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Firm Value versus Social Value: Dealing with the Trade-offs

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March 2023

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Abstract

In this paper, I analyse the main trade-offs between the economic value of the firm and its social value exploring how they are solved through corporate governance and regulation. To begin with, I show how firms generate social value while also increasing their long-term value under the enlightened shareholder value approach. Thanks to organizational and technological innovation, firms are led to change their business models and organization to enhance their environmental and social sustainability and increase long-term profitability. In addition, managers promote their firms' sustainability in compliance with ethical standards which are part of corporate culture. In similar situations, generating social value may have a negative impact on corporate profits. I argue therefore that the perspective of instrumental stakeholderism appears too narrow, for situations exist where non-economic values are also relevant to the firm. The importance of ethics is especially underlined by CSR and stakeholder theory. Moreover, management studies emphasize the role of corporate governance and organizational theory in the promotion of social value. The board of directors should identify the ethical and cultural values of the firm and monitor their application at all levels. In addition, organizational purpose plays a fundamental role in the "intrinsic" motivation of people in corporations. The international soft law on corporate due diligence further contributes to the design of corporate purpose and to the motivation of managers and employees. Once sustainability due diligence is recognized by European hard law through the proposed Directive, specific obligations will arise for companies which will impact their governance and could become a source of public sanctions and civil liability. As a result, the corporate purpose orientation to sustainability will be reinforced by the regulation of environmental and human rights externalities and by the due diligence obligations deriving from them.

Keywords: Corporate purpose, corporate governance, corporate social responsibility, business ethics, ESG, shareholder value, shared value, social value, stakeholder theory, stakeholder governance, sustainability

JEL Classifications: G30, G32, G38, K20, K32, L21, M14, P12

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Firm Value *versus* Social Value: Dealing with the Trade-offs[*]

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Abstract: *In this paper, I analyse the main trade-offs between the economic value of the firm and its social value exploring how they are solved through corporate governance and regulation. To begin with, I show how firms generate social value while also increasing their long-term value under the enlightened shareholder value approach. Thanks to organizational and technological innovation, firms are led to change their business models and organization to enhance their environmental and social sustainability and increase long-term profitability. In addition, managers promote their firms' sustainability in compliance with ethical standards which are part of corporate culture. In similar situations, generating social value may have a negative impact on corporate profits. I argue therefore that the perspective of instrumental stakeholderism appears too narrow, for situations exist where non-economic values are also relevant to the firm. The importance of ethics is especially underlined by CSR and stakeholder theory. Moreover, management studies emphasize the role of corporate governance and organizational theory in the promotion of social value. The board of directors should identify the ethical and cultural values of the firm and monitor their application at all levels. In addition, organizational purpose plays a fundamental role in the "intrinsic" motivation of people in corporations. The international soft law on corporate due diligence further contributes to the design of corporate purpose and to the motivation of managers and employees. Once sustainability due diligence is recognized by European hard law through the proposed Directive, specific obligations will arise for companies which will impact their governance and could become a source of public sanctions and civil liability. As a result, the corporate purpose orientation to sustainability will be reinforced by the regulation of environmental and human rights externalities and by the due diligence obligations deriving from them.*

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1. INTRODUCTION

In this paper, I analyse the trade-offs between maximizing the firm's economic value and generating social value in business activities. I refer to firm value rather than shareholder value to underline the need to take stakeholder interests into account when pursuing economic value maximization. Social value concerns stakeholder interests in general (including future generations)

and the objectives relating to environmental and social sustainability covered by the ESG concept.[1] Firms can either increase social value directly – for instance by taking care of local communities or promoting the welfare of employees - or indirectly (typically by reducing carbon emissions). They can do it autonomously or under regulatory constraint. On one side, firms create long-term value by taking stakeholder interests into account through corporate purpose and corporate governance. On the other side, soft law and regulation enhance social value by constraining firm value maximization to reduce negative externalities to the environment and society ("people and planet").

In a previous paper, I connected corporate purpose with sustainability from a general perspective redefining the former in ways which allow for environmental and social externalities to be considered in business decision making.[2] In this paper, I deepen my analysis with reference to the main trade-offs between economic value and social value of the firm and consider how they are solved through corporate governance mechanisms under ethical and regulatory constraints. In sec. 2, I examine how such trade-offs are dealt with from a finance perspective by analysing the "enlightenment" of shareholder value under the influence of stakeholder theory. In sec. 3, I consider the criticisms recently moved to enlightened shareholder value (ESV) from different perspectives. While rejecting similar criticisms, I suggest that ESV is conveniently complemented by business ethics, soft law and regulation. In sec. 4, I focus on scholarly developments that emphasize the role of corporate governance and organizational theory in developing corporate purpose and sustainability. In sec. 5, I examine how business ethics, soft law and regulation constrain firm value maximization and contribute to dealing with negative externalities. In sec. 6, I draw some general conclusions on the impact of ESV, business ethics and regulation on corporate purpose.

[1] On the ESG concept, see E. Pollman, 'The Making and Meaning of ESG' ECGI Working Paper N° 659/2022, October 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4219857.

[2] G. Ferrarini, 'Redefining Corporate Purpose: Sustainability as a Game Changer', in D. Busch, G. Ferrarini and S. Grünewald, *Sustainable Finance in Europe*, Palgrave Macmillan, 2021, p. 85, where I argued that corporate purpose is a multifarious concept which can be understood from different perspectives.

2. SHAREHOLDER VALUE MAXIMIZATION AND STAKEHOLDERS

Enlightened Shareholder (or Stakeholder) Value (ESV) is the dominant approach to analyse the trade-offs between firm value and social value from a finance perspective. It was proposed by Michael Jensen at the beginning of this century as a merger of shareholder value theory and stakeholder theory[3] and is often used also by legal scholars in the analysis of director duties.[4] To introduce this approach, I briefly consider the parable of shareholder value and the rise of CSR practices and stakeholder theory as original motivators for ESV. I then examine the "shared value" approach which is one of ESV derivatives often used in corporate sustainability discussions. In the next section, I consider some of the main criticisms of ESV and propose a revision of the same emphasizing the role of business ethics and regulation.

2.1. *The Parable of Shareholder value*

Milton Friedman is often considered as the father of shareholder value and therefore also responsible, from a theoretical perspective, for its negative consequences in the two financial crises of this century.[5] His famous 1970 paper on the New York Times Magazine is widely quoted as the foundation of shareholder value theory.[6] However, this reading is not entirely correct,[7] as such theory was developed later by finance scholars and consultants,[8] while its diffusion in practice mainly occurred in the last two decades of the last century.[9]

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[3] M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2002) 22 Journal of Applied Corporate Finance 32, and (2002) 12 Business Ethics Quarterly 235 (from which I quote).
[4] P. Davies, Introduction to Company Law, 3rd ed., Oxford University Press, 2020, 48.
[5] See B. Cheffins, 'Stop Blaming Milton Friedman!', University of Cambridge Faculty of Law Legal Studies Research Paper Series, Paper N. 9/2020, March 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3552950.
[6] M. Friedman, The Social Responsibility of Business is to Increase its Profits, The New York Times Sunday Magazine, September 13, 1970, 32.
[7] See B. Cheffins, note 5.
[8] See the classic work by A. Rappaport, *Creating Shareholder Value*, New York, 1998.
[9] See G. Davis, *Managed by the Markets*, How Finance Reshaped America, Oxford University Press, 2009, 50 ff.

Friedman referred to the corporate practices of his time, but his emphasis on corporate profits reflected a criticism of those practices and anticipated the advent of shareholder value theory. As B. Holmstrom and S. Kaplan later explained: "Before 1980, corporate managements tended to think of themselves as representing not the shareholders, but rather 'the corporation.' In this view, the goal of the firm was not to maximize shareholder wealth, but to ensure the growth (or at least the stability) of the enterprise by 'balancing' the claims of all important corporate 'stakeholders'—employees, suppliers, and local communities, as well as shareholders".[10] The external governance mechanisms available to dissatisfied shareholders, such as proxy fights and hostile takeovers, were seldom used. Corporate boards tended to be dominated by management, making board oversight weak, while internal incentives from management ownership of stock and options were also modest.[11]

Partly in response to the neglect of shareholders, the 1980s saw the emergence of the corporate raider and hostile takeovers.[12] In the 1990s, the pattern of corporate governance activity changed again, as hostile takeovers and leverage declined substantially. However, other corporate governance mechanisms began to play a larger role, particularly executive stock options and the greater involvement of boards of directors and shareholders:[13] "With the implicit assent of institutional investors, boards substantially increased the use of stock option plans that allowed managers to share in the value created by restructuring their own companies. Shareholder value thus became an ally rather than a threat."[14]

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[10] B. Holmstrom and S. Kaplan, 'The State of U.S. Corporate Governance: What's Right and What's Wrong?' (2003) 15 Journal of Applied Corporate Finance 3, 10.

