Changing Paradigms in Corporate Governance:
New Cycles and New Responsibilities

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Abstract

Purpose

This article analyses the evolution of corporate governance, highlighting the different eras of governance, and the dominant theoretical and practical paradigms. The article demonstrates that as the contest between paradigms occurs over time, the reformulation of paradigms and the creation of counter paradigms takes place in a continuous dialectical tension of ideas with practice.

Design/methodology/approach

The approach of the paper is conceptual and historical analyzing the competing paradigms and cycles of governance in terms of the transformation of the political economy of market capitalism, and the contrasting attempts to interpret and legitimate this,

Findings

The conclusions of the analysis are that while agency theory and shareholder value orientations have dominated the understanding of corporate governance for half a century, the inherent weaknesses in this theoretical and practical approach limit considerably its usefulness in facilitating the corporate response to a resource constrained world. Corporate social and environmental responsibility will require broader and more inclusive definitions of corporate purpose.

Originality/value

This article portrays the conceptual and practical contests in corporate governance over the last century in a comprehensive, critical and accessible way. Highlighting the paradigmatic eras and the causes of the historical paradigm shifts in corporate governance.

Biography

Thomas Clarke is Professor of Management and Director of the Centre for Corporate Governance at UTS Sydney. He has wide interests in international and comparative corporate governance; corporate governance in the finance sector; and corporate social responsibility and sustainability; and boards and directors research. He has published International Corporate Governance, London: Routledge (Second Edition 2016); and with Douglas Branson edited The Sage Handbook of Corporate Governance, London: Sage 2012. He is the editor with Justin O'Brien and Charles O'Kelly of the Oxford Handbook of the Corporation (OUP 2016).

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Introduction

This paper is designed to interpret the evolution of corporate governance through a series of changing paradigms in response to wider transformations in the political economy, business and society. The paper begins with the paradigm shifts from entrepreneurship to management, from simple owner operated businesses at the time of the industrial revolution to the large, vertically integrated businesses with dispersed shareholders of the 20th century. The power of paradigms is identified in providing the conceptual lens in which managers understand and act upon the world. The analysis continues with a focus upon how the technocratic corporation of the mid-20th century pursued wider social and economic objectives, which were severely constrained by the arrival of increasingly financialised conceptions of the corporation marked by the arrival of agency theory and shareholder primacy in the late 1970s.

How this financialised and dehumanized approach to corporate purpose has damaged economies and societies is highlighted, resulting in the global financial crisis. The hegemony of maximizing shareholder value as the sole objective of corporations is questioned by a comparison with the more practical approach of team production theory. The wider initiatives to introduce a greater sense of corporate social and environmental responsibility are reviewed in a context of the imminent peril of planetary failure through global warming. In this context the objectives of business and the definition of wealth creation will face dramatic transformation with the rapid emergence of the paradigm of sustainability as the primary goal. The paper concludes with how corporate governance will integrate with corporate social and environmental responsibility to sustain this new business paradigm.

Changing Paradigms

Contemporary corporate governance has evolved through a series of competing epoch making paradigmatic contests. Tricker (1984; 2012) has suggested three distinct eras of corporate governance during which these contests have occurred can be identified:

- 19th C Entrepreneurship
- 20thC   Management
- 21st C Governance

In the 19 th century entrepreneurs advanced innovative new technologies and products, building businesses as enterprises they owned and controlled, and upon which they forged their own personalities and interests, often with great determination. As these enterprises increased in scale and complexity there was a requirement for specialized management and additional investment beyond

the means of the single entrepreneur. The call for external investment from dispersed shareholder led to the separation of ownership and control. Though they existed from the beginning of the limited liability company, boards of directors became more firmly established in the 20th century to pursue the best interests of the company and provide accountability for performance to wider shareholders. Often however the board remained nominally in control, and the incumbent executive management exercised effective control. In the 21st century there is a demand for wider accountability and responsibility from business with the increasing recognition of the profound environmental and social impact of corporations. The UN and other international agencies have prompted national governments and business corporations to take action to reduce the damaging environmental and social impact of business activity, and a broad movement of investors and civil society have campaigned for more sustainable and responsible enterprise. Leading this movement are the vast investment institutions representing large sections of the community including superannuation, insurance and mutual funds. This has promoted a greater interest in the governance of corporations, and most recently in their sustainability.

Managers working in a specific era typically see the world through the lens of a powerful paradigm, encompassing frames of reference, metaphors and perspectives which represent a degree of coherence, but which offer interpretations that often differ radically from those in use in preceding and succeeding eras. Paradigms are means of understanding the world, and the basis for informing action. The concept of paradigm is at once ancient and contemporary. Its name derives from the ancient Greek *paradeigma*. Classically it meant a model or framework and this meaning has survived to the present day. It was a historian of science Thomas Kuhn who pioneered the idea of changing paradigms in *The Structure of Scientific Revolution* (1970). For Kuhn science was characterized by the dominance of succeeding paradigms as models of thinking: "a constellation of concepts, values and perceptions and practices shared by a community which forms a particular vision of reality, that is the way a community organizes itself."

While the idea of paradigms has been widely accepted in management studies it has been more a contested than settled domain. In management at any one time there are a number of competing paradigms available (Clarke and Clegg 2000a). Using new frames of reference the managerial and organizational world not only looks different, it becomes different (sometimes presented as the social construction of reality) (Berger and Luckmann (1966). *Paradigm shifts*, occur with a transformation from one paradigm to the next new paradigm. In these circumstances during the period of transition uncertainty and ambiguity will apply. Paradigm shifts are continuously challenging today because the pace of social, economic and technological change is more rapid, and the impact of business on the environment and society is more profound. A combination of multiple technological breakthroughs, shortening product life cycles along global value chains, and rapidly changing markets are

accelerating the pace of paradigm shifts, while serious questions are being raised concerning the sustainability of business enterprise (Clarke and Clegg 2000b).

