

# Editorial: Averting corporate crises



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## Colin Mayer issues a call for reform

### Trust

Every year for the past 35 years, Ipsos MORI, the market research company, has undertaken a survey of which professions in Britain people trust. They ask 1000 people whether they trust people in different professions to tell the truth.

Near the bottom come business leaders, just above estate agents, professional footballers, journalists and politicians, and below trade union leaders and 'the man in the street'. This is not predominantly a bankers' phenomenon; in fact business leaders come below bankers. Nor is it just a post financial crisis phenomenon, since every year from the start of the survey in 1983, business leaders have come near the bottom. Mistrust in business is pervasive, persistent and profound. Why?

### The consensus

The answer is the conventional view of business, as expounded in 1962 by Milton Friedman in what has come to be known as the Friedman Doctrine – 'there is one and only one social responsibility of business ... to increase its profits so long as it stays within the rules of the game.'

It is reflected in corporate law around the world. For example in the UK, the 2006 Companies Act states that 'a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.'

Such has been influence of this doctrine that it forms the basis of a near global consensus on corporate policy: law defines fiduciary responsibilities of directors as promoting the success of the company for the benefit of its shareholders; corporate governance aligns interests of management with shareholders; regulation and laws protect creditors, customers, employees, the environment, shareholders and society; competition law promotes a competitive environment and prevents competitive abuses; companies maximise shareholder value while conforming to the legal, regulatory and competitive rules of the game.

The Friedman Doctrine is the basis of virtually all business education, which starts from the premise that the purpose of business is to maximise shareholder value, and everything – accounting, fi-

nance, marketing, operations management, organisational behaviour, and strategy – follows from that.

### History

But it is only over the last 60 years of the corporation's 2,000-year history that the idea that the only purpose of business is to produce profits has emerged. As shareholdings became increasingly dispersed during the first half of the 20th century, ownership and control became separated, resulting in a lack of accountability of management. The response to this took the form of the market seizing corporate control, first through takeovers and then through hedge fund activism.

This was a mistake. And, as Henrietta Moore describes in this issue (page 23), it is the source of growing disaffection with business, its environmental, social and political problems, and the erosion of trust in it. Those problems will be intensified in the future by technological advances that risk exacerbating social detriments as well promoting benefits of corporations, and lengthening the regulatory lag between innovations and policy responses.

Foremost amongst these advances is Artificial Intelligence (AI) – and articles in this issue describe the fundamental changes that AI is bringing about, and the profound consequences of them (pages 26–35).

Business took a wrong turn during the 1960s, and we have now reached a defining moment when the consequences of that have become unsustainable – environmentally, socially and politically. We need to redefine business for the 21st century as a matter of urgency. This requires a new framework that combines and connects defined corporate purposes, a commitment to trustworthiness, and corporate values and culture that are both enabling and conducive. The British Academy programme on the ‘Future of the Corporation’ provides exactly that new framework.

### Carillion – a case in point

The case for reform is graphically illustrated by the collapse of Carillion plc, the British multinational facilities management and construction services company, on 15 January 2018. The UK Parliamentary cross-party enquiry into the collapse of Carillion plc describes how:<sup>1</sup>

In the company’s final years, directors rewarded themselves and other shareholders by choosing to pay out more in dividends than the company generated in cash, despite increased borrowing, low levels of investment and a growing pension deficit. (page 19)

In essence, Carillion raised debt and borrowed against its pension scheme in order to pay dividends to its directors and shareholders.

With limited liability, shareholders benefit from a company borrowing £1 to pay £1 of dividends, while leaving the costs of the ensuing bankruptcy to be borne by its lenders and pensioners, along with its customers, employees and taxpayers. As a consequence, as the enquiry noted, Carillion is not just a case of one bad apple:

The individuals who failed in their responsibilities, in running Carillion and in challenging, advising or regulating it, were often acting entirely in line with their personal incentives. Carillion could happen again, and soon. (page 86)

Furthermore, the enquiry states that, while the directors of the company were the main culprits, Carillion reveals a much



The collapse of Carillion plc in January 2018 provoked widespread public anger, as evidenced by this defaced sign outside Carillion’s Royal Liverpool Hospital site. Photo: Christopher Furlong / Getty Images.

more extensive problem:

The collapse of Carillion has tested the adequacy of the system of checks and balances on corporate conduct. It has clearly exposed serious flaws, some well-known, some new. In tracing these, key themes emerge. We have no confidence in our regulators. The Financial Reporting Council and The Pension Regulator share a passive, reactive mindset and are too timid to make effective use of the powers they have... The economic system is predicated on strong investor engagement, yet the mechanisms and incentives to support engagement are weak and possibly weakening... The audit profession is in danger of suffering a crisis in confidence...

