

# Corporate Governance Beyond the Shareholder and Stakeholder Model

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## Abstract

There is a heated debate on shareholder versus stakeholder governance. The debate has expanded from traditional stakeholders who are directly involved with the company, such as employees and customers, to stakeholders who are indirectly affected by the company's conduct, for example through ecological damage and climate change, including future stakeholders. But the lack of an integrated measure makes it difficult to hold the board accountable against multiple goals. This article develops an integrated model of corporate governance including current and future stakeholders, building on an integrated measure for corporate value. The board can use this integrated value measure to balance the interests of the various stakeholders in a structured way. The integrated value measure can also be used by stakeholders (including shareholders) to hold the board accountable for its decisions. Finally, the article examines mechanisms, such as stakeholder councils and sustainability-related performance pay, to include the interests of the various stakeholders on the board.

**Keywords:** shareholder model, stakeholder model, sustainability, corporate governance.

## 1 Introduction

The debate on the shareholder versus the stakeholder view on the company goes back to the 1930s. Berle, one of Roosevelt's New Deal architects, wanted to include the interests of labour in the control of companies. His mechanism for labour to influence the company was diversified ownership of stocks through savings or pension funds.<sup>1</sup> Berle stressed the disciplining role of shareholders to control company management.<sup>2</sup> By contrast, Dodd argued that business has obligations to the com-

munity,<sup>3</sup> including customers, creditors and employees. At the time, he predicted that 'public opinion will demand a much greater degree of protection to the worker'.<sup>4</sup> In his view, the company should be run in the interests of its stakeholders.

Almost a century later, the debate has expanded to the environment. Following the Paris Climate Agreement of 2015 and the EU's Green Deal of 2020, the question arises as to how the interests of the environment (which we label further on as future stakeholders) should be incorporated by a company's board. History repeats itself. Answers range from the view that business should just follow the legal requirements and not make its own ecological policies (a prime example is Bebchuk and Tallarita)<sup>5</sup> to the recognition of the firm's responsibility to serve its stakeholders.<sup>6</sup> Again, the main arguments of the shareholder proponents are that the government should take care of externalities via regulation<sup>7</sup> and that the board is accountable to none in the case of multiple goals or masters.<sup>8</sup>

The Friedman doctrine still has wide support.<sup>9</sup> But Zingales shows that two conditions are needed for the Friedman doctrine to hold.<sup>10</sup> The first is that companies do not have market or political power. The second is that companies do not pose externalities or, alternatively, that the government could address these externalities perfectly through regulation. Both conditions are violated in practice. Large corporations are too big to regulate.<sup>11</sup> Moreover, governments cannot effectively regu-

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1 A. Berle and G. Means, *Private Property and the Modern Corporation* (1932).

2 A. Berle, 'Corporate Powers as Powers in Trust', 44(7) *Harvard Law Review* 1049 (1931).

3 E.M. Dodd, 'For Whom are Corporate Managers Trustees?', 45(7) *Harvard Law Review* 1145 (1932).

4 *Ibid.*, at 1151.

5 L. Bebchuk and R. Tallarita, 'The Illusory Promise of Stakeholder Governance', 106(1) *Cornell Law Review* 91 (2021); see also B. Cornell and A. Shapiro, 'Corporate Stakeholders, Corporate Valuation and ESG', 27(2) *European Financial Management* 196 (2021).

6 C. Mayer, L. Strine & J. Winter, 'The Purpose of Business is to Solve Problems of Society, Not to Cause Them', in L. Zingales, J. Kasperkevic & A. Schechter (eds.), *Milton Friedman 50 Years Later* (2020) 65; and J. Winter, 'Towards a Duty of Societal Responsibility of the Board', 17(5) *European Company Law Journal* 192 (2020).

7 M. Friedman, 'The Social Responsibility of Business is to Increase Its Profits', *The New York Times Magazine* 13 September (1970).

8 Bebchuk and Tallarita, above n. 5.

9 S. Kaplan, 'The Enduring Wisdom of Milton Friedman', in L. Zingales, J. Kasperkevic & A. Schechter (eds.), *Milton Friedman 50 Years Later* (2020) 4.

10 L. Zingales, 'Friedman's Legacy: From Doctrine to Theorem', in L. Zingales, J. Kasperkevic & A. Schechter (eds.), *Milton Friedman 50 Years Later* (2020) 128.

11 *Ibid.*

late all companies' externalities owing to asymmetric information between governments and companies.<sup>12</sup>

Analysing the control structure of companies, Tirole shows that the implementation of the stakeholder model leads to deadlocks in decision-making and a lack of a clear mission for management.<sup>13</sup> The reason for the failure of the stakeholder model is the absence of a measure of the aggregate welfare of the stakeholders (including investors). Tirole argues that it is harder to measure the firm's contribution to the welfare of employees, of suppliers or of customers than to measure its profitability.<sup>14</sup> There is no accounting measure of this value, although in some examples one can find imperfect proxies (e.g. the number of layoffs). Moreover, there is no market value of the impact of past and current managerial decisions on the future welfare of stakeholders (i.e. the counterpart of the stock market measurement of the firm's assets).