The Evolution of Corporate Governance Paradigms

The evolution of corporate governance is shown in Figure 1 which highlights the different eras of governance, and the dominant theoretical and practical paradigms. As the contest between paradigms occurs over time the reformulation of paradigms and the creation of counter paradigms takes place in a continuous dialectical tension of ideas with practice. The early decades of governance in the 19th century were spent wrestling with the implications of the limited liability corporation. In the 1930s Berle and Means (1932) recognition of the paradigm shift from owner-entrepreneurs to modern corporations with professional managers and dispersed shareholders defined the parameters of debate for the next half century, leading ultimately to the ideas of John Kenneth Galbraith (1952:1967) and Alfred Chandler (1977) on the nature of the new industrial state and the managerial revolution during the expansionary years of the post-war recovery. In more troubled economic times in the closing decades of the 20th century the narrower focus of Jensen and Meckling (1967) on the principal-agency problem took hold with a vice-like grip on the minds of economists, lawyers, policy makers, and sometimes self-interested business people.

FIGURE 1

The Evolution of Corporate Governance Paradigms

More recently a reform movement in corporate governance, initiated in the 1992 UK Cadbury report, and disseminated internationally by the OECD, World Bank and other international agencies has continued, though defied by the spectacular corporate failures of Enron and WorldCom, and almost imploding in the recklessness of the global financial crisis, which led to the world-wide effort to regulate and constrain the excesses of the finance sector in the Dodd-Frank Act in the US, the Basel dregulations on capital adequacy and the governance of strategically important financial institutions, and many other international and national measures. Finally there has been a widespread and insistent questioning of the sustainability of a carbon economy in the context of increasing pollution and global warming. While this interest in corporate social and environmental responsibility was deflected in the urgency of restoring financial stability following the global financial crisis, it is these profound questions of the impact of corporations upon social and environmental sustainability that will preoccupy the paradigmatic contests of corporate governance throughout the remaining decades of the 21st century.

Throughout the last century there were always radical voices that offered a different critique of the political economy of capitalism and the role of large, multinational corporations that increasingly

dominated the global economy. In different era's socialist, progressive, communitarian, and stakeholder ideas possessed resonance, and an appeal to an alternative economic and political system, that led to many countries pursuing a different path of economic development.

It should not be forgotten that for much of the 20th century in many countries large sectors of industry were placed into public ownership because of the recognition of widespread market and managerial failure, while the international privatization movement since the 1980s Reagan/Thatcher era has reversed this trend doubts remain about the viability of replacing public monopolies with private monopolies and oligopolies in many countries (Clarke 1994a; 1994b). In addition the voluntary, social and cooperative sectors of many economies remains large and vibrant catering for needs the market neglects. Radical critiques of capitalism survive, and have achieved a new vibrancy with the realization that unrestrained capitalism is threatening the ecology and community in a more critical way than ever before.

Yet towards the end of the 20th century it seemed apparent that the market based system and the neo-classical economic rationale on which it was constructed was very much in the ascendancy. Among the strongest intellectual forces of this neo-classical legacy is undoubtedly a particularly lethal, stripped down interpretation of agency theory and shareholder value. How the crudest of conceptions could capture such a hegemonic hold in the way corporations are conceived is a subject worthy of deep study in the sociology of knowledge.

Another tributary of ideas has offered a more thoughtful interpretation of the corporate governance dilemma: team production theory initiated by Alchian and Demsetz (1973) comprehends something of the collaborative basis of business endeavor that was fundamental to earlier theorists. The reformulation of team production theory by Margaret Blair and Lynn Stout (1999; 2001) presents a recognizable and meaningful explanation of the purpose of the corporation and the duties of directors. However to meet the imminent challenge of social and environmental sustainability in a post-carbon economy, further rethinking of corporate purpose, corporate governance and directors duties will be essential. This sustainability revolution has only just commenced, but in the course of the 21st century will transform business and society.

In a context where the adequacy of the dominant paradigms of corporate governance is increasingly challenged, the search for coherent new paradigms is a vital task in corporate governance since the discipline's critical weaknesses are becoming more apparent:

- Corporate governance has become identified almost exclusively with endless templates for compliance and regulation;

- Corporate governance is overwhelmed by the intellectual constrictions of Agency Theory (Weinstein 2012; Clarke 2014);
- Corporate governance is neglectful of diversity, creativity and innovation in corporate forms and activity;
- Corporate governance is unaware of its impact upon the intensification of inequality in both the corporation and wider society (Ireland 2005; Pickety 2014);
- Corporate governance is discipline with a narrow focus on empirical studies of abstracted variables and bereft of attempts at holistic explanations of integrated and inter-related social and economic institutions and systems.
- Corporate governance is ill-equipped to deal with the urgent imperative of climate change and to deliver sustainable enterprise (Clarke 2016).

Berle and Means and the Search for a New Conception of the Corporation

From the origins of contemporary capitalism, the wider purposes and interests of the corporation were recognised and valued. Berle and Means were the first to fully explore the structural and strategic implications of the separation of ownership and control (Weinstein 2012). Berle wrote in the preface to *The Modern Corporation and Private Property* (1932) that "it was apparent to any thoughtful observer that the American corporation had ceased to be a private business device and had become an institution." In their monumental work Berle and Means searched for a new conception of the corporation that embraced the wide constituency of corporate interests and responsibilities (a concern tragically abandoned by most contemporary financial economists):

> "Neither the claims of ownership nor those of control can stand against the paramount interest of the community....It remains only for the claims of the community to be put forward with clarity and force. Rigid enforcement of property rights as a temporary protection against plundering by control would not stand in the way of the modification of these rights in the interests of other groups. When a convincing system for community obligations is worked out and is generally accepted, in that moment the passive property right of today must yield before the larger interests of society…It is conceivable, indeed it is almost essential if the corporate system is to survive, that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income streams on the basis of public policy rather than private cupidity" (Berle and Means 1932: 312).

