Global Peter Drucker Challenge 2011
"Management, what is it good for?"

3rd Global Peter Drucker Forum
Aula der Wissenschaften, Vienna
3-4 November 2011

Humanizing the law of business corporations for good management practices

Wasima Khan
PhD Candidate
Erasmus University Rotterdam

12 July 2011

HUMANIZING THE LAW OF BUSINESS CORPORATIONS FOR GOOD MANAGEMENT PRACTICES

> *"For the enterprise is a community of human beings. Its performance is the performance of human beings. And a human community must be founded on common beliefs, must symbolize its cohesion in common principles. Otherwise it becomes paralysed, unable to act, unable to demand and to obtain effort and performance from its members."*[1]

Clashing powers of business and society

Does the law of business corporations recognize a balance between the powers of business and society? From an Anglo-Saxon perspective, corporations have frequently been perceived as money-machines with the primary goal of shareholder value maximization. Recently, President Bill Clinton addressed this notion as a bad idea that has taken hold over the United States in the past thirty years:

> "I was probably the last generation of Americans until the present day who could have gotten an MBA – if I had gone to business school instead of law school – with the prevailing theory being that American corporations had obligations primarily to all their stakeholders. Ever since then we've been teaching our young people that your primary obligation is only to the shareholders. The problem is if you do that you ignore the other stakeholders. That could be why wages have been virtually stagnant for thirty years, because the workers are stakeholders. It could be why communities haven't been able to undertake economic transformations in many places, because communities are stakeholders. It could be why customers don't care so much what the sources of their purchases are, they're stakeholders. I think we have to move back toward a stakeholder – not just a shareholder-only – society in the United States and throughout the world."[2]

Clinton's view summarizes the managerial neglect of non-shareholders' societal concerns and interests nourished in the business community. Moreover, business schools have been educating their students that the manager of a corporation acts as a *homo economicus* by primarily making rational decisions in his own interest.[3] Because of the perceived opportunistic behavior of managers, shareholders constantly need to monitor corporate decision-making to get the maximum return on their financial stake in the company. All of this leads to a cat-and-mouse game between self-centered managers and shareholders.

Such a concept of the free market delivers us the disquieting message that we are contributing to society if we concentrate on getting the most for ourselves. In the words of Nobel Peace Prize laureate Muhammad Yunus, this theory suffers from "a failure to capture the essence of what it is to be human."[4] The human side of business has been a significant point of controversy throughout the history of corporate governance. It is encapsulated in the never-ending debate on whose interests are to be served by managers in the performance of their duties for the corporation. Should the purpose of the corporation be to solely make profit for

---

[1] Drucker (2007:56).
[2] As stated during his speech as a honorary degree recipient on May 18, 2011 to the Class of 2011 at NYU's Commencement. A webcast of this event is available online at YouTube: <http://www.youtube.com/watch?v=rSfSk92wDog> (last visited: 12 June 2011).
[3] See e.g. Stout (2011:4-5), Gintis & Khurana (2008), Goshal (2005), Mintzberg, Simons & Basu (2002:68), De Geus (2002:82).
[4] Yunus (2007:18).

shareholders, or is a wider scope allowed where profits may be sacrificed in order to serve the needs of non-shareholders?

When Milton Friedman answered this question in his famous essay by stating that "the social responsibility of business is to increase its profits" he was only partly correct.[5] A distinction should be made between the quantity of profits and the quality of profits. Quantity is merely determined by the value measured in dollars. On the other hand, quality takes the origins and composition of profits into account and is therefore more concerned with human values. In the world of today where business and society are deeply interdependent, corporations cannot afford to make a trade-off between quantity and quality. The social responsibility of business is to increase the quantity as well as the quality of its profits. What would Drucker have said about these clashing powers of business and society?

Drucker's perspective

Peter Drucker also predicted the problems of management and governance of corporations early on and emphasized the importance of including other stakeholders' interests in corporations. About the importance of employees he mentioned:

> "We will have to redefine the purpose of the employing organization and of its management as *both*, satisfying the legal owners, such as shareholders, and satisfying the owners of the human capital that gives the organization its wealth-producing power, that is, satisfying the knowledge workers."[6]

With this statement he made clear that employees – as stakeholders – contribute to the creation of profit. If this is the case, then why should employees not be able to reap the fruits of their labor equal to shareholders? Managers should look at the bigger picture of wealth creation and start rewarding a wide range of stakeholders at their merits. This becomes even clearer as we see Drucker also valuing the interests of customers to be at the heart of a corporation by stating:

