CSR and Corporate Governance: Shareholders do not own the firm

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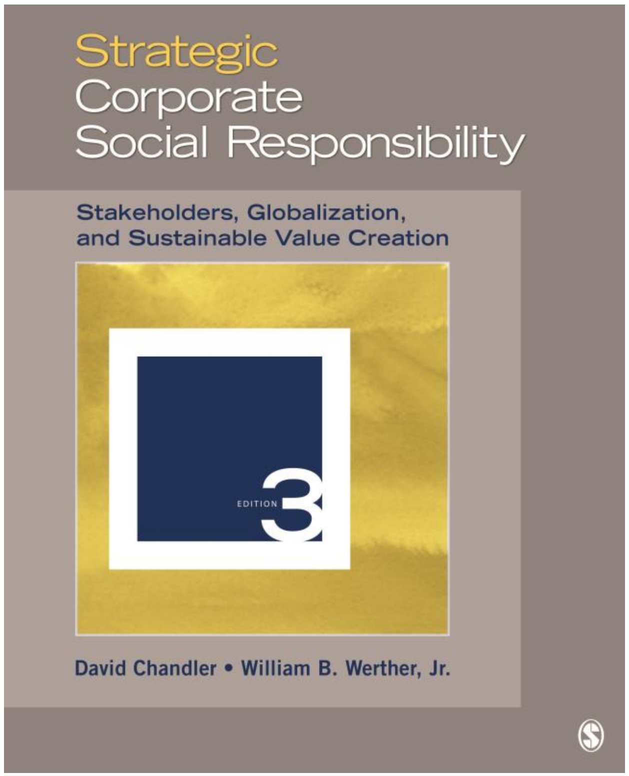
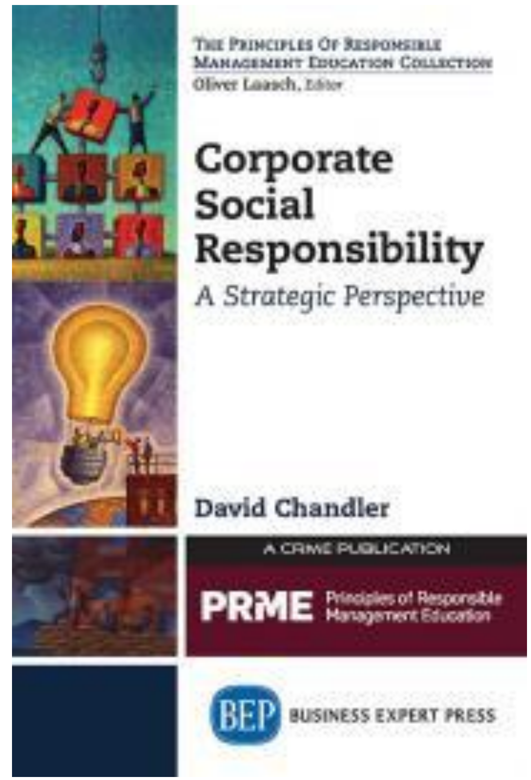
Strategic CSR





Before I begin, some qualifiers …

- I am not a lawyer:
  - The last thing America needs is another lawyer.
- I am not an expert in corporate governance:
  - My expertise is CSR and, in particular, *strategic CSR*.
- The ideas I will present relate to publicly-traded corporations:
  - Not private firms, family businesses, partnerships, or any other business form.
- The ideas I will present are based on US corporate law:
  - There are similar aspects in corporate law elsewhere, but also important differences among cultures/countries.
- So, with my excuses out the way ……

Business has a problem

- On the one hand:

"The great achievements of civilization have not come from government bureaus. Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way. In the only cases in which the masses have escaped from [grinding poverty], the only cases in recorded history, is where they have had capitalism and largely free trade. If you want to know where the masses are worst off, it is exactly in the kinds the societies that depart from that. So the record of history is absolutely crystal clear, that there is no alternative way so far discovered of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system."

Milton Friedman, interviewed on *The Donahue Show*, 1979.

Business has a problem

- On the other hand:

> "Recent surveys report that only one in four members of the general public trusts business leaders to correct issues, and only one in five trusts them to tell the truth and make ethical and moral decisions."

