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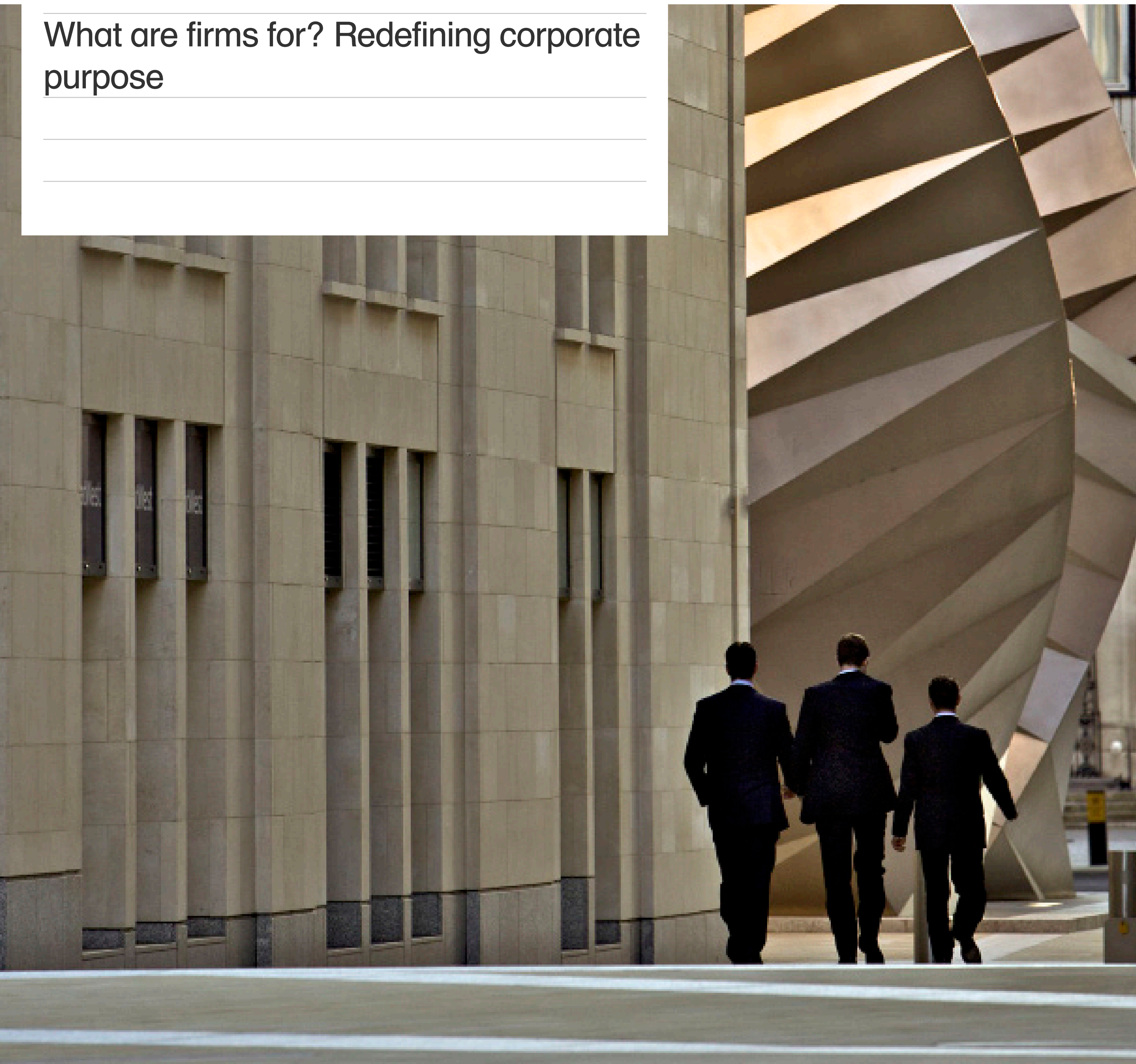
Advancing economics in business

oxera

November 2019

What are firms for? Redefining corporate purpose



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What should be the purpose of a firm? To maximise profits or shareholder value, or to pursue wider societal objectives? Professor Julian Franks of London Business School, and Oxera Partner, discusses the roles of trust and implicit contracts in redefining corporate purpose. He looks at changes that may be required in regulated utilities, with a focus on water