As Olivier Weinstein suggests the clear features of the new form of corporate enterprise advanced by Berle and Means included three essential dimensions:

- The separation between investors and the enterprise, the status of the corporation making the corporation an autonomous entity, involving the strict separation between the assets of the enterprise and the assets of the investors;
- Incorporation required governance rules legally separating business decision-making from the contribution of finance capital, and giving discretionary powers to directors and officers, recognizing their managerial rights to allocate corporate resources (Blair 2005);
- The freedom in a public corporation for shareholders to sell their stock with the development of capital markets. This signified a radical change in the relationship of the investors and the enterprise (Weinstein 2012:5).

These dimensions are integral to the investment, operation and development of corporations, and the workings of capital markets, and are the foundation on which Berle and Means built their theory of the implications of the separation of ownership and control. Integral to this theorisation is a realisation that there is a distinction between the corporation as a legal entity and the firm as a real organisation. The corporation is both a legal entity, and a collective, economic set of activities, that cannot be simply reduced to a series of contracts. It is this latter existence that gives the corporation an existence independent from the changing shareholders (Blair and Stout 1999; Mitchell, O'Donnell and Ramsay 2005). This gives rise to the enduring question of in whose interests should the corporation be managed (Dodd 1932)?

Berle and Means could never have imagined that 80 years later corporations, managers, shareholders and lawyers would remain mired in the controversial issues raised by their ideals. And however undermined and marginalized the idealism of Berle and Means became in the work of financial economists in the later 20th century who reasserted shareholder primacy with a purity and intensity not witnessed since the early 19th century *laissez-faire* origins of industrial capitalism, yet the resonances of good sense of the original Berle and Means statement continued in the minds and actions of practical managers and corporations.

The New Deal? From Managerialism to Shareholder Primacy

An emerging collective conception of the corporation was conveyed in the early work of Berle and Means who identified the importance of managing multi-dimensional relationships, and the increasing accountability of the corporate entity with profound obligations to the wider community. Yet paradoxically Berle and Means left an ambiguous legacy (Cioffi 2011), that was subsequently interpreted in two alternative and sharply contrasting theories, one collective and collaborative, the

other individualistic and contractual (Weinstein 2012). Throughout much of the 20th century the large modern enterprise was represented by Galbraith (1952; 1967), Chandler (1977) and others as a social institution: an organisation formed through collective action, and technological advance. Chandler is identified with the conception of the large corporation as an integrated, unified, collective entity that could not possibly be reduced to the sum of individuals it comprises (Weinstein 2012). Then in the later decades of the 20th century the view of the enterprise as a simple contractual arrangement, a nexus of contracts, and a mode of interaction between individuals became ascendant, providing the theoretical framework for the ultimately hegemonic agency theory and its insistence on shareholder primacy and shareholder value.

The modern corporation as typified by Berle and Means manifested the separation of ownership and control, where professional managers were able to determine the direction of the enterprise and shareholders had "surrendered a set of definite rights for a set of indefinite expectations" (Berle and Means 1932:244). After the New Deal and the end of the Second World War, managers seized the opportunities newly open to them, and many US corporations grew massively in scale and market domination achieving a pre-eminent position in the world economy. A new managerial mode of coordination of enterprise, technology, and planning had arrived transcending the market (Chandler 1977; 1984; Marris 1964). As Lynn Stout recounts:

> "History suggests that Berle and Means's 1932 prediction proved largely correct. For the next half-century, boards and executives of public corporations embraced a philosophy that has been called "managerial capitalism" or "managerialism." Rather than seeing themselves as mere agents of shareholders, corporate directors and professional executives—who usually worked for fixed fees and owned relatively little stock in the company—viewed themselves as stewards or trustees charged with guiding a vital social and economic institution in the interests of a wide range of beneficiaries. Certainly they looked out for investors' interests, but they looked out for the interests of employees, customers, and the nation as well…" (Stout 2013:1171).

This was the era of Galbraith's *New Industrial State* (1967) in which corporate growth and brand prestige appeared to displace profit maximisation as the goal of technocratic managers, (who possessed in his view often excessively concentrated power). In a technocratic milieu the shareholder was rendered "passive and functionless, remarkable only in his capacity to share without effort or appreciable risk, the gains from growth by which the technostructure measures its success"(Galbraith 1967:356) This Galbraithian idyll was disintegrating by the time of the severe recession of the early

1970s, with the incapacity of US corporations to compete effectively with Japanese and European products in important consumer market sectors, accompanied by a push by Wall Street towards conglomerate formation in the interests of managing multiple businesses by financial performance. "Over time purely financial interests have increasingly asserted their influence over hybridised giant corporations" (Henwood 1998:262).

The New Hegemony? From Agency Theory to Shareholder Value

While the nexus of contracts theory associated with Alchian and Demetz (1973) preceded agency theory, and provided the intellectual foundation upon which it was based, it was the cruder aspects of agency theory that became the dominant paradigm in business and law in the later decades of the 20th century. The insistence on the collective and public nature of the new corporations which Berle and Means convincingly made and others including Galbraith and Chandler developed, invited a response from economists and lawyers who retained a belief in private property, free markets and shareholder rights. This was a determined and successful effort to impose "the re-privatization of the corporation" (Ireland 2005; Weinstein 2012)

A fertile scene was set for Michael Jensen, his colleagues in the Business and Law Schools at Harvard, and the Chicago school of economics, as enthusiastic advocates of the financialization sweeping through corporate America, to develop a finance-based theory of corporate governance that was to envelop Anglo-American policy and practice. Management theory and practice for some decades has been overwhelmed by this narrow and constricted view of the modern corporation, distilled into agency theory. Agency theory is often assumed to be eternal, universal and unquestionable in its explanation of the essence of the nature of the corporation. In fact agency theory is of quite recent construction, heavily focused on the Anglo-American business world, and is profoundly questionable. All of the sophistication, rich diversity, nuances and insights of management scholars and the experience and wisdom of management practitioners have been displaced by the rigid simplicity of the assumptions of agency theory in recent decades (Ghoshal 2005). This one-dimensional management, with its self-validating hypotheses, as Marcuse (1964) warned, has populated the management journals, and infused management discourse.

