

What is Wrong with Corporate Law? The Purpose of Law and the Law of Purpose

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Abstract

This article argues that corporate purpose should be put at the heart of corporate law. It addresses the objections to this that there is little that corporate law prevents firms from doing in determining their corporate purposes, and, even if they were given greater latitude, companies would do little more than they do at present in formulating their purposes. The claim of the article is twofold. First that the critics of the law of corporate purpose have failed to recognize the role that purpose can play in addressing the primary defect of the current system – namely the divergence of the private interests of the corporation from the public interests of society and the natural world. That derives from the disconnect that currently exists between the private incentives of the pursuit of profit from the public interest in human and natural world flourishing and prosperity. The second claim is that not only can the law address that defect through requiring the adoption of appropriately formulated corporate purposes, but it also provides an essential means of commitment to the delivery of long-term prosperity. At present, the law does not permit of commitment to objectives beyond the pursuit of the success of the company for the benefit of its members and it thereby fails to protect companies which seek to create long-term prosperity through committing to the interests of others. The law can and should both ensure the alignment of the corporation's incentives with individual, societal, and planetary interests and promote the resolution of their problems by enabling one of the most powerful institutional entities that we have created to date, namely the firm, to commit credibly to their resolution. Its failings on both counts have been the source of intensifying crises. We need to acknowledge this and recognize the potential to provide a remedy for the cause of them – namely the laws that have created the corporation.

Keywords: Corporate Law, Purpose, Profit, Prosperity

JEL Classifications: D21, G3, K2, L2

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2 May 2022

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The claim of the article is twofold. First that the critics of the law of corporate purpose have failed to recognize the role that purpose can play in addressing the primary defect of the current system – namely the divergence of the private interests of the corporation from the public interests of society and the natural world. That derives from the disconnect that currently exists between the private incentives of the pursuit of profit from the public interest in human and natural world flourishing and prosperity.

The second claim is that not only can the law address that defect through requiring the adoption of appropriately formulated corporate purposes, but it also provides an essential means of commitment to the delivery of long-term prosperity. At present, the law does not permit of commitment to objectives beyond the pursuit of the success of the company for the benefit of its members and it thereby fails to protect companies which seek to create long-term prosperity through committing to the interests of others.

The law can and should both ensure the alignment of the corporation's incentives with individual, societal, and planetary interests and promote the resolution of their problems by enabling one of the most powerful institutional entities that we have created to date, namely the firm, to commit credibly to their resolution. Its failings on both counts have been the source of intensifying crises. We need to acknowledge this and recognize the potential to provide a remedy for the cause of them – namely the laws that have created the corporation.

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1. Introduction

What is the purpose of business, why does it exist, why is it created and what is its reason for being? What is the relevance of law to the determination and nature of business and how does it define what its purpose should be? These are age-old questions dating back to the emergence of enterprises and partnerships in the reign of Hammurabi in Babylonia and the corporation in Ancient Rome. But they remain very relevant to today's discourse and debates about business and its role in contemporary society.

In September 2021, the British Academy, the UK Academy of the Humanities and Social Sciences, published a report on the Future of the Corporation (British Academy (2021)). It suggested that the purposes of businesses should be reassessed in the context of the challenges and problems they face and the remarkable opportunities that scientific advances and new technologies offer them. It proposed that the purposes of businesses should be considered in relation to solving the major problems we encounter as individuals, societies, and the natural world, that businesses have a major role to play in solving such problems, and that they should do so in ways that are commercially viable and profitable for those who invest in them. The report went on to describe how public policy could promote the implementation of corporate purposes and how law has a particularly important role to play in that regard.

This paper sets out the origins and background to this proposal. It begins in section two by describing the emergence of modern concepts of the nature and purpose of business. It then looks at the role of law and debates about the relevance of corporate law to defining the purposes of businesses. As section three describes, the current formulation of corporate law is in relation to the fiduciary duties of directors to promote the success of the company. In some countries and states, corporate law specifies little more than that. In others, such as the UK, the success of the company is specified as being for the benefit of its shareholders (what are termed its "members").

