The Mediating Function of Corporate Boards of Directors: Lessons from Corporate History

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Corporate Governance and Corporate Social Responsibility

- Hot topics in management and finance in recent years – in India as well as in western economies.
- Corporate law in India now requires larger publicly-traded corporations to spend 2% of profits on CSR.
- A major concern, repeatedly raised: corporate managers cannot "serve two masters." If corporate managers are not required to maximize share value, they will divert resources to wasteful activities.

Contrary to conventional wisdom:

- Corporations have always been contexts in which management and boards must balanced and resolve competing interests.
- Among the many competing interests:
  - Interests of government that grants a charter versus interests of private investors
  - Interests of different classes of investors, e.g. creditors vs. shareholders, or preferred shareholders vs. common shareholders
  - Interests of a controlling shareholder versus a minority shareholders
  - Interests of entrepreneurial founder versus outside/passive investors
  - Interests of financial investors versus other stakeholders
  - ETC.

This fact provides insight into why corporations are universally governed by boards of directors.

- Conventional wisdom, building on Jensen and Meckling (1976), says directors are supposed to act as “agents” of shareholders.
- Many corporate law scholars adopted this rhetoric beginning in 1980s. The role of corporate directors came to be viewed as “maximizing share value.”
- History tells us something different:
  - Boards were used in the earliest business corporations.
    - E.g., East India Co.
  - Boards were the preferred governance device for organizations that had <u>multiple competing interests and goals</u>.
  - Boards were (often) structured so that they could “mediate” among these competing interests.

This history may be better explained by Team Production Theory

- Alchian & Demsetz defined TP as:
  - Inputs needed from a number of people
  - Inputs are complex, difficult to specify or measure, difficult to contract over.
  - Output is non-separable
- Solution: Let one team member be the "owner" – make all decisions, capture all the economic surplus.

Oliver Hart, Nobel Laureate

- Hart says to "own" means to have right to make residual decisions.
- Let most important team member be the "owner."

Why “ownership” may not be the solution:

Raghuram Rajan & Luigi Zingales, 1998:

- Ownership creates perverse incentives.
- The “owner” can expropriate value from those who invest in “human capital.”

- Solution: Let an outsider to the team make the residual decisions.
- Holmstrom, 1982, suggested the same solution.
- Blair & Stout, 1999: This solution explains role of boards of directors of corporations.

How corporate law solves Team Production Problem:

- Corporate law says all business assets and outputs are "owned" by the corporation (not by individual team members).
- "All corporate powers" are vested in the board of directors
- Board members are <u>outsiders to the team</u>. They have no power individually, do not own corporate assets.
- Role of board is to "mediate" – to balance competing interests to keep the "team" together.

Arbitration theory points to same solution

- Model from Broughman (2010): Suppose E owns common stock, VC owns preferred.
- E favors high risk, high return ventures; VC favors lower risk, lower return ventures.
- Suppose there is intermediate project that creates less value for each than their preferred venture, but more total social value.
- If mediator makes the call based on recommendations, both will have incentive to moderate their demands and recommend intermediate strategy.

Law delegates the most conflictual decisions to the board

- Hiring and firing of CEO
- Compensation of CEO and of board itself
- Plan for merger or acquisition
- Sale of all or substantially all of assets
- Dissolution
- Issuing new stock.
- Conflicting interest transactions
- Responding to derivative suits

What does history tell us?

- One of the earliest business corporations: East India Co.

Governance of EIC:

- Founded in 1600.
- Delegated by charter to a governor, deputy governor and 24 “committees” or directors.
- Governed trading rights among its members. Members competed with each other within the trading area.
- Among jobs of committees: <u>to adjudicate disputes among the members.</u>

The London Company (later, The Virgnia Company)

- Governed by “Council of Virginia” in England, and a resident council in the colony.
- Charter provided for self-government in the colonies.
- Corporate charter for Massachusetts Bay Co. (1628) provided for one of first colonial legislatures.
- These bodies would have been serving/balancing multiple interests.

Corporations in colonies and early states

- Each charter was a separate act of legislature.
- Expected to serve the local communities by providing infrastructure (bridges, canals, water works) and financial services (banks and insurance companies).
- Entitled to earn some profits, but profit wasn’t the point.
- No distinction between “for-profit” and “not-for-profit.”

Who served on the boards?

- Relatively wealthy prominent members of business community (Hilt, 2014).
- Some were shareholders, but definitely not all.
- Some represented customers (Hansmann & Pargendler, 2014).
- Almost certainly: directors were “respected citizens” (to overcome political resistance to granting the charters).

1930s – 1970s

- Research on boards of directors emphasized balancing, and mediating role.
- E.g., Copeland and Towl (1947):
  - "The board of directors potentially is in a strategic position among the elements which make up a corporate enterprise. . . The board has an opportunity to keep a broad perspective and to serve somewhat as a balance wheel."

Business Roundtable, 1978:

- “The board of directors then is located at two critical corporate interfaces – the interface between the owners of the enterprise and its management, and the interface between the corporation and the larger society. The directors are stewards – stewards of the owners’ interst in the enterprise and stewards also of the owners’ legal and ethical obligations to other groups affected by corporate activity.”

21^{st} Century, and beyond:

- Shareholder activists are more influential than ever, keep pressure on boards for profitability.
- Meanwhile, demands on corporations to be socially responsible, and to pursue sustainable business strategies, have increased, and will continue to increase.
- Boards of directors remain the institutions that must respond to, and balance, these conflicting claims and interests.