[11] Ibid. For example, in 1980 only 20% of the compensation of U.S. CEOs was tied to stock market performance. Long-term performance plans were widely used, but they were typically based on accounting measures like sales growth and earnings per share that tied managerial incentives less directly, and sometimes not at all, to shareholder value.

[12] Ibidem, arguing that "nearly half of all major U.S. corporations received a takeover offer in the 1980s—and many companies that were not taken over responded to hostile pressure with internal restructurings that made themselves less attractive targets."

[13] Ibid., 11.

[14] Ibid.

After the two financial crises at the beginning of this century, there were repeated practical and scholarly efforts to reconcile shareholder value with 'good' corporate governance.[15] Indeed, shareholder value showed its limits and its dark side, with flawed corporate governance and excessive executive compensation being indicated amongst the main causes of both crises.[16] Also short-termism was considered as one of the main causes of the failures of non-financial companies (in the 2001 crisis) and financial institutions (in the 2008 crisis).[17]

2.2. *The Rise of CSR and Stakeholder Theory*

In his 1970 paper, Friedman argued for the rejection of corporate social responsibility as a "fundamentally subversive doctrine".[18] He contended that the executives are agents of the stockholders and cannot spend the company's money for social purposes. However, CSR practices are considered today as predominantly aligned with the company's interest, for they promote the reputation of the firm as an entity which regularly complies with ethical standards and satisfy the expectations of those shareholders who follow responsible investment practices.[19] In addition, the coverage of CSR has been expanded to include a range of topics which did not belong to it at its origin,[20] such as environmental sustainability, employees' welfare and supply chain monitoring.[21]

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[15] See D. Lund and E. Pollman, 'The Corporate Governance Machine' (2021) 121 Columbia Law Review, 2563.

[16] J. Coffee, 'A Theory of Corporate Scandals: Why the USA and Europe Differ'(2005), 21 Oxford Review of Economic Policy, 2, 198; G. Ferrarini and P. Giudici, 'Financial Scandals and the Role of Private Enforcement: The Parmalat Case', in J. Armour and J. McCahery (eds.), *After Enron*, Hart Publisher, 2006, 159.

[17] A. Blinder, *After the Music Stopped.* The Financial Crisis, the Response, and the Work Ahead, Penguin, 2013.

[18] Friedman, note 4, 32.

[19] See N. Smith and G. Lenssen, 'Mainstreaming Corporate Responsibility: An Introduction', in N. Smith and G. Lenssen (eds.), *Mainstreaming Corporate Responsibility*, Wiley 2009, 2, who argue: "The *business case* at the level of the firm is becoming increasingly clear as more companies come to understand that, aside from any moral obligation, it is in their economic interest to address environmental, social and governance issues and in a manner that is integrated with strategy and operations".

[20] See A. Crane, D. Matten and L. Spence, 'Corporate Social Responsibility in a Global Context', in A. Crane, D. Matten and L. Spence (eds.), *Corporate Social Responsibility*. Readings and Cases in a Global Context, Routledge, 2008, 3 ff., where current definitions of CSR and analysis of its core characteristics.

[21] As argued by academic experts of the field: "… CSR encompasses issues such as sustainability (meeting the needs of the present without compromising the ability of future generations to meet their needs), stakeholder management and corporate governance, as well as corporate philanthropy, although the latter is increasingly seen as a peripheral consideration". N. Smith and G. Lenssen, note 39, 2, also noting that the case for business

Thirdly, CSR is increasingly integrated with business strategy and positively affects corporate purpose that extends to social goals in addition to the pursuit of corporate profit.[22]

Also, stakeholder theory has been developed in the last forty years to counter the dominant theory of the corporation which is shareholder centric.[23] As originally outlined by E. Freeman,[24] this theory tried to explain how business could be understood against the backdrop of the environmental turbulence which was already in motion. Freeman assumed that the "current approaches to understanding the business environment fail to take account of a wide range of groups who can affect or are affected by the corporation, its 'stakeholders'."[25] Moreover, stakeholder theorists argue that, contrary to what traditionally assumed in economic theory, the questions of values and ethics must be considered and dealt together with economic reality.[26] They criticize the separation of business decisions from ethical decisions and suggest to integrate the two types of decisions and recognize the managers' moral responsibility for them.

Stakeholder theory therefore was directed to solve the problem of the "ethics of capitalism" and show how business can be managed "to take full account of its effects on and responsibilities towards stakeholders".[27] Indeed, such theory was developed and discussed within the normative business ethics literature and there are many reasons to see stakeholder theory "as having a central place in

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to engage in ESG issues is based on the realization that a new global social contract between business, government and society is needed.

[22] See A. Pettigrew, 'Corporate Responsibility in Strategy', in N. Smith and G. Lenssen (eds.), note 76, 12 . Nonetheless, some finance studies argue that CSR is often a manifestation of agency problems within the firm and therefore problematic. See R. Benabou and J. Tirole, 'Individual and Corporate Social Responsibility' (2010) 77 Econometrica, 1, and the other works cited by A. Ferrell, H. Liang and L. Renneboog, 'Socially Responsible Firms' (2016) 122 Journal of Financial Economics 585. Agency problems are manifested, for example, by corporate managers engaging in CSR that either benefits themselves rather than shareholders or reduces their engagement on core responsibilities within the firm. See P. Krueger, 'Corporate Goodness and Shareholder Wealth' (2015) 115 Journal of Financial Economics 304. According to the "agency view", CSR is generally not in the interest of shareholders. However, under another view socially responsible firms often implement value-maximizing practices, while well governed firms are more likely to follow CSR standards. The empirical studies testing these two theories have offered mixed results. See A. Ferrell, H. Liang and L. Renneboog, 586.

[23] See R.E. Freeman, J. Harrison, A. Wicks, B. Parmar and S. De Colle, *Stakeholder Theory*. The State of the Art, Cambridge University Press, 2010, 4.

[24] R.E. Freeman, *Strategic Management.* A Stakeholder Approach, Pitman, 1984.

[25] Ibidem, 1.

[26] R.E. Freeman et al., note 48, 4.

[27] Ibid., 9.

business ethics (and vice versa)", also considering that "values, a sense of purpose that goes beyond profitability, and concern for the well-being of stakeholders were critical to the origins of stakeholder theory".[28]Also CSR scholars have used stakeholder theory to better specify and operationalize their concepts.[29] In fact, the stakeholder approach to strategic management requires abandoning the idea that shareholder value maximization is the exclusive purpose of the corporation and accepting that specific stakeholder interests should be considered in defining it.[30]

2.3. *Enlightened shareholder value*

In his seminal paper on value maximization and stakeholder theory, M. Jensen tried to reconcile the theoretical strands examined in the preceding two paragraphs by arguing that it is logically impossible to maximize in more than one dimension at the same time.[31] Consequently, a firm should specify the trade-offs amongst the various dimensions and then identify an "objective function" that explicitly incorporates the positive and negative effects of decisions on the firm. In essence, a firm must have a single objective that tells the directors and managers what is better and what is worse. Jensen submitted that "200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy maximize total firm value. The intuition behind this criterion is simply that (social) value is created when a firm produces an output or set of outputs that are valued by its customers at more than the value of the inputs it consumes (as valued by their suppliers) in such production. Firm value is simply the long-term market value of this stream of benefits".[32]

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[28] Ibid., 196.
[29] Ibid., 242, with reference to D. Wood, 'Corporate Social Performance Revisited' (1991) Academy of Management Review, 16, 691.
[30] R.E. Freeman et al., note 48, 242.
[31] See Jensen, note 3, who argued: "telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with no objective" (238).
[32] Ibid., 239, where it is also specified: "When monopolies or externalities exist, the value-maximizing criterion does not maximize social welfare."