Recent advances in impact valuation enable companies to measure social and ecological quantities and express these in monetised form using cost-based or welfare-based prices.<sup>15</sup> The monetisation of the different value components enables aggregation. Building on these impact valuation methods, Schramade, Schoenmaker and De Adelhart Toorop develop a measure of integrated value, which combines financial, social and ecological value.<sup>16</sup> This integrated value measure allows managers to balance several types of value (financial, social and ecological) at the same time, which often involves trade-offs. Schramade et al. derive decision rules that help managers *ex ante* to make investment decisions accordingly.<sup>17</sup> The integrated value measure can also be used to hold managers *ex post* accountable for their decisions.

The contribution of this article is twofold. First, we develop an integrated model for corporate governance that allows for a systematic inclusion of future stakeholders. Conventional stakeholder models include the interests of direct stakeholders, such as employees and customers, alongside the financial stakeholders. More recent models argue for the inclusion of ecological concerns (climate change, biodiversity and water scarcity) and wider societal concerns (human rights, precarious work), but that is not always done in a systematic way.<sup>18</sup> Moreover, the incorporation of ecological value implies the inclusion of future stakeholders, representing future

generations that bear the consequences of ecological degradation.

Second, we elaborate on the governance implications of the integrated value measure for decision-making and accountability. This integrated value measure addresses the problem of multiple goals and masters posed by Tirole<sup>19</sup> and, more recently, by Bebchuk and Tallarita.<sup>20</sup> The measure provides guidance for decision-making that balances the interests of current and future stakeholders. The measure also allows for the prioritisation of specific types of value,<sup>21</sup> in line with a company's purpose.<sup>22</sup> The integrated value measure also serves to hold management accountable.

The article is organised as follows. Section 2 reviews the main corporate governance models and introduces the integrated model. Section 3 discusses how management can balance the interests of a company's various stakeholders. The integrated value measure provides guidance for balanced decision-making. Section 4 examines the mechanisms to include the interests of the various stakeholders on the board. Section 5 concludes.

## 2 Corporate Governance Models

This section reviews the strengths and weaknesses of the current corporate governance models. These are the shareholder model (as adopted in the United States), the stakeholder model (as adopted in Germany and the Netherlands) and the enlightened shareholder model (as applied in the United Kingdom).<sup>23</sup> The integrated model is presented as an alternative corporate governance model to address the drawbacks of the current models. Table 1 summarises the key characteristics of the main models.

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12 R. Shapira and L. Zingales, 'Is Pollution Value-Maximizing? The Dupont Case', *CEPR Discussion Paper No. 12323*, (2017), [www.nber.org/papers/w23866](http://www.nber.org/papers/w23866).

13 J. Tirole, 'Corporate Governance', 69(1) *Econometrica* 1 (2001).

14 *Ibid.*

15 G. Serafeim, R. Zochowski & J. Downing, 'Impact-Weighted Financial Accounts: The Missing Piece for an Impact Economy', *White Paper, Harvard Business School* (2019), [www.hbs.edu/faculty/Pages/item.aspx?num=59129](http://www.hbs.edu/faculty/Pages/item.aspx?num=59129); and R. De Adelhart Toorop, J. Kuiper, V. Hartanto & A. de Groot Ruiz, *Framework for Impact Statements, Beta Version* (2019).

16 W. Schramade, D. Schoenmaker & R. de Adelhart Toorop, 'Decision Rules for Integrated Value', *Working Paper, Erasmus Platform for Sustainable Value Creation* (2022), <https://ssrn.com/abstract=3779118>.

17 *Ibid.*

18 C. Mayer, 'Shareholderism Versus Stakeholderism—A Misconceived Contradiction', 106(7) *Cornell Law Review* 1859 (2022).

19 Tirole, above n. 13.

20 Bebchuk and Tallarita, above n. 5.

21 Schramade et al., above n. 16.

22 C. Mayer, *Prosperity: Better Business Makes the Greater Good* (2018).

23 J. Wieland, 'Corporate Governance, Values Management, and Standards: A European Perspective', 44(1) *Business & Society* 74 (2005).

Table 1 Comparing Corporate Governance Models

Dimension	Shareholder model	Stakeholder model	Integrated model
Goal	Shareholder value	Stakeholder value	Integrated value
Optimisation	$FV$	$STV = FV + SV$	$IV = FV + SV = EV$
Stakeholders	Shareholders	Current stakeholders	Current and future stakeholders
Assumptions	<ul style="list-style-type: none"> <li>– Shareholder, as residual claimant, 'owns' the company and deserves control</li> <li>– Serving the interests of other stakeholders is instrumental to shareholder value</li> </ul>	<ul style="list-style-type: none"> <li>– Managers act in the interest of the company on behalf of financial and direct stakeholders</li> </ul>	<ul style="list-style-type: none"> <li>– Managers act in the interest of the company on behalf of financial, social and ecological stakeholders</li> </ul>
Implications	<ul style="list-style-type: none"> <li>– Shareholder value provides clear guidance for decision-making and accountability</li> <li>– Social and ecological value considerations come second, if considered at all</li> </ul>	<ul style="list-style-type: none"> <li>– Multiple goals suggest unclear guidance and require balancing rules for decision-making and accountability</li> <li>– Financial and social value considerations incorporated</li> <li>– Ecological value considerations come second, if considered at all</li> </ul>	<ul style="list-style-type: none"> <li>– Multiple goals suggest unclear guidance and require balancing rules for decision-making and accountability</li> <li>– Financial, social and ecological value considerations incorporated</li> </ul>

Note:  $FV$  = financial value;  $SV$  = social value;  $EV$  = ecological value;  $STV$  = stakeholder value;  $IV$  = integrated value.