It is widely thought that the generality and permissiveness of corporate law are sufficiently great as to accommodate virtually any formulation of a corporate purpose and that nothing further needs to be or should be done in relation to law to facilitate the adoption of purposes (Rock (2020a), Vos (2020)). Nevertheless, the British Academy programme suggested that corporate purpose should be put at the heart of corporate law and that, in place of the current formulation of fiduciary duties of directors of companies to promote the success of the company (for the benefit of their shareholders), should be one that relates the duties of directors to the determination and delivery of their corporate purposes.

Section four describes why this is the case. It suggests that there are two fundamental deficiencies of corporate law as currently constituted. The first is in determining the legitimate source of corporate profits, and the second in establishing how firms can commit to their achievement through the delivery of human, social and natural world prosperity and flourishing. Section five concludes the paper.

2. Corporate Purpose

The currently prevailing notion of corporate purpose is what is termed “shareholder primacy” - businesses exist first and foremost to promote the interests of their shareholders and the financial returns they earn on their investments (Clark (1986), Fisch (2006)).

The association of corporate purpose with profit is a recent phenomenon, certainly in the context of the 2000-year evolution of the corporation since Roman Law, (Mayer (2018)) and arguably in relation to modern corporate history. Shareholder primacy has its roots in Adam Smith’s assertion “that individual acts of economic self-interest combine, through the ‘invisible hand’ of market forces, to further the best interests of society at large,.....that the individual owner would necessarily be solely entitled to all the fruits of his property, the profit,and use his industrial property and labour ‘efficiently’ and grow [the business] for the strict purpose of accumulating profit” for himself” (Smith (1776)).

There were three phases to the origination of the corporation in the U.S. (Guenther (2020)). The first was in the pre-1780 period when corporations served multiple purposes in relation to religious, educational, and municipal activities amongst others. The second from the 1780’s to 1830’s was the rise of the corporation in relation to the provision of much-needed infrastructure - bridges, canals, railroads, and turnpikes. The third phase was from the 1820’s to the 1860’s and thereafter, which was associated with the expansion of manufacturing, railroads, and banking corporations whose purposes were predominantly financial in nature.

During this period the understanding of the purpose of the corporation transitioned from the statement in the 1805 case of the Trustees of the University of Carolina v. Foy that “it seems difficult to conceive of a corporation established for merely private purposes” to one in the Dodge v. Ford case brought in the Michigan Supreme Court in 1919, which concluded that “a business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.” Dodge v. Ford (1919) has been presented as a demonstration that the “theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time” (Bainbridge (2012)).

In contrast to shareholder primacy, “stakeholder theory” suggests that businesses should take account of the interests of all their stakeholders in promoting the success of their companies (Freeman (1984)). According to stakeholder theory, a company should seek to create value for those contributing to and affected by the firm – its customers, employees, suppliers, communities, environment, creditors, and shareholders. All those who affect or are affected by the firm play a role in the success of the company and should be regarded as an end, not just a means to an end. So, management should seek to balance the interests of all its stakeholders (Keay (2011)).¹

¹ This recent literature comes against the backdrop of a long debate on the subject, e.g., Dodd (1932) and Berle (1932).

The “Constituency Statute” introduced in several states the US in the 1980’s and 1990’s was the legal manifestation of stakeholder theory (Davids (1995)). It allowed, and in some states required, directors to take account of the interests of stakeholders beyond their shareholders, in part as a response to the takeover wave in the US of the 1980s (Springer (1999)). In practice, there is much scepticism as to the degree of protection that constituency statutes afforded stakeholders. Part of the problem appears to have been a reluctance on the part of courts to interpret statutes in anything other than a shareholder primacy context (Bisconti (2009)). Another problem was that stakeholders had no means of seeking redress if directors failed to take their interests into account (Springer (1999)). Combined with concerns about the practicality or desirability of businesses adopting stakeholder practices (Bebchuk and Tallarita (2020)), some observers concluded that “constituency statutes failed to deliver the benefits to stakeholders that were promised or hoped for in the push for the adoption of these statutes” (Bebchuk, Kastiel and Tallarita (2020))