Maximizing the total market value of the firm - that is the sum of the market values of equity, debt, and any other contingent claim on the firm - will resolve the trade-off problem amongst multiple constituencies.[33] To the extent that stakeholder theory argues that firms should pay attention to all their constituencies, it is completely consistent with value maximization, which also requires managers to pay attention to all constituencies, such as customers, employees, suppliers of capital, communities, and so on. The objective function must specify how to make the trade-offs between the often-conflicting demands of these constituencies. In the words of Jensen, value maximization offers an answer to these trade-offs: "Spend an additional dollar on any constituency to the extent that the long-term value added to the firm from such expenditure is a dollar or more".[34]

Traditional stakeholder theory, in contrast, contains no conceptual specification of how to make the trade-offs amongst stakeholders, leaving boards of directors and executives without a principled criterion for problem solving. However, according to Jensen, the conflict between value maximization and stakeholder theory can be solved by melding together what he calls 'enlightened value maximization' and 'enlightened stakeholder theory'.[35] Value maximizing tells the participants in an organization how their success in achieving a vision or in implementing a strategy will be assessed. However, it does not say anything about how to create a superior vision or strategy and about how to find or establish initiatives or ventures that create value. It only tells how success in the activity will be measured. Therefore, employees and managers must be given a "structure" that will help them to resist the temptation to maximize the short-term financial performance of the organization, which is a way to destroy value.

Enlightened stakeholder theory plays an important role by leading corporate managers and directors to think more generally and creatively about how the organization treats all constituencies of the firm, not only financial markets, but stakeholders in general.[36] Value cannot be created in the

[33] Ibid.
[34] Ibid.
[35] Ibid., 245.
[36] Ibid.

absence of good relations with customers, employees, investors, suppliers, regulators, communities, and so on. Moreover, the value criterion can be used for choosing among those competing interests, because no constituency can be given full satisfaction if the firm is to flourish and survive.[37] However, as critically noted by Edmans, when decisions are instrumental "they'll be made only on the basis of outcomes that can be quantified with some degree of accuracy. But most important outcomes can't be quantified".[38] This is particularly true for intangible assets like stakeholder capital: "The returns to intangibles aren't only *uncertain*, but also *distant* – even if they do arise, they will be far into the future".[39]

2.4. *Shared Value*

Shared value is an interesting specification of ESV which seems particularly fit to the discussion on sustainable governance. In a largely influential paper of 2011, Porter and Kramer essentially propose to merge the two concepts of shareholder value and societal value into one of "shared value".[40] The latter concept refers to creating economic value in a way that also creates value for society by addressing its needs and challenges. The two authors argue that in the old view of capitalism business contributed to society by generating a surplus, which supports employment, wages, purchases, investments and taxes. The firm is a self-contained entity and social issues fall outside its proper scope, as argued by Milton Friedman in his critique of CSR.[41] Today, a growing

[37] Ibid., 246, where it is also stated that Enlightened stakeholder theory includes the processes and audits to measure and evaluate the firm's management of its relations with all important constituencies, while specifying that the objective function of the firm is to maximize total long-term firm market value. In fact, changes in total long term market value of the firm are the scorecard by which success is measured. The reference to long-term market value is justified by the fact that markets may not know the full implications of a firm's policies until they show up in cash flows over time. Markets will recognize the real value of the firm's decisions as they become evidenced in market share, employee loyalty, and finally cash flows and risk.
[38] A. Edmans, *Grow the Pie.* How Great Companies Deliver Both Purpose and Profit, Cambridge University Press, 2020, 45.
[39] Ibid., 46.
[40] M. Porter and M. Kramer, 'Creating Shared Value: How to reinvent capitalism – and unleash a wave of innovation and growth' (2011) Harvard Business Review 3.
[41] Ibid., 6.

number of companies make important efforts to create shared value by "reconceiving the intersection between society and corporate performance".[42]

The purpose of the corporation should therefore be redefined in terms of shared value, not just profit. The new concept includes the policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates.[43] The underlying premise is that both economic and social progress must be addressed through value principles, i.e. by looking at benefits relative to costs. Value creating has long been recognized in business, where profit is revenues earned from customers minus the costs incurred.[44] However, societal issues have rarely been approached from a value perspective.

Rebecca Henderson similarly argues that a new conception of capitalism can be grounded on "shared value". In fact, the evidence supports "a business case for creating shared value or for treating people well and reducing environmental damage".[45] She considers particularly three cases of large companies which have shown how business and therefore capitalism can be rethought. The first is Unilever's switching to the distribution of 100 percent sustainably grown tea under the Lipton brand, which took place after the beginning of this century and was motivated by risk management and marketing considerations. One reason was that ensuring the supply of tea would reduce the firm's exposure to risk, given that the prevailing practices of growing tea – such as deforestation and large-scale application of insecticides, pesticides and fertilizers - were putting the entire viability of the supply chain at risk.[46] Another argument also concerned risk exposure on the supply chain, with particular regard to the grim working conditions on conventional tea plantations: tea workers were often paid less than $1 a day and many suffered from inadequate housing and sanitation.[47] The third argument stated that embracing sustainability would increase consumer demand for Unilever's teas.

[42] Ibid., 4.
[43] Ibid., 6.
[44] Ibid.
[45] R. Henderson, *Reimagining Capitalism.* How Business Can Save the World, Penguin Business, 2020, 49.
[46] Ibid., 52.
[47] Ibid., 53.

Indeed, most consumers are not willing to pay more for sustainable products, which are seen by most of them as something "nice to have" rather than a "must have".[48] However, "if they find a product that they like – one that ticks all the right boxes in terms of quality, price, and functionality – then many of them will switch to the more sustainable product".[49] As a result of this and other initiatives, "in June 2019, Unilever announced that its 'sustainable living' brands were growing 69 percent faster that the rest of the business and generating 75 percent of the company's growth".[50]

The second case referred to by Henderson is that of Walmart, the gigantic retail company which over thirty years reinvented its business developing skills in logistics, purchasing and distribution that led it becoming one of the largest companies in the world.[51] After being increasingly under fire for anti-union activities, gender discrimination, employment of illegal immigrants, child labour etc., Walmart decided to take a strong stance on corporate responsibility.[52] As a result of its sustainability programs, the company found to its surprise that saving energy was making it gain a great amount of money: "By 2017 Walmart had met its goal of doubling the transportation fleet's efficiency and was saving more than a billion dollars a year in transportation costs – around 4 percent of net income".[53] While at Unilever building a sustainable business model meant identifying fundamental shifts in consumer behaviour, Walmart's success came from focussing on the everyday operational details of its business from the profoundly different perspective of sustainability: "In its way, Walmart's commitment was just as transformative as Lipton's."[54]

The third business case concerns renewable energy and in particular CLP, one of the largest investor-owned utilities in Asia. CLP announced in 2004 that 5 percent of its power would come by 2010 from renewables and in 2007 reiterated that 20 percent of its generating capacity would be

[48] Ibid., 54.
[49] Ibid., 59.
[50] Ibid.
[51] Ibid., 60.
[52] Ibid., 62.
[53] Ibid., 64.
[54] Ibid., 64-65.

carbon free by 2020.[55] In 2013 the CEO of CLP explained the company's strategy by saying: "We see carbon as a long-term threat to any business. In 2050, if you are a carbon-intensive business, you are in big trouble; chances are you won't be in business by then".[56] Henderson comments that "the flip side of risk is opportunity … moving to carbon-free energy ahead of the competition was potentially an exceedingly attractive business opportunity".[57] Subsequent events have proven this assumption to be correct, as alternative energies like solar and wind are already in some places cheaper than coal.

Henderson concludes the case studies just summarized by noting that there is enormous opportunity to create shared value.[58] By addressing environmental and social problems firms can build successful new businesses (CLP), reduce their costs (Walmart), and ensure long term sustainability of their supply chains while increasing demand for their products (Unilever).[59]

3. Critique of Enlightened Shareholder Value

ESV has been criticised from two different perspectives. Some scholars argue that ESV is nothing but traditional shareholder value, while others emphasize the role of social value in corporate governance, criticize ESV as too narrow and propose a new approach grounded on social value primacy. After considering both types of criticism, I suggest a third view under which ESV is complemented by business ethics and regulation.

