

Book Review

Colin Mayer: Firm Commitment.

Oxford 2013: Oxford University Press.

ISBN: 0199669937

by Moritz Ziegler

In his latest book “Firm Commitment” Colin Mayer argues that current-shareholder value orientation leads to the exploitation of both current as well as future stakeholder groups. Drawing on research conducted throughout his entire career, Mayer asserts that market processes distort resources operating to the exploitation of stakeholders to those who have the most opportunity to use them—current shareholders of corporations. According to Mayer, factors that have facilitated the shareholders’ opportunity to obtain such a position are reputation, hostile take-overs and imprudent regulation. However, not only will shareholders guide their corporation’s resources to fund activities that harm current and future stakeholders (i.e. all stakeholders excluding current, but including future shareholders), but also will this behaviour be anticipated by these stakeholder groups. They will subsequently refuse to invest capital into, or in other words not commit, to such a corporation. This lack of commitment is harmful to all parties involved, including current shareholders. Mayer proposes corporate structures designed to overcome it.

1. How the Corporation Is Failing Us

“Firm Commitment” begins by outlining the central role of the shareholder value principle and its economic and ethical underpinnings in business practices of modern corporations. A corporation can be described as a ‘nexus of contracts’ between different stakeholder parties (i.e. all those parties involved in the firm, such as the board of directors, employees, the local community and also future shareholders)¹ and its owners, the current shareholders. The owners of the company (the shareholders) entrust running the corporation to the board of directors, hoping that they will act to the best of the shareholders’ interests. Thus, the board of directors is perceived as being under a fiduciary obligation to increase shareholder value by increasing the corporation’s efficiency and consequently the value of its shares. Shareholder value has become “the purpose

¹ For different definitions of stakeholders, see Freeman 1984.

of the corporation, its moral imperative and its directors' primary obligation" (Mayer 2013, 67), and has found its way as a guiding idea into corporate law in continental Europe, the UK and the US. Mayer notes that there are arguments in favour of the 'shareholder value first' approach with regards to managerial duties: shareholders, being residual claimants, are more vulnerable than stakeholders, whose claims are contractually fixed and prioritized. So there is an argument based on the moral obligation to protect the 'vulnerable' in favour of a special moral obligation of managers to protect share owner interests beyond welfare economic efficiency considerations. On the other hand, as Mayer emphasizes, shareholders elect the board of directors and they hold the exclusive right to make decisions on crucial company policies, and thus have, in fact, efficient control over the company. This contrasts with their liability being only limited. As a result stakeholders—including future shareholders—may well be vulnerable to exploitation by current shareholders.

Mayer illustrates shareholders' ability to employ a corporation's resources to exploit other current stakeholders with a simple numerical example.² Consider a company ABC with a total amount of capital \$100.000 and loans of 50%: ABC owes \$50.000 to its creditor-stakeholders with an equity stake of \$50.000 of the shareholders. The equity owners have the right to decide on how to invest the full capital. Thus equity controls capital investment twice its own amount (leverage). Assume now that ABC can invest in a project that will either double its capital to \$200.000 or, equally likely, lose it entirely. Although this investment seems unreasonable—effectively putting the existence of the corporation at stake for an expected return of \$0—it is attractive for shareholders. Turning out well, shareholders will have doubled their equity. Paying back the \$50.000 to creditors, minus the \$50.000 of equity they had invested in the first place, they are left with \$100.000. Crucially, due to limited liability, the loss of \$100.000 in case the investment turns sour is not fully borne by the shareholders. In fact only \$50.000 are covered by the equity shareholders put at risk. Therefore shareholders expected earnings of the investment are \$25.000. Creditors either keep their investment of \$50.000 in case the investment turns out well, or they lose the entire amount. Unsurprisingly, creditor's expected earnings are – \$25.000—exactly the wealth that has been transferred to shareholders. Creditors might try to protect themselves through contracts granting them rights over the assets of the corporation in case of a default on their loans. These assets, however, are worthless in case the investment fails and the corporation goes bankrupt. This example, Mayer suggests, mirrors actual cases of expropriation of stakeholders for the benefit of shareholders.