### 2.1 The Shareholder Model

In the shareholder model, the goal of the company is to maximise the value of the company. This is the value of the securities provided by the financiers, i.e. shareholders and creditors. Shareholders are in control of the company, because they are residual, non-contractual claimants.<sup>24</sup> They get paid after all contractual claims to other stakeholders, such as creditors, employees, customers, and government, are paid. Shareholders thus maximise financial value  $FV$ , after the other stakeholders are satisfied.

The shareholder model is consistent with Friedman's argument that 'the business of business is business'.<sup>25</sup> In this view, it is the task of the government to take care of social and ecological concerns. Mehrotra and Morck discuss several challenges for proponents of the shareholder view: contractual and business ethics.<sup>26</sup> First, it is difficult to incorporate all possible future circumstances in contracts with stakeholders. Unforeseen circumstances, including externalities, can happen, which give rise to the notion of incomplete contracts.<sup>27</sup> In these cases that

the contract does not provide for, the shareholder interest would override the interests of the other stakeholders in the shareholder model.

Second, business ethics concerns are a final line of defence for stakeholders.<sup>28</sup> Obeying the letter of the law regarding the rights of stakeholders can pit shareholder value maximisation against social welfare. Where externalities are important, a narrow focus on shareholder value can create scope for managers making morally dubious decisions. For example, maximising shareholder value ex ante might justify cutting costs and entertaining acceptably small risks of ecological disasters. Even if such a disaster triggers legal actions that bankrupt the committing company, its shareholders are protected by limited liability and so lose only the value of their shares.

Such disasters might be discouraged by exposing directors to personal liability should they occur. But there are several hurdles to holding directors to account. A first step is to determine board accountability, and then the biggest hurdle is the 'business judgment rule' that provides a high threshold for board (personal) liability. Finally, directors have usually liability insurance, which limits their personal exposure. Shapira and Zingales show how a respected company, like DuPont, willingly caused ecological damage by disposing of a toxic chem-

24 M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', 3(4) *Journal of Financial Economics* 305 (1976).

25 Friedman, above n. 7.

26 V. Mehrotra and R. Morck, 'Governance and Stakeholders', in B. Hermalin and M. Weisbach (eds.), *The Handbook of the Economics of Corporate Governance* (2017) 637.

27 S. Grossman and O. Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration', 94(4) *Journal of Political Economy*

691 (1986); and O. Hart and J. Moore, 'Property Rights and the Nature of the Firm', 98(6) *Journal of Political Economy* 1119 (1990).

28 Mehrotra and Morck, above n. 26.

ical used in the making of Teflon in its West Virginia plant.<sup>29</sup> This case was turned into a legal thriller film called *Dark Waters*. The harmful pollution was a rational decision: under reasonable probabilities of detection, polluting was ex ante optimal from the company's perspective, albeit a very harmful decision from a societal perspective. The DuPont case is an example of how, as Winter points out,<sup>30</sup> the modern corporation under this shareholder model has become amoral: the consequences of its conduct towards third parties are irrelevant for decision-making. Shapira and Zingales examine why different mechanisms of control, like legal liability, regulation and reputation, can all fail to deter socially harmful behaviour.<sup>31</sup> One common reason for the failures of deterrence mechanisms is that the company controls most of the information and its release. The key question remains, how to rank shareholder and other stakeholder interests? Should all interests be put on an equal footing (the stakeholder model), or should shareholder interests come first (the enlightened shareholder model).

## 2.2 The Stakeholder Model

The stakeholder model states that managers should balance the interests of all stakeholders, which include financial agents (shareholders and debtholders) as well as direct agents (consumers, workers, suppliers).<sup>32</sup> Adopting the stakeholder view, Magill, Quinzii and Rochet develop a model where a large firm typically faces endogenous risks that may have a significant impact on the workers it employs and the consumers it serves.<sup>33</sup> These risks generate externalities on these stakeholders, which are not internalised by shareholders. As a result, in the competitive equilibrium, there is under-investment in the prevention of these risks.

Magill, Quinzii and Rochet suggest that this under-investment problem can be alleviated if companies are instructed to maximise the total welfare of their stakeholders rather than shareholder value alone (stakeholder equilibrium).<sup>34</sup> The stakeholder equilibrium can be implemented by introducing new property rights (employee rights and consumer rights) and instructing managers to maximise the stakeholder value *STV* of the company (the value of these rights plus the shareholder value).

In a setting with three stakeholder groups (consumers, employees and shareholders), Magill, Quinzii and Rochet show how companies can maximise the total value for the stakeholders – the value to consumers measured by the consumer surplus, the value to employees measured by workers surplus and the value to shareholders measured by profit.<sup>35</sup> The company balances these three

values, depending on the weight given to each stakeholder.