3.1. *Radical shareholder value*

Lucian Bebchuk and Roberto Tallarita warn against the growing acceptance of stakeholderism.[60] Their opposition to this rising trend in corporate governance is unconditional. Stakeholderism should

[55] Ibid., 65.
[56] Ibid., 69.
[57] Ibid.
[58] Ibidem, 82
[59] Ibidem.
[60] L. Bebchuk and R. Tallarita, 'The Illusory Promise of Stakeholder Governance' (2020) 106 Cornell Law Review 93. See also L. Bebchuk, K. Kastiel, and R. Tallarita, 'Does Enlightened Shareholder Value Add

not be expected to benefit stakeholders; to the contrary, it would impose substantial costs on them and society, as well as on shareholders.[61] The two authors argue that corporate leaders have strong incentives to enhance shareholder value, but little incentive to treat stakeholder interest as an end. Corporations will pursue stakeholder interests only to the extent that it is beneficial to shareholders. In addition, stakeholderism makes corporate leaders less accountable by insulating them from shareholder pressure. Indeed, the support of corporate leaders for stakeholderism is motivated, at least in part, by a desire to obtain insulation form hedge fund activists and institutional investors.[62]

Bebchuk, Kastiel, and Tallarita distinguish between two types of stakeholderism: the "enlightened shareholder value" (ESV) approach and the "pluralistic approach".[63] They define the former as "instrumental stakeholderism" but suggest that it is not different to shareholder value *tout court*. In their opinion, whenever treating stakeholders well is useful for long-term shareholder value maximization, such treatment would be called for under either ESV or shareholder value.[64] They ask what the reason could be for switching to ESV and offer some possible explanations. One is that referring to stakeholder effects has "informational and educational value" for the board and management of corporations.[65] However, they argue that there is no evidence that corporate leaders have systematically underestimated the stakeholders' effects on shareholder value maximization, finding therefore no reason for educating the same. Another reason is that ESV provides "moral support and practical coverage for directors who wish to offer some benefit to stakeholders at the

Value? (April 6, 2022), forthcoming, The Business Lawyer, Vol. 77 (2022); European Corporate Governance Institute - Law Working Paper No. 643/2022, Available at SSRN: https://ssrn.com/abstract=4065731 or http://dx.doi.org/10.2139/ssrn.4065731. In a similar direction, see Matteo Gatti and Chrystin Ondersma, 'Can a Broader Corporate Purpose Redress Inequality? The Stakeholder Approach Chimera' (2020) 46 The Journal of Corporation Law 2, focussing however on stakeholderism's incapacity to redress inequality. The authors aim to demonstrate that a stakeholder approach can do nothing to ameliorate inequality concerns and suggest a multidisciplinary framework to evaluate policies inside and outside corporate governance.

[61] L. Bebchuk and R. Tallarita, note 60, 96.

[62] Ibid., 101.

[63] L. Bebchuk, K. Kastiel, and R. Tallarita, note 60.

[64] Ibid., 3 ff.

[65] Ibid., 22 ff.

expense of shareholders".[66] They object nonetheless that also under "old-fashioned" shareholder value directors would be able to justify a stakeholder-friendly decision on the basis that it would contribute to long-term value maximization. A further reason is that the move to ESV would improve the way in which corporations are perceived by outsiders and therefore produce positive reputational effects.[67] Nevertheless, they argue that such a move could have significant adverse effects by reducing demand for meaningful legal and regulatory reforms that could effectively protect stakeholders.

I submit that their objections are important but not decisive. Firstly, the fact that directors and managers already consider stakeholder interests that are instrumental to long-term shareholder value maximization does not deprive ESV of educational value. In fact, reiterating the benefits of similar behaviour is not costly and may be beneficial in some cases. Secondly, the fact that not only ESV, but also "old fashioned" shareholder value allows directors and managers to act in the interest of selected stakeholders when their actions are in the long-term interest of shareholders is insufficient to discard ESV, which is different to shareholder value exactly for its emphasis on the long-term, enlightened view of the corporation. Thirdly, there are no doubt reputational advantages from the corporations' acting in the interest of selected stakeholders, but this should not necessarily lead to a reduction in the demand for stakeholder protection. A similar reduction would mainly occur when the incentives for corporations to further the interest of given stakeholders at the expense of shareholders' short-term interest are too low.

Bebchuk, Kastiel, and Tallarita describe the second version of stakeholderism as one treating stakeholder welfare as an end in itself rather than a mere means.[68] It is a "pluralistic approach" because it requires directors to weigh and balance a plurality of autonomous ends. They see several conceptual problems arising in this respect. The first is to identify the stakeholder groups whose interests should be considered. The term "stakeholders" usually refers to individuals who are affected

[66] Ibid, 28.
[67] Ibid., 25 ff.
[68] Ibid., 3 ff.

by corporate decisions; however, in many cases, the set of individuals who are directly or indirectly affected by the activities of the corporation is very large.[69] Deciding which stakeholders should be especially considered is difficult and the criteria for taking this type of determinations are often impossible to establish *ex ante*. As a result, much discretion is left to directors who are therefore free to choose which interests should be prioritized and for what reasons. Moreover, the authors note that potential trade-offs between shareholders and stakeholders are "ubiquitous" and the criteria for solving them are often left unexplored by stakeholderists.[70]

This critique of stakeholderism has solid grounds, given the risk that the interests of stakeholders will unduly prevail over those of shareholders even on a long-term view, if the decision criteria are not specified ex ante and the corporate decision makers want to advantage selected stakeholders. However, managerial actions can be justified on a sound basis even when they cannot be justified on economic grounds.[71] As argued below, ethical norms may be applicable to managerial choices which protect given stakeholders, such as employees or local communities. These norms are known in advance for they are either stated in the companies' codes of conduct or included in the international soft law which applies to multinational corporations. Their application can be monitored also by external observers and assessed with reference to the relevant standards. The discretion of boards and managers is limited as a result and the risk that shareholders' interests are neglected is consequently reduced. Moreover, only shareholders are entitled to appoint directors and are therefore able to prevent directors and managers' repeated deviations from their interests. This should work as a disincentive for disproportionate protection of stakeholders' interests by the corporation.

3.2. *Social value primacy*

[69] Ibid., 18.
[70] Ibidem, 20.
[71] See, in general on this topic, M. Sandel, *What Money Can't Buy*. The Moral Limits of Markets, New York, 2012, 47 ff.

A different view of the trade-offs between firm value and social value is expressed by Alex Edmans in *Grow the Pie*.[72] The pie represents the value that an enterprise creates for society. The different members of society capture different slices of the pie, depending on what strategy management chooses to adopt. They are investors, on one side, and stakeholders (customers, employees, suppliers, environment, government and communities) on the other. Investors enjoy profits, but the pie includes more than profits. It includes the value that an enterprise gives to its employees, "their pay, but also training, advancement opportunities, job security, and the ability to pursue a vocation and make a profound impact on the world".[73]

The pie also includes the value that customers enjoy over and above the price they pay ("surplus"). Moreover, it includes the value accruing to suppliers through a stable source of revenue.[74] Furthermore, the pie includes the value provided to the environment, by reducing resource consumption and carbon emissions. In addition, it includes the value enjoyed by communities, as an enterprise provides employment opportunities, contributes to schools, donates its knowledge or products to local initiatives, etc. Lastly, the pie includes the value given to the government through tax revenues. On the whole, stakeholders enjoy value, while investors enjoy profits which are a form of value.

Edmans defines the traditional approach to his topic as "pie-splitting mentality." Such approach views the pie as being fixed in size, so that the only way to increase one member's share of the pie is to split it differently. Since the pie is fixed, at least in the short-term, the only way to maximise profits is by taking from stakeholders.[75] Pie-splitting can be done almost immediately at zero cost. Enterprises can take surplus from customers either by "price-gouging" or by pushing products

[72] See note 38.
[73] Ibid., 19.
[74] Ibid., arguing that "what matters is not only how much money suppliers receive, but how promptly they're paid"
[75] Ibid., 20.

that customers don't need or don't understand.[76] They can also exploit employees - e.g. by paying workers below the minimum wage – or squeeze suppliers by paying them as late as possible.[77]

The new approach suggested by Edmans – that he dubs "pie-growing mentality" - sees the pie as expandable "to create value for society … Profits, then, are no longer the end goal, but instead arise as a by-product of creating value (…)."[78] Investors do not need to take from stakeholders, and stakeholders don't need to defend themselves from investors. Edmans uses the term "Pieconomics" to capture "an approach to business that seeks to create profits only through creating value for society".[79] His views differ from traditional CSR which in his opinion typically refers to activities such as charitable contributions. Pieconomics rather ensures that the primary mission of the core business is to serve society. Being a responsible business isn't about splitting the pie differently (e.g. sacrificing profits to reduce carbon emissions), but about growing the pie by innovating and being excellent at its own business. Indeed, enterprises often fail to serve society not by giving too much to leaders or investors, but by failing to grow the pie by sticking to the status quo.[80]

Pieconomics has many similarities with ESV. Both highlight the criticality of companies investing in their stakeholders. Both argue that investor value and stakeholder value are highly correlated in the long run. Both stress the importance of profits. However, ESV assumes that an enterprise's ultimate goal is to increase long-term profits, while Pieconomics claims that an enterprise should create value for society and profits will increase as a by-product. Profits are an outcome, not a goal.[81] Moreover, Pieconomics takes externalities into account, while ESV considers only profits.

