dissolving into disaggregated but interworking transactions among the participating actors. All of these interworking firm transactions resemble one another. The “separation of ownership and control,” on which the managerialist picture based management power, no longer matters. “Ownership” becomes as irrelevant a concept as “firm entity.” The “firm” is only a series of contracts covering inputs being joined so as to become output. “Capital,” and thus the traditional legal situs of ownership, devolved into one of the many types of inputs.”

As Bratton explains, the new theory offers support to and finds favour with the management to continue the status quo of management dominance:

165 Bratton, at 1495-6.
166 Bratton, at 1496.
167 Bratton, at 1496.
168 Bratton, at 1497.
169 Bratton, at 1497, note 135.
170 Bratton, at 1475-76.
171 Bratton, at 1476.
172 Bratton, at 1477.
173 Bratton, at 1499.
174 Bratton, at 1499.
175 Bratton, at 1499.
“Treating hierarchy as if it does not exist offers wonderful support to those at the top of the hierarchy, so long as the treatment implies no concomitant reordering of the status quo. Moreover, by challenging the anti-managerialist critique of corporate law, the neo-classicists in some respects challenge the status quo in management’s favour. They rebut the anti-managerialists’ “public” characterization with a model of “private” contracts among successfully contracting market actors. “Concessions” of sovereign authority have no place in this picture of free contract.

By stripping the content from the firm entity and introducing the self-interested rational economic actor, the new theory also rebuts the concept of fiduciary duty. Legal duties of selflessness do not figure into the neoclassicists’ conception of bilateral contract relations… To one anti-managerialist observer, the new economic theory completes the twentieth century trend toward loosened fiduciary restraints and enhanced management discretion. In fact, management spokespersons did make dramatic use of the theory in the early 1980s to protest the first draft of the American Law Institute’s Principles of Corporate Governance.”

The institutionalists, on the other hand, developed a variant that legitimized the received hierarchical structure of the management corporation as a contractual arrangement which minimizes transaction costs, treated the corporation as a “private” phenomenon, and affirmed the corporate structure and management’s place in it.

It is said that the new theory returned the corporate entity to limited life as a legal institution.

2. Doctrinal theory

However, despite the development and changes in the economic and legal theories of the firm, the doctrinal theory of the corporate firm remains substantially constant, and embodies values of traditional corporate practitioner, rather than those of the legal or economic theorist, or corporate chief executive officer or the Wall Street investment banker. The first definition of a corporation could be traced back to Angell and Ames’s writing drawing from Chancellor Kent:

“A corporation is [an artificial and fictitious], a body, created by law, composed of individuals united under a common name, the members of which succeed each other, so that the body continues the same, notwithstanding the change of individuals who compose it, and is, for certain purposes, considered as a natural person”.

The second definition was provided by Kyd:

“A corporation, or a body politic, or body incorporate, is a collection of many individuals, united into one body, under a special denomination, having perpetual succession under an artificial form, and vested, by the policy of law, with the capacity of acting, in several respects, as an individual, particularly of taking and granting property, of suing and being sued, of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence.”

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176 Bratton, at 1499.
177 Bratton, at 1500.
178 Bratton, at 1501-02.
179 Bratton, at 1502.
The third was from Chief Justice Marshall in the famous case of *Trustees of Dartmouth College v Woodward*:

“A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality … Its immortality no more confers on it political power, or a political character, than immortality would confer such power or character on a natural person. It is no more a state instrument, than a natural person exercising the same powers would be.”

Chief Justice Marshall’s definition provides foundation for early nineteenth century “fiction” theory and presents a concession theory of its origin. The second and third sentences set out the *ultra vires* doctrine and state that the powers of a corporation are for the purposes for which the powers are granted and since the corporation is not a natural person it has no ability to formulate its own purposes and follow them, the corporation is only a means to prescribed ends. His reference to corporate immortality and “political power” were directed to the application of the contract clause of the US constitution to the Dartmouth College charter, the issue disputed in the case, on which he found corporation to be, in substance, private and moved to a contractual ruling, balancing a concession theory with contractualism.

The three definitions have survived till this day albeit with some adjustment as corporate doctrine changed. Even with the changes in corporate power caused by the era of “market for corporate control”, the changes have not been sufficiently revolutionary to effect a break with the historical doctrinal theory of the firm. Much of the concerns were effectively dealt with by fiduciary duty concepts to restrain the conduct of management in defending against tender offers, and to protect the interests of minority shareholders after takeovers. As Bratton concluded:

“[T]he doctrinal theory of the corporate firm refutes the assertion that the corporation “is contract”. History tells us that the corporation “is contract, and always has been contract and other things besides”. While the doctrinal theory always takes cognizance of contractual elements, it never makes contract the essence. The doctrinal theory balances contract against the corporate entity and a sovereign presence. If, as seems probably, corporate law continues to evolve in accordance with the historical pattern, decisionmaking will proceed with reference to the particulars of the corporate relationship in question… Contractual notions will be entertained, but any move to foreclose wider discussion by the assertion that contract should govern as a function of the intrinsic nature of the corporation will fail … Doctrinal reconstruction tends to occur in response to practical, not theoretical, developments, legitimizing or inhibiting them as the case may be. Actors who create corporate law have shown little disposition to reconstitute it as a means to the end of recognition of the latest academic theory”.

3. Conclusion

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183 17 US (4 Wheat) 518, 636 (1819).
184 Bratton, at 1504-05.
185 Bratton, at 1505.
186 Bratton, at 1506 and 1510.
187 Bratton, at 1516.
188 Bratton, at 1519, citing Revlon Inc v MacAndrews & Forbes Holdings Inc 596 A 2d 173 (Del 1986) (managerial decisions regarding control); Weinberger v UOP Inc 457 A 2d 701 (Del 1983) (minority protection after takeover).
189 Bratton, at 1517 and 1527.
Thus, from the legal perspectives, despite development in law and economic theories, judges applying the doctrinal theory, treat a corporation as a collective body separate from shareholders. Whilst they do not say categorically that corporation consists of all other stakeholders, they clearly do not treat corporation as being equal to shareholders. At the end of the day, it is the doctrinal theory that trumps all legal and economic theories.

C. Economic Perspective

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Hansmann and Kraakman argued that the shareholder-oriented model is more efficient than stakeholder model. They point out (see 449) to develop further

As mentioned above, the idea of corporation as a separate legal personality and the concession of limited liability allow entrepreneurs to access economic reward without the corresponding risk, and encourage them to use corporation as a vehicle for conducting business for their private benefit even though legally the corporation is generally subject to the same law and regulations (except those applicable to only public or private companies or specific industries etc).

As Bratton observes, classical economic thinking assumed that market competition would keep the incompetence and greed of owners of the means of production under control and that profit-oriented investors closely scrutinized the managers of firms. 190 This latter point however overlooked the fact that profit-oriented investors have incentive to force managers to maximize profit even at the cost of causing harm to other stakeholders. The economic theory of the firm, in the form of institutional economics, first appears in a Nobel Prize winning essay Ronald Coase published in 1937, The Nature of the Firm, 191 also did not consider the interest of other stakeholders. This says that firms and markets are alternative forms of contracting, identifying transaction costs as the determinants of the choice between the two. 192 It accepts the received managerialist view in contractual terms. The neoclassical variant came in 1972 with the publication of a paper by Alchian and Demsetz, 193 and in 1976 when Jensen and Meckling’s analysis of the firm appeared. 194 These papers attempt to reject the managerialist approach by drawing on neoclassical conceptions of contract: their central point is that the firm is a legal fiction that serves as a nexus of contracts among factors of productions, and managers are seen as agents to shareholder principals. 195 What the neoclassical economists missed out in their equation is other stakeholders. Managers should be seen as agents to stakeholder principals.

However, because of the economic function of corporations, and with the success of the post-civil war entrepreneurs, economists have viewed corporations, mistakenly in

192 Coase, at 390-94.
195 Bratton, at 1478, 1479.
my view, as a mean for maximizing shareholder (investors) values rather than for the benefits of the stakeholders which became something more incidental. Veldman and Wilmott observe:

“The economic imaginary does not directly challenge or overturn the legal imaginary. Instead, the ‘entity’ that is central to the legal imaginary is placed in the background as an inconsequential ‘legal fiction’. In this process of displacement, attention is shifted away from the legal entity and the role of executives in safeguarding and expanding the assets of the corporation on behalf of a wide range of stakeholders to the material interests and right of control that is ascribed exclusively to investors.”

This, together with agency theory, shifted attention from the original purpose of corporation (which is to benefit society) to profit maximization for the shareholders.

This was worsened by the growth of dispersed share ownership in public corporations in the US since 1920s, which led to the separation of ownership and control, as observed by Berle and Means (1932). Such separation gave managers control over corporations. According to the agency theory, managers lack sufficient incentive to maximize the interests attributed to shareholders. This is called an agency problem, and its associated cost, agency cost, by Jensen and Meckling (1976). Unfortunately, the economists professed corporations as for the benefit of shareholders, to eliminate the agency cost and to align the interest of the managers with the interest of shareholders, sufficiently potent incentives in the form of stock options or short term performance related bonuses designed to align managers’ decision-making with the maximization of shareholder value were used (Khurana, 2007). This in turn led to manager acting to maximize profit for shareholders.

As Veldman and Wilmott point out:

“In this agency-theoretic economic imaginary there are three radical departures from the legal imaginary....There is ... a departure from a view of managers as impartial experts or mediators who apply their expertise to make informed, well-balanced decisions in the interest of wider sets of stakeholders...Second, according to the agency-theoretic economic imaginary, the most critical aspect of corporate governance concerns the contract between shareholders (principals) and directors and executives (agents) (Bratton, 1989; Jackson, 2000). This leads to a dyadic view of corporate governance in which parties other than investors, directors, and executive officers are largely external to this conception of the corporation and its governance. As Johnson (2012: 1160) observes:

‘Other parties, however important their contributions to the flourishing of dynamic enterprise, are regarded as secondary, instrumental participants, and are remitted to contract law or other legal regimes dealing with creditors’ rights, employees’ rights, consumer protection, or environmental concerns, and so on.’

Third, the contemporary, agency-theoretic economic imaginary ‘recasts firm relations in terms of discrete, bilateral contracts. [It] deemphasizes the entity […] To find the firm’s essence, [it] looks solely to the behaviour of individual economic actors” (Bratton, 1988/9). 428.

This continues to be the case with the reconcentration of ownership since the 1980s with the rise of institutional investors (mutual, pension, and to a lesser extent hedge funds), as institutional investors look to corporate managers to maximize shareholder

196 Veldman and Wilmott, at 16.
197 Veldman v Wilmott, at 19-23.
value for the beneficiaries of funds. This is because the current board of listed firms, which Gilson and Gordon called board 2.0, is “thinly informed”,\textsuperscript{198} and therefore only looks at share price to assess managerial performance, which also contribute to profit maximization. As the thinly informed board is not able to convincingly rebut the claims of activists institutional investors who assert strategic and operational shortfalls,\textsuperscript{199} it becomes dysfunctional under pressure from institutional investors.\textsuperscript{200}

Although institutional investors now collectively own more than half of the shares in many US listed firms, and can in theory collectively act to remove agency cost, in practice mutual and pension funds remain “rationally reticent” because of their business model and the need to diversify and cut cost.\textsuperscript{201} Mutual funds trade frequently, so are not interested in activism. Research shows that only a small percentage of votes by shareholders are on social proposals and only Shareholder Intervention Party will likely vote in favour of shareholder’s social proposals, not Traditional Governance Party.\textsuperscript{202} Where the funds invest in index, activism in individual firm is not likely to affect the performance of the index significantly, so again there is no incentive for activism. Although pension funds eg CalPER are long term and have fiduciary duty to vote, many rely on proxy advisors. This rational reticence has led to double agency costs, or “agency cost of agency capitalism”.\textsuperscript{203} Although hedge funds are increasingly playing a more active role in activism, as they do not have to diversify, so can select companies to invest, and often select undervalued companies to create value through activism, they are still in the minority.\textsuperscript{204} They are generally also focusing on maximization of shareholder value in their activism,\textsuperscript{205} even though increasingly some, eg Blackrock\textsuperscript{206} and Vanguard, find it necessary to get stakeholders involved to create value and some investors are more “stability minded” than “efficiency-minded”.\textsuperscript{207} So, the use of stock-option and focus on share performance continue which all lead to shareholder profit maximization.

Globalization of product and fluidity of capital market also increase pressure for profit maximization. Gordon thinks that it is hard to imagine that corporate governance can produce a solution: the competitive environment makes it difficult for firms to provide sufficient social insurance or internalize the adjustment costs of economic change; idea of developing a social/economic policy that truly takes on system-wide questions would

\textsuperscript{198} Jeff Gordon 2007, 2015.  
\textsuperscript{199} Gilson & Gordon 2017.  
\textsuperscript{200} Gilson & Gordon (2017) called for a thickly informed board 3.0 modeled on governance structure in PE to improve board’s monitoring role.  
\textsuperscript{201} See Gilson & Gordon, 2013.  
\textsuperscript{202} See Ryan Bubb and Emiliano Catan, The Party Structure of Mutual Funds, at ???.  
\textsuperscript{203} Gilson and Gordon, 2017.  
\textsuperscript{204} Another factor that might limit activism by hedge fund is if the SEC adopts rules to lower the threshold for mandatory disclosure from 5% to 3% and to shorten the current 10 days disclosure window, following the adoption of disclosure of threshold of 3% and a two-day disclosure requirement in the UK and similar initiatives in the EU: see Gilson and Gordon 2017.  
\textsuperscript{205} Some hedge funds would ‘take private’ the firms with different corporate governance arrangements. Also private equity is only accessible to qualified investors, not publicly inclusive.  
\textsuperscript{206} See BlackRock (Larry Fink’s letter of 6 Jan 2018: companies need to do more for society than just make money for investors).  
\textsuperscript{207} Gilson and Gordon 2017.
entail a different level of engagement and costs; and political economy of global capital markets makes it harder to develop locally-based socio-economic solutions.208

Some argue that this displacement of the legal perspective by the economic perspective

“amounts to intellectual shamanism (Bratton, 1989; Robé, 2011; see also quote below), as it lends unsupportable (academic) legitimacy to the assertion that ‘public companies should be run predominantly, if not exclusively, in [the shareholders’] interests’ (Ireland, 1999: 49), and because the distinctive advantages of the corporate form over the partnership form — such as limited liability and the reduction of opportunity costs — are trumpeted without regard to the legal imaginary of the firm in which a collective, multi-stakeholder conception of its purpose is assumed.”209

“There has been insufficient acknowledgment of the role of the state in bringing corporations into existence and of how the development of company law stimulated entrepreneurial organizations that drove much of the explosive growth of capitalism in the last two hundred years”.210 Jensen and Meckling viewed firm as a “nexus of contracts” and failed to understand firm as a legal person. “The personalization of the firm … is seriously misleading. The firm is not an individual”, they claimed.211 “The corporation is neither the creature of the state nor the object of special privileges extended by the state … [T]he corporation requires for its existence only freedom of contract. Corporate vitality is in no way dependent on special dispensation from the authorities. Limited liability, for example, is not an idea specialized to corporations… Freedom of contract surely encompasses the right of parties to prescribe limits to liability in contracts.”212 Their argument against the idea that corporate vitality and limited liability are necessarily creations of the state flies in the face of legal doctrinal reality. As Hodgson points out, “viewing the firm simply as ‘a set of contracting relationships among individuals’213 they failed to show how this ‘nexus’ itself forms a contract with suppliers or customers if it is no longer deemed to be a singular legal entity… they evaded the issue of how the firm survives the legally operational lives of the individuals in the nexus.”214 Hodgson argues that “these puzzles concerning the nature and identity of the firm are solved once we treat it as a legal entity. The glue that holds the firm together consists of the contracts or articles that bind the parties into one legal entity with its own legal rights and obligations. The organization becomes a firm when it acquires a legal personality.”215

“Crucially, the firm is distinct from any or all of its human constituents, contrary to views of the firm as a coalition of owners, and it is distinct from any and all of its nonhuman assets, contrary to the new property rights theory of Grossman, Hart and Moore… There is no good reason for economists to relinquish a legally grounded definition of the firm or corporation. All major theories of the firm depend

208 He called for a government match to provide life-long entry and exit portals for training and retraining (for the labour market) funded principally out of the gains generated by the purported efficiencies of firms managed for maximum competitive advantage. (see Gordon at 4, class 1 material).

209 Veldman v Wilmott, at 25.

210 Hodgson, at 205.


213 Jensen and Meckling, at 311.

214 Hodgson, at 220.

215 Hodgson, at 223.
on legal concepts – particularly ownership – despite neglect of the firm itself as a legal entity. Legal specifications and frameworks are vital for the firm to operate. Legal relations are an unavoidable part of the definition, alongside other factors. This argument is strengthened, not undermined, by the real growth of other economically significant entities such as business units, conglomerates, keiretsu, strategic alliances, suppliers networks, relational contracting, and so on. Each of these entities make use of legal forms, including contracts and property rights. Indeed, the growth of a diversity of business and industrial structures makes it imperative to develop clear, distinct definitions of the different entities involved and to understand their legal structure.”

“A neglect of legal realities impairs any attempt by the social scientist to give advice on appropriate legal structures to enhance economic performance. Furthermore, without attention to legal relations, social scientists are ill equipped to intervene in the long debate concerning the limitation of abuses of corporate power. They will be less able to evaluate the conditions involved in any legal incorporation of a firm by the state and the nature of the quid pro quo for society in return for the legal privilege of limited liability. Without attention to these features, social scientists may become dangerously indifferent to policies that extend or diminish the scope of corporate power or the real market. They will be unable to engage effectively in important debates concerning corporate law reform and the development of corporate structures that are more conducive to social welfare.”

Ireland has reminded us not to forget that corporations were originally to serve the interests of wider stakeholders:

“[…] it is important that scholars of corporate governance do not permit deeply political processes to be passed off as the products of a politically neutral, purely economic logic or allow the distributional dimensions of corporate governance to be spirited off the agenda by the shamans of law-and-economics, those unremitting class warriors for the rich and powerful” (Ireland, 2005: 81, emphasis added).

D. Politics and Political Economy Perspectives

What causes the original purpose to change politically? Could we change it back? Gilson and Gordon argue that “Changes in the capital markets drive the efficient structure of corporate governance, not the other way around” and “efficient structure of corporate governance is driven by capital market evolution, whether as a result of financial innovation or of political economy.” For example, the increase of investment in capital markets by mutual funds and pension funds was caused by the political decision in the US after the World War II to fund retirement security through private pensions funds, not through an expansion of the government Social Security programme, and the requirement under ERISA that a pension promise must be supported by assets held in trust rather than by a book entry on a corporate balance sheet. The significant shift from defined benefit pension plans to defined contribution pension plans by corporations also means that a small number of individuals and institutions as trustees of the funds (the record owners of funds) have a very important role to play and are obligated to act only for the best interests of the future retirees, the beneficial owners of funds. They can be a significant force in the

216 Hodgson, at 223-4.
217 Hodgson at 232 (emphasis added).
218 Gilson and Gordon, at 869.
219 Gilson and Gordon, at 873.
220 Gilson and Gordon, at 879-880.
221 Gilson and Gordon at 881-882.
222 Gilson & Gordon at 884.
governance of large US corporations\textsuperscript{223} but they are ‘rationally reticent’ because of their business model of diversification and low-cost investing, as mentioned earlier. This then creates the ‘agency costs of agency capitalism’ which requires a complementary efficient governance structure to reduce the agency cost, and this led to that governance role played by hedge funds.\textsuperscript{224}

From the perspective of politic, the emergence and evolution of corporation, like everything else, is all about power between different groups in the society.

As Veldman and Wilmott argue:

“The political imaginary gives primacy to relations of power, formulated primarily in terms of class and of contests between fractions of capital in which legal and economic elements are conceived as a medium as well as an outcome of relations of domination and subjugation. Within the political imaginary, the key to understanding the historical emergence and subsequent development of the corporate form is neither economic efficiency nor refinements in legal theory. Rather, \textit{the evolution of the corporate form is understood to be integral to shifts in power relations between classes}, and their respective capacities for mobilizing resources to consolidate or transform relations of domination in which elites systematically gain material and symbolic advantage. The political imaginary facilitates an account of the emergence of the joint stock companies based upon the priorities of a rentier class … It is informed by the understanding that, when historically viewed, the partnership form was appropriate and viable for all but a few business ventures (Mclean, 2004). The exception of incorporation was granted only where a public benefit was clear, where the risks were exceptionally high, and where the activities of the business could be readily routinized. Only in such limited circumstances, as Adam Smith argued, may the rewards of the joint stock companies, in terms of prospective public benefits, conceivably outweigh the risks of ‘negligence and profusion’ invited by the joint stock companies…”\textsuperscript{225}

As mentioned above, between 1800-1850, it was to satisfy the need of the growing, and increasingly influential, class of rentiers (the entrepreneurs) who were short of investment opportunity that free incorporation of joint stock companies with limited liability was granted by the state to offer investment opportunity without unlimited liability. But “there is no guarantee that this position can be maintained, as occasional calls for the mutualization and nationalization of assets attest. As circumstances change, restrictions upon speculative investment activity may be (re) imposed in order to redress their excessive relaxation.”\textsuperscript{226}

As mentioned earlier, during the 20th century, the rapid growth of the joint stock company drew in comparatively small shareholders in addition to the rentier class resulting in the growth of dispersed shareholder ownership followed by the reconcentration of share ownership through institutional investment, and a ‘socialization’ of the ownership of the modern corporation. As a result of separation of ownership and control which led to ‘managerial capitalism’ (Khurana, 2007), the rentiers were firmly in control of corporation and were running corporations to maximize shareholder value creating externalities. Such externalities were dealt with not through boardroom decisions, as the rentiers helped by neo-liberal economists firmly believed that corporation’s purpose was to maximize shareholder value. Thus, these externalities had to be dealt with through law and regulation on each externality.