Tirole formulates three problems with serving various stakeholders in the stakeholder model.<sup>36</sup> First, the stakeholder model may reduce pledgeable income (income available for financiers), as cash flows are distributed to various stakeholders. Second, it may lead to a less clear mission and fewer incentives for managers, as they have to serve multiple masters. Third, divided control among multiple stakeholders may lead to deadlock in decision-making. But Tirole recognises that the shareholder model also has its shortcomings, such as biased decision-making leaving scope for important externalities.<sup>37</sup> The debate on the stakeholder model has traditionally focused on stakeholders with a direct relation to the company, i.e. employees, creditors, customers, suppliers. The ecological and social challenges the world faces, however, make clear that a much wider circle of stakeholders is affected by the conduct of companies. In the seminal Shell decision of the District Court of The Hague of 26 May 2021, for example, it was held that Shell would commit a tort towards people in the Netherlands, in general, and inhabitants of the *Waddengebied* (the coastal and island area of the north of the Netherlands), in particular, by not committing to more specific CO<sub>2</sub> reductions.<sup>38</sup> Future stakeholders, by definition, are also not included in the classical stakeholder model thinking. The ecological and societal challenges we face cannot be effectively addressed if we stick to this classical stakeholder model.

## 2.3 The Enlightened Shareholder Model

Although the shareholder model cannot fully satisfy the interests of stakeholders, there are also problems with the stakeholder model.<sup>39</sup> The manager has to serve all interests and in the end will serve none.<sup>40</sup> Managers may in that case choose an objective function that is most closely relevant to their own interests.<sup>41</sup> Stakeholder theory may thus leave managers unaccountable, as optimising several objectives simultaneously is difficult to measure and control.

Jensen argues that shareholder value maximisation is best achieved in practice by catering to all stakeholders – an approach he calls Enlightened Value Maximisation.<sup>42</sup> This view defends stakeholder interests as a means to the end goal of shareholder value maximisation. But Mehrotra and Morck show that this argument is flawed.<sup>43</sup> It fails to resolve the many situations of clear conflict between the interests of shareholders and different stakeholders. It also fails to value externalities

29 Shapira and Zingales, above n. 12.

30 Winter, above n. 6.

31 Shapira and Zingales, above n. 12.

32 R. Freeman, *Strategic Management. A Stakeholder Approach* (1984).

33 M. Magill, M. Quinzii & J.C. Rochet, 'A Theory of the Stakeholder Corporation', 83(5) *Econometrica* 1685 (2015).

34 *Ibid.*

35 *Ibid.*

36 Tirole, above n. 13.

37 *Ibid.*

38 [www.rechtspraak.nl/Organisatie-en-contact/Organisatie/Rechtbanken/Rechtbank-Den-Haag/Nieuws/Paginas/Royal-Dutch-Shell-must-reduce-CO2-emissions.aspx](https://www.rechtspraak.nl/Organisatie-en-contact/Organisatie/Rechtbanken/Rechtbank-Den-Haag/Nieuws/Paginas/Royal-Dutch-Shell-must-reduce-CO2-emissions.aspx).

39 Tirole, above n. 13.

40 Bebchuk and Tallarita, above n. 5.

41 M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', 12(2) *Business Ethics Quarterly* 235 (2002).

42 *Ibid.*

43 Mehrotra and Morck, above n. 26.



that the corporate may inflict on more distant stakeholders, such as the environment.

Nonetheless, Mehrotra and Morck argue that enlightened value maximisation, or refined shareholder value, may well be the least bad alternative on offer.<sup>44</sup> In contrast to stakeholder theory, the approach has a single roughly measurable objective, refined shareholder value, while explicitly recognising that good relations with stakeholders can boost firm value by easing contracting costs and facilitating surplus creation. Companies put systems in place for energy and emissions management, sustainable purchasing, IT, building and infrastructure to enhance ecological standards, and all kinds of diversity in employment. The underlying objective of these activities remains economic. Although introducing sustainability into business might generate positive side effects for some sustainability aspects, the main purpose is to reduce costs and business risks, to improve reputation and attractiveness for new or existing human talent, to respond to new customer demands and segments and thereby to increase profits, market positions, competitiveness and shareholder value. Business success is still evaluated from a purely economic point of view and remains focused on serving the business itself and its economic goals.<sup>45</sup>

In the enlightened shareholder model, shareholder value or profit maximisation is still the guiding principle for the organisation, though with some refinements. Jensen proposes that the company should avoid excessive negative social and ecological impact.<sup>46</sup> Examples of excessive negative impacts are using child labour, unsafe work conditions and/or heavy pollution in the production process. The problem with this enlightened shareholder model is that the interests of other stakeholders are considered relevant only to the extent they are seen as conducive to creating financial value to shareholders. They are not valued as interests to be taken into account for their own sake that should lead management to not maximise shareholder value. The amoral character of the company continues under the enlightened shareholder value model. This will continue to keep business from taking sufficient responsibility for addressing the ecological and societal problems we face.

#### 2.4 The Integrated Model

While the traditional stakeholder model incorporates only direct social value alongside financial value into the company's objective, it does not deal with ecological and broader social value. Hart and Zingales make a distinction between shareholder value, which aims for maximisation of financial value only, and shareholder welfare, which incorporates social and ecological externalities.<sup>47</sup> An important assumption in their model is

that these externalities are not perfectly separable from production decisions. So companies face a choice in the degree of sustainability in their business model. The mechanism in the Hart-Zingales model to guide that choice is voting by prosocial shareholders on corporate policy.

