**COMPARATIVE COMPANY LAW**

**(SUSTAINABLE CORPORATIONS)**

**People Externalities: Greening of Corporation**

Today’s readings conclude this week’s look at different ideas to confront corporate externalities and the corporation’s unsustainable design. Today you’ll see how the corporation – beyond voluntary CSR – is being reconceived as an instrument beyond promoting profits for shareholders (providers of equity capital) to encompass other constituents – including a far-ranging role for corporate directors and institutional shareholders.

The first reading is a famous case – *Dodge v. Ford Motor Co. – that* we have already seen before, in connection with Chancellor Leo Strine’s article on *The For-Profit Corporation*. You’ll find a case overview in the student book (that you’ve already read from), and I’ve also included in the readings an excerpted version of the case. The case is not what it seems!

The next reading is an article by a law professor who has been arguing for a while that shareholder primacy in the US corporation is a misstatement of the law, a misstatement of actual practice, and a mistake of theory. Instead, she points out that the corporation is more valuable and robust – for all of its constituents if the board is seen (and acts) as a “mediator” of the different constituent interests, thus placing employees and others on par with investors.

The next reading is not a reading, but a video of the CEO of Exxon-Mobil (which moved ahead of Apple to reclaim the position of the largest corporation by capital). You will find interesting that the CEO accepts climate change science, but ends up declaring his job is to make profits for the company and its investors.

Finally, I would ask you to review another corporate document – this one the annual “corporate social responsibility report” of Cisco, the big electronic company. As with yesterday’s readings, I have some questions for you (on the next page) as you review the document.

**CORPORATIONS: EXAMPLES & EXPLANATIONS (7th ed. 2012)**

CHAPTER 11

Corporate Fiduciary Duties—An Introduction

§11.1.3 To Whom Are Fiduciary Duties Owed?

Corporate directors are said to owe fiduciary duties to the "corporation," not the particular shareholders who elected them. Some courts and many commentators assert that fiduciary rules thus proceed from a theory of maximizing corporate financial well-being by focusing on *shareholder wealth maximization*. \*\*\*

***Dodge v. Ford Motor Co.***

Despite its prevalence, the theory of shareholder wealth maximization has gaps. For example, the case most often cited as supporting the theory may actually have turned on nonshareholder concerns. In *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), the Michigan Supreme Court reviewed Ford Motor’s decision to discontinue paying a special $10 million dividend, ostensibly to finance a new smelting plant while paying above-market wages and reducing the price of Ford cars. Minority shareholders claimed the decision was inconsistent with the fundamental purpose of the business corporation—to maximize the return to shareholders. The court agreed and faulted Henry Ford for reducing car prices and running Ford Motor as a ‘‘semi-eleemosynary institution and not as a business institution.’’ The court ordered the special dividend, though curiously refused to enjoin Ford’s expansion plans since ‘‘judges are not business experts.’’

At first blush, the case seemed to turn on Ford’s stated view that his company ‘‘has made too much money, has had too large profits … and sharing them with the public, by reducing the price of the output of the company, ought to be undertaken.’’ Nonetheless, more was below the surface. The plaintiff Dodge brothers (former suppliers of car chassis and motors to Ford Motor) hoped to use the special dividend to finance their own start-up car manufacturing company, and Henry Ford’s dividend cutback was meant to forestall this competition, despite the attendant benefits of competition to the car-buying public and Michigan’s auto industry. The court’s decision to second-guess perhaps the most successful industrialist ever is at odds with the general judicial deference to management, as well as with the Michigan court’s specific observation that Ford Motor’s great success had resulted from its ‘‘capable management.’’

Using corporate law, the court advanced a social agenda. Fixing on snippets from Henry Ford’s public relations posturing, the court labeled him an antishareholder altruist. This allowed the court to order Ford to fund the Dodge brothers’ new car company, thus injecting some competitive balance into the expanding auto industry and ultimately into Michigan politics. Soon after, the Dodge brothers parlayed their court victory into a sizeable buyout of their Ford Motor holdings. (It is worth noting that no other minority shareholders participated in the case, though Henry Ford eventually bought them out, too.) Ironically, the case so often cited as declaring a philosophy of shareholder wealth maximization turns out—on closer examination—to have been about a squabble between two competitors where the stakes were consumer prices, product choice, employee wages, industry competition, and political pluralism.

