



The Error at of Corporate

MOST CEOS AND BOARDS BELIEVE THEIR MAIN DUTY

In the fall of 2014, the hedge fund activist and Allergan shareholder Bill Ackman became increasingly frustrated with Allergan's board of directors. In a letter to the board, he took the directors to task for their failure to do (in his words) "what you are paid \$400,000 per year to do on behalf of the Company's owners." The

board's alleged failure: refusing to negotiate with Valeant Pharmaceuticals about its unsolicited bid to take over Allergan—a bid that Ackman himself had helped engineer in a novel alliance between a hedge fund and a would-be acquirer. In presentations promoting the deal, Ackman praised Valeant for its shareholder-friendly

capital allocation, its shareholder-aligned executive compensation, and its avoidance of risky early-stage research. Using the same approach at Allergan, he told analysts, would create significant value for its shareholders. He cited Valeant's plan to cut Allergan's research budget by 90% as "really the opportunity." Valeant CEO Mike



the Heart Leadership

IS TO MAXIMIZE SHAREHOLDER VALUE. IT'S NOT.

BY JOSEPH L. BOWER AND LYNN S. PAINE

Pearson assured analysts that “all we care about is shareholder value.”

These events illustrate a way of thinking about the governance and management of companies that is now pervasive in the financial community and much of the business world. It centers on the idea that management’s objective is, or should

be, maximizing value for shareholders, but it addresses a wide range of topics—from performance measurement and executive compensation to shareholder rights, the role of directors, and corporate responsibility. This thought system has been embraced not only by hedge fund activists like Ackman but also by

institutional investors more generally, along with many boards, managers, lawyers, academics, and even some regulators and lawmakers. Indeed, its precepts have come to be widely regarded as a model for “good governance” and for the brand of investor activism illustrated by the Allergan story.

Yet the idea that corporate managers should make maximizing shareholder value their goal—and that boards should ensure that they do—is relatively recent. It is rooted in what’s known as agency theory, which was put forth by academic economists in the 1970s. At the theory’s core is the assertion that shareholders own the corporation and, by virtue of their status as owners, have ultimate authority over its business and may legitimately demand that its activities be conducted in accordance with their wishes.

Attributing ownership of the corporation to shareholders sounds natural enough, but a closer look reveals that it is legally confused and, perhaps more important, involves a challenging problem of accountability. Keep in mind that shareholders have no legal duty to protect or serve the companies whose shares they own and are shielded by the doctrine of limited liability from legal responsibility for those companies’ debts and misdeeds. Moreover, they may generally buy and sell shares without restriction and are required to disclose their identities only in certain circumstances. In addition, they tend to be physically and psychologically distant from the activities of the companies they invest in. That is to say, public company shareholders have few incentives to consider, and are not generally viewed as responsible for, the effects of the actions they favor on the corporation, other parties, or society more broadly. Agency theory has yet to grapple with the implications of the accountability vacuum that results from accepting its central—and in our view, faulty—premise that shareholders own the corporation.

The effects of this omission are troubling. We are concerned that the agency-based model of governance and management is being practiced in ways that are weakening companies and—if applied even more widely, as experts predict—could be damaging to the broader economy. In particular we are concerned about the effects on corporate strategy and resource allocation. Over the past few decades the agency model has provided the rationale for a variety of changes in governance and management practices that, taken together, have increased the power and influence of certain types of shareholders over other types and further elevated the claims of shareholders over those of other important

IN BRIEF

THE PROBLEM

A widespread belief holds that “maximizing shareholder value” is the number one responsibility of boards and managers. But that’s confused as a matter of corporate law and a poor guide for managerial behavior—and it has a huge accountability problem baked into it.

THE SOLUTION

A company’s health—not its shareholders’ wealth—should be the primary concern of those who manage corporations. That may sound like a small change, but it could make companies less vulnerable to damaging forms of activist investing—and make it easier for managers to focus on the long term.

constituencies—without establishing any corresponding responsibility or accountability on the part of shareholders who exercise that power. As a result, managers are under increasing pressure to deliver ever faster and more predictable returns and to curtail riskier investments aimed at meeting future needs and finding creative solutions to the problems facing people around the world.

Don’t misunderstand: We are capitalists to the core. We believe that widespread participation in the economy through the ownership of stock in publicly traded companies is important to the social fabric, and that strong protections for shareholders are essential. But the health of the economic system depends on getting the role of shareholders right. The agency model’s extreme version of shareholder centrality is flawed in its assumptions, confused as a matter of law, and damaging in practice. A better model would recognize the critical role of shareholders but also take seriously the idea that corporations are independent entities serving multiple purposes and endowed by law with the potential to endure over time. And it would acknowledge accepted legal principles holding that directors and managers have duties to the corporation as well as to shareholders. In other words, a better model would be more company centered.

Before considering an alternative, let’s take a closer look at the agency-based model.

FOUNDATIONS OF THE MODEL

The ideas underlying the agency-based model can be found in Milton Friedman’s well-known *New York Times Magazine* article of 1970 denouncing corporate “social responsibility” as a socialist doctrine. Friedman takes shareholders’ ownership of the corporation as a given. He asserts that “the manager is the agent of the individuals who own the corporation” and, further, that the manager’s primary “responsibility is to conduct the business in accordance with [the owners’] desires.” He characterizes the executive as “an agent serving the interests of his principal.”