Moving to corporate law, Mayer, Strine and Winter argue that companies should focus on sustainable wealth creation and that the balance between shareholders and stakeholders needs to be restored.<sup>48</sup> They recommend for the US context that large companies (with over \$1 bn of revenues) should become Public Benefit Corporations that should state a public purpose beyond profit maximisation and should fulfil that purpose as part of the responsibilities of their directors and be accountable for it. Winter et al. argue for an explicit duty of societal responsibility for directors.<sup>49</sup> The European Commission's recent proposal for a Directive on Corporate Sustainability Due Diligence (2022/0051 COD) takes a similar direction by stating that the member states must ensure that directors, when fulfilling their duty of care to further the interests of the company, take into account the consequences of their decision for sustainability matters, including, where applicable, human rights, climate change and ecological consequences, in the short, medium and long term (Art. 25 of the proposal).<sup>50</sup>

These developments raise the question of how to balance the interests of the various stakeholders. Schoemaker and Schramade introduce integrated value *IV*, which combines financial, social and ecological value in an integrated way.<sup>51</sup> The company should optimise this integrated value in the interest of current and future stakeholders. The optimisation requires a careful balancing of the three dimensions whereby interconnections and trade-offs are analysed but none should deteriorate in favour of the others.<sup>52</sup> Next, the systematic inclusion of future stakeholders, who will face the consequences of (lack of) ecological actions today ensures that ecological externalities are incorporated. While the Hart-Zingales model argues that (prosocial) shareholders vote on corporate policy, the Schoemaker-Schramade integrated model states that the managing board decides on corporate policy and is accountable to all stakeholders. The key difference is that the board is accountable to shareholders in the former and to stakeholders in the latter. There are two major drawbacks for

44 *Ibid.*

45 T. Dyllick and K. Muff, 'Clarifying the Meaning of Sustainable Business: Introducing a Typology from Business-as-Usual to True Business Sustainability', 29(2) *Organization & Environment* 156 (2016).

46 Jensen, above n. 41.

47 O. Hart and L. Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', 2(2) *Journal of Law, Finance, and Accounting* 247

(2017).

48 Mayer et al., above n. 6.

49 J.W. Winter, J.M. de Jongh, J.B.S. Hijink, et al., 'Naar een zorgplicht voor bestuurders en commissarissen tot verantwoorde deelname aan het maatschappelijk verkeer', 86 *Ondernemingsrecht* 471 (2020); see for critical reactions H.J. de Kluiver, 'Over de verantwoordelijke onderneming. Naar een Paradise by the dashboard light?', *Ondernemingsrecht* 2020/126; and W.A. Westenbroek, 'Een maatschappelijke verantwoordelijkheid voor ondernemingen en (bange?) bestuurders of co ro nawetenschap in crisistijd?', *Ondernemingsrecht* 2021/3.

50 EC proposal for Directive 2022/0051 COD, [https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2022/0051\(COD\)&l=en](https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2022/0051(COD)&l=en).

51 D. Schoemaker and W. Schramade, *Principles of Sustainable Finance* (2019).

52 Schramade et al., above n. 16.

leaving the balancing of stakeholder interests to prosocial shareholders. First, shareholders are not representative for the preferences of other stakeholders (and wider society). Second, shareholders are subject to the free-rider problem in that they face the full cost of prosocial decisions but only part of the benefits. This leads to an underprovision of social and ecological value. Hart and Zingales acknowledge the potential for underprovision in their model.<sup>53</sup>

A new business language is emerging around ‘the integrated value’ of the company. Traditional financial reports record assets, liabilities and profits on the basis of only financial and manufactured capitals (financial value). Integrated financial reports broaden this range to six capitals, by adding human, social, intellectual and natural capitals, reflecting social and ecological value.<sup>54, 55</sup> These capitals incorporate the social and ecological externalities and are expressed in money. This single language of integrated reporting enables managers to analyse the trade-offs for decision-making.

The review of the corporate governance models in this section indicates that the integrated model is best able to serve the interests of all stakeholders. Section 3 deals with decision-making in a multiple stakeholder setting.

### 3 Balancing Interests

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The balancing of shareholder and other stakeholder interests is a key question in the reviewed corporate governance models. A company’s board has to make a judgment on this balancing of interests in setting corporate strategy, policies and investments. The forming of this judgment is relevant for ex ante decision-making and ex post accountability.

The power of the shareholder model is the clear and single objective of shareholder value maximisation, which improves decision-making and accountability. But it comes at the cost of important externalities, as noted by Tirole.<sup>56</sup> Mayer and Edmans show how companies can create long-term value by combining economic (shareholder) and societal (stakeholders) value.<sup>57</sup> Companies operate in a disruptive world where their performance on climate change, consumer trust and employee satisfaction is becoming as important for society as their financial performance.<sup>58</sup> The balancing of interests for

53 Hart and Zingales, above n. 47.

54 R. Eccles, M. Krzus & S. Ribot, ‘Meaning and Momentum in the Integrated Reporting Movement’, 27(2) *Journal of Applied Corporate Finance* 8 (2015).

55 Integrated value is related to the capitals approach of the International Integrated Reporting Council, which uses six capitals: financial and manufactured capital (financial value), social and human capital (social value), natural capital (ecological value) and intellectual capital (all three values); see International Integrated Reporting Council, ‘The international IR framework’ (2013).

56 Tirole, above n. 13.

57 Mayer, above n. 22; A. Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (2020).

58 L. Kurznack, D. Schoenmaker & W. Schramade, ‘A Model of Long-Term Value Creation’, *Journal of Sustainable Finance & Investment* 1 (2021), <https://doi.org/10.1080/20430795.2021.1920231>.

long-term value creation can be done qualitatively and quantitatively.

