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THE CORPORATE LAW DILEMMA AND THE ENLIGHTENED SOVEREIGN CONTROL PARADIGM: IN SEARCH OF A NEW LEGAL FRAMEWORK

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ABSTRACT

This Article is centered on the proposal of a new model of corporate decision-making: the enlightened sovereign control paradigm. In revisiting the long-standing academic debate on the corporate objective, typically enshrined in the dichotomy between shareholder value and stakeholder theory, a critique of these existing models is put forward. In particular, it questions the ability of the existing theories to take account of the complex and multidimensional risks that are created by the company which affect different constituencies both inside and outside the company. While the global financial crisis of 2008 reignited the urgency to further define an appropriate legal framework for decision-making in large public firms, there have not been many substantial changes within the legal and business circles regarding the way this problem is treated.

The Article is grounded in the recognition of the historical quest to find a legitimization of corporate power, and attempts to create a system of public accountability that could justify managerial decision-making. These tasks have become ever more central in the wake of the many scandals that exploded from the early 2000s to the present day, showing that many constituencies can suffer from the externalities of corporate activities.

While much has been written on this topic, more recent events illustrate the need to find an alternative approach to the question of the corporate objective. This is because of its centrality in defining legal strategies to control managerial behavior, but also because of the shortcomings of existing paradigms. The asserted urgency to find a new theoretical model to govern managerial actions and coordinate them with the interests of different constituencies leads to the proposition of a new theory. The enlightened sovereign control paradigm flows from a pluralistic theoretical foundation and provides a novel, legal, and institutional framework for the balancing of different interests that are affected by the behavior of large public corporations.

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INTRODUCTION

> *". . . the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself. That, in its essence, is Fascism – ownership of Government by an individual, by a group, or by any other controlling private power. . . . Among us today a concentration of private power without equal in history is growing."*
>
> F.D. Roosevelt[1]

> *"The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state."*
>
> A.A. Berle[2]

This Article revisits the long-standing academic debate on the corporate objective, typically enshrined in the question of in whose interest should large public corporations be run. This has been traditionally addressed by two main theoretical paradigms: shareholder value and stakeholder theory. The global financial crisis of 2008 (GFC) and the events thereafter have reignited the urgency to firstly, further define this theoretical debate, or expand it beyond the above dichotomy, and secondly, find an appropriate legal framework to address the fundamental question of corporate decision-making. Notwithstanding the necessity to recalibrate problems related to corporate decision-making, neither of the above questions has resulted in substantial changes in the way the problem of the corporate objective is theorized and treated in business and legal circles.[3]

Post-crisis regulation has failed to address the fundamental issue of the corporate goal and it has also failed to reassess—at the higher level—the purpose (and scope) of regulatory intervention. Both questions are very central to this debate because they involve, *inter alia*, defining the rationale for public intervention in corporate affairs and more generally, the degree to which private corporate interests should be subservient to social priorities.[4]

1. Franklin D. Roosevelt, 32nd President of the United States, Message to Congress on Curbing Monopolies (Apr. 29, 1938) (transcript *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=15637#axzz1Ze7GRv3W) [hereinafter Roosevelt's Message to Congress].

2. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 313 (rev. ed. 1967).

3. Despite interesting and thought-provoking proposals: *see generally* Andrew Keay, *Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model*, 71 MOD. L. REV. 663 (2008) [hereinafter Keay, *Ascertaining the Corporate Objective*]; *see also* Dr. Daniel Attenborough, *Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle*, 32 LEGAL STUD. 4 (2012).

4. *See* Justin O'Brien, *Back to the Future: James M. Landis, Regulatory Purposes and the Rationale for Intervention in Capital Markets*, *in* INTEGRITY RISK AND ACCOUNTABILITY IN

The question of public interest came to the fore in 2014 in the context of the attempted hostile takeover of UK pharmaceutical giant AstraZeneca by its U.S. counterpart Pfizer. Pfizer's bid sparked heated political debates because of the consequences that the takeover would have had on research and development in the UK pharmaceutical sector.[5] The widespread perception was that Pfizer's strategy was aimed at breaking up AstraZeneca and eventually selling off its assets.[6] While a high bid could have met target shareholders' favor, other more pressing socio-political concerns reflected the long-term impact that the transaction could have had on the United Kingdom's science and research environment, with losses of jobs and infrastructures following the acquisition of the largest British drug-maker.[7] This in particular led labor representatives to invoke a public interest test on sensitive takeovers in order to block transactions that have a negative impact on the national economy.[8]

Eventually, Pfizer's offer was rejected by AstraZeneca's board, despite pressure from some of its shareholders to reconsider the bid.[9] This situation exemplifies the aforementioned friction between the private interest of shareholders, concerned with reaping the benefit of their investment (mostly in the short-term), and the broader public interest, reflected in this case by issues of science and research development. It is in the context of these highly topical junctures that this Article contributes a new approach to the problem

CAPITAL MARKETS – REGULATING CULTURE 41, 59–60 (Justin O'Brien & George Gilligan, eds., 2013).

5. AstraZeneca was at that time considered the largest pharmaceutical company in the United Kingdom. It was argued at the time of the hostile bid that research and development in new pharmacological treatments and products in the United Kingdom was effectively, to a substantial degree, reliant on AstraZeneca and its strategic priorities to direct funding toward research. Concerns about the taking over of this particular company were thus not so much driven by the fact that the bidder was an overseas firm, but rather by the reputation that Pfizer had built as a "short-term raider" of competing businesses. The proposed takeover, it was felt, would have therefore compromised pharmaceutical research in the United Kingdom as a whole. *See* Andrew Ward & David Crow, *Pfizer and AstraZeneca: One Year After Deal that Never Was*, FIN. TIMES (May 26, 2015), https://www.ft.com/content/e8320ccc-0327-11e5-8333-00144feabdc0.

6. *See* Martin Wolf, *AstraZeneca Is More Than Investors' Call*, FIN. TIMES (May 8, 2014), http://www.ft.com/cms/s/0/6fe31054-d691-11e3-b251-00144feabdc0.html#axzz33PqNE3d6.

7. *See* Julia Kollewe, *Labour Threatens to Block AstaZeneca Takeover Bid If It Wins 2015 Election*, THE GUARDIAN (May 16, 2014), http://www.theguardian.com/politics/2014/may/16/labour-threatens-to-block-astrazeneca-deal-if-it-wins-election.

8. *Id.*

9. *See* Rupert Neate, *AstraZeneca Tells Shareholders to Stop Pressuring It to Reconsider Pfizer*, THE GUARDIAN (May 20, 2014), http://www.theguardian.com/business/2014/may/20/astrazeneca-chairman-leif-johansson-shareholders-pressure-pfizer. It needs to be noted though, that Pfizer never reached the stage of making a firm hostile bid for AstraZeneca, mainly for two reasons: namely the public bashing that this was already causing, and secondly, the rules introduced by the Takeover Code following the Cadbury acquisition by Kraft in 2010, which limited the time between the bidder's initial announcement and its firm offer to 28 days. *See* Adam Bogdanor, *The Regulators Were Right to Force Pfizer's Hand*, FIN. TIMES (May 28, 2014), https://www.ft.com/content/a476fdf0-e5bc-11e3-a7f5-00144feabdc0.

of balancing diverging interests in the decision-making process of large public corporations.

In Part I, this Article defines the importance and the difficulty of directing decision-making processes in large public corporations. This is followed, in Part II, by a critique of the two existing models of corporate management (shareholder value and stakeholder theory), which highlights each theory's assumptions and the impact that each has on the running of large public firms. While much has been written on the topic, the unfolding of events within the GFC shows that the need to find an alternative approach to the issue of the corporate objective remains, mainly because of its centrality in defining legal strategies to control and direct managerial behavior, but also because of the shortcomings of the above models.

The asserted urgency to find a new theoretical model to govern managerial actions and align such actions with the interests of a broader range of constituencies leads to the proposition of a new framework. In Part III, the enlightened sovereign control (ESC) paradigm is put forward as an alternative model to shareholder value and stakeholder theory. In proposing a pluralistic theoretical foundation, the ESC provides the background for more specific measures to regulate managerial behavior and channel decision-making in boards of directors.

I. DEFINING THE PROBLEM: THE IMPORTANCE OF DECISION-MAKING IN LARGE PUBLIC CORPORATIONS

The ongoing economic crisis, sparked in 2008, has re-evoked memories of the Great Depression and, more surprisingly, of the regulatory and policy concerns that emerged at that time. The quotes at the beginning of this Article reflect striking similarities with some of the current issues faced within both academic and political circles. While President Roosevelt pointed in more general terms to the concentration of private power as a threat to the functions of a democratic state, Adolf Berle had framed the problem by identifying public corporations as the vehicle that elicits the concentration of private power, which could supersede the democratic state and escape regulation.[10]

This section provides a background to this Article's main theme as it explains why it is important to establish sound mechanisms of decision-making in large public corporations.

Large public corporations[11] have reached a new zenith. In the age of globalization, their position within society has become increasingly central

10. *See* Roosevelt's Message to Congress, *supra* note 1.

11. Large public firms are referred to in this Article as listed corporate entities that, because of their size and activities, create externalities on a varied range of constituencies. Examples of this category are represented by financial institutions, multinational corporations, or companies involved in the extraction of natural resources. This categorization will be discussed in more detail in the second part of this Article. For an explanation of what is meant by "large companies," *see* J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY 4 (2002).

because they stand as catalysts of financial, economic, and social changes. While this was already recognized by Berle, the magnitude of corporate power has today reached a new dimension. One reason for this is the much-augmented interplay between corporations and capital markets that has taken place since the 1980s in the United Kingdom and the United States. The liberalization and then the progressive deregulation of financial centers (chiefly London and New York, but this process extended globally) created new opportunities for multinational corporations to diversify sources of capital and enhance their returns through innovative corporate finance strategies.[12] The increased interdependence with capital market logics accentuated the alignment of corporate decision-making with the pursuit of increases in share value (i.e., shareholder wealth maximization), which has also become the main metric to gauge corporate success. The interest of shareholders became preponderant in the context of financialized economies and brought about a redefinition of corporate success, which is today distanced from the concept of wealth creation.[13] Even though the goal of maximizing shareholder value is not prescribed by the law—both in the United Kingdom and in the United States[14]—it has come to represent the chief priority of corporate management, often to the detriment of other constituencies that are also vital components of corporations.[15]

The process just described, referred to by Professor Lawrence Mitchell as "financialization" of corporate law, has extended beyond the United Kingdom and the United States.[16] Although there are reasons to believe that there is no "end of history" in sight for corporate law,[17] the business model

12. This was already epitomized in the Enron-type scandal, where the company's core business became subservient to financial and accounting strategies aimed at short-term profitmaking. *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections* (Colum. L. Sch. Ctr. L. & Econ. Stud., Working Paper No. 203, 2002).

13. Wealth creation is understood here as the process directed at productive activities, as opposed to mere financial activities which generate profits in the short term. For a discussion on share buybacks as tools that allow management to increase the value of shares without really creating any value for the company, *see* Lorraine Talbot, *Trying to Save the World with Company Law? Some Problems*, 36 LEGAL STUD. 513, 532–34 (2016); *see also* William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV., Sept. 2014, at 50 (discussing share buybacks as tools that allow management to increase the value of shares without really creating any value for the company).

14. *See* Vincenzo Bavoso, *The Global Financial Crisis, the Pervasive Resilience of Shareholder Value and the Unfulfilled Promises of Anglo-American Corporate Law*, 6 INT'L COMPANY & COM. L. REV. 213 (2014); *see also* LYNN STOUT, THE SHAREHOLDER VALUE MYTH (2012).