Jensen and Meckling's (1976) *Theory of the Firm: Managerial Behaviour, Agency Costs and Capital Structure* remains one of the most cited economic articles of the last four decades. It sets out a new theory of the firm firmly triangulated between 1) property rights, 2) agency and 3) finance. The singular concern for agency theory is that the 'agents' (managers) represent the interests of the 'principals' (shareholders). The new theory of the firm aims to go beyond standard neoclassical theory's distancing treatment of the firm as a 'black box,' and offers a stringent alternative to the managerial theories of Galbraith, Chandler and others, in which the objective of the managerial firm

was determined to be maximization of growth or size, and fulfillment of a wide spectrum of economic, technological, social and political goals (Weinstein 2012).

Agency theory has become “a cornerstone of … corporate governance” (Lan, and Heracleous 2010) Agency theory is often regarded not only as the dominant current interpretation, but as an eternal and universal explanation, but is very much a product of the Anglo-American corporation and capital markets. Rooted in finance and economics, it has somehow managed to penetrate not only policy and practice, but the essential understanding of corporate law regarding directors’ duties.

The mythology of shareholder value has proved one of the most debilitating ideologies of modern times. The pursuit of shareholder value has damaged and shrunk corporations, distracted and weakened managers, diverted and undermined economies, and, most paradoxically, neglected the long term interests of shareholders (Stout 2012a; Lazonick 2014). An unfortunate lacuna in corporate law was filled by the simplistic tenets of agency theory, which has promulgated enduring myths of shareholder primacy that have been misconstrued as authentic legal interpretations of directors’ duties, and often guided directors with increasingly narrow and damaging corporate objectives. The tenets of shareholder value are portrayed as eternal, universal, and unarguable when they are of recent origin, exclusive to Anglo-American regimes, and profoundly contentious (Blair and Stout 1999; Stout 2012; Lazonick 2012; 2013; 2014; Weinstein 2012; Clarke 2009; 2012; 2013; 2014; Aglietta and Reberioux 2005).

Among the central defects of agency theory as presently interpreted by the above authorities and many others are:

- Agency theory focuses on an oversimplification of complex financial and business reality
- Agency theory damagingly insists upon the single corporate objective of shareholder value
- Agency theory misconceives the motivations of managers
- Agency theory ignores the diversity of investment institutions and interests
- Agency theory debilitates managers and corporations, and ultimately weakens economies
- Agency achieves the opposite of its intended effect.

As Didlier Cossin, Professor of Finance at IMD, Switzerland has recently observed:

> “Most financial models taught today rely on false mathematical assumptions that create a sense of security even as failure approaches... The list of flawed theories (including agency theory)..are all finance models based on over-simplifying complex choices. This pretence that mathematical models are the solution for human problems is dangerous and is not only at the

core of finance theory but is also in the heads of many corporate and financial managers. Given the tremendous changes in financial systems, these theories must be scrutinised and then abandoned as models for the future" (*Financial Times* 5 September 2011).

Not only does agency theory dangerously over-simplify the complexities of business relationships and decisions, but it damagingly demands a focus on a single objective. Agency theory asserts shareholder value as the ultimate corporate objective which managers are incentivised and impelled to pursue: "The crisis has shown that managers are often incapable of resisting pressure from shareholders. In their management decisions, the short-term market value counts more than the long-term health of the firm"(Segrestin, and Hatchuel 2011).

Agency theory while claiming an interest in how companies are controlled, dares not to enter the "black box" of the firm itself, and from a distance hopelessly misconceives the motivations of managers, reducing their complex existence to a de-humanised stimulus/response mechanism: "The idea that all managers are self-interested agents who do not bear the full financial effects of their decisions (Jensen and Meckling 1976) has provided an extraordinary edifice around which three decades of agency research has been built, even though these assumptions are simplistic and lead to a reductionist view of business, that is, comprising two participants – managers (agents) and shareholders (principals)" (Pye and Andrew Pettigrew 2005).

Agency theory tends to ignore the diversity of investment institutions and interests, and their variety of objectives and beneficiaries. As Lazonick has argued institutional investors are not monolithic and different types of institutional investors have different investment strategies and time horizons (Lazonick 1991; 1992). Corporate governance becomes less of a concern if a shareholding is a very transitory price based transaction, and much share trading today is computer generated, with rapid activity generated by abstract formulas. While life insurance and pension funds do have longer term horizons, and often look to equity investments to offer durable and stable returns, the behaviour of other market participants is often focused on the shorter term, and more interested in immediate fluctuations in stock prices than in the implications of corporate governance for the future prospects of a company. In the competition for funds all institutional investors compete for returns, putting relentless pressure upon corporations to deliver short term returns at whatever the cost.

Lazonick asks why did senior executives bow to this pressure to focus on the short-term, and to willingly diminish the financial strength and resilience of major corporations in this reckless way? "The ideology of maximizing shareholder value is an ideology through which corporate executives have been able to enrich themselves. The economists' and corporate executives' mantra from 1980

until the 2007-2008 meltdown of shareholder value and the need to 'disgorge…free cash flow'(Jensen 1986: 323) translated into executive option grants and stock buybacks, and resulted in increasing dramatically those executive options' value." (Lazonick 2012; 2009;2014).

The power of the shareholder value model "has been amplified through its acceptance by a worldwide network of corporate intermediaries, including international law firms, the big accounting firms, and the principal investment banks and consulting firms – a network whose rapidly expanding scale give it exceptional influence in diffusing the ... model of shareholder-centered corporate governance." (Ireland 2005: 49)

Blair and Stout's Team Production Theory

In recent decades many theories of corporate governance have developed that have attempted to complement or displace agency theory including institutional theory, resource dependence theory, stewardship theory, and stakeholder theory, and each has enjoyed varying degrees of support at different times. However one theorisation of corporate governance, due to its origin in the nexus of contracts literature has received more attention from legal scholars but deserves more attention in the business schools, is the adaption of team production theory by Margaret Blair and Lynn Stout (1999). In this director primacy model the firm is viewed as a team production, defined as a complex productive activity involving multiple parties where the resulting output is neither separable nor individually attributable.