Meanwhile in the UK, a different approach was taken. A Company Law Review Group that was assembled at the end of the 20th century to re-evaluate company law in the UK “expressed the opinion that the law ought to be revised to bring it into line with existing best practice, encouraging directors to look beyond maximising short term returns to institutional shareholders towards the longer term and to recognise the roles that relationships with other stakeholders, such as employees, suppliers, customers and others affected by the company’s commercial activities, play in the success of the company” (House of Commons (2003))

However, it rejected a stakeholder approach, namely that directors should consider the interests of stakeholders and regard shareholders as just one of the parties whose interests need to be taken into consideration on “the grounds that it would confuse the issue of directors’ duties, giving directors little in the way of guidance in decision-making. It also ran the risk of creating a litigious climate for business where those parties who felt they had not been treated as they would have liked by a company’s directors sought recompense through the courts” (House of Commons (2003)).

Instead, it proposed what is known as an Enlightened Shareholder Value (ESV) approach. This maintains that the primary duty of directors is to maximize shareholder value but that in realizing this objective, particularly in promoting the success of the company for the benefit of shareholders in the long-term, a company must recognize the importance of its relationships with other parties – employees, customers, suppliers, communities, and the environment. ESV did not therefore represent a fundamental change in law but instead a codification of what was involved in promoting the interests of shareholders.

Another legal form that originated in the US which lies somewhere between a stakeholder and ESV approach in promoting stakeholder interests beyond shareholders is the benefit corporation, also known as the public benefit corporation. Benefit corporations are formally established under state statutes that require for-profit entities to pursue a dual mission of profits and social purpose (Vaughan and Arsneault (2018)). Maryland was the first state to adopt a benefit corporation law in 2010 and 38 states (including the District of Columbia) have now passed one.

Critics claim new legislation is unnecessary as existing legislation permits directors sufficient latitude (Heminway (2018)) and that benefit corporations will be used for “purpose washing” (Khatib (2015)). Some studies of benefit corporations have attempted to evaluate these claims. One finds that there is much inactivity amongst benefit corporations, and many are not delivering any social or environmental benefits (Berrey (2018)) Another concludes that, contrary to concerns that benefit corporations will fail to attract investors, they are receiving significant amounts of investments largely because they are concentrated in consumer-facing sectors where their benefit status acts as a driver of enhanced financial returns for investors (Dorff et al (2021)).

If this is the case then benefit corporations are in effect enlightened shareholder value companies, conferring superior financial returns as well as public benefits. Attempts to promote stakeholder interests in their own regard either through enlightened shareholder value or stakeholder-oriented legislation have therefore arguably failed to deliver much variation from conventional shareholder primacy. Empowering directors to adopt practices that incorporate the interests of parties beyond shareholders does not appear to be sufficient on its own.

The last decade has witnessed a re-focusing of the debate around corporate purpose.² What has motivated this has been a realization and concern about the problems created, as well as addressed, by a pre-occupation of business with corporate profits. These problems relate particularly to the environment, inequality, social exclusion, and the spate of corporate failures and scandals that have blighted business over the past two decades. The response has been a shift of corporate purpose away from its raw shareholder primacy form to in essence ESV, pursuing the potential for environmental and social benefits to enhance financial performance and firm resilience (Business Roundtable (2019)).³ However, as we have just seen, there are limitations to the extent to which ESV differs from conventional profit maximization and therefore avoids and solves problems created by it.

Instead, what the British Academy programme suggests is that corporate purpose should be considered in the context of the problems that individuals and societies face at different points in time. The historical evolution of corporate purpose reveals that there is nothing in the origin or development of the corporation that intrinsically or necessarily associates it with maximizing profits. Purpose has been dictated by need and that is sometimes predominantly private and profitable in nature and at other times public and social, and frequently a combination of the two. A focus on profits might have been appropriate for an era of manufacturing and the large-scale financial requirements that imposed, but it may be less suited to an age in which the predominant challenges that confront humanity are

² Rock distinguishes between what he terms “business purpose” and “corporate objective”. He states that: “business purpose” should be understood to be a property of business enterprises, however they are organized. “Corporate objective,” by contrast, is best understood as a characteristic of a particular enterprise form (the general corporation) and not as a description of what actual businesses do on a day-to-day basis” Rock (2020b).