15. *See* Michael C. Jensen, *Value Maximization, Stakeholder Theory and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 242 (2002).

16. *See generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY – AMERICA'S NEWEST EXPORT (2001).

17. *See* Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–440, 468 (2001) (discussing the emergence of shareholder-value ideology); *see also* David Kershaw, *No End in Sight for the History of Corporate Law: The Case of Employee*

based on shareholder value (which could also be referred to more broadly as shareholder capitalism[18]) has been widely exported over the last three decades,[19] giving rise to similar legal issues and socio-economic questions across a variety of jurisdictions.[20] Some of these legal issues have surfaced repeatedly through a number of crises and scandals that occurred over the last decade, and the GFC has proposed them with new vigor. Generally speaking, corporate governance problems can be encapsulated in the failure to establish sound mechanisms of control over managerial behavior. This pertains to both internal governance mechanisms, represented most prominently by the function of non-executive directors (NED) on the board, and to external mechanisms, which rely on market forces (chiefly the employment of stock options, or the market for corporate control) and on the role of gatekeepers. At a higher level, a more deep-seated corporate governance problem is represented by the unresolved dilemma of the corporate objective, which has become more urgent because of the widespread employment of shareholder value as a parameter of corporate success.[21]

It is worth stressing that identifying the corporate objective with the interest of one constituency—shareholders—proves more problematic in the context of large corporations, because these entities are the offspring of the cooperation between different stakeholders,[22] and more importantly because their actions can create externalities on a very broad range of corporate and societal constituencies. In this context, the corporate governance problems above are exemplified by the failure of boards of directors (BoDs) to weigh different interests at stake and to understand the long-term risks related to certain activities. Relevant illustrations in this sense are provided by the BP oil spill in 2010 and by the behavior of most banks involved in the GFC.[23] Arguably, the BoDs' failures were all underscored by the intellectual bias flowing from shareholder value rhetoric and from the short-term goals embedded in it, which contributed to highlight the problem of

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Participation in Corporate Governance, 2 J. CORP. L. STUD. 34, 37 (2002) (providing a different perspective).

18. *See* Karel Williams, *From Shareholder Value to Present-Day Capitalism*, 29 ECON. & SOC'Y 1, 6 (2000). It is observed that shareholder value is not a viable principle for industrial and commercial companies which would have to compete for product market supremacy rather than capital market supremacy, prioritizing therefore a different set of interests, namely product innovation versus returns on equity holders.

19. *See* MITCHELL, *supra* note 16, at Introduction.

20. *See* Beate Sjafjell, *Regulating Companies as if the World Matters: Reflections from the Ongoing Sustainable Companies Project*, 47 WAKE FOREST L. REV. 113, 129–30 (2011) (reflecting on European and Nordic Company Law).

21. *See generally* Andrew Johnston, *Reforming English Company Law to Promote Sustainable Companies*, 11 EUR. COMPANY L. 63 (2014).

22. *See generally* Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (analyzing the interplay between different corporate groups).

23. *See* Vincenzo Bavoso, *Sustainable Companies Through Enlightened Boards: Combining Private and Public Interest in the Decision-Making of Large Public Firms*, 11 EUR. COMPANY L. 90, 90–93 (2011).

"managerialism" originally noted by Berle.[24] A brief illustration of the above contextualizes the discussion of the role of shareholder value as a mechanism of corporate decision-making.

In the case of BP, the oil spill unveiled the inadequate supervision of high-risk activities related to oil extraction. The nature of BP's business and the repercussions of its activities on local communities in the Gulf of Mexico prompted reflections on how the company was balancing different interests[25] and the extent of its approach to corporate social responsibility (CSR).[26] It has been observed that BP repeatedly bypassed environmental legislation in order to achieve short-term profits flowing from its oil extraction activities.[27] BP's business, in other words, was primarily focused on profitability,[28] and the company acted in a socially responsible way only insofar as this could contribute to its "green image," or when it would not hinder profitability.[29] Decision-making at the board level showed that environmental concerns, and more generally CSR, were considered subordinated interests to the creation of short-term profits for shareholders. As it became evident, this went to the detriment of many stakeholders whose interest was not represented on BP's board.

The facts of Royal Bank of Scotland (RBS) and its nationalization prove the same points. In the pre-crisis years, RBS had become particularly engaged in subprime lending, exposing the bank to high risks related to complex structured finance products.[30] While the company profited enormously from participating in this market, it failed to oversee the risks that were accruing due to increased levels of leverage and the insufficient capital that RBS was operating with. Ensuing problems of liquidity meant that the bank was highly vulnerable to market shocks.[31] As it is well known, RBS' perilous position was further aggravated by the decision to acquire ABN Amro in 2007. This was driven, *inter alia*, by desires to further increase the bank's asset growth. It also, however, resulted in increasing RBS's exposures to asset classes that were the subject of market concerns.[32] When

24. *See* BERLE & MEANS, *supra* note 2, at 78.

25. *See* Nick Lin-Hi & Igor Blumberg, *The Relationship Between Corporate Governance, Global Governance, and Sustainable Profits: Lessons Learned from BP*, 11 CORP. GOVERNANCE 571, 574–75 (2011).

26. *See* Tineke Lambooy et al., *The Corporate Responsibility to Remedy (3rd Pillar Ruggie Framework) - Analysis of the Corporate Responses in Three Major Oil Spill Cases: Shell – Nigeria; BP – US (the Gulf); Chevron – Ecuador*, (U. of Oslo Fac. of L., Research Paper No. 2011-26 (2011)), *available at* http://ssrn.com/abstract=1953190.

27. Miriam A. Cherry & Judd F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983, 997, 1037 (2011).

28. *See* Gordon, *supra* note 12.

29. *See* Cherry & Sneirson, *supra* note 27, at 1014–15.

30. *See generally* FIN. SERVS. AUTH., THE FAILURE OF THE ROYAL BANK OF SCOTLAND (2011).

31. *Id.* at 159–63, 267.

32. *Id.* at 324.

the market eventually collapsed in 2008, the magnitude of losses and write-downs at RBS forced the government to effectively nationalize the bank.[33]

The failure of the Scottish bank epitomized a business model in the banking industry, conceived to maximize rates of return on equity through aggressive asset growth and minimization of capital and funding risk.[34] In essence, this increased short-term gains for shareholders, while the business risk was externalized onto other stakeholders and society.

Notwithstanding the lessons from recent and past crises, corporate law has remained anchored to a legal form that is very close to that of its initial modern codifications.[35] Despite reviews and law reforms, it has been observed that the current form of company law increasingly shows its inefficiency to face the ever-changing challenges that are posed by new corporate structures and by the ubiquitous influence of capital markets on corporate strategies.[36] This is the case especially in the context of leveraged financial institutions where the risk-bearers are not only the shareholders, but a broader range of stakeholders.[37] However, while large public corporations play a prominent role in society, their actions vis-à-vis societal stakeholders remain unregulated or neglected by company law. This is largely due to the narrow framework that is widely accepted as being the mandate of company law, focusing chiefly on the relationship between shareholders and directors (i.e., the agency problem), and giving way to the shareholder primacy assumption.[38] Under this view, the regulation of other relationships, namely those affecting social stakeholders or the environment, should be left to contractual negotiations or to specific regulation external to company law.[39]

The GFC, and the cases highlighted earlier, represent an ideal case study to support the contentions made in this Article. Firstly, that the process of corporate decision-making has been flawed and it has failed to correctly appreciate issues of risk-taking.[40] Secondly, that corporate decision-making

33. *Id.* at 319 (chronology).

34. *See* Marco Onado, *Northern Rock: Just the Tip of the Iceberg*, *in* THE FAILURE OF NORTHERN ROCK: A MULTI-DIMENSIONAL CASE STUDY 99, 107 (2009).

35. *See* The Companies Act 1862 (UK) (which followed from the Joint Stock Companies Acts of 1844 and 1856), which is widely recognized as the first comprehensive set of rules governing companies.

36. This has been argued by Simon Deakin, *Corporate Governance and Financial Crisis in the Long Run (Cambridge U. Centre for Bus. Res., Working Paper No. 417)*, *in* CBR RESEARCH PROGRAMME ON CORPORATE GOVERNANCE 1, 7–8 (2010).

37. It is observed that the ultimate risk-bearers in financial institutions are not the shareholders, but taxpayers, by virtue of the implicit government bailout mechanisms. *See* Edward J. Kane, *A Theory of How and Why Central Bank Culture Supports Predatory Risk-Taking at Megabanks* (Inst. for New Econ. Thinking, Working Paper No. 34, 2015).

38. *See* Johnston, *supra* note 21, at 63–64 (Johnston argues that this assumption is flawed, and policy-makers should consider broadening the scope of company law in order to take into account the interest of a wider range of stakeholders.).

39. MARK MOORE, CORPORATE GOVERNANCE IN THE SHADOW OF THE STATE 64 (2013).

40. In the financial sector, risk-management is a central task of the board because of the systemic risk attached to certain products; these risks however, were repeatedly ignored or misstated in the

can have an impact on a wide range of constituencies both within and outside the corporate vehicle. In most cases though, these constituencies—namely consumers, employees, creditors—have no say on how the company should be run, and are not empowered by company law mechanisms to hold the board accountable.[41]

II. A CRITICAL VIEW OF THE EXISTING MODELS OF CORPORATE MANAGEMENT

A. THE QUESTION OF LEGITIMACY AND PUBLIC ACCOUNTABILITY IN LARGE PUBLIC CORPORATIONS

The questions raised in the previous section lead to the fundamental task of finding sources of legitimacy to the decision-making process in large public corporations. Before providing a critique of the two guiding criteria of corporate management, this section delineates the difficulties associated with directing and controlling BoDs' decision-making.

Traditionally, the central concern within UK and U.S. corporate law has been related to the regulation of the agency problem.[42] This flows directly from the delegation of managerial powers to the board and the resulting separation of ownership and control.[43] The divorce of the two main components of corporations (equity ownership and the relating management) triggered the necessity to find a model of corporate governance that provided legitimization to the decision-making process within large public corporations. The resulting problem of managerial hegemony was initially identified by Berle, who recognized that the modern corporate form epitomized by dispersed ownership gave rise to a control void.[44] While this was considered an intrinsic feature of the modern corporation, it posed questions of accountability and legitimacy.[45] It is useful to appraise here how

years prior to the crisis. *See generally* HOUSE OF COMMONS, TREASURY COMMITTEE, THE RUN ON THE ROCK, 2007–08, HC 56–I (UK); *see also* U.S. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011).

41. Under UK and U.S. law, the board of directors is delegated managerial power over all but the most important issues (where shareholders' consent is needed), and is accountable to shareholders. This accountability link is problematic because the board is only constrained by what shareholders perceive as acceptable. In the case of RBS for instance, as well as other banks involved in the GFC, shareholders were not able to assess whether the profit-making strategies carried out by the board were socially acceptable and in the interest of the market as a whole. *See generally* Joan Loughrey, *Breaching the Accountability Firewall: Market Norms and the Reasonable Director*, 37 SEATTLE U. L. REV. 989 (2014).

42. *See generally* Eugene F. Fama, *Agency Problem and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

43. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301–02 (1983).

44. *See* BERLE & MEANS, *supra* note 2, at ch. V.

45. *Id.* at 119–40.

the pioneering work conducted by Berle approached the problem that is today persisting in contemporary corporate governance.