#### 3.1 Qualitative-Based Judgment

Mayer argues that directors should act according to the reasons why the company was created and exists and what it is there to do, namely its purposes.<sup>59</sup> These should be the guiding star of the board, not rigid rules of shareholder rights or primacy that trump other interests. It is against those purposes and their associated values that the board’s actions and performance should be judged. Directors have the right to act with judgment – business judgment – and they should exercise that judgment in a form that they believe is appropriate to the circumstances. By making corporate values explicit, corporate purpose makes management accountable for its delivery. Mayer claims that ‘corporate purpose and values make accountability laser sharp’.<sup>60</sup> He encourages a multiplicity of purposes across companies and competition in models to deliver them in order to stimulate innovation.

A different approach is taken by Edmans.<sup>61</sup> He develops principles of multiplication, comparative advantage and materiality, which also do not rely on calculations. Edmans stresses that ‘value is only created when an enterprise uses resources to deliver more value than they could do elsewhere – the social benefits exceed the social opportunity costs’.<sup>62</sup> The three interrelated principles should guide a manager’s judgment to deliver value in complex situations with multiple stakeholders. The principle of multiplication ensures that the social benefits exceed the private costs, which is an easy hurdle to pass. The principle of comparative advantage requires the company to deliver more value than other companies with an activity. Finally, the principle of materiality asks whether the stakeholders that the activity benefits are material to the company. The combined application of these principles makes it likely that the activity creates profits by creating value for society.

The common element of these qualitative approaches is that a company should – in accordance with its purpose – deliver value to its main stakeholders. Both Mayer and Edmans argue that it is difficult or impossible not only to forecast the monetary effect on each stakeholder, but also to weight the different stakeholders.<sup>63</sup> So you cannot measure overall societal value. That still leaves the problem of holding management accountable to its multiple stakeholders.<sup>64</sup>

It is important to distinguish two aspects of being held accountable. The first is the circumstances under which a court may hold that the directors have breached their duties and impose liability for damages. In some jurisdictions liability will only occur when there is a certain level of bad faith or intent to do wrong on the part of the

59 Mayer, above n. 22.

60 *Ibid.*

61 Edmans, above n. 57.

62 *Ibid.*

63 Mayer, above n. 22; Edmans, above n. 57.

64 Tirole, above n. 13; Bebchuk and Tallarita, above n. 5.

director. In other jurisdictions a somewhat more objective standard is applied, which comes down to acting like no director acting reasonably in the circumstances would act. Both approaches allow for a margin of discretion for directors to make judgments. Only if the margin is transgressed and the director acts in bad faith or with bad intent or in a way that no reasonable director would have acted are courts likely to impose liability on directors. Courts have developed various concepts, such as reasonability, proportionality and procedural fairness that guide them on the question of whether and to what extent they should hold directors liable for the company's conduct.<sup>65</sup> This prevents directors from being held liable merely because some stakeholder would have favoured another decision.

The second aspect of accountability is the judgment of whether directors have performed well, have taken the best possible decision and have not succumbed to comfortable managerial slack as there is no clear measure to indicate what an optimal decision would be. The basic question is whether directors have delivered value to various stakeholders, as promised. If not, directors should be able to explain why there was a shortfall in value compared with expectations/promises. A quantitative approach that captures overall society value can be helpful in the accountability of the management board to stakeholders (including shareholders). The next subsection proposes to use an integrated value measure to quantify and balance the various forms of value – financial, social and ecological – within the integrated value concept.

### 3.2 Quantitative Judgment

To quantify the company objective, Schramade, Schoemaker and De Adelhart Toorop have developed an integrated value measure that combines financial, social and ecological value.<sup>66</sup> Recent developments in impact valuation enable companies to not only measure or forecast social and ecological quantities but also to express these in monetised form.<sup>67</sup> At the moment, these cost-based or welfare-based assessments of social and ecological value are typically less robust than those of financial value. But innovations in technology (measurement, information technology, data management) and science (life cycle analyses, social life cycle analyses, ecological extended input-output analysis, ecological economics) make the quantification and monetisation of social and ecological impacts increasingly possible.

The next question is how to steer on this integrated value measure. Schramade et al. design decision rules for corporate investment and valuation.<sup>68</sup> The balancing of positive and negative values across the financial, social and ecological domains is a key element of these decision rules. Just summing of positives and negatives al-

lows for the netting of financial, social and ecological values. Imbalances in the social and/or ecological dimension can then continue to build up, as is currently happening. The other extreme, no netting, is very restrictive. Any negative value should then be avoided, which may lead to a standstill of corporate investments. Schramade et al. suggest taking the middle ground, whereby negative values get a higher weight than positive values.<sup>69</sup> Companies thus have an incentive to reduce negative (social and ecological) values. A credible transition pathway back to positive on the problematic value dimension(s) is then a main focus of management. A second element of the decision rules is the weighting across the value dimensions. While shareholder-driven companies only value the financial dimension, companies that pursue long-term value creation also give a positive weight to the social and ecological dimensions. The model allows companies to choose their degree of sustainability: from moderate (weight of half) and equal weights (weight of one) to purposeful (higher weights for the social and ecological dimensions than for the financial dimension). While the majority of companies may apply moderate or equal weights, purposeful companies act as front runners in the return to operating within social and planetary boundaries. Companies can then prioritise specific types of value, in line with their purpose.<sup>70</sup>

Following Schramade et al., these decision rules can be formalised in an integrated value measure  $IV$  as follows:<sup>71</sup>

$$IV = \{FV^{+} + \beta \cdot SV^{+} + \gamma \cdot EV^{+}\} + \delta * \{FV^{-} + \beta \cdot SV^{-} + \gamma \cdot EV^{-}\} \text{ with } \delta > 1,$$

whereby  $FV$ ,  $SV$  and  $EV$  represent the financial, social and ecological value. The superscript  $+/-$  stands for a positive/negative value, respectively.  $\beta$  and  $\gamma$  are the weightings for the social and ecological value dimensions, and  $\delta$  reflects the higher weighting of negative values.