> "If we want to know what a business is we have to start with its *purpose*. And its purpose must lie outside of the business itself. In fact, it must be in society since a business enterprise is an organ of society. There is only one valid definition of business purpose: *to create a customer*."[7]

Drucker carried out the message that business and society should not clash. Business cannot be seen as a distinct matter because it forms a vital part of society, or in Drucker's words: 'an organ of society'. Separating business from society leads to social disintegration and dehumanization. Drucker mentioned the potential of the corporation as a social institution recognizing society's stake in corporation policies.[8] And for that reason, it is once more evident that the business of business cannot solely be business. It is obvious that the current way of doing business is not working for a large part of society because large powerful corporations only look after the interests of their managers and shareholders.

Drucker recognized the notion that corporations are inevitably confronted with various stakeholders within society in decision-making procedures. And the recent credit crunch confirms this statement all the more as multinational corporations are struggling to survive

[5] Friedman (1970).
[6] Drucker (2007a:138).
[7] Drucker (2007:31).
[8] Drucker (1993).

and leave a worldwide trail of affected stakeholders behind. For example within the US in 2009 when General Motors Company (GM) faced a reorganization resulting in the US government as largest shareholder, the White House announced: "The president strongly believes all stakeholders involved in the company – labor, management, bond holders and debt holders – are going to have to make sacrifices if we are going to see GM continue." Yet, despite the important role of various stakeholders in corporations, it is not self-evident that directors make decisions for the benefit of all corporate stakeholders. Until today the clash between business and society is kept alive in practice when we look at the prevailing law of business corporations.

The law of business corporations and shareholder value maximization

The current law of business corporations contains various flaws as it focuses almost entirely on the narrow-minded concept of shareholder value maximization thereby undermining the human character of the business profession and corporate law. Legal norms embody notions of 'right' and 'wrong' and enable us to make choices. When a legal norm remains unclear, it creates uncertainty potentially leading to wrongful behavior because it is difficult to judge correctly on what we do not know. It becomes even more problematic when a legal norm defines certain behavior as 'right' while in fact it could be considered as 'wrong' for many people. The following problems lead managers into the wrong direction of leadership.

Problem 1: managers learn to maximize shareholder value

Law schools – next to business schools – participate in teaching students that shareholder value maximization is the leading paradigm in corporate law. The leading case regarding this matter taught in legal courses is the 1919 Michigan Supreme Court decision in the *Dodge* v. *Ford* case. Most law professors mistakenly derive the notion that directors should regard shareholder value maximization as a matter of law by citing from the case that 'a business corporation is organized and carried on primarily for the profit of the stockholders'. Recently, the prominent legal scholar Lynn Stout attacked this established proposition in legal doctrine by stating this is a mistake, irrelevant and bad law.[9] Others also refer to 'the myth of shareholder capitalism' and state that boards bow at shareholders, even though this is not necessary when looking at the law.[10] It is argued that this problem occurs because directors do not know what their legal duties are and because they are taught the wrong things.

Problem 2: managers get paid to maximize shareholder value

The law provides managers with incentives to maximize shareholder value by means of aligning their conflicting interests through stock-based executive compensation.[11] Nowadays it is common for managers to receive company stock in order to become shareholders. This remedy might solve the conflict of interests between managers and shareholders.[12] Yet, at the same time the interests of a wide range of other stakeholders are not taken into account. When managers get paid to perform for the good of profit maximization, they are not free anymore to make decisions which could maximize values of the people or the planet. This legal norm is considered as 'right' in the eyes of the managers and the shareholders but is to be considered 'wrong' by the majority of society being non-shareholders as it neglects their interests. The situation remains unchanged as managers and shareholders together share a monopoly on

[9] Stout (2008).
[10] Heracleous & Lan (2010).
[11] Bebchuck & Fried (2003).
[12] See e.g. Jensen (1998:275) "The most powerful link between shareholder wealth and executive wealth is direct ownership of shares by the CEO."

corporate decision-making at annual shareholder meetings where non-shareholders do not have a voice. Justice is not able to flourish when it is seen through the eyes of a powerless beholder.

Problem 3: besides managers, shareholders only look after their own interests to maximize shareholder value
According to the law, shareholders are allowed and mostly supposed to look only after their own interests. This fact is taken for granted, but is it really as obvious as it sounds? Selfish and opportunistic behavior by shareholders increases tensions within corporations putting managers even under more pressure to gain shareholder value and it provokes short-term behavior. This is why the conflicting interests of managers and shareholders often lead up to legal disputes with court rooms as battlefields.[13] Such battles would be unnecessary when shareholders would get the idea that a sacrifice of profits on the short term in the public interest promotes the well-being and the profits of the corporation on the long term. Receiving fewer dividends on shares for a while because of investment in other stakeholders' interests will eventually reap rewards as stakeholders are more likely to associate themselves and become customers with corporations who are able to look beyond short-term profit making.

