Board As Sovereign Steward Not Shareholders’ Agent

Mikko Ketokivi, IE University
Liisa Välikangas, Technical University of Denmark

Those in positions of power must not use their positions to serve their own interests. This principle applies to the governance of both corporations and sovereign nations. To think that shareholders appoint the board mainly to prioritize shareholder interests is similar to the misconception held by President Trump when he assumed that because he appointed the Attorney General, the Attorney General worked for him and served his personal interests.

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It is surprising how persistently we think of board membership in terms of representing particular interests, whether those of shareholders, employees, lenders, the government, etc.

However, just like the Attorney General represents the people of the United States, the board of directors represents the corporation as a whole. Corporate law compels all decisions to be made in the “best interests of the corporation.” While it may be difficult to prove and take legal action against a board that is serving interests other than those of the entire corporation, it behooves all board members to understand the corporation’s primacy as a legal entity unto itself. No, shareholders do *not* own the corporation itself. Instead, they own shares that the corporation has issued to assign specific decision-making rights and residual rights after the corporation has met all its legal and contractual obligations, such as salaries, invoices, interests on loans, taxes, etc. It is important to note that shareholders do not have ownership over the corporation’s assets, which are the property of the separate legal entity.

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Even if we conceded that shareholders owned the corporation and, consequently, their interests were a top priority in board decisions, the notion of *shareholder interests* would remain fundamentally problematic because shareholder interests are not uniform. Examples are numerous: (1) the interests of majority and minority shareholders are often in tension (this is why minority shareholders’ rights are written into corporate law); (2) conflicts between common shareholders and preferred shareholders may be so profound they must be litigated; and (3) the interests of private equity funds differ significantly from those of mutual funds.

As an example of the tension between common and preferred shareholders, consider Trados, a U.S. software company that was sold to a larger incumbent in 2005 for $60 million. In the deal, Trados executives received $8 million, preferred shareholders $52 million, and common shareholders nothing. When common shareholders sued the board for an alleged breach of fiduciary duty, both the Delaware

trial court and the Supreme Court ruled that the transaction was "entirely fair" even though it did not benefit the common shareholders.

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Corporate law, principles of good governance, and the Trados case jointly suggest that the idea of the corporate board serving primarily shareholder interests is painfully oversimplified and inoperational.

Corporations raise funds by attracting investors, not donors. Therefore, the idea of seeking to increase shareholder wealth is more or less inherent: You don't attract an investor without offering the potential of a return on their investment. However, there is nothing—either in law or otherwise—that compels the corporation or its directors to *privilege* shareholders, let alone try to maximize the returns on their investment. In short, the objective of *shareholder wealth maximization* is simply a myth. Furthermore, corporate law is not the only legislation that applies to corporations. Being employers and contracting parties means they also have to comply with numerous labor laws and contract laws.

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A growing perspective in today's corporate law literature describes the board as a *mediating hierarch*. This (a) emphasizes the board's role as the organization's steward, a trustee whose task is to function as an arbiter of only partially overlapping and sometimes conflicting stakeholder interests, and (b) points to the board's independence as the top decision maker in the organization (the "hierarchy").

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To be considered independent, a board member must not have financial or other connections to the corporation or its influential shareholders. Establishing independence is not a check-the-boxes activity. Instead, the board must thoroughly assess each of its members and explicitly declare the independence of each of its directors transparently and affirmatively.

While *independence* considerations are patently essential, it's important to also focus on the related but distinct matter of the board's *sovereignty*. Even though shareholders appoint the board, a board that takes instructions from shareholders breaches its fiduciary duty to the corporation and, in so doing, breaks the law. The board chairperson is particularly key in this situation, as influential shareholders may seek to affect board decision-making.

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The foundational principle of limited liability asserts that a corporation's liabilities are the sole burden of the organization, not its constituencies or stakeholders. By this principle, it is thus the corporation itself, through its board of directors, that makes the central decisions. These decisions should not be the exclusive domain of any individual constituency, no matter how much power that constituency may wield within the corporation. Building on the premise that the ability to exert influence on a governance decision can be just as significant as the formal authority to decide in the first place, corporate law might impose a fiduciary duty not only on the board of directors but on

any constituency with *de facto* power in the organization. Consequently, fiduciary duty may be extended to influential shareholders as well.

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The board's sovereignty is unproblematic if the board acts in the best interest of the corporation as the law compels. But this implies that the board neither is a stakeholder nor represents one. Moreover, because the board is the corporation's sovereign ruler, shareholders must exercise utmost care in selecting this sovereign. Once the board has been appointed, shareholders must step aside and let the board exercise its independent judgment. While it might be unsettling for shareholders that the board does not follow their instructions, appointing a corporate sovereign—instead of one's own "agent"—to the board may ultimately be in the shareholder's best interest. Come to think of it, the proposition should not be too controversial: While equity financing is an indispensable part of value creation, it is hardly the only part. A board that emphasizes the interests of just one value-creating constituency immediately jeopardizes the organization's credibility in the eyes of everyone else. Focusing primarily on the interests of one constituency may jeopardize the viability of the organization.

Many shareholder-focused approaches are problematic because they tend to be based on one-size-fits-all thinking that fails to consider the fact that equity plays a more crucial value-creating role in some organizations than in others, effectively creating a continuum. At one end of this continuum, there are organizations such as *private equity firms* whose entire business model, as the name suggests, is based on investments in equity. Therefore, the best interest of the organization readily aligns with the interests of private equity investors; although even here it must be noted that not all private-equity investors want the same thing.

At the other end of the continuum, we find *professional service organizations* that do not need to raise equity to finance their operations. Because the organization is revenue-financed and revenue is created by professionals (lawyers, accountants, consultants, and other experts), the best interest of the organization links more strongly to the company's employee base, not shareholders.

Finally, *industrial firms* fall somewhere between the two ends, as value is created through a combination of people, technology, and capital.

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As mediating hierarchs, boards must conduct a comparative analysis of all value-creating factors and prioritize accordingly. Consider the prioritization protocols used in the delivery of Covid-19 vaccines. The rationale behind vaccinating essential workers before non-essential ones was to protect the collective interest. Analogous prioritization in governance decisions is justified as long as the focus remains on the best interests of the entire organization, rather than just those being prioritized.

Acting as an effective mediating hierarch requires that board members use their judgment to understand the best interests of the organization in its specific context, and then prioritize accordingly. Because every context is at least partly idiosyncratic, boards must not rely on general prescriptions to guide their way.

In conclusion, appointing a genuine sovereign to lead the corporation is a vital step towards establishing and maintaining the organization's credibility in the eyes of all its

constituencies. More generally, credible and viable corporations serve as an integral part of a functioning society.

This essay was published in the IE Insights magazine on November 16, 2023, and is also available online at

https://www.ie.edu/insights/

The essay is based on and partially elaborates on an op-ed published by the same authors, in Finnish, in the Finnish Kauppalehti magazine (August 14 issue, 2023). 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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