These ideas were further developed in the 1976 *Journal of Financial Economics* article “Theory of the Firm,” by Michael Jensen and William Meckling, who set forth the theory’s basic premises:

- Shareholders own the corporation and are “principals” with original authority to manage the corporation’s business and affairs.
- Managers are delegated decision-making authority by the corporation’s shareholders and are thus “agents” of the shareholders.
- As agents of the shareholders, managers are obliged to conduct the corporation’s business in accordance with shareholders’ desires.
- Shareholders want business to be conducted in a way that maximizes their own economic returns. (The assumption that shareholders are unanimous in this objective is implicit throughout the article.)

Jensen and Meckling do not discuss shareholders’ wishes regarding the ethical standards that managers should observe in conducting the business, but Friedman offers two views in his *Times* article. First he writes that shareholders generally want managers “to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.” Later he suggests that shareholders simply want managers to use resources and pursue profit by engaging “in open and free

competition without deception or fraud.” Jensen and Meckling agree with Friedman that companies should not engage in acts of “social responsibility.”

Much of the academic work on agency theory in the decades since has focused on ensuring that managers seek to maximize shareholder returns—primarily by aligning their interests with those of shareholders. These ideas have been further developed into a theory of organization whereby managers can (and should) instill concern for shareholders’ interests throughout a company by properly delegating “decision rights” and creating appropriate incentives. They have also given rise to a view of boards of directors as an organizational mechanism for controlling what’s known as “agency costs”—the costs to shareholders associated with delegating authority to managers. Hence the notion that a board’s principal role is (or should be) monitoring management, and that boards should design executive compensation to align management’s interests with those of shareholders.

THE MODEL’S FLAWS

Let’s look at where these ideas go astray.

1 Agency theory is at odds with corporate law: Legally, shareholders do not have the rights of “owners” of the corporation, and managers are not shareholders’ “agents.” As other scholars and commentators have noted, the idea that shareholders own the corporation is at best confusing and at worst incorrect. From a legal perspective, shareholders are beneficiaries of the corporation’s activities, but they do not have “dominion” over a piece of property. Nor do they enjoy access to the corporate premises or use of the corporation’s assets. What shareholders do own is their shares. That generally gives them various rights and privileges, including the right to sell their shares and to vote on certain matters, such as the election of directors, amendments to the corporate charter, and the sale of substantially all the corporation’s assets.

Furthermore, under the law in Delaware—legal home to more than half the *Fortune* 500 and the benchmark for

corporate law—the right to manage the business and affairs of the corporation is vested in a board of directors elected by the shareholders; the board delegates that authority to corporate managers.

Within this legal framework, managers and directors are fiduciaries rather than agents—and not just for shareholders but also for the corporation. The difference is important. Agents are obliged to carry out the wishes of a principal, whereas a fiduciary’s obligation is to exercise independent judgment on behalf of a beneficiary. Put differently, an agent is an order taker, whereas a fiduciary is expected to make discretionary decisions. Legally, directors have a fiduciary duty to act in the best interests of the corporation, which is very different from simply doing the bidding of shareholders.

2 The theory is out of step with ordinary usage: Shareholders are not owners of the corporation in any traditional sense of the term, nor do they have owners’ traditional incentives to exercise care in managing it. This observation is even truer today than when it was famously made by Adolf Berle and Gardiner Means in their landmark 1932 study *The Modern Corporation and Private Property*. Some 70% of shares in U.S.-listed companies today are held by mutual funds, pension funds,

insurance companies, sovereign funds, and other institutional investors, which manage them on behalf of beneficiaries such as households, pensioners, policy holders, and governments. In many instances the beneficiaries are anonymous to the company whose shares the institutions hold. The professionals who manage these investments are typically judged and rewarded each quarter on the basis of returns from the total basket of investments managed. A consequence is high turnover in shares (seen in the exhibit “Average Holding Period for Public Company Shares”), which also results from high-frequency trading by speculators.

The decisions of asset managers and speculators arise from expectations regarding share price over a relatively short period of time. As the economy passes through cycles, the shares of companies in entire industry sectors move in and out of favor. Although the shareholders of record at any given moment may vote on an issue brought before them, they need not know or care about the company whose shares they hold. Moreover, the fact that they can hedge or immediately sell their shares and avoid exposure to the longer-term effects of that vote makes it difficult to regard them as proprietors of the company in any customary sense.

The anonymity afforded the shares’ beneficial owners further attenuates their relationship to the companies whose shares they own. Some 85% of publicly traded shares in the United States are held in the name of an institution serving as an intermediary—the so-called street name—on behalf of itself or its customers.

And of the ultimate owners of those shares, an estimated 75% have instructed their intermediaries not to divulge their identities to the issuing company.

3 The theory is rife with moral hazard: Shareholders are not accountable as owners for the company’s activities, nor do they have the responsibilities that officers and directors do to protect the company’s interests. The problem with treating shareholders as proprietors is exacerbated by the absence of another traditional feature of ownership: responsibility for the property owned and accountability—even legal liability, in

The health of the economic system depends on getting the role of shareholders right.