Towards a human side

Several hurdles have to be taken along the path of humanizing the law of business corporations. Recognizing the rewards and benefits of this need for change will enable and facilitate a change of mindset among future managers. So what are the steps towards a human side of business?

Managers as well as shareholders should end their cat-and-mouse game and take the interests of a wide range of stakeholders' interests into account. In order to achieve this goal, the law of business corporations needs an adaptation in three ways in accordance to the abovementioned current problems. Firstly, law (and business) schools need to stop teaching their students the primary goal of a corporation is to maximize shareholder value. Secondly, corporate law needs to recognize that stock-based compensation provides managers with the wrong incentives of running a corporation and therefore the legal accommodation of this notion should be adapted. Finally, corporate law needs to encourage a change of shareholders' mindset towards socially responsible investing in order to stop shareholders of thinking and acting solely in their own interests.

In the aftermath of the financial crisis it has become clear that a wide range of stakeholders has been affected by decisions of corporate managers. No change is going to come if students remain to study the opportunistic *homo economicus* view of a manager until today after we have witnessed its harmful consequences. We need ways to rethink management practices and break the destructive cycle we have been facing during the last decades. In this essay I have argued that the law of business corporations needs to be humanized by ending the currently prevailing doctrine of shareholder value maximization. The proposed law reforms would be a step in the right direction of ending the clash between business and society. Moreover, changing the law of business corporations in order to humanize it deeply reflects Drucker's concept of the corporation. Corporations are communities of human beings and this notion should certainly not be forgotten during a financial crisis. After all, is it fair asking a wide

[13] For example, in The Netherlands notable cases are the *ABN AMRO* case and the *Stork* case. In both cases, activist shareholders wanted to pursue a different strategy than the managers in order to maximize shareholder value.

range of stakeholders to carry the burdens in hard times meanwhile letting only managers and shareholders reap the benefits in the form of profits in good times?

Management, what is it good for? Let us hope that it will be good for bringing the human side of business to life again in the upcoming decades – with a little help from reforms in the law of business corporations.

Bibliography

Bebchuck, L.A. & Fried, J.M. (2003). Executive compensation as an agency problem, *Journal of Economic Perspectives* 2003, vol. 17, no. 3, pp. 21-92

De Geus, A. (2002). *The living company*, Boston: Harvard Business Press 2002

Drucker, P.F. (1993). *Concept of the corporation*, New Brunswick, NJ: Transaction Publishers 1993

Drucker, P.F. (2007). *The practice of management*, Oxford: Butterworth-Heinemann 2007 (The Classic Drucker Collection)

Drucker, P.F. (2007a). *Management challenges for the 21st century*, Oxford: Butterworth-Heinemann 2007 (The Classic Drucker Collection)

Friedman, M. (1970). The social responsibility of business is to increase its profits, *The New York Times Magazine*, 13 September 1970

Gintis, H. & Khurana, R. (2008). *Corporate honesty and business education: a behavioral model*, pp. 300-327 in: Paul J. Zak (ed.), Moral markets: the critical role of values in the economy, Princeton: Princeton University Press 2008

Goshal, S. (2005). Bad management theories are destroying good management practices, *Academy of Management Learning & Education* 2005, vol. 4, no. 1, pp. 75-91

Heracleous, L. & Lan, L.L. (2010). The Myth of Shareholder Capitalism, *Harvard Business Review* 2010, vol. 88, no. 4, p. 24

Jensen, M.C. (1998). *Foundations of organizational strategy*, Cambridge: Harvard University Press 1998

Mintzberg, H., Simons, R. & Basu, K. (2002). Beyond selfishness, *MIT Sloan Management Review* 2002, vol. 44, no. 1, pp. 67-74

Stout, L.A. (2008). Why we should stop teaching Dodge v, Ford, *Virginia Law & Business Review* 2008, vol. 3, no. 1, pp. 163-176

Stout, L.A. (2011). *Cultivating science: how good laws make good people*, Princeton: Princeton University Press 2011

Yunus, M. (2007). *Creating a world without poverty: social business and the future of capitalism*, Philadelphia: PublicAffairs 2007