\textsuperscript{223} Ibid, at 886.
\textsuperscript{224} Gilson and Gordon, at 896.
\textsuperscript{225} Veldman and Wilmott, at 27-29.
\textsuperscript{226} Veldman and Wilmott, at 31.
“little was left of the classical corporation. Its internal dealings with shareholders and its debtor-creditor relations were substantially regulated by the federal securities acts. Its labor relations were regulated by the new federal labor laws. Its relations in the general market with consumers and suppliers became increasingly regulated by the antitrust laws [...]” (Hovenkamp quoted in Tsuk, 2003: 1897). “227

Whilst in the post-War era, there was a consensus that a cadre of scientific and impartial corporate managers could be trained to represent the interests of multiple stakeholders (Drucker, 2006; Kaysen, 1957; Khurana, 2007), this turned out to be a false imagination in the 1970s when there was a mounting fiscal crisis, poor returns to investors, and disillusionment with what were now construed as the smothering attentions of a bloated and unsustainable nannying state.228

“Economic decline and fiscal crisis presented an awaited opportunity for the rentier class to pursue a neo-liberalist agenda with an emphasis upon market discipline as a remedy for weak economic performance. In response to demands to revive flagging growth attributed to the dampening effects of Keynesian full employment policies, welfare provision, and extensive state ownership, Bretton Woods was dismantled. This unleashed the expansionist powers of finance and hastened the concentration of shareholding in financial institutions.” 229

These developments, together with a broad and sustained shift in the direction of neo-liberalism, reversed the over-hyped ‘managerial revolution’ and the degree of autonomy enjoyed by corporate management in the post-War years was reigned in by the imposition of performance measures, based on shareholder value metrics, as the tiller of economic development passed from corporate managers and state bureaucrats to the rentiers.230

The sizable gathering concentration of share ownership within investment funds, including hedge funds and sovereign wealth funds created and exerted influence upon ‘the market for corporate control’ and provided the basis for a rapid expansion and resulting domination of financial markets, fuelled by leveraged buyouts and an associated growth of private equity funds. 231 Deregulation and liberalization of financial markets also hugely increased and accelerated international capital flows. 232

“The expansion of financial (ized) capitalism was also promoted and legitimized by advocates of agency theory, whose thinking both chimed with and guided the thinking of neo-liberal policy-makers.” 233

As mentioned, agency theory only focuses on shareholders and managers, to the exclusion of all other stakeholders, with managers being identified as the recalcitrant but tractable servants of shareholders, rather than stakeholders. To align the interests of the managers with the interest of shareholders, stock options and other forms of financial incentives (e.g. performance bonuses) have been widely used...

227 Veldman and Willmott, at 32-37.
228 Veldman and Willmott, at 32-37.
229 Veldman and Willmott, at 32-37.
231 Veldman and Willmott, at 32-37.
232 Veldman and Willmott, at 32-37.
233 Veldman and Willmott, at 32-37.
The turn to neo-liberalism has restored the value of the corporate form as an unsurpassed means of private wealth accumulation and those occupying commanding positions in markets are the best placed to enhance their positions. 234

“When viewed in this way, the creation of the JSC, and especially the concession of limited liability, is understood to have been ‘more the product of the growing political power of the rentier investors than it was of economic imperatives, an argument that might easily be extended to the current attempts to universalize corporate law in its resolutely shareholder-oriented Anglo-American form’. 235

“In the contemporary imaginary the corporate form is dominated by neo-liberalism: exclusive control rights are granted to shareholders and the singular pursuit of shareholder value is prioritized. The focus on shareholders as the sole ‘principal’ to which managers, functioning as ‘agents’, are accountable, means that the domain of governance and responsibility is very often disconnected from wider social concerns such as environmental degradation and global warming. The scope of corporate governance is routinely restricted to the question of how boards may better serve their shareholders, notably by disclosure of financial and legal indicators, and by strengthening the role and training of non-executive directors and extending some forms of reporting (Ezzamel, Veldman and Willmott, 2013). Within this imaginary, the purpose of corporate governance and the development of corporate social responsibility is indifferent to the representation of diverse stakeholders on company boards and to the payment of taxes by ‘corporate citizens’, which serve to support and improve the public infrastructures of education, health, and the like, upon which corporate activity depends. Considerations of social responsibility rarely extend beyond calculations of how investment in CSR (corporate social responsibility) will or can protect corporate image and reputation. (emphasis added)”

E. Conclusion

Viewed from the political perspective it becomes clear how

“the neo-liberal version of the economic perspective, in which corporate assets are conflated with the ownership of shares, has become such a deeply consolidated and performative myth which formally acknowledges but substantively ignores and obscures the status of corporate form as it exists in the legal perspective, where the entity, rather than shareholders or boards, holds the assets (Ireland, 1999, Bratton, 1989; Ireland, 1996; Robe, 2012), and where the fiduciary duty of managers is to ‘the company’ (Armour et al., 2003: 537), instead of to its shareholders”. 236

Unfortunately, historical and legal perspective (of stakeholder interests) was replaced by economic perspective (of shareholder supremacy/prioritized) because of increased class of influential rentiers looking for risk free and higher return investment. JSC fits the bill compared to partnership as it provides limited liability. Although it is not necessary to have shareholder supremacy to promote investment, it was the economic perspective that erroneously equates it with the interest of the company. A stakeholder approach may actually increase the company’s profit as CSR can be good for business. Even in cases where it will reduce the profit to shareholders, it should not be objectionable as it may reflect the true cost of business. I will return to this point later.

234 Veldman and Willmott, at 32-37.
235 Veldman and Willmott, at 32-37, citing Ireland, 2010: 838
The erroneous economic perspective was worsened by the Agency theory which came to dominate the debate, as it treats shareholders (excluding other stakeholders) as the principals, and tries to align interest of managers (agents) with interest of shareholders only.

The Anglo-American policy of profit maximization has contributed to two world most pressing issues: (i) wastage of world’s natural resources and (ii) environmental pollution. As I will demonstrate later, companies can still thrive and be successful with stakeholder policy. As the manufacturing activities of many giant corporations have moved to China and elsewhere, and as China becomes the second largest economy it is imperative that China must not make the same mistakes and must learn from history and origin of companies and its own political history. (See Paper 3)

Politics, influenced by economics, history, societal, legal and political considerations, determines what rights should be granted to private citizens (including the right to form a corporation) and corporations (the content of their rights). Historically the courts have been true to the spirit of the corporate law and upheld the historical legal position. For example, although the US Supreme Court upheld a royal charter that set up a corporation (the Dartmouth College) as a contract that could not be amended by the state, it said that the state could reserve such power to amend the charter expressly or implicitly.237

The economics perspective has occasionally influenced the court since mid-19th century to move away from the original legal position to hold that corporations are for shareholders,238 and legislatures to give rights only to shareholders (e.g. to appoint and remove directors, approve significant transactions etc) but not other stakeholders. This in turn restricts the court’s power to apply the law to give stakeholders rights. It has also influenced the development of legal theory as mentioned above. It is important for the law to be move back from the economic perspective to the original historical and legal perspectives, namely corporations are for the public good, stakeholders have different legitimate interests in the corporations that need to be protected by law in various ways. Mainstream economists see the shareholders as the bearers of residual

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237 For nature of Corporate Charters and rules governing corporations see Supreme Court judgment (Story J’s summary) in Dartmouth College v Woodward 17 US 518 (4 Wheat 518)(1819). For a commentary see Paul Finkelman and Melvin I Urofsky, Landmark Decisions of the United States Supreme Court (Washington DC: CQ Press, 2nd edition 2008), at 30-31; Francis N Stites, Private Interest and Public Gain: The Dartmouth College Case 1819 (Amherst: University of Massachusetts Press, 1972). Other examples include a corporation being treated as coming within the definition of a ‘person’ for the purpose of 14th Amendment (Pacific Railroad Removal Cases 115 US 1 (1885)) (see Finkelman at 127) and entitled to the same protection under the Constitution like a private citizen, including the due process clause under the 14th amendment (Santa Clara County v Southern Pacific Railroad Co 118 US 394 (1886)) (see Finkelman, at 129).

238 For example, Dodge v Ford Motor. In Tellabs, Inc v Makor Issues & Rights, Ltd 551 US (2007), SCt 2499, the majority of the Supreme Court found for the Republican government who was trying to put limits on shareholder suits as they tended to discourage investment and encourage companies to seek capital overseas. It was held that before a case alleging fraud by shareholders would go to trial against the company’s senior executives and the company of deliberate overstating projections for revenue and product demand, shareholders must meet the higher standard of ‘cogent and compelling’ evidence that ‘a reasonable person could infer that the defendant acted with the required intent’. This is impossible unless a criminal case has proved the fraud: see Paul Finkelman and Melvin I Urofsky, Landmark Decisions of the United States Supreme Court (Washington DC: CQ Press, 2nd edition 2008), at 695. See also Serafeim.
risks and so shareholders are said to have an interest to have the residual claim to corporation assets and profits. But they overlooked the residual risks taken by workers with firm-specific skills, especially in knowledge-intensive contexts\(^\text{239}\) consumers who consume or use the company products or services, and environmental risks taken by residents and community in the locality of company’s operation. So, workers have an interest to be paid as much as the corporation can afford and not to be exploited, consumers have an interest to pay as little as possible for the goods or services produced by the corporation and not to be harmed; creditors have an interest to be paid in full on due day; the community affected by the corporation’s activity has an interest not to be harmed by its operation. These interests need to be protected and are indeed protected by various laws but because of the problem with law enforcement as explained earlier, corporations have been able to operate in violation of these interests. Since corporate decisions are made in the board, a more effective way of protecting these interests is to allow stakeholders to have a voice and vote in the board to prevent corporate decisions being taken to their detriment, or at least to reduce their impact. But not all interests need to be protected in this way. Some interests should be left to the free market where there is an efficient market, for example, the price of goods and services, the wages, the interest rate to be charged by creditors etc. However, some interests cannot be left to the market for there is no such market or the market does not function efficiently. For example, the production methods and materials to be used by the corporation and the impact of such use on the consumers and the environment. There is inadequate information in the market about such use and its impact for the consumers to decide whether to buy such goods or services in the market. The community and the environment do not have a contract by which they can prevent the corporation from harming their interest. Such interests could be more directly and effectively protected by the stakeholder directors in the boardroom. I will return to the question how such a board structure can be designed in Paper 2.

IV DOES PROFIT MAXIMIZATION ACHIEVE THE MOST EFFICIENT OUTCOME?

A. Corporate Social Responsibility and Profit Maximization

Stone point out that from time to time we see a revival of the notion that the corporation problem would wither or die if only we had publicly elected representatives to boards of directors, and said that the idea is not entirely vacuous and might be worth implementing.\(^\text{240}\) Although the concept of corporate social responsibility is vague, it is possible to define its scope and purpose with enough precision that its spirit can be translated into tangible institutional reform by clarifying what it is that proponent and opponent are concerned about, and identifying the relative strengths and weaknesses of their respective positions.\(^\text{241}\)

There are many references in the literature that say that corporate managers should not do anything other than maximize company profits or “the return on shareholders’ investments”. What this really means is maximizing profits within the constraints of the law.

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\(^{240}\) Stone, at 71.

\(^{241}\) Stone, at 72-73.
According to this thesis, as Stone summarized:

“rather than have corporation managers decide how to resolve competing social claims, they follow the dictates of the market within the constraints of the law. If the majority of the people believe the law inadequate to keep corporations within socially desirable bounds, the society can, through its democratic processes, make more satisfactory – tougher if need be – regulations. Unless and until it does so, however, we are all better off if corporations steer themselves by profit, rather than by their managers’ various and vague personal notions of what is best for the society. So stated, there is a great deal that can be said for this [thesis]. Why, the advocates of this position might ask, should we have to augment market forces and legal duties with some nebulous demand that corporations be “responsible” in some sense over and above obeying the laws?”

In Capitalism and Freedom, and the celebrated piece in New York Times, Milton Friedman said corporate officers’ sole obligation is to maximize profits while abiding by the rules of the game. Did he mean staying within the boundary of the law? Or did he refer to some broader obligations than the law? In the New York Times piece he said that the responsibility of business is “to make as much money as possible while conforming to the basic rules of society, both those embodied in the law and those embodied in ethical customs”. He did not explain which ethical standards should manager refer to. And two columns down after this observation, when asking whether a corporation should “make expenditures on reducing pollution beyond the amount that is in the best interest of the corporation or that is required by law” in order to improve the environment, he answered no, dropping the “ethical customs” qualifications without any explanation.

Stone asks, supposed the corporation’s plant was emitting a pollutant that caused $200,000 damage annually to the environment, which the corporation could remedy by the construction of a pollution-abatement device that costs, amortized, $50,000 annually, and suppose the addition of the device is not required by law, should manager construct such device? It would not be in the best interest of the corporation in terms of profit maximization, but the imposition on society of a $200,000 social cost which the company could have remedied by spending $50,000 is “the very sort of evil that Friedman specializes in - a clear misallocation of resources.” What if the plant is producing a pollutant not yet detectable by the government, or the danger of the pollutant is not known by the public but are known or strongly suspected by the corporation’s management? Or suppose the corporation did not know the danger inherent in its pollutants, but could set up a task force at the cost of shareholder profits to find out?

Those who opposed to CSR also say that company should not engage in the fields not related to their “proper aim”. Ronald Coase observed, “Corporations should avoid involving themselves in activities which impede the carrying out of their main function

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242 Stone, at 74-75.
245 Stone, at 76.
246 Stone, at 76.
247 Stone, at 76.
248 Stone, at 77.
and which they are in fact ill-equipped to perform”. However, Stone, asks how does one determine what is the “proper aim” of the corporation? Many charters that contain the all purposes clause do not help. Even if it means what the corporation is doing in fact (making cars, banking etc), should an auto company develop clean engine before the law (or market forces) requires it to do so? Would expenditures in this direction be within the “proper aim” of the company? Should a bank make low-interest (or high risk) loans to minority businesses? Should a company make its working conditions “humane” beyond the level the unions could have bargained for? Should a regulated utility engage in an advertising and lobbying campaign to influence legislation? These are difficult questions to answer. However, in my view, we don’t have to answer these questions if we let the stakeholders decide, who will decide in accordance with their calculation of cost and benefit in their specific circumstances.

Stone argues that “the strongest moral argument corporate executives can advance for looking solely to profit is … one that says, if the managers act in such fashion as to maximize profits … then it will be best for all of us.” Termed “polestar argument”, its appeal to the interests of the shareholders is a means of charting a straight course toward what is best for the society as a whole. Whereas moral judgments are peculiar, arbitrary, or vague, not amenable to rational discussion, profits (or sales), or price-earnings ratios are at least measurable standards. Also, making social choices requires special expertise and social authority. Stone acknowledged that “there is a germ of validity to what the “antis” are saying. But their essential failure is in not pursuing the alternatives. Certainly, to the extent that the forces of the market and the law can keep the corporation within desirable bounds, it may be better to trust them than to have corporate managers implementing their own vague and various notions of what is best for the rest of us. But are the “antis” blind to the fact that there are circumstances in which the law – and the forces of the market – are simply not competent to keep the corporation under control?” As he points out, understand the shortcomings of traditional restraints on corporate conduct is the first step in the design of new and alternative measures of corporate control. As will be explained, since managers do not have the expertise to make social choices, it is crucial to have stakeholders sitting in the board to make social choices collectively, as an alternative institutional design.

B. Why Can’t We Rely on Market or Profit Maximization to Achieve CSR?

Stone claims that “whatever its limits, the “invisible” hand of the market is the most effective force we have to keep corporations operating within socially desirable bounds, especially when the various costs of our legal mechanisms are considered.” I would

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251 Stone, at 78.
252 Stone, at 79.
253 Stone, at 79.
254 Stone, at 85.
255 Stone, at 85.
256 Stone, at 85.
257 Stone, at 86-87.
258 Stone, at 87.
259 See paper 2
260 Stone, at 88.
agree with this. Hansmann and Kraakman argue that the best means to achieve the aggregate social welfare is to make corporate managers strongly accountable to shareholder interests and only to those interests. However, as Stone also points out:

“Nonetheless, the case for the market (as well as against it) is easily and often overstated… even at its ideal best, the market is not a remedy for all the problems a society may have with its commercial actors, but plays a general allocative role, encouraging capital, labour, and other factors of production to flow to those industries and firms that can put them to the most beneficial social use… although economists may differ as to the advisability of various forms of intervention with market dictates, or as to the various sectors at which intervention best takes place (banking, farming), few if any are satisfied that the market of itself can allocate resources adequately to fill social needs.”

This is because those who have faith in the market or profit maximization as an adequate guarantee to achieve socially desirable goals are implicitly making certain assumptions each of which is often questionable: (i) that the consumers know the fact that they are being “injured”. It often takes a long while for consumers and the public to know that certain products cause harm, eg cigarette and coal dust in a coal mine etc or what the products contain and their likely effect in the long term; (ii) that they know where to apply pressure, ie. Who is the culprit. Consumers identify products by brand name, not usually by the producing company. Thus, when dissatisfied with one product, they might switch unknowingly to another brand which is produced by the same company; (iii) that they are in a position to apply pressure. The complaining party may not have any legal (contract or tort) relation with the company to be able to apply pressure. Or the company is a monopoly or oligopoly; and (iv) that their pressure will be translated into warranted changes in the institution’s behavior. When dissatisfied consumers turned to another brand, the management may not know why the company lost sales, or even if they know they may not be willing or able to remedy the problem in the most desirable way. “All large organizations seek to seal off or “buffer” their technical core from disruptive environmental influences (like the market – or the law). So far as possible their tendency is to fight rather than to switch.” Thus, you cannot leave it to the management to decide whether and how to remedy. Stakeholder board will help or force them to change.

C. What Does CSR Mean?

Stone argues that we need to go back and examine in detail what “being responsible” entails – in the ordinary case of the responsible human being. It is not simply about corporate giving to charity, which is seen as a copout. In the case of human being, being responsible has two senses. Responsibility 1 means following the law. Responsibility 2 means

“a person’s deliberations include the following elements:

261 At 442.
262 Stone, at 88. (author’s own emphasis)
263 Stone, at 89. (author’s own emphasis) See also 89-92 for detailed explanation.
265 Stone, at 111.
266 Stone, at 111.
267 Stone, at 113.
268 Stone, at 113.
• Viewed in its cognitive aspects, responsibility involves a degree of repression. The responsible person does not immediately implement his initial desires or impulse, his “gut reaction”… reflection is always an ingredient of responsibility in this sense.
• Responsible behavior begins with perception. The responsible person observes phenomena the irresponsible person ignores; more than this, his perceptions are stamped with moral categories. The responsible person looks for certain morally significant features of his environment: other persons (and other creatures), harm, pain, benefit to the social group.
• A responsible person takes measure of the full range of his freedom … acts with an awareness that he will be accountable for what happens.
• … taking into account the consequences and repercussions of his actions…
• He must consider and weigh alternatives.
• … involves reflection in all the above senses, but reflection per se is not enough; the reflection must be structured by reference to the society’s more vocabulary – that is, by characterizations in terms of “good”, “bad”, “just”, and so forth, by thinking of “obligations,” “rights,” and “duties”.
• … must have, in addition to a moral vocabulary, a moral inclination – a desire, probably as much internalized as conscious, to “do the right thing”.
• … must be prepared to give some justification for what he is doing… to be responsible involves being prepared to explain, to give good reasons for one’s actions; the responsible actor is willing to generalize the grounds for what he has done. This preparedness to justify, and especially the preparedness to do so in terms that admit of generalization (the Golden Rule, Kan’s Categorical Imperative), is an important step toward the socialization of one’s actions, inasmuch as it forces awareness of the social setting and the socially sanctified grounds of behavior.”

Stone says that we want corporations to be responsible in both senses. In cases where it is feasible to design relatively unambiguous rules for corporate behavior, responsibility in the first sense is sufficient. Where, however, rigid rules are ineffective, or even counterproductive, responsibility in the second sense would be required.

“The perception element of responsibility in a human being has a counterpart in problems we might want corporate responsibility to solve, and that changes in the organization’s perception – its information-gathering system – would be a step … toward alleviating some of the problems… Are there counterparts in the organization’s other internal variables – its authority structure, its reward and advancement criteria, its information channels – to the other cognitive processes that we saw to be associated with responsibility in the human being - holding action in abeyance pending an analysis of consequences, assessing contemplated behavior by reference to socially “moral” categories, and the like? If so, and if the responsibility model indicates that changes in them are warranted, how can we get companies to go ahead and implement them?”

D. Law and Economic Perspective

The debate on corporate social responsibility has been complicated by the shareholder profit maximization argument in the US and the UK, championed by economists and law and economics scholars. In his famous quote, Milton Friedman said that:
“There is one and only one social responsibility of business--to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”

Unfortunately, this quote has often been misquoted, as most people seem to have focused on the first part of the quote ignoring the second part (in italics), which sets the condition that qualifies his view: in other words, Milton Friedman did not suggest that companies can focus solely on profit maximization without complying with the law and by externalizing its cost. Companies can maximize profits only if all costs are internalized by complying with the rules of the game. Where rules are not adequate or not complied with or enforced, other way to internalize costs would be necessary.

Shareholder profit maximization gives shareholders incentive to use or monitor the use of company resources in an efficient way as they are the last claimants, so the argument goes. In economic theory, this is good for allocative efficiency. However, it also has a downside, that is that shareholders also have the temptation to externalize costs, which is bad for allocative efficiency. This is the current problem we see in cases of corporate abuse. Hitherto, we have been relying on law and regulation to internalize those costs. And in the last decade or so, we have been requiring companies to make ESG reporting to internalize costs. But as with many such reporting or disclosure, it tends to degenerate into a box ticking exercise. We need some internal governance mechanism of check and balance. As already mentioned earlier and will be explained below, this paper suggests that having stakeholder directors on the board as an internal check and balance is one way to internalize the costs.

But first, is stakeholder governance or profit maximization more efficient from a law and economic perspective? As Fox observes, the contemporary views on profit maximization versus societal interest is a ‘hard-fought transnational debate’.275

1. Arguments for Profit Maximization

Unfortunately, the idea of profit-maximization has moved to the central stage since 1960s as Hansmann and Kraakmann observed in 2001.276 They claim that the recent dominance of a shareholder-centered ideology of corporate law among the business, government, and legal elites in key commercial jurisdictions is exerting pressures for governance practices around the world to converge to the shareholder-centered idea of profit maximization.277 Under the shareholder-centered model, “ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; noncontrolling shareholders should receive strong protection from exploitation at the hands of controlling shareholders; and the market value of the publicly traded corporation’s

275 Fox at 458.
276 Hansmann and Kraakman, at 444.
277 At 439.
shares is the principal measure of its shareholders’ interests.”278

Although they admit that “This is not to say that there is agreement that corporations should be run in the interests of shareholders alone – much less that the law should sanction that result,” they point out that “all thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society.”279 However, they claim that “as a consequence of logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests.” They claim that, “the most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies – or at least all constituencies other than creditors – lie outside of corporate law.”280 I respectfully disagree. As I will explain below, because of externalities, it is not the most efficient model (see below).