In adapting the nexus of contracts theory Blair and Stout consider shareholders as only one of the parties that make a contribution to the firm, and effectively are not the only residual claimants of the firm (2001). Other groups, including employees, creditors, managers, and government, make contributions to ensure the enterprise will succeed (Kaufman & Englander 2005; Stout 2002; Clarke 1998). The assets created are generally firm specific and, once committed to team production, cannot be withdrawn and sold elsewhere for their full value. Blair and Stout provide an expansive adaption of the original theoretical framework of Alchian and Demsetz (who themselves did not use the concept of 'nexus of contract' though it is closely associated with their work). For Blair and Stout team production theory with the board of directors serving as a 'mediating hierarchy' between the different interests provides a sound foundation for conceiving of the corporation in both law and practice:

> "We believe, however, that our mediating hierarchy approach, which views public corporation law as a mechanism for filling in the gaps where team members have found explicit contracting difficult or impossible, is consistent with the "nexus of contracts" approach to understanding corporate law. The "nexus of contracts" view of the firm holds that

relationships in the firm should be understood as an intertwined set of relationships between parties who agree to work with each other in pursuit of mutual benefit, even though not all the relationships that comprise a firm are necessarily spelled out in complete "contracts." It might perhaps be more informative to think of corporations, and hierarchical governance structures within corporations, as institutional substitutes for contracts, just as property rights are an institutional substitute and necessary precondition for contracts. Nevertheless, we locate the mediating hierarchy model of the public corporation within the nexus of contracts tradition because in the model, team members voluntarily choose to submit themselves to the hierarchy as an efficient arrangement that furthers their own self-interests" (Blair and Stout 2009:254).

FIGURE 2

Berle and Means Model of Ownership and Control

As Figure 2 demonstrates Blair and Stout have reformulated the Alchian and Demsetz approach to a nexus of contracts around the wider stakeholder relationships that exist in the business enterprise. While agency theory and shareholder primacy focus simply on the nexus between shareholders (principals) and directors (agents), the Blair and Stout conception of team production theory recognizes the significance and contribution of all with an interest in the success of the company including employees, customers, suppliers, creditors, and government (Blair 2005). At the centre of this constellation of relationships and interests is the mediating hierarch of the board of directors who negotiate effective outcomes in pursuit of the success of the business. Compared to the stark and binary assumptions of agency theory, Blair and Stout's team production theory conceives of much of the complexity of contemporary business activity, the expansiveness of corporate purpose, and the demands upon boards of directors and managers in securing performance:

"The team production approach, however, offers another and in many ways more intriguing explanation for the anomaly of open-ended corporate purpose. In brief, it suggests that the appropriate normative goal for a board of directors is to build and protect the wealth-creating potential of the entire corporate team—"wealth" that is reflected not only in dividends and share appreciation for shareholders, but also in reduced risk for creditors, better health benefits for employees, promotional opportunities and perks for executives, better product support for customers, and good "corporate citizenship" in the community" (Blair and Stout 2006).

Blair and Stout have portrayed a convincing alternative view of the essentially collaborative basis of corporate wealth generation across an array of involved and skilled stakeholders (Blair and Stout 1999; Mitchell, O'Donnell and Ramsay 2005). This understanding of the business enterprise

resonates closely with the approach of European and Asian business (Clarke 2016). Lester Thurow, the former Dean of MIT School of Management placed these differences in the fundamental conception of business purpose at the heart of his analysis of the relative competitive performance of Anglo-American, European and Asian enterprise:

> "If the executives of profit maximizing firms are asked to state the order in which they serve various constituents, shareholders come first with customers and employees a distant second and third. Most managers will argue that the sole purpose of the company is to maximize shareholder wealth. When Japanese firms are asked the same question, the order of duty is reversed: employees first, customers second, and shareholders third. In the United States, private research and development falls in recession and rises in booms. In Europe and Japan, it does not. To an American firm, cutting R & D is a technique for manufacturing profits during a period of declining sales. The same spending patterns exist in investment and training. These different patterns are reflected in the respective accounting systems. In US accounting conventions, since R & D is expensed, cutting R & D leads to higher bottom-line profits immediately. In Japan, where R & D is capitalized, it does not. Thus the Japanese accounting system discourages short-term behavior, and the American system encourages it." (Thurrow 1992a:9; 1992b)

The Increasing Financialisation of Corporations and the Global Financial Crisis

A cruel paradox is that while in recent decades we have been working back towards a broader and more inclusive definition of directors' duties, and corporations themselves have been at pains to profess new found responsibilities, the practical realities of corporate existence and impact have often become more stark as they have become increasingly financialised. Financial imperatives have driven a relentless pursuit of shareholder value, while the very concept has been exposed as narrow and damaging (Dore 2008; Davis 2009; Krippner 2005; 2012; van der Zwan 2013). This process is an integral part of the cumulative financialisation of economies, corporations and society. Multiple changes in the structural transformation of finance are occurring at three levels: financial markets and institutions increasingly displacing other sectors of the economy as the source of profitable activity; the insistent financialization of non-financial corporations through a regime of maximizing shareholder value and the emphasis on financial metrics; and the penetration of finance into every aspect of life as people are increasingly incorporated into financial activity.