**‘‘Other Constituency’’ Statutes**

Some states have recently enacted ‘‘other constituency’’ statutes that permit, but do not require, directors to consider nonshareholder constituents (or stakeholders), particularly in the context of a corporate takeover. See Pa. BCL §1715 (directors may consider ‘‘shareholders, employees, suppliers, customers and creditors of the corporation … communities in which offices or other establishments of the corporation are located … short-term and long-term interests of the corporation’’). The statutes have been controversial. Some commentators have praised them as signaling a new era of corporate social responsibility; others have criticized them as a ruse for incumbent entrenchment and fecklessness. By permitting directors to rationalize corporate decisions on such open-ended concepts as ‘‘long-term interests’’ and ‘‘communities where the corporation operates,’’ the statutes appear to dilute director accountability.

Although no cases have confronted the meaning of the ‘‘other constituency’’ statutes, other cases give mixed signals about directorial deference to nonshareholder stakeholders. Some cases suggest directors can take stakeholders into account only if rationally related to promoting shareholder interests. See *Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173 (Del. 1986). Yet others suggest directors have significant latitude to consider ‘‘corporate culture,’’ not just immediate shareholder returns, when responding to takeover threats. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1142 (Del. 1990).

[***Dodge v. Ford Motor Co.***](http://www.businessentitiesonline.com/Dodge%20v.%20Ford%20Motor%20Co.pdf)

170 N.W. 668 (Mich. 1919)

[The Ford Motor Company was founded in 1903 by a number of investors, including Henry Ford and brothers John F. Dodge and Horace E. Dodge (“the Dodge brothers”). Henry Ford, who held a 58% interest in Ford Motor, was also Ford Motor’s President and a director on its board. The Dodge brothers held a 10% interest, were not on the board of directors nor employed by Ford Motor.

Ford Motor’s business strategy was focused on mass-market cars that were lower priced but appealed to a larger group of potential customers. To afford to sell cars at a low price, Ford Motor focused on mass production of cars and vertical integration (owning the businesses that produced the raw materials needed to produce cars). These allowed it to continuously reduce the cost of its cars, and the lower costs allowed selling the car at a lower price, making its cars affordable to customers who were previously priced-out. For example, according to Wikipedia, the standard Model T 4-seat open tourer of 1909 cost $850 (equivalent to $20,513 today). The price dropped to $550 in 1913 (equivalent to $12,067 today); to $440 in 1915 (equivalent to $9,431 today); and to $290 (equivalent to $3,258 today) in the 1920s.

Beginning in 1911, regular annual dividends were $1.2M. In addition, between 1913 and 1915 the company paid special dividends of $10-11M each year. Then, in 1916, Henry Ford announced that Ford Motor would no longer pay special dividends and that profits would be retained to pay for the new River Rouge plant, which will allow Ford Motor to expand its production capacity; to double employees‟ salaries; and to cut the price of cars.

The Dodge brothers sued: (1) for a decree requiring Ford Motor to distribute to stockholders at least 75% of the accumulated cash surplus, and to distribute in the future all of its earnings “except such as may be reasonably required for emergency purposes”; and (2) to enjoin the construction of the River Rouge plant.]

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[The court rejected plaintiffs‟ arguments that Ford Motor violated a state law that placed an upper limit on a corporation’s capital; that Ford Motor exceeded the activities it was authorized to conduct (ultra vires); or that Ford Motor violated antitrust laws.]

As we regard the testimony as failing to prove any violation of anti-trust laws or that the alleged policy of the company, if successfully carried out, will involve a monopoly other than such as accrues to a concern which makes what the public demands and sells it at a price which the public regards as cheap or reasonable, the case for plaintiffs must rest upon the claim, and the proof in support of it, that the proposed expansion of the business of the corporation, involving the further use of profits as capital, ought to be enjoined because inimical to the best interests of the company and its shareholders, and upon the further claim that in any event the withholding of the special dividend asked for by plaintiffs is arbitrary action of the directors requiring judicial interference.

