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Accountable capitalism

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Paul Lee

A new governance framework

‘Given that complex organisations are governed by layers of management, shareholders and public oversight, there is great benefit in articulating these boundaries by defining the company’s reward philosophy and risk appetite.’

Hans-Kristian Bryn and Carl Sjostrom

Content

Feature

Accountable capitalism

Paul Lee asks if Elizabeth Warren's Accountable Capitalism Act is actually debating points not legislation?

Veteran US Democrat senator Elizabeth Warren introduced new legislation in August intended to 'return to the era when American corporations and American workers did well together'. Called the Accountable Capitalism Act, she states that it 'aims to reverse the harmful trends over the last thirty years that have led to record corporate profits and rising worker productivity but stagnant wages'.

The legislation seems to have little chance of progressing in the current fractious political environment – particularly given the Act's federalist tendencies which run counter to the strong tide running in favour of power staying devolved at state level. But perhaps the more interesting question is whether it is addressing the right issues and how effectively it deals with those issues.

There are five main elements of the proposed Act:

1. *Federal charter:* any US corporation with revenue over $1 billion must have a federal charter as a 'United States corporation' under which it must (a) have a stated purpose of creating a 'general public benefit', ie a material positive impact on society, and (b) take account of the interests of all stakeholders, not just shareholders.
2. *Employee directors:* every United States corporation must have at least 40% of its board selected by employees.
3. *Restriction on share sales:* directors and officers of a United States corporation are barred from selling shares within five years of receiving them, or within three years of a share buyback.
4. *Ban on political expenditures:* no United States corporation may make political expenditures without the approval of both 75% of the board and 75% of its shareholders.
5. *Charter revocation:* a new Department of Commerce Office of United States Corporations will be able to revoke the federal charter of a United States corporation that engages in repeated and egregious illegal conduct.

The proposed Act is backed by a number of academics, both from legal and business faculties. Their supportive letter notes the historic origins of the privilege of incorporation – and the great gift that it brings of limited liability, whereby losses are kept at the level of the company and not attributed directly to the shareholders. It also highlights the race to the bottom for company standards that has occurred between the US states competing with each other for the tax revenue from incorporating businesses, a race comprehensively won by the small state of Delaware which is home to more than half of all publicly traded corporations in the US.

But there is a surprising elision in the argument made by the academics from this historic perspective. They rightly note that the original US (they don't say this, but it was also the approach globally) corporations were subject to limiting charters under which they were established for specific purposes and were only granted limited liability to the extent they were carrying forward that purpose or purposes. The academics go on to suggest that since the abandonment of this narrow understanding of limiting charters the corporate sector has focused solely on shareholder value and that this has been to the detriment of broader prosperity. This seems to suggest that the change from the original form of charters happened sometime around 1980 rather than more than 50 years earlier – and the era of shared economic prosperity that the academics are clearly harking back to is clearly the 1950s and 1960s when economic growth lifted all ships. Yet the 1950s and 1960s were scarcely an era of narrowly-defined corporate charters, indeed they featured some of the most rambling conglomerates ever witnessed.

The break point that the academics have in mind is not based on corporate charters, but on the growth of the belief that it was enough of a purpose for companies that they should promote shareholder value alone, rather than seek something greater than themselves. It is the point when corporate purpose went out of fashion and was replaced by a mindset of shareholder value maximisation.

Is there a problem? Purpose and fairness

It is clearly the US business culture that the only role of companies is to maximise shareholder value. Yet it is a mystery why Americans imagine that their law requires them to think this.

The two cases usually quoted as evidencing this view are *Dodge v Ford Motor* from 1919, and the 2010 decision in *eBay v Newmark*. Both are cases of clear abuse of minority shareholders, whereby the majority is seeking to squeeze out the minority by trampling on their interests – the decisions are more about unfair treatment than they are about the purpose of the corporation.

continued on page 8

Feature

continued from page 7

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Indeed, it is nothing short of bizarre that *eBay v Newmark* is quoted as being a decision in favour of shareholder supremacy when the judge – who is transparently frustrated that the case was not argued as a breach of contract case – repeatedly notes the community service nature of Craigslist, the company at the core of the dispute, and the fact that it is successful while not seeking to maximise profits or operate competitively. Indeed, the judge states explicitly: ‘the Court will not question rational judgments about how promoting non-stockholder interests – be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture – ultimately promote stockholder value’.

It would be hard to find a statement nearer to the strictures of the UK Companies Act 2006, s 172, that directors should promote the success of the company while having regard to the interests of a full range of stakeholders.

Thus, just as in the UK, the issue is psychological and cultural more than legal. The law in the US just as much as the UK commends attention being paid to stakeholder interests beyond a narrow understanding of shareholder value maximisation. It is just that boards and directors have forgotten this, and tend to focus on the narrowest possible understanding of their role. By doing so, over time they diminish their corporations and diminish the corporate world in the eyes of the population.

Just as greedy individuals tend to become despised by broader society, so too do greedy businesses. Over time they are shunned and do not prosper. When a whole corporate world becomes consumed by a narrow understanding of its role – by greed – this is rightly over time perceived as unfair, and the corporate world becomes brought into disrepute. Perhaps it should be no wonder then that we currently face a growing sense of disaffection with the corporate world.