Interestingly, despite acknowledging the development of capital markets as a means of capital allocation, Berle remained dismissive of the powers of the market as a discipline mechanism over managerial behavior. This stemmed from Berle's doubts on the informational efficiency of capital markets, which he argued were reflected in the irrationality of investors' decision-making and in their incentives to choose strategies often not aligned with the long-term interest of the firm.[46] As Berle was also cognizant of the increasingly externalized (and arguably residual) role of shareholders in the governance of corporations,[47] the main source of direction over corporate decision-making rested on professional managers who were tied to the company through trust and property law mechanisms.[48] While this did not solve the accountability deficit and, if anything, further exacerbated it, Berle also developed a theory of "public consensus" based on the existence of a set of values endorsed by the community, and often by the corporation too. In Berle's rather optimistic view, the company's decision-makers would not disregard the interest of the community due to citizens' increasing influence on corporate affairs.[49] Moreover, under this design the public consensus would be enforced on managers because of a "corporate conscience," represented by managers' perception of the public consensus.[50] This is close to what is recognized today as a firm's reputation, described as "loss of prestige, public standing and popular esteem," which would undermine the public trust toward the corporation.[51] This represented a first level of informal constraint over corporate decision-making according to Berle, and it would be supplemented by more forcible measures in the shape of regulation, reflecting the democratic force of the state reacting to a violation of the public consensus.[52]

The idea that management would not act in a way that is contrary to what is perceived as "public good" represented probably an overvaluation of the democratic mechanisms available to the general public. Enforcing the lack of consensus against corporate power (the board) was and remains today a prerogative of shareholders, both in the United Kingdom and in the United

46. *Id.* at Introduction.

47. *See* Marc T. Moore & Antoine Reberioux, *Corporate Power in the Public Eye: Reassessing the Implications of Berle's Public Consensus Theory*, 33 SEATTLE U. L. REV. 1109, 1116–17 (2010).

48. *See* BERLE & MEANS, *supra* note 2, at 219–43.

49. The idea of public opinion was initially introduced in *The Modern Corporation and Private Property*, and was later expanded in *Power without Property: A New Development in American Political Economy*. *See* ADOLF A. BERLE, POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY (1959).

50. *Id.* at 90–91.

51. *Id.* at 91.

52. *Id.* at 114–15.

States.[53] In this sense then, the control void identified by Berle remained legally unresolved, especially given his lack of faith in shareholders to be able to bring about accountability in a wider context. This legal problem persists today given that shareholders are unable to assess the extent to which strategies endorsed by the board are socially acceptable or aligned to wider interests.[54]

This argument is even stronger today, because institutional shareholders (representing a large slice of the shareholder population in the United Kingdom and the United States) are increasingly identified with hedge funds and similar investment vehicles.[55] These entities hold stock for short periods of time, averaging eight months, and therefore tend to have little interest in the company's long-term success, with their main concern being represented by quarterly gains.[56] Ultimately, the solution to the accountability problem envisaged by Berle seemed to be a "least bad" scenario, with corporate power held by professional managers only theoretically accountable to a community consensus.[57]

It is realistic today to say that accountability hinges on a private-type legal relation between those who hold decision-making powers (the board) and those who are seen as beneficiaries of those managerial power (shareholders).[58] These private arrangements are, in most cases, inadequate for two main reasons. Firstly, because from a legal perspective, as highlighted earlier in this Article, this leaves the board unaccountable to a number of constituencies (all but the shareholders in fact). Secondly, the multidimensional nature of large public firms, with different layers of management and a multitude of interested stakeholders, sits very oddly with a mono-dimensional accountability framework that essentially relies on the wisdom of one constituency in the company. This leaves an open question, not only in terms of accountability, but more importantly of legitimacy. As already stated, finding new forms of legitimacy to the decision-making process of large public corporations remains an open task in corporate law scholarship.

The question has been reprised by John Parkinson, who in more recent times stressed the importance to find a public interest justification of corporate power.[59] The central argument of Parkinson's work was the

53. *See* Bavoso, *supra* note 14, at 215.

54. Loughrey, *supra* note 41, at 1008–10.

55. Andrew R. Keay, The Global Financial Crisis: Risk, Shareholder Pressure, and Short-Termism in Financial Institutions – Does Enlightened Shareholder Value Offer a Panacea? 10–11 (2011) (unpublished manuscript) *available at* http://ssrn.com/abstract=1839305 [hereinafter Keay, The Global Financial Crisis].

56. *Id.*

57. BERLE, *supra* note 49, at 109 (Berle defines management as a "government of best minds.").

58. Marc T. Moore, *The Neglected Value of Board Accountability in Corporate Governance*, 9 L. & FIN. MKT. REV. 10, 13 (2015).

59. *See generally* PARKINSON, *supra* note 11, at 21.

recognition of public corporations as a force capable of shaping society. As such, the public outcome of private (internal) decision-making needed to be legitimized so that modern corporations could provide some form of public or social purpose to the wealth they created. In essence, he viewed large public firms as forms of social enterprises.[60] This line of thought has been supported by both legal and political theory. In particular, it has been maintained that the possession by private companies of decision-making power which has a social dimension is legitimate only if decisions are taken in the public interest.[61] It follows that society is entitled to ensure that corporate power is exercised in a way that is consistent with the public interest.[62] Ultimately, Parkinson's argument was not aligned with the conventional wisdom prevailing over the last three decades—that pursuing shareholder value would bring about benefits for all other stakeholders and more generally that profit maximization was conducive to public interest goals.[63]

The agenda espoused by Parkinson reflected to some extent the work of Eric Orts, who, again in sharp contrast with the direction of mainstream corporate scholarship, contended that corporate law should provide a framework for legal and political legitimacy of decision-making.[64] This should take account of the technical and normative complexity of the underlying process and therefore should result in more detailed standards of behavior. While Orts accepted that the advocated legal and technical process would increase complexity, he argued that this would be offset by the social benefits deriving from the resulting standards.[65]

At this stage of the discussion it needs to be specified that the problems so far debated are originally related to the Anglo-American corporate ownership structure and its model of corporate governance. However, it has been argued by Professor Mitchell that this model has been exported globally,[66] together with the process of "financialization" of corporate governance, which inevitably attenuated the difference between shareholder

60. *Id.* at 23.

61. *Id.*

62. *See* Melvin A. Eisenberg, *Corporate Legitimacy, Conduct and Governance—Two Models of the Corporations*, 17 CREIGHTON L. REV. 1, 6 (1983).

63. PARKINSON, *supra* note 11, at 41–42 (contending that there was no conclusive evidence suggesting that profit maximization is consistent with public interest).

64. Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1596 (1993).

65. *Id.*

66. MITCHELL, *supra* note 16, at 7. Mitchell observes that globalized consulting, accounting, and law firms sell advice based on shareholder value to companies in Europe and globally, and they sell the U.S. way of doing business; moreover, legal and business consultants have contributed to drafting Corporate Governance Codes in developing countries and imposed a model of Corporate Governance based on shareholder value. *Id.*

and stakeholder orientations.[67] The global integration of financial markets that occurred from the 1990s was mainly prompted by ideological developments from the United Kingdom and the United States. These were grounded on the undisputed reliance on market discipline and shareholder value, and similarly, global financial institutions promoted the application of the shareholder-oriented model across many different jurisdictions.[68] However, as discussed earlier, there has been no end of history in corporate law. Scandinavian countries, as well as Germany or France, have maintained a more balanced approach to corporate governance and financial development by prioritizing issues of social stability and welfare.[69] This argument is important for the present discussion because it shows that a different model to control and direct corporate decision-making is possible and it is eventually rooted in different ways to regulate corporate relationships.[70] This fundamental differentiation originates from a different idea of corporation that emerged in Germany and other northern European countries, and is still reflected today in a process of decision-making that allows greater centrality to employees' interests.[71]

Early German companies were already concerned with general welfare interests and were geared toward social goals rather than simply the pursuit of profits for shareholders, which characterized their UK counterparts.[72] German companies were the product of a different regulatory framework which reflected a type of capitalism centered on cooperation and pluralism, where the state retained a central, and at times intrusive, role in steering market players' behavior toward these goals.[73] Similarly, German financial markets were traditionally characterized by the overwhelming role of large banks vis-à-vis securities markets, which entailed a more limited access for corporations to disintermediated sources of finance and less interdependence with market logics.[74]

67. *See* Susanne Lutz & Dagmar Eberle, *On the Road to Anglo-Saxon Capitalism? German Corporate Governance and Regulation Between Market and Multilevel Governance* (FernUniversität in Hagen, CLPE Research Paper 4/2007), *available at* https://ssrn.com/abstract=988696.

68. Hansmann & Kraakman, *supra* note 17, at 451.

69. *See* Williams, *supra* note 18, at 12. This also entailed that the interplay between corporate decision-making and capital market logics remained lower. For a relevant overview, *see* Mark J. Roe, *German Codetermination and German Securities Markets*, 5 COLUM. J. EUR. L. 199 (1999); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 539–606 (2000).

70. *See* Williams, *supra* note 18, at 11–12.

71. *See* Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret M. Blair & Mark J. Roe ed., 1999).

72. *See* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 80 (2003).

73. *Id.* at 90–93.

74. *See* Horst Siebert, *Germany's Capital Market and Corporate Governance* (Kiel Inst. for the World Econ., Working Paper No. 1206, 2004).

The challenges of directing decision-making processes in a more inclusive way seems thus to be traditionally related to the Anglo-American model of corporate governance, based on large public companies with dispersed shareholding, driven by the pursuit of profits for shareholders.[75] The following section will clarify this contention by illustrating the shortcomings of the two main models of corporate governance: shareholder value and stakeholder theory.

B. A CRITIQUE OF SHAREHOLDER VALUE

Since the 1930s, corporate law scholars have strived to address the fundamental question of the corporate objective and clarify what constituency should be identified as main beneficiary of corporate decision-making. This debate originated at Harvard, around the contrasting views of professors Berle and Dodd.[76] The crux of the dispute was reflected in the dichotomy between a minimalist and a maximalist stance on corporate governance.

Professor Berle's approach was grounded on the configuration of managerial powers as powers held in trust, whereby the beneficiaries of that trust should have been the shareholders as owners of the firm. This minimalist position was grounded in Berle's view of property law mechanisms as tools to protect shareholders by creating legal safeguards against management's deviation from the ultimate profit goal.[77] Professor Dodd, on the other hand, advocated what was defined as a maximalist vision of corporate governance, whereby the powers held by management were not to be conceived only for the pursuit of shareholders' wealth, but for the benefit of other social groups too.[78]

The seeds of this quest have flown in more recent times into what has substantiated the corporate objective dilemma. As already announced, this is reflected in two models of corporate management that provide diverging approaches to the problem of controlling and directing decision-making: shareholder value and stakeholder theory. As will be explained in the following sections, these two paradigms originated from very diverging politico-economic assumptions developed in the 1970s and it is fair to say that the recent GFC has contributed to reassess their appropriateness. A critique of both models will be useful to better understand the difficulty to channel corporate activities and provide sound mechanisms of

75. Johnston, *supra* note 21, at 65 (observing that smaller companies tend to be subject to greater social control and are naturally constrained by social norms with respect to the effects that their decision-making creates).

76. *See generally* E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf A. Berle, *For Whom Managers are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

77. *See generally* Berle, *supra* note 76, at 1365.

78. *See generally* Dodd, Jr., *supra* note 76, at 1145.

accountability. This critique will also pave the way for the proposal of a new paradigm, the ESC, as an alternative model of corporate decision-making.