Fox points out that281 there is a ‘rough consensus’

“among most (though not all) academic commentators that the proper goal for good corporate governance is that the firm should be operated to maximize its residuals – the difference between what the firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs – over the life of the firm, discounted to present value” (citing Publicly traded corporations: governance & regulation, Haansman & Kraakman, and Friedman),

and that

‘doing so maximizes the social wealth generated by the real operations of the corporation, assuming that firms operate in competitive markets and that the potential externalities resulting from their activities, such as environmental damage, are properly regulated.’(emphasis added).

This resonates well with Friedman’s famous quote above.

“Under these circumstances, the value of what the firm takes from society is, at the margin, properly measured by what it pays out at market-determined prices for contractually obtained resources, and the value of what it contributes to society, at the margin, is what it receives at market-determined prices for its output. The difference, the residual, is the firm's value added and its contribution to society.”

Fox further points out that

“For investor-owned firms, shareholders are the recipients of these residuals. Thus, according to the U.S. consensus, such firms need to operate in a fashion that maximizes share value. This need in turn suggests that the directors of the corporation should primarily represent the shareholders.” (emphasis added)

Whilst I agree with Fox’s quote above, it is important to note the qualification that Fox has very accurately observed, like Friedman, Stone, Bruner, Hodgson and others for that view: that is that two pre-conditions must exist for the shareholder maximization

278 At 441.
279 At 441.
280 At 442.
to be equivalent to the contribution company makes to the society, that is that (i) there has to be a free competition for the goods or services that the firm is providing; and (ii) all potential externalities of the activity of the firm are properly regulated (ie internalized).

If externalities are not properly regulated (or internalized), the contribution the company makes to society is not accurately reflected:

For example, if company A produces bottled waters at the cost of 50 cents per bottle, but uses poor quality plastic bottles that are harmful to consumers and production methods that pollute the environment, and sells the product at 70 cents per bottle and manages to sell 1,000,000 bottles a month. The difference between the price it pays for its input and the payment it receives for its output is 20 cents x 1,000,000 = $200,000. The benefit it contributes to the society without taking into account of the cost of externalities is $200,000. If the real cost of externalities is taken into account, the benefit will be lower.

If the externalities are properly regulated, and if this cost is say 10 cents per bottle, and if the company still sells at 70 cents per bottle, then the true benefit it contributes to the society would be 10 cents x 1,000,000 = $100,000. And if the company wants to maintain a 20 cents profit per bottle, and sells at 80 cents per bottle, the volume of sale may come down, and so the benefit would not be as high as $200,000.

In many cases in the real world, as Stone points out earlier in Part I, the two preconditions do not always exist: (i) the market is either not competitive so dominating firms get to externalize externalities, or the competition drives firm to externalize externalities in order to cut cost, as Hart and Zingales observe; competition can drive firms to choose dirty operation and cause damage (at 19); (ii) externalities are not properly regulated (ie regulation is incomplete or not enforced) (see Goo, AJLS). Therefore in these circumstances, shareholder maximization approach falsely magnifies the benefit firms make to the society, and encourages firms to externalize externalities and cause harms to society at the same time as it benefits the society.

As Baliga and Maskin explain, “Once externalities are admitted, the first welfare theorem no longer applies”. In the same vein, Armour says that:

“… the appropriate goal of corporate law is to advance the aggregate welfare of all who are affected by a firm’s activities, including the firm’s shareholders, employees, suppliers, and customers, as well as third parties such as local communities and beneficiaries of the natural environment. This is what economists would characterize as the pursuit of overall social efficiency.”

He further elaborates that:

“… it is sometimes said that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders or, more specifically, to maximize financial returns to shareholders or, more specifically still, to maximize the current market price of corporate shares… such claims can be understood as saying, more modestly, that focusing principally on the maximization of shareholder returns is, in general, the best means by which corporate law can serve the broader goal of

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283 Armour et al, anatomy, at 25 working paper/chapter 1) (3rd fl reserve. Comp 615 An 162009.)
advancing overall social welfare. In general, creditors, workers, and customers will consent to deal with a corporation only if they expect themselves to be better off as a result. Consequently, the corporation—and, in particular, its shareholders, as the firm’s residual claimants and risk-bearers—have a direct pecuniary interest in making sure that corporate transactions are beneficial, not just to the shareholders, but to all parties who deal with the firm. We believe that this second view is—and surely ought to be—the appropriate interpretation of statements by legal scholars and economists asserting that shareholder value is the proper object of corporate law."

However, he added that, “Whether, in fact, the pursuit of shareholder value is generally an effective means of advancing overall social welfare is an empirical question on which reasonable minds can differ…”  

In my view, it is arguably true that “the creditors, workers and customers will consent to deal with a corporation only if they expect themselves to be better off as a result.” However, in reality, as explained above by Stone, many creditors, workers and customers who deal with a corporation either do not have a choice or do not have all the information to enable them to know whether they are better off as a result of the deal. For example, many customers do not know they will be $2 worse off for every dollar that shareholders gain, for example they do not necessarily know that the materials or method of production used will be harmful to them in the long run. The workers and customers may not know if in the long run they will be worse off indirectly as the state has to spend money to clean up the environment and to provide medical care and therefore has less money for the worker and customer welfare in other ways, or have to raise more tax. In the quote above, Armour et al admitted that whether profit maximization in fact advance overall social welfare is debatable. I argue that profit maximization cannot in fact advance overall social welfare when companies are able to externalize part of the cost and harm stakeholders interests, as the quotes from Friedman and Fox seem to imply.

With many years of profit maximization since 1850, whilst the world GDP has grown exponentially, Jeff Gordon argues that US and much of the OECD are caught in certain malaise: significant inequality, economic insecurity and slow economic growth. Some have identified corporate governance of public corporations as a first order cause. However, even with significant corporate governance changes, “the pressures from globalizing product and capital markets will produce an on-going need for complementary government policies to mitigate adjustment costs that no firm can internalize over the long run” (at 1, reading materials, class 1). Gordon proposed Board 3.0 for future CG adopting the model of CG used in PE. And points out that large family ownership and institutional shareholders (and government) would prefer “stability” than “efficiency”, so stakeholder interests would come in by the side door. (at 38 reading material of class 1)

2. Arguments ambivalent about profit maximization

Allen argues that if the firm faces cost uncertainty, stakeholder governance can benefit shareholders, whereas if it faces demand uncertainty, stakeholder governance can hurt shareholder profit. Ernst Maug argues that in incomplete, imperfect markets a

stakeholder corporate governance system stressing cooperation between management and employees (i.e. co-determination) may allocate resources more efficiently than a shareholder system, although he pointed out that the empirical studies examining the impact of co-determination on stock returns, on market-to-book ratios, and on performance ratios, do not provide conclusive evidence regarding the impact of BLER on corporate performance. This is because of the shortcomings related to data, the fact that none of those measures fully capture the impact of BLER on firm value and more generally the presence of multiple dimensions of corporate governance that interact in ways that are difficult to capture. He noted that companies never opt to use BLER voluntarily but do not seem to try to avoid it either, and concluded that the empirical literature is inconclusive but firm behaviour seems to suggest that there are no first order gains from having employee representation or from avoiding employee representation.

3. Arguments Against Profit Maximization

What, then, really is the dominant objective of American business? Anthony suggests that “the objective of a business is to use its resources as efficiently as possible in supplying goods and services to its customers and to compensate equitably those who supply these resources. As a way of making this general statement operational, I suggest that the objective be considered as earning a satisfactory return on capital employed (a "satisfactory" return being equitable compensation paid for the use of capital).”

He explained that in the real world, businessmen do not engage in profit maximization in many complicated problems such as pricing, choice of product line, marketing strategy, the direction of research efforts, what size plant to build, capital budgeting and a long list of others. This is because “it is too difficult, and it would be immoral”. Anthony explained why in reality, businessmen are not profit maximizers:

“The ethical problem is that profit maximization requires that the business manager think only of the best interest of the shareholders, whereas any responsible manager knows that he must actually consider the interest of all parties who have a stake in the business, of which the shareholders are only one. Profit maximization requires the businessman to use every trick he can think of to keep wages and fringe benefits down, to extract the last possible dollar from the consumer, to sell as low quality merchandise as he can legally hoodwink the customer into buying, to use income solely for the benefits of the stockholder, to disclaim any responsibilities to the community, to finagle the lowest possible price from his vendors regardless of its effect on them, and so on. …[The profit maximizers] deny the existence of a businessman's conscience, and they exclude ethical considerations as being irrelevant to the subject. A businessman is a human being, and it is completely unrealistic to assume that he should act in an ethical vacuum. As a human being, he is deeply concerned with how his actions jibe with his own conscience, the respect of his family, and the opinions of his associates. Moral standards change, and whereas 50 or 100 years ago the profit maximizing manager would perhaps have been tolerated in some circles of some communities, today society clearly expects the businessman to act responsibly. He cannot do this and at

286 See ECGI Rountable Report, at 7, citing Fauver and Fuerst 2006 at 674.
290 At 128.
291 At 128-132.
292 At 132.
the same time seek to maximize the share of income going to just one of the several parties that have a

Anthony asserts that “It is blindness to build a theory on the premise that businessmen
completely disregard such beliefs. In fact, I doubt very much if an economist could
imagine himself running a business with no ethical standard, as required by profit
maximization”. It is perhaps that many businessmen did not in fact act as profit
maximizers that we saw far fewer problems in the 1950s. What businessmen in fact
look for is “satisfactory return” which is not the same as profit maximization. However,
from 1970s investors began to put pressure on managers to maximize profits. “Labor
unions, boards of directors, investors, bankers, and the government all exert pressure to
ensure that the group each represents receives an equitable share of the revenue,”294 but
this is not always possible, especially when managers are under pressure to maximize
profits. “Satisfactory return” does not mean that managers are not acting for the
interest of the company to be efficient. “They will vigorously seek out opportunities to
improve profits when they can do so ethically, and competition will force them to seek
ways to improve efficiency even if no increase in profits results. In our vigorous,
dynamic society, considerable effort is required merely to hold one's own.”295 It is time
we return to the good old value that Anthony was describing.

In conclusion, Anthony said that:

“The consequences of the profit maximizers' misinterpretation are not only that their concepts are not
useful to businessmen, but also that they happen to be conveying a false impression of what our economy
really is like. Consider this statement, which is part of Samuelson's sum- mary of the essence of our
economic system:

"A rich man's dog may receive the milk that a poor child needs to avoid rickets. Why? Because supply
and demand are working badly? No. Because they are doing what they are designed to do — putting
goods in the hands of those who can pay the most, who have the money votes."

This is a shocking statement. If it were true, no one should be proud of the American system; such a
system would certainly not be welcomed in other countries. If it were true, we should prefer communism.
The plain fact is that this statement is not true. Our system does not condone, let alone encourage,
fattening dogs by starving children. Our system is one of which we may be proud. It can be described
accurately if the assumption of profit maximization is discarded for the idea of satisfactory return. Such
a change will lead to more accurate reporting and to the development of more useful rules and concepts,
concepts which focus on the businessman's responsibility to all the parties at interest, concepts which we
can be proud of, and which will lead to improvements in our system of which we can be even more
proud.”

A rash of corporate collapses in the US since Enron296 and Global financial crisis also
raised concern about the merits of shareholder primacy and market discipline. There
are increasingly many voices against profit maximization.

“Very little evidence exists to suggest that sustainability can be an impediment to corporate profitability.
In contrast, evidence is emerging that under certain conditions ‘sustainability pays’.297

293 At 132-3.
294 At 133.
295 At 133.
296 Hill, Jennifer (2005), Regulatory Responses to Global corporate Scandals, Wisconsin International
297 Serafeim, at 12.
In a recent conference on Board Level Employee Representative (BLER), Franklin Allen argued that corporations should serve stakeholders noting that there is however cross-cultural differences as far as the answer to this question is concerned, having considered a number of papers that argued against stakeholder governance on grounds of being biased against innovation (Hellwig, 2000) and of posing problems with correct incentives to managers (Tirole, 2001, 2006), as well as papers that support corporate governance on grounds of facilitating the implementation of stakeholders’ concerns (Blair, 1995) and of providing the benefit of internal mutual monitoring (Allen, Gale, 2000). He asserts that there is a separation of academic research from the reality of corporate scandals involving revelation of fraud such as Kobe Steel, Volkswagen and Rio Tinto.

BLER has been around in Europe for a long time. There is a depth of knowledge and experience on how such a system works. Experience shows that the German system is not necessarily efficient (though the reason could be due to lack of sufficient powers), and more flexibility should be given to firms to experiment with different governance/BLER regimes. There is growing number of German companies re- incorporating as SE to avoid and mitigate BLER and to opt for a one-tier board system.

Fox points out:

“Corporate decisions that advance the interests of other stakeholders beyond what is required by the corporation's existing contracts may, of course, enhance share value at the same time. For example, a firm's discounted-to-present-value aggregate future residuals, and hence its share value, might increase if, despite a cost in terms of current earnings, the firm develops a reputation among current and potential workers as a good employer or among consumers as a ‘green’ company that works to reduce global warming” (at 460).

However, he warns against making

“the self-evidently overly broad generalization that, at least in the long run, doing good for other stakeholders consistently benefits shareholders as well. The happy incantation of this generalization by
some authorities evades the fact that often an act that benefits other stakeholders reduces share value” (at 460).

He said that if stakeholder approach is good for business, it collapses into shareholder maximization model, but warn that it often reduces share value, and so one has to make a choice.

Steem Thomsen argued that employee as well as gender board representation should not necessarily be judged in terms of its impact on firm value but in terms of changing societal values and setting models which engender long term cultural changes. In a recent paper, Hart & Zingales argue that firm should maximize shareholder welfare, not just shareholder value.

Berle and Means, who observed the phenomenon of separation of ownership and control in modern corporations that led to Jensen and Meckling’s agency theory which misconceived shareholders as the principal of the management, did not advocate for shareholder profit maximization as the ultimate goal of corporations. They said that:

“It is conceivable, --indeed it seems almost essential if the corporate system is to survive,-- that the ‘control’ of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupididy.”(pp. 312- 313)

Stout (2012) argues that the view that the fiduciary duty of managers and directors is to maximize shareholder wealth is not consistent with US corporate law.

A clear statement supporting stakeholder interests comes also from Sir Adrian Cadbury, whose Cadbury Report started the debate on corporate governance in the UK:

“Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.” (emphasis added)

Hart & Zingales point out the flaw in the idea of shareholder profit maximization. First, they argue that Friedman was wrong to separate profit maximization and externalities or damage as these two are not always separable. They said that Friedman is right only if they are separable (eg his example of charitable giving by companies.) (at 3-4) or if government “perfectly internalizes externalities through laws and regulations”, neither of which seems very plausible (at 28). In the absence of these conditions, they argue that “shareholder welfare and market value are not the same, and that companies should maximize the former not the latter.” (at 28)

They divide the literature on Friedman into the following types:

1. “Friedman-type argument holds only in Arrow-Debreu complete markets economy where each firm is a perfect competitor”. (at 5)

304 See ECGI Rountable Report, at 8.
2. “In a world of incomplete contracts, these groups [stakeholders] are all vulnerable to opportunistic behavior and so to encourage them to make relationship-specific investments it may be important for managers to deviate from short-run profit or value maximization. Under some conditions it may be efficient for the company to be set up as a worker, producer, or consumer co-operative or as a non-profit.” (at 6)

3. “This part of the literature, and it is vast, is mainly concerned with the empirical implications of a company’s pursuing a broader objective than just shareholder value. Might putting some weight on social issues actually increase profit in the long-run? There is also a small theoretical literature on corporate objectives when shareholders care about public goods and externalities. … One point to note is that most of the theoretical literature is concerned with corporate gift-giving rather than with the mitigation of externalities” (at 6)

4. “Elhauge (2005). Elhauge (2005) makes many of the same arguments that [Hart & Zingales] do in a more informal way. Specifically, he recognizes that profit maximization is too narrow a goal for managers when shareholders have social concerns….Stout (2012), like Elhauge (2005), also argues that, given that shareholders are prosocial, managers should pursue a broader agenda than profit maximization.” (at 6)

They argue that companies should maximize shareholder welfare and not market value from an economic analysis of how consumer who owns shares in a company will choose between clean and dirty decision: (at 7-10)

1. consumer/shareholder will vote for clean over dirty decision if and only if profit from clean decision (eg $10) is larger than profit from dirty decision (eg $12) minus the damage (eg $4) and if the significance he attaches to damage is large enough;
2. If profit for clean decision ($10) is larger than profit for dirty decision (eg $9), he will vote for clean over dirty decision;
3. If profit for clean decision ($10) is smaller than profit for dirty decision ($12) minus damage ($1), he will vote for dirty over clean decision;
4. What if profit for dirty ($12) is larger than profit for clean ($10) but profit for clean ($10) is larger than profit for dirty ($12) minus damage ($4)? It will be the same as in situation 1.
5. If profit for clean ($10) is the same as profit for dirty ($12) minus damage ($2)? It will be the same as in situation 3.

Hart & Zingales were looking at how shareholders (not stakeholders) would choose between clean and dirty decisions, and their analysis reveals that pro-social shareholders will vote for clean decision in situation 1. This shows that Friedman was wrong in situation 1: pro-social shareholders will vote for clean decision even if the profit is less than the dirty decision because the profit and externalities cannot be separated. However, one interesting point from Hart & Zingales’s analysis is that even pro-social shareholders cannot be relied on to make socially responsible decisions in situations 2, 3 & 5. And managers who are required to act for shareholder’s interest will likewise do so.

Hart and Zingales also show that in the case of perfect competition, dirty choices by other companies will likely reduce marginal costs and force prices down, reducing firm’s profit. If company A is in duopolistic competition with a second company B that has chosen a dirty technology, shareholders of company A has a dilemma. If they choose clean, they will lose market share to company B if B’s marginal cost is lower. The consequence is a large amount of environment damage by B. If they choose dirty decision (which they would prefer not to), they may produce possibly smaller damage themselves and still make money. (at 19)
In view of the analysis, what is the fiduciary duty of managers or directors? Hart and Zingales said that the academic literature is confused (at 19). They argue that the duty is to maximize shareholder welfare, not just shareholder value. Unfortunately, as they point out that, managers of pension funds are required by law to maximize value rather than welfare, unless there is a vote at shareholder meeting to tell them otherwise (at 22). They also found that a consequentialist shareholder would vote to transform the company into a clean one as “she feels guilty about the pollution produced if she does not act to curb it”, unless the pollution is “moderately inefficient” (at 26). However, if a shareholder is categorically imperative, he will make all inefficient takeovers impossible and eliminate any problem of free riding, collective action and even adverse selection or moral hazard. (at 27)

The point of Hart and Zingales’s analysis is that profit maximization for shareholder value is not efficient. However, they say nothing about stakeholder welfare. It seems to me intuitively that there is an economic case for stakeholder welfare applying their analysis in an imperfect market or where there is no perfect competition, or even if there is perfect competition, firms are able to externalize their costs, profit maximization would lead to inefficiency; firms acting for stakeholder welfare will be more efficient.

[Check also:
Geoffrey Heal, When Principles pay: corporate Social responsibility and the bottom line, CBS.
Jeffrey D Sachs, The age of sustainable development; and Building the new American Economy; Smart, Fair & Sustainable
John Gerald Ruggie, Just Business (Cir Desk HF5387.R835 2013)

4. The Trend

As has been pointed out, increasingly many large corporations, especially the world’s largest corporations, are now engaging in environmental and social causes with multiple stakeholders in mind; the largest corporations are forced by civil society (principally local and international NGOs) to balance different stakeholders' interests instead of simply maximizing shareholder wealth. Because of the concentration of wealth and resources on these corporation and their size, it is easier to identify them

307 One problem is for the managers or directors to find out what shareholders want (their welfare). Hart & Zingales think that this can however be resolved by using digital polls that are cheap and fast. (at 20). Another option is to have specialized socially responsible mutual funds (not the normal mutual fund which trade regularly for profit only). On the strategy for social investing, they advocate that “invest and engage” would be more successful than “diverting” from dirty companies (at 21).

and hold them accountable and subject them to a test of public benefit. The Global 1000 companies spent financial resources on ESG that are immaterial to their long term financial performance. It was argued that this will lead to what Berle and Means (1932) predicted more than 80 years ago: both owners and "the control" accepting public interest as the objective of the corporation.

Berle and Means said,

“The control groups have, rather, cleared the way for the claims of a group far wider than either the owners or the control [groups]. They have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society” (at p 312).

Blair (1995) argues that stakeholders make their “investments” in the company to achieve their goals, so they have a legitimate or moral right to claim a share of the value created; they are a team production, so the governance structure must allow effective negotiations, coordination, cooperation and conflict resolution to maximize and distribute the joint gains among the multiple stakeholders, so as to maintain their commitment.

Proponents of representation of stakeholders on corporations board to legitimize and safeguard interests of stakeholders now include: Evan and Freeman 1993, Freeman and Evan 1990, Jones and Goldberg 1982, Luoma and Goodstein (1999) (stakeholders as directors, members of board committees, members of CSR committee), Kaufman and Englander (2005), Silvia Ayuso and Antonio Argandoña (2007).

“Firms must assess the stakeholders that are relevant to them because of their specific business and environment and select board members who represent them adequately, also bearing in mind diversity issues such as giving equal opportunities to women and ethnic minorities. These stakeholders, in turn, will be able to provide the needed board capital, ie human and relational capital, to allow the firm to create value”.

5. The Misguided Agency Theory and a New Agency Theory

As mentioned above, the agency theory propounded by Jensen and Meckling was concerned with abuses by managers due to separation of ownership and control as observed by Berle and Mean. However, Jensen and Meckling erroneously treated managers as agent of shareholders and forgot that other stakeholders also form part of the company. Thus, incentives were invented to align interest of managers with shareholders, rather than stakeholders. This led to the idea of shareholder profit maximization, which causes externalities. A better view is that managers are agent of the company, which is the stakeholders (including shareholders). They must therefore act for the interests of stakeholders. Incentives and devices should be designed to align interests of managers with interests of stakeholders. Governance structure should also reflect this to bring about better corporate governance. It is difficult for a director to

309 Serafeim 1, at 8.
310 See http://www.stormscape.com/inspiration/website-lists/global1000/
311 Serafeim 1, at 3.
312 Serafeim 1, at 3.
consider and balance the interests of all stakeholders and be held accountable to all stakeholders, a dilemma explained elsewhere (see AJLS). One option is to divide the board into directors representing different stakeholders, so that directors can argue for interest of the stakeholders they represent and be held accountable to them. This idea, explained elsewhere (Goo, AJLS), will be elaborated below.

