Editorial European Company Law

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The enterprise has been put into a straightjacket by investors, investment bankers, stock traders, strategy consultants, financial analysts, and the financial press. The pursuit of shareholder return on investment has become the dominant objective for listed companies. Moreover, the consensus view is that a persistent, preferably double-digit growth in profit per share, will cause the stock price to go up.

By bowing to these pressures, enterprises are incurring considerable damage. The first problem is that the stock price no longer reflects the value of the enterprise. The efficient-market hypothesis that stipulates that the stock price reflects all that is known about the company and its future prospects, and is therefore a correct and just reflection of the value of the company, has been invalidated. With the stock market producing the wrong signals, corporate initiatives and capital are misdirected.

In addition, the link between profit per share and the stock price is at best tenuous, and declared dead by reputable firms like Deloitte and BCG. Yet, many management remuneration packages are tied to profit per share, and management has, on average, four years to put their stamp on the company and cash in.

Given these constraints, they can be forgiven for concentrating on the optimization of a simple ratio, rather than being entrepreneurial and bringing the company to a structurally higher plain by investing in people, plant, and partnerships. In optimizing profit per share stock-purchasing programmes are very effective. Increase of profits over a relatively short period of time puts the emphasis on cost-cutting and mergers so as to cut more costs. Investments suffer as they depress profits in the short and medium term. No one can tell how many business opportunities are wasted because of this apparently inescapable logic.

Given these structural problems many are now pointing at the stakeholder model as the new paradigm.

It sounds appealing enough to ask the enterprise to take the interests of all parties that are affected by its actions into consideration. The weakness is that we live in a world where all interests organize themselves to increase the pressure they can exercise. Recognition is the name of the game, with the ultimate aim to become embedded in policy-setting processes. When circumstances change and support dwindles vested interest have every reason to hold on to their positions of power to fight back. The ambitious professionals that man the good offices of interest groups have also personal axes to grind. At the same time, room must be found for newcomers. In short, special interests groups tend to accumulate. The history of trade unions in the Netherlands serves as a warning. Sixty years after trade unions, employers associations, and the Dutch government came together to lift the country out of its post-war economic misery, the unions, deeply embedded in policymaking at all levels, still exercise considerable leverage despite a much reduced membership. Meanwhile, white collar unions and unions representing mini-entrepreneurs have entered the scene and have fought successfully for their place in the sun.

Moreover, special interests have two cards to play. They enter in direct negotiations with the enterprise in pursuit of the short term interests of their members and get their demands at least partially honoured, leaving it to the management to cope with a range of unintended consequences of the agreement, to control unaccounted cost and to reconcile the demands with demands of other interest groups.

Special interests can also draw attention to failings of individual enterprises, calling for investigations that are bound to unearth more cases which then give rise to demands for regulation and, of course, the monitoring of compliance. So-called iron rings are forged, linking special interests to specialist civil servants and specialized parliamentarians. The influence of knowledgeable and committed minorities is large, and at the end of the day large numbers of enterprise are encumbered by regulation that is only partially relevant, if at all.

Both the shareholder model and the stakeholder model constrain the enterprise from reaching its potential. Future cash flows are sacrificed to serve short term financial or political interests. This is an insidious process, since unrealized cash flows do not show up in corporate accounts. It runs counter to the pursuit of the common good, as we rely on the enterprise to generate the surpluses that we need to pursue our social objectives.

It is time to focus on a paradigm that has a much longer history and deeper roots and that can glory in extraordinary success. A paradigm that underpins most of European economic activity: the family enterprise. Looking at the way enterprises are financed, 80% of American companies rely on stock markets, in Europe only 20%. The given that European companies by and large rely on their cash flow and bank loans to finance their

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operations and growth helps to put the interests of the company at centre stage.

Generations of owners and employees contribute to the growth of the enterprise and its capacity to generate and capture economic value. The balance sheets of those enterprises are loaded with immaterial assets. Most importantly: the enterprise can operate as a working community, not a community of interests.

There is no reason why the entrepreneurial functions (most of the time implicitly) exercised by owners – the positioning of the enterprise, decisions on the portfolio of activities, the design of the organization and its decision making procedures, the appointment of managers and the financing of the enterprise – cannot be codified and institutionalized. An entrepreneurial board leading large companies would be a vast improvement over shareholder servants and political animals.