These decision rules acknowledge the interrelations between the different types of values and allow a structured balancing of stakeholder interests. An important corporate governance question is with whom to vest responsibility for setting the parameters ( $\beta$ ,  $\gamma$  and  $\delta$ ) of the decision rules for calculating integrated value. In our view, the executive directors should set the parameters as part of company strategy, which is subsequently challenged in a strategy dialogue with the non-executive directors (in a one-tier board) or the supervisory board (in a two-tier board). In addition, stakeholder-driven companies often have a stakeholder council (see Section 4) where the company's priorities are discussed. Stakeholders can thus indirectly influence the setting of the parameters.

By setting the parameters ( $\beta$ ,  $\gamma$  and  $\delta$ ) of the decision rules in advance, executive management can be held ac-

65 Winter, above n. 6.

66 Schramade et al., above n. 16.

67 Serafeim et al., above n. 15; De Adelhart Toorop et al., above n. 15.

68 Schramade et al., above n. 16.

69 *Ibid.*

70 Mayer, above n. 22.

71 Schramade et al., above n. 16.



countable by non-executive directors or the supervisory board on delivery of integrated value (IV) against these rules. The annual general meeting of shareholders and, if applicable, the stakeholder council can also use the reporting on realised integrated value to hold the board accountable.

It should be acknowledged that the integrated value measure is not absolute. Not every aspect of various stakeholder interests, including interests of future generations, can be measured and monetised. But applying an integrated value measure may provide useful and necessary guidance for boards in their decision-making by counterbalancing the bias to prioritise the clearly measurable financial value. This helps the board to widen the scope of their concerns and thus to explicitly balance the various interests for which they are responsible.

## 4 Mechanisms

While Section 2 has set out how the integrated model can broaden corporate governance to various stakeholders, Section 3 has shown how the board can apply an integrated value measure to quantify and balance the underlying financial, social and ecological value creation for these stakeholders. The next question is, what mechanisms can be designed to make the integrated model operational: how to include the interests of the various stakeholders in board decision-making? The following types of mechanisms are reviewed: formal governance models, formal board mandates, board composition, stakeholder councils (including future stakeholders) and incentive mechanisms.

Formal stakeholder models, such as co-determination (under which employees and possibly other groups elect directors along with shareholders), typically focus on the particular interests of the involved stakeholder groups rather than the general interest of the company. Moreover, the scope and number of stakeholders evolve over time, while formal mechanisms are static.

A more flexible mechanism is formulating formal board mandates for sustainability at the company level. These formal board mandates can be incorporated in the company's charter or bylaws.<sup>72</sup> The European Commission's proposal to include sustainability in the directors' duty of care has the same effect (see proposal for a Directive on Corporate Sustainability Due Diligence (2022/0051 COD)).<sup>73</sup> Such mandates make sustainability an explicit board priority and facilitate board sustainability oversight. To make it work, boards have to disclose whether boards and management discuss sustainability during board meetings. Boards can then work with management to identify specific social and ecological priorities for the company, include them in the company's strate-

gy and assess their impact on the company's long-term value. In terms of our model, boards have to set the parameters ( $\beta$ ,  $\gamma$  and  $\delta$ ) for the integrated value. Under the EU Corporate Sustainability Reporting Directive (2022/2464), boards will have to disclose the outcomes and specific results in a wide range of sustainability matters.<sup>74</sup>

Another mechanism is the composition of a board and the expertise of its members. Coffee argues for broadly representative and diverse boards that are sensitive to the company's impact on society.<sup>75</sup> Such broad and diverse boards are diverse not only on gender, ethnic and age characteristics but also on expertise. Without directors with the proper expertise, boards do not possess the collective skill set and background to examine the impacts of complex social and ecological issues on corporate strategy. However, international evidence shows that less than 5% of executive and non-executive role specifications require sustainability experience or a sustainability mindset.<sup>76</sup> This seems a missed opportunity for companies in their pursuit of broader stakeholder interests. Winter proposes that boards work with an X-team model.<sup>77</sup> An X-board consists of a core group of members that comprise the formal board and additional members that can advise on specific (sustainability) matters. Additional members could be advisory members of the board who would not share in the collective responsibility of the full board. This could speed up the increase in knowledge that is available in boards without overcrowding boards with members for each specific topic.

To foster accountability, a company can establish a stakeholder council with the relevant stakeholders. The board would discuss, at least once a year, the sustainability performance of the company. The board can also consult the stakeholder council on important decisions, with societal impact. To promote transparency, the stakeholder council reports annually about its activities and advice in the company's integrated annual report. Winter et al. have proposed to include the setting up of a stakeholder council as a best practice in the Dutch Corporate Governance Code.<sup>78</sup> A challenge is to include not only current stakeholders but also future stakeholders. An interesting mechanism, developed in Japanese local politics, is Future Design.<sup>79</sup> Future design aims to

72 V. Ramani and B. Ward, 'How Board Oversight Can Drive Climate and Sustainability Performance', 31(2) *Journal of Applied Corporate Finance* 80 (2019).