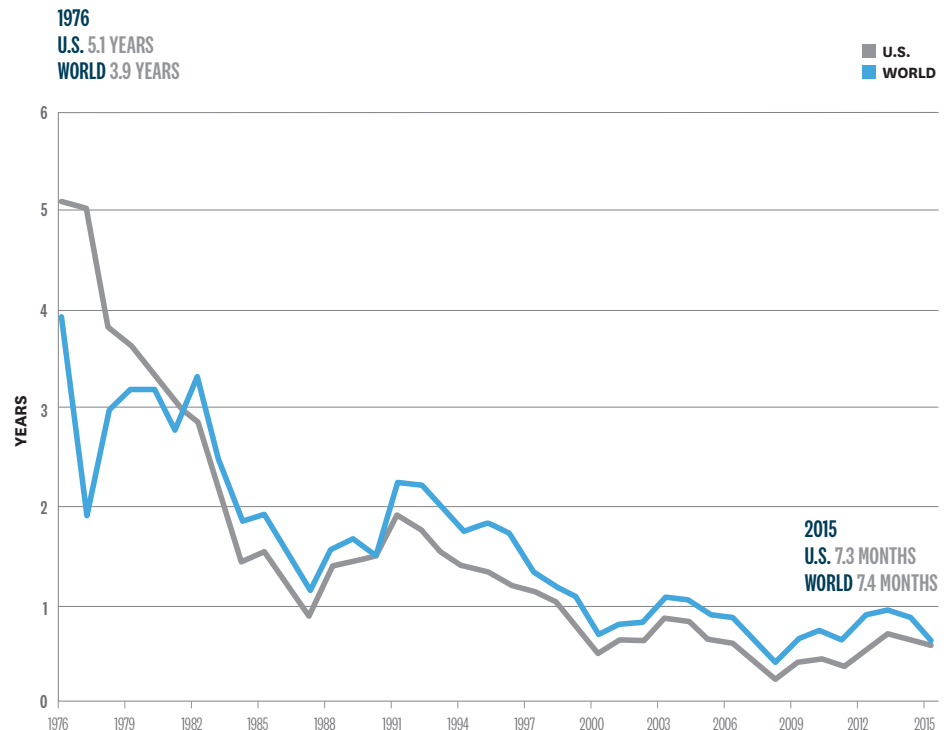
some cases—for injuries to third parties resulting from how that property is used. Shareholders bear no such responsibility. Under the doctrine of limited liability, they cannot be held personally liable for the corporation's debts or for corporate acts and omissions that result in injury to others.

With a few exceptions, shareholders are entitled to act entirely in their own interest within the bounds of the securities laws. Unlike directors, who are expected to refrain from self-dealing, they are free to act on both sides of a transaction in which they have an interest. Consider the contest between Allergan and Valeant. A member of Allergan's board who held shares in Valeant would have been expected to refrain from voting on the deal or promoting Valeant's bid. But Allergan shareholders with a stake in both companies were free to buy, sell, and vote as they saw fit, with no obligation to act in the best interests of either company. Institutional investors holding shares in thousands of companies regularly act on deals in which they have significant interests on both sides.

In a well-ordered economy, rights and responsibilities go together. Giving shareholders the rights of ownership while exempting them from the responsibilities opens the door to opportunism, overreach, and misuse of corporate assets. The risk is less worrying when shareholders do not seek to influence major corporate decisions, but it is acute when they do. The problem is clearest when temporary holders of large blocks of shares intervene to reconstitute a company's board, change its management, or restructure its finances in an effort to drive up its share price, only to sell out and move on to another target without ever having to answer for their intervention's impact on the company or other parties.

4 The theory's doctrine of alignment spreads moral hazard throughout a company and narrows management's field of vision. Just as freedom from accountability has a tendency to make shareholders indifferent to broader and longer-term considerations, so agency theory's recommended alignment between managers' interests and those of shareholders can skew the perspective of the entire organization. When the interests of successive layers of management are "aligned" in this manner, the corporation may become so biased toward the narrow

AVERAGE HOLDING PERIOD FOR PUBLIC COMPANY SHARES



SOURCE THE WORLD BANK, WORLD FEDERATION OF EXCHANGES DATABASE

interests of its current shareholders that it fails to meet the requirements of its customers or other constituencies. In extreme cases it may tilt so far that it can no longer function effectively. The story of Enron's collapse reveals how thoroughly the body of a company can be infected.

The notion that managing for the good of the company is the same as managing for the good of the stock is best understood as a theoretical conceit necessitated by the mathematical models that many economists favor. In practical terms there is (or can be) a stark difference. Once Allergan's management shifted its focus from sustaining long-term growth to getting the company's stock price to \$180 a share—the target at which institutional investors were willing to hold their shares—its priorities changed accordingly. Research was cut, investments were eliminated, and employees were dismissed.

5 The theory's assumption of shareholder uniformity is contrary to fact: Shareholders do not all have the same

objectives and cannot be treated as a single "owner." Agency theory assumes that all shareholders want the company to be run in a way that maximizes their own economic return. This simplifying assumption is useful for certain purposes, but it masks important differences. Shareholders have differing investment objectives, attitudes toward risk, and time horizons. Pension funds may seek current income and preservation of capital. Endowments may seek long-term growth. Young investors may accept considerably more risk than their elders will tolerate. Proxy voting records indicate that shareholders are divided on many of the resolutions put before them. They may also view strategic opportunities differently. In the months after Valeant announced its bid, Allergan officials met with a broad swath of institutional investors. According to Allergan's lead independent director, Michael Gallagher, "The diversity of opinion was as wide as could possibly be"—from those who opposed the deal and absolutely did

not want Valeant shares (the offer included both stock and cash) to those who saw it as the opportunity of a lifetime and could not understand why Allergan did not sit down with Valeant immediately.

