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OPINION

Corporate governance

It's good for shareholders when boards consider public interest

Corporate purpose debate makes false distinction between investors and everyone else

RODGIN COHEN

Why do companies exist? Debate has sharply increased recently in academic, political and legal circles about the fundamental "purpose" of corporations. Now the business community itself is joining the conversation.

The argument has focused on whether companies exist solely to advance the interests of their equity investors, a theory known as "shareholder primacy", or whether corporation should also serve other constituencies or stakeholders, such as employees, customers and communities.

This debate often bogs down because it involves both legal and policy considerations, and the two are often confused. In addition, the two views — shareholders versus stakeholders — are described as antithetical.

In fact, there need not be a divergence between a legal regime of shareholder primacy and a corporate purpose that takes into account multiple constituencies. The two can be and should be synthesised.

There is a legal issue of fiduciary duty: whose interests are the directors required to put first — and a policy issue: what is the board's judgment as to how best to serve those interests? Neither prevents directors from considering the impact of her or his decisions on other stakeholders. In fact, if the board fails to consider the impact of its decisions on other constituencies, the results will generally fail to advance the shareholders' best interests as well.

Most major US corporations are incorporated in Delaware or other shareholder primacy states where directors owe fiduciary duty to the company and its shareholders. Half of all publicly traded companies are in Delaware alone. But 44 states permit directors to consider the interests of constituencies in addition to shareholders. Most often this is only permitted during a merger or acquisition, but some states allow directors to consider stakeholders in a broader range of decisions.

In addition, Delaware and a number of other states allow businesses to organise themselves as "public benefit corporations" with charters that allow for the public benefit to be a stated objective of the organisation. No major corporation has adopted such a charter, but the existence of this option makes clear that shareholder primacy is the "default" standard for ordinary companies.

Even so, there should be no question that the interests of other constituencies are directly relevant to the creation of value for a corporation and its stockholders. The success of a company is highly dependent on its workforce. Therefore company decisions on issues such as diversity programmes, equal pay, minimum wage and healthcare, retirement and other benefits are not only important to workers. Rather they can lead to substantial shareholder benefits by enhancing the company's reputation as an employer of first choice and helping it to attract and retain top quality employees.

More broadly, some big institutional investors — and some smaller ones — now expect companies to take into account the public interest. Many customers feel the same way. That could lead a board to decide that it is in the best interests of shareholders for the corporation to be recognised as a good public citizen.

Likewise, as we have seen time and again, reputational damage is one of the worst things that can happen to a company's share price. A reputation takes years to earn and a blink-of-the-eye to lose.

Actions taken by a board to build and preserve the company's reputation will almost always be in the shareholders' best interest.

This debate over corporate purpose also papers over another difficult challenge for boards and managers: the interests of different constituencies are not always aligned. The choice is not always shareholders versus stakeholders but sometimes among stakeholders.

Consider the decision on whether or not to decommission, or finance, a major coal fired electric generating facility. Maintaining the facility could harm the environment, but reduce costs to consumers and provide jobs for the miners supplying the coal. Which concern should prevail?

Individual companies cannot expect to thrive if they remain bound by the conventions and expectations of the past. They must respond to the changing demands of the world around them.

This does not require a change in the legal regime that puts shareholders first. Rather it requires an enlightened and far-sighted approach to applying that principle.

The private sector needs to live up to those standards and address such problems as climate change, job losses from technological change and income inequality. If it doesn't there will inevitably be increasing calls for the government to step in.

The writer is a partner at Sullivan & Cromwell. Joseph Frumkin and Melissa Sawyer of the same firm also contributed