³ According to Edmans (2020) and Gartenberg (2022), clarity and commitment to a corporate purpose enhances commercial performance and profitability. According to Gartenberg, Prat and Serafeim (2019); Gartenberg and Serafeim (2021); Gartenberg (2021); Henderson (2020 and 2021a and b), while corporate purposes are not always “win-win”, particularly in the short-term, they promote stakeholder interests in a form that yields superior financial performance in the long-term.

environmental and social in nature. What is required is a notion of purpose which allows the different requirements of people, place, and time to be accommodated.

This suggests that corporations should employ their distinctive advantages of separate legal form, perpetual existence, limited liability, and capital raising to help address the problems we face as individuals, societies, and the nature world, and do so in a form that is commercially viable, financially sustainable, and profitable. So, the British Academy Future of the Corporation (2018) programme defines the purpose of business as being “to produce profitable solutions to the problems of people and planet”. However, there is a second part to the definition which is particularly critical to this paper and that is that companies should “not profit from producing problems”.

This highlights the issue of the definition of a profit. At present, the economic notion of a profit is simply the net financial earnings of a company over and above the variable operating and fixed capital costs it incurs. It takes no account of whether in the process a company profits at the expense of other parties through, for example, making employees or suppliers redundant or imposing negative externalities on third parties, such as communities and the natural world.

The importance of the assertion of not profiting from producing problems is that it provides a natural way of addressing the deficiencies of accountability and enforcement that underpin the limitations of ESV and stakeholder theories mentioned above. So long as accountability and enforceability relate to assessments of the benefits and detriments suffered by different parties then they involve making largely incalculable interpersonal comparisons. How for example does one trade-off the employment benefits that derive from expansion of a company’s activities against the environmental detriments that might be incurred in the process? Answering this involves undertaking incomparable and incommensurable measurements.

If on the other hand one poses the question of the extent to which the company has profited from not avoiding or offsetting the environmental damage it has created, then one has the basis for determining the extent to which it is profiting from producing problems. In other words, the emphasis shifts from highly subjective valuations of benefits and detriments incurred by different parties to the costs of remedying problems. As will be described in section 4, this strengthens the degree to which the firm can be held accountable for its activities and the enforceability of remedies by courts of law.

3. Corporate Law

Corporate law in the UK and US and many other jurisdictions around the world is permissive in allowing companies to adopt any purpose that promotes the success of the company for the benefit of its shareholders (Kraakman et al (2017) and Kershaw (2018)). For example, UK company law states that “(a) director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole” (UK Companies Act (2006). Under General Incorporation Law of the State of Delaware “the directors of a Delaware corporation entrusted with management responsibility must protect the interests of the corporation and effectively serve as “trustees”

for the stockholders with respect to the interests of the stockholders in the corporation”, and “directors of Delaware corporations owe a duty of loyalty to the corporation and its stockholders” (Lafferty et al (2012)).

So, company and corporate law appear to be permissive and supportive of the adoption of any of the first three interpretations of corporate purpose and only exclude the fourth where stakeholder interests are promoted at the expense of shareholder interests and, even then, only in the context of “the likely consequences of any decision in the long term” (UK Companies Act (2006)). Many academic and practising lawyers therefore believe that promotion of corporate purpose does not require a change in corporate law.⁴ However, some recognize the complexity that confronts corporate lawyers. For example, Paul Davies in the final chapter of the third edition of the “Introduction to Company Law” (Davies (2020)) concludes by lamenting that:

“When this author first began the study of company law, many decades ago, company law was a relatively simple business. The purpose of company law, broadly, was to align the incentives of those who run large companies with those of investors (both those who had actually invested in the company as shareholders and those who might do so in the future) and to protect corporate creditors from exploitation arising out of limited liability. To be sure, this was not as simple an exercise as this bald statement might suggest..... But the underlying objective could be simply stated, despite the considerable array of legal techniques needed to achieve it successfully, taking account of the vast complexity of corporate experience. It is sometimes thought that those who viewed the goal of corporate law in this way knew nothing of the costs thrown by corporate activities upon those who were neither investors nor creditors. This, of course, is nonsense. The solutions to these costs, as this chapter has suggested, were thought to lie in contract (for those in contractual relations with the company) and in regulation (for those without). Faith in both these extra-corporate legal mechanisms seems to have waned over the past decade or so. In respect of regulation, the financial crisis beginning in 2007 seems to have been a major turning point.” (p. 340)

The world has indeed become more complex and faith in extra-corporate legal mechanisms has waned. Nevertheless, there is a marked reluctance to act and a strong belief that, even if there were a will to act, it is not an obvious there is a way:

“Whilst company law can do a lot, it is doubtful it can do everything. It is unlikely it can provide a panacea for all the regulatory and contractual problems which beset the corporation. And we would be unwise to try to make it do that: the risk is that it would perform less well the objective it already discharges effectively.” (p. 341)

⁴ Raz (2021) dismisses the suggestion that corporate law should be classified as public rather than private law. He notes that “it is no coincidence that corporate statutes, such as the Delaware General Corporation Law, state that corporations may only engage in “any lawful act or activity.” Indeed, “[t]he modern practice of allowing corporations to broadly state their purpose as pursuing ‘any lawful activity’ still reflects a public-regarding limit on corporate activity.” This statement is entirely accurate; yet, it is crucial to remember that “public regarding” is not the same as “public law,” and does not mean that the “state” is directly involved in corporate affairs—not any more than contract law’s prohibition on unlawful provisions turns contract law to public law, or makes the state party to every contract” (p. 27).

Davies argues that any straightforward attempt to require companies to adopt purposes is destined to fail (Davies (2022)). He cites as an illustration of that the unsuccessful attempts in early UK Companies Acts (e.g. UK Companies Act (1862)) to require companies to adopt object clauses in response to the granting of limited liability and the *ultra vires* doctrine, which established that companies that strayed outside their stated object clauses were acting beyond their designated powers (Nyombi (2014)).

There were three difficulties with object clauses and their imposition through the *ultra vires* doctrine. The first was the liability directors potentially incurred from acting *ultra vires*. The second was the limitation it imposed on the activities in which companies could engage and the ability of companies to modify their objectives. The third was the inability of parties to enforce contracts that were deemed to be *ultra vires*.

In response, companies specified progressively more general and less meaningful object clauses that served no useful function of clarifying or restricting corporate activities. Attempts by courts to sustain substantive interpretations of the *ultra vires* doctrine became clouded in confusion and obscurity, and progressively the doctrine was weakened until its death knell was sounded in the 2006 Companies Act.

Davies therefore regards the introduction of meaningful corporate purposes as “not simple” (Davies (2022)). To the extent that corporate purpose is pursued he believes that its enforcement mechanisms should avoid imposing limitations on the validity of corporate transactions, be solely in the hands of shareholders not third parties, civil society, or public authorities (such as regulators), and limited to court orders to observe purpose statements (Davies (2022)). In other words, the law should do no more than encourage shareholders to nudge companies in the direction of promoting their corporate purposes.

The limited role for corporate law in promoting corporate purpose statements reflects a belief that investors and companies will only adopt them to the extent that they are perceived to assist in delivering corporate and financial success. Anything beyond that will require the intervention of government and regulators to uphold a broader public interest. There is little prospect of companies being created or operated of their own volition with purposes of promoting the interests of society beyond their customers and shareholders.

It is not therefore realistic to expect that companies will make meaningful statements of why they are created or exist beyond the interests of their shareholders without governments or regulators forcing them to do so. This takes one down the dangerous path of politically determined corporate purposes. Far from inspiring a plurality of corporate purposes which reflect a multiplicity of interests beyond those of the members of a corporation, the adoption of purpose statements risks the imposition of politically inspired and bureaucratically managed corporate objectives.