The rule which will govern courts in deciding these questions is not in dispute. […] This court, in *Hunter v. Roberts, Throp & Co*., recognized the rule in the following language: It is a well-recognized principle of law that the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount. Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders.

In Cook on Corporations (7th Ed.) §545, it is expressed as follows:

The board of directors declare the dividends, and it is for the directors, and not the stockholders, to determine whether or not a dividend shall be declared. When, therefore, the directors have exercised this discretion and refused to declare a dividend, there will be no interference by the courts with their decision, unless they are guilty of a willful abuse of their discretionary powers, or of bad faith or of a neglect of duty. It requires a very strong case to induce a court of equity to order the directors to declare a dividend, inasmuch as equity has no jurisdiction, unless fraud or a breach of trust is involved. There have been many attempts to sustain such a suit, yet, although the courts do not disclaim jurisdiction, they have quite uniformly refused to interfere. The discretion of the directors will not be interfered with by the courts, unless there has been bad faith, willful neglect, or abuse of discretion.

Accordingly, the directors may, in the fair exercise of their discretion, invest profits to extend and develop the business, and a reasonable use of the profits to provide additional facilities for the business cannot be objected to or enjoined by the stockholders.

[…] One other statement may be given from *Park v. Grant Locomotive Works*:

In cases where the power of the directors of a corporation is without limitation, and free from restraint, they are at liberty to exercise a very liberal discretion as to what disposition shall be made of the gains of the business of the corporation. Their power over them is absolute so long as they act in the exercise of their honest judgment. They may reserve of them whatever their judgment approves as necessary or judicious for repairs or improvements, and to meet contingencies, both present and prospective. And their determination in respect of these matters, if made in good faith and for honest ends, though the result may show that it was injudicious, is final, and not subject to judicial revision.

[…] When plaintiffs made their complaint and demand for further dividends, the Ford Motor Company had concluded its most prosperous year of business. The demand for its cars at the price of the preceding year continued. It could make and could market in the year beginning August 1, 1916, more than 500,000 cars. […] It had declared no special dividend during the business year except the October 1915, dividend.

It had been the practice, under similar circumstances, to declare larger dividends. Considering only these facts, a refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done. These facts and others call upon the directors to justify their action, or failure or refusal to act.

In justification, the defendants have offered testimony tending to prove, and which does prove, the following facts: It had been the policy of the corporation for a considerable time to annually reduce the selling price of cars, while keeping up, or improving, their quality. As early as in June 1915, a general plan for the expansion of the productive capacity of the concern by a practical duplication of its plant had been talked over by the executive officers and directors and agreed upon; not all of the details having been settled, and no formal action of directors having been taken. The erection of a smelter was considered, and engineering and other data in connection therewith secured. In consequence, it was determined not to reduce the selling price of cars for the year beginning August 1, 1915, but to maintain the price and to accumulate a large surplus to pay for the proposed expansion of plant and equipment, and perhaps to build a plant for smelting ore. It is hoped, by Mr. Ford, that eventually 1,000,000 cars will be annually produced.

The contemplated changes will permit the increased output. The plan […] calls for a reduction in the selling price of the cars. [The] plan does not call for and is not intended to produce immediately a more profitable business, but a less profitable one; not only less profitable than formerly, but less profitable than it is admitted it might be made. The apparent immediate effect will be to diminish the value of shares and the returns to shareholders.

It is the contention of plaintiffs that the apparent effect of the plan is […] to continue the corporation henceforth as a semi-eleemosynary institution and not as a business institution. In support of this contention, they point to the attitude and to the expressions of Mr. Henry Ford.

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. “My ambition,‟ said Mr. Ford, „is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business.” […]

He had made up his mind in the summer of 1916 that no dividends other than the regular dividends should be paid, “for the present.”

“Q. For how long? Had you fixed in your mind any time in the future, when you were going to pay-- A. No.