The foundation of shareholder value lies in the emergence of financial-economic theories in the early 1980s, which in turn stemmed from the strong neoliberal consensus that occurred in the same period, chiefly in the United Kingdom and the United States.[79] In the context of corporate governance, this translated into the development of "contractarian" theories of the firm by law and economics scholars, who identified the company as a nexus of contracts among different constituencies, with shareholders recognized as owners and residual claimants.[80] This economics-centric approach advanced the concept of economic efficiency which in turn justified the corporate goal of maximizing returns for shareholders as the best possible allocation of resources.[81]

It is worth repeating that the prioritization of shareholders ahead of other stakeholders became more critical in the last twenty years due to the increasing influence of capital markets on corporate strategies.[82] Deep and liquid stock markets were relied upon as sources of information in regard to the value of stock[83] and as monitoring mechanisms.[84] This was exemplified more typically by the employment of stock options and other forms of market-based compensations which were envisaged as an ideal tool to align the interest of management and shareholders.[85]

The assumptions that justified the application of shareholder value have however, become unpopular in recent years. The corporate scandals that occurred during the last decade and the GFC contributed greater strength to the critics of shareholder value.[86] This section lays out some of the arguments brought against the shareholder value paradigm.

The first strong argument made by legal scholars is that the economic conception of shareholders' ownership is misguided. It overlooks the fact that by law, shareholders are merely owners of the shares they hold and not of the

79. *See* PARKINSON, *supra* note 11, at ch. 4.

80. FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36–39 (First Harvard Univ. Press paperback ed., 1991).

81. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33.

82. Lawrence E. Mitchell, *Financialism: A (Very) Brief History*, 43 CREIGHTON L. REV. 323 (2010).

83. *See* Marc T. Moore & Antoine Reberioux, *Revitalizing the Institutional Roots of Anglo-American Corporate Governance*, 40 ECON. & SOC'Y 84, 88–89 (2011).

84. EASTERBROOK & FISCHEL, *supra* note 80 (Financial markets were seen as a way to counter "managerialism.").

85. *See generally* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 20 ACAD. OF MGMT. PERSP. 8 (Feb. 2006).

86. *See* Andrew Keay, *Shareholder Primacy in Corporate Law: Can It Survive? Should It Survive?*, 7 EUR. COMPANY & FIN. L. REV. 369 (2010); STOUT, *supra* note 14; MITCHELL, *supra* note 16; Paddy W. Ireland, *Company Law and the Myth of Shareholder Ownership*, 62 MOD. L. REV. 32 (1999).

company.[87] This entails that rights and expectations are limited by law to what flows from their shares (typically a right to vote, and receive dividends) and this automatically defies the rhetoric of ownership that has essentially redefined the property rights of one constituency in the corporation.[88]

Similarly, the identification of shareholders as residual claimants has been strongly refuted. The rationale for the assumption was that unlike other constituencies who have a right to a fixed claim (such as employees, managers, creditors) shareholders rely on whatever remains after the company has paid its fixed claims.[89] Law and economics scholarship argued that shareholders, as ultimate risk-bearers, have the greatest stake in the company and should benefit from it being run for the purpose of maximizing the value of stock.[90] This construction however, is based on an incorrect proposition because, as pointed out by Lynn Stout, shareholders are treated by corporate law as residual claimants only when the company is insolvent.[91] Outside insolvency, shareholders are entitled by corporate law mechanisms to receive payments only if the company has retained sufficient profits, and if the board declares dividends to be paid.[92]

Together with the above two points, shareholder value rests on another assumption that derives from the economic—rather than legal—configuration of the company, namely the principal-agent model. This is closely linked to the contractarian view of the company advocated by Michael Jensen and William Meckling in the late 1970s and then consolidated in more recent scholarship.[93] The principal-agent model has,

87. STOUT, *supra* note 14, at 37; Ireland, *supra* note 86, at 32–33. This legal stance also draws on the legal definition of shares provided by courts in England. *See* Short v. Treasury Comm'rs [1948] 1 KB 116.

88. Margaret M. Blair, *Shareholder Value, Corporate Governance, and Corporate Performance, A Post-Enron Reassessment of the Conventional Wisdom*, *in* CORPORATE GOVERNANCE AND CAPITAL FLAWS IN A GLOBAL ECONOMY 53, 57 (Peter K. Cornelius & Bruce Kogut eds., 2003).

89. EASTERBROOK & FISCHEL, *supra* note 80, at 36. The authors suggested that in most firms, the risk-bearers will have an expectation (or they will have contracted) for a promise to see the value of their stock maximized. Unlike other participants in the firm, who will have contracted for fixed claims, risk-bearers receive a residual claim to the firm's profits. The authors went on to emphasize how this configuration of fixed and variable claims would serve an economic function. *See id.*

90. *Id.* at 37. The assertion by Easterbrook and Fischel here is grounded in the belief that investment by shareholders is based on a promise to maximize the value of stock. If that promise is not maintained, it will be difficult to raise new money, because prospective investors would not trust the promise to maximize shareholder value. This, in turn, would lead to undesirable consequences in the economy because the general level of investments would collapse.

91. STOUT, *supra* note 14, at 40 (observing that outside bankruptcy, it is wrong to suggest that shareholders are entitled to whatever is left once the company's obligations are paid).

92. *Id.* This leads to concluding that shareholders are just one of several groups that can be described as residual claimants, in the sense that they can enjoy benefits beyond those provided in their explicit contracts.

93. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. OF FIN. ECON. 305, 310–12 (1976); EASTERBROOK & FISCHEL, *supra* note 80, at 36–39; Hansmann & Kraakman, *supra* note 17, at 439.

however, been strongly criticized for failing to capture the essence of large public firms. The structure of these entities is based on many fractional shareholders and different organizational layers of management, which go clearly beyond the simplification proposed by the principal-agent model.[94]

One of the presumed advantages associated with the shareholder model is the direct accountability that it creates, because shareholders would be motivated to monitor the board. This assertion has become contentious for two reasons. Firstly, because the degree of accountability is not evident in large public corporations, where the effective powers of shareholders to control the board and shape its decision-making is not substantial enough.[95] Secondly, it is observed that shareholders are not a monolithic category, as they encompass different categories and types of investors. Beyond having different preferences and interests in the company, their involvement in the company's affairs will also vary.[96]

Much of the criticism against shareholder value in the last ten years has revolved around the increased interplay of corporations with financial markets. In particular, the belief that share prices are a reliable measure of the value of the company has been contradicted. While deep and liquid stock markets do respond quickly to new information, it has become evident that share prices deviate substantially from their value through periods of boom and bust.[97] This has a number of explanations, primarily identified with the complexity of financial information that is transmitted to the market and the difficulty to process it correctly.[98] Behavioral explanations are also put forward because markets tend to overreact, leading to investors' herding behavior and other socio-pathological phenomena. This translates into stock prices going out of line, moving upward or downward, regardless of the fundamentals.[99] More generally, share price can be misrepresented by market or industry fluctuations which do not necessarily reflect the real value of the company.[100]

94. STOUT, *supra* note 14, at 36.

95. *See* Andrew Keay, *Company Directors Behaving Poorly: Disciplinary Options for Shareholders*, J. OF BUS. L. 656 (2007) (arguing that shareholders' powers vary and are more effective in the United Kingdom than in the United States, but still, they do not amount to a reliable accountability mechanism to hold directors responsible if they fail to maximize share value).

96. *See* Keay, *Ascertaining the Corporate Objective*, *supra* note 3, at 672.

97. *See* Lynn A. Stout, *Stock Prices and Social Wealth* 10, 21 (Georgetown Univ. Law Ctr., Law & Economics Research Paper No. 24,9991, 2000).

98. *See generally* Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. UNIV. L. REV. 2 (2009).

99. Blair, *supra* note 88, at 59; Emilios Avgouleas, *The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy*, 9 J. CORP. L. STUD. 23, 33 (2009). Avgouleas explains that investors' herding behavior (as well as other forms of cognitive bias, such as overconfidence) is what also contributes to (or directly causes) irrational price changes.

100. *See* Thomas Clarke, *Accounting for Enron: Shareholder Value and Stakeholder Interests*, 13 CORP. GOVERNANCE 598, 598 (2005).

In essence, share price has been tainted as an unreliable index of corporate success. This became evident after Enron, which showed how manipulated and misleading information could be released into the market. The pressure to maximize shareholders' wealth led executives to pursue short-term strategies finalized at inflating the company's share value, mainly through accounting manipulations or complex off-balance sheet transactions.[101] In other words, pursuing the quarterly growth of share price became the main goal of management, regardless of the company's fundamentals.

This problem was accentuated by the application of stock options, employed as corollaries of shareholder value to guarantee a strong link between firm's performance and managers' remuneration, whose interests would remain aligned with shareholders.[102] The main problem of stock options is the incentive they create to pursue risky strategies. This is due to the intrinsic moral hazard they involve, because option-holders win big if the option goes up but are not penalized if the stock price plunges.[103] Shareholders' limited liability allows benefiting from high risks and high levels of leverage because they can reap the gains of the investment, while the underlying risks are borne by other stakeholders.[104] In highly-leveraged financial institutions in particular, the opportunity for rapid expansion of financial assets and short-term returns on equity has led to excessive risk-taking.[105] Stock options have exacerbated executives' incentives to speculate through risky transactions because the more valuable the options, the more risky the underlying investment.[106]

The criticism toward executives' pay is often associated with more general concerns over the suitability of market mechanisms to control managerial behavior and direct decision-making toward the long-term interest of the company. Much scholarship has been dedicated to clarifying whether the market for corporate control (in the shape of hostile takeovers) could represent a valid corporate governance tool. While no conclusive

101. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

102. *See* Blair & Stout, *supra* note 22, at 249 (for an understanding of the relationship and dynamics between different corporate constituencies). Executive compensation, such as stock options, was conceived as a mechanism to align the interests of shareholders and management, mitigating thus the agency problem that is typical of widely-held corporations. Conventional wisdom since the 1980s has advocated the application of these equity-based incentives, which would spur executives toward the goal of achieving increases in share value. *See* Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. OF CORP. L. 189, 203–04 (2014).

103. Stuart L. Gillan, *Option-Based Compensation: Panacea or Pandora's Box*, 14 J. OF APPLIED CORP. FIN. 116 (2001).

104. Sepe, *supra* note 102, at 204, 217.

105. Emilios Avgouleas & Jay Cullen, *Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship*, 20 COLUM. J. OF EUR. L. 1, 7–9 (2015).

106. On the distorting effect of leverage, *see generally* Margaret Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225 (2010).

evidence has been produced in this sense,[107] shareholder value proponents supported the assumption that the threat of takeovers would constitute a sufficient discipline mechanism on the board and that liability rules and statutory mechanisms would be superfluous.[108] Against this proposition, it has been argued that hostile takeovers often have detrimental effects on employees and other stakeholders,[109] and they exacerbate short-termism when executives engage in "empire-building" strategies,[110] something that was feared in the context of the recent AstraZeneca's attempted takeover. Despite providing an allocative function of corporate resources, hostile takeovers' role as a corporate governance mechanism has been largely redefined as a residual one, whereas other internal tools should provide the necessary control of managerial decision-making.[111]

C. A CRITIQUE OF STAKEHOLDER THEORY

The stakeholder theory originated from social-democratic ethos that were developed in the post-war years and were later channeled into a communitarian philosophy. This envisaged a more inclusive and multidimensional approach to corporate law.[112] The ideology was more clearly defined in the 1980s when the concept of stakeholder was integrated within organizational behavior studies.[113] It posited that beyond shareholders, other constituencies contribute to the corporation and their interests too deserve consideration, particularly because they are often not covered by contractual provisions.[114]

Traditionally, German corporate law epitomizes a typical stakeholder approach with its codetermination system. This grants employees certain powers in the management of the company by allowing employees' representatives to sit on the supervisory board.[115] In essence, the fundamental

107. *See* B. Clarke, *Where Was the 'Market for Corporate Control' When We Needed It?, in* CORPORATE GOVERNANCE AND THE GLOBAL FINANCIAL CRISIS: INTERNATIONAL PERSPECTIVES 75 (W. Sun, J. Stewart et al. eds., 2011); PARKINSON, *supra* note 11, at 113.