THE AGENCY-BASED MODEL IN PRACTICE

Despite these problems, agency theory has attracted a wide following. Its tenets have provided the intellectual rationale for a variety of changes in practice that, taken together, have enhanced the power of shareholders and given rise to a model of governance and management that is unrelenting in its shareholder centrality. Here are just a few of the arenas in which the theory's influence can be seen:

Executive compensation. Agency theory ideas were instrumental in the shift from a largely cash-based system to one that relies predominantly on equity. Proponents of the shift argued that equity-based pay would better align the interests of executives with those of shareholders. The same argument was used to garner support for linking pay more closely to stock performance and for tax incentives to encourage such “pay for performance” arrangements. Following this logic, Congress adopted legislation in 1992 making executive pay above \$1 million deductible only if it is “performance based.” Today some 62% of executive pay is in the form of equity, compared with 19% in 1980.

Disclosure of executive pay. Agency theory's definition of performance and its doctrine of alignment undergird rules proposed by the SEC in 2015 requiring companies to expand the information on executive pay and shareholder returns provided in their annual proxy statements. The proposed rules call for companies to report their annual total shareholder return (TSR) over time, along with annual TSR figures for their peer group, and to describe the relationships between their TSR and their executive compensation and between their TSR and the TSR of their peers.

Shareholders' rights. The idea that shareholders are owners has been central to the push to give them more say in the nomination and election of directors and to make it easier for them to call a special meeting, act by written consent, or remove a director. Data from FactSet and other sources indicates that the proportion of S&P 500 companies with majority voting for

directors increased from about 16% in 2006 to 88% in 2015; the proportion with special meeting provisions rose from 41% in 2002 to 61% in 2015; and the proportion giving shareholders proxy access rights increased from less than half a percent in 2013 to some 39% by mid-2016.

The power of boards. Agency thinking has also propelled efforts to eliminate staggered boards in favor of annual election for all directors and to eliminate “poison pills” that would enable boards to slow down or prevent “owners” from voting on a premium offer for the company. From 2002 to 2015, the share of S&P 500 companies with staggered boards dropped from 61% to 10%, and the share with a standing poison pill fell from 60% to 4%. (Companies without a standing pill may still adopt a pill in response to an unsolicited offer—as was done by the Allergan board in response to Valeant's bid.)

Management attitudes. Agency theory's conception of management responsibility has been widely adopted. In 1997 the Business Roundtable issued a statement declaring that “the paramount duty of management and of boards of directors is to the corporation's stockholders” and that “the principal objective of a business enterprise is to generate economic returns to its owners.” Issued in response to pressure from institutional investors, the statement in effect revised the Roundtable's earlier position that “the shareholder must receive a good return but the legitimate concerns of other constituencies also must have the appropriate attention.” Various studies suggest ways in which managers have become more responsive to shareholders. Research indicates, for instance, that companies with majority (rather than plurality) voting for directors are more apt to adopt shareholder proposals that garner majority support, and that many chief financial officers are willing to forgo investments in projects expected to be profitable in the longer term in order to meet analysts' quarterly earnings estimates. According to surveys by the Aspen Institute, many business school graduates regard maximizing shareholder value as their top responsibility.

Investor behavior. Agency theory ideas have facilitated a rise in investor activism and legitimized the playbook of hedge funds that mobilize capital for the express purpose of buying company shares and using their position as “owners” to

effect changes aimed at creating shareholder value. (The sidebar “The Activist's Playbook” illustrates how agency theory ideas have been put into practice.) These investors are intervening more frequently and reshaping how companies allocate resources. In the process they are reshaping the strategic context in which all companies and their boards make decisions.

Taken individually, a change such as majority voting for directors may have merit. As a group, however, these changes have helped create an environment in which managers are under increasing pressure to deliver short-term financial results, and boards are being urged to “think like activists.”

IMPLICATIONS FOR COMPANIES

To appreciate the strategic implications of a typical activist program, it is instructive to use a tool developed in the 1960s by the Boston Consulting Group to guide the resource-allocation process. Called the growth share matrix, the tool helped managers see their company as a portfolio of businesses with differing characteristics. One group of businesses might be mature and require investment only for purposes of modest expansion and incremental improvement. Assuming they have strong market share relative to their nearest competitors, those businesses are likely to be profitable and generate cash. Another group might also have leading positions but be in fast-growing markets; they, too, are profitable, but they require heavy investment to maintain or improve market share. A third group might have weak competitive positions in mature markets; these businesses require cash for survival but have no prospects for growth or increased profits. A final group might be in rapidly growing new markets where several companies are competitive and prospects are bright but risky.

The developers of the matrix called these four groups cash cows, stars, dogs, and bright prospects, respectively. The segmentation was meant to ensure that cash cows were maintained, stars fully funded, dogs pruned, and a limited number of bright prospects chosen for their longer-term potential to become stars. (See the exhibit “The Growth Share Matrix.”) When companies don't manage a portfolio in this holistic fashion, funds tend to get spread evenly

across businesses on the basis of individual projects' forecasted returns.

It's a simple tool—but using it well is not simple at all. Managing a cash cow so that it remains healthy, nurturing star businesses in the face of emerging competition, fixing or divesting unpromising businesses, and selecting one or two bright prospects to grow—all this takes talented executives who can function effectively as a team. Companies that succeed in managing this ongoing resource-allocation challenge can grow and reinvent themselves continually over time.

The growth share matrix illuminates the strategic choices managers face as they seek to create value indefinitely into the future. It's also useful for showing how to drive up a company's share price in the short term. Suppose a corporation were to sell off the dogs, defund the bright prospects, and cut expenses such as marketing and R&D from the stars. That's a recipe for dramatically increased earnings, which would, in turn, drive up the share price. But the corporation might lose bright prospects that could have been developed into the stars and cash cows of the future.

