Redefining the Investor

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In a recent op-ed, my colleague and I pointed out that the corporation's board of directors owes its fiduciary duty to the corporation, not the shareholders.[1]

In a wholesale rejection of our argument, a financial economist responded that modern theories of corporate finance make no distinction between the corporation and its shareholders.

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Yes, financial economists often think of shareholders *as if* they were the principal and the board *as if* it were the agent in a principal-agent relationship. Here is the problem, though: The fact is that the corporation is a separate legal entity owned by no one and the board is not an agent of the shareholders but a fiduciary of the corporation.

In her 2012 book[2] *The Shareholder Value Myth*, Cornell University legal scholar Lynn Stout noted that the shareholder-primacy premise may persist simply because it provides "a simple, easy-to-understand, sound-bite description of what corporations are and what they are supposed to do." And this is precisely what as-if thinking provides us: A way to think of a complex issue as if it were something simpler.[3]

Can complex governance decisions be guided by simple premises? They can, but probably shouldn't.

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An idea for the future? Let us replace the emotional comfort of simple rules with an analytical mindset that takes the context seriously. Most importantly, boards of directors should broaden their view of what it means to invest in an organization. Here are some ideas that might be useful:

1. Acknowledge that the foundational organizational problem that corporations face is how to secure and maintain the contributions of all those who create value in the organization.
2. Acknowledge that some of those who contribute are more vulnerable in that they are asked to put more at stake than others.
3. Ensure that the corporate governance system is designed in a way that protects the most vulnerable.

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Who are the most vulnerable? Conventional wisdom suggests that because shareholders are the last in line to receive economic benefits from the firm, they are also the most vulnerable. Indeed, firms cannot pay dividends to shareholders unless they have paid all their invoices, salaries, taxes, interests, and other mandatory obligations.

It is high time we put the conventional wisdom to pasture because in today's organizations, shareholders are not the only vulnerable constituency that merits the board's attention. Imagine a technical expert who joins a high-tech firm to further develop its highly strategic technological competencies and patents. My key message is that just like the firm's shareholders, this person is placing a wager on the future of the firm, only the currency of their wager is different than the shareholders' wager.

Of course, there are also employees who provide the firm with generic skills they could in principle offer to any other organization; in fact, this is the essence of the word *general* in the title General Manager.

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I invite you to replace the conventional stakeholder categories (shareholders, employees, suppliers, customers, etc.) with an explicit analysis of wagers. Then, ensure that those who place the highest wagers are prioritized in governance decisions.

I predict that as boards view stakeholders through the lens of wagers, conventional categories fade into the background. Questions such as "Are shareholders more important than employees?" lose their meaning. Instead, questions such as "Which employee groups should receive special attention in governance decisions?" and "Which shareholder groups are more vulnerable than others?" gain traction.

This is not just about the future of corporate governance, there are much broader issues at stake. For example, for almost two decades, policymakers in the EU have lamented the low levels of innovation in the region. The problem is often portrayed as an underinvestment issue, effectively suggesting that the problem arises from insufficient investments in equity by shareholders. I am convinced that we could make much headway by embracing the idea that to be innovative, firms must be able to attract investments that extend beyond those made by shareholders.

Consider this: What is ultimately more challenging, raising equity financing or attracting technical experts to join a risky startup that involves highly organization-specific skills and technologies?

These are the kinds of questions that boards of directors, as fiduciaries of the corporation, should be compelled to ask.

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[1] The original version, written in Finnish with co-author Liisa Välikangas, appeared in the 14.8.2023 issue of Kauppalehti: https://www.kauppalehti.fi/uutiset/yhtion-hallitus-ei-ole-osakkeenomistajien-talutusnuorassa-kirjoittavat-professorit

The English version will be published by IE Insights in October 2023: https://www.ie.edu/insights/

[2] Lynn Stout, 2012. *The Shareholder Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*. San Francisco: Berrett-Koehler Publishers. https://www.bkconnection.com/books/title/the-shareholder-value-myth

[3] Mikko Ketokivi, Saku Mantere, and Joep Cornelissen, 2017. Reasoning by analogy and the progress of theory. *Academy of Management Review*, vol. 42, pp. 637-658. https://journals.aom.org/doi/abs/10.5465/amr.2015.0322

This essay was published in the *50 Ideas to Shape the Future* special of the IE Insights online magazine:

www.ie.edu/insights

Mikko Ketokivi acknowledges his joint work with Joseph T. Mahoney (University of Illinois) and Leon Anidjar (Vanderbilt University) on the topic.

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