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Stakeholder Governance—Issues and Answers

The Business Roundtable's recent call for a commitment to long-term sustainable economic value creation has prompted a vigorous debate about the optimal corporate governance model for achieving that goal.

Certain familiar arguments have reappeared in reaction to the Business Roundtable's important statement rejecting shareholder primacy and embracing stakeholder governance. Various law firms and commentators insist that such innovation in corporate governance is constrained by an imperative to maximize shareholder value—the ideology that a corporation can have no purpose other than profit maximization for shareholder gain. Others assert that the path to effective governance reform lies with prescriptive regulation, presumptively by the federal government.

We disagree, and propose an alternative: *The New Paradigm*. Our approach reimagines corporate governance as a cooperative exercise among a corporation's shareholders, directors, managers, employees, business partners, and the communities in which the corporation operates. *The New Paradigm* promotes transparency and engagement to ensure fair treatment of all stakeholders. It also aims to curtail, if not eliminate, short-termism and to combat activist pressure for financial engineering focused on short-term gain. Our approach thus addresses the fundamental criticism of corporations today—that their preoccupation with maximizing short-term shareholder gain has failed to generate economic growth and security for the rest of society—while avoiding the substantial risks of heavy-handed regulatory intervention.

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Most people are affected by corporations not as shareholders, but as consumers, employees, and members of the communities in which corporations operate. But for a half a century, corporate managers have been told to seek shareholder value alone, without answering to, or even accounting for, these broader constituencies. The present debate on corporate purpose reflects the growing tension created by these competing realities.

It also supplies an occasion to reemphasize first principles. Governments charter corporations—and bestow upon them the remarkable gifts of perpetual life and limited liability—not primarily to make money for shareholders, but rather to promote the economy and opportunity for society at large. The essential obligation of corporate directors has thus historically been to the corporation itself: to nurture long-term economic growth that reaps benefits for, and avoids costly externalities on, the broader society. A corporation that succeeds in that effort will advance the interests of all its stakeholders, not just its shareholders. Conceived in this way, shareholder profit is not the sole objective of the corporation, but rather the byproduct of a well-functioning corporate governance regime.

In opposition to this point of view, some have argued that prevailing law requires directors to promote share price before all other objectives. As we have elsewhere noted, the notion that, in the real world, maximizing share price necessarily maximizes long-term growth has been discredited by observable market inefficiencies and the lessons of behavioral economics.

Nor does any rule of law mandate director obeisance to the ideology of share-price maximization. No statute anywhere enshrines or even endorses the objective of share-price maximization. Nor does case law require directors to manage the ongoing business and affairs of the corporation with the paramount goal of maximizing share price. Directors may be obligated to seek the highest price in the context of a corporate auction, and the market's perception of a corporation's future prospects, as reflected in the stock price, is no doubt a relevant factor in deciding how to manage the company to maximize its potential. But not even the most aggressive reading of precedent identifies share-price maximization as the polestar of director decision-making.

Insightful commentators accurately emphasize that shareholders alone enjoy the corporate franchise, and with it the power to select directors. But that voting structure does not compel the conclusion that directors who are elected by shareholders must or should manage the corporation only in shareholder interests. Nor does it mean that directors, once impaneled as corporate stewards, cannot manage with the interests of society and people in view. To be sure, the vote makes directors accountable to shareholders, but it does not define or delimit the scope of directors' duties—which remain, first and foremost and in every U.S. jurisdiction, the preservation and promotion of long-term corporate health and value.

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Some of those who doubt directors' legal authority to adopt socially responsible policies for the purpose of generating long-term corporate value, and others who question directors' ability or inclination to do so, support new mandatory corporate governance regulation.

We are deeply skeptical that mandatory corporate governance regulation is the solution. The track record of such regulation is poor. Recent rounds of prescriptive regulation have failed to solve the problem of myopic focus on share value, but instead—as a broad scholarly consensus agrees—have undermined business flexibility and with it economic growth. As Yale Law School's Roberta Romano has observed, corporations, unlike legislators, "operate in a dynamic environment in which there are many unknowns and unknowables, and state-of-the-art knowledge quickly obsolesces." But legislative mandates respond to political rather than economic imperatives and, as static prescriptions, lack the capacity for adaptation necessary to enable a dynamic economy.

For those reasons, legislative solutions usually don't fit. Like generals fighting the last war, business legislation invariably looks backwards rather than forwards and implements compulsory solutions on the basis of yesterday's news. One proof of this is that incremental governance regulation—establishing, among other things, director independence requirements and key board committee composition rules—has done nothing to forestall the costly social externalities and unsustainable business models that have given rise to today's debate.

Regulatory prescriptions cannot produce optimal governance outcomes because corporate governance is not amenable to one-size-fits-all requirements. Corporations compete in radically different industries and must respond to constantly evolving business conditions. Start-ups and companies on the innovative edge often have different governance needs than established firms. An effective corporate law must be highly adaptive and broadly enabling—everything that mandatory governance prescriptions are not.

The New Paradigm offers a better way: the mutual commitment of directors, corporate executives, asset managers and investors to long-term sustainable economic growth. Directors can and must mediate the differing and often conflicting interests of the corporation's various stakeholders. But the principle guiding that mediation should be the imperative to achieve long-term corporate health and value with the active engagement and cooperation of investors—who share with the rest of society an interest in sustainable and equitable economic growth. We again urge our February 2019 paper, *It's Time to Adopt the New Paradigm*.

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