In essence what Davies is seeking to do is to bring an element of realism and practicality to what he perceives as a worthy but unworldly view of business and law. The power of the law to ensure that companies do what they state they will do may be limited but its ability to require them to state anything other than what they want to do is even less. The difficulty to

which Davies points and the conclusion to which he comes is that companies will not of their own volition state or adopt meaningful purposes for which they are legally liable. Since corporate purpose is the reason why a company is created and exists, this implies that business will not voluntarily set out its reason for being beyond promoting its own and its members success for fear of being held accountable for doing it.

What this points to is an inherent problem in the way in which business has been conceived, namely that private interest does not correspond to the public except in very particular circumstances where the functioning of competitive markets and contracts is so complete and efficient that perfect competition and contracts prevail everywhere.⁵ Without this, the failure of markets results in the failure of business and a reliance on regulation that has proven increasingly incapable of meeting the challenge. This imposes an intolerable strain on government and our democratic systems to bridge the divide between those who advocate for the unrestrained operation of markets and businesses, and those who seek to tie them down with the heavy hand of regulation and enforcement (Admati (2021)).

A resolution of this problem lies in business itself, not in reliance on external parties to constrain it. At the heart of the notion of the corporation is the benefit that is derived from the pursuit of profits. As Adam Smith stated: "It is the stock that is employed for the sake of profit, which puts into motion the greater part of the useful labour of every society" (Smith (1776)). But as Nathan Rosenberg (1974) noted, Adam Smith had a very ambivalent attitude to profit: "The rate of profit does not, like rent and wages, rise with the prosperity, and fall with the declension, of the society. On the contrary, it is naturally low in rich, and high in poor countries, and it is always highest in the countries which are going fastest to ruin. The interest of this third order [i.e., capitalists], therefore, has not the same connexion with the general interest of the society as that of the other two [i.e., landlord and worker]". Profits are not derived exclusively or solely from the delivery of human and natural world benefits. They can also come from the exploitation of human and planetary wellbeing and, as we reach natural and social environmental boundaries, the impact of that exploitation intensifies.

It is this potential conflict between the financial inducement of profit and the delivery of human, social and environmental benefits that lies at the heart of the division between the private and public purpose of business. The role of a purpose statement is to address this problem in two ways – first to establish what is out of bounds in determining legitimate sources of profit for companies, and second to provide a means for companies to commit to the delivery of public as well as private benefits that drive the legitimate earning of profits. The purpose statement describes how business will seek to avoid profiting from producing problems (for example in not paying below a fair wage in its supply chains or degrading natural assets in its possession) and what problems it will solve for whom and over what period (for example in relation to soil erosion, deforestation and obesity caused by the food products it sources and sells). In both cases these are statements of purpose beyond what regulation explicitly requires of business and to which companies are at present incapable of committing.

⁵ See Roe (2021) for a discussion of the relation between market competition and corporate purpose.

The current problem of commitment is most starkly illustrated by the market for corporate control – the takeover market. Existing law implies that directors have a duty to prioritize shareholder over other party interests in determining the validity of a takeover or at least demonstrate that the takeover is in the long-term if not short-term interests of shareholders. Directors are therefore unable to commit to uphold the interests of other stakeholders.

In contrast, a law which specifies that companies must refrain from profiting from creating detriments for others requires a target firm to decline an offer that does not compensate affected parties, and the acquiring firm to ensure that compensation is paid. This means that target management must reject and acquiring firms must refrain from proposing bids that do not respect the interests of all parties including, but not exclusively, shareholders. Bids that are profitable solutions not profiting from producing detriments are then “Pareto improving” in providing a firm lock on the interests of all parties including shareholders, in contrast to existing law which provides a firm lock on the interests of shareholders alone, potentially to the detriment of others.⁶

4. Profit and Prosperity

The British Academy Future of the Corporation programme definition of corporate purpose - “producing profitable solutions for the problems of people and planet, not profiting from producing problems for either” - is not just a statement of the object of the firm but also of what is deemed to be a legitimate source of profits, namely profiting from solving not creating problems for people or the natural world. The reason why this is critical is that it resolves the conflict that arises between the pursuit of objectives that are in the corporate interest of its members in financial terms and those of society or the natural world more generally in social and environmental wellbeing.⁷

Where the company has effects on others that are not reflected in market prices there will be externalities that are not internalized in its financial performance. Since they are not priced, they are not included in a company’s revenues or costs and therefore not relevant to the management of its profitability. What the reformulation of the company’s purpose does is to require a firm to take account of the effects of its activities on others irrespective of whether they are priced.