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[76] Ibid., 23, noting that from 1990 until the mid-2010s, UK banks sold payment protection insurance to customers who took out mortgages, loans and credit cards. This insurance had the potential to create value by repaying customers' debts if they lost their jobs or became ill, but it was mis-sold.
[77] Ibid.
[78] Ibid., 26.
[79] Ibid.
[80] Ibid., 27.
[81] Edmans, note 38, concedes that ESV is better than Pieconomics under two angles. Firstly, ESV is "concrete" having a single, clear objective: to increase long-term profit. Pieconomics has multiple objectives and therefore does not offer a clear-cut way to take decisions: ibidem, 43. Secondly, ESV is "focused". A company practising ESV will only take an action if it boosts its profits. It won't spend millions on reducing emissions if they're already below the level that would lead to a fine, whereas a pie-growing enterprise might do so, simply to help the environment and such actions may reduce profits. E. argues, nonetheless, that the pie-growing mentality is

As stated in the previous paragraph, most actions creating social value will increase long-run profits, but a few will not. Pieconomics claims that corporate leaders should go beyond their legal responsibility to shareholders and care about externalities. Investors care about externalities not only due to being stakeholders themselves, but also for altruistic reasons. As argued by Hart and Zingales, shareholder welfare includes not only shareholder value, but also externalities.[82] Indeed, these externalities are becoming increasingly important to investors who largely invest under Socially Responsible Investing (SRI) strategies, which choose stocks on social rather than purely financial criteria.[83] Even many mainstream investors, who are not classified as 'socially responsible', take externalities very seriously.[84]

3.3. *Our approach*

ESV has been widely adopted in policy discussions and in corporate practice, possibly with variations like those suggested by the 'shared value' approach. However, ESV needs reviewing today in the light of the current discussion on stakeholder capitalism. Indeed, stakeholder protection should not be seen exclusively as instrumental to long-term value maximization—as narrowly suggested by ESV—but also as an outcome of the compliance with legal rules and ethical standards, which apply to different types of firms and aim at internalizing externalities that either directly or indirectly derive from their activities. In a rising number of situations firms internalize externalities not only because it is profitable in the long-run or at least suitable to reduce their risk exposures, but also to comply

preferable because it is "intrinsic" rather than "instrumental". Under ESV, a company should only create value for stakeholders if this increases profits in the long term. In other words, for ESV an enterprise should be instrumentally motivated to create profits, whereas for Pieconomics it should be intrinsically motivated to create social value.

[82] O. Hart and L. Zingales, 'Companies Should Maximize Shareholder Welfare not Market Value' (2017) Journal of Law, Finance, and Accounting, 247.

[83] Ibid., 53.

[84] Ibid., arguing that "Across all investors, 2,372, representing $86.3 trillion of assets, had signed the UN Principles for Responsible Investment – a commitment to incorporate environmental, social and governance (ESG) issues into investment decisions – by March 2019. That's substantially higher than the 63 investors and $6.5 trillion of assets when the principles were founded in 2006".

with the regulatory and ethical standards that protect relevant stakeholders, as I argue below under sec. 5.[85]

Business ethics and regulation complement ESV leading to outcomes similar to those suggested by Pieconomics. As argued by Edmans, "enlightened shareholder value believes an enterprise should be *instrumentally* motivated to create profits, whereas Pieconomics believes it should be *intrinsically* motivated to create social value".[86] In our approach, the motivation of the managers to internalize externalities often derives from business ethics and soft law (mainly incorporating ethical standards) and/or regulation. The fact that corporate managers instrumentally motivated to create profits internalize externalities confirms that ESV and business ethics/regulation are complementary. Indeed, managers pursue profits whether we define them as a primary or secondary goal of the firm, while reference to social values is a powerful motivator of people in the firm, as we shall see in para. 4.2.

4. ROLE OF CORPORATE GOVERNANCE

Recent scholarship has further developed the social instances expressed by traditional CSR and stakeholder theory in works leveraging on corporate governance and organizational theory, as I show in this section.

4.1. *Corporate governance as governance of purpose*

[85] Interestingly, these regulatory and ethical constraints on firm behaviour do not necessarily determine a reduction in firm value. Some empirical studies on the relationship between CSR and economic performance rather prove the opposite. A. Ferrell, H. Liang and L. Renneboog, note 20, 585 find that well governed firms that suffer less from agency concerns engage more in CSR and have higher CSR ratings. They also find that a positive relation exists between CSR and value, suggesting at least that CSR is not inconsistent with shareholder value maximization. Their general argument is interesting for present purposes: "Corporate social responsibility need not to be inevitably induced by agency problems but can be consistent with a core value of capitalism, generating more returns to investors, through enhancing firm value and shareholder wealth."

[86] Note 38, 43.

Colin Mayer's *Prosperity* reformulates stakeholder theory from a corporate governance perspective by emphasizing the role that the latter can play in redefining corporate purpose.[87] His "enlightened corporations" balance and integrate the six components of capital that ground business activities: human, intellectual, material, natural, social, and financial capital.[88] Mayer believes that it is wrong to protect shareholders by emphasizing their rights and powers and viewing the corporation as their instrument. However, it would be wrong to transfer control of the corporation to stakeholders such as creditors, customers or employees, for this would make it difficult to raise capital. Mayer rather suggests enhancing the separation of management control from ownership of the firm and focus on the fiduciary responsibility of directors to the members of the corporation.[89] This is what Hansmann and Kraakman define as the 'trustee model' of stakeholder governance, distinguishing it from the 'representative model'.[90] Both models address the problem of protecting non-shareholder interests in the corporation. However, under the representative model qualified non-shareholder constituencies appoint their own directors, who together elaborate policies that maximize the joint-welfare of all stakeholders subject to the bargaining between different groups in the boardroom. Under the trustee model the board of directors and the senior managers act on behalf of the enterprise by co-ordinating the contributions and returns of all its stakeholders.

In Mayer's proposed model, directors balance the interests of shareholders with those of creditors, employees, customers, and communities, in pursuit of the long-term prosperity of the corporation. In fact, an excessive focus either on shareholders returns or on stakeholder interests would jeopardize the delicate balance between present members and future generations.[91] He assigns to the board the

[87] C. Mayer, *Prosperity*. Better Business Makes the Greater Good, Oxford University Press, 2018; more recently Id., 'The research background to the final report of the Future of the Corporation programme on 'Policy & Practice for Purposeful Business' Journal of the British Academy (2022), 10(s5), 1, available at https://www.thebritishacademy.ac.uk/documents/4264/JBA-10s5-00-FULL.pdf.
[88] *Prosperity*, note 87, 42.
[89] Ibid.
[90] See H. Hansmann and R. Kraakman, 'The End of History for Corporate Law', in 89 Geo. L. J. 439 (2001).
[91] A similar argument was advanced by M. Blair and L. Stout, 'A Team Production Theory of Corporate Law', in 85 Vanderbilt L. R. 247 (1999), which focused attention on the mediating role of the boards of directors. See also M. Blair, 'Boards of Directors and Corporate Performance under a Team Production Model', in J. Hill and Randall Thomas (eds.), *Research Handbook on Shareholder Power*, Elgar, 2015, 249, at 257.

role of defining and implementing corporate purpose and of monitoring the firm's commitment to it. In his theory, corporate purpose should be defined by contract and fiduciary duties should be based on the corporate purpose so defined. This would originate trust in the corporation by its members. The solution proposed is clearly grounded on private law, as Mayer argues that regulation has been a failure because the interests of regulators are opposed to those of shareholders. Company law should be reformed to replace regulation, which would require redefining corporate purpose and avoiding its identification with the pursuit of profit.

Mayer describes corporate governance as 'governance of purpose', while defining purpose as 'the reason for a company's existence'.[92] However, 'corporate governance is not and should not be about enhancing shareholder value'.[93] The correct focus of corporate governance should be about how all aspects of ownership, boards, and remuneration promote corporate purpose and the success of companies. Company's customers should comprise all its consumers, communities, and citizens. In this way, corporate governance enhances economic growth, entrepreneurship, innovation, and value creation. It may also lead to increased shareholder value; but in an inversion of the traditional ranking 'purpose is primary and shareholder value derivative'.[94] This last statement reflects the widespread and well-known criticism of the shareholder value philosophy. However, similar criticism is usually addressed to managerial excesses in the pursuit of corporate profits, particularly short-term profits, rather than to the practice of long-term value maximization which also considers stakeholders' interests.

If we take the suggested 'inversion' literally – purpose is primary and shareholder value derivative – Mayer's theory appears to be a radical version of stakeholder theory. Under the prevailing theory, stakeholders' interests are satisfied subject to long-term shareholder value maximization, whereas Mayer subordinates shareholder value maximization to the realization of corporate purpose.