It has long been a personal red flag of mine to worry about companies whose only stated aim is the promotion of shareholder value. So many such companies boom marvellously for a short period of time and then see massive value destroyed as they find that narrow self-interest destroys value over time – destroying the very thing the directors claim to be targeting. These are also usually the hardest companies to influence, because in the boom years much of the investment community loves them and the executives are tempted to believe their own hype.

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In place of this narrow focus on shareholder value, the growing agenda of corporate purpose (as championed by organisations such as the admirable Blueprint for Better Business) has to be right. Companies need to be aiming for something greater than themselves. This makes sense in terms of inspiring their workforce, shaping strategic thinking and driving success over time by remaining close to customers and communities. Sure, this may mean a slower form of value creation as the value needs to be shared a little more, but it is a more sustainable form of value creation, for society as a whole, but also for the individual company.

Thus the aim of the Federal Charter concept within the Accountable Capitalism Act has much to commend it: a purpose that is greater than narrow self-interest and a focus on stakeholders not just shareholders. But the problem is that the Act cedes too much ground – because those issues are already embedded in American law. They have just been conveniently forgotten. The wrong messages have been taken from the *eBay* case. This should be better understood; perhaps the Accountable Capitalism Act may provide an

Feature

opportunity to reopen this debate and reawaken people's understanding. A corporate sector that more explicitly aims to add value to society and not simply to itself has a better chance of reversing the current perceptions of significant unfairness, and beginning to change the negative view of capitalism as a whole.

Employees on boards

In my time at Aberdeen, I was in the happy position of being one of the few investors empowered to be positively disposed towards the briefly mooted idea of employee directors in the UK. While most of my peers threw up their hands at the very idea, I was given scope to speak positively, not least because my CEO had been Chair of FirstGroup, one of the only PLCs to enjoy board level employee representation, and had felt the experience to be a positive one.

It always struck me as odd that at the same time as investors were pressing ever harder for diverse boards – recognising the value that diverse viewpoints can bring – they were vehemently opposed to the very idea of employee representation at board level. Of course, there are issues, not least in having one or a few individuals being 'representative' of thousands of colleagues. But given the significant evidence that more diverse boards are better able to take informed decisions, and decisions that have been truly challenged and examined from a whole range of perspectives, it seems an omission to ignore this potential source of diversity. Certainly, Martin Gilbert's experience was that having an employee director helped the FirstGroup board understand a range of perspectives and come to better decisions as a result – though he did note that it might not be the best structure for all companies.

Yet it is a very different matter to have 40% of a board comprised of employee directors. The only country currently to require this order of staff representation is Germany, and many German businesspeople believe that the structure of codetermination is not wholly a good thing. Given the combative nature of industrial relations in the US – rather a contrast to the more collegiate German culture – one suspects that, certainly in the first few years, any such move would be particularly painful in America. Perhaps this requirement might become the foundation of a dramatic change in US industrial relations, but that would represent a very remarkable revolution.

The (mostly) uncontroversial elements

To deal finally with a couple of areas that, for shareholders at least, are largely uncontroversial: longer term executive director shareholdings and controlling political expenditure. Both seem to be unalloyed goods from the investor perspective.

One of the oddities about US executive remuneration, aside from its absurd – obscene – generosity, is its short-termism. While its advocates claim that significant value is aligned with share*holders* through the linkage to share price, still many companies have pay schemes that they have the gall to call long-term even though the shares or options begin to be released within a year of their award. These are not instruments that align the interests of executives with shareholders, but with share-sellers. They do not engender long-termism, so any move to extend the time-horizon of executive pay must be a good thing from the perspective of those interested in long-term performance of companies.

The proposed extension related to share buybacks reflects the growing demonisation of buybacks as a poor use of corporate funds. Certainly, with shares trading at unprecedented highs, lifted at least in part by the helium gas of quantitative easing, the current overheated level of buybacks does seem ill-timed. Buybacks are a useful discipline for companies but the discipline is for them to be tested against options of reinvesting in the business – too often this testing seems not actually to be done in the US, because the corporate culture requires that certain levels of earnings per share be hit. It is a sad statement about American capitalism currently that so many companies can find no better investment than in their own shares.

And again from a European perspective the US culture of political donations seems absurd. There is no reason why the human right of freedom of speech needs to be extended to corporations, and no reason why this needs to be the basis for limitless levels of funding for political parties. Much of the world frowns on corporate spending directly into the political process and so many would welcome this aspect of the Warren proposals. Whether they can ever get any traction in the US culture – or could overcome the Supreme Court decisions that underpin it – seems doubtful.

And this is at the end of the day the answer to the Accountable Capitalism Act. Much of it runs contrary to established US legal precedent, and much more against established culture. It may spark a debate that many would agree is welcome – not least, reawakening America to the idea that there is something more to the corporation than merely creating shareholder value in a narrow sense – but it seems wholly unlikely to actually become law, certainly not law that will survive Supreme Court challenge. But perhaps what Warren is seeking is just that: the debate on some vital issues around the life and purpose of the company in our modern world. If she can deliver that, perhaps we will begin to have again a capitalism that is seen to be fair and delivering more for society as a whole.

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