Carillion is not simply a case of greedy executives, incompetent regulators, ineffective government, and conflicted auditors overseeing the collapse of a major corporation. It is one of a system with fundamental defects in the incentive arrangements that drive corporate activity. Shareholders are not the hapless

bystanders, but the passive recipients of the largesse delivered by an ownerless economy. Strengthening governance around a system predicated on profits as the sole purpose of business risks exacerbating, not alleviating, the problem. This focuses attention where it needs to be – on why companies exist, what they are there to do, what is their purpose, and who they are there to service.

### A new framework for business

As David Rodin makes clear in this issue (page 8), the purpose of business is not to produce profits. The purpose of business is to produce profitable solutions to the problems of people and planet and not profit from producing problems for people and planet. In the process it produces profits. But profits are not *per se* the purpose of business.

The corporation commits to a common purpose, and it commits to those who contribute to the common purpose, thereby creating relations of trust that produce reciprocal benefits for the parties to the firm as well as the firm itself. Putting profits first is neither a law of nature nor a

<sup>1</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, HC 769 (9 May 2018). See also Colin Mayer, ‘Carillion: one bad apple?’, British Academy Blog (20 June 2018).



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product of history. Instead, purpose comes first, and the rest, including profits, follow.

The achievement of corporate purpose requires an alignment of the ownership, governance, measurement and management of the firm in the context of appropriate law and regulation. As John Armour (page 19) and Daniela Weber-Ray (page 14) discuss in this issue, law and regulation between them have the power to bring this about. This reflects the fact that the corporation is a creation of the law, and it is the law from which its identity is derived.

Corporations need to define their purposes, and to align their ownership and governance with a commitment to achieving them. They should have owners who support the corporations' purposes, and boards of directors that ensure that purposes are reflected in the cultures, values, strategies, performance measurements and incentives of their organisations.

Corporate laws should enable companies to adopt ownership and governance arrangements that are suited to their purposes. They should encourage diversity of forms of ownership – families, foundations, employees, mutuals, co-operatives, states, sovereign funds as well as institutional investors – to meet the diverse

needs of corporate purposes. They should empower different parties to the firm – employees, investors, customers and communities – to exercise governance and hold management to account for delivery of their purposes.

Peter Buckley (page 12) discusses how regulation, together with the adoption of national and international norms such as the Sustainable Development Goals, can align corporate with social and public purposes. This is particularly important in companies that perform public functions, such as utilities, banks and companies with significant market power. It requires companies to take account of human, natural and social as well as other forms of capital, and to incorporate these as appropriate in their measures of performance. It requires companies to refrain from certain purposes and activities that are contrary to the common good, and to restore detriments where harm has been done.

One illustration of this is in relation to corporate taxes. The effective rate of corporation tax paid by the world's ten largest companies by market capitalisation has declined by 9 per cent since the financial crisis.<sup>2</sup> Mihir Desai (page 20) considers three approaches to dealing with this, but

notes that all of them have their deficiencies as well as advantages. Corporations need to recognise their dependence on the societies in which they operate, and their corresponding need to incorporate the payment of fair share of taxes in the corporate purposes as part of their licences to operate.

Putting purpose at the epicentre of the corporate system is as significant a revolution for economies and societies as the Copernican one was for our understanding of our planetary system. Using law and regulation to facilitate the centrality of purpose provides the transformational realignment of the planetary system of shareholders and stakeholders that is required to achieve a new corporate revolution.

**The purpose of business is not to produce profits. The purpose of business is to produce profitable solutions to the problems of people and planet**

<sup>2</sup> 'Multinationals pay lower taxes than a decade ago', *Financial Times* (11 March 2018).