The activist investor Nelson Peltz's 2014 proposal for DuPont provides an example of this idea. At the core of his three-year plan for increasing returns to shareholders was splitting the company into three autonomous businesses and eliminating its central research function. One of the new companies, "GrowthCo," was to consist of DuPont's agriculture, nutrition and health, and industrial biosciences businesses. A second, "CyclicalCo/CashCo," was to include the low-growth but highly cash-generative performance materials, safety, and electronics businesses. The third was the performance chemicals unit, Chemours, which DuPont had already decided to spin off. In growth-share-matrix terms, Peltz's plan was, in essence, to break up DuPont into a cash cow, a star, and a dog—and to eliminate some number of the bright prospects that might have been developed from innovations produced by centralized research. Peltz also proposed cutting other "excess" costs, adding debt, adopting a more shareholder-friendly policy for distributing cash from CyclicalCo/CashCo, prioritizing high returns on invested capital for initiatives at GrowthCo, and introducing more shareholder-friendly governance, including tighter alignment between executive

compensation and returns to shareholders. The plan would effectively dismantle DuPont and cap its future in return for an anticipated doubling in share price.

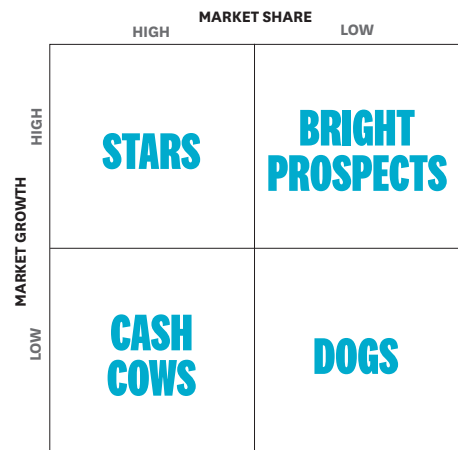
VALUE CREATION OR VALUE TRANSFER?

The question of whether shareholders benefit from such activism beyond an initial bump in stock price is likely to remain unresolved, given the methodological problems plaguing studies on the subject. No doubt in some cases activists have played a useful role in waking up a sleepy board or driving a long-overdue change in strategy or management. However, it is important to note that much of what activists call value creation is more accurately described as value transfer. When cash is paid out to shareholders rather than used to fund research, launch new ventures, or grow existing businesses, value has not been created. Nothing has been created. Rather, cash that would have been invested to generate future returns is simply being paid out to current shareholders. The lag time between when such decisions are taken and when their effect on earnings is evident exceeds the time frames of standard financial models, so the potential for damage to the company and future shareholders, not to mention society more broadly, can easily go unnoticed.

Given how long it takes to see the fruits of any significant research effort (Apple's latest iPhone chip was eight years in the making), the risk to research and innovation from activists who force deep cuts to drive up the share price and then sell out before the pipeline dries up is obvious. It doesn't help that financial models and capital markets are notoriously poor at valuing innovation. After Allergan was put into play by the offer from Valeant and Ackman's Pershing Square Capital Management, the company's share price rose by 30% as other hedge funds bought the stock. Some institutions sold to reap the immediate gain, and Allergan's management was soon facing pressure from the remaining institutions to accelerate cash flow and "bring earnings forward." In an attempt to hold on to those shareholders, the company made deeper cuts in the workforce than previously planned and curtailed early-stage research programs. Academic studies have found that a significant proportion of hedge fund interventions involve large increases in

THE GROWTH SHARE MATRIX

BCG's growth share matrix enables companies to manage a portfolio of businesses: "cash cows," mature businesses that throw off cash; fast-growing "stars"; businesses with a weak position and few prospects for growth ("dogs"); and risky but big-upside businesses in fast-growing markets ("bright prospects").



SOURCE BOSTON CONSULTING GROUP

leverage and large decreases in investment, particularly in research and development.

The activists' claim of value creation is further clouded by indications that some of the value purportedly created for shareholders is actually value transferred from other parties or from the general public. Large-sample research on this question is limited, but one study suggests that the positive abnormal returns associated with the announcement of a hedge fund intervention are, in part, a transfer of wealth from workers to shareholders. The study found that workers' hours decreased and their wages stagnated in the three years after an intervention. Other studies have found that some of the gains for shareholders come at the expense of bondholders. Still other academic work links aggressive pay-for-stock-performance arrangements to various misdeeds involving harm to consumers, damage to the environment, and irregularities in accounting and financial reporting.

We are not aware of any studies that examine the total impact of hedge fund interventions on all stakeholders or society

at large. Still, it appears self-evident that shareholders' gains are sometimes simply transfers from the public purse, such as when management improves earnings by shifting a company's tax domicile to a lower-tax jurisdiction—a move often favored by activists, and one of Valeant's proposals for Allergan. Similarly, budget cuts that eliminate exploratory research aimed at addressing some of society's most vexing challenges may enhance current earnings but at a cost to society as well as to the company's prospects for the future.

Hedge fund activism points to some of the risks inherent in giving too much power to unaccountable "owners." As our analysis of agency theory's premises suggests, the problem of moral hazard is real—and the consequences are serious. Yet practitioners continue to embrace the theory's doctrines; regulators continue to embed them in policy; boards and managers are under increasing pressure to deliver short-term returns; and legal experts forecast that the trend toward greater shareholder empowerment will persist. To us, the prospect that public companies will be run even more strictly according to the agency-based model is alarming. Rigid adherence to the model by companies uniformly across the economy could easily result in even more pressure for current earnings, less investment in R&D and in people, fewer transformational strategies and innovative business models, and further wealth flowing to sophisticated investors at the expense of ordinary investors and everyone else.