The impact of financialization is greatest among US corporations and was highlighted by Michael Porter in his research for the US Council on Competitiveness on Capital Disadvantage: America's Failing Capital Investment System (1992), with Porter explaining America's failure to compete effectively with European and Japanese corporations in the 1970s and 1980s, even in domestic markets, on the highly liquid but unstable US financial markets, compared to the more stable finance and governance of their overseas competitors. Bill Lazonick has completed a series of major research programs on the myths of the market economy and the failure of US capital markets to provide support for innovation in business in any sustainable way. Lazonick provides extensive evidence of four central elements driving the increasing financialization of US corporation: maximising shareholder value; the continuous payment of high share dividends; regular large scale share buy-backs by corporations; and high executive stock options.

The international expansion of financial markets and institutions amounts for Krippner to a new "pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production" (2005:175). The finance sector has progressively increased its share of GDP, and even for non-financial corporations the pursuit of interest, dividends and capital gains outweigh any interest in productive investment. As non-financial corporations have become increasingly drawn into a financial paradigm they have less capital available for productive activity despite increasing profits from financial activity (Lazonick 2012;2014).

This accumulation of an unrelenting international expansion of financial markets, the insistent financialization of corporate objectives and values, and the subordination of whole populations to financial services, exploded in the 2008 global financial crisis (Clarke 2010; Reich, 2008; Posner, 2010). The relentless search for returns, regardless of the consequences, embodied in the pursuit of shareholder value was at the heart of the causes of the global financial crisis, and the continuing reverberations that are occurring. The self-interest and irresponsibility inherent in the practice of pursuing shareholder value reached its zenith with the reckless excesses of the global financial crisis. Bratton and Wachter (2008) relate the activities of financial sector firms in the years and months leading to the financial crisis of 2007/08:

> "For a management dedicated to maximizing share-holder value, the instruction manual was clear: get with the program by generating more risky loans and doing so with more leverage. Any bank whose managers failed to implement the [high-risk strategy] got stuck with a low stock price. ... Unsurprisingly, its managers labored under considerable pressure to follow the strategies of competing banks."

The global financial crisis and its aftermath consisted of multiple and compounding failures in financial markets, institutions, regulation and governance (Clarke 2010; Rajan 2010; Phillips 2009;

Das 2011; Sorkin 2009). The 'animal spirits' unleashed in unfettered securities markets, massive incentivisation of risk taking and leverage, and the abandonment of effective governance and ethical commitments occurred in a regulatory vacuum. Governments were convinced that lightening the burden of regulation was the means to promote more dynamic financial markets and business development. The realisation of the consequences of unchecked systemic risks has prompted national governments and international agencies into a major series of regulatory reforms and interventions in financial markets and institutions, the effect of which remains to be discerned.

The US Investment Banks (Strategically Important Financial Institutions) (SIFIs) have grown even larger since the financial crisis due to further consolidation in the industry following the crisis. The enormous wave of regulation from the G20, Basel Bank of International Settlements, and the passage of Dodd-Frank in 2010 have not changed the banks in any substantial and meaningful way. The Wall Street banks are now larger and more remote than before, and continue business as usual, and have not fundamentally changed their behaviour, leading the campaigning US Senator Elizabeth Warren in calling for a *21st Century Glass-Steagall Act* described them as; "*Too big to fail, Too big to manage, Too big to regulate, and Too big to jail*." There is a profound paradox that after two decades of corporate governance reform, governments and corporations remain fully engaged in the governance challenges posed by the transformation of markets, operations and technologies in the finance sector. And yet despite the insistent and compelling influence of financialization in the world economy, there is another issue of even greater salience which must now be confronted and resolved, and that is the social and environmental sustainability of the planet.

The Integration of Corporate Governance and Social and Environmental Sustainability: A New Sustainability Paradigm?

While critical attention remains largely focused on the present and continuing risks in the finance sector, the greatest and most imminent pressure upon business in the present era is the demand for corporate social and environmental responsibility in a severely resource constrained planet. The successive reports of the Intergovernmental Panel on Climate Change (IPCC) has produced detailed guidance on the catastrophic consequences of global warming due to emissions. After years of debating the path to reducing emissions, finally the G7 countries in June 2015 committed to achieving zero carbon emissions by the end of the 21st century. This is a clarion call for both governments and business to develop detailed strategies for radically reducing carbon emissions, and reporting on this process.

The business imperative for sustainability is becoming increasingly urgent and unavoidable. However challenging the prospects, there are growing indications of large corporations being made to take their

social and environmental responsibilities more seriously, and of these issues becoming more critical in the business agenda, and being taken up as part of the duties of company directors (McBarnett, Voiculescu, and Campbell 2007). This is a consequence of several factors: besides the impact of national government policies and international policy frameworks, technological advances such as social media make it much easier to find out about companies and broadcast any misdemeanors; maintaining a good reputation is a vital asset for many companies; civil society groups have become more vocal regarding companies' public responsibilities, and some of the protections formerly offered by law have been eroded. The substance of company reports is changing, from purely environmental reporting up until the late 1990s, to sustainability reporting (social, environmental and economic), which has become the mainstream approach of global companies (KPMG 2012a).

At the confluence of these multiple emerging initiatives and trends towards greater corporate social and environmental responsibility, there is emerging a dynamic stakeholder model for driving what is still often referred to as "enlightened shareholder value" (or more expansively, stakeholder values). This "enlightened shareholder value" approach posits that there can be a win-win situation whereby a company will benefit financially in the long term if it behaves responsibly towards its employees, the environment, customers, suppliers and other stakeholders. The obvious manifestations of this are reputational benefits, reduced costs from more efficient use of natural resources and the support of local communities ("the *licence to operate*"). Critics of this view maintain that there will be circumstances where the win-win scenario is simply not possibly or too costly: not all companies are concerned with reputation and the benefits from bad behaviour can be all too tempting. A business case for corporate responsibility may exist for some companies but not for all, indeed Vogel (2005) in discussing the limits of CSR comments that it should be understood as "a niche rather than a generic strategy," (though this may represent the approach of US corporations rather than the more engaged approach of European or Japanese corporations in corporate responsibility).