He extends the example of the ABC Corporation to depict how not only current stakeholders, but also future stakeholders, particularly future shareholders, can be exploited by current shareholders. In this second step shareholders decide that ABC now issues options on a derivative involving a bet on an unlikely event. The probability of the event occurring is 10%, which means that

² The example is adapted from Mayer 2013, 37f., and has been simplified for clarity.

with a 90% chance ABC wins the bet. One option can be purchased at \$1 and ABC has to pay \$10 per option in case the event takes place. ABC decides to issue 100,000 options. The earnings from the sale are \$100,000, unless the highly unlikely event materializes and ABC is forced into bankruptcy since it cannot afford to pay the \$1,000,000 it owes to the owners of the options. Mayer shows that shareholders have an incentive to mask small probabilities of severe losses with high probabilities of small gains. By doing so, they effectively defer these losses into the future. The ones at risk from these schemes are future shareholders having to pay the owners of the options.

Shareholders will always push the corporation to engage in these types of (intergenerational) wealth transfer—according to Mayer, this is how the corporation is failing us. His analysis of the causes of this failure, however, is somewhat opaque. It is unclear whether shareholder value is the cause of the corporation's failures, or whether it is market failure and shareholders are merely the ones in the position to take advantage of this circumstance. On the one hand, Mayer argues that all of the corporation's failures have the same fundamental reason—shareholder value pursuit. On the other hand, he claims that, generally speaking, market processes allocate too many resources to actors having most opportunities to employ them to the detriment of other stakeholders—“be they future generations of the same class of investors, or other current classes such as creditors, employees, or customers” (Mayer 2013, 55). Albeit Mayer does not explicitly mention the term market failure, he does make a stronger point that it is the market's shortcomings allowing for this behaviour. He continues that reputation is the reason for this distortion of resources. Instead of promoting activities that are harmless to the stakeholders involved, reputation incentivizes decision makers in companies (i.e. the board of management) to always seek opportunities comparable to the examples above in order to promote shareholder value. Any deviation from maximizing shareholder value is threatened by hostile take-overs, i.e. other investors that are willing to take over the company to push it to invest in exactly these socially harmful activities. The expected returns of such activities compensate a hostile investor for the premium he/she pays the current investor in order to acquire his/her shares.

Yet, not only is there no market-solution to the problem of stakeholder's exploitation, there is presently also no direct regulation that could fulfil this task. The regulatory bodies of Europe and the US are mainly concerned with identifying agency-problems (i.e. misaligned interests between shareholders and the board of directors) and strengthening the principal in the principal-agent-relationship of shareholders and managers. Mayer argues that such regulation only deteriorates the position of other stakeholders.

The analysis of “Firm Commitment” continues by assessing the consequences of stakeholder's exploitation. Having experienced such, stakeholders will expect this to occur again in the future. In an extreme case, they will subsequently refuse to commit to the corporation. Stakeholder's commitment to the corporation is for instance acquiring certain job-specific skills or investing financial resources into the corporation. However, potential creditors will not grant loans

to a company engaging in activities comparable to the examples above. Likewise will potential employees not acquire job-specific skills, if they fear redundancies following the take-over of their firm. In other words, Mayer argues that such investments by stakeholders will only be made, if they trust the corporation to safe-guard their specific commitments—i.e. if the corporation itself commits to its stakeholders. Instead of simply arguing that the exploitation of stakeholders is unacceptable for certain moral reasons, Mayer wants to make a more fundamental point. Following his rationale, the central problem is that shareholder value pursuit hinders a corporation's possibility to restrain shareholders. Restraint is needed, however, because otherwise shareholders will (via decision-makers) promote their corporations to act myopically. A lack of commitment by the corporation leads to stakeholders' refusal to commit to it, because they anticipate their exploitation. In summary, initially there is a commitment problem by the corporation, caused by a lack of restraint of shareholders who control it.