108. PARKINSON, *supra* note 11, at 132–34. It was suggested that the effect of implementing legal regulation on top of what is already provided by the market would be an inefficient distortion of managerial behavior.

109. Deakin, *supra* note 36, at 15–16.

110. *See generally* Ajit Singh, *Take-overs, Economic Natural Selection, and the Theory of the Firm: Evidence from the Postwar United Kingdom Experience*, 85 ECON. J. 497, 497–515 (1975).

111. John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1221 (1984).

112. JOHN GRAY, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM 94 (1999).

113. *See generally* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984).

114. *Id.* at 97. The argument was that the board has a duty to create value for all the actors who are affected by the company's decision-making.

115. *See generally* Mark J. Roe, *German Codetermination and German Securities Markets*, 5 COLUM. J. EUR. L. 199 (1999); *see also* ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW 315, 445 (2010).

feature of stakeholder theory consists of having boards that undertake the function of balancing the interests of different constituencies.

The pluralistic foundation of stakeholder theory has been often pointed at as its main problem. This line of criticism became recurrent in the 1990s in connection with the stagnation of social-democratic economies in continental Europe.[116] It was then suggested that the theory could lead to inefficiency because it did not provide guidelines as to how the board should balance different (possibly conflicting) interests and it did not even define the concept of stakeholder, therefore leaving a problem of subjectivity in the identification of these interests.[117] The enforceability of stakeholders' rights was also seen as a problem because courts would find it problematic to interfere with subjective boards' policies, trying to impose objective standards.[118] The enforceability of stakeholders' rights is further hindered by the procedural barriers that in most legal systems do not permit all stakeholders to initiate derivative actions.[119]

Another problem associated with the stakeholder theory is the lack of standards to evaluate corporate performances. Departing in fact from shareholder value entails that share price is not relied on as the main metric of corporate success. The absence of equivalent stakeholder standards upon which the management can be evaluated leaves an accountability gap, because under the theory there is no specific constituency that can hold the board accountable. From a different perspective, it would be unlikely that any group will perform an efficient monitoring function on the board for fear of other groups' free-riding.[120]

The above arguments have led to strong criticism on the competitiveness of corporations organized under the stakeholder model. The underlying objection is that departing from shareholder primacy would affect firms' ability to maximize their value because of the impossibility to balance conflicting claims and operate beyond a mono-dimensional (shareholder) goal.[121] Shareholder value proponents argued that this dilemma would be most clearly reflected in the context of takeover bids where the interest of

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116. Hansmann & Kraakman, *supra* note 17, at 451.

117. Elaine Sternberg, *The Defects of Stakeholder Theory*, 5 CORP. GOVERNANCE 1, 4–5 (1997).

118. Sarah Kiarie, *At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?*, 17 INT'L COMPANY & COM. L. REV. 329, 333– 334 (2006).

119. Keay, *Ascertaining the Corporate Objective*, *supra* note 3, at 676. In the United Kingdom, for instance, only shareholders on behalf of the company are allowed to bring a derivative claim. Keay observes that unless they are also members of other stake-holding groups, they will be reluctant to bring an action that will entail costs. *Id.*

120. Jeswald W. Salacuse, *Corporate Governance in the New Century*, 25 COMPANY LAW. 69, 75 (2004).

121. Jensen, *supra* note 15, at 300.

employees is likely to conflict with shareholders and may induce directors to frustrating bids.[122]

This last critique carries also a normative dimension. Stakeholder theory would inevitably broaden the narrow framework that has so far characterized the mainstream Anglo-American approach to corporate law, because it would encompass and directly regulate the social costs created by the company (currently dealt with by external regulation or market mechanisms).[123] Moreover, this approach would be less competitive according to shareholder value proponents because of its less facilitative normative framework.

D. WHY A NEW MODEL?

Much of the critique laid out in the previous sections is supported by corporate scandals that occurred throughout the last fifteen years. In particular, corporate and financial failures have coincided with the breakdown of shareholder value mechanisms: this was true for the Enron-type scandals, for the failures of financial institutions in the United Kingdom and in the United States during the GFC, and for the environmental disasters epitomized by the BP oil spill.[124] The corporate governance dimension of these failures can be identified, *inter alia*, with flawed systems of decision-making. In particular, risk-management and control functions were not adequately conducted by boards whose priorities remained geared toward the increase of share value[125] to the detriment of long-term objectives.[126] This approach to corporate management resulted in the failure to take account of different societal interests that were heavily affected by corporate behaviors.

A more specific manifestation of this unfair societal arrangement is provided by recent events in the financial and environmental industries, which have been illustrated earlier in this Article with the cases of BP and RBS. Admittedly, the failure of shareholder value to provide a valid model of corporate management became evident in the early 2000s with the wave of "accounting frauds" epitomized by Enron. In the context of financial institutions, the centrality of shareholder value has become even more

122. *See* Kiarie, *supra* note 118, at 337; *see generally* THE PANEL ON TAKEOVERS AND MERGERS, THE TAKEOVER CODE (2016).

123. Johnston, *supra* note 21, at 65.

124. *See generally* Bratton, *supra* note 101 (with specific reference to the Enron failure); STOUT, *supra* note 14 (for a broad and strong critique of shareholder value); Cherry & Sneirson, *supra* note 27, at 983 (for an account of the BP oil spill and the corporate governance failures therein); Bavoso, *supra* note 23, at 91.

125. The aim to increase share price in the short-term often underscores empire-building strategies. A topical example is the acquisition of ABN-Amro by Royal Bank of Scotland in 2007, which eventually had disastrous effects on the UK bank that needed public bailout in 2008.

126. *See* RICHARD POSNER, A FAILURE OF CAPITALISM 80 (2009) (explaining that risk managers' activity is not conducive to profit-making and therefore, is often overlooked by the board).

contested.[127] This was recently confirmed by an EU Green Paper that acknowledged a number of problems in the governance of financial institutions.[128] It noted that a presumption of effective shareholder control in financial institutions is misguided because shareholders will be concerned with short-term financial goals instead of the entity's long-term viability.[129]

However, this view has not translated in substantial reforms or shifts in policy directions. On the contrary, despite much criticism (particularly within academic circles[130]) shareholder value has remained the widely accepted criterion of corporate decision-making[131] and policy responses to the GFC have not departed from a shareholder-centric agenda.[132] This tendency shows that, notwithstanding the lessons drawn from recent events, the neoclassical theories advancing shareholder supremacy are still very central to policy-making and law reforms in the area of corporate law.[133] In the United Kingdom, both the Stewardship Code of 2012 and the Corporate Governance Code of 2016 promoted wider shareholder participation in corporate governance. The former followed the recommendation of the Walker Review[134] and set out monitoring responsibilities on shareholders, and recommendations for institutional investors to act collectively to that end and on voting policies.[135] The Corporate Governance Code also promoted enhanced shareholder power specifically with regard to pay-setting procedures.[136]

127. *See* Daniel Ferreira et al., *Measuring Management Insulation from Shareholder Pressure* (LSE Legal Studies, Working Paper No. 01/2016, 2016) (The authors show that banks where management is more insulated from shareholders were less likely to need bailouts.).

128. *See generally Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies* COM (2010) 284 final (June 2, 2010).

129. *Id.* at 8 (The report specified that this attitude reflected shareholders' excessive risk-taking which is in turn encouraged by performance-related incentives for managers.).

130. This emerges from a number of initiatives, which includes the *Sustainable Companies Project*, promoted by Professor Beate Sjafjell at Oslo University. *See The Sustainable Companies Project*, U. OF OSLO, DEP'T OF PRIV. L., https://www.jus.uio.no/ifp/english/research/projects/sustainable-companies/ (last modified Mar. 14, 2016).

131. Bavoso, *supra* note 14.

132. FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2012). In the United Kingdom, this is exemplified by the UK Corporate Governance Code (2016) and by the Stewardship Code (2012), while in the European Union, similar views emerged from the EU Commission Green Paper *The EU Corporate Governance Framework*. *See Commission Green Paper on The EU Corporate Governance Framework* COM (2011) 164 final (Apr. 5, 2011). These Codes, as well as the EU Framework, have maintained a strong shareholder value approach to corporate governance, identifying shareholders as key components in the governance of large corporations and advocating their further empowerment, especially insofar as monitor and control functions are concerned.

133. *See* Lorraine Talbot, *Why Shareholders Shouldn't Vote: A Marxist-Progressive Critique of Shareholder Empowerment*, 76 MOD. L. REV. 791, 809–10 (2013).

134. *See* DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES (2009).

135. FIN. REPORTING COUNCIL, *supra* note 132.

136. *Id.* Section D of the Corporate Governance Code sets out best practices with regards to remuneration. In doing so, it states that shareholders should specifically approve remuneration schemes or significant changes to them. *Id.*

As noted earlier, this approach is misguided in the context of large public corporations. It has been observed that fragmented ownership and foreign investments are not conducive to shareholders' enhanced participation[137] because the interest of this type of shareholder is largely geared to short-term quarterly gains,[138] and active engagement in corporate governance represents costs that would reap economic benefits only in the longer term. This assertion is confirmed by shareholders' votes in 300 annual general meetings in 2012 where, on average, votes against remuneration reports reached only 7.64%.[139]

One of the reasons for the resilience of shareholder value over the last fifteen years is the absence of an alternative model, given the mistrust in the United States and the United Kingdom, for stakeholder-based theories which are regarded as fundamentally impractical.[140] The flaws associated with shareholder-based decision-making processes, however, can no longer be neglected. Placing one constituency at the center of very complex and multidimensional organizations has proven unjustified[141] and socially destabilizing. The corporate governance failures, of which mention has been made, have created externalities on a number of constituencies whose interests were not adequately considered by BoDs, notably: employees, taxpayers, consumers, local communities, and the environment. Notwithstanding the potential harm to large sections of society, complex risks (such as environmental or financial) in large public firms were consistently understated by executives who were kept myopically focused, due to perverse market incentives, on the pursuit of short-term goals.

The question as to why risks were not properly gauged is a complex one. Assessing and managing risks is among the most critical aspects of the decision-making process of large public firms. While this delicate process has resulted in unsatisfactory outcomes, it needs to be explained that in many circumstances, warning signs were raised by risk-managers within firms. Richard Posner has argued that BoDs driven by shareholder value goals are more likely to ignore red flags, chiefly because the function of risk-managers is not aligned with the overarching profit-making objective.[142] On the other hand, boards tend to rationally follow traders who pursue short-term profits driven by market-based incentives.[143]

The way in which risks have been underestimated in large public firms can also be explained through the mechanics of risk perception in boards.

137. *See* Brian Cheffins, *The Stewardship Code's Achilles' Heel*, 73 MOD. L. REV. 1004, 1024 (2010).