TOWARD A COMPANY-CENTERED MODEL

A better model, we submit, would have at its core the health of the enterprise rather than near-term returns to its shareholders. Such a model would start by recognizing that corporations are independent entities endowed by law with the potential for indefinite life. With the right leadership, they can be managed to serve markets and society over long periods of time. Agency theory largely ignores these distinctive and socially valuable features of the corporation, and the associated challenges of managing for the long term, on the grounds that corporations are "legal fictions." In their seminal 1976 article, Jensen and Meckling warn against "falling into the trap" of asking what a company's objective should be or whether the company has a social responsibility. Such

THE ACTIVIST'S PLAYBOOK

For an understanding of the agency-based model in practice, there is no better place to look than an activist campaign. As a first step, the activist acquires shares in the targeted company—typically somewhere between 5% and 10%, but sometimes less than 1%. Shares in hand, he then claims the right to issue directives. (To leverage that power, he will often alert other hedge funds to his actions.) The language of ownership typically plays a prominent role. For example, in 2014, to advance a takeover of Allergan by Valeant Pharmaceuticals, Bill Ackman, of Pershing Square Capital Management, attacked Allergan's board for failing to do what the directors were paid to do "on behalf of the Company's owners." The activist may challenge the board's professionalism by appealing to agency theory norms of directorship. In one letter to the Allergan board, Ackman declared: "Your actions have wasted corporate resources, delayed enormous potential value creation for shareholders, and are professionally and personally embarrassing for you."

Although campaigns differ in their particulars, the activist's playbook for increasing shareholder value is fairly standard. As our colleagues Ian Gow and Suraj Srinivasan (with others) have documented in their study of nearly 800 campaigns at U.S. companies from 2004 to 2012, activists tend to focus on capital structure, strategy, and governance.

questions, they argue, mistakenly imply that a corporation is an "individual" rather than merely a convenient legal construct. In a similar vein, Friedman asserts that it cannot have responsibilities because it is an "artificial person."

In fact, of course, corporations *are* legal constructs, but that in no way makes them artificial. They are economic and social organisms whose creation is authorized by governments to accomplish objectives that cannot be achieved by more-limited organizational forms such as partnerships and proprietorships. Their nearly 400-year history of development speaks to the important role they play in society. Originally a corporation's objectives were set in its charter—build and operate a canal, for example—but eventually the form became generic so that corporations could be used

They typically call for some combination of cutting costs, adding debt, buying back shares, issuing special dividends, spinning off businesses, reconstituting the board, replacing the CEO, changing the strategy, and selling the company or its main asset. Tax reduction is another element of many activist programs.

An activist whose demands go unheeded may initiate a proxy fight in an attempt to replace incumbent board members with directors more willing to do the activist's bidding. In a few instances, activists have even offered their chosen nominees special bonuses to stand for election or additional incentives for increasing shareholder value in their role as directors.

By most indications, hedge fund activists have been quite successful in effecting the changes they've sought. As reported by the industry, more companies are being targeted—473 worldwide in the first half of 2016 (including 306 in the United States), up from 136 worldwide in all of 2010—and activists' demands are frequently being met. In the United States in 2015, 69% of demands were at least partially satisfied, the highest proportion since 2010. Activists are also gaining clout in the boardroom, where they won 397 seats at U.S. companies in 2014 and 2015. Although activist hedge funds saw outflows of some \$7.4 billion in the first three quarters of 2016, assets under management were estimated at more than \$116 billion in late 2016, up from \$2.7 billion in 2000.

to accomplish a wide variety of objectives chosen by their management and governing bodies. As their scale and scope grew, so did their power. The choices made by corporate decision makers today can transform societies and touch the lives of millions, if not billions, of people across the globe.

The model we envision would acknowledge the realities of managing these organizations over time and would be responsive to the needs of all shareholders—not just those who are most vocal at a given moment. Here we offer eight propositions that together provide a radically different and, we believe, more realistic foundation for corporate governance and shareholder engagement.

1 Corporations are complex organizations whose effective functioning depends on talented leaders and managers. The

success of a leader has more to do with intrinsic motivation, skills, capabilities, and character than with whether his or her pay is tied to shareholder returns. If leaders are poorly equipped for the job, giving them more “skin in the game” will not improve the situation and may even make it worse. (Part of the problem with equity-based pay is that it conflates executive skill and luck.) The challenges of corporate leadership—crafting strategy, building a strong organization, developing and motivating talented executives, and allocating resources among the corporation’s various businesses for present and future returns—are significant. In focusing on incentives as the key to ensuring effective leadership, agency theory diminishes these challenges and the importance of developing individuals who can meet them.

2 Corporations can prosper over the long term only if they’re able to learn, adapt, and regularly transform themselves.

In some industries today, companies may need reinvention every five years to keep up with changes in markets, competition, or technology. Changes of this sort, already difficult, are made more so by the idea that management is about assigning individuals fixed decision rights, giving them clear goals, offering them incentives to achieve those goals, and then paying them (or not) depending on whether the goals are met. This approach presupposes a degree of predictability, hierarchy, and task independence that is rare in today’s organizations. Most tasks involve cooperation across organizational lines, making it difficult to establish clear links between individual contributions and specific outcomes.