According to Mayer this commitment problem is harmful to the shareholders themselves. Given the circumstances, no corporation will be able to generate wealth as efficiently as possible. Negative effects on the share-value are inevitable and, thus, owners are worse-off than they could be. Shareholders' lack of restraint is accounted for by a "Tragedies of the Commons"-explanation: even though shareholders may well know that they could obtain higher profits by collectively restraining themselves, they cannot individually do so. If they do they face the risk of being exploited by other, more opportunistically acting shareholders. Introducing corporate structures, which restrain shareholders, would, therefore, benefit these very shareholders. This is the quintessence of "Firm Commitment": the commitment problem is harmful to both, stakeholders and shareholders. By solving the problem of collective action among shareholders, negative consequences for stakeholders are also relieved and, thus, all of Mayer's proposed reforms focus exclusively on that.

Since neither market forces nor direct regulation alone provide a solution to the commitment problem. His alternative is to allow for a separation of ownership and control—a suggestion that he refers to as "the reversal of Berle and Means" (Mayer 2013, 147).³ He identifies two elements that may form the core of a reformed legal basis of the 'Trust Firm'.

The first element is the introduction of dual-class 'loyalty shares'. In order to foster long-term shareholder commitment a corporation can issue two classes of shares: 'registered' shares that are associated with (possibly qualified) voting rights and unregistered shares that bear no voting rights at all. When buying the registered shares, shareholders need to register, stating for how long they are willing to keep their shares. The number of voting rights is, then, allocated proportionally to the number of years outstanding upon registration. In order to allow for partial alienability of shares, shareholders could be permitted to sell registered shares prior to maturity at a penalty, for example at half the price of unregistered shares. Provided that contracts about how to exercise the voting

³ Mayer references the famous book "The Modern Corporation And Private Property" by Berle and Means (1932).

rights of inalienable shares are impermissible the scheme might be effective. Decisions about take-overs, the company's policy or the election of the board would then be mainly in the hands of shareholders, who are committed.

The second element is the implementation of a trust structure with a 'Board of Trustees' that is obliged to uphold the corporation's values. The board could and should communicate the company's values publicly, allowing potential stakeholders of the company to allocate their trust according to their own values. How this kind of commitment is to be fixed institutionally remains somewhat unclear, though. Governments would not have to impose direct regulation, but only enforce the 'Trust Firm' by providing the legal framework, which does not exist, yet.

Mayer's point is that corporate structures such as the 'Trust Firm' will ultimately prevail on the market, since they promote commitment between stakeholders and the firm, leading to more efficient cooperation. Crucially, shareholders' demand depends on whether they are really in a 'Commons-Tragedy'. Only then are such structures incentive-compatible, i.e. will be demanded by shareholders if they exist on the market. If shareholders are not in such a situation, they gain no benefit from stopping their current activities. Mayer does not provide compelling empirical evidence in "Firm Commitment" illustrating why shareholders are currently in a position where their behaviour substantially decreases their future returns. It is at least doubtful, that firms engaging in wealth transfer have major trouble hiring new personnel or attracting credit-financing. In other words, Mayer's main argument that the commitment problem has negative effects on shareholders and stakeholders at the same time is as bright as it is risky. To the extent that the critique above is true, shareholders do not have a keen interest in self-restraint. Governments would have to enforce the 'Trust Firm' based on its social agreeability for all stakeholders and care for its success, since shareholders would not necessarily demand it. Maybe, this is why Mayer keeps stressing the general social implications of shareholders' lack of commitment throughout the book. Shareholder value undermining the corporation's purpose to create wealth for the society as a whole could arguably be a reason to restrain shareholders' behaviour independently of them facing consequences from corporate misconduct.

Colin Mayer's book raises important questions concerning corporate behaviour and its regulation. Not only is it of particular use to business ethicists and students of corporate governance, but also for social scientists in general, seeing that it also takes into account efficiency-considerations. Mayer's thoughts open up room for further research, particularly concerning the question what consequences harmful activities by the corporation have on itself and its owners.

References

- Berle, A. A. and G. C. Means (1932), *The Modern Corporation & Private Property*, New Jersey: Harcourt.

Freeman, R. E. (1984), *Strategic Management: A Stakeholder Approach*, Boston: Pitman.

Mayer, C. (2013), *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It*, Oxford: Oxford University Press.