This article is based on a speech provided in response to Fletcher, R. (2019), 'Regulators and the social contract', Beesley Lecture, 16 October 2019. The author discusses the general direction of travel regarding corporate purpose, before returning to the issue of the governance of privately owned water companies in England and Wales.

Today we seem to need statutory protection for stakeholders, including investors, customers and the community. There was a period when such protection was not always necessary, when relationships of trust seemed to bind Boards of companies to stakeholders. In 2009, Professor Colin Mayer, Professor Stefano Rossi and I examined a sample of mergers in the first half of the 20th century. In every single one we found an equal price rule—that is, large shareholders or inside shareholders received the same price for their shares as smaller shareholders.

There is a great temptation for large shareholders to try to gain an advantage over small shareholders, or for insiders to obtain a price advantage over outside shareholders. What is surprising is that we found no rule requiring Boards to observe this equal price rule; it was observed by social convention. It was not until 1968 with the introduction of the UK Takeover Code that it was felt necessary to enshrine an equal price rule in the Code.

In 1937, in what must seem today as a rather quaint response to demands for more regulation, *The Economist* asked whether it 'might not be wise to devote increased attention to the possibility of reforming public taste rather than the statute law. Many things which are perfectly legal in this country are not the acts of a gentleman and are "just not cricket"'.

Building trust

We associate with cricket concepts of fair play and level playing fields. It is interesting to ask what factors might explain the voluntary adherence to informal or implicit contracts between Boards and shareholders, as illustrated in the evidence on the equal price rule in mergers. In examining the shareholder records of a large number of listed companies over the period 1900–50, Professor Mayer and I noticed that the addresses of many shareholders were in the same city as the head office and the Board. We found that the median distance between shareholders and the head office was around 15 miles, and that 56% of shareholders lived within six miles of the company's head office.[1]

Our view was that geographic proximity generated trust between Boards and shareholders and, indeed, other stakeholders. This explains why the equal price rule was adhered to by social convention: when your shareholders are your neighbours, you don't easily take decisions that harm them.

How likely would a water company be to pollute a river if the users were the neighbours of the Board members? Studies in Scandinavia show that valuations of companies are significantly higher when the shareholders are local to the company's operations. Professor Mayer and Professor Rossi and I believe that geographic proximity generates trust, and that this means that management is more likely to serve the shareholders' interest rather than its own—in other words, proximity lowers agency costs.

Interestingly, by 1950 the median distance between shareholders and the head office in our sample of listed companies had risen to 150 miles—more than ten times what it was earlier. While it is often argued that global diversification is good for risk reduction, there may be a cost: increasing the distance between shareholders and management, and the associated cultural differences that this brings, may result in less trust, poorer governance and greater agency costs.

I return to this issue of trust later as I retrace the intellectual basis of the shareholder wealth maximisation model, and why it has begun to lose its legitimacy.

Defining purpose

In Finance 101 we ask in almost a rhetorical way: 'what should be the objective of the firm?' Students rarely question the principle of shareholder wealth maximisation. In Brealey, Myers and Allen (2011), a finance textbook used in business schools throughout the world, the authors write:[2]

> A smart and effective manager makes decisions that increase the current value of the company's shares and the wealth of its stockholders. This increased wealth can then be put to whatever purposes the shareholders want. They can give money to charity or spend it in glitzy nightclubs; they can save it or spend it now. Whatever their personal tastes or objectives, they can all do more when their shares are worth more.