6. Can Looking After Stakeholder Interests or Not Maximizing Profit be Bad for Efficiency?

The law and economic scholar often cite efficiency as the justification for shareholder profit maximization. I have explained elsewhere that this is only true if all costs are internalized (see Goo, AJLS). Japanese companies, often seen as the odd man out, provide interesting examples of how looking after stakeholder interests is not bad for efficiency. Since 2002, Japan’s emergence, albeit slowly, from its decade-long economic malaise, had prompted intriguing questions as to whether recovery was achieved by refashioning its laws and economic institution along more American lines as Kelemen and Sibbett argue, or does the recovery provide evidence of “the robustness of its broader, stakeholder-oriented system of governance” as Collison and Kozuma argue? “Does Japan’s experience … reflect the triumph of US-style shareholder-oriented governance, or the endurance of Japan’s stakeholder-based model of capitalism?”

It is well known that Japanese companies are not primarily interested in profits and dividends, and yet “large Japanese companies, though they may be privileged, are also intrinsically efficient. They could hardly make goods of such high quality and deliver them on time if they were not. No one, Westerner or Japanese, need be in any doubt that the Japanese system works”. Very little had changed after the lost decades. One reason for the status quo was “political, using that world in the widest sense. The company and Japanese industry as a whole confer their benefits on enough people for there to be considerable support for the status quo”.

Although there has been a shift in Japan since 2002 from “employee sovereignty” markedly towards “shareholder sovereignty” and development of a market for corporate control, and other phenomenon such as real threats of takeovers and much

319 Ibid, at 225.
320 Dore, 2005a, at 443.
greater managerial concern with share price, \[321\] faster growth of directors’ compensation compared to that of other workers,\[322\] there has been little revision of bureaucratic internal promotion system for top managers.\[323\] Thus, Haley (2005b) maintains that the corporate sector in Japan continues to display a broader stakeholder approach to corporate governance which fits with Japan’s ongoing communitarian approach to law and society, and Dore (2007) concurs with Haley that Japan still retains key infrastructure for stakeholder-based firms. Jacoby (2005c, at 11-12) also argues that Japanese companies are still very much organization-oriented, focusing on long-term employees and broader stakeholders in their corporate governance, with a high-powered centralized human relations department. Even the rational self-interest theorists, such as Ramseyer, who argue that the Japanese are not communitarian, but are driven by straightforward market forces, not idiosyncratic and persistent institutional arrangements (Ramseyer and Nakazato 1999; Miwa and Ramseyer, 2006), agreed that little had changed.

On the other hand, there was the opposite view that Japan was departing from stakeholder capitalism and moving towards an embrace of shareholder primacy.\[324\] For example, Emmott, editor of The Economist in 2005, claimed in rather colorful terms that:\[325\]

“Cross-shareholdings have largely been unwound. Lifetime employment, even in big firms, is now the exception not the rule thanks to changes in labor laws that have allowed workers to be employed on short-term contracts. Such employees make up 40 per cent or more of the total at manufacturers such as Toyota. Many – though not all – corporate boards have been streamlined, with more independent directors and fewer placemen [sic] … Executive remain primarily bureaucratic but there are now many more exceptions, sounding and behaving more like American CEOs and with senior management pay geared to performance. And foreign executives are no longer unacceptable.”

Lifelong employment, along with seniority-based wages and enterprise unions are the ‘three sacred treasures’ that represent ‘stakeholder governance’ (Jacoby 2005b), even though it is neither mandated under Japanese corporate law nor part of any explicit contractual promise, but a mere ‘unwritten guarantee’ (Dore 2000b, at 107), ‘social norm’ (Jackson 2007, at 282) or a ‘moral imperative’ (Ahmadjian and Robinson 2001, at 624). In fact, Japanese corporate law, like Anglo-American law,

“presupposes that a corporation is [the] shareholder’s property and the role of management is to maximize the interests of shareholders. Unlike [the] German co-determination law which opens the supervisory board to employee representatives, Japanese law does not give employees or their representatives any status as a constituent of the corporation … Thus, ostensibly Japanese law resembles more the Anglo-Saxon market oriented model.”\[326\]

However, lifelong employment marks the difference between the Japanese and the US system:

“Traditionally, Japanese firms have been ‘organisation oriented’ while American firms have been more ‘market oriented’. This is reflected in the dominant features of corporate governance and work organization, where despite movement towards the American model, the Japanese system of stakeholder-

\[321\] Dore (2007)
\[322\] Dore (2007)
\[323\] Dore (2007)
\[325\] Emmott (2005), quoted in Nottage, Wolff and Anderson at 27.
oriented corporate governance and its view of labour as a productive resource continues to stand in sharp contrast to the American shareholder-based system and view that labour is a factor of production with a cost to be determined.”327

During the height of the Japanese economy, lifelong employment and the broader model of stakeholder capitalism was trumpeted as the secret of the Japanese success, providing a worthy alternative to the liberal market economy, whilst during the recent downtown, it was regarded as a drag on labour mobility and economic efficiency.328

There has been debate as to whether lifelong employment is dead in Japan. However, the empirical evidence seems to indicate that lifelong employment persists, but is under strain.329 Despite Emmott’s claim, and despite many changes since 2002,330 the Japanese stakeholder-oriented model remains largely intact albeit with considerable realignment of stakeholders.331 “Japan is experiencing significant but not overwhelming change in its system of corporate governance”.332

“Shareholders have become more central compared with creditors and employees (with more change underway than acknowledged by Haley). However shifts are more embivalent in some areas of industrial organization (especially in relation with key suppliers). Influences on firms from regulators or the broader community (such as NGOs) are also changing, but remain more peripheral.”333

It has been suggested that:

“[S]uch changes are best understood as evidence of an intensification of an existing mode of regulation – flexicurity – rather than a harbinger of more dramatic institutional shift. The system is undergoing stress, clearly, but its key features remain in place… Lifelong employment … is not ‘withering away’; rather, it is reinventing itself in response to the intensification of the flexicurity mode of regulation. As the empirical evidence illustrates, the ‘tree’ of lifelong employment may have many of its branches swaying in the wind (some may have even snapped off), but this tree remains rooted in the same political compromise between labour and management settled over five decades ago.”334

[Check also stakeholders board supported by resource dependency theory, increases board capital (Hillman and Dalziel (2003)), and enhance company's social performance].

7. Conclusion (TWU)

Economists’ new theory of the firm has lent support to the notion of profit maximization and caused the phenomenon of CSR abuses despite law and regulation to prevent abuses. The new theory of firm is not inline with the original purpose of a corporation which was to benefit the society. It suits economists as it is easier to teach and quantify firm performance by looking at profit maximization, and legal academic because of the reference to contract.

328 Ahmadjian and Robinson, 2001, at 624; Boyer and Yamada, 2000 at 3; Nottage, Wolff and Anderson at 57.
330 For a detailed analysis of the changes, see Nottage, Wolff and Anderson at 30-37.
331 Nottage, Wolff and Anderson at 28 and 38.
332 Nottage, Wolff and Anderson at 38.
333 Nottage, Wolff and Anderson at 29.
334 Nottage, Wolff and Anderson, at 79.
When individual contracts, he contracts for his own benefit, so to prevent his decision harming other, we have to use law and enforcement. When a corporation contracts, economists treat them as the embodiment of individual shareholders, so, like individuals, corporation can contract for their own benefits, and again we have to use law and enforcement to prevent harm. Treating corporations as the embodiment of shareholders would be correct if they are formed for the sole purpose of shareholder interests. However, corporations are not allowed to be formed solely for the purpose of the shareholders. They are formed to serve the interests of the society. Thus, corporations must contract not solely for the interests of shareholders, but also for the society’s interests. The key question is what kind of mechanism will allow corporations to make such a decision. The current board structure where directors are said to owe duty to maximize profit for the interest of the shareholders does not allow such decision to be made. The suggestion that there should be directors representing stakeholders in the board is one way to do that.

Looking at the historical development, it is clear that legal and economic theories simply seek to explain the power relation affecting the corporation as a legal entity. These theories come and go as they successfully explain the reality of powers affecting corporations and become irrelevant. They do not dictate the development of the doctrinal theory which remains largely constant subject to adjustment within legal doctrinal as the power relations change.\(^{335}\) That corporation is a legal entity created by sovereign power for various purposes including conducting business for the benefit of the society is unquestionable both historically and at present day. Until 1980s, large corporations were basically controlled by managers. To prevent abuses by managers, doctrine fiduciary duties were used to restrain the managers, and other principles were developed to allow derivative suits to protect shareholders. Even as shareholders began to exercise their power through takeovers and proxy voting, fiduciary principles were enough to control management’s anti-takeover defences and protect minority shareholders. However, these are ex post remedies. Increasingly, institutional shareholders are demanding board seats to represent them and to protect their minority interests as an ex ante measure. Other stakeholders have so far been protected not by corporate law but other law as ex post measures. It would be a matter of time when they will demand board seat to represent their interest too to effect better ex ante protection.

\(^{335}\) Bratton, at 1524.

E. Stakeholders Verses Shareholders Post-War

Armour et al, the anatomy of corporate law 2nd edition: Three agency problems, corporate law tries to reduce three: see chapters 2 and 4. (Check how well does it reduce third agency problem – shareholders verse stakeholders?)

From the discussion in Part III, it is clear that originally corporation with limited liability and separate legal identity came into existence organically to serve the public interest. In the case of the Mills of Toulouse in France, it was to provide members of the community with grain. In the case of the UK and the US, it was to fund the colonial ambition originally and much later for infrastructural development in the interest of the state. However, in the US and UK, there has been a big shift in the focus of corporations’ purpose from serving the state to serving shareholders who invested in
the corporations. This change can be explained from the perspectives of political economy and law and economics development. But this change is undesirable and is caused by the rentier class supported by the misconceived agency theory as explained above.

“A single constituency, often public shareholders, is declared to be the principal, at least economically, if not in the legal sense. This move implicitly forecloses meaningful examination of corporate purpose, or how each country conceptualizes the aims and ultimate beneficiaries of the corporate enterprise.” 336

In the previous sections, O have attempted to explain why corporations should act for stakeholder welfare. However given that in both UK and US, shareholder supremacy has been trumpeted as the ultimate purpose of a corporation, in this section, I will analyze the development in US and UK to predict how the idea of stakeholder value might develop in the future. To do that, it is important to appreciate the differences between the UK and US systems. As Bruner points out:

“while corporate governance systems in other countries often aim explicitly to balance the competing claims of various ‘stakeholders’ in the corporate enterprise, the U.S. and U.K. corporate governance systems tend to place greater emphasis on generating investment returns for public shareholders, leaving other stakeholders—such as employees and creditors—to bargain contractually for what they can. These traits reflect a shareholder-centric and market-oriented approach to corporate governance that may be fairly described as uniquely ‘Anglo-American.’” 337

Although managers have more powers than shareholders in the US than in the UK, so they are allowed by constituency statutes to take into account stakeholder interests, in practice, managers tend to act for shareholders interests as their interests are aligned, encouraged by agency theory, by executive compensation with shareholder interests.

1. Differences Between US and UK

Although the UK and the US have much in common, “arguably have more in common than any other pair of developed economies”, 338 they take “radically different approaches to the role of shareholders in corporate governance” and “differ radically in their prevailing politics and social welfare landscapes” 339

Bruner points out that:

“Shareholders in the United Kingdom are, in fact, far more powerful, and far more central to the aims of the corporation than are shareholders in the United States. UK shareholders possess considerably greater corporate governance authority and capacity to discipline errant officers and directors. In addition, UK shareholders benefit from fiduciary duties and a conception of corporate purpose that focuses far more clearly on their interests than is the case in any US state … The practical consequence is that UK shareholders loom much larger in the boardroom than US shareholders do … the differing posture of shareholders in the United States and the United Kingdom suggests that public corporations in these countries do not, in fact, perform identical functions in their respective societies. Put differently, the

337 Bruner, Vir JIL (2010) at 381.
339 Bruner book at 144.
purpose of the US corporation and the purpose of the UK corporation are not, strictly speaking, the same.”

(a) US

Bruner points out that although it is often said that the Anglo-Saxon systems do not take stakeholder interests into account, this is in fact a gross oversimplification of the U.S. corporate governance system. In fact, the U.S. corporate law is ambivalent with respect to each of three fundamental and related issues: the locus of ultimate corporate governance authority, the intended beneficiaries of corporate production, and the relationship between corporate law and the achievement of the social good.

“Contrary to the broad characterization of ‘Anglo-Saxon’ systems as single-mindedly pro-shareholder, U.S. corporate law in fact sharply constrains the power of shareholders to undertake independent action.”

For example, under s 141(a) of the Delaware General Corporation Law, which governs most U.S. public corporations, “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.” As Bruner explains, majority shareholders cannot directly compel the board to take any particular action, and apparently cannot be given the power to do so. Furthermore, although it is the shareholders who elect the board, and as a default matter, shareholders can remove directors “with or without cause”, if the board is classified—ie divided into classes elected in subsequent years (a common practice in the US and is on its way out)—shareholders may remove directors without cause only if the charter expressly permits it. And shareholders cannot call special meetings unless expressly given such power in the charter or bylaws to do so. Shareholders cannot initiate a fundamental transaction or a charter amendment without prior proposal by the board.

“The authority for direct action that shareholders do possess, such as suing directly or derivatively to vindicate a breach of fiduciary duty, tends to be quite limited and post hoc. … [even] in the critical context of corporate takeovers, which are said to represent an important means of disciplining management, target boards are afforded substantial latitude to interfere with the shareholders’ freedom to sell their stock to a hostile bidder.”

As Bruner explains, although the Delaware Supreme Court stated in *Revlon v. MacAndrews & Forbes Holding, Inc.* that in some instances the board is required to focus single-mindedly on the shareholders’ interests,

“the duty to maximize short-term return to shareholders is narrowly limited to circumstances where a sale, break-up, or change of control of the company has become ‘inevitable.’ Beyond such instances, *Unocal* itself explicitly permits the board to consider the effects of a hostile bid on ‘the corporate enterprise’ more broadly, including ‘the impact on “constituencies” other than shareholders’ such as ‘creditors, customers, employees, and perhaps even the community generally.’ (at 597-8)”

As Bruner further explains:

“Many states have adopted ‘other constituency statutes’ that unequivocally establish the legitimacy of such considerations in the hostile takeover context, and in some states, in all board decision-making. (at 598) . . . Delaware has long adhered to the view that management owes fiduciary duties of care and loyalty ‘to the corporation and its stockholders’ simultaneously, a formulation reflecting a studied ambiguity regarding whose interests should prevail when push comes to shove. To be sure, the shareholders are

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340 Bruner, at 594
341 Bruner, at 596.
favored over other constituencies as a practical matter (emphasis added), at least insofar as they alone can sue directly for breaches of fiduciary duty and pursue derivative litigation in the corporation’s name (so long as the corporation remains solvent, anyway). But at the same time, this formulation reflects a decided reluctance to focus solely on the shareholders, to the exclusion of the other constituencies contributing to the corporate enterprise—a reluctance further reflected in the absence of a clear duty to maximize shareholder wealth in any but the narrowest circumstances, the enormous discretion afforded management under the business judgment rule, and the takeover jurisprudence described above. (emphasis added) (at 599) … Delaware’s ambivalent statement of fiduciary duties long persisted as ‘a pragmatic doctrinal accommodation’ of differing views on the nature of the corporation … Delaware’s awkward doctrinal approach to hostile takeovers primarily reflects a strong desire to avoid clear endorsement of either a shareholder- or stakeholder-oriented conception of the corporation, even in the face of transactions with clear winners and clear losers.” (emphasis added) (at 599)

(b). UK

In the UK, shareholders have more powers to intervene directly in corporate governance and the takeover regime is more shareholder-centric. “The result is a decidedly shareholder-centric governance system exhibiting little of the ambivalence that characterizes U.S. corporate governance” … In addition, U.K. company law explicitly confirms that the defining aim of the corporation is to advance the interests of shareholders. Section 172 requires that a director ‘must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members [i.e., the shareholders] as a whole.’

“The provision does instruct the director to consider the interests of various stakeholder groups, including employees, suppliers, customers, and the community. Directors are also to consider larger issues including environmental impacts, the company’s business reputation, and the “long term” consequences of board decisions, naturally giving the board substantial room to maneuver, just as in the United States. Ultimately, however, as a formal matter, such considerations are relevant only to the extent that they relate to the actual duty imposed on directors to make a good faith effort to advance the shareholders’ interests. Notwithstanding the political nod to other stakeholders and issues of larger social interest, the core duty articulated in section 172 is clear, reflecting none of the ambivalence that continues to characterize the prevailing formulation of a U.S. director’s fiduciary duties … it would appear that the U.K. corporate governance system is substantially more compatible with theories emphasizing shareholders’ interests than the U.S. corporate governance system is.”

That there is a difference in law in the treatment to stakeholder interest in the US and UK is significant, as the US gives recognition to the importance of stakeholders over and above the shareholders.

2. Why are the US and UK different? Political Economy Perspective

In Corporate Governance in the Common-Law World: The Political Foundations of Shareholder Power, (Cambridge UP, 2013) Christopher M. Bruner did an excellent analysis of the divergence among the United States, the UK, Australia and Canada in terms of the relative degrees of shareholder-centrism exhibited by their corporate governance systems, and argues that “prevailing economic and political theories of comparative corporate governance offer no compelling explanation for this divergence.” He argues that existing theories cannot explain the differences:

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342 Bruner, at 603.
344 Bruner, at 610.
345 Bruner book, at 143.
“The shareholder primacy theory—the view that shareholders straightforwardly ‘own’ the corporation, and thus are entitled to dictate its aims in the way that any principal would direct her agent—is plainly contradicted both by the sharp constraints placed on shareholder action and the range of structures permitting deviations from shareholder wealth maximization. The remaining theories, however, do not fare much better. The ‘team production’ theory of the corporation, developed by Margaret Blair and Lynn Stout, styles the board as a ‘mediating hierarch’ with the duty and capacity to protect all of the various corporate stakeholders from opportunism at the hands of the others, facilitating the range of firm-specific investments required for a successful corporate enterprise. This theory of corporate governance depends critically on the characterization of directors as ‘trustees for the corporation itself,’ without favoring any particular group, because otherwise their claim to protect all stakeholders from opportunism would lack credibility. As David Millon observes, however, the board’s substantial discretion under the business judgment rule does not support this view of the corporation, and in fact tends to contradict it. As Millon explains, the ‘very discretion that allows corporate boards to pay attention to nonshareholder as well as shareholder interests also allows them to pursue shareholder value with relentless disregard for social costs.’ In this light, the board’s discretion under the business judgment rule is every bit as inconsistent with the team production theory as it is with the shareholder primacy view described above. Blair and Stout likewise fail to account for the privileged position of shareholders in advancing derivative claims on the corporation’s behalf, as well as the fact that the formulation of fiduciary duties in Delaware, ambivalent as it may be, does mention just one constituency by name—the shareholders. The ‘nexus of contracts’ view of the corporation—probably the leading theory of corporate governance among U.S. academics—also fails to account for the fundamental characteristics of U.S. corporate law. The core claim is that the corporation, as a descriptive matter, is fundamentally private and contractual in nature, and, as a normative matter, ought to be treated as such. As Frank Easterbrook and Daniel Fischel express it, the idea is that ‘corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm’s length for every contingency sufficiently low,’ the various parties (e.g., shareholders, boards, employees, creditors, and communities) would work out, the claim is that they would favor strong boards—and correlatively weak shareholders—for the efficiency of such an arrangement. … Those adhering to the nexus view typically argue that other stakeholders, such as employees, creditors, and communities, are entitled only to what they can secure through ‘explicit, negotiated contract’ and that corporate law should not mandate regard for non-shareholders. Delaware case law clearly establishes that the legitimacy of board authority derives from election by the shareholders, rejecting the depiction of directors as ‘Platonic masters.’ … all nexus-based theories, like the shareholder primacy view, fail to explain the fact that U.S. corporate law does not mandate shareholder wealth maximization as the defining aim of the corporation, and that it is in fact replete with structures permitting substantial deviations from shareholders’ interests in an enormous range of circumstances.”

He argues that “stronger welfare protections in the UK have permitted the UK corporate governance system to focus more intently on shareholders without precipitating political backlash” whereas in the US “weaker social welfare protections have inhibited US corporate governance from doing the same.”

He further argues that “placing corporate governance within its broader political context is critical to understanding both the origin and persistence of shareholder-centric regulatory structures in the United Kingdom”:

“left-leaning social democratic structures are not only compatible with shareholder-centrism, but that the stark form of shareholder-centrism embraced in U.K. corporate governance could only have taken root in tandem with social democratic policies serving to deflect political pressures by lowering the stakes of corporate governance for non-shareholder groups. … Perhaps ironically, a balance of internal and external forces is implicitly recognized by nexus theorists who argue that stakeholders’ interests are best addressed through external contracts and regulation. Yet, these theorists routinely fail to recognize the degree to which shareholder-centric corporate governance and external stakeholder protections interrelate. Nexus scholars portray the position of shareholders’ interests in corporate governance as

346 Bruner, at 599-600.
347 Bruner, at 600-602.
348 Bruner, at 143.
fundamental and primary; external stakeholder protections are either assumed to be sufficient, or the consequences of their insufficiency for corporate governance itself are left unexplored. In reality, as the evolution of U.K. corporate governance illustrates, both internal and external structures have continually responded to one another in a dynamic process, and it is only by reference to such a process that one can fully explain the strong association of the U.K.’s shareholder-centric corporate governance structures with social democratic policies and Labour Party politics.\(^{349}\)

Referring to Martin Gelter, Bruner argues that shareholder-centrism and extra-corporate stakeholder protections are intrinsically related and that “stronger shareholder influence”—including through European-style blockholding, as opposed to greater formal governance authority as a matter of corporate law—“implies a greater risk of expropriation for stakeholders, such as employees.”