> "… the Oxford dictionary defines capitalism as 'an economic and political system in which a country's trade and industry are controlled by private owners for profit, rather than by the state.'"

- The perception is that the benefits of capitalism are narrowly distributed.

AMJ, 2014, p1227; *The Economist*, November 15, 2014, p76.

Strategic CSR is the answer!

- This situation has arisen due to a failure of communication:
  - Failure on the part of firms to listen and explain how they add value
  - Failure on the part of society to understand how value is created

- Companies that understand this will perform more effectively in the twenty-first century.

What do we have to do?

- Two steps:

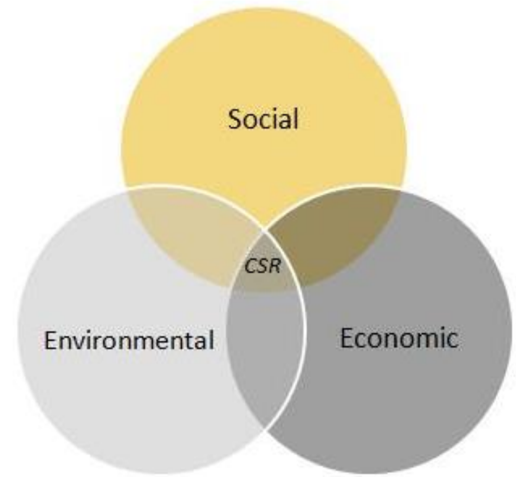
1. Redefine CSR and better understand how value is created.

2. Move firms away from a narrow focus on shareholders to a broader focus on all stakeholders.

Step 1: Redefine CSR

What is corporate social responsibility?

What is wrong with these pictures?



What is CSR?

- We are asking the wrong questions:

What are the social responsibilities of business?

How can we get firms to perform these actions?

- The most important question we face as a society is this:

How does the firm create the most value for the broadest section of society?

Who adds more value?

Share price: $58.37	Share price: $40.03
Mkt. Cap.: $28.66bn	Mkt. Cap.: $25.40bn
Employees: 343,000	Employees: 2,300
2013 sales: $98.4bn	2013 revenues: $665mn
2013 profit: $1.5bn	2013 profit: ($645mn)

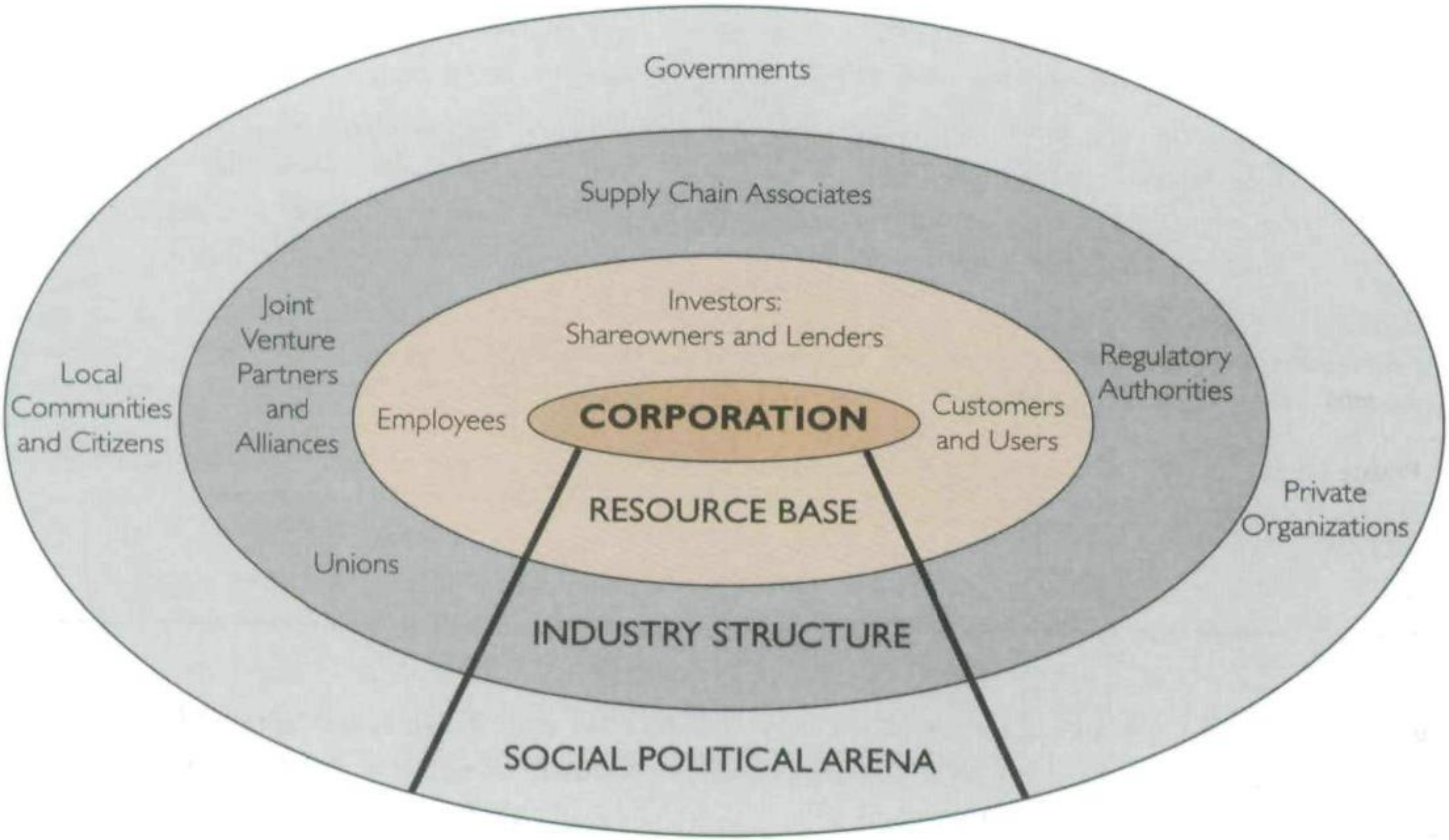
How many of these brands are known for CSR?