73 EC, above n. 50.

74 EU Directive 2022/2464, *Official Journal of the European Union*, L322/15, 16.12.2022.

75 J. Coffee, 'Diversifying Corporate Boards – The Best Way Toward a Balanced Shareholder/Stakeholder System of Corporate Governance', in L. Zingales, J. Kasperkevic & A. Schechter (eds.), *Milton Friedman 50 Years Later* (2020) 36.

76 H. Reus, 'Call to Action: Accelerating Sustainable Business Leadership', *Paper, Russell Reynolds Associates* (2018), [www.russellreynolds.com/en/insights/reports-surveys/call-to-action-accelerating-sustainable-business-leadership](http://www.russellreynolds.com/en/insights/reports-surveys/call-to-action-accelerating-sustainable-business-leadership); I. Sørensen and T. Handcock, 'Leadership for the Decade of Action', *White Paper, United Nations Global Compact & Russell Reynolds Associates* (2020), [www.russellreynolds.com/en/insights/reports-surveys/leadership-for-the-decade-of-action](http://www.russellreynolds.com/en/insights/reports-surveys/leadership-for-the-decade-of-action).

77 Winter, above n. 6.

78 Winter et al., above n. 49.

79 T. Saijo, *Future Design: Incorporating Preferences of Future Generations for Sustainability* (2020).



solve the dilemma between current stakeholders, who bear the cost of long-term investment, and future stakeholders, who reap the benefits.

The idea of future design is simple. If there is no one to protect the interests of future generations, then designate people to take on the role of future generations and have them stand in for future generations. This is the same reasoning as role-playing scenarios used frequently in, for example, war games. Saijo calls these people who are to take on the role of future generations the ‘imaginary future generation’ or ‘imaginary future persons’.<sup>80</sup> People, when they become an ‘imaginary future generation’, really change their lines of thought and points of view, becoming clearly aware of the interests of future generations. As a result, they actually think and act in the interest of future generations. One or more persons with such a designated role can be added to the stakeholder council.

Finally, incentive mechanisms also play a role. While variable executive pay is related mainly to financial performance, companies are starting to include sustainability targets in executive remuneration. Using an international sample of ISS Executive Compensation Analytics, Ormazabal et al. show that the adoption of sustainability metrics in executive compensation contracts is rising fast: from 1% in 2011 to 38% in 2021.<sup>81</sup> They also find that adoption of sustainability variables in managerial performance is accompanied by improvements in sustainability performance and meaningful changes in the compensation of executives. Linking executive compensation to sustainability goals helps boards to make management accountable for sustainability performance.<sup>82</sup> The EU proposal for a Directive on Corporate Sustainability Due Diligence (2022/0051 COD) mandates the obligation to adopt a plan to ensure that the strategy and business model of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C when setting variable remuneration (Art. 15 of the proposed Directive).<sup>83</sup> Another incentive mechanism is deferral of variable compensation, for example by up to 3, 5 or 7 years. Such deferral helps to align executives’ interests with the long-term interests of their company. The deferral of bonuses means they can be forfeited if evidence emerges of unexpectedly poor financial, social or ecological performance by the executive, their team or the company overall.

## 5 Conclusions

This article moves the corporate governance debate beyond the shareholder and stakeholder model. To address the societal and ecological challenges, the debate has to be shifted beyond the inner circle of shareholders and other direct stakeholders (employees, customers, creditors). Broader society and future stakeholders are also affected by the company’s conduct through ecological damage (e.g. climate change) and social damage (e.g. human rights violations or underpayment in the value chain).

Such a broad remit for corporate governance requires measures to balance the interests of all these stakeholders. This article presents an integrated measure for corporate value that includes financial, social and ecological value. The board can use this integrated value measure to balance the interests of the various stakeholders in a structured way. The integrated value measure can also be used by stakeholders (including shareholders) to hold the board accountable for its decisions.

To make our proposed integrated model operational, several mechanisms are reviewed. The formal board mandate could include sustainability. A diversely composed board helps to broaden discussions on the board. Companies are starting to work with stakeholder councils to incorporate the views of external stakeholders. A promising idea is to include future generations in such stakeholder councils. Next, incentive mechanisms could reflect the company’s objective function. The relative weights of financial, social and ecological value in the company objective could be applied to the weighting of financial, social and ecological targets in performance pay (which still tends to be financially driven). Linking executive compensation to sustainability goals helps supervisory/non-executive boards to make executive management accountable for sustainability performance.

Our proposed integrated model of corporate governance broadens the remit to all relevant stakeholders, both current and future stakeholders. By taking its moral responsibility in society, the company’s board can ensure that the company retains its social licence to operate.

80 *Ibid.*

81 G. Ormazabal, S. Cohen, I. Kadach & S. Reichelstein, ‘Executive Compensation Tied to ESG Performance: International Evidence’, *CEPR Discussion Paper DP17267* (2020), [https://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=3841435](https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=3841435); see also K. Maas, ‘Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?’ 148(3) *Journal of Business Ethics* 573 (2018).

82 Ramani and Ward, above n. 72.

83 EC, above n. 50.