Many advances in corporate social responsibility and sustainability international policy and practice have occurred in recent years. These include:

- The UNEP Finance Initiative
- UN Global Compact
- UN Principles of Responsible Investment
- The Global Reporting Initiative
- UN Sustainable Stock Exchanges
- OECD Guidelines for Multinational Corporations
- AccountAbility AA 1000 series
- Sustainability Accounting Standards Board

- Dow Jones Sustainability World Index
- Integrated Reporting

Together these international initiatives and many more at a national, business or professional level are slowly but continuously establishing internationally a new paradigm of corporate social and environmental responsibility. The further development of the United Nations Environmental Program Finance Initiative linking environmental, social and governance issues to company value has persuasively argued the relationship between sustainability and valuation (UNEP 2006); the UN Global Compact is derived from wider initiatives for human rights, environmental responsibility, and ending corruption in business; the UNEP FI Principles of Responsible Investment has recruited 1287 investment institutions as signatories of the principles, with assets under management of approximately US$45 trillion; the Global Reporting Initiative (GRI) has been adopted world-wide by major corporations as a means of integrated reporting (GRI 2013); the London Stock Exchange has recently joined a UN coordinated Sustainable Stock Exchanges (SSE) initiative is aimed at exploring how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and ultimately performance on ESG (environmental, social and corporate governance) issues (UNCTAD 2014).

The OECD Guidelines for Multinational Corporations are extensive social and environmental principles applied to the operations of multinational corporations; AccountAbility is a consultancy that has produced the AA 1000 series to become more accountable, responsible and sustainable; the Sustainability Accounting Standards Board is developing sustainability accounting standards; the Dow Jones Sustainability World Index provides an index of corporations committed to sustainability; and the Integrated Reporting movement is dedicated to business reporting that integrates social, environment and governance issues.

Together with many other international, national and private sector initiatives the knowledge about sustainability and sophisticated policies of corporate sustainability and social responsibility have gained global significance. However significant questions remain - to what degree have these policies, however refined, become embedded in the governance processes of corporations? Have these policies impacted on fundamental business models? How effectively have the policies been implemented in practice? One extensive survey offers sobering answers to these questions:

> "Corporations that have grasped the importance of sustainability in the value creation process and the necessity for innovation in products, processes, and business models have made the first important step towards a sustainable strategy. However, realization on its own is not enough if it is not followed by implementation. To enable innovation and make sustainability

> considerations core to a company's strategy and operations, a company needs to have a governance structure and process that is supportive of developing and executing a sustainable strategy… Corporate governance has a key role in the implementation of a sustainable strategy as the board of a firm is responsible for setting the overall direction and creating the appropriate systems that will facilitate it… By examining archival data on how many firms embrace this approach today, we have found that the governance of sustainability is still at an embryonic stage (UNEP 2014b)."

Transforming the formal policy commitment of international corporations into a fundamental change in business models and management practices has yet to be achieved in practice. For this to occur extensive changes have to happen in management education and training, executive incentive systems, company board development and orientation, business strategies and investment institutions policies (Klettner et al 2014). Much management education remains primitive in the assumption of simplistic profit maximization, maximization of shareholder value models (still regarding external impacts as 'externalities' to be resolved by others). While business ethics and sustainability may have found a way onto the business curriculum often this is marginalized from the mainstream subjects of finance, accounting, strategy, marketing and organization rather than embedded in these core subjects. Whatever ideals and principles managers possess when they begin their careers, these will be heavily influenced by the structure and objectives of incentive systems that reward and promote management performance. Presently management and executive incentive systems are systemically oriented towards the short term, and narrow financial definitions of performance. Incentive systems need to be geared towards the long term and sustainable value creation.

Similarly the orientations and objectives of boards of directors require rethinking for sustainability, which involves a fundamental transformation of business strategy towards sustainable value creation. Guiding this transformation will be the policies of investment institutions. There is little doubt that the further financialization of the global economy has proved a substantial restraint upon efforts towards corporate social and environmental responsibility. While financial institutions may themselves have fine sustainability polices the pressures they exert insistently for short-term performance through global value chains undermines the commitment to responsibility (Clarke and Boersma 2015). This effects all publicly listed corporations including the strongest and most successful. For example Apple is the richest and most successful corporation in the world in financial terms, and yet it is under pressure to deliver hundreds of billions of dollars to institutional investors (led by activist hedge funds) while there remain widespread and systemic problems of human rights, employment rights, and environmental issues in its contractors 350 plants in China making Apple products employing over a million young people (Clarke and Boersma 2016).

Both the operating and reporting environment for corporations is about to change radically as the implications of the sustainability imperative become fully apparent:

> "Over the next 20 years there is likely to be increasing pressure for the price of resources, products and services to reflect the full cost of their production including the cost of environmental impacts. Such pressure is likely to grow as governments address the effects of sustainability mega-forces. Possible futures include the removal of subsidies on input commodities (such as fossil fuels and water) and the wider introduction of mechanisms to increase the cost of environmentally damaging outputs. It is therefore prudent for companies to expect to pay in the future a rising proportion of their external environmental costs which today are often not shown on financial statements" (KPMG 2012b).

Coming to terms with the real cost of the natural capital of the earth they have freely exploited, will induce a profound transformation upon business thinking and practice. Trucost is a research body established by several UK financial institutions to estimate in monetary terms

> "the financial risk from unpriced natural capital inputs to production, across business sectors at a regional level. By using an environmentally extended input-output model (EEIO), it also estimates, at a high level, how these may flow through global supply chains to producers of consumer goods. It demonstrates that some business activities do not generate sufficient profit to cover their natural resource use and pollution costs. However, businesses and investors can take account of natural capital costs in decision making to manage risk and gain competitive advantage. Natural capital assets fall into two categories: those which are non-renewable and traded, such as fossil fuel and mineral "commodities"; and those which provide finite renewable goods and services for which no price typically exists, such as clean air, groundwater and biodiversity" (Trucost 2013:7).