	$98,316 mn		$46,947 mn
Google	$93,291 mn		$41,992 mn
Coca-Cola	$79,213 mn	SAMSUNG	$39,610 mn
IBM	$78,808 mn	intel	$37,257 mn
Microsoft	$59,546 mn	TOYOTA	$35,346 mn

Alternatively, how many of these companies are known for creating value?

Interbrand, Best Global Brands (2013).

How do we know these firms add value?



Post, Preston & Sachs, *CMR,* 2002.

The problems with stakeholder theory

- Stakeholder theory is good at:
  - Defining the firm's stakeholders
  - Placing all expectations on firms to act
- Stakeholder theory is bad at:
  - Helping managers prioritize among stakeholder interests
  - Recognizing that firms respond best to stakeholder oversight
- Ultimately, the firm does not exist independently of its stakeholders:
  - It is the joint responsibility of all stakeholders to determine firm action

What does it mean to have a "responsibility"?

Responsibility: "the state or fact of being accountable or to blame for something."

- If there is no consequence to not acting, there is no responsibility.

A new definition of CSR

"A view of the corporation and its role in society that assumes a *responsibility* among firms to pursue the interests of stakeholders, broadly defined, and a *responsibility* among the firm's stakeholders to hold the firm to account for its actions."

- An iterative, inter-related process:
  - Firms listen to their stakeholders.
  - Stakeholders act in ways that reflect their values and self-interest.
- But, how do we get firms to broaden their perspective?

Step 2: Shareholders do not own the firm

- Corporate governance is not adequately taught in the MBA
- In particular, the history of the corporation is not taught:
  - I went through three business Masters without one class

- This matters because:

> "In the 2011-2012 school year, more than 366,000 undergraduate business degrees and 191,000 graduate business degrees were awarded in the U.S., more than any other type of undergrad or masters-level degree… . The same trend is occurring globally."

Why does the corporation exist?

- The Joint Stock Companies Act (1862). Three big ideas:
  - Created the corporation as an "artificial person" with the legal rights of an individual
  - Allowed firms to issue tradable shares
  - Gave investors limited liability – only liable for extent of investment.

- These ideas were revolutionary, but were also controversial:

> "The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private company frequently watch over their own."

Adam Smith, *The Wealth of Nations*, 1776.

