Harvard Law School Forum on Corporate Governance

The Illusion Of Reasoning

Posted by Dina Medland and Alison Taylor (Ethical Systems), on Sunday, September 6, 2020

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Editor's Note: **Dina Medland** is an independent commentator and **Alison Taylor** is Executive Director of Ethical Systems. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum **here**).

The gentlemen do protest too much, we think—with apologies to William Shakespeare for abusing his fine words in Hamlet, Prince of Denmark. Lucian Bebchuk and Roberto Tallarita, both at Harvard, have joined fellow princes in academia (not a princess in sight) and, it seems, the Financial Times in a veritable onslaught on stakeholder capitalism over the last 10 days. Amplifying a message by loud repetition is one way to promote the status quo in corporate governance and also, perhaps, to sell newspapers. But in a world of misinformation, we found our eyebrows rising.

The timing of this onslaught, just as the US presidential election starts to hurtle towards November 3, 2020, is interesting. It comes too in the middle of a pandemic that has seen a decoupling between the real economy and a stock market pushed ever higher by the monopoly power of technology companies. At issue is the historic statement of corporate purpose made by the **Business Roundtable** last year. The BRT is now composed of 200 CEOs, not the 180 still referred to by many in the media too bored by the concept of corporate purpose to keep track. Given that each of these CEOs on average employs 100,000 people or more, the addition of 20 more is a significant number.

The real problem with Messrs Bebchuk and Tallarita and the paper that kicked off this campaign, **"The illusory promise of stakeholder governance "** is their reliance on a mix of tautology and airbrushing. It's a common academic ploy—say something is true, add excerpts and footnotes and "empirical evidence" and even "novel empirical evidence", say you have shown it is true, and move on. Repeat. A better title might have been "The fallacy of illusion in any promise of change."

If you call what you want to shoot down "naïve" at the start, and then hunt around for "tangible" evidence to do so, it had better be good. Instead, the paper is based on their discovery that many of the CEO's signing the BRT statement did not get the approval of their boards to do so. It is a huge leap from this information to their conclusion that the BRT statement was not expected by signatories to bring about major changes. In further support of their argument, they review the history of anti-takeover legislation in the 1980s and 1990s, and conclude that leadership discretion inevitably leads to self-interest and a focus on shareholder value. Their conclusion is not that we might learn from this obscure episode to improve corporate governance efforts today. Rather, capitalism is trapped in a sea of hopelessness, between the Scylla of managerialism and the Charybdis of quarterly reporting.

"Incentives play an important role in shaping the behavior of corporate leaders" they say, and clearly, that's true. But the only incentives the authors can imagine are financial. They jump straight to their triumphant conclusion that as director compensation is linked to stock options, shareholder primacy rules. The inconvenient but interesting paradox that even powerful shareholders are advocating for stakeholder capitalism is skated over. And in fact, boards are keeping a much closer eye on remuneration as investors keep up the pressure, as **the FT reported** earlier this month. With one fell swoop, they dismiss the role of ethics in corporate governance and the dramatic shifts in the social and environmental context that have taken place since the 1980s.

As the essence of a business, corporate governance must keep evolving as businesses evolve to adjust to changing societies. We live in the middle of extraordinary times, with massive technological change, amid a late realisation of the urgency needed in climate action, and only now waking up to the potential of innovation in everything from healthcare to our working lives. Why should anyone listen to an argument that harks back to history for its validation (but doesn't actually credit Milton Friedman)?

Messrs Bebchuk et al appear to consider it a flaw that, as they suggest "pluralistic stakeholderism relies on directors to make the hard choices necessary to define the groups of stakeholders whose interests should be taken into account." They dismiss what is difficult, suggest that "trade-offs" are inherently insurmountable, and claim to give examples that any attempt to delineate the set of relevant stakeholders "will confront difficult and challenging questions that have no clear answer" ergo "any answer to them would be highly contestable."