3 Corporations perform many functions in society. One of them is providing investment opportunities and generating wealth, but corporations also produce goods and services, provide employment, develop technologies, pay taxes, and make other contributions to the communities in which they operate. Singling out any one of these as “the purpose of the corporation” may say more about the commentator than about the corporation. Agency economists, it seems, gravitate toward maximizing shareholder wealth as the central purpose.

Marketers tend to favor serving customers. Engineers lean toward innovation and excellence in product performance. From a societal perspective, the most important feature of the corporation may be that it performs all these functions simultaneously over time. As a historical matter, the original purpose of the corporation—reflected in debates about limited liability and general incorporation statutes—was to facilitate economic growth by enabling projects that required large-scale, long-term investment.

4 Corporations have differing objectives and differing strategies for achieving them. The purpose of the (generic) corporation from a societal perspective is

It appears self-evident that shareholders’ gains are sometimes simply transfers from the public purse.

not the same as the purpose of a (particular) corporation as seen by its founders, managers, or governing authorities. Just as the purposes and strategies of individual companies vary widely, so must their performance measures. Moreover, companies’ strategies are almost always in transition as markets change. An overemphasis on TSR for assessing and comparing corporate performance can distort the allocation of resources and undermine a company’s ability to deliver on its chosen strategy.

5 Corporations must create value for multiple constituencies. In a free market system, companies succeed only if

customers want their products, employees want to work for them, suppliers want them as partners, shareholders want to buy their stock, and communities want their presence. Figuring out how to maintain these relationships and deciding when trade-offs are necessary among the interests of these various groups are central challenges of corporate leadership. Agency theory’s implied decision rule—that managers should always maximize value for shareholders—oversimplifies this challenge and leads eventually to systematic underinvestment in other important relationships.

6 Corporations must have ethical standards to guide interactions with all their constituencies, including shareholders and society at large. Adherence to these standards, which go beyond forbearance from fraud and collusion, is essential for earning the trust companies need to function effectively over time.

Agency theory’s ambivalence regarding corporate ethics can set companies up for destructive and even criminal behavior—which generates a need for the costly regulations that agency theory proponents are quick to decry.

7 Corporations are embedded in a political and socioeconomic system whose health is vital to their sustainability. Elsewhere we have written about the damaging and often self-destructive consequences of companies’ indifference to negative externalities produced by their activities. We have also found that societal and systemwide problems can be a source of both risk and opportunity for companies. Consider Ecomagination, the business GE built around environmental challenges, or China Mobile’s rural communications strategy, which helped narrow the digital divide between China’s urban and rural populations and fueled the company’s growth for nearly half a decade. Agency theory’s insistence that corporations (because they are legal fictions) cannot have social responsibilities and that societal problems are beyond the purview of business (and should be left to governments) results in a narrowness of vision that prevents corporate leaders from seeing, let alone acting on, many risks and opportunities.

8 The interests of the corporation are distinct from the interests of any particular shareholder or constituency group.

As early as 1610, the directors of the Dutch East India Company recognized that shareholders with a 10-year time horizon would be unenthusiastic about the company's investing resources in longer-term projects that were likely to pay off only in the second of two 10-year periods allowed by the original charter. The solution, suggested one official, was to focus not on the initial 10-year investors but on the strategic goals of the enterprise, which in this case meant investing in those longer-term projects to maintain the company's position in Asia. The notion that all shareholders have the same interests and that those interests are the same as the corporation's masks such fundamental differences. It also provides intellectual cover for powerful shareholders who seek to divert the corporation to their own purposes while claiming to act on behalf of all shareholders.

These propositions underscore the need for an approach to governance that takes the corporation seriously as an institution in society and centers on the sustained performance of the enterprise. They also point to a stronger role for boards and a system of accountability for boards and executives that includes but is broader than accountability to shareholders. In the model implied by these propositions, boards and business leaders would take a fundamentally different approach to such basic tasks as strategy development, resource allocation, performance evaluation, and shareholder engagement. For instance, managers would be expected to take a longer view in formulating strategy and allocating resources.

The new model has yet to be fully developed, but its conceptual foundations can be outlined. As shown in the exhibit "Contrasting Approaches to Corporate Governance," the company-centered model we envision tracks basic corporate law in holding that a corporation is an independent entity, that management's authority comes from the corporation's governing body and ultimately from the law, and that managers are fiduciaries (rather than agents) and are thus obliged to act in the best interests of the corporation and its shareholders (which is not the same as carrying out the wishes of even a majority of shareholders). This model recognizes

FURTHER READING

Below are some of the books and articles that examine themes touched on in this article.

Capitalism at Risk: Rethinking the Role of Business

Joseph L. Bower, Herman B. Leonard, and Lynn S. Paine
Harvard Business Review Press, 2011

Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It

Colin Mayer
Oxford University Press, 2013

Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL

Roger L. Martin
Harvard Business Review Press, 2011

The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public

Lynn Stout
Berrett-Koehler, 2012

"Focusing Capital on the Long Term"

Dominic Barton and Mark Wiseman
HBR, January–February 2014

"A Global Leader's Guide to Managing Business Conduct"

Lynn S. Paine, Rohit Deshpandé, and Joshua D. Margolis
HBR, September 2011

"The Incentive Bubble"

Mihir Desai
HBR, March 2012

"Managing Investors: An Interview with Sam Palmisano"

Justin Fox
HBR, June 2014

"What Good Are Shareholders?"