[92] C. Mayer, note 84, 109. He also argues that companies exist to do things, not simply to make profits: 'The purpose of companies is to produce solutions to problems of people and planet and in the process to produce profits, but profits are not per se the purpose of companies'.
[93] Ibid., 113.
[94] Ibid., 114.

Therefore, shareholder wealth is not necessarily maximized when corporate purpose, as announced in the corporate charter, is fulfilled. Indeed, there might be cases in which the activities required by the commitment to corporate purpose are pursued by the managers even in the absence of a foreseeable long-term value maximization.

While sharing Mayer's view on the importance of corporate governance to corporate purpose, I believe that regulation should have a greater say in disciplining corporations than Mayer suggests. We cannot expect firms to fully internalize the social costs of their externalities in areas like, for instance, climate change or corruption. Similarly, we cannot rely on corporate governance and shareholders as the main instruments to preserve the integrity of corporations. We need regulation and to some extent criminal law to obtain compliance with the legal principles protecting the environment and the social conditions within the firms. No doubt, corporate governance and ownership (including institutional investors and controlling shareholders) can contribute to effective compliance and are therefore good complements to regulation, but we should not expect them to become substitutes for it. Environmental and social issues are, for many aspects, like the stability and systemic issues generated by financial institutions, which are widely dealt with under financial regulation.

4.2. *Organizational purpose as key to change*

An organizational perspective on corporate purpose is offered by Rebecca Henderson in *Re-imagining Capitalism* where she argues that, in addition to shared value, organizational purpose is key to change.[95] The reasons for it are grounded on organizational psychology, as purpose "aligns everyone in the organization around a common mission"; "it gives everyone a reason to work toward the goals of the organization as a whole"; "it unleashes … creativity, trust and sheer excitement".[96] Henderson acknowledges the importance of "extrinsic" motivation – such as that deriving from

[95] R. Henderson, note 18, 83.
[96] Ibid., 92.

money, status and power – but argues that "intrinsic" motivation is often more powerful.[97] "Shared purpose" makes people in the organization feel that their work has "meaning", "creates a strong sense of identity" and enhances "positive emotions".[98]

This is the language of behavioural science and motivational theory. We know that human motivation has at least three drivers: autonomy, mastery and purpose.[99] As argued by Daniel Pink, "autonomous people working toward mastery perform at very high levels. But those who do so in the service of some greater objective can achieve even more. The most motivated people … hitch their desires to a cause larger than themselves."[100] If we translate these concepts into the language of business, we recognise that "the profit motive, potent though it is, can be an insufficient impetus for both individuals and organizations".[101] To sum up, the organizational perspective followed by Henderson is grounded on motivational theory and corporate purpose plays the role of a powerful motivator. However, her approach does not exclude the ethical perspective that we follow in this paper. Rather, business ethics contributes to defining corporate purpose together with organizational psychology but does not eliminate profit from its scope given the need to remunerate financial capital.

4.3. *Sustainability and duty of loyalty*

Mayer's 'governance of purpose' reflects one of the main tenets of comparative corporate governance, which is the role of the board of directors in setting corporate purpose together with the

[97] Ibid.
[98] Ibid, 93.
[99] See D. Pink, *Drive*, Canongate, 2009, 85 ff.
[100] Ibid., 133. M. Csikszentmihaly similarly remarked: "In the lives of many people it is possible to find a unifying purpose that justifies the things they do day in, day out – a goal that like a magnetic field attracts their psychic energy, a goal upon which all lesser goals depend." See M. Csikszentmihalyi, *Flow.* The Psychology of Optimal Experience, HarperCollins, 1990, 218.
[101] Pink, note 187, 134. See also G. Hamel, *The Future of Management*, Harvard Business Review Press, 2007, 76. He refers to Whole Food Market, a company with a game changing business model and the following corporate purpose: "to reverse the industrialization of the world's food supply and give people better things to eat" (ibid. 77). Its CEO "sees profits as a means to the end of realizing Whole Foods' social goals." In 2005 he wrote: "We want to improve the health and well-being of everyone on the planet through higher quality food and better nutrition"; but also specified: "We cant' fulfil this mission unless we are very profitable."

company's mission and values.[102] This is recognized by national corporate governance codes and goes together with the deliberation of corporate strategies which is also one of the core competences of the board.[103] Henderson's 'organizational purpose' similarly focusses on corporate governance and organization as a powerful transmission chain of mission and values to the whole company, in addition to underlying the motivational aspects of corporate purpose.

Environmental and social sustainability are generally included in the formulation of corporate purpose and further described in related documents approved by the board of directors, such as the statement on non-financial disclosure. Sustainability is considered from two different angles under the concept of double materiality.[104] One underlines the impact of externalities on the firm ("outside-in") which can be damaged either by climate change and other environmental events or by social problems affecting its reputation, like those regarding its employees (e.g. gender discrimination) and clients (e.g. confidentiality breaches in services offered by social networks).[105] The other angle ("inside-out") regards externalities that are caused by the firm to the outside world. They can also damage the firm which however does not necessarily internalize them.

In principle, corporate actions that reduce or eliminate negative externalities to the environment and society should be performed only if they respond to the interest of the company and its

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[102] See M. Gelter and G. Helleringer, 'Lift not the Painted Veil! To Whom Are Directors' Duties Really Owned?' University of Illinois Law Review (2015) 1070, arguing that since corporate law does not provide a clear and enforceable objective, the interest of the corporation, however defined, becomes primarily the outcome of board deliberations (at 1114).

[103] See the UK Corporate Governance Code (2018), available at https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code; Principle 1 on Board Leadership and Company Purpose states what follows: "1. A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society. 2. The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture (…)."

[104] The concept of 'double-materiality' was first formally proposed by the European Commission, Guidelines on Non-financial Reporting: Supplement on Reporting Climate-related Information, published in June 2019. It encourages a company to judge materiality from two perspectives: 1) "the extent necessary for an understanding of the company's development, performance and position" and "in the broad sense of affecting the value of the company"; 2) environmental and social impact of the company's activities on a broad range of stakeholders. See Global Reporting Initiative (GRI), The double-materiality concept. Application and Issues, invited contribution by C. Adams et al., 2021, available at https://www.globalreporting.org/media/jrbntbyv/griwhitepaper-publications.pdf.

[105] See S. Gadinis and A. Miazad, 'Corporate Law and Social Risk' (2020) 73 Vand. L. Rev. 1401, 1410.

shareholders. Under the ESV model, which is accepted in several jurisdictions,[106] such a requirement is complied with whenever the corporate actions maximize the long-term value of the company while benefitting specific stakeholders. Under the shared value approach, the relevant actions produce economic value for the firm and societal value at the same time, in ways that allow the total pie to be distributed in greater amounts to shareholders and stakeholders.

However, also actions that may have a negative impact on the firm's long-term value are justified from the duty of loyalty perspective if they respond to ethical norms, such as those recognized by the standards issued by international organizations. Indeed, the company should not only maximize its long-term economic value, but also behave as a good corporate citizen and comply with the legal and moral standards of the international community. Similarly, the board's deliberations which conform to CSR best practices should be considered as being in the company's interest and therefore in compliance with the duty of loyalty even if their net impact on firm value is negative.[107] Indeed, the roles of the board and of management should not be reduced to dry numerical analyses of the impact of pro-stakeholder actions on the long-term value of the company, also considering that the long-term impact of those actions may be difficult to measure. Moral considerations should rather be pondered and acted upon even when they may determine a negative impact on firm value, especially if they improve corporate reputation or enhance the firm's resilience in the long-term.

The primacy of social value over shareholder value proposed by Edmans and Mayer leads to similar consequences, but risks undermining the corporation as a capitalist institution which only survives by being profitable. In my proposed view, the need for long-term value maximization still characterizes the business corporation, with the important specification however that the latter should act as a good corporate citizen, i.e. in compliance with CSR best practices and the ethical requirements regarding corporations in general and their specific business activities.[108] In addition, my proposal

[106] See for references Ferrarini, note 2, 108 ff.
[107] See notes 22 and 83 above.
[108] On the concept of corporate citizenship, see A. Crew and D. Matten, *Business Ethics*, 4th ed., Oxford University Press, 2016, 69.

emphasizes the role of regulation in minimizing the negative externalities caused by the corporation, a task which is increasingly relevant in the current quest to protect people and planet from business and its negative impacts.