A classic paper that has influenced academic opinion on shareholder wealth maximisation is by Milton Friedman.[3] Of course there are others going back in time to Berle and Means and even Adam Smith—books that are so often cited but so rarely read.

In an essay for the *New York Times* in 1970, Friedman wrote:[4]

> In a free enterprise, private property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct business in accordance to their desires…the key point is that, in his capacity as a corporate executive, the manager is the agent of individuals who own the corporation…and his primary responsibility is to them.

Friedman concludes:

> 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 and fraud.

Friedman often gives the example of charitable contributions—advising that firms should leave charitable giving to shareholders and not make those choices for them.

In 1988, Andrei Shleifer and Larry Summers provided an important modification to this Friedmanite view, in a paper called 'Breach of Trust in Hostile Takeovers'.[5] They argued that much of the value gain to shareholders in such mergers comes from other stakeholders rather than from innovation or productivity increases. They pointed to airline takeovers, where much of the increase in the market value of shares came from reductions in wages. They cited Carl Icahn, who took over an airline and laid off thousands of highly paid senior employees who had previously been promised lifetime employment. He also shut down the factories that dominated several small towns, and as a result numerous stores

went bankrupt. In today's terms there was a real cost to social capital—a cost that was not paid for by shareholders.

Implicit understandings

Shleifer and Summers argued that the firm is in effect a nexus of long-term contracts between shareholders and stakeholders, and that many of these contracts are hard to articulate and write down. Instead, we must rely on the company to be trusted to deliver on them.

One reason for these long-term contracts is that we want people to commit their human capital to the company—even if it means that their value outside the company will be much lower. We get this commitment by promising them long-term employment or proper compensation for the loss of it. An employee will dedicate time and effort to learn how to do his or her own job only if they know that they will eventually be rewarded. An individual will learn to teach Latin only if they know there is a long-term job for them. What can a Latin professor do if that teaching job is terminated mid-career, or if the compensation is reduced, in the knowledge that they have already committed their human capital to that activity? The same might go for finance professors at business schools, but I shall not dwell on that. The answer is that upholding implicit commitments or promises is essential to much long-term investment in human capital—but there are also other forms of capital (which I refer to later).

We are surrounded by implicit contracts. We give tips in restaurants not because of a signed contract but because of an informal one—give me good food and good service and I will give you an extra 15%. Drivers of black cabs spend four years learning the 'Knowledge' in the belief that regulation will offer in compensation some advantage over the competition. These contracts are efficient, but only if we uphold them. The closure of coal mines in South Wales and in the north of England greatly affected the social fabric of their communities. Customers of insurance companies or energy firms do not expect to be charged a very large premium for staying with the company (often referred to as the 'loyalty premium'). They regard it as unfair and sharp business practice and a breach of trust.

Business models that place great reliance on the laziness or ignorance of a large number of customers do not have survival value. Of course, there have to be incentives to search and to switch, but the loyalty premiums that we have recently been observing go far beyond that. Similarly, innovation has to be encouraged, but when there is great social disruption those costs have to be internalised by somebody.

Economists often argue, rightly I think, that free trade and labour mobility are 'Pareto optimal'—that is, even after compensating the losers, society is better off. Unfortunately, we have often forgotten to compensate the losers. Importantly, these losers have votes, and they do not forget what they have been denied.

Redefining corporate purpose

I started with the Friedman view of the objective of the firm. More recently, Oliver Hart (another Nobel laureate) and Luigi Zingales have written a paper entitled 'Companies Should Maximize Shareholder Welfare Not Market Value'.[6] They argue against the Friedmanite view—that companies should focus on making money and that ethical issues should be left to individuals and government. They believe that shareholders want to (and should) be allowed to internalise their pro-social views into corporate policy.