Justin Fox and Jay W. Lorsch
HBR, July–August 2012

the diversity of shareholders' goals and the varied roles played by corporations in society. We believe that it aligns better than the agency-based model does with the realities of managing a corporation for success over time and is thus more consistent with corporations' original purpose and unique potential as vehicles for projects involving large-scale, long-term investment.

The practical implications of company-centered governance are far-reaching. In boardrooms adopting this approach, we would expect to see some or all of these features:

- greater likelihood of a staggered board to facilitate continuity and the transfer of institutional knowledge
- more board-level attention to succession planning and leadership development
- more board time devoted to strategies for the company's continuing growth and renewal
- closer links between executive compensation and achieving the company's strategic goals
- more attention to risk analysis and political and environmental uncertainty
- a strategic (rather than narrowly financial) approach to resource allocation
- a stronger focus on investments in new capabilities and innovation
- more-conservative use of leverage as a cushion against market volatility
- concern with corporate citizenship and ethical issues that goes beyond legal compliance

A company-centered model of governance would not relieve corporations of the need to provide a return over time that reflected the cost of capital. But they would be open to a wider range of strategic positions and time horizons and would more easily attract investors who shared their goals. Speculators will always seek to exploit changes in share price—but it's not inevitable that they will color all corporate governance. It's just that agency theory, in combination with other doctrines of modern economics, has erased the distinctions among investors and converted all of us into speculators.


If our model were accepted, speculators would have less opportunity to profit by transforming long-term players into sources of higher earnings and share prices in the short term. The legitimizing argument for attacks by unaccountable parties with opaque holdings would lose its force. We can even imagine a new breed of investors and asset managers who would focus explicitly on long-term investing. They might develop new valuation models that take a

broader view of companies’ prospects or make a specialty of valuing the hard-to-value innovations and intangibles—and also the costly externalities—that are often ignored in today’s models. They might want to hold shares in companies that promise a solid and continuing return and that behave as decent corporate citizens. Proxy advisers might emerge to serve such investors.

We would also expect to find more support for measures to enhance shareholders’ accountability. For instance, activist shareholders seeking significant influence or control might be treated as fiduciaries for the corporation or restricted in their ability to sell or hedge the value of their shares. Regulators might be inclined to call for greater transparency regarding the beneficial ownership of shares. In particular, activist funds might be required to disclose the identities of their investors and to provide additional information about the nature of their own governance. Regulators might close the 10-day window currently afforded between the time a hedge fund acquires a disclosable stake and the time the holding must actually be disclosed. To date, efforts to close the window have met resistance from agency theory proponents who argue that it is needed to give hedge funds sufficient incentive to engage in costly efforts to dislodge poorly performing managers.

THE TIME HAS come to challenge the agency-based model of corporate governance. Its mantra of maximizing shareholder value is distracting companies and their leaders from the innovation, strategic renewal, and investment in the future that require their attention. History has shown that with enlightened management and sensible regulation, companies can play a useful role in helping society adapt to constant change. But that can happen only if directors and managers have sufficient discretion to take a longer, broader view of the company and its business. As long as they face the prospect of a surprise attack by unaccountable “owners,” today’s business leaders have little choice but to focus on the here and now. ☹

HBR Reprint R1703B

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CONTRASTING APPROACHES TO CORPORATE GOVERNANCE

	SHAREHOLDER CENTERED	COMPANY CENTERED
THEORY	AGENCY THEORY	ENTITY THEORY
CONCEPTION OF THE CORPORATION	Legal fiction; nexus of contracts; pool of capital	Legal entity; social and economic organism; purposeful organization
ORIGINS OF THE CORPORATION	Private agreement among property owners to pool and increase capital	Created by lawmakers to encourage investment in long-term, large-scale projects needed by society
FUNCTIONS OF THE CORPORATION	Maximize wealth for shareholders	Provide goods and services; provide employment; create opportunities for investment; drive innovation
PURPOSE OF SPECIFIC CORPORATIONS	Maximize shareholder value	Business purpose set by the particular company’s board
RESPONSIBILITIES TO SOCIETY	None (fictional entities can’t have responsibilities)	Fulfill business purpose and act as a good corporate citizen
ETHICAL STANDARDS	Unclear: whatever shareholders want, or obey law and avoid fraud or collusion	Obey law and follow generally accepted ethical standards
ROLE OF SHAREHOLDERS	Principals/owners of the corporation with authority over its business	Owners of shares; suppliers of capital with defined rights and responsibilities
NATURE OF SHAREHOLDERS	Undifferentiated, self-interested wealth maximizers	Diverse, with differing objectives, incentives, time horizons, and preferences
ROLE OF DIRECTORS	Shareholders’ agents, delegates, or representatives	Fiduciaries for the corporation and its shareholders
ROLE OF MANAGEMENT	Shareholders’ agents	Leaders of the organization; fiduciaries for the corporation and its shareholders
MANAGEMENT’S OBJECTIVE	Maximize returns to shareholders	Sustain performance of the enterprise
MANAGEMENT’S TIME FRAME	Present/near term (theory assumes the current share price captures all available knowledge about the company’s future)	Established by the board; potentially indefinite, requiring attention to near, medium, and long term
MANAGEMENT PERFORMANCE METRICS	Single: returns to shareholders	Multiple: returns to shareholders; company value; achievement of strategic goals; quality of goods and services; employee well-being
STRENGTH	Simple structure permits clear economic argument	Consistent with law, history, and the realities facing managers
WEAKNESS	Principles do not accord with law or good management; shareholders have power without accountability	Principles describe complex relationships and responsibilities; success is difficult to assess