5. Role of Ethics and Regulation

We should therefore deepen our understanding of ethics and regulation to complement corporate purpose and enhance both firm value and social value. Corporations are managed by human beings who have their own ethical standards. However, corporations generally clarify their ethical standards by formalizing them in corporate documents such as codes of ethics and codes of conduct. In addition, they enforce such standards by monitoring their employees' compliance with them and sanctioning their breaches. Moreover, firms' ethical standards are usually reflected into the corporate culture which further specifies them and eases their adoption by employees. Indeed, corporate culture establishes the conditions for compliance with ethical standards furthering mutual respect for employees who abide by those standards and shame for those who violate them.[109]

In addition, the ethical standards regarding business activities and their stakeholders are often crystallised in international soft law documents and/or regulation. In this section, I show how maximizing firms' value is often conditional upon ethical and/or regulatory constraints that force enterprises to internalize some of the externalities produced in their activities. Firstly, I consider the standards issued by international organizations and adopted by firms voluntarily; secondly, I examine the standards endorsed by regulation, with special reference to corporate due diligence which was traditionally subject to international soft law and is about to become hard law in the EU.

5.1. *Soft law for multinationals*

[109] See G. Ferrarini and S. Zhu, 'Culture of Financial Institutions', in D. Busch, G. Ferrarini and G. van Solingen, *Governance of Financial Institutions*, Oxford University Press, 2019, 381.

Many actions are performed by firms, particularly the large ones, in compliance with standards of conduct that have been issued by international organizations and subscribed by individual firms for the protection of their stakeholders, such as the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the International Labour Organization standards. These documents are not binding per se, but their principles are often reflected in the applicable national laws and for the rest may be followed voluntarily by corporations, especially when their managers have officially committed to respect high standards of conduct.

Notwithstanding the non-binding nature of similar standards and their limited enforcement, large companies' policies and practices increasingly comply with them and respond to investors' growing attention to the ESG performance of investee companies, including the formal adoption of due diligence in line with international standards. In the sustainable investment strategies usually followed by institutional investors, the "norm-based screening" - which screens issuers against minimum standards of business practice based on international frameworks - is one of the most commonly used for portfolio selection.[110] Moreover, common voluntary standards have been developed targeting investor stewardship obligations (such as the ICGN Global Stewardship principles and the EFAMA Stewardship Code)[111] or sustainable investment (such as the Principles for Responsible Investing) [112] which put further pressure on investors with regard to the sustainability-related initiatives and policies of investee companies.

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110 See https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article. See also Eurosif, '2018 SRI Study for an overview of trends related to SRI strategies in Europe' (2018); ISS ESG, 'Norm-based Research Evaluation of ESG Controversies. Research Methodology' (2020), for an overview on the methodological process adopted by ISS ESG to evaluate corporate compliance/failure to comply with international principles (in particular, the Principles of the UN Global Compact and the OECD Guidelines for Multinational Enterprises).

111 S. Alvaro, M. Maugeri, and G. Strampelli, 'Institutional Investors, Corporate Governance and Stewardship Codes: Problems and Perspectives' (2019), CONSOB Legal Research Papers (Quaderni Giuridici), 19.

112 S. Kim and A. Yoon, 'Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment' (March 17, 2020), available at SSRN: https://ssrn.com/abstract=3555984 or http://dx.doi.org/10.2139/ssrn.3555984.

The voluntary application of international standards is also motivated by reputational concerns and by the personal conviction of the managers about the morality of the actions in question. Therefore, like in the case of regulation, the calculus of instrumentalism promoted by ESV and similar theories may be "indirect" or even absent, as the protection of stakeholders simply derives from the compliance with the relevant standards. In other words, the managers do not necessarily compare the shareholders' interests with those of given stakeholders, nor ask to what extent protecting the latter will enhance the long-term value of the firm, given that their action is required per se under the international standards. Of course, to the extent that discretion is left to the managers under the individual standard – particularly if the latter is broadly formulated and there are no implementing provisions – the managers will also consider the impact of their actions on the long-term value of the firm. But they might primarily decide on moral grounds, filling their discretion in a way that they deem consistent with the content and spirit of the standard to apply.

Reputational concerns will also be at play, especially in situations where either consumers or investors monitor the firm's compliance with the relevant standards. The increasing importance of sustainability multiplies this type of situations, given that not all aspects of sustainable growth are specifically dealt with by regulation. Moreover, the urgency of the problems involved requires the active cooperation of corporations, which increasingly follow (or at least declare to follow) the international guidelines and standards both in environmental and social matters. Sustainability can therefore be seen as a game changer, to the extent that not only regulation, but also conduct guidelines and ethical standards operate as constraints on the behaviour of enterprises and their pursuit of profits.[113]

5.2 *Main international standards*

[113] See G. Ferrarini, note 2.

The UN Guiding Principles on Business and Human Rights [UN Guiding Principles] deserve special mention.[114] They provide standards for both States and business enterprises to prevent, address and remedy human rights abuses committed in business operations. The UN Guiding Principles include 14 principles specifically addressing the responsibilities of business enterprises in relation to the respect of human rights and provide a set of operational recommendations going from the issuance of a specific policy on human rights to the performance of a human rights due diligence and the provision of remedies to the adverse impacts the company has caused or has contributed to generate with its actions. The Human Rights Council formally endorsed the Principles in 2011 and to date at least 377 large companies adopted a formal statement explicitly referring to human rights in compliance with Principle 16 of the UN Guiding Principles on Business and Human Rights.[115] Unlike the UN Guiding principles, the UN Global Compact is an initiative that global corporations can commit to by respecting 10 key principles of business behaviour in human rights, labour, the environment, and corruption.[116] Currently, the UN Global Compact counts more than 12000 signatories in over 160 countries covering all business sectors.[117]

The UN Guiding Principles deal with the corporate responsibility to respect human rights. Amongst the 'foundational principles', Principle 11 states that business enterprises should respect human rights, while Principle 12 specifies that their responsibility refers to internationally recognized human rights. Under Principle 13, business enterprises are required to '(a) avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur; (b) seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts.' Principle 15 further specifies that 'business enterprises should have in place policies and processes appropriate to their size and circumstances, including: (a) a policy

[114] The Principles are available at https://www.ohchr.org/en/publications/reference-publications/guiding-principles-business-and-human-rights.
[115] See https://old.business-humanrights.org/en/company-policy-statements-on-human-rights.
[116] See https://www.unglobalcompact.org/what-is-gc/mission/principles.
[117] See https://www.unglobalcompact.org/what-is-gc/participants.

commitment to meet their responsibility to respect human rights; (b) a human rights due diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights; (c) processes to enable the remediation of any adverse human rights impacts they cause or to which they contribute.'

Amongst the 'operational principles', Principle 16 deals with the 'policy commitment' of business enterprises,[118] while Principle 17 provides for 'human rights due diligence' which is directed to 'identify, prevent, mitigate and account for how [business enterprises] address their adverse human rights impacts'. Human rights due diligence should cover 'adverse human rights impacts that the business enterprise may cause or contribute to through its own activities, or which may be directly linked to its operations, products or services by its business relationships.' Interestingly, the commentary to this Principle states what follows: 'Human rights due diligence can be included within broader enterprise risk-management systems, provided that it goes beyond simply identifying and managing material risks to the company itself, to include risks to rights-holders'.

The OECD Guidelines for Multinational Enterprises, firstly adopted in 1976, are also important.[119] They consist of a set of voluntary standards and principles for responsible business conduct addressed to multinational enterprises operating in or from the adhering countries. Specifically, the latest version of the OECD Guidelines was adopted in 2011 by the 42 OECD and non-OECD governments adhering to the OECD Declaration on International Investment and Multinational Enterprises, and today 49 governments have established a National Contact Point with the duty of ensuring the effectiveness of the OECD Guidelines by undertaking promotional activities, handling enquiries, and providing a grievance mechanism to resolve cases with regard to the non-

[118] 'As the basis for embedding their responsibility to respect human rights, business enterprises should express their commitment to meet this responsibility through a statement of policy that: (a) is approved at the most senior level of the business enterprise; (b) is informed by relevant internal and/or external expertise; (c) stipulates the enterprise's human rights expectations of personnel, business partners and other parties directly linked to its operations, products or services; (d) is publicly available and communicated internally and externally to all personnel, business partners and other relevant parties; (e) is reflected in operational policies and procedures necessary to embed it throughout the business enterprise.'