138. Keay, The Global Financial Crisis, *supra* note 55, at 11.

139. Talbot, *supra* note 133, at 814.

140. *See* Keay, *Ascertaining the Corporate Objective*, *supra* note 3, at 679.

141. It is worth reiterating that the law does not mandate so in both the United Kingdom and the United States. *See* STOUT, *supra* note 14; Bavoso, *supra* note 14.

142. POSNER, *supra* note 126, at 80.

143. *Id.*

Behavioral studies have examined how psychological and cultural forces alter risk perception in large firms and thus affect decision-making. Donald Langevoort has observed that overconfidence in periods of boom leads to persistence, effort, and enhanced risk-taking, which will outperform more realistic and cautious strategies.[144] Overconfidence, especially in times of boom, becomes embedded in the corporate culture and will result in common bias in the organization, which also risks affecting the perception of those who conduct external assessments.[145] It is correct to say that the way risk is perceived within an organization becomes institutionalized because of psychological and cultural forces that will make individuals believe that there is no risk big enough to worry about.[146] In the context of decision-making processes, overconfidence toward risk can become a self-fulfilling prophecy in times of good fortune. It is also true that overconfidence before the crisis was fueled by the availability of risk modeling and risk mitigation techniques that further affected individuals' cognitive bias and led to institutional underestimation of risk.[147]

Boards' decision-making was also driven by investors' expectations. Keeping the stock price inflated required firms to keep "dancing,"[148] because this form of behavior was deemed functional to maintain a competitive edge over other firms (especially in the financial sector) and satisfy investors' demands for quarterly gains.[149] This suggests that beyond the behavioral explanation of investors' irrational exuberance, stock prices were fundamentally mispriced because firms failed to disclose information to allow the accurate assessment of risk.[150] In other words, if share price remains the metric for corporate management, the distorted reactions of the stock market will likely produce biased behavior among investors and affect decision-making at board level.[151]

144. Donald Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk-Taking*, 96 CORNELL L. REV. 1209, 1221 (2011); *see generally* GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DIVES THE ECONOMY 11–18, 86 (2009).

145. Langevoort, *supra* note 144, at 1220–23 (The inside bias will influence non-executive directors and also gatekeepers because they will tend to believe in the inaccurate disclosure produced by those who have inside knowledge.).

146. *Id.* at 1242. The institutionalized perception therefore overrides the individual one and defies the assumption that managers act rationally.

147. *Id.* at 1221. Posner, however, argued that excessive risk-taking was primarily due to wrong incentives and moral hazard rather than psychological factors. *See* POSNER, *supra* note 126, at 80.

148. This term is borrowed from the sentence used by Citigroup CEO Chuck Prince, who stated at the outset of the 2008 crisis that "you've got to get up and keep dancing." This refers to strategies at firm level that would positively affect the stock price, hence the wilder the dancing, the higher the stock price. *See Citigroup's Chuck Prince Wants to Keep Dancing, and Can You Really Blame Him?*, TIME (July 10, 2007), http://business.time.com/2007/07/10/citigroups_chuck_prince_wants/.

149. Langevoort, *supra* note 144, at 1231.

150. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 654 (2010).

151. Langevoort, *supra* note 144, at 1233.

The brief behavioral explanations of corporate decision-making show that risk-management functions have been hindered by cultural and organizational factors. This means that the cognitive dimension of this fundamental function has been dominated by profitability instead of an objective assessment of risks.

A final note needs to stress that the Anglo-American shareholder-centric model of corporate governance has relied since the 1980s on non-executive directors (NED) to bring an independent outside perspective to the company's decision-making. The collapse of financial institutions during the GFC unveiled, however, a systematic failure of banks' financial strategies. This included general breakdowns in the duties of executives but more importantly in the risk-management function performed by NEDs who were not able to scrutinize the transactions entered into by banks and their increasing level of leverage.[152]

One problem associated with NEDs is that they tend to lack industry or firm-specific expertise because of the "outside" position they have in the company. It has also been observed that their primary function in public corporation is to manage the stock price and its maximization in the short term, which effectively makes them guardian of shareholders' interests.[153] It may be further noted in this sense that NEDs' independence is particularly valued for their ability to relate to inputs by securities analysts and institutional investors in regard to the optimal firm's capital allocation. NEDs' full inception in the United States in the 1980s corroborates the above explanation, given that the 1980s were characterized by the increase in debt finance and leveraged buyouts and the employment of off-balance sheet financing.[154]

The dilemma related to NEDs' independence is that while their objective and detached perspective is necessary to balance CEO's and executives' bias, this function equally depends on a certain degree of knowledge of the company's strategies and culture, which, however, risks defying NEDs' independence.[155] As noted by Marc Moore, this tension between independence and expertise has clearly shifted over the last ten years, with the former prevailing in the 2000s and the latter in the post GFC period.[156] As these requirements can hardly coexist in NEDs, this may result in more specialized boards in industries that involve complex products and/or an element of public concern (such as financial services or utilities), while

152. *See generally* Roman A. Tomasic, *Corporate Rescue, Governance and Risk Taking in Northern Rock (Part 1)*, 29 COMPANY LAW. 297 (2008).

153. *See generally* Marc T. Moore, *The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance*, 10 J. CORP. L. STUD. 279, 305–06 (2010).

154. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1520–23 (2007).

155. Moore, *supra* note 153, at 305–06; WALKER, *supra* note 134, at para. 3.7; Wolf-Georg Ringe, *Independent Directors: After the Crisis*, 14 EUR. BUS. ORG. L. REV. 401, 415 (2013).

156. Moore, *supra* note 153, at 306.

independence may prevail in contexts where the main corporate governance concern remains the conflicts of interests at the board level.[157]

More general criticism has pointed to the lack of incentives for NEDs to provide objective assessments. This has a twofold explanation. Firstly, the same behavioral explanations apply to NEDs who are acquiescent to market conditions in times of boom.[158] Secondly, agency problems extend to independent directors too, and this translates in dangers of "groupthink" between executives and independent directors with the same industry background.[159] In essence, the natural solution to this problem would be to bring ex ante an expert outside perspective to work inside the firm. The next section will illustrate how this could be realized.

III. THE ENLIGHTENED SOVEREIGN CONTROL PARADIGM AS A NEW MODEL OF CORPORATE DECISION-MAKING

A. THE CONCEPT OF ESC

The arguments laid out in the previous section expose the urgency to find a new model to govern decision-making processes in large public firms and provide legal certainty to the question of the corporate objective. To address this problem, this Article puts forward the ESC paradigm as an alternative to shareholder value and stakeholder theory.

The concept of ESC is derived from a number of theories that need to be briefly highlighted in this section. The work conducted by Mitchell emphasized the nature of corporations as "externalising machines."[160] He observed that while at the individual level, decisions have an impact on the decision-maker who will often directly feel the effect of its consequences and hence will have moral constraints, the result of the same process within a corporation is depersonalized because of limited liability and the interposition of the corporate vehicle between decision-makers and those affected by the decision.[161] The corporate structure also allows externalizing costs related to corporate profit-making activities onto other groups who are affected by the corporation but have no powers to shape its behavior. Mitchell argues that as artificial legal entities, corporations lack the framework that allows a moral perspective of the choice, and thus they are naturally led

157. *Id.* at 34.
158. *See* Langevoort, *supra* note 144, at 1233 (arguing that NEDs lack motivation and interest in objectivity because they also prioritize profitability over caution in times of growth, when market mechanisms become legitimate).
159. WALKER, *supra* note 134, at para. 2.17. For a specific overview of the question of cognitive boundaries and groupthink at board level, *see generally* Emilios Avgouleas & Jay Cullen, *Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries*, 41 J. OF L. & SOC'Y 28 (2014).
160. MITCHELL, *supra* note 16, at 49.
161. *Id.* at 40–43.

toward behaviors that are irresponsible and unaccountable. This contributes to creating a more unequal society.[162]

This line of critique leads to questioning limited liability and its conceptual foundations. In particular, this has involved the reprisal of the old concession company law theory, first developed in the Victorian Age. The theory viewed limited liability as a concession concurred by the state, flowing into the right of incorporation.[163] While under this construction the company was seen as a right granted by the state and thus derived from its power, contemporary scholarship has revisited the theory in a more socialized form. Professor Dine has argued that modern corporations are actually derived from society because they benefit from the cooperation and interplay of several social groups.[164] This implies a bottom-up concession theory whereby society represents the foundation of corporations, and communities would have the power to influence corporate decision-making.[165] This line of thinking entails that companies would not only be derived from society, but they would be responsible to a democratically represented community.[166]

In this sense, a strong pluralist approach has been developed by Gunther Teubner who expanded the gist of the traditional stakeholder concept. He regarded corporations as entities that should advance the privileges of both internal (shareholders or employees) and external groups (such as communities and the environment). The board would therefore be called to embrace a more holistic approach to management.[167] Teubner's proposition rests on the hypothesis that a corporation does not only exist as a self-serving and self-realizing entity, but it has to fulfill a broader social role. In order to achieve this, the organizational structure of the corporation and the way it is managed should be shaped to reflect the interest of society.[168] This entails a different determination of the corporate objective because different social groups would become relevant insofar as they represent social interests and are in a position to control fiduciary duties.[169] An ensuing and more complex

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162. *Id.* at 43–44 (observing that this is so because decision-makers in the company take the shape of the company and are absorbed by the corporate culture).

163. The idea of limited liability as a right concurred by the state brings back the restrictions of the Bubble Act of 1720, which prohibited joint stock concerns for commercial purposes. *See* Andrew H. Miller, *Subjectivity Ltd: The Discourse of Liability in the Joint Stock Companies Act of 1856 and Gaskell's Cranford*, 61 ELH 139, 146 (1994).

164. *See* JANET DINE, THE GOVERNANCE OF CORPORATE GROUPS ch. 4 (2000).

165. *See id.* at 124. The structure would be from the bottom, because there would not be in this case a monarch or a sovereign giving the concession; rather, it would come from society.

166. Paddy Ireland, *Property and Contract in Contemporary Corporate Theory*, 23 LEGAL STUD. 453, 506 (2003).

167. Gunther Teubner, *Corporate Fiduciary Duties and their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility*, *in* KLAUS J. HOPT & GUNTHER TEUBNER, CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES: LEGAL, ECONOMIC AND SOCIOLOGICAL ANALYSES ON CORPORATE SOCIAL RESPONSIBILITY 157 (1987).

168. *Id.* at 157.

169. *Id.* at 165–67. This may entail a process of "proceduralization" of fiduciary duties directed at the creation of organizational structures that allow the optimal balancing of corporate

configuration of corporate relationships would address problems of accountability, explored earlier in this Article, because all those who have interests in the company would be represented in the decision-making process. According to Eric Orts, corporate law theory should depart from the simplifications dictated by economic policy, and the resulting legal framework should take account of the technical and normative complexities that underpin the varieties of corporate relationships. Orts argues that more detailed rules on corporate behavior can provide social benefit notwithstanding the increase in legal complexity, because they would create the right balance between positive freedoms and negative constraints that would adequately structure corporate power.[170] Ultimately, corporate law should provide legal and political legitimacy in the context of board decision-making, but this has been difficult to achieve. As observed by Orts in 1993, policy-making in the sphere of corporate law is anchored to economic efficiency discourse, which in turns dominates discussions about legitimacy.[171]

The ESC is proposed as an alternative model of corporate management and embraces the motives of the above theories to the extent that they offer greater recognition of social priorities vis-à-vis economic ones. It generates from the overarching belief that social and welfare interests should be embedded among the goals of those corporations whose activities impact a wide range of constituencies. However, the ESC recognizes the importance of public firms for the creation of social wealth, and therefore looks at measures that would not curtail entrepreneurship. The ultimate need to combine economic interests and social concerns pushes toward a balanced (indeed *enlightened*) intervention of the state (hence the use of the word *sovereign*) as guardian of social interests (which implies *control*).