More importantly, however …

- Before the 1862 Act, companies existed, but they required:
  - A "special sanction from Parliament"
  - A "specific worthy aim" (i.e., specified social benefit, such as building a railroad)

- After the 1862 Act, companies focused more on maximizing profit for investors.

What is the purpose of the firm?

"Is the company essentially a private association, subject to the laws of the state but with no greater obligation than making money, or a public one which is supposed to act in the public interest?"

- Is incorporation a right or a privilege?
- Is a corporate charter something that can/should be revoked?

Micklethwait & Wooldridge, *The Company*, 2003.

In the U.S. …

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In the U.S. …

- … the avenue to corporate personhood came via the Supreme Court and the 14^{th} amendment to the constitution.
- Ironically, the same legal argument that limits the liability of the investors (that they are not responsible for the corporation's debts) also determines that they do not own the firm.
- In other words, the corporation exists independently of its shareholders.

"Ownership" – The law

- Two components to the legal definition:
  - The law as it is written by the legislature (i.e., legislation)
  - The law as it is interpreted by the courts (i.e., legal precedent)
- In the U.S., most corporate law is conducted at the state level:
  - Delaware is the most important state because:

> "Approximately two-thirds of the Fortune 500 companies are incorporated in Delaware, and 83% of all new U.S. corporations in 2013 were incorporated there."

The Wall Street Journal, November 15-16, 2014, pA11.

Delaware General Corporation Law

"… the purp se of the corp ration is ngage in any lawful act or activity for wh rporati may ganized under the General Corporation Law w nent all lawful acts and activities sha the corporation."

r incorporation

"[The directo corporation and may do whatever is neces p the organization of th po n."

107 Powers of incorporators

Delaware corporate law makes no mention of the shareholder as owner of the firm

 General Corporation Law, http://delcode.delaware.gov/title8/c001/

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Shareholders own stock

"This argument [that shareholders own the firm] is based on a misinterpretation of the legal position on the issue of share ownership. … Once shareholders subscribe to shares in the corporation, payment made in consideration for the shares is considered property of the corporation, and the shareholders are not free to withdraw the sum invested except for payments through dividends, selling their shares, and other permitted means. Shareholders own the shares, not the corporation itself, which is an autonomous legal entity."

Lan & Heracleous, 'Rethinking Agency Theory: The View from Law,' *Academy of Management Review*, Vol.35, No.2, 2010, p301.

<u>The firm is an independent legal entity.</u>

Directors have no special fiduciary duty to shareholders

"Oddly, no previous management research has looked at what the legal literature says about the topic, so we conducted a systematic analysis of a century's worth of legal theory and precedent. It turns out that the law provides a surprisingly clear answer: … when directors go against shareholder wishes—even when a loss in value is documented—courts side with directors the vast majority of the time."

Lan & Heracleous, 'The Myth of Shareholder Capitalism,'

Harvard Business Review, April 2010.

The business judgment rule.

Who are shareholders today?

- The vast majority of stock market trades are made among third-parties with no direct connection to the firm.
- Most trades and almost all orders are placed by computer algorithms:
  - "[While high-frequency trades] comprise half of all trades on the American market [they] submit almost 99% of the orders."
- Largest shareholders are institutional investors managing passive index funds:
  - "[In 2013, BlackRock managed investments totaling $4.1 trillion and was the] biggest shareholder in half of the world's 30 largest companies."
- The result?
  - Separation between shareholder investment and operational relevance.

The Economist, April 5, 2014, p73; December 7, 2013, p25.

Berle & Means

- This is not news, even to the guys who invented agency theory:

"In the late 19th century industry had a voracious need for capital; it found it by listing shares publicly on exchanges. The problem with this, Berle observed, was that over time big successful corporations would come to finance themselves out of retained earnings and have little need for investor-supplied capital. So while the ownership structure provided liquidity for shareholders—they could easily exchange rights for cash—it did not give them the authority tied to conventional ownership, because the company did not need it to maintain their support."

The Economist, October 26, 2013, p30.

What legal "rights" do shareholders have?

- Right to the companies future profits?
  - No "right" to dividends unless the company issues them.
- Right to vote at company's AGM?
  - Many votes are non-binding.
  - Extremely difficult to nominate candidates for the board
- Right to sell their shares at the time of their choosing?
  - Yes, that is about it.
- That is the only meaningful shareholder legal "right."