The reason why Friedman argued that shareholders should be responsible for charitable giving is that he regarded this as separable from the firm's production and investment decisions. However, in many cases profit-making and damage-making are not separable. Hart and Zingales give the example of stores that sell guns that are used in mass killings. It may be more efficient for shareholders to prohibit their companies from making such sales, rather than shareholders using dividends to change legislation to prohibit gun control. Similarly, the same authors state that it may be more efficient for shareholders to force their firms to engage in 'fair trade' than try to persuade governments to legislate. Governments are rarely the perfect planner or the 'deus ex machina' that swoops down to protect stakeholder interests.

In these circumstances shareholder welfare and market value are not the same thing. Hart and Zingales argue that companies should maximise shareholder welfare and not shareholder value. How to implement this? Build in votes so that shareholders may incorporate their pro-social views into the company's production and investment decisions.

Sometimes the two will coincide. There is interesting evidence by Professor Marco Becht of the Université Libre de Bruxelles and his colleagues that giving shareholders votes over important firm decisions, such as mergers, and allowing them to overrule management, is more value-increasing than giving management total sway over those decisions.[7] Professor Elroy Dimson of the London Business School and others show that an asset manager successfully engaging companies in environmental, social and governance concerns increases the market value of the shares.[8] However, it would be wishful thinking to believe that maximising shareholder welfare will always be consistent with market value. The whole point of the article by Hart and Zingales is that it is often not the same thing: they argue that shareholders should be allowed to make those trade-offs even if it means sacrificing profit.

Hart and Zingales make important assumptions that shareholders are pro-social, that they wish to internalise social issues in their firm's decision-making, and that they are representative of society in general. However, shareholders may not place great value on protecting the climate and, in a period of great wealth inequality, they may not be very representative of society. Moreover, there are coordination problems that encourage shareholders either not to vote, or to leave it to other companies to pursue social issues.

In this respect it is interesting that Larry Fink, CEO of BlackRock, in his annual letter said that within five years all investors would measure a company's impact on society and the environment to determine its worth.[9] It will be interesting to see how he thinks we are going to get there.

I have discussed thus far the case for maximising shareholder value, upholding trust in implicit contracts, and maximising shareholder welfare in the hope that the firm will be required to address social concerns. I now come to a recent piece of academic work by Colin Mayer, who has also published a book on the purpose of the corporation. He argues for more radical changes—that the purpose of the corporation must not be simply to maximise shareholder value. Instead:[10]

> Corporations should be required to specify their corporate purpose, and
>
> They should clarify their commitments to different parties to the firm and relate it to their corporate purpose.
>
> They should show they can be trusted to adhere to these commitment, and
>
> They should record how their ownership, governance, performance measurement and managerial incentives promote their corporate purpose. In measuring performance recognition should be given to the fact that the firm is not simply using up financial capital, but also other forms

of capital, natural capital (eg climate), or social capital (eg. Quality of place, trust) or human capital (labour and intellectual property, and physical capital (water network or road network).

Professor Mayer argues that these commitments should be enshrined in a company's articles of association and that corporate law should require it. In other words, corporate law should pre-commit the company to a wider social purpose. It would be helpful if there were off-the-shelf structures available, such as public benefit corporations. These are corporations that allow in their articles of association some public purpose (often explicitly stated) in addition to the traditional one of serving shareholders. There are more than 4,000 across the USA.

Essential services (and beyond)

My discussion thus far has concerned corporations across all sectors. However, there is a special class of firms for which the issue of corporate purpose has come under particular scrutiny—regulated utility companies.

For example, in the privately owned England and Wales water sector, concerns have been raised where (some) companies have engaged in financial engineering—and where this has gone hand in hand with high profits, opaque executive pay and poor environmental performance. Is the water sector fulfilling its purpose? Rachel Fletcher, CEO of Ofwat, the economic regulator of the water industry in England and Wales, argues that fundamental change is required across the sector.

In my view, to resolve these issues—in the water sector and beyond—there are at least three options.