“In Europe this problem has been addressed through stakeholder-oriented directors’ duties, employee governance powers (for example, co-determination), and restrictive employment law rendering it ‘difficult and costly to lay off workers, thus eliminating potential threats that can result in holdup-type renegotiations.’ In the U.S. context, on the other hand, this problem has been addressed through broad managerial discretion to deviate from shareholders’ interests. The United Kingdom, then, is treated as an ‘intermediate’ case, with shareholder influence greater than one finds in the United States but weaker than that of a blockholder, and employment protections likewise falling somewhere between the weaker U.S. protections and the stronger European protections.”\(^{350}\)

In the UK, as Bruner points out, another form of stakeholder protection actually co-evolved with the U.K.’s starkly shareholder-centric corporate governance structures—welfare state protections:

“In fact, these extra-corporate stakeholder protections arguably preceded the emergence of the relevant corporate governance structures. To this extent, the welfare state might be aptly characterized as a form of what David Millon has called ‘precontractual’ state action—indeed and action that conditions how various corporate stakeholders conceptualize their interests and negotiate their claims upon the corporation. (at 623) Though its roots date back to the Liberal government of the early Twentieth Century, the modern U.K. welfare state arose out of inter-war economic difficulties and what one observer described as the consequent ‘craving for stability [that] dominated British public life’—a fact recognized by the left and the right alike, with both parties ‘increasingly accept[ing] the idea that the state had to provide jobs and comforts when business could not.’ (at 624) … Like its ongoing commitment to the welfare state, the British left’s general tolerance for shareholder-centric corporate governance evidently had not waned by the turn of the millennium, when an in-depth review of company law culminating in the Companies Act (2006) was undertaken. A Steering Group created by the Department of Trade and Industry under Tony Blair’s centrist ‘New Labour’ government to aid the company law reform effort explicitly addressed ‘the proper scope of company law, that is, whose interests it should be designed to serve and the legal means by which it should do so.’ In its February 1999 consultation document, the Steering Group characterized the preexisting law on directors’ duties as shareholder-centric, citing Easterbrook and Fischel and suggesting that permitting directors to pursue ‘a wider range of interests’ would require a change to the company law. The goals of the reform effort were to maximize ‘benefits for all participants in the enterprise’ while, ‘to the extent it is appropriate,’ minimizing ‘the negative impacts of corporate activity on participants’ and maximizing ‘welfare more widely.’ This involved explicit consideration of whether to remain with a shareholder-centric formulation of directors’ duties or to adopt what was termed the ‘Pluralist’ approach, broadly reflecting the team production theory described above, requiring that directors be duty-bound to maximize aggregate benefits for all corporate stakeholders. The Steering Group rejected the Pluralist approach, taking the view that, among other things, such a ‘broader objective’ could ‘dangerously distract management into a political balancing style at the expense of economic growth and international competitiveness,’ and suggesting that other stakeholders’ interests ‘are best made good by changes in other areas of the law and public policy.’ The Steering Group preferred what it termed the ‘Enlightened Shareholder Value’ approach, which preserves ‘shareholder wealth maximisation’ as the ‘ultimate objective of companies’

\(^{349}\) Bruner, at 621.

\(^{350}\) Bruner, at 622.
while requiring that other stakeholders’ interests be considered toward that end—an approach ultimately reflected in section 172 of the Companies Act. Characterized by some as ‘a classic piece of New Labour triangulation,’ and as a sort of ‘half way house’ between shareholder wealth maximization and the Pluralist view, section 172 is more widely, and accurately, recognized as a continuation of the prior law, requiring that directors pursue the best interests of shareholders. (632-633) Labour’s willingness to see the creation of shareholder-centric governance structures reflects, to a great extent, the simultaneous construction of extra-corporate structures that address other constituencies’ needs, notably welfare state structures that substantially mitigate the consequences of job loss. (at 634) The explanatory power of such variables is underscored by contrast with circumstances in the United States, where the relative absence of U.K.-style welfare state structures has had an enormous impact on the development of the corporate governance system. In some instances … this has led U.S. corporate governance in a radically different direction.”

In the US, Bruner observes:

“that such an anti-shareholder regulatory regime should have emerged during the pro-market and pro-takeover Reagan administration is as surprising as a pro-shareholder regime taking shape under the U.K. Labour Party… (at 637) Neither would be predicted by Roe’s social democracy theory, which associates anti-shareholder policies with left-leaning politics and pro-shareholder policies with right-leaning politics. Indeed the analysis of [Bruner’s paper] has suggested that it may have been the very presence of left-leaning, social democratic regulatory structures in the United Kingdom that permitted the coalescence and maintenance of a shareholder-centric corporate governance system. This suggests that, conversely, the emergence of a more stakeholder-oriented regime in the United States may be related to the relative weakness of social democratic structures”.

Bruner explains the political background for the situation in the US:

“Unlike in the United Kingdom and most other industrialized countries, where social welfare programs have been administered predominantly by the government, in the United States large corporate employers ‘have been primarily responsible for workers’ social welfare.’ This includes ‘health insurance, pensions, unemployment insurance (in the form of severance pay, and job security and income guarantees), disability insurance, and life insurance,’ as well as mandatory employer contributions to various state-run programs.’ … this ‘elaborate web of legally enforceable contracts, implicit agreements, background legal norms, and discrete public regulatory and insurance systems’ aims to accomplish the very things that government programs do in other countries, namely, protecting workers against the risk of lost income, and providing health and retirement benefits. Charny observes that while this system ‘provided fairly comprehensive social insurance protections’ from the 1920s to the 1970s, those elements of the U.S. approach not taking the form of enforceable legal rights—so-called implicit contracts—are inevitably difficult to maintain during periods of crisis. In particular, hostile takeovers upset the relationships within the corporation that formed the foundation of what he terms ‘the employee welfare state.’ (at 638) … The United States and the United Kingdom have similarly emphasized private pensions, and neither country’s labor laws offer particularly strong protections (either in the context of hostile takeovers or more generally), though as between the two countries these protections tend to be weaker in the United States. The two countries have taken radically different approaches, however, to at least one of the core components of workers’ social welfare that Charny identifies—health care. In the United States, the medical profession and the insurance industry have historically opposed comprehensive national health insurance programs. So unlike the United Kingdom, which maintains the reasonably well regarded National Health Service—a system founded in 1948 that today ‘remains free at the point of use for anyone who is resident in the UK’—the United States adheres to an employer-based system, at considerably higher cost, that as of 2007 provided no coverage whatsoever to 45.7 million Americans.” (at 639)

This suggests that with weak state-run social welfare, US needs to put stakeholder directors on board to exercise the power of the board for the benefit of stakeholders, power which the law already recognizes.

351 Bruner, at 635.
352 Bruner, at 637.
“While the Delaware General Corporation Law has explicitly endorsed neither a shareholder-oriented nor a stakeholder-oriented view of the corporation, these jurists candidly concede that judges facing takeover cases ‘are unavoidably aware that the interests of more than stockholders are usually at stake’ and express ‘uncertainty over whether the [shareholder-centric] property model is, in fact, the corporate law system that will best facilitate the maximization of societal wealth.’ Ultimately they recognize as ‘credibly arguable’ the claim that board power over hostile takeover attempts can effectively balance the interests of shareholders and other stakeholders. This notion was, of course, flatly rejected by the U.K. Steering Group spear-heading the Companies Act review, which declares shareholder wealth maximization to be the defining purpose of a U.K. corporation. Delaware judges facing takeover cases have, for lack of legislative action, been forced to address defining issues of corporate law that can only be resolved by reference to ‘exogenous and broad-based social norms.’” (at 641)

[This supports the view that the existing structure where directors representing only shareholders does not make it possible for them to balance interests of other stakeholders, a dilemma explained elsewhere (see Goo, AJLS) which can be resolved by having stakeholder directors on the board (see Goo, AJLS)]

“While the rise of institutional investors and increasing capital mobility over recent decades may tend to favor the interests of shareholders capable of voting with their feet, more recent events tend to suggest that the U.S. political dynamics described above remain just as powerful today. For example, when Walmart—the largest private sector employer in the United States as of 2006—endeavored to boost returns for shareholders at the expense of other constituencies by “shifting health care costs” to employees and to taxpayers funding limited state health care programs, states reacted angrily with legislation aimed at thrusting those costs back onto the company. Although such legislative efforts were found to be preempted by federal employment legislation, Walmart ultimately decided to improve the health benefits offered to its employees, ‘reacting to a vast range of campaigns and litigation against the corporation.’ As Julia Contreras and Orly Lobel rightly suggest, Walmart’s problems stemmed from bucking the political equilibrium represented by Charny’s ‘employee welfare state’ by excessively favoring shareholders at the expense of employees and taxpayers.” This suggests that in the US the state is supportive of a stakeholder approach being implemented in the US, but it is the managers and companies who are opposed to the idea.”

In summaries, Bruner argues that the UK’s more shareholder-centric corporate governance system is due to its relative political leanings; it is typically thought to be the more left-leaning.

“Yet shareholder-centrism, as a normative position, is typically associated with the economic right. Given these facts, one might reasonably have predicted that any divergence between the United States and the United Kingdom would reveal a greater degree of shareholder-centrism in U.S. corporate governance, but that is emphatically not the case.” (Bruner, VJIL, at 583-4)

Bruner argues that “the U.S. and U.K. corporate governance systems diverge because of the different ways in which they relate to external regulatory structures that affect relationships among stakeholders in the corporate enterprise.” (Bruner, VJIL, at 583-4)

He argues that:

“stronger stakeholder-oriented social welfare policies and legal structures permitted the U.K. corporate governance system to focus more intently on the interests of shareholders without giving rise to political backlash and, conversely, that weaker stakeholder protections have inhibited the U.S. corporate governance system from doing the same… an important factor permitting the U.K. corporate governance system to evolve toward a high degree of shareholder-centrism—and to have this shareholder centrism represent a stable political equilibrium over time— was the fact that employees enjoyed social safety nets and employment” (at 585)
In other words, the weak social welfare in the US may have provided the condition for strong managerial control. What happened was that US companies were originally owned by founders who were managers, so the company law gave management power to them; when the company went public to raise fund, they prefer to retain control, so they lobbied successfully for the state law to allow them to do that. This is perhaps tolerable because it was done in the name of protecting other stakeholders and this has the support of legislators given the weak social welfare in the state, as Bruner observed. Whereas in the UK, historically there is a stronger culture of shareholder rights with shareholders given rights to intervene as early as ???. (Check historical legislation). Strong social welfare may have provided the condition for stronger shareholder rights, whereas in the US there is “a set of weighty social concerns that have long tended to inhibit U.S. corporate governance from endorsing shareholder interests as the defining purpose of the public corporation”. Despite the difference in the law, in practice, UK and US are both obviate of stakeholder interests, and it is only recently that in the UK and Europe that there are calls for stakeholder interests to be respected. But it is still not so in the US.

“[C]omparative analyses ignoring the impact of political context will inevitably present a distorted picture, resulting in unsupported claims regarding what the future might bring. (at 646) This problem is readily apparent in normative work advocating that one country adopt a practice or norm prevalent in another—for instance, shareholder-centrism. The problem also arises in descriptive work forecasting convergence on such a global model or norm. Lucian Bebchuk, for example, has suggested that the United States should adopt something resembling the strong shareholder-centrism of U.K. corporate governance, but no analysis of the substantial political and institutional differences discussed above is provided. His dismissal of stakeholders’ interests as mere cover for management entrenchment—again, with no substantial political or historical analysis—is perhaps ironic in light of his own prior work with Mark Roe on the power of path dependence in corporate governance, exploring, among other things, the role of ‘complementarities’ between regulatory regimes and firm structures. (at 646)… ‘Culture and ideology,’ they rightly conclude, ‘might influence a country’s choice of corporate law.’ (at 647)… the U.K. case suggests that we could create a starkly shareholder-centric corporate governance system if we really wanted it. But it also suggests that, to remain politically viable over time, such an approach would require substantially greater non-shareholder protections outside corporate law—a move that would require fundamental changes to existing social welfare structures that are unlikely to attract sustained political support.” (at 651)

In conclusion, the lesson from Bruner’s analysis is that the weak employee social welfare has caused the US law to allow directors to act for stakeholders interest in theory. The good news is that legally it is possible for stakeholder interests to be pursued in the US. The bad news is that in practice, beyond the compulsory employee welfare, managers are not using the law to benefit other stakeholders because managers’ pay is tied to company’s profit. And there are profit-related considerations as mentioned earlier. We need to change the pay package. And they need stakeholder directors to help them. However, it is hard to convince companies, managers, and economists of the value of stakeholders representative on board as they believe that they need to stay competitive by externalizing cost, as evidenced by the law and economics school of literature discussed earlier. Government is reluctant to introduce welfare state system for political reasons. So the political equilibrium in favour of present law is likely to continue. In the UK, the stronger welfare state makes it possible for the law to be more shareholder centric. The stand the UK 2006 Company Law took was strange and perhaps misinformed by the Steering Group which cited Easterbrook as authority for shareholder maximization, as the British court had never ruled to that effect before. (Cite British cases). However, having taken that unusual stand, they
realized the mistake of the enlightened shareholder approach without admitting it as they are now proposing to have stakeholder directors (see Green Paper and FRC consultation on CG Code). The stronger welfare state system ironically also makes it possible for that U turn to take place because if companies fail, there will still be the welfare safety net. In the US, Senator Elizabeth Warren has proposed a bill – Accountable Capitalism Act on 15 August 2018 that would revolutionalize the way large corporations are run by putting employee representatives on the board.353

IV RECOMMENDATIONS

This part will first discuss Christopher Stone’s pioneering work on corporate social responsibility and his proposals and their relevance today. It then explores the four different models of protecting stakeholder interests and concludes that stakeholder model is the best model, but that it will be restricted at this stage to only MNCs and SOEs in China that have a bad record for CSR.

A. How to Protect Stakeholder Interest?

It was once thought that the managerial model would be efficient to promote CSR (see Hansmann and Kraakman and literature cited therein, p 444 and footnotes 6 and 7). However it is now accepted that managers with wide discretion tend to act for their own interest, however well intended. So Hansmann and Kraakman argued that the shareholder-oriented model is the most efficient model. Various alternatives have been suggested before and exist today. For example, worker co-operatives,354 B-corporation (benefit corporations),355 social enterprises using different types of legal structures etc.356 As Hodgson suggests, “The general policy approach toward the organization of enterprise should be experimental, trying different types of firms, including cooperatives and other structures. Find what works best, in regard to individual satisfaction and human flourishing as well as profitability or revenue. Then experiment anew.”357

However, this paper does not address the desirability and problems with each of these alternatives. Rather, a solution is sought within the existing corporate governance

354 David Ellerman (1992) see employment as a partial slavery and proposed that employment be outlawed and replaced by worker co-operatives. For examples of worker co-operatives see Chèque Déjeuner and Acome in France and Mondragón Cooperative in Spain. US-based national Center for Employee Ownership reported that in 2009-11 there were about 10,900 enterprises in employee-ownership, stock bonus, or profit-sharing schemes, involving 10.3 million workers with assets estimated at about $869 billion (see Hodgson at 378, Check latest figures??). For problems with worker co-operatives see Hodgson at 369: though workers have equal rights, there would inevitably be hierarchies of power; while workers cannot be dismissed, there can be other threats and sanctions; workers may not be able to sell their shares or obtain full value for their shares; Mansmann (1996): limited adaptability, dealing with wide range of products, changing workforce through recruitment or exit.
355 B-Corporation is company adopting enlightened shareholder approach and certified as such.
356 For example: normal limited liability companies, a registered charity or industrial and provident society, or a community interest company: see https://www.britishcouncil.org/sites/default/files/social_enterprise_in_the_uk_final_web_spreads.pdf
357 Hodgson, at 370.
structure to try and “find what works best, in regard to individual satisfaction and human flourishing as well as profitability or revenue”, as mainstream corporation is the predominant form adopted and these corporations dominate the world economy and causes the largest amount of harm to consumer, environment and society.

1. Need for Internal Institutional Configurations

Stone argues that the traditional legal strategies have only a limited success in bringing about internal institutional configurations that are necessary, eg the ideal authority structures, patterns of information flow etc, to remedy the problems. Many corporate social problems do not feasibly lend themselves to the traditional legal treatments, and need some institutional analogue to the role that responsibility plays in the human being. We cannot continue to just rely on legal threats on corporation or key individual, though we should not abandon these strategies, but “the society shall have to locate certain specific and critical organizational variables, and where feasible, reach into the corporation to arrange them as it itself deems appropriate. In other words, if we can first clarify what ideal internal configurations of authority and information flow would best ameliorate the problem of, say, corporate pollution ... the society might then consider programs aimed at mandating such ideal internal configurations directly.”

In other words, Stone argues that we need:

“a legal system that, in dealing with corporations, moves toward an increasingly direct focus on the processes of corporate decision-making, at least as a supplement to the traditional strategies that largely await upon the corporate acts. Instead of treating the corporation’s inner processes as a “black-box”, to be influenced only indirectly through threats laid about its environment like traps, we need more straightforward “intrusions” into the corporation’s decision structure and processes than society has yet undertaken”.

Like the approach adopted in public governance, we need a structure or procedure by which “whatever outcome is arrived at, it must be channeled through such-and-such a system, one designed to insure that certain types of facts have been gathered and considered, and that certain values have received their due weight.”

“We ... have to consider the possibility of impacting corporate behavior directly by, for example, mandating the addition of specified roles, eg laying down by law that companies of a certain class must establish vice-presidents for environmental affairs, or vice-presidents for consumer affairs, and undertaking to establish – ourselves – the functions for these various roles so as to make them effective. ... The best place to begin a consideration of these possibilities is with the board of directors ... directorships are the one internal role on which corporate activists have been focusing their attention, periodically demanding a publicly elected director for corporations over a certain size, or for a member to be selected, as in some European countries, from among the workers, or even, presumably, from some other constituency, such as consumer or environmental groups. Such ideas are, if naively optimistic, not without merit.”

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358 Stone, at 120.
359 Stone, at 120.
360 Stone, at 120-21.
361 Stone, at 121.
362 Stone, at 124.
363 Stone, at 124-25. (emphasis added)
However, Stone points out that just putting some public directors or constituency directors on the board is not enough.\textsuperscript{364} We have to combine it with concomitant reform on the functions and responsibilities of the directors and the rules, understanding, and practices.\textsuperscript{365} We have to define clearly what is to be expected of those directors, but bearing in mind that directors, especially outside directors, in the current practice know a lot less about what is happening throughout his company than we might imagine.\textsuperscript{366} There is too much happening within the corporation for the directors to be in touch with it all; they often do not have independent staff; their primary responsibilities normally lie somewhere else; they meet infrequently; their compensations are nominal; they often serve on many boards at the same time.\textsuperscript{367}

As Stone points out:

“In such circumstances, the outside directors, unfamiliar with the ongoing details of the corporation’s operations, dependent on such data as management gives them – neither predigested nor critically analyzed by any independent source – are by and large going to hear the problems management wants them to hear, and dispose of them in accordance with management’s prior recommendations. As Stanley Vance has observed, “only in the rarest instances do outside directors have even the faintest idea of the technical processes, the competitive strains, or the real financial status of the host company”.\textsuperscript{368} This is a state of affairs that is likely to get only worse as the typical company grows, diversifies its product lines, becomes conglomerate and multinational, and thus increasingly gets involved in more and more problems that have fewer and fewer common features that any single group of men can effectively comprehend and direct.”\textsuperscript{369}

This is one of the reasons why problems were not detected before the Enron’s collapse and other scandals such as Worldcom and others, and the Global Financial Crisis.

The failure of the typical board is due to problems deeper than just lack of time, familiarity and expertise.\textsuperscript{370} It is also the lack of a probing culture, the outside directors being selected by the management, rather than the other way around, it is thought to be “plain bad manner” to ask about declining earnings.\textsuperscript{371} Whilst outside directors representing dominant shareholders, or major creditors are inclined to be a little more probing, the overall picture is one of board harmony.\textsuperscript{372} The collapse of Penn Central was an example of board failure Stone gave, in which the management was allowed by the board to engage in a wide range of questionable and in some cases illegal empire building activities that destroyed the company, even though the board was staffed with a large group of eminent directors from the company’s bank creditors.\textsuperscript{373} More recent examples are Enron, Global Financial Crisis etc. If a board of directors representing the financial community cannot or will not effectively attend to the financial well-being of Penn Central, how can we suppose they will be effective in advancing “softer” values less consistent with the interests of the financial community, such as environmental

\textsuperscript{364} Stone, at 125.
\textsuperscript{365} Stone, at 125.
\textsuperscript{366} Stone, at 127.
\textsuperscript{367} Stone, at 127. See also Goo & Carver, at ???; Cheffin, at ???
\textsuperscript{369} Stone, at 127.
\textsuperscript{370} Stone, at 128.
\textsuperscript{372} Mace, at 42-43, cited in Stone, at 128.
\textsuperscript{373} Stone, at 129-130.
pollution, or the workers’ well-being, or other avant-garde social consciousness issues, questioned Stone? Of course, those financiers would be even less concerned about other stakeholders’ interest because they do not represent them. The key is to select people who represent them, and to give them specific terms of reference.

2. Reforming the Board

Although Stone warned that nothing we do at the board level is going to cure all or even most of the corporate problems, he said that:

“Notwithstanding these reservations, I have become increasingly convinced in the past few years that there are fundamental board level reforms that should be implemented. These changes, particularly if reinforced by, and carefully linked with, changes elsewhere in the corporate system, could become an integral part of a major and significant reevaluation of the ways in which we control corporations.”

Stone does not advocate, quite rightly so, replacing the use of legal threats and market forces, despite the problems with those threats and forces discussed above. However, there is a gap between what these forces can achieve and what we might ideally want them to achieve, and board reform is necessary to fill that gap. He said there are two types of corporate behaviour: Class A is relatively feasible to deal with through board reform whereas Class B is considerably harder.

(a) Class A Behaviour

This is behavior regarding which there is little conflict between what the public at large would want and what a cross section of businessmen sitting on the board would approve if they were fully informed of the facts. This is likely to include:

- Gross financial and inventory manipulations;
- An overt policy of racial discrimination in hiring and promotion;
- Violations of criminal laws;
- The production of adulterated, unsafe, and shoddy products;
- Corporate espionage;
- Environmental and consumer abuses that businessmen would regard as contrary to the long term interests of the corporation, if only because if not remedied, they are likely to bring forth more repressive law.

It can also include positive behavior which the management may be prevented by all sorts of reasons from pursuing eg short-term interests of the management or shareholders, or the stock market atmosphere.

374 Stone, at 130.
375 Stone, at 134.
376 Stone, at 134.
377 Stone, at 134.
378 Stone, at 134.
379 Stone, at 135.
380 Stone, at 136.
381 Stone, at 137.
(b) Class B Behavior

This is behavior which the interests of public and the business community are less overlapping – negative (or positive) conduct that a cross section of the businessmen sitting on the American corporation’s board, even if fully informed of the facts would quite likely not vote against (or in favour of). 382

- Consumer deception that are mere “puff” than outright fraud;
- Pollution and other environmental harms, not clearly unlawful, but remedy of which would be inconsistent with turning a fair profit;
- A range of “citizenship” problems, from a corporation’s decision to move from some locale without prior consultation with the local officials, to labor and investment policies abroad that may have adverse effect on our international policies.

There is obviously an overlap between Class A and Class B at the edges where opinion whether a particular conduct falls into which class can vary.