The characteristic feature of the ESC is represented by the involvement of the state in balancing the different interests at stake in large public corporations and therefore in shaping their corporate objective. Unlike other stakeholder-oriented propositions that advocated a similar redirection of corporate actions toward more inclusive goals, the ESC is unique in the way it seeks to rebalance this fundamental function. This procedural mechanism will be explained in the next section, but it is worth clarifying at this stage that decision-making processes in large public corporations would be shaped by the different composition of their BoDs, which would be complemented by the direct inclusion of state professionals.

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performance and function, taking into account at the same time the interest of the non-economic environment.

170. Orts, *supra* note 64, at 1597.

171. *Id.* at 1595. Orts argues that while economic efficiency has driven all legitimacy arguments, a normative justification that would be reflected in legal rules and processes is also needed. These would provide legitimacy to corporate power. *Id.*

Moreover, while the rationale behind the ESC is aligned with other pluralistic theories, it differentiates for two main reasons. Firstly, in line with its aims, the ESC is conceived as a more multidimensional approach than traditional stakeholder theories. Much of the scholarship on stakeholder theory has concentrated on the impaired nature of stakeholders' rights in the company, which are outside the principal-agent umbrella and are not sufficiently covered by contractual provisions.[172] It was also mentioned earlier in this Article that traditionally, the German codetermination system has epitomized the stakeholder approach to corporate decision-making. While rebalancing the relationship between shareholders and labor, this approach fails to appreciate the importance of other relevant stakeholders and the centrality of the modern corporation in society, largely due to its interplay with financial markets. Secondly, the ESC differs in the way in which the balancing of different interests is pursued, and in particular because of the proposed institutional design at the heart of the decision-making function. The institutional framework is not only important to determine the involvement of the state in BoD's decision-making, but also to provide the legitimization of corporate power that has been so far missing.[173]

The next section illustrates the institutional dimension of this proposal.

B. The Institutional Dimension

The ESC is cognizant of the natural tension between economic and social interests and of the need to regulate corporate activities in a way that promotes the former while protecting the latter. These conflicting concerns pose a dilemma as to how corporations could be regulated in a way that is both economically viable and socially sustainable in the long term. The way in which this interest-weighing problem is addressed under the ESC is by creating a two-tiered classification of corporations, each attracting a different degree of state intervention.

State interference into what is predominantly perceived as the realm of private ordering[174] remains very unpopular, despite the regulatory failures associated with market mechanisms in the pre-crisis years.[175] This is so largely because of the rhetoric flowing from regulatory theories developed in the 1980s. Public and state forms of regulation became increasingly problematic in that period due to the challenges posed by the globalized

172. Freeman, *supra* note 113, at 97.

173. The institutional framework of this proposal also differentiates it from other post-crisis initiatives, such as the Irish experience with public interest directors appointed to credit institutions involved in the banking crisis. For an overview of the Irish experience, *see generally* Blanaid Clarke & Gail E. Henderson, *Directors as Guardians of the Public Interest: Lessons from the Irish Banking Crisis*, 16 J. Corp. L. Stud. 187 (2016).

174. *See generally* Marc T. Moore, *Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism*, 34 Oxford J. Legal Stud. 693 (2014).

175. Posner, *supra* note 126, at 234–35.

business community.[176] It was then believed that independent, market-based professionals would possess the necessary skills and expertise required by the business environment, and that independence from political circles should be achieved.[177] From a regulatory perspective, this process resulted in the reassignment of political powers to non-elected bodies (non-majoritarian agencies), and it had the effect of creating an accountability and democratic deficit.[178] This, however, was considered a legitimate policy because of the cost-effectiveness of the resulting arrangements, which would guarantee a number of regulatory outcomes that were not thought to be possible with democratically elected governments. Cost-effectiveness was justified because of the expertise and independence (from government) of those who were delegated.[179] This line of reasoning contributed to redefining state intervention as an uneconomic intrusion, conceived as a last resort mechanism.[180]

The discussion on the democratic deficit of non-majoritarian regulatory agencies has become particularly relevant in the context of corporate law scholarship. Even though BoDs are not regulatory agencies, it is important to remember that corporate decision-making in large public firms affects the welfare of large sections of society. In essence, this can be regarded as an assignment of quasi-political powers to private bodies (BoDs) who remain, however, unaccountable to the stakeholders (but the shareholders[181]) who are affected by their powers. Arguably, this results in a democratic deficit that has led to the already announced problem of finding a legitimization of corporate power in a democratic society.[182]

The above task has proven to be particularly difficult because the quasi-regulating powers of the market and the related financial-economic theories that were developed from the 1970s have advanced the pre-eminence of

176. *See* Giandomenico Majone, *From the Positive to the Regulatory State: Causes and Consequences of Changes in the Mode of Governance*, 17 J. OF PUB. POL'Y 139, 139 (1997).

177. Giandomenico Majone, *The Regulatory State and its Legitimacy Problems*, 22 WEST EUR. POL. 1, 2 (1999) [hereinafter Majone, *Legitimacy Problems*] (referring in particular to the delegation of regulatory powers to independent administrative authorities).

178. The democratic gap in particular is the result of the broken chain of political delegations. *See* David Coen & Mark Thatcher, *The New Governance of Markets and Non-Majoritarian Regulators*, 18 GOVERNANCE: INT'L J. POL'Y, ADMIN. & INSTITUTIONS 329, 330 (2005).

179. Majone, *Legitimacy Problems*, *supra* note 177, at 4.

180. Government intervention was considered a viable regulatory mechanism in the event of market failure, because market failure would result in higher costs than those associated with government intervention. *See* ANTHONY I. OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 30 (2004).

181. It can be argued that in contexts of dispersed ownership, shareholders' power and incentive to hold the board to account is limited too. *See* Richard A. Posner, *From the New Institutional Economics to Organization Economics: With Applications to Corporate Governance, Government Agencies and Legal Institutions*, 6 J. INSTITUTIONAL ECON. 1, 11 (2010).

182. *See* PARKINSON, *supra* note 11, at ch. 1.

firms' economic interests.[183] A broader concept of corporate law encompassing wider socio-economic concerns has therefore been understated.[184] The ensuing narrow view of company law has hindered its role in regulating a number of legal relationships that give rise, *inter alia*, to social costs.[185] While the decision-making process in such entities has had effects on a broad range of social constituencies, it has remained anchored to the interests of a very narrow section of society—the stockholders. The model proposed in this Article therefore aims at filling this democratic deficit by providing a legitimization of corporate decision-making for entities whose activities impact society.

This Article in particular identifies BoDs of large public corporations as the engines of corporate power. As discussed earlier in this section, they are custodians of a very particular power, which is at odds with the very limited accountability that they have. This Article argues that this power should be brought within a democratic dimension, which would in turn provide society with an indirect accountability link.[186]

Under the ESC, the state is envisaged as the natural custodian of different societal interests because of its democratic underpinning, which places it in a better position to attain regulatory goals in the public interest. However, it needs to be clarified that the inclusion of a democratic-based social interest in BoDs would be premised on the setting up of a permanent, state-based institutional/regulatory body (the body).[187] The institutional design, and the related mechanisms of public accountability (illustrated later in this section), will contribute in making the body a more effective tool to balance different relevant interests that surface in BoD's decision-making processes. In particular, its institutional position and design would make the body substantially different from the existing independent committees and from other type of regulators, which in different ways have been traditionally affected by problems of regulatory capture. The remainder of this section focuses on the discussion of the organizational and institutional settings that

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183. This has chiefly been the case through the application of "contractarian" theories of the firm centered around the agency relationship between shareholders and directors, and the ensuing efficiency rhetoric. It is also correct to say that the degree to which shareholder primacy and economic efficiency have prevailed over stakeholder-oriented goals varied and took different shape in the United Kingdom and the United States. *See* Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 636 (2010); Marc T. Moore, *supra* note 174, at 699–701.

184. *See* Teubner, *supra* note 167.

185. Johnston, *supra* note 21, at 3. This exacerbated the democratic deficit described by Parkinson and the lack of public legitimization of managerial power.

186. Majone, *Legitimacy Problems*, *supra* note 177, at 10, 13. Majone observed that lack of full democratic link does not necessarily amount to lack of accountability, which could be supplemented through institutional design. *Id.*

187. A more general discussion on this is conducted in VINCENZO BAVOSO, EXPLAINING FINANCIAL SCANDALS: CORPORATE GOVERNANCE, STRUCTURED FINANCE AND THE ENLIGHTENED SOVEREIGN CONTROL PARADIGM 236–75 (2013).

would provide a degree of democratic accountability to corporate decision-making through the operation of the proposed body.

It needs to be admitted that a degree of delegation is the necessary compromise in modern regulatory processes.[188] However, the consequential lack of democracy can be mitigated through institutional arrangements that regulate the relationship between the state and the regulatory body.[189] Public accountability[190] could still be achieved via an appropriate institutional design flowing into an arm's-length relationship, whereby the regulatory body is independent from government, or political control, and at the same time its actions are consistent with the interests of the democratically elected legislature.[191] This could be achieved through procedural and substantive constraints imposed on the regulatory body that would be required to issue guidelines governing its discretion, and motivate its decisions. More generally, a regime of public participation could also be seen as a viable option.[192] The ultimate aim of these institutional arrangements would be to ensure that the proposed body is independent from political control insofar as it is insulated from problems of "time limit" which are typically associated with changes in government and political fluctuations; equally, the democratic link would be preserved through accountability procedures that would ensure consistency with broad social interests.

It is also necessary at this stage to submit that under the ESC, the proposed public body is conceived as a new type of regulator, closer in its institutional design to a professional body. This would address a number of questions that arise in connection with the proposal, namely whether the public body would be better at balancing conflicting interests and whether it would escape the agency problems that typically characterize BoDs. With respect to the first problem, professionals working in the proposed body

188. This is so because national political structures are not practicable outside of the political sphere. This becomes particularly true when decisions have to be taken in complex or technical contexts such as those that BoDs have to take in relation to environmental or financial matters. *See* Renate Mayntz, *Legitimacy and Compliance in Transnational Governance* 9 (Max-Planck-Inst. for the Study of Societies, Working Paper No. 10/5, 2010); Martin Lodge & Lindsay Stirton, *Accountability in the Regulatory State*, *in* THE OXFORD HANDBOOK OF REGULATION 352, 354, 357 (Baldwin, Cave & Lodge eds., 2012).

189. Majone, *Legitimacy Problems*, *supra* note 177, at 8–10.

190. Accountability in this sense can be defined as the system whereby those who take decisions can be held accountable by being answerable in front of a predetermined forum. *See generally* Mark Bovens, *Public Accountability*, *in* THE OXFORD HANDBOOK OF PUBLIC MANAGEMENT (Ferlie, Lynn & Pollitt eds. 2007); Mark Bovens, *Analysing and Assessing Accountability: A Conceptual Framework*, 13 EUR. L. J. 447, 450 (2007).