It expects a company to identify where its activities as a producer, employer, purchaser, neighbour, or consumer of public goods and ecosystem services are having a detrimental effect on the interests and wellbeing of others. It must then determine the ways in which it can best mitigate, remedy, rectify or compensate for the detriments it is causing. If the costs of so doing are too great for it to profit from those activities, then it should desist from

⁶ This addresses the concern that Bebchuk, Kastiel and Tallarita (2022) raise about the preservation of stakeholder interests in takeovers under existing corporate law, and their concerns about the apparent failure of constituency statutes in the US to protect stakeholder interests despite their purported ability to do so. Bebchuk, Kastiel and Tallarita (2021).

⁷ For a view of the “psychopathic” nature of business, see Babiak, Neumann and Hare (2010); Bakan (2004); and Brueckner (2013).

undertaking them because, as the first part of the purpose statement says, a company should not undertake activities from which it does not profit.⁸

What this concept of purpose does is to align social and environmental interests with those of a company's members. Companies only profit where they create positive societal and environmental benefit, not where they have a negative impact on either.⁹ It is no longer an empirical matter of whether there is a positive relationship between profits and problem solving but definitionally true in at least an *ex-ante* sense of anticipated profits, if not *ex-post* in terms of unanticipated outcomes.

The purpose of a business clarifies what together the board of a company and its shareholders regard as the legitimate source of its profits and therefore the return on shareholders' capital. It establishes where together they understand the company as contributing to enhancing the wellbeing of its customers, employees, suppliers, societies, and environment, and where investors are therefore appropriately rewarded for their investments. What this does is to avoid the current situation by which any profits not earned illegally by violating regulatory rules or at the expense of the value of a firm by undermining its reputation, are regarded as legitimate. It diminishes reliance on regulation to stop companies from damaging society and the environment.

The significance of corporate law in incorporating corporate purpose in the fiduciary responsibilities of directors is twofold. It establishes, first, a principle of not profiting from detriments and, second, it provides a means by which companies can commit to upholding the interests of other parties (Fisch and Solomon (2021)). It extends directors duties of loyalty from the members of a company to those whose problems it is seeking to solve and introduces a duty of care not to profit from creating detriments for them.

The firm exists to assist others, not just itself, its owners, directors, and executives.¹⁰ It is there to serve individuals, communities, nations, the natural world, and its environment, to do so in a way that allows it to access the human, natural, social, material, and financial resources it requires to achieve that, and to reward them appropriately. It must therefore respect the rights of its shareholders and those on whom it depends and impacts. The firm establishes for whom it exists, why, for what purpose and how it should engage with them to deliver what they require in a form that respects their interests. No longer is the objective of the firm merely to promote the success of the company but instead to promote the success of all those whom the company seeks to serve and avoid adversely affecting others. The firm embodies the resolution of individual and collective needs and desires and realizes them through devoting itself to this purpose.¹¹

⁸ Hart and Zingales, (2017); Broccardo, Hart and Zingales (2020); and Brest, Gilson and Wolfson (2019).

⁹ There are reasons beyond profit why they may wish to confer benefits on other parties. See, for example, Bénabou and Tirole (2010); and Armour, Min, Garrett and Gordon (2020).

¹⁰ For contending theories of the purpose of the corporation see Bebchuk and Tallarita (2020b), Friedman (1962 and 1970), Mayer (2022), and Stout (2012).

¹¹ For discussions of the political theory of corporations see Ciepley (2013); Culpepper (2011); Ferreras (2017); Neron (2010); and Singer (2017).