For Class A behavior, although there may be differences of judgment between the public and the management on calculation of risk, on relevance, on how the costs of various means should be balanced etc, at least insofar as these problems are concerned, the disparities can be reduced “by first conforming the makeup of the board to a more and more representative cross section of businessmen, and then reinforcing the changes in representation by changes in the institutional design of the board – in the information it receives, in the incentives under which it operates, in its effective authority to carry out prophylactic and remedial programs”. 383

Stone proposed a number of changes in the institutional designs:

(i) companies with increasingly more and more potential social impact should have proportionately more and more outside directors. 384 In his time in the 1970s, the NYSE December 1973’s white paper recommended that all companies listed on the Big Board should have at least 3 outside directors, and set up audit committee of such directors to deal closely with independent auditor. This has been implemented for a while. Now, the NYSE rules require a majority of independent directors on the board of listed companies, and audit committee that consists entirely of independent directors. 385 So progress has been made on this front.

(ii) Such outside directors should be financially independent of the company. 386 He proposed that companies that had sales of $50 million or more should have at least 2 or 10% of the directors (whichever were larger) of independent outside directors, who should not personally own shares in the company or be a director or officer of a firm that owned shares in the company. Again, progress has been made on this front. The

382 Stone, at 137-138.
383 Stone, at 139.
384 Stone, at 139-140.
385 ??
386 Stone, at 140.
NYSE rules require that for a director to be “independent,” the board must affirmatively determine that the director has no “material relationship” with the company “either directly or as a partner, shareholder or officer of an organization that has a relationship with the company.”

(iii) There should be detailed description of the specific functions of the board and directors with liability attached to non-performance. However such description or guidelines should not be established by the directors and top management in whatever detail they can agree upon. This is because management do not want to have outside directors poking around, and outsider directors do not want to have additional liability. So, if left to their own device, they will not come up with detailed job descriptions that will have much real bite to them. Society should identify core functions that the director ought to be performing and providing for them by law. The federal government can do this by general legislation under the Commerce Clause. Such description should contain the criteria by which the board is required to evaluate the performance of the management annually, and on matters of high social concern relevant to the particular industry, such as worker safety, environmental problems, capital ratios etc. The task of proposing and reviewing such description should not be left to the general legislation but given to a specialized Federal Corporations Commission.

(iv) We have to change the standards for directors’ liability. At the moment the standards of care and skills are pretty low. And they are protected by the business judgment rule, indemnity or D&O insurance, or the company will pick up the tab. Stone suggests that directors should be liable for gross negligence and self-dealing and failure to perform vital mandated functions or specific statutory duties. The law has moved on in the UK and HK in this respect. Both UK and HK have adopted objective standards as a minimum with higher subjective standards where applicable. There are also hundreds of statutory duties in various Ordinances in HK that impose duty on directors, some of which deal with stakeholders’ interests. There should be proper limits on indemnity and D&O insurance. Defaulting directors should be barred from directorship or consulting for a period of time, say, three years.

(v) Outside directors should be supported by staff who are responsible to the board and not unduly subject to the influence of management. The compensation for these staff and their appointment and dismissal should be a matter for the board members.

387 NYSE Listed Company Manual Section 303A.02(a).
388 Stone, at 142.
389 Stone, at 143.
390 Stone, at 144.
391 Stone, at 147.
392 Stone, at 146.
393 Stone, at 147.
394 See Companies Act 2006 (UK), s ??? and Companies Ordinance (Cap ???) (HK), s ???
395 Goo, ???
396 Stone, at 150.
397 Stone, at 150.
(vi) Board should be provided with certain critical information by law with liability for failing to demand it and failing to provide it as many of the corporate wrongs occurred without board’s knowledge.398

Stone’s proposals for reform outlined so far involved outside directors being appointed by directors, and may be effective for ameliorating Class A behavior, but as we go deeper into Class B behavior, it is likely to become more complicated and less effective.399

3. Redesigning the Decision Making Process

Stone points out the core of the problem: focusing too much on what corporations decide rather than how they decide.400 It is the decision making process that one needs to look into. This has several aspects:

(i) Decisions that have social impact should be made at board level, not at lower levels, of the organization.401 Decisions that are likely to have a critical social impact, should require a special majority of the board, and if such a consensus cannot be reached, the matter should automatically be referred to an outside agency, eg the Environmetal Protection Agency, the State Department or the Consumer Protection Agency, for decision.402

(ii) Like Nader et al, Stone also argues that those that are affected by corporate decisions should be involved in decision-making process. He points out that the federal labor laws (check) require labor and management to sit down and “bargain in good faith” and argues that the same should be done in other areas,403 for example, before the top officers of the company in some distant headquarters decide to move its operation out of a dependent community which will affect the community significantly, they should be required to “negotiate in good faith” with community leaders to find an alternative give-and-take solution.404 As stone points out, there are examples in administrative law where public agencies are required to take into account relevant matters including the impact on affected groups, and that therefore those groups should be given an opportunity to present their view.405 Stone’s suggestion would appear to support my proposal to have stakeholder directors on the board to be involved in the decision making process on matters that affect them.

(iii) Stone argues that corporations should be required to make certain mandated facts finding about the impact of their decision before they make a decision, drawing on existing examples elsewhere, for example, public agencies are often required to make an environmental impact report of their proposed
course of actions under the Environmental Protection Act. The need to justify its decision will cause the company to take into account and explain how it weighs the relevant factors, and reflect and re-evaluate its proposed action at the beginning before further cost is incurred. It will also put pressure on the company to be self-disciplined and the person in charge of preparing the report is also under pressure not to mislead. Environmental Impact Reports are standard requirements for public bodies. Why should private companies be required to do the same? And it should not be confined to impact of corporate decision on environment, but also impact of product on consumers or technology applications on society.

B. Can We Trust Directors to Look After Stakeholder Interest? (Managerial Model)

As Mansmann and Kraakman point out, in the US, from 1930s to 1960s there was a view that professional corporate managers should be given substantial discretion to serve as disinterested technocratic fiduciaries who would guide business corporations to perform in ways that would serve the general public interest. However, the conventional wisdom now is that managers, when given great discretion, tend to serve disproportionately their own interests, however well-intentioned they may be. And the price paid in inefficiency of operations and excessive investment in low-value projects is considered too great. There are other problems with managerial model as I explained elsewhere: managers owed a duty to the company and not to other stakeholders directly; and this duty is misinterpreted as a duty to act for shareholder maximization. Managers are more willing to take risk.

C. Can We Rely on the State? (State-oriented Model)

This model of governance was most extensively adopted in postwar France and Japan and the strong performance of the Japanese economy and other state-guided Asian economies lent substantial credibility to this model through the 1980s. Hansmann and Kraakman claim that, with the move away from state socialism in England in the 1970s and France in the 1980s, and the sudden collapse of communism nearly everywhere in the 1990s, and the poor performance of the Japanese economy after 1989 and the more recent collapse of other Asian economies that were organized on this model, this model has lost its credibility. However, Hansmann and Kraakman did not appear to have considered the performance of China’s state capitalism which seems to have helped the unprecedented growth of China’s economy since 1978. They also did not consider the impact of the currency war waged by the US against Japan in the

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406 Stone, at 222.
407 Stone, at 223.
408 Stone, at 223.
409 Stone, at 225-227.
410 At 444.
411 At 444. See also p 11 on the limit of law.
412 At 444.
413 See Goo AJLS.
414 At 447.
415 At 447.
1980s on Japan’s economy. Despite Japan’s lost decades, it still retains its corporate governance model.\textsuperscript{416} It is therefore too early to dismiss this model.

D. Stakeholder-Model

As Fox points out in Europe and Japan there have been many voices advocating that the governance mechanism of the corporation be designed to take significant account of the interests of other stakeholders (at 459). Fox points out that ‘One way to take account of these interests is for other stakeholders to have a formal role in the firm’s governance’ citing the representation of labour on the supervisory board under the German scheme of co-determination (the co-determination model) as an example. Another way is ‘to include among the duties of directors the obligation to take account of such interests’, for example the UK’s enlightened shareholder approach.

As mentioned in Goo, AJLS, both ways are problematic. The co-determination model, or the Labor-oriented model, was seriously experimented in Europe, especially in Germany, after the Second World War. It was adopted by legislation in Germany for the coal and steel industries in 1951 and extended to the rest of German industry between 1952 and 1976.\textsuperscript{417} Under this model, employees were entitled to elect half of the members of the supervisory board in all large German firms,\textsuperscript{418} whilst in other European countries that experimented it, only one to three labor representatives on the board were required. Although it did attract considerable attention in the US, with the failure of EU’s proposed Fifth Directive on Company Law proposing to extend the German model to all EU countries, the appeal of the model has been lost.

Hansmann and Kraakman claim that “the growing view today is that meaningful direct worker voting participation in corporate affairs tends to produce inefficient decisions, paralysis, or weak boards, and that these costs are likely to exceed any potential benefits that worker participation might bring. The problem, at root, seems to be one of governance. Whilst director employee participation in corporate decisionmaking may mitigate some of the inefficiencies that can beset labor contracting, the workforce in typical firms is too heterogeneous in its interests to form an effective governing body – and the problems are magnified greatly when employees must share governance with investors, as in codetermined firms. In general, contractual devices, whatever their weaknesses, are (when supplemented by appropriate labor market regulation) evidently superior to voting and other collective choice mechanisms in resolving conflicts of interest among and between a corporation’s investors and employees”\textsuperscript{419}

It is said that even inside Germany, few commentators\textsuperscript{420} argue for the German model for other jurisdictions.\textsuperscript{421} However, the main problem perhaps lies in the two tier system rather than employee representation per se. Thus, the better approach is to have single tier/unitary board with stakeholder directors. (to be explained further drawing on Goo, AJLS)

\textsuperscript{416} See Goo et al.
\textsuperscript{417} See Hansmann and Kraakman at 445.
\textsuperscript{418} This is now reduced to one third see Goo et al.
\textsuperscript{419} At 446, citing Henry Hansmann, The Ownership of Enterprise (1996), at 89-119; Hency Hansmann, Worker Participation and Corporate Governance, 43 U Toronto LJ 589, 589-606 (1993); Mark Roe, German Securities Markets and German Codetermination, 1998 Colum Bus L Rev 167.
\textsuperscript{420} See for example, Michel Albert, Capitalism v Capitalism (1993) asserting the superiority of the Rhine Model of capitalism over the Anglo-Saxon Model (at 169-190).
\textsuperscript{421} Hansmann and Kraakman, at 446.
I agree that managerial model is problematic. I also agree that the two tier German model has its problems. In my view, a single tier stakeholder board would be an optimal model.

As Hansmann and Kraakman, explain, “In this “representative” model… two or more stakeholder constituencies appoint representatives to the board of directors, which then elaborates policies that maximize the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table. The board functions ideally then as a kind of collective fiduciary, even though its individual members remain partisan representatives. The board of directors (or supervisory board) then becomes an unmediated “coalition of stakeholder groups” and functions as “an arena for cooperation with respect to the function of monitoring the management,” as well as an arena for resolving “conflicts with respect to the specific interests of different stakeholder groups”."422

Hansmann and Kraakman argue that the stakeholder model is just a variant on yesterday’s labor-oriented model and suffer the same weaknesses. “The mandatory inclusion of any set of stakeholder representatives on the board is likely to impair corporate decisionmaking processes with costly consequences that outweigh any gains to the groups that obtain representation. Thus, the same forces that have been discrediting the older models are also undermining the stakeholder model as a viable alternative to the shareholder-oriented model”.423 I respectfully disagree as I will explain later. More recently in the US, Senator Elizabeth Warren has proposed putting employees’ representatives on US boards. And survey suggests that majority of employees surveyed supports such an idea.424 In the UK, Teresa May has issued a Green paper acknowledging possibility of having stakeholder representatives on the board. In fact, First Group plc actually has employee representatives on its board. The Green paper says that there is nothing to stop companies from appointing employees to their boards (but they would owe duty to shareholders under existing law, so that needs to change). It outlines four options for consideration:

Option 1 – stakeholder advisory panel. The problem is that it does not give stakeholder a direct say in decision making. The panel could turn out to be a talk shop and hijack the idea of stakeholder board, like how Eisenberg’s board of directors hijacked Nader’s stakeholder board.

Option 2 – designating non-executive directors to representing stakeholders. This is similar to my idea, but again constrained by directors’ duty to shareholders.

Option 3 – appoint individual stakeholder director to the board – same as my idea. But again constrained by duty to shareholders. PM already said that this would not be mandatory.

423 At 448.
Option 4 – strengthening reporting of stakeholder engagement. This is the weakest option.

All options can be used in combination.

E. Can We Trust Investors to Protect Stakeholder Interests? (Shareholder-oriented Model)

In a much cited paper, Hansmann and Kraakman predicted the end of history for corporate law pre-Enron. Whilst they agreed that corporations are there to serve the interest of the society, and not just the shareholders, they argued that profit maximization is the best way to achieve the societal welfare.

“All thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society. The point is simply that now, as a consequence of both logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests… the most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies—or at least all constituencies other than creditors—lie outside of corporate law”\(^{425}\)

This may be right in theory. But as explained above, in practice because of the gaps in the law and the enforcement of such law, leaving non-shareholder constituencies outside corporate law is not the “most efficacious” legal mechanisms for protecting those constituencies.

In a recent hearing at a joint session of several US senate committees, after it was revealed that about 87 million people had their profile information accessed by marketing firm Cambridge Analytica,\(^{426}\) Facebook CEO Zuckerberg said,

“it is clear now that we didn’t do enough to prevent these tools from being used for harm as well. And that goes for fake news, foreign interference in election and hate speech, as well as developer and data privacy. We didn’t take a broad enough view of our responsibilities and that was a big mistake. And it was my mistake and I am sorry”.

Asked if you could ask Zuckerberg one question, what would it be, a protester outside the Whitehouse said “are you willing to make the American people and people of the world first before your profits. I think he is rich enough”. (see BBC.com 10 April 2018). When asked by Senator, “would you be comfortable sharing with us the name of the hotel you stayed in last night?” and “if you message anybody this week, would you share with us the names of the people you messaged to?” Zuckerberg answered No.

The issues, as the Senator sees them, are “Your right to privacy, the limits of your right to privacy and how much you give away in modern America in the name of ‘connecting people around the world’”. The questions are “what information is Facebook collecting? Who they are sending it to? And whether they would ask me in advance my

\(^{425}\) Hansmann and Kraakman, at 441-2.

\(^{426}\) A personality quiz developed by an academic, Aleksandr Kogan, collected personal data from people who used it and their Facebook friends and sold to Cambridge Analytica: see BBC.com 10 April 2018.
permission to do that. Is that a fair thing for user of Facebook to expect?” “Yes Sir, I think everyone should have control over how their information is used,” said Zuckerberg. Another protester asked, “Why they are not doing more to stop this information we are seeing taking over their awesome platform”.

Gilson and Gordon (2013)\textsuperscript{427} explains the agency problem in agency capitalism caused by the reconcentration of shareholding by mutual finds in US public corporations since the 1980s, arguing that hedge fund plays an important governance role to remove such agency cost. The new agency problem in agency capitalism, like the classic Berle and Means type of agency problem, deals with the conflict between managers and the shareholders (the beneficial owners of funds), not non-shareholder stakeholders’ interest. To the extent that one agrees that stakeholder interests are important and ought to be seen as part of the ‘interest of the company’, and there is a considerable amount of literature supporting this view, the data in this paper also shows that one cannot rely on institutional investors to protect stakeholder interests for the following reasons:

First, their interests are not aligned. Shareholders including institutional investors are interested in their monetary return, which is measured mostly with reference to gain in share price which is linked to profit maximization, which often excludes or is detrimental to stakeholder interest. True, some institutional investors invest in socially responsible investment, but they are still in the minority. Although 80% of all mutual fund proposals during 2007 to 2009 proxy seasons concerned social and environmental issues, presumably proposed by socially responsible funds, they only account for a very small percentage of shareholder proposals (around 1870 proposals, around 3.2% of all proposals) (at 887). This means that one cannot rely on institutional investors (especially mutual funds and pension funds that are required by law to diversify) to pursue CSR activism.

Second, with the exception of hedge funds, even though since 2009 institutional investors owns more than 73% of the top 1000 corporation in the US, and could exert influence on the board and management, institutional investors are still passive, or ‘rationally reticent’ (at 874, 887) because of the cost, time and expertise that activism requires that their business model cannot accommodate,\textsuperscript{428} and the lack of incentive or sufficiently attractive return that justifies activism, and free riding problem ( at 890): a syndrome described as ‘agency costs of agency capitalism’ (at 876).

Third, the paper said the problem can be solved by having a new set of actors - the activist investors who would develop the skills to identify strategic and governance shortfalls, to acquire a position on a company with governance-related underperformance, and then to present reticent institutional investors with their value proposition: a specified change in the company’s strategy or structure (at 896), and Hedge funds fill in that gap. Eg BlackRock (Larry Fink’s letter), Vanguard, State Street etc. However, again, hedge funds are in the minority, and may not represent stakeholder interests, though BlackRock has emphasized the importance of stakeholder interests.


\textsuperscript{428} See pp 891-894 for an excellent account.
Thus, it would appear that there is still an agency problem between the managers and the stakeholders which is still unresolved, and another governance structure or devise is needed.

Bubb & Catan adopt a parsimonious spatial model with two dimensions to explain the bulk of mutual fund voting using a comprehensive dataset of the 5,332,353 votes cast on 33,262 proposals from 3,844 portfolio companies from 2010 to 2015 by 3,617 mutual funds that in total hold almost 80% of mutual fund industry assets.\(^{429}\) They note the shift of mutual fund industry away from actively managed funds to index funds, as well as increasing concentration of assets in the largest mutual fund families (at 1). This has raised concerns about its effects on corporate governance, and as Azar, Schmalz, and Tecu (2017) note, has had anticompetitive effects.

Bubb & Catan find that mutual funds are clustered into three parties: (1) the Managerialist Party, (2) the Shareholder Intervention Party, and (3) the Shareholder Veto Party. “The Shareholder Intervention Party supports efforts to actively intervene in corporate affairs, including by supporting shareholder-initiated reforms to basic corporate governance rules and activist investor proxy contests for board seats. In contrast, the Shareholder Veto Party focuses on monitoring corporate management and vetoing management’s proposed courses of actions when they raise concerns.” (at 10)

They also find that “funds’ preferences are shaped by fund characteristics that influence their incentives. Index funds, growth stock funds, and larger funds are all more managerialist than actively managed funds, value stock funds, and smaller funds, respectively … , with the growth of large passive management fund families, the shareholder bases of public companies have become more managerialist over time… the shareholders of growth stock companies are more managerialist than shareholders of value stock companies, consistent with the hypothesis that the investment thesis for most growth stocks includes belief in the company’s current management. … Shareholder proposals are less numerous and mostly focused on corporate governance issues \textit{rather than corporate social responsibility}. Table 2 further breaks down the shareholder proposals on corporate governance into more specific corporate governance issue categories.” (emphasis added) (at 10)

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<th>Table 2: Corporate Governance Shareholder Proposal Categories by Meeting Year</th>
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<td>SP-Proxy Access</td>
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<td>SP-Independent Chairman/Lead Director</td>
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<td>SP-Written Consent</td>
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<td>SP-Special Meetings</td>
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<td>SP-Declassify Board</td>
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<td>SP-Reduce Supermajority Requirements</td>
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<td>SP-Majority Vote for Directors</td>
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<td>SP-Cumulative Voting</td>
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<td>SP-Eliminate Dual Class Shares</td>
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<td>SP-Subject Pill to Shareholder Approval</td>
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<td>SP-Other Corporate Governance Proposals</td>
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\(^{429}\) See Gordon’s class paper 10.
“[T]here are a few funds in the preference plot in Figure 2 that score highly on both dimensions of fund preference. These are funds that often vote against management when either ISS or Glass Lewis recommends against management. We have labeled the fund families with average scores in the upper right of the preference space—note that they are socially responsible fund management companies, like Domini and Calvert. Our framework shows that these socially responsible fund families are extreme in their shareholder rights orientation, as expressed through their votes.” (at 19)

Their research finding shows clearly that we cannot rely on shareholders/investors to protect stakeholder interests. First, as Bruner explained above, US corporation law is more managerial-centric. Shareholders have little say on how the company should be run. Secondly, mutual fund hold about 80% of the stocks in public companies, meaning that how they vote (on the matters they can vote on) could impact on board behaviour. However, mutual funds are subject to their own agency problem vis-a-vis the ultimate beneficial owners who invest in them (Rock, 1991; Black, 1992) as

“any improvement in portfolio company value produced by a mutual fund exerting effort to vote in an informed manner is shared with all of the mutual fund competitors who hold the company’s stock. For index funds, this means that costly voting effort increases their costs without improving their returns relative to competitors.”

Actively managed funds have somewhat stronger voting incentives than those of index funds (Kahan and Rock, 2007; Shapiro-Lund, 2017) as they can improve the fund’s return relative to competitors by taking actions that increase the value of a stock in which the fund is overweight relative to the market, and the process of investment selection might generate information that is useful for voting. (at 23)

Thirdly, as their data shows, the Managerialist Party is much larger than the others, at 68% of mutual fund industry TNA, followed by the SI Party at 11% and the SV Party at 5%. (at 19) And even when SI Party and SV Party vote against management, they are mostly on corporate governance issues, not corporate social responsibility. Fourthly, they also find from time trends that public companies’ shareholder bases have become systematically more managerialist over time (especially after 2007) along both of our dimensions of shareholder preferences” (at 3-4).

Hansmann and Kraakman argue that the shareholder-oriented model is more superior to any of the above models. The reasons offered to support their argument run something like: shareholders as firm’s residual claimants cannot protect themselves by contract, so they must be protected by the right to control the firm, hence the shareholder-oriented model. With the right to control, they will have incentive to maximize the value of the firm. The interests of other participants can be protected by contract and regulation, “so that maximization of the firm’s value by its shareholders complements the interests of those other participants rather than competing with them.” “Even where contractual and regulatory devices offer only imperfect protection for nonshareholder interests, adapting the firm’s governance structure to make it directly responsible to those interests creates more difficulties than it solves”.

430 At 22. Even though index funds (unlike actively managed funds) cannot sell when they are not happy with management, and may therefore resort more to “voice”.