Business is now faced by the greatest political and social challenge ever: how to stop the continuous and cumulative environmental despoliation of the planet before we reach the point of ecological disaster. Since the time of the industrial revolution industry has been deeply implicated in the emissions that have contributed to global warming, and now must be central to the achievement of zero carbon emissions and sustainable business enterprise. Tackling this challenge will necessitate a fundamental revision of corporate purpose, corporate governance and director's duties.

To tackle these compounding problems corporations will be required to engage in a sustainable revolution just as profound as the industrial revolution in which we will move from a 19th century focus on production, and a 20th century focus on marketing and consumption, to a 21st century focus

on sustainability. Business will respond to the irresistible forces of the sustainability revolution in a similar way that it responded earlier to the arrival of mass markets and consumer demands, when confronted by government, regulatory, social and economic demands for sustainability. But the integration of corporate governance and sustainability is still to be achieved: while corporate policy has become more sophisticated, implementation remains in its infancy. The reformulation of corporate purpose, corporate governance and directors' duties in the direction of greater environmental and social responsibility is now a matter of survival.

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Figure 1 The Evolution of Corporate Governance Paradigms

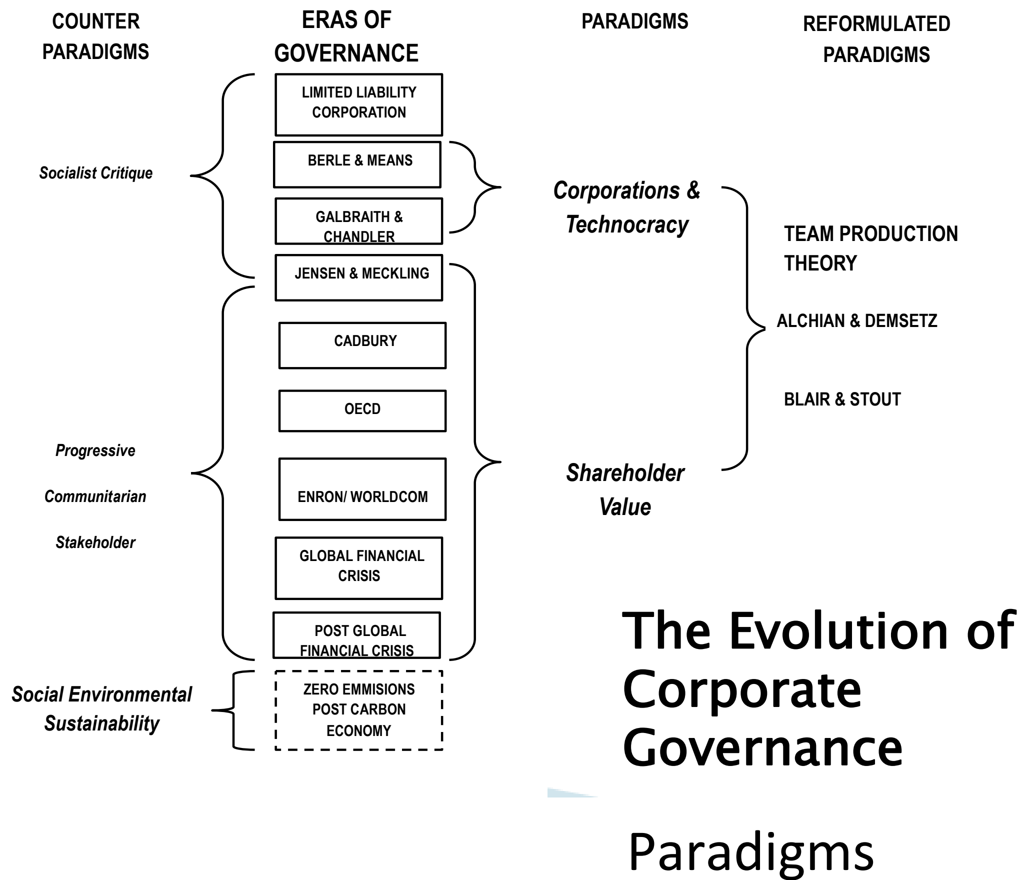
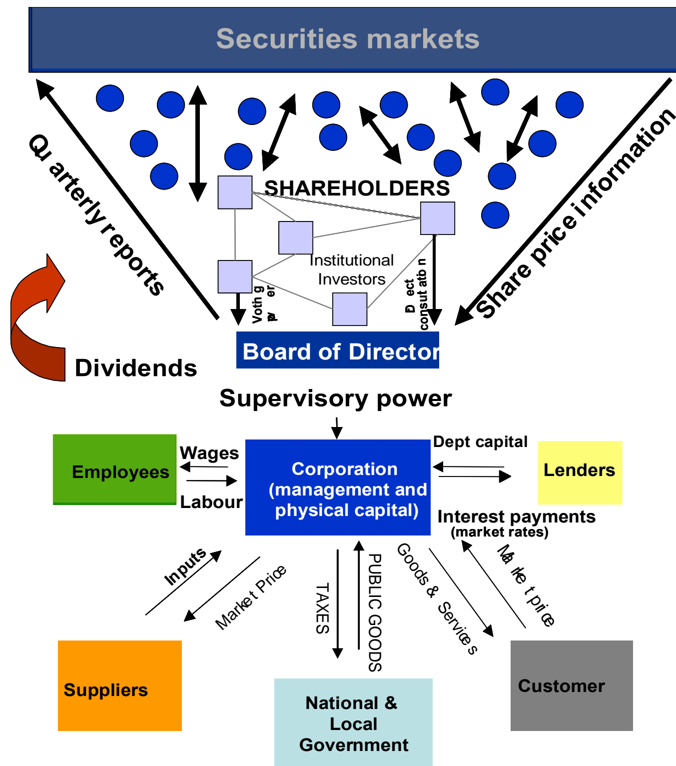


Figure 2 Berle and Means Model of Ownership and Control

Berle & Means Model of Ownership and Control



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