Summary

The Justifiability and Sustainability of the Corporate Management Inconsistent with the Interests of the Shareholders —The Corporation as a Vehicle to Make an Affluent and Livable Society—

* The words in bold are defined in the main body of the thesis.

Subject matter of the thesis

The subject matter of the thesis is to discuss (i) an issue (**legality issue**) as to whether there are cases where an initiative (**non-profit initiative**) taken by **corporate management** that does not accord with the aim of maximizing the profits distributed to the shareholders is legally justifiable under the corporate law, and (ii) an issue (**sustainability issue**) regarding under what circumstances management can sustainably implement such non-profit initiative. Hereinafter, the type of corporate management that implements such non-profit initiative in a sustainable manner is referred to as **non-profit management**.

Justification and limitation of the profit maximization principle

One solution to the legality issue may be to adhere to the following principle: "Management should act only for the purpose of maximizing profits for distribution to shareholders, and should not perform any non-profit initiatives."

The profit maximization principle is justifiable according to three theories: the **residual claimant theory**, the **fundamental theorems of welfare economics**, and the **capital asset pricing theory**. Specifically, first, under the residual claimant theory, if management, acting as the representative of the shareholders, on one hand, and each of the other stakeholders of the corporation, on the other, negotiate to maximize their respective **payoffs**, the result will always be **individually rational** and **Pareto efficient** as between them. Second, the weakness of the residual claimant theory (specifically including the unwarranted assumption that the parties' objective is to receive money rather than **utility** and the inability to find a solution to the problem of uneven distribution of wealth) can be resolved by drawing on the fundamental theorems of welfare economics; this is so because, according to these theorems, if a corporation acts to maximize the profits distributed to the shareholders, the result will be individually rational and Pareto efficient for all the members of the society who aim to maximize their respective utilities, and the problem of the uneven distribution of wealth can be addressed by the tax and the social security systems, without changing the profit maximization principle. Third, the problem of a difference in **preference** among shareholders concerning time and/or uncertainty of the profits to be received in the future can be resolved by the capital asset pricing theory; this is so because, according to this theory, if management sets the **shareholders' value** as an objective of the maximization, management can maximize the utilities of all the shareholders who may have mutually different preferences concerning time and/or uncertainty.

Notwithstanding the forgoing, the profit maximization principle is not the best solution to the legality issue; this is so because, if the management of a corporation follows this principle, problems such as **externalities, monopolies,** the inability to make a **complete contract** and **asymmetric information** will inevitably give rise to inefficiencies. It is true that some of these issues can be resolved provided management complies with the laws, but, as a matter of fact (as will be mentioned below in more detail), many of the problems will remain unresolved even if management strictly complies with the laws. In addition, if management adheres to the profit maximization principle while complying with (i) the corporate law embodying the **principle of limited liability of shareholders** or (ii) the **corporate income tax law** counting income on an accounting basis, it will trigger different types of inefficiencies.

So as to address the various problems stated above, management needs to be subject to a code of conduct that differs from the profit maximization principle in certain aspects. That is, that code of conduct should oblige the management "to implement non-profit initiatives to the extent necessary to increase social welfare," which is hereinafter referred to as the **welfare maximization principle**. It should be noted that the term **welfare** used herein represents a notion by which the change in each individual utility can be estimated using the **amount that one is willing to pay**, under the assumption that each individual consumer's **utility function** is **quasilinear**.

<u>Analysis of the legality issue</u>

(1) Protection of creditors

If management pursues the profit maximization principle under the current principle of limited liability of shareholders, there will be a decrease in the **creditors' value** that exceeds an increase in the shareholders' value. If management acts in accordance with the welfare maximization principle, such a situation is avoidable; and management can discern behaviors that serve the purpose of the welfare maximization principle, by using a threshold that maximizes the **present discount value** of the **operation and investment cash flow**.

(2) Procurement of tax revenue

If management follows the profit maximization principle under the current corporate income tax system, there will be a decrease in **tax revenue value** that exceeds an increase in the shareholders' value. If management acts in accordance with the welfare maximization principle, such a situation is avoidable, and management can discern behaviors that serve the purpose of the welfare maximization principle, by using a threshold that maximizes the present discount value of the **before tax cash flow**.

(3) Negative externalities

If management follows the profit maximization principle under the **current tort law**, **negative externalities** cannot be avoided. The main cause therefor is stated as follows; however, in each case, if management acts in accordance with the welfare maximization principle, such negative externalities can be either avoided or lessened.

(i) If and to the extent a market transaction is involved part or all of the losses are excluded from the scope of the damages.

(ii) As much as the tort law applies the **negligent liability rule**, the activities generating a negative externality will be excessive.
(iii) The damages assessed for the **nonpecuniary losses** will be extremely small.
(iv) Infringed interests sometimes are not perceived as protected by law.
(v) There are cases in which an act having a causal relationship with the infringement of the interests protected by law is not treated as illegal.

(4) Positive externalities

It is true that there are various legal systems, such as the copyright system and tax incentive system, available to encourage initiatives to generate **positive externalities**. Positive externalities generated under these systems, however, are inherently limited, and to increase positive externalities to an optimal level, management needs to act in accordance with the welfare maximization principle.