- Leave it to markets in the hope that public opinion, including social media, and political imperatives will change the behaviour of companies and their shareholders including asset managers. Some might point to the efforts of some of the water companies to draft a social contract, or to Larry Fink, who accepts the principle of the social purpose of the corporation.
- Change company law to require a company's articles to specify its purpose and how this will be implemented and measured. This would apply to all companies and is the view of Professor Mayer.
- Change the licences of some companies, particularly water companies (and other utilities) and banks, where there are strong public and social functions.

Under the first two options there is the important question of measurement and audit. Who would provide sign-off and how, and what would be the penalties for failure? Professor Mayer has suggested that dividends should be distributed only if the companies' profits exceed the costs of all forms of capital used up. There is an analogy here to the principle that profits can be distributed only after allowance has been made for the depreciation of the assets of a company.

I do not think it wise to leave it to the first option. Public opinion has moved on considerably over recent years, and there are too many cases of corporate failures. It is astonishing that the culture of some firms has permitted the falsification of records. Rachel Fletcher refers to a water company in her speech. Others also come to mind, such as Volkswagen.

As in other areas, I think the law has a role to play in endowing legitimacy on defining the wider responsibilities of the corporation. The case is relatively straightforward for water companies and some other utilities, and I think there should be serious consideration of the redrafting of licences. My understanding is that some companies have indicated that they would willingly engage in defining their purpose to embrace social concerns without legislation. So much the better. If we could construct good templates, the regulator might require companies to 'comply or explain'. While this approach has been viewed as a great success, the originator of the concept, Sir Derek Higgs, thought there was too much 'comply' and too little 'explain'.

It would be better if the regulator and some companies could agree on the drafting of a new licence or a proxy for it. But if this proves impossible, legislation should do the job.

Finally, let me finish with a quote from a recent article in the *Financial Times* by H. Rodgin Cohen:[11]

> 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.

I agree.

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Now—more than ever—firms are feeling the pressure to reconsider their purpose from many directions. Investors, regulators and wider society are all important stakeholders, and business leaders must carefully consider their perspectives every day.

To help you to find practical and sustainable solutions during this time of great change, we at Oxera are encouraging business leaders, Boards and investors to think Beyond the Bottom Line. You can join us in this conversation by visiting www.oxera.com/beyond-the-bottom-line, where you will find articles and podcasts that explore the concept of purposeful business from multiple perspectives and across different industries.

[1] Franks, J., Mayer, C. and Rossi, S. (2009), 'Ownership: Evolution and Regulation', *The Review of Financial Studies*, **22**:10, pp. 4009–4056.

[2] Brealey, R.A., Myers, S.C. and Allen, F. (2011), *Principles of Corporate Finance*, McGraw-Hill, tenth edition.

[3] Friedman, M. (1962), *Capitalism and Freedom*, University of Chicago Press.

[4] Friedman, M. (1970), 'The Social Responsibility of Business is to Increase Its Profits', *The New York Times Magazine*, 13 September.

[5] Shleifer, A. and Summers, I. (1988), 'Breach of Trust in Hostile Takeovers', in A.J. Auerbach (ed), *Corporate Takeovers*: *Causes and Consequences University of Chicago Press*.

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[7] Becht, M., Polo, A. and Rossi, S. (2019), 'Does Mandatory Shareholder Voting prevent Bad Acquisitions? The Case of the United Kingdom', *Review of Financial Studies*, **29**:11, November, pp. 3035–3067.

[8] Dimson, E., Karakas, O. and Li, X. (2015), 'Active Ownership', *Review of Financial Studies*, **28**:12, December, pp. 3225–3268.

[9] Fink, L. (2019), 'Purpose & Profit', letter to CEOs.

[10] Mayer, C. (2018), *Prosperity: Better Business Makes the Greater Good*, Oxford University Press.

[11] Cohen, H.R. (2019), 'It Benefits Shareholders to Consider the Public Interest', *Financial Times*, 16 October.