The result?

"Today, … there seems to be substantial agreement among legal scholars and others in the academy that shareholders do not own corporations."

- Conclusion:
  - The corporation is an independent legal entity
  - The Board of Directors is the Principal of the corporation

University of Illinois Law Review, Vol. 2010, No. 3, 2010, p899.

A growing argument?

"… elevating the creation of shareholder value to the status of primary objective [of the firm] is based on a faulty assumption—that capital is the scarcest resource in an economy."

McKinsey Quarterly, September, 2014

Who believes this?

"Unilever has been around for 100-plus years. We want to be around for several hundred more years. So if you buy into this long-term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company."

Paul Polson, Unilever CEO, November, 2012.

"If you want me to do things only for ROI reasons, you should get out of the stock."

Tim Cook, Apple CEO, March, 2014.

Has anything changed?

"There is no longer anything to reconcile, if there ever was, between the social conscience and the profit motive. Improving the quality of society – investing in better employees and customers for tomorrow – is nothing more than another step in the evolutionary process of taking a more farsighted view of return on investment."

Henry Ford, 1969.

BusinessWeek, November 1, 1969, p64.

The foundation of *strategic CSR*

1. Redefine CSR and better understand how value is created.

2. Move firms away from a narrow focus on shareholders to a broader focus on all stakeholders.

Strategic CSR

- There are five components essential to defining *strategic CSR*:

    1. Firms incorporate a CSR perspective within their strategic planning process.

    2. Any actions they take are directly related to core operations.

    3. Firms incorporate a stakeholder perspective (e.g., define and prioritize among stakeholders).

    4. Value, broadly defined, is optimized by working in the interests of a broad range of stakeholder groups.

    5. Firms shift from a short term perspective to managing the firm's resources and stakeholder relations over the medium to long term.

Strategic CSR

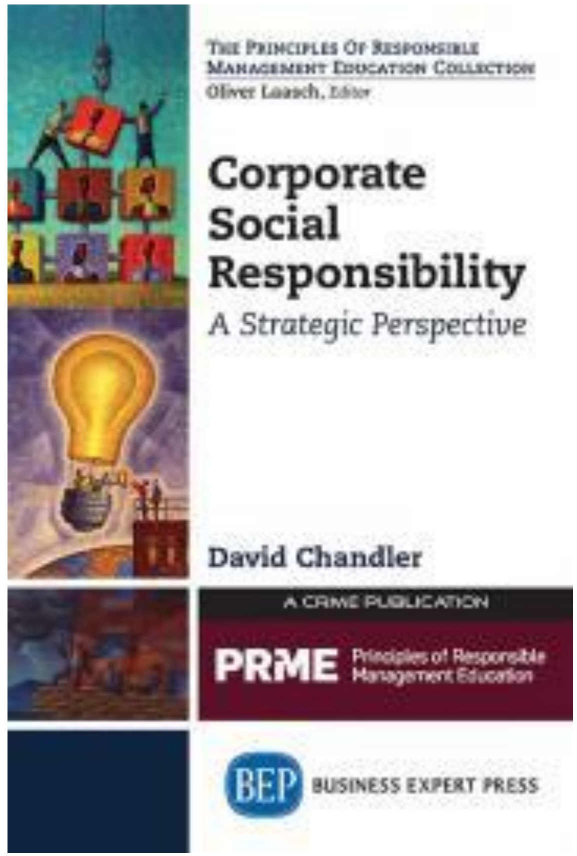
"The incorporation of a holistic CSR perspective within a firm's strategic planning and core operations so that the firm is managed in the interests of a broad set of stakeholders to optimize value over the medium to long term."

Strategic CSR – 10 defining principles

1. Business equals social progress.
2. Shareholders do not own the firm.
3. Identifying stakeholders is easy; prioritizing stakeholder interests is difficult.
4. CSR is not solely a *corporate* responsibility.
5. Market-based solutions are optimal.
6. Profit = Economic value + social value.
7. The *free* market is an illusion.
8. Scale matters; only business can save the planet.
9. *Strategic CSR* is not an option; it *is* business.
10. Milton Friedman was right; the only social responsibility of business is *business*.

Conclusion: *Strategic CSR* as sustainable value creation

Strategic CSR



Thank you.

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