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In my view, the reasons offered overlooked many fundamental facts: First, shareholders are already protected by limited liability and separate legal personality. And for those who are seeking a fixed rate of return, they can opt for preference shares. Secondly, consumers are often poorly protected by contracts, or they may not even have a contract with the company that makes the products they purchase. The community in which the company operate certainly are not protected by contract. Thus, by the force of the same argument, they should be protected by having right of control over the company. Third, as many have observed, due to the gap in the law and problem with enforcement, other stakeholders are not adequately protected by regulation. Fourth, it is true that shareholders will have powerful incentive to maximize the value of the firm, but they do that only for themselves, and often at the cost of other stakeholders. Thus, it is not true to say that maximization complements the interests of those other participants rather than competing with them. Whilst it is true that adapting the firm’s governance structure to make it directly responsible to stakeholder interests is not going to be easy – I will address this in another paper, there are ways to solve the problems it creates, and it is in the right direction, and would offer a better solution to achieve the equilibrium between all interests.

Another reason for the superiority of the shareholder model offered by Hansmann and Kraakman is the economic performance in very recent years of developed common law jurisdiction (example given is US) where the shareholder model predominates compared to principal East Asian (Japan given as an example) and continental European countries (Germany and France given as examples) which “lends credence to the view that adherence to the standard model promotes better economic outcomes”. First, it is not clear by what account they measure the economic performance of those countries; is it the GDP, GDP growth rate, size of the economy etc? They do not offer any data or evidence to support the correlation they claim. Secondly, there are many factors outside the governance structure of firms that account for the economic performance of each country. In the example given, Germany has had to deal with the economic problems brought by the unification and Japan was forced to devalue its currency which caused two decades of stagnation. And what about China which is most certainly not a shareholder-oriented model? From 1979 (when economic reforms began) to 2017, Its real gross domestic product (GDP) grew at an average annual rate of nearly 10% from 1979 to 2017, and according to the World Bank, it has “experienced the fastest sustained expansion by a major economy in history—and has lifted more than 800 million people out of poverty.” So, economic performance cannot really support the claim of superiority of shareholder model. Secondly, even if shareholder model does lead to better economic performance, does it take into account the harm that it causes to consumers and environment? Or does it even perversely include the cost of remedying the harm as part of the economic performance?

They also argue that the shareholder model, with access to institutional investors and the international equity markets which prefer shareholder-oriented model and are influential advocates of the model, is likely to win the competition in the long run, especially among start-up firms, in new product markets, and in industries that are in

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431 See for example the famous case of Donoghue v Stevenson (1932).
432 See Paper 2, Mechanism Design and stakeholder board.
433 At 450.
the process of rapid change, and as the pace of technological change continues to quicken, this competitive advantage should continue to increase.\textsuperscript{434} However, the recent evidence suggests that there is a move away from the traditional equity market to private equity to raise capital,\textsuperscript{435} or from ordinary stocks to dual class stocks to counter the pressure and control from shareholders.\textsuperscript{436} As finance becomes more widely available, there will be less pressure for managers to maximize profit to keep investors happy. In any event, that there is convergence to the shareholder-oriented model, and support from the investors, does not mean that it is efficient, as Hansmann and Kraakman themselves admit.\textsuperscript{437} There are flaws in markets or in political institutions, reinforced by cross-border competition, that cause inefficient convergence.\textsuperscript{438}

As Hansmann and Kraakman point out, while two tier board seems to be on its way out, the single tier board is converging to having outside directors on its board.\textsuperscript{439} The next step is for the shareholder model to move to stakeholder model by having outside directors representing different stakeholders, instead of only shareholders generally. The position that shareholder-oriented model has over its principal competitors as Hansmann and Kraakman claim is far from assured. There may be yet more developments to come.

However, which model is better depends on local political reality.

“Corporate law everywhere clearly reflects the institutional and political power of a country’s dominant corporate interests, whether they be banks, prominent families, investment funds, or unions. At the same time, all of the wealthy countries whose law we focus on have, to a greater or lesser degree, self-consciously shaped their law to enhance the efficiency with which corporations can be financed and managed in the context of the country’s particular pattern of ownership. The distributional effects of ownership patterns often work against efficiency. But that is not necessarily the case. Sometimes the interests of a dominant interest group are aligned with broader social welfare.”\textsuperscript{440}

In the context of the Russian model of privatization, where directors representing government were appointed on SOE boards as a result of cronism or corruption within the political system, and are making incompetent or self-interested decisions inconsistent with goals justifying government control in the first place,\textsuperscript{441} Fox argues that ‘the case for share value maximization model is especially strong’. This is because

“The particular pattern of privatization of state enterprises in Russia involved incumbent managers, employees, and local governments each receiving significant blocks of stock. This led to a situation where restructurings that could have greatly enhanced the value of these enterprises failed to be undertaken. Instead, each of these shareholder blocks, rather than trying to maximize the pie that they could then split up as shareholders, looked, as in Soviet times, to the corporation to provide them with direct benefits beyond what they could command if they offered their services in the outside market.”

\textsuperscript{434} At 451.  
\textsuperscript{435} See Kahle and Stulz at 85.  
\textsuperscript{436} See ???.  
\textsuperscript{437} At 466.  
\textsuperscript{438} At 466-67.  
\textsuperscript{439} At 456.  
\textsuperscript{440} Armour et al, Anatomy, working paper/chapter 1, at 29.  
\textsuperscript{441} See fox p.411.
So, “Granting non-shareholder stakeholders in Russia a formal role in corporate governance risks their using their influence again to obtain direct benefits from the corporation in ways that are not social-wealth-maximizing.” (at 460-461).

I agree with the above, and think that the Russian model is the wrong model for granting stakeholder a role, as they are at the same time shareholders with expectation on the corporation to continue to provide the ‘rent’ they are used to receiving without making any effort: with labour and local government being given shares with no responsibility of running the firm and only expecting the firm to give them benefit they would not be able to get in the outside world themselves. They become a burden and liability rather than a check on shareholder externalizing externalities. This may be a question of historical baggage or corporate/societal culture. With the right culture, government ownership and role in governance need not be a liability, eg Chinese SOE and Singapore SOE (GLC).

I agree with Fox that adding stakeholder interests to the list of interests directors to take into account would not work.442

F. Regulating MNC and SOE

As of 2011, the ten largest institutional investors in the world hold 27.1 per cent of shares in Global 1000 companies, but none of them are active in engaging and affecting the management of operation of these companies.443 This is another piece of evidence that shows that we cannot rely on shareholders to protect shareholder interests.

But many companies are changing. “A joint study in 2012 by the Boston Consulting Group and the MIT Sloan Management Review found that nearly 50 percent of the companies surveyed had changed their business model as a result of sustainability”, and “many companies have established a new C-level executive position for sustainability officers (e.g. AT&T, Blackstone, BT, Dow Chemical, Nestle, SAP, Siemens, Unilever, among many others”444 However, the C-level executives are presumably accountable to the shareholders who mostly don’t care. So there is a mismatch between responsibility and accountability. They should be accountable to stakeholders who should be given locus standi to sue. But is C-level executive a first step in the direction of stakeholder representative board?

1. Why Concentrate on MNCs and SOE?

(i) their economic impact (check figure for China, ask □ □ ’s students or Joanna)
Kahle and Stulz (Kathleen M Kahle and René M Stulz, Is the US Public Corporation in Trouble? (2017) Journal of Economic Perspectives (31: 67) found that the number of listed firms in the US has dropped since its pick in 1997 at 7507 firms rapidly until 2003 and continued to fall at a slower pace before leveling out around 2013 with 3766

442 See Fox, at 461; see Goo, AJLS for my comments on UK enlightened shareholder approach.
443 Serafeim 1, at 8.
444 Serafeim1, at 11.
listed firms in 2015 primarily as a result of firms mergers. (at 70). The aggregate market capitalization of listed firms in 2015 is about 7 times bigger than in 1975 (at 71). Smaller listed firms are rarer today than 20 or 40 years ago. (at 72). So now there are fewer, but larger, and older listed firms, which means that they are likely to be less innovative and more rigid, which could adversely affect competition. Smaller firms are moving away from the stock market for fund raising and are looking to private equity and venture capital firms for funding or are willing to be acquired to become part of a group. (at 85) Also they found that earnings of the top 200 firms by earnings exceed the earnings of all listed firms combined in 2015, which means that firms not in the top 200 are not making very much. (at 77) Another finding is that payout rate is at an all-time high in 2015 which possibly means that there is a lack of investment opportunities or there is less incentive for firms to invest. (at 81). All these suggest Jensen’s prediction of the demise of public corporation in his famous 1989 Harvard Business Review article “Eclipse of the Public Corporation”, might turn out to be true, though for different reasons. (at 67, 87) If this is true, it means that we also need to think about the corporate governance issues (in particular the stakeholder interests) of firms funded under private equity. But for now, it is the largest Global 1000 corporations that dominate the scene, most of them are MNCs. If we can focus on how they take care of stakeholders interest, we would have solved a lot of problems and made a good start.

As of end of 2012, the Global 1000 were responsible for more than half of market value of the world’s 60,000 publicly traded companies; they made $34 trillion in revenue, employed directly 73 million people, had total market cap of $28 trillion.445 They provided goods and services for consumers, created wealth for shareholders and jobs for millions of people, but also consume vast amount of natural resources, pollute environment at little or no cost, threw economies into recessions, and harm employee’s welfare when wages and working conditions are inadequate.446

“Firm size appears to be a very important determinant of firms’ social and environmental commitments”.447 “By the end of the 20th century, about half of the world’s trade was conducted between such firms (Kobrin, 2006: 220). Twenty-nine corporations then figured in the list of the world’s largest economies (Chandler and Mazlish, 2006; Goodwin, 2006: 135). These firms alone hold 90 percent of all technology and product patents worldwide (Dine 2006: 152)”.448

“As of the end of 2012, just 1,000 corporations (Global 1000) were responsible for half of the total market value of the world’s more than 60,000 publicly traded companies. Consider how quickly this situation has emerged. In 1980 the world largest 1000 publically listed companies made $2.64 trillion in revenue, or $7.0 trillion in 2012 dollars, adjusted using the consumer price index. They directly employed nearly 21 million people, and had a total market capitalization of close to $900 billion ($2.4 trillion in 2012 dollars), or 33 percent of the world total. By 2012, the Global 1000 made $34 trillion in revenue. They directly employed 73 million people, hundreds of millions in their supply chains, and had a total market cap of $28 trillion. These companies and their supply chains have an enormous potential to confer both good and ill on society. They create goods and services for customers, wealth for their shareholders, and jobs for millions of people. They also consume vast amounts of natural resources, pollute local and global environment at little or no cost, in the case of large financial institutions they throw economies into recessions due to poor risk management, and, in some cases, hurt employees’ well-being if wages and working conditions are inadequate.449

445 Serafeim 1, at 6.
446 Serafeim 1 at 6. See also 6-8 for examples for size, control and impact of these corporations.
447 Serafeim1, at 12.
448 Veldman and Wilmott, at 6.
449 “This great concentration of economic activity makes clear that the Global 1000 affects billions of people around the world. For example, Philips, the Dutch diversified industrial giant, estimated that it
The Global 1000 are now able to exercise incredible power over employees, suppliers, customers, and even regulators. Consider for example the extraordinary concentration of food supply in just a handful of multinationals. Nestle, Kellogg’s, General Mills, PepsiCo, Kraft, Unilever, and Procter & Gamble comprise a group of consumer goods giants that control the dietary lifestyles of consumers and have been accused of consciously contributing to the increasing problem of obesity.450 Or consider that at the end of the first decade of the 21st century, DuPont and Monsanto together dominated the world seed markets for maize (65%), and soya (44%).451 Monsanto controlled more than 90 percent of the global genetically modified (GM) seed market.452 Three companies, ADM, Cargill, and Zen Noh, handled over 80 percent of U.S. corn exports.453 Similarly, through a series of mergers and acquisition in the 1980s, and continuing through today, the U.S. media industry is now dominated by six large conglomerates: Comcast, Walt Disney, News Corp, Time Warner, Viacom, and CBS.454 These companies are estimated to control 70 percent of cable broadcasting. Time Warner alone is estimated to transmit news to 178 million unique users every month.455

Elizabeth Warren proposes that corporations with more than $1 billion in annual revenue to obtain a new federal charter that would require that at least 40 percent of their board of directors be appointed by employees.457

2. Material Issues

Another caveat on my stakeholder model is that only ‘material issues’ will be considered by the stakeholder board. ‘Materiality’ is defined as ‘a measure of corporate impact on society for a specific sustainability issue’,458 and varies from industry to industry, for example, “climate change is a material issue for oil and gas firms. Human rights are a material issue for apparel manufacturers. Corruption is a material issue for extractive companies. Customer health and safety is a highly material issue for

`improved’ the life of 1.7 billion people in 2012 through its products.449 Dow estimates that it is consuming, on a daily basis, as much energy as Australia (Eccles et al. 2012). Between 1995 and 2010 efforts to improve Dow’s environmental performance resulted in energy savings that could power all residential buildings of California for 20 months (Eccles et al. 2012). Royal Dutch Shell and Wal-Mart booked sales of $454 billion and $447 billion respectively in 2011. Out of 206 countries recognized by the United Nations, only 26 had nominal Gross Domestic Product (GDP) higher than these sales numbers. Deutsche Bank held $2.8 trillion in assets in 2011. Gazprom spent more than $48 billion in capital expenditures in 2011 and Toyota more than $10 billion in research and development. For comparison, only 16 countries spent more than $10 billion in research and development.” (Veldman v Wilmott at 6-7)


456 Veldman v Wilmott, at 6-7.


458 Serafeim1, at 13.
pharmaceutical companies’.459 This approach is adopted by GRI (Global Reporting Initiative). The approach adopted by the SASB (Sustainability Accounting Standards Board) is issues that will eventually have an economic impact on the long-term financial performance of the company. SG: the CRI definition is better as it is not tied to the shareholder interest.

G. Other Options

1. Would Public Directors on the Board Solve the Problem?

This was proposed by former Supreme Court Justice Arthur Goldberg before when he resigned from the TWA’s board,460 and was the case with Comsat (Communications Satellite Corporation) where three of the fifteen directors were presidential nominees, and Union Pacific Railroad.461 Stone points out that there are three problems:

(i) “the public” is too wide as a constituency; asking the public director to advance the “public interest” is too ill-defined and open-ended a mandate to be very effective.462 And it is not well-meaning generalists that the boards need, or they who could command the respect of the board.463 In my view, this means that we should have each stakeholder director representing each stakeholder interest with more specific mandate. Also these stakeholders would have to be full-time and professional people with the right qualification (see Paper 2)

(ii) Board usually only get to consider matters relating to finance (dividends, executive salaries, funding programs), proposed organic changes (mergers, consolidations), and new ventures (establishing a foreign subsidiary) etc, but not environmental issues, consumer problems, transnational conduct, employee well-being etc.464 It is not possible at present to force these matters by the public directors to the board because of the third problem below.

(iii) Although Board is given power by corporate charter to have control of the company, the power is by the same charter delegated to the management or subcommittee to make decision by passing the board.465 Thus, it would be necessary to make stakeholder issues no-delegable or for mandatory stakeholder representation on subcommittee.

Stone is skeptical as it is difficult to define “public” and who represents it, and the small number of them can be outvoted.466 My solution is that we should have different stakeholder directors representing different stakeholders, not a general public director. This, together with a detailed description of their function and duties will avoid the difficulty in defining public interest. Secondly, the number of stakeholder directors

459 Serafeim, at 13-14.
461 Stone, at 130, and chapter 14.
462 Stone, at 131.
463 Stone, at 131.
464 Stone, at 131.
465 Stone, at 132-33.
466 Stone, at 152.
should be sufficiently large so as to make a difference. At least half of the board should consist of such directors.

Public directors were abolished after the Union Pacific Railroad Company’s experience. Stone points out that there can be negative lessons from it:467

(i) it is important to define clearly public directors’ duties, functions, and objectives;
(ii) there should be authoritative guide as to how the public directors should vote, and clear mandate on the matters into which they should inquire;
(iii) there should be clear and meaningful channels for transmission of information to the public; there should be clear rules as to what information the public directors should be transmitting to whom;
(iv) They should be full-time directors, staffed, and selected for their special expertise; there should be effective machinery to ensure that public directors would be invited to directors’ and committee meetings. They should be paid properly.

These suggestions are applicable to stakeholder directors. Stone points out that there are certain matters that are beyond public directors’ ability to make a difference: eg the level of rates, and rate discrimination.468 However, one of the reasons for that is that they were in the minority and the investor directors were in the overwhelming majority. So public directors could only try to influence investor directors by moral persuasion. With stakeholder board, investors will not be in the majority, although consumer directors will be in the minority, they may be able to form alliance with other stakeholder directors and exert greater influence on investor directors.

Unfortunately, the negative lesson from UP experience was not learned when the government appointed public directors to the Comsat board.469 They had no special mandates, powers, duties, or responsibilities whatsoever, and owing obligations under the District of Columbia Corporations Code to no one but the shareholders.470 “This is the window dressing of public participation at its worst. We can, certainly, do better.”471

Stone proposes two types of public directors: general public directors and special public directors.472 General public directors would operate with a fairly broad mandate in all companies of very large size.473 Special public directors would be appointed to meet the exigencies of special situations, and whose mandates and responsibilities would be tailored accordingly.474

(a) General Public Directors (GPD)

467 Stone, at 155-56.
468 Stone, at 156.
469 Stone, at 157.
470 Stone, at 157.
471 Stone, at 157.
472 Stone, at 157.
473 Stone, at 157.
474 Stone, at 157.
Stone’s proposals on general public directors relate to the following:

(i) selection and placement of GPD: First, which companies should have GPD? Stone proposed a what I would call “One and Three formula” – that is every corporation should have 10 percent of its directors GPD for every billion dollars of assets or sales (whichever is higher), except in the case of banking, life insurance, diversified finance and utilities (in which the figures run much higher), 10 per cent of the board should be GPD for each $3 billion in assets rather than each $1 billion.\textsuperscript{475} With this formula, at the time of the publication of his proposal, using Fortune 1973 survey, a total of 262 corporations would be affected.\textsuperscript{476} These giant corporations represented the most powerful in American commerce and industry. The problem with this formula is of course the arbitrariness of the figures adopted. Why $1 billion and $3 billion? Why not $1.5 billion or $4 billion? The figures will have to be reviewed annually. How do you do that scientifically? Even if we use inflation rate as one of the criteria, once you get the first figure wrong ($1 billion), the mistake will be magnified in subsequent years as we review it upwardly by reference to the inflation rate which tends to go up rather than down. That they are giant corporations does not mean they are engaging in qualifiedly disfavor behavior. Why should we impose GDP on some of them if they are good corporate citizen? Thus, I would suggest targeting on Fortune 500 or 1000 that have a record of abuses (I will return to this point later) as a first step and review periodically to see if we need to include other corporations.

Secondly, how should GPD be selected and removed? Stone proposed that the GPD could be nominated by a Federal Corporations Commission (if established) or SEC, to be approved by a majority of the board, and removable by the board unanimously without cause or 2/3 majority for cause.\textsuperscript{477} How many nominations can the FCC or SEC make? On what basis would the FCC or SEC choose the nominee? Would the nominee have had to apply to FCC or SEC to be nominated? Or would FCC or SEC approach people out of their own initiative? To make the process more transparent, I would propose that FCC or SEC would only serve as a filter to review applications for qualified candidates, who would be selected randomly by computer after certain pre-determined selection criteria are configured. (I will return to this later)

Thirdly, on compensation, Stone proposed that the GPD should be a half-time rather than full time person, and be paid at the highest civil servant grade.\textsuperscript{478} He thinks that half-time is more than what most outsiders do today, and there are not that many people who can devote full time to the post.\textsuperscript{479} The best candidates are unlikely to be able to devote full time away from their own jobs, but some might be able to arrange half-time.\textsuperscript{480} Also, being

\textsuperscript{475} Stone, at 158.
\textsuperscript{476} Stone, at 158-59.
\textsuperscript{477} Stone, at 159.
\textsuperscript{478} Stone, at 160.
\textsuperscript{479} Stone, at 160.
\textsuperscript{480} Stone, at 160.
full time might cause them to lose objectivity.\textsuperscript{481} I think we need to take this job seriously. So, it needs to be a full time post. They need to be paid well, as well as the other outside directors if not better. We are only talking about some of the Fortune 500 or 1000, so not a big number. There must be enough candidates who would do this as a full time job. We need not rely on semi-retirees as a pool of candidates. We can train qualified people to be GPD. People with appropriate MBA or other relevant qualifications and experience can enter the pool. Working full time gives them more knowledge and better understanding of what the company is doing. If that means they can see things from the management’s perspective and agree with them after objective assessment, so be it.

(ii) Functions of GPD: First, GPD should exercise the superego function of the corporation, a probing and vigilant mind, so that the corporate can exercise some “responsibility” in the sense defined above: reflecting a bit before it acts; considering a broad range of consequences of its actions; considering alternatives; extending its time horizon; bring to bear on its analysis certain social categories of judgment; doing only things that it would be able to justify publicly in socially approved rhetoric of responsible action; taking into account its impact on the environment etc.\textsuperscript{482} GPD should also oversee programs designed to assure that law was being complied with in good faith, to prevent systematic and chronic law violation and circumventions that is the product of the organizational system itself, its established ways of marketing etc.\textsuperscript{483} He should work with the in-house and outside independent law form counsel to do legal audits.\textsuperscript{484} Where soft spots are identified, he should ensure appropriate steps are taken, and report periodically to the board.\textsuperscript{485} He should not however turn information (confidential or otherwise) to the public authority unless prior recommended remediable actions are not taken adequately and in good faith and he has reported the matter to the board and felt that there is a possible course of unlawful conduct.\textsuperscript{486} GPD could serve as a conduit to public agencies in proposing legislation and trade standards as often corporations have the relevant information about the problems in the company’s products, services and processes far earlier than public agencies and the legislatures.\textsuperscript{487} GPD could oversee the gathering of such data, make recommendations for law reform and comment on pending legislation.\textsuperscript{488} He should also act as a check on the effectiveness of fundamental internal systems, eg system relating to research and design, production, maintenance of internal authority, gathering and transmission of data etc. For example, the flaw in the Goodrich’s testing system where the testing of the brake was entrusted to the same personnel who had designed it, could have been picked up by GPD.\textsuperscript{489} He should also act as a “hot line”, a person to whom anyone

\textsuperscript{481} Stone, at 160.
\textsuperscript{482} Stone, at 161.
\textsuperscript{483} Stone, at 163.
\textsuperscript{484} Stone, at 163.
\textsuperscript{485} Stone, at 164.
\textsuperscript{486} Stone, at 164.
\textsuperscript{487} Stone, at 164.
\textsuperscript{488} Stone, at 165.
\textsuperscript{489} Stone, at 166.
within or outside the corporation could whistle-blow without fear of retaliation, and advertise this as one of their functions.\footnote{Stone, at 166-167.} GPD should also oversee the preparation of impact studies of corporation actions, for currently many corporations do not and are not required to do an impact study of their products on consumer and the environment.\footnote{Stone, at 168.} GPD should also monitor how the company gets information from its environment and how it gives out information to its environment – the gathering, verification, and dissemination of information, and to ensure that the new system of board reform is observed by the company.\footnote{Stone, at 167-70.} GPD should act as directors for the corporation as a whole, not just for the interest of the majority shareholders, major suppliers, or major financial institutions who have representatives on the board as is currently the case.\footnote{Stone, at 170-171.} As will be explained below, it is difficult for directors to consider and balance the interests of all interested parties. For conflict between director’s own interest and the company’s interest, the solution is obviously the law on fiduciary duty and duty against self-dealing. For conflict between different stakeholders, my proposals to have stakeholder directors owing duty to stakeholders they represent subject to an overarching duty to the company as a whole, will resolve the dilemma.\footnote{Stone, at 171-173.}

(iii) Special powers of GPD: \footnote{Stone, at 171-173.} GPDs should have power to select their own staff, though paid by the corporation, who would be responsible to them. They should have power to retain consultants from time to time. They and their staff should have power to inspect all corporate books and records, and ask from general corporate staff reasonable survey, reports etc. They should sit on all corporate committees whose work is relevant to their functions, and be given reasonable notice of all relevant board and committee meetings. They should have the power to stay the firing or any other punishments of an employee who co-operate with the GPDs and their staff. They should have a say in the reward and advancement system so as to reward lower level workers who pursue corporate goals not currently rewarded and protect those whose co-operation with GPD might put them in disfavor. They should also have power to apply to the court for an order against anyone within the corporation who obstructs the work of GPD or fails to carry out the board orders. However, Stone suggests that these powers (except the power to apply for court order) should not be exercisable absolutely but subject to proper balance by the board and management. If there is a dispute, the matter should be referred to the FCC and the courts. There should also be guidelines agreed upon by the GPDs and the board and the management for the release of confidential information or secrecy. Again, any disagree on the guidelines can be referred to the FCC.