The significance of the law in providing a means of committing to parties other than the shareholders is twofold, first in establishing that the direction of causation runs from solving other parties' problems to yielding benefits for shareholders, not the converse, and second in thereby determining the company's trustworthiness in upholding other party interests. At present, in making the duty of the board to promote the success of the company for the benefit of its shareholders, the interests of shareholders are primary and those of other parties are derivative of shareholders'. Contrary to conventional wisdom, the residual claimants in a firm are therefore not the shareholders. The profits of the firm are its target, and the interests of other parties are subsumed in those so that, in reporting on its performance, primary emphasis is on whether profits have fulfilled expectations, and if not, how the company will address the failure by cutting costs.

Profits are a classic example of Goodhart's Law – "when a measure becomes a target it ceases to be a good measure" – because it has the unintended consequence of making other parties – redundant employees, discarded suppliers, abandoned communities – the victims. Reversing causality correctly restores shareholders as the risk bearers and, in the process, establishes the firm's trustworthiness to earn the trust of others as a trustworthy supplier, purchaser, employer, partner, debtor, neighbour, and citizen.

Why was this not incorporated in the original design of the corporation? The answer is that it was not regarded as being either necessary or desirable. It was not necessary because private companies at the time of freedom of incorporation were for the most part relatively small, generally family businesses whose primary requirement was access to finance to invest in the newly emerging manufacturing industries. The imposition of objectives beyond their financial survival was thought to be a distraction and impediment to their success. Furthermore, the growing influence of economic thought pointed to the role that competitive markets could play in promoting the alignment of the private interests of firms and their owners with those of society more generally.

It was not desirable because concepts of property suggested that the rights of shareholders over firms were and should be equivalent to those over any form of property.¹² The risks of this for at least one party, namely creditors, were recognized and the basis of the unsuccessful attempts to restrain firms through objective clauses and the *ultra vires* doctrine described above. What was not anticipated is what has happened since, namely that corporations have grown to global scale and significance, straining the operation of markets to their limit, and demanding interventions to restrain firms that impose intolerable burdens on legal and political systems. We have therefore moved to and beyond the limits of the original conception of the firm and must recognize the need now for it to embrace its potential to promote local, national, and international prosperity as well as profits.

5. Conclusions

The corporation is a product of the law, and the law can fashion it in its preferred form. That is what it did when the corporation was constrained to be publicly chartered and then

¹² For discussions of property views of the firm, see Anderson (2020), Harris (2006), Honoré (1961), Millon (1990), Orts (2013), Pistor (2019), Pollman (2021) and Raz (2020).

released to be freely incorporated. To assert now that there is nothing wrong with the law and nothing to be done even if there is something wrong, is complacent and complicit in its failings.¹³

What this article has sought to do is to take seriously the objection that the purpose of business is not the fundamental defect of corporate law. That objection centres on two claims – the first is that there is little or nothing that existing corporate law prevents firms from doing in determining their corporate purposes, and secondly, if given greater latitude in formulating purposes, companies would do little more than they do at present.

The claim of the article is twofold. First that the critics of the law of corporate purpose have failed to recognize the role that purpose can play in addressing the primary defect of the current system – namely the divergence of the private interests of the corporation from the public interests of society and the natural world. That derives from the disconnect that currently exists between the private incentives of the pursuit of profit from the public interest in human and natural world flourishing and prosperity.

The second is that not only can the law address that defect through requiring the adoption of appropriately formulated corporate purposes, but it can also provide an essential means of commitment to the delivery of long-term prosperity. The permissiveness of the law is part of its problem. In being permissive, it is inadequately enabling in allowing firms to commit to anything other than that which is permitted. It does not enable commitments to objectives beyond the pursuit of the success of the company for the benefit of its members and thereby fails to protect companies which seek to promote wider prosperity through preserving and protecting the interests of others.

The law can and should ensure the alignment of the corporation's incentives with individual, societal, and planetary interests and promote the resolution of their problems by enabling the most powerful institutional entity that we have created to date alongside governments, namely corporations, to commit credibly to their resolution. Its failings on both counts have been the source of our intensifying crises. Instead of being in denial, we need to acknowledge this and recognize our power to provide a remedy for the cause – namely the laws that create the corporation.

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¹³ Mayer (2013 and 2018).

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