191. Majone, *Legitimacy Problems*, *supra* note 177, at 11.

192. It has been observed that the intrinsic problem of accountability arising from the delegation of regulatory powers rests on the dilemma of what degree of autonomy the delegated actors should be given to perform their tasks, while ensuring an adequate level of control. *See* Colin Scott, *Accountability in the Regulatory State*, 27 J. L. & SOC'Y 38, 39 (2000).

would not be appointed from market players,[193] nor would they be hired from other public institutions.[194] Instead, the proposed body would draw its members from an ad hoc career path consisting of either a specifically designed academy or a state exam that would qualify for the profession. In both cases, professionals would receive the necessary training by a mix of academics, regulators, and chartered practitioners (such as lawyers and accountants). A predetermined career path would achieve the purpose of equipping the professionals with the desired set of skills and knowledge, in essence the expertise that BoDs were assumed to possess in order to understand and balance conflicting interests.[195] The result would be a knowledge-based profession emphasizing the intellectual and independence standards of its members. These would be closely linked to the cultural values promoted within the proposed body. On the one hand, these values would stem from the democratic and pluralist mission embedded in the body; on the other, they would also derive from the intrinsic attributes and motivations of those interested in this type of profession.[196]

With respect to the second problem, related to possible agency problems afflicting the proposed body, a fundamental feature of this proposal is represented by the compensation and the relating incentives that the professionals would receive. Firstly, it is important to note that salaries to the professionals would be paid by the body (hence by the state effectively) instead of the company. This automatically shifts the question of agency problems away from the company's BoD.[197] Secondly, the proposed body would compensate its professionals with salaries that are not aligned to market incentives (such as bonuses and stock options for instance).[198] While compensation schemes should be high enough to attract and retain talents, it is contended that professionals, unlike company directors and executives,

193. This would avoid problems of "revolving doors," which have become common and have created undesired ties between financial institutions and regulators, with the former exerting pressure on regulatory and policy outcomes. *See* LUCIANO GALLINO, FINANZCAPITALISMO 23–24 (2011).

194. This is the case, for instance, of the French regulator Autorite' des Marches Financiers (AMF). *See The AMF*, AUTORITÉ DES MARCHÉS FINANCIERS (July 8, 2013), http://www.amf-france.org/en_US/L-AMF/Organisation/Gouvernance.

195. The professionals sitting on the board would not duplicate the set of skills and expertise that the company already has. Board members (including NEDs), as well as executives, are not a profession in fact, and they remain limited in their decision-making by the truncated rationality that is typical of market actors. The professionals' predetermined career path would, in this sense, serve to intellectually educate them to balance the more traditional economic rationale underpinning corporate decision-making with the long-term interests of different social groups affected by corporate externalities.

196. Posner, *supra* note 181, at 23–24. Posner identifies the judiciary as a valid example in this sense; academia could be another example. *Id.*

197. Similar agency-type problems may, in fact, arise in the context of the public body itself. A discussion on this more specific problem is, however, beyond the scope of this present discussion.

198. Fixed salaries would more likely keep professionals averse to the high level of risk-taking that has been induced by perverse market incentives like stock options.

would remain unaffected by the incentives that determine the behavior of most market actors. Instead, their main motivation would be to do their job in a satisfactory way in order to attain consensus among their peers and ultimately increase their professional reputation.[199]

C. THE TWO-TIER CLASSIFICATION

State intervention under the ESC is premised on a two-tier classification of public corporations. The first tier is designed to comprise entities whose activities can create externalities on society. This classification categorizes firms beyond size, ownership structure or industry sector. While financial firms, for instance, are today perceived as intrinsically dangerous for many social groups due chiefly to the systemic importance they bear, other corporate entities can equally cause harm to society because of the activities they conduct.[200] According to the ESC, the social interest needs to be factored into the regulation of these entities. More specifically, the type of supervision and control over decision-making would guarantee that the social role of tier-one corporations is fulfilled and that costs created by the entity are internalized.

From a practical standpoint, the representation of the social, democratic-based interest on BoDs would occur by drawing professionals from the aforementioned institutional body to serve full-time on the board in a capacity similar to that of non-executive directors. While serving on the board, professionals would still be remunerated with public money by the institutional body. Their professional background, as explained in the previous section, would provide them with the necessary awareness of the specific industry dynamics and of the related social and ethical issues. The illustrated institutional setting would enhance the independent balancing of different interests at stake in the decision-making process of tier-one firms and avoid issues of groupthink. The hierarchical position of professionals in the board would then implement a corporate objective aligned with the multidimensional aspects of the business.

The second tier of public corporations would include firms that, regardless of size, pose only limited risks to society, either because their eventual failure would not threaten social welfare to a considerable extent, or because their business does not affect the interests of a broad range of social groups and local communities. These entities would be subject to a regulatory framework typical of public companies, and their decision-making processes would not be shaped by social concerns beyond a voluntary approach. In other words, the corporate objective of tier-two corporations would remain

199. Posner, *supra* note 181, at 24.

200. Examples of environmental disasters made earlier in this Article serve to clarify this point, but other entities too, like pharmaceutical corporations, may retain a social importance because of the public interest inherent to their research and development (R&D) activity.

aligned to the interest of shareholders as private corporate interests would prevail over social ones.

The two-tier classification proposed under the ESC is based upon five criteria that are designed to assess whether corporations can have a negative impact on society. In essence, the degree to which firms trigger the emergence of the five criteria will determine whether they fall under tier-one or tier-two regulatory framework. It is useful at this stage to provide a brief illustration of the five criteria employed under the ESC.

First, the entity's size and number of employees at group level would provide an initial parameter to determine whether the business activity should attract sovereign control. A large workforce can shape decision-making, particularly when a high number of jobs are at stake, as it is the case during takeovers, for instance. Social concerns would also emerge when a city or a regional community relies on a large corporation for occupation and strategic industrial purposes.

The *second* criterion would also provide a means to quantify the entity's position in society, and it looks at group turnover. A very high turnover should attract public scrutiny because of the fiscal and financial repercussions that this may have. In particular, the audit of such entities would need to draw specific attention to a range of financial and accounting issues, such as off-balance sheet liabilities or the entity's level of leverage.

The *third* criterion shifts the assessment onto another aspect of corporate activity. It focuses on the geographical spread of the business, and is thus directed to a large degree at multinational firms. Multinational entities benefit from economies of scale that allow extracting value from society often due to a decrease in competition. Their economic position also puts them in an ideal place to exploit the benefit of regulatory arbitrage, particularly with respect to tax issues. A higher degree of public scrutiny over these entities would be needed to socialize the economic advantages that derive from this organizational pattern and direct them toward more inclusive goals (beyond profit-making for shareholders).

In connection with the geographical spread, the *fourth* criterion looks at the range and nature of business activities. This has a twofold significance because it firstly examines the degree to which firms embrace multiple areas of business, therefore becoming conglomerates. This has increasingly been the case within the financial services industry, where deregulation allowed the proliferation of universal, too-big-to-fail institutions. As with the previous criterion, the same rationale for sovereign control over the entity's decision-making would apply in this context. This criterion is also important for a second reason, and it refers to the nature of the activity conducted by the corporation, or the group. This, in turn, encompasses both a public interest test over those activities (whether they attract broader societal concerns as it is the case for instance for energy, pharmaceutical or media), and a test concerning the level of risk that the activities pose on society (relevant example would be the environmental risks related to natural resources extraction).

The *fifth* and final criterion looks at the externalities on social groups, and it represents a synthesis of whether and to what degree corporate activities can have a negative impact on a wider range of societal groups, according to the first four criteria.

D. SUMMARY OF FINDINGS —WHY THE ENLIGHTENED SOVEREIGN CONTROL?

This Article contends that the proposed institutional framework of tier-one companies would provide legal certainty to the unresolved question of the corporate objective. Firstly, it would have an impact on the dynamics of board decision-making. The passing of major board resolutions would be subject to the special powers vested in the professionals drawn from the institutional body described earlier. Their majority would be needed in order to approve the resolution, ensuring that due regard is given to the social dimension of corporate strategies together with the business one. Equally, a majority of the professionals would have powers of veto over high-risk activities, or alternatively they could refer specific resolutions raising higher concern to the professional body.[201] Most importantly, these powers would result in an ex ante gatekeeping function performed within the board of tier-one corporations. This is so because the judgement of state professionals would remain aligned with the social dimension of tier-one entities, also due to their compensation structure.

Additionally, the proposed design would bring intellectual and professional resources which are currently lacking from BoDs. It was argued earlier in this Article that NEDs have failed to bring an expert and independent perspective to curb the high-risk strategies (such as financial or environmental) implemented by their firms. State professionals would complement the expertise already available on BoDs because of their different independent background, and this would allow them to depart from shareholder-oriented bias. Their powers would essentially affect corporate decision-making by pursuing the corporate objective in a more balanced and contextual way. Drawing from some of the boards' failures that characterized the GFC, it can be argued that state professionals would be able to heed warning signs raised by risk-managers, whereas directors of financial institutions were incapable of doing so because they were hindered by shareholder value bias and followed the irrational exuberance of traders, motivated by lust for short-term profits.[202] In essence, the intrinsically

201. Examples would be transactions whose long-term effects impact the firm's amount of leverage and thus threaten systemic stability, or takeovers within sensitive industries that impact national interests.

202. *See* POSNER, *supra* note 126, at 80.

truncated rationality of market actors, which has so far prevailed in BoDs' decision-making, would be complemented by a more socially responsible approach to business and a deeper awareness of its long-term implications.

CONCLUSION

This Article has advanced the urgency to recalibrate the corporate objective of large public corporations toward more socially inclusive goals. The analysis conducted in the first part of this Article reviewed the old-standing dilemma to find a public interest justification to the managerial power of large corporations. The quest of creating mechanisms of public accountability was already recognized by Berle who relied on the optimistic construction of his "public consensus" theory; more recently, Parkinson further defined the problem by highlighting the void in democratic legitimacy characterizing corporate management.

The difficulty to construct a viable model of corporate management, encompassing both business and social interests, is reflected on the one hand by the ambiguous ubiquity of shareholder value, which has survived a number of crises and much criticism, and on the other hand by the reluctance (particularly in the United Kingdom and United States) to adopt a stakeholder orientation to corporate governance. The critique provided in Part II shows that neither of the two models is suitable to deliver legal certainty in the process of decision-making, and that problems of democratic legitimization of managerial power have remained unresolved. The corporate scandals that occurred in succession from the early 2000s amplified this void and suggest that large public corporations need to embed wider societal interests among their objectives.

This Article proposes a new model of corporate management, the enlightened sovereign control, to fill this void. In constructing a two-tier classification of public corporations, the ESC advocates a state-based democratic intervention in the decision-making process of tier-one companies. The aim of this model is to bring an external element of judgement in the dynamics of BoDs in order to counter the intellectual and cultural bias that persists within corporate and financial organizations. Behavioral explanations put forward in Part III deconstructed the presumed rationality of market-players' decisions chiefly because of the persistence of bias within corporate environments.[203] Equally, evidence from corporate, financial, and environmental disasters showed that BoDs' strategies were often not cognizant of the level of risk-taking that was being reached. This justifies solutions that seek either an external regulation of the process of decision-making or a change in the environment in which decisions are taken. The ESC provides both the former, insofar as it brings external non-market-

203. *See* Langevoort, *supra* note 144, at 1241.

based expertise on the board, and the latter, by shaping the environment in which decisions are taken.

In addition, the state professionals drawn from the institutional body described in Part III would constitute a new "knowledge-based" profession[204] (by virtue of an ad-hoc educational path) capable of offering a deeper awareness of critical decision-making processes and thus bring about much needed balancing of different interests at stake.

204. It is worth specifying that the different intellectual backgrounds of state professionals would be the result of a new profession that currently, despite similarities with the judiciary or academia for instance, does not exist.