(5) Welfare losses generated by a monopoly

Antimonopoly laws do not prohibit any corporation from gaining **monopoly profits** unless the corporation resorts to such means as controlling or excluding its competitors. Hence, provided management adheres to the profit maximization principal, a monopolistic corporation will necessarily keep generating welfare losses, which can be decreased only when management applies the welfare maximization principle. Monopoly profits, however, should not be abandoned (i) if, without maintaining the monopoly profits, the corporation would incur losses, or (ii) if abandoning monopoly profits would adversely affect the investors' behaviors. In addition, (iii) under certain conditions, it will be the best (or, at least, a second best) option to implement **price discrimination** while maintaining monopoly profits at the same time.

(6) Incomplete contracts

Provided the main obligation of an incomplete contract is nonpecuniary, welfare maximization can often be accomplished by the parties renegotiating the contract if and after an unexpected situation takes place. When the main obligation of an incomplete contract is pecuniary, on the other hand, it is often difficult to maximize welfare by entrusting the renegotiation of the parties. In this case, management complying with the welfare maximization principle should act as if it were bound by the contract provision that would have been agreed upon if there had been sufficient negotiation at the time of execution of the contract.

(7) Asymmetric information

The role that can be played by the welfare maximization principle for asymmetric information is significantly limited. As for sale and purchase contracts, for example, management needs to amend its behavior by accepting the welfare maximization principle only when it represents the seller having **socially valuable information**; and in other circumstances, the society has to resort to elaborating the relevant laws and regulations.

(8) Charitable donations

In principle, **donations** only accomplish **transfer of welfare** between the members of a society. Therefore, the welfare maximization principle (as well as the profit maximization principle) should dictate that management refrain from making donations in the name of the corporation and to leave donations to the discretion of the shareholders. In Japan, however, the long-standing case law has allowed management to make donations at its reasonable discretion, and the ratio of corporate donations as a proportion of total donations in Japanese society is significant. Given this situation, charitable donations should not be considered illegal as a matter of the interpretation of the laws now in force, which is inevitably path-dependent.

Economic analysis of the sustainability issue

When examining the effect of non-profit management on the company's stock price, it is useful to consider non-profit management to be the production of **public goods**. Analysis is thus conducted using a model in which part of the goods owned by each member of the society is allocated for the production of public goods. Here, since each member can consume all public goods regardless of their producers, the members are in a **game**-like situation in which they each predict the other members' production of public goods in determining their own production. In such games, there will always be one **Nash equilibrium point**. As the number of members increases, this Nash equilibrium point will generate such a situation in which only the most affluent members of the society will produce public goods.

According to the above analysis, only the most affluent members of the society will see value other than an economic return in the stocks of a corporation carrying out non-profit management; therefore, unless they are involved in stock market transactions, the stock prices of the companies carrying out non-profit management would have to be lower than the stock prices of other companies. However, the above analysis contradicts reality, i.e., many low to middle income workers also make donations, which, itself, justifies incorporation into a social model, on the assumption that many members of society see utility in "producing" (not "consuming") public goods. In view of this, let us assume a social model comprising a multitude of consumers who can select between purchasing shares of a corporation that allocates part of its profits to the production of public goods and producing public goods in person. This model leads to the conclusion that there is, under sufficiently realistic conditions, a situation in which the market equilibrium price of stocks (hereinafter referred to as "**equilibrium stock price**") of a corporation producing public goods does not fall below the stock price (hereinafter referred to as "**potential stock price**") that would result by distributing all the profits to the shareholders.

Conditions for making non-profit management possible

In order to make non-profit management possible, one of the following three conditions has to be satisfied.

Condition I	(i) There is no **controlling shareholder** in the target corporation and (ii) a **hostile takeover** of the target corporation is not possible.
Condition II	There is a controlling shareholder who approves of non-profit management.
Condition III	There are a multitude of shareholders that appreciate non-profit management, and as a consequence, the equilibrium stock price does not fall below the potential stock price.

Condition I is satisfied in either of the following cases.

(i) The target corporation either has succeeded in gaining a sufficient number of **stable shareholders**, or is a **broadcast holding corporation**, of which, as a matter of law, no shareholder is allowed to exercise more than 34% voting rights associated with its capital stock.
(ii) The profits that the takeover buyer would earn by raising the equilibrium stock price to the potential stock price falls below the sum of the **management loss cost**, the **social sanction cost** and the **pure transaction cost**, each to be generated by the takeover.

The companies falling under category (i) pay the price of **lost disciplinary effect**, and the total amount of non-profit initiative that can be performed by the companies falling under category (ii) is inevitably limited.

In reality, **Condition II** is satisfied only when the corporation founder is the controlling shareholder.

It is difficult to maintain **Condition II**, without sacrificing company growth. The only solution would be to introduce **dual class stock**; however, this would risk worsening the efficiency of management.

Condition III presents the best solution to the sustainability problem; accordingly, future corporate managers should focus on satisfying **Condition III**.