[119] They are available at http://mneguidelines.oecd.org/guidelines/.

observance of the recommendations. The OECD Guidelines cover a diverse range of topics related to business behaviour, from company disclosure and reporting on financial, social and environmental material information to the respect of employees, human rights, the environment, consumers interest and the fight against bribery and other illicit conducts, as well as the promotion of science and technology development, fair competition and tax compliance. To complement the standards of behaviour established by the OECD Guidelines, in 2018 the OECD Due Diligence Guidance for Responsible Business Conduct was adopted[120] with the aim of providing practical support to business enterprises on the implementation of the OECD Guidelines. Moreover, the OECD has developed sector-specific due diligence guidance and good practice documents for the minerals,[121] agriculture,[122] garment and footwear supply chains,[123] and for the extractive sector.[124]

The OECD Guidelines for Multinational Enterprises rely extensively on the UN Guiding Principles on Business and Human Rights but have a broader scope also including employment and industrial relations, environment, combating bribery, bribe solicitation and extortion, consumer interests, science and technology, competition, and taxation. In Chapter II on General Policies, they state: 'Enterprises should: 11. Avoid causing or contributing to adverse impacts on matters covered by the Guidelines, through their own activities, and address such impacts when they occur. 12. Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship'. These two paragraphs reflect the 'protect, respect and remedy framework' of the UN Guiding Principles, extending it beyond human rights to areas such as the environment and

[120] OECD (2018), OECD Due Diligence Guidance for Responsible Business Conduct.
[121] OECD (2016), OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas: Third Edition, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264252479-en.
[122] OECD, Recommendation of the Council on the OECD-FAO Guidance for Responsible Agricultural Supply Chains, OECD/LEGAL/0428.
[123] OECD (2017), OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector.
[124] OECD (2016), Recommendation of the Council on the Due Diligence Guidance for Meaningful Stakeholder Engagement in the Extractive Sector.

employment relations. In a similar vein, para. 14 states that 'due diligence is understood as the process through which enterprises can identify, prevent, mitigate and account for how they address their actual and potential adverse impacts as an integral part of business decision-making and risk management systems. Due diligence can be included within broader enterprise risk management systems, provided that it goes beyond simply identifying and managing material risks to the enterprise itself, to include the risks of adverse impacts related to matters covered by the Guidelines. Potential impacts are to be addressed through prevention or mitigation, while actual impacts are to be addressed through remediation.'

The Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (MNE Declaration),[125] which was approved by the International Labour Office (ILO) in 1977 and later amended (the last time in 2017) similarly refers to the UN Guiding Principles on Business and Human Rights, extending however their reach to the fundamental rights set out in the ILO Declaration on Fundamental Principles and Rights at Work.

5.3. *Regulation and externalities*

The role of regulation in constraining shareholder wealth maximization is well known. Environmental protection, to make an obvious example, largely depends on government regulation, which is binding on firms and influences their actions.[126] No doubt, firms comply with regulation not only for ethical and reputational reasons, but also to avoid the administrative and criminal sanctions which would derive from violations of the relevant rules and would negatively affect their economic value. Stakeholder protection in similar cases cannot be seen as directly instrumental to firm value maximization, for it is primarily required by regulation. Moreover, regulation takes care of negative

[125] The MNE Declaration is available at https://www.ilo.org/empent/areas/mne-declaration/lang--en/index.htm.
[126] For a thoughtful introduction, see O. Young, *On Environmental Governance.* Sustainability, Efficiency, and Equity, Routledge 2016.

externalities forcing firms to internalize them beyond what firms would spontaneously do given the costs of internalization.

However, a new type of sustainability regulation is emerging in the EU based on the Commission's 2021 proposal for a Directive on corporate sustainability due diligence.[127] The new Directive once adopted will transform soft law principles, such as those included in the UN and OECD guidelines examined above, in hard law rules that member States will adopt to implement the Directive. Such rules will give rise to human rights and environmental due diligence obligations that companies will have to comply with under the vigilance of supervisory authorities.[128] A new area of public regulation will therefore be established, which however does not specify in detail what firms should do or avoid doing to minimize corporate externalities.[129]

Indeed, the proposed Directive defines the due diligence obligations with reference to the adverse human rights impacts and to the adverse environmental impacts which arise from their own operations or those of their subsidiaries, and from their value chains.[130] Such adverse impacts are identified with reference to the environmental and human rights international conventions listed in the two Annexes to the Directive.[131] Moreover, companies should comply with their due diligence obligations by adopting "appropriate measures" which must be "commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the

[127] See the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, Brussels, 23.2.2022 COM (2022) 71 final. On the origins of this proposal, see A. Pietrancosta, 'Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives' ECGI - Law Working Paper No. 639/2022, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4083398.

[128] These obligations are defined by Article 4 (1) of the proposed Directive as including the following actions: integrating due diligence into corporate policies; identifying actual or potential adverse impacts; preventing and mitigating potential adverse impacts; establishing and maintaining a complaints procedure; monitoring the effectiveness of their due diligence policy; publicly communicating on due diligence.

[129] See my article 'Corporate Sustainability Due Diligence and the Shifting Balance between Soft Law and Hard Law in the EU' in ECGI Blog, 22 April 2022, available at https://ecgi.global/blog/corporate-sustainability-due-diligence-and-shifting-balance-between-soft-law-and-hard-law-eu.

[130] See Article 6 (1) concerning the obligation to identify actual and potential adverse impacts.

[131] Article 3 (b) defines an 'adverse environmental impact' as 'resulting from the violation of one of the prohibitions and obligations pursuant to the international environmental conventions listed in the Annex, Part II'. Article 3 (c) defines an 'adverse human rights impact' as 'resulting from the violation of one of the rights or prohibitions listed in the Annex, Part I Section 1, as enshrined in the international conventions listed in the Annex, Part I Section 2'.

circumstances of the specific case, including the characteristics of the economic sector and of the specific business relationships and the company's influence thereof, and the need to ensure prioritisation of action".[132]

Non-compliance with such obligations will expose companies to public sanctions and civil liability for damages potentially caused to third parties.[133] As a result, negative externalities will be internalized by companies facing the costs of their prevention and mitigation, and those of restoring the damages for which they are liable towards third parties. Companies will also be accountable for the negative externalities caused by the firms operating within their value chain, which could be either direct or indirect contractors or partners involved in the business activities of the corporations directly bound by the corporate due diligence obligations.[134]

6. CONCLUSIONS

In this paper, I tried to show how firms can generate social value while increasing their long-term economic value. ESV explains how taking care of core stakeholders contributes to firm value maximization and therefore to the creation of social value. Moreover, pursuing social value often generates more value to shareholders thanks to organizational and technological innovation. Indeed, firms are incentivised to improve their business models and/or processes to enhance their environmental and social sustainability, while increasing their long-term profitability. Managers are also incentivised to create social value through their business activities for this will be reflected on the amount of their variable remuneration which is linked to financial performance and increasingly also to ESG parameters.

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[132] See Article 3 (q) of the proposed Directive.
[133] See Articles 20 on sanctions applicable for infringements of national provisions adopted pursuant to the Directive which shall be effective, proportionate and dissuasive; and Article 22 on civil liability for the non-compliance with the obligations laid down in the Directive, including the liability for damages caused by an adverse impact arising as a result of the activities of an indirect partner with whom it has an established business relationship (see Article 22 (2)).
[134] See A. Pacces, 'Supply Chain Liability in the Corporate Sustainability Due Diligence Directive Proposal', ECGI Blog, 12 April 2022, at https://ecgi.global/blog/supply-chain-liability-corporate-sustainability-due-diligence-directive-proposal.

In addition, managers have non-pecuniary incentives to promote their firms' sustainability to the extent that the relevant behaviour reflects ethical standards which are part of their corporate culture. In similar situations, social value may be generated even if it translates into sheer costs for the enterprise. Indeed, some scholars suggest that shareholder welfare includes not only shareholder value but also externalities to which investors attach increasing importance. The opposite view that only instrumental stakeholderism should apply to firm management appears too narrow, for situations exist where non-economic values are also relevant to the firm. The relevance of ethics in general is underlined by CSR and stakeholder theory. Moreover, today's management studies emphasize the importance of corporate governance and organizational theory in the promotion of social value. The board of directors should identify the ethical and cultural values of the firm and monitor their application at all levels. Moreover, organizational purpose should play a fundamental role for the "intrinsic" motivation of people in the corporations.

The soft law on corporate due diligence further contributes to the design of corporate purpose and to the motivation of managers and employees. Once corporate due diligence is recognized by European law with the approval of the proposed Directive, specific obligations will arise for companies which will impact their governance, including risk management, and could become a source of civil liability in cases of breach. As a result, the corporate purpose orientation to sustainability will be reinforced to the extent that corporate internalisation of environmental and human rights externalities becomes mandatory.

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