Carrying their baton, Robert Armstrong of the FT writes in **an opinion piece**: "If stakeholder capitalism means anything, it is that corporate leaders must sometimes make choices that benefit stakeholders at the cost of shareholders." That this zero-sum, binary argument ignores the role of time horizons is not the only problem. Armstrong concludes: "rewriting the internal rules of corporate capitalism would put at risk a system that has served us well in its remit: to create wealth." Any attempt to address the existential environmental and social risks generated by this wealth-creation system is apparently hopeless. The author suggests "some distant and ideal future" when taking ESG seriously might happen, but kneecaps any attempt to embark on that path.

In fact, simplistic prioritisation of shareholder interests ceased to be an option some time ago. Shareholders today are not a monolithic interest bloc, and business leaders have some choices about which owners they seek to attract. Many shareholders today argue enthusiastically for longer time horizons and more substantive measurement of environmental, social and governance issues.

More broadly, the value of intangible assets such as reputation, innovation and network effects now constitute 61% of the value of the S&P500. Return on investment takes longer, and is harder to measure. Any attempt to navigate successfully through this new environment is inherently "contestable", too. It is the idea that a focus on shareholder value negates any need to consider complex trade-offs that is naïve and unrealistic, not the BRT statement.

There was change in the air well before Covid-19 arrived. And that is change that will continue as Generation Z enters the workforce and millennials assume more power over corporate decisions. Employee and consumer expectations are shifting dramatically, and in a hyper-transparent world, corporate behaviour is subject to constant scrutiny and evaluation. Attempting to proceed without acknowledging these concerns and opinions is in fact a rapid path to obsolescence.

Newspaper headlines often offer clues on neutrality in reporting. It would be easy to replace **"CEOs plans to reset capitalism bump into the reality of the pandemic"** with "CEOs struggle with governing amid a pandemic reality." Saying that "a year on, CEOs are still struggling to convince doubters" is almost laughable—a year in a pandemic is the blink of an eye in a storm.

Bebchuk et al hark back to decades of corporate behaviour as their validation, when leadership is surely about creating and giving new direction. These arguments are also all being made by male voices, which talk of the **"Insidious downside of stakeholderism"**—when what is insidious is the way "supporters of ESG" are linked in the same sentence with "cuddly images" and there is also talk of "changing their cut-throat ways"—clearly intended to ridicule those who might attempt any form of progress.

Bebchuk and Tallarita argue that "it's the incentives, stupid"—and indeed the vested interests in our financial and political systems are incentivised to back the status quo. But despite this, corporations enthusiastically launch themselves into efforts that are counter-intuitive if you assume an agenda of maintaining short-term shareholder value and undermining regulatory oversight.

In 2019, a number of large US banks voluntarily **restricted** financing for gun manufacturers and retailers. In December 2019, major multinational consumer goods companies including Mondelez and Mars Wrigley **called for** EU legislation to require companies to be legally responsible for negative impacts on human rights and the environment in their cocoa supply chains in Cote D'Ivoire and Ghana. Oil majors including **BP**, Shell and Total have withdrawn support from industry lobby groups who promulgate climate denial. American companies have maintained commitments to the Paris Climate

Agreement, even as environmental regulation weakens. It seems that companies are well aware they must consciously consider trade-offs if they wish to survive.

Words can easily be used as weapons to turn an intelligent nuanced debate into a caricature, thereby dismissing it from further evolution. We agree with this spate of sceptical authors that managerial discretion is insufficient, and ultimately, new corporate governance approaches are needed—and much more. But laws do not spring fully formed from a vacuum. Democracy is in crisis, and corporate interests have corrupted political decision-making for years.

What the BRT statement has done is not enough, but it has already broadened the Overton window of debate, and raised public and employee expectations that Boards, managers and shareholders must address. Returning to the 1980s is not an option. It is those who suggest otherwise that are the victims of magical thinking, not those trying to shape a better future.