Stone says that we cannot tell in advance how well the system of GPD would work, but “it is hard to argue against at least giving it a try,” and that the companies that would be affected are as large and powerful as states, and “if the only virtue of the general
public directorship system were the symbolic one – a more obtrusive, nagging reminder of these companies’ obligations to society than the American flag over their plants – the system would … have justified itself.”495 He believes that as time goes by, and experiences with the system build up, the system can be further improved and developed.496

(b) Special Public Directorships (SPD)

Stone says that one weakness of the GPD system is the breadth and magnitude of what the GPDs are asked to do, so in addition to the GPD, there should be SPD for some highly critical areas of need that call for more immediate and certain action.497

In Stone’s plan, the introduction of SPDs does not depend on the size of the company, should be reserved for companies in which the forces of the market and legal threats seem inadequate to keep them within socially desirable bounds in critical areas of social concern, eg problems relating to technological innovation, product safety, environmental pollution, foreign relations etc.498 Two situations were identified which require SPD: the demonstrated delinquency situation (repeated breach by the company), and the generic industry problem (no company is apparently in repeated law violations, but there is a general phenomenon of problems in the industry, eg illness suffered by asbestos workers (lung or stomach cancer), plastics workers (liver cancer), paper mills and steel companies (water pollution), oil refineries (air pollution), multinational (foreign relations and monetary stability), manufacturers of consumer products eg automobiles and televisions (consumer safety problems), nuclear energy (safety threats to nearly everyone in the vicinity).499

(i) Appointment: How should SPD be appointed? Stone suggests that when the delinquent company is brought to court or a government agency, the SPD could be appointed by the court, with advice from the company, prosecuting agency, court’s own probation staff, management-organizational consultant.500 In the case of generic industry situation, the company will not be before any court or agency, so the impetus would have to come from the GPD or regulator to apply to the court for the appointment having observed or become aware of the problem.501

(ii) Functions: the SPD should be expert on the related problem, eg if the problem is water pollution, the SPD should be a sanitary engineer; in asbestos industry, a doctor of public health; nuclear plant, a nuclear engineer concerned with safety; paper mill, an environmental engineer etc,502 and should know what he is looking for, to have access to the court, to receive all complaints from customers and other stakeholders, to put suspect practices under effective surveillance, to fire any employees who persist in

495 Stone, at 174.
496 Stone, at 174.
497 Stone, at 174.
498 Stone, at 174-75.
499 Stone, at 177-78.
500 Stone, at 178-179.
501 Stone, at 180.
502 Stone, at 180-81.
the improper techniques or practices, to follow up complaints, to interview even non-complaining customers, to recommend changes to remove the defects in the organizational structure or to the compensation plans that are the reasons for the wrongdoing.

(iii) Powers of SPD: Stone suggests that SPD should have similar powers as GPD as are relevant to their narrow range of authority, eg to examine medical records of asbestos workers, to suspend or fire an employee in appropriate cases, to veto promotions, to halt production, or to apply for temporary restraining order from the court if necessary, to influence the internal budgeting to demand an increase in safety R&D etc.503

There is no proposal on who can sue GDP or SDP for failing to perform their duty. To whom is their duty owed? I think GDP and SDP are in many ways similar to my stakeholder directors. So Stone’s proposals can be adapted to stakeholder directors to make it work.

2. Mid or Lower-Level Officers

(i) Working with the management: when violation occurs, the court can instead of imposing a small fine which does not stop the violation, place the corporation on probation upon condition that the corporation set up and complete a program to handle the violation within a specified period of time, failing which the court can appoint a special probation officer to visit the plant and require the corporation to abate the problem. 504 Check Volkswagen. There are precedents for this.505 This officer can be appointed at a level below the board where the problems are, and be provided with adequate necessary reinforcement and powers.506 But why can’t the special director or officer be appointed before things go wrong in generic industry situation, where some social problems can be predicted throughout an industry, as Stone asked?507

Stone argues that:

“it is not unthinkable that the society should establish by law that corporations (or certain classes of corporations) include in their management structure certain specified offices. Indeed, when state corporations codes require that corporations, as a condition of enjoying the corporate privileges, have a board of directors, the society is doing just that.”

He said that the law could have required that corporations establish designated medium-level and lower-level management positions for specific social problems but chose to leave it to the corporations to do so on its own initiative because of laissez-faire, and that this is not a defensible legal vacuum because due to self-interests of corporations and top

503 Stone, at 182-3.
504 Stone, at 184.
505 Stone, at 184-85, citing the ARCO case (repeated oil spillage), check BP Oil, Laventhol case (accounting problem with SEC), check enron, and Ecological Science Corporation case (financial disclosure on questionable financial activities).
506 Stone, at 187.
507 Stone, at 186.
executives, corporations are not doing this, even if the appointment of a special officer would have been the best way for the corporation to cut its losses.\textsuperscript{508} He suggests that where a special public director is less effective than someone located at a lower level closer to operations, a special officer at that level should be seriously considered.\textsuperscript{509} Again, there are precedents for this.\textsuperscript{510} Such officer, to be truly effective must be given well-defined and meaningful powers and duties, as well as a place in the organization that guarantees the appointee’s effective role.\textsuperscript{511} For example, the product service manager established in the Holland Furnace case failed to keep the salesmen within the law, not because the appointment was a bad idea, but because he was not given the power to suspend or fire anyone or contribute to those decisions.\textsuperscript{512} (Check Wells Fargo)

There should also be liabilities on those officers for inadequate performance of their functions.\textsuperscript{513} There are also similar precedents in legislations for this. For example, the Food and Drug Acts that followed in the wake of the thalidomide and MER/29 cases provide that there be an ‘investigator’ for each drug under development with specific functions.\textsuperscript{514} Currently the law lays down requirements for company’s financial reports to be examined and approved by certified public accountant, and financial prospectus to be done only by lawyers. This is a form of “intrusion” into the management autonomy designed to protect the corporation’s investors.\textsuperscript{515} “What about the consumers of the company’s products?\textsuperscript{516} Or its neighbours? Should they not have, and is it not feasible to accord them, comparable protection?” Stone questioned.\textsuperscript{517} Any corporate officer who commits a crime by failing in his function should be disqualified from further such posts.\textsuperscript{518}

\textbf{(ii)} While Stone does not call for an outside source to pass upon entire management plans for every corporation, as each corporation evolves into its own unique organization patterns, both formal and informal, and what is best organizational mode for one may not be best for others even if producing same production on the same scale, he does not see why there should not be such review in certain situation or for certain troubled corporation.\textsuperscript{519} Check AIG bailout after financial crisis.

\textsuperscript{508} Stone, at 188-189.
\textsuperscript{509} Stone, at 189.
\textsuperscript{510} Stone, at 189, citing the Mattel case (court order imposing a financial controls and audit committee and a litigation and claims committee).
\textsuperscript{511} Stone, at 189.
\textsuperscript{512} Stone, at 189-190.
\textsuperscript{513} Stone, at 190.
\textsuperscript{514} Stone, at 190-191.
\textsuperscript{515} Stone, at 192.
\textsuperscript{516} In the Merrell MER/29 case, when the directors of toxicology and pathology laboratory resigned, he was replaced by a “Dr” William M King, whose degree title was fake, to review and evaluate such matters as blood changes in the laboratory animals: see Stone, at 192.
\textsuperscript{517} Stone, at 192.
\textsuperscript{518} Stone, at 193, citing the Sylmar Tunnel disaster as an example where convicted safety officers were not disqualified by the terms of probation to return to similar job in the future.
\textsuperscript{519} Stone, at 195-197, citing Penn Central merger (lack of such review); Department of Defense’s procurement rules (requiring would-be defense contractor to set out its proposed management and organizational procedures to get the production of the ship or plane it bids done, and the Department of
Corporate internal Information: There is no control on how corporations gather, disseminate and shred whatever data they choose, or mutual information sharing between corporations and external related organizations.

“The importance of a company’s information processes cannot be overstated; they are as vital to the corporation as the nervous system of a human being to the body. What information the corporation seeks from its environment, where it looks for feedback (both within and without itself), where it dispatches what it learns, what it stores in memory, and what, for all intents and purposes, it “forgets” (or destroys) … are fundamental determinants of the corporation’s behavior. There is no reason why each of these information processes, in turn, cannot be influenced directly by the society”.

Yet, so often critical information about a corporation’s product, services or operation, whilst available in the public, is not being steered to the appropriate place in the corporation for action. Corporations tend to focus their limited information gathering resources on such matters as industry sales volumes, capital costs, market shifts, and competitor behavior, and not on the “softer” data, less immediately relevant to profits, growth, and prestige, or impact they are having on social issues. To improve the information search, a corporate office should be established with specific terms as to where to collect data and what to look for. Again, there are precedents for this. But they are not extended to corporations. (Check current listing rule/code of CG)

Another problem is that information that corporation possesses is not processed upward to the people that are in a position to do something about it. A legal requirement that some officer is to be the recipient of the information, and to report the information to the board, and the minutes must reflect that the board saw it, would help improve the system, with criminal sanction for failure to pass the information upward and to act on the information. That way, no one can plead ignorance of the information.

Stone also suggests that consent decrees can be used to impose appropriate information systems as part of a settlement package, tailored to the particular company and problem involved, with failure to comply enforceable by a contempt proceeding and be prima facie evidence of guilt or liability, with double or triple liability against the company.
Another option is to make non-compliance non-insurable risk or non-recoverable loss.529

There should be internal system to ensure command or instruction for action to be taken upon the information flows from the board downward to the relevant operating levels in appropriate languages.530 There should be legal requirement for the information to be stored and recalled.531 And it is the raw data, not the second-level abstractions or final charts or indications, that should be retained to avoid any “fudging”.532 The raw materials should be signed by person responsible for preparing them with penalty for perjury.533

3. Outside Inspectors

Stone argues there should be disclosure of relevant audited information not only to shareholders and regulators, but also to consumers, workers and the community.534 He argues that government inspector should be appointed to be in a position to identify where the weaknesses are, to precipitate the remedies in advance.535 However, he concedes that there are practical difficulties in such an approach, for example the potential for co-option or corruption and costs, and failure by inspector to do a proper job.536 However, he thinks that the solution is to improve the inspector system.537 There should be proper pay and career prospects for the inspector; there should be inspector rotation to ameliorate risk of bribery; inspector should be involved in the process as early as possible, eg the design stage, rather the end of the production process.538 The inspector should approve the corporation information procedures.539 He also suggests encouraging whistle-blowing with protection to the whistle-blowers.540 (check current requirement)

H. Corporate Culture

Stone’s proposals are ground breaking and involve a more widespread invasion of corporate managerial autonomy than anything ever tried in the US, and he is asking corporations not only to accept these intrusions but also to affirmatively co-operate even if it would involve a sacrifice of profits in some cases.541 The big question is how can we change those things that corporations care about.542 His proposals would not

529 Stone, at 206.
530 Stone, at 206-07, citing AT&T Anti-Bias Decree as an example.
531 Stone, at 207.
532 Stone, at 208.
533 Stone, at 208.
534 Stone, at 209.
535 Stone, at 210.
536 Stone, at 211.
537 Stone, at 212.
538 Stone, at 212.
539 Stone, at 212.
540 Stone, at 214-16.
541 Stone, at 228.
542 Stone, at 228.
work so effectively if the person in authority will not act on the information generated under his proposals, or does not care about his company running the risk of imposing long-range health hazards to the public or other risks of harm, or other company officers undermine him in all the subtle ways possible, or the workers don’t come forward because they simply don’t care. In the final analysis, the most these measures can do is to reduce the resistance of the preexistent corporate cultures, and as long as the underlying attitudes are left untouched, some measure of resistance is inevitable.

Is it possible to change the attitude of corporate America? Stone thinks that “we are very limited in what we can do”. It is not just a matter of autonomy: no organization will hand over control gladly. But there is the different, potentially competing aims and attitudes of corporations.

“To be realistic, with the American business corporation the dominant orientation of the institution is going to remain toward profit, expansion, and prestige… [however] even if we accept profit orientation as a basic and inalterable fact of American corporate life, we don’t have to accept, or expect, sheer corporate hedonism. What I am asking of our chemical companies, for example, is not that they abandon profits. Producing fertilizers and chemicals that will get the world fed would be, and should be, a profitable activity. But what we want, too, is that the companies will manifest enough concern about the effects their products are having on the health of the field workers who use them, that they will accept the internal structures we deem appropriate; that in cooperation with the imposed systems they will perform some amount of follow-up; that if suspicious circumstances are apparent, they will undertake appropriate studies and notify health authorities; that they will make data available to interested parties – rather than cover up the apparent risks and deny their very possibility.”

Stone sets out a wish list of desirable corporate attitudes in connection with the various social roles the corporation plays:

“The Corporation as citizen
• To be concerned with obeying the laws (even if it can get away with law breaking profitably)
• To aid in the making of laws, as by volunteering information within its control regarding additional measures that may need to be imposed on industry
• To heed the fundamental moral rules of the society
• Not to engage in deception, corruption, and the like
• As a citizen abroad, to act decently to host country citizens, and not inimically to US foreign policy

The corporation as producer
• To aim for safe and reliable products at a fair price

The Corporation as employer
• To be concerned with the safety of the work environment
• To be concerned with the emotional well-being of its workers
• Not to discriminate

543 Stone, at 229.
544 Stone, at 229.
545 Stone, at 230.
546 Stone, at 230.
547 Stone, at 230.
548 Stone, at 230-231.
The corporation as resource manager
- Not to contribute unduly to the depletion of resources
- To manifest some concern for the aesthetics of land management

The corporation as an investment
- To safeguard the interests of investors
- To make full and fair disclosures of its economic condition

The corporation as neighbor
- To be concerned with pollution
- To conduct safe and quiet operations

The corporation as competitor
- Not to engage in unfair competition, on the one hand, or cozy restrictions of competition, on the other

The corporation as social designer
- To be innovative and responsive in the introduction of new products and methods
- Not to close its eyes to the fact that the movies it turns out, the shows it produces, the styles it sets, have an impact on the quality of our lives, and to concern itself with that impact responsibly"\(^{549}\)

Would corporation ever do these things? If the business is in sole proprietorship where manager and owner are one and the same person, the owner manager might not do these things as the cost of doing these come out of his own pockets.\(^{550}\) Oddly enough, with giant corporations, because of the separation of ownership and management (control) as Berle and Means observed in their famous book, The Modern Corporation and Private Property (1932), there is a possibility that manager would do these things as the costs do not come out of his own pockets but from the company’s coffers.\(^{551}\) So, in theory and in practice, “the giant, broadly held company is more likely to be socially accountable, and less likely to engage in sharp, irresponsible conduct, than the small, closely held concern…”\(^{552}\)

At the time when Berle and Means observed the separation, the corporate problems were mainly about widespread tragedy to investors, rather than “consumerism” or “environmentalism”, so the attention was given to how to align the interest of managers and owners, not consumers and the society.\(^{553}\) Now attention should be turned to other stakeholders that are also affected by corporate action.

Although it is more likely that giant corporations would be more socially accountable, why aren’t they? A lot of them are in various ways. But there is room for them to do more. Here are some reasons why they are not doing enough. First, a satisfactory level

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\(^{549}\) Stone, at 231-232.
\(^{550}\) Stone, at 233.
\(^{551}\) Stone, at 233.
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of profits is necessary to survive. Second, even when they have made enough profit, and have no pressure from investors for even more profit, there are “profit-connected” reasons, eg prestige – being listed in NYSE, or Fortune 500, where the measures of the success are usually related to profit. Third, like any organization, even non-profit organizations, they become depersonalized and insensitive to the world and their workers as they get bigger. Fourth, there is the group dynamics, where men do things they would normally not do. So it is not all because of profits or venality, but there are other institutional attitudes and forces at play, including a desire for profits, expansion, power; desire for security; the fear of failure; group loyalty identification; feelings of omniscience; organizational diffusion of responsibility; and corporate ethnocentrism.

Different corporations in different industries display different attitudes: law abiding or law breaking; tolerant or intolerant to poor safety record etc. We don’t know enough the variables that make some more responsible than others to be able to directly manipulate those variables. But even so, we do have some good clues as to how attitudinal changes can be brought about. In the situation where there is existing norm in the organization that supports the attitude we want to inculcate: the ideal that price-fixing is bad, competition properly pursued can produce far more consistent profits than conspiracy, self-esteem from being able to make better products etc, and there is the group within the corporation that is more supportive of the desired attitude, the strategy is to locate this group and strengthen its hand, eg the engineers who care about their design, the lawyers who will look bad if things go wrong, the union, the insurance companies etc, and the task is to change perceptions and get the problem into the open for discussion. In the situation where the attitudes society want to inculcate are at odd with all the dominant norms of the corporation and there is no alliance group which supports the attitudes within the corporation, eg getting insiders to give notice of the company’s pollution, halting industrial espionage and campaign law violations, keeping clear of political adventures in foreign countries, exercising concern for land use aesthetics, is more complicated. Any attempt to shift basic corporate attitudes has to involve profit motive, not replacing it. A lot also depends on changing attitudes and values of the society. Reward or recognition should be given for doing good to society. This is increasingly done, eg the Best Corporate Governance companies awards in HK. Stone also suggests having social audit to present on paper the total social costs and benefits of a corporation’s activities.
over and above those that are now reflected in its financial statements.\textsuperscript{570} It is difficult to quantify many of the features, and complex. This is now done in the form of ESG reporting.\textsuperscript{571} There should also be mutual communication between the workers and management, and between the public and the regulators, and the company. Again, this is now done in the form of stakeholder engagement.

\textbf{CONCLUSION AND IMPLICATIONS}

\textbf{(TO WRITE UP)}

We cannot simply rely on law and regulation to regulate corporations, though that is necessary, and must continue. We need to tackle the problems at their core – the decision making process. Stone’s proposed GPD and SPD should be modified to be stakeholder directors with adequate powers and well-defined functions. Such stakeholder directors could be supported by mid-level officers and or outside inspectors as Stone proposed.

\textsc{“From about 1880, advanced capitalism has been powered increasingly by large-scale finance and large corporations coordinated by global markets. These structure and organizations have led to huge economies of scale, rapid technological development, massive increases in productivity, and growing average personal incomes. Any attempt to reform or replace capitalism must take account of these facts… some academic writers still believe in the complete abolition of markets, private property, and money. They overlook the perils of their abolition, as illustrated by ruinous experiments in the twentieth century, from Stalin and Mao to Pol Pot. We have to understand capitalism, the roots of its success, and the feasible possibilities for reform and progress. Large corporations can have disbenefits as well as benefits. Corporations can act as powerful lobbies for rich and established interests. Unless there is effective countervailing legislation, corporate power can distort democracy and mislead public opinion. The political financing, lobbying, and media powers of large corporations should be on the agenda of capitalist reform… Legal structures such as the joint-stock company and the limited liability corporations have facilitated large agglomerations of capital to reap the economies of scale involved in mass production. But \textit{that does not mean that corporation should be left as they are}. Because legal structures are often overlooked or downgraded in social science, critics of capitalism have paid insufficient attention to the possibilities for the reform of corporate law. Friedrich Hayek (1948, 116) worried about corporate legal personhood and limited liability, rightly blaming the state for their existence, but wrongly assuming that clock could be turned back to the eighteenth century. The abolition of both corporate legal personhood and limited liability would tear apart the institutional fabric of modern capitalism. Such a radical move would counter Hayek’s own doctrine of cautious experimentalism. Such reserves could hobble the system, especially in the sphere of large-scale production. The concept of corporate social responsibility has arisen after concerns about alleged malpractices against the public interest… An important question is whether renewed corporate law reform could reverse the trend toward making corporate directors responsible for the maximization of shareholder value rather than more diverse objectives, including serving the public interest (Hutton 1995, 1997).\textsuperscript{571} Karl Marx and Joseph A Schumpeter foresaw that capitalism carries the seeds of its own destruction with the abolition of private property.\textsuperscript{572} As an important vehicle of capitalism the seeds might lie within the governance structure of a corporation. The seeds of profit maximization that grow excessively to become greed for shareholders and managers at all costs, to the destruction of the environment and the society.
Globalization has exacerbated the harm, but being able to move production to poor developing countries as a result of globalization, the urgency of the matter for developed nations has been somewhat postponed for a short period of time. However as the world temperature rises, and environmental damage is felt in developed countries, the time has come for the developed countries to do something to contain the seeds of destruction. It is hoped that the proposed reform to the board structure would remove the toxic element of the seeds before they grow too big and destroy the environment and society and ultimately capitalism.
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