“Q. That was indefinite in the future? A. That was indefinite; yes, sir.”

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that, although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken.

We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company – the policy which has been herein referred to.[…] There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

There is committed to the discretion of directors, a discretion to be exercised in good faith, the infinite details of business, including the wages which shall be paid to employees, the number of hours they shall work, the conditions under which labor shall be carried on, and the price for which products shall be offered to the public.

It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. As we have pointed out, […] it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that, if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. [… T]he ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs.

It may be noticed, incidentally, that it took from the public the money required for the execution of its plan, and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

[…] Defendants say, and it is true, that a considerable cash balance must be at all times carried by such a concern. But, as has been stated, there was a large daily, weekly, monthly, receipt of cash. The output was practically continuous and was continuously, and within a few days, turned into cash. Moreover, the contemplated expenditures were not to be immediately made. The large sum appropriated for the smelter plant was payable over a considerable period of time. So that, without going further, it would appear that, accepting and approving the plan of the directors, it was their duty to distribute on or near the 1st of August, 1916, a very large sum of money to stockholders.

[The court upholds the lower court’s decree that a dividend must be paid, but reverses the lower court’s injunction against building the smelting plant.]

[**THE PROBLEM OF CORPORATE PURPOSE**](https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&ved=0CEkQFjAC&url=http%3A%2F%2Fwww.brookings.edu%2F~%2Fmedia%2Fresearch%2Ffiles%2Fpapers%2F2012%2F6%2F18-corporate-stout%2Fstout_corporate-issues&ei=q2RTUYcCgZD1BMyngMgK&usg=AFQjCNF4Z6cr71B8o_Ze6cZyV4-hnQbdSA&sig2=LE3UEkRRNqCQPZIXHhoHvg&bvm=bv.44342787,d.eWU)

Lynn A. Stout

48 Issues in Corporate Governance (June 2012)

What is the purpose of the modern public corporation? Most people today would say corporations have but one proper purpose: maximizing their shareholders’ wealth as measured by stock price. Other goals—serving customers, building great products, providing good jobs—are viewed as legitimate business ends only to the extent they increase “shareholder value.”

This view prevails in large part because it’s what is taught in our nation’s classrooms. According to a recent Brookings study of the curricula of top law and business schools, professional school courses emphasize maximizing corporate profits and shareholder value as the proper purpose of business corporations. As a result, “students believe the primary purpose of the corporation is to maximize shareholder value, and they believe this is how current corporate leaders behave when they are making business decisions.”

This “shareholder primacy” theory can be hazardous to the health of investors, companies, and the public alike. Shareholder value ideology in fact is a relatively new development in the business culture. It is not supported by the traditional rules of American corporate law; is not consistent with the real economic structure of business corporations; and is not supported by the bulk of the empirical evidence on what makes corporations and economies work.

Indeed, focusing on “shareholder value” may in fact be a mistake for most business firms. This is because there is no single shareholder value—different shareholders have different needs and interests depending on their investing time frame, degrees of diversification and interests in other assets, and perspectives on corporate ethics and social responsibility. Shareholder value ideology focuses on only a narrow subgroup of shareholders, those most short-sighted, opportunistic, willing to impose external costs, and indifferent to ethics and others’ welfare. As a result shareholder value thinking can lead managers to focus myopically on short-term earnings; to harm employees, customers, and communities; and to lure companies into reckless and socially irresponsible behaviors. This ultimately harms most shareholders themselves—along with employees, customers, and communities.

**Where Did Shareholder Value Thinking Come From?**

The public company as we know it today came to prominence at the turn of the 20th century. Before then, most corporations were “closely held” companies whose stock was held by a single controlling shareholder or group of shareholders who were intimately involved in the company’s affairs. The question of corporate purpose wasn’t really on the table, because the company’s purpose was whatever its controlling shareholders wanted it to be. Some controlling shareholders might care only about profits, others about their employees, consumers, and communities, and others about the growth and long-term health of the business itself.

By the early 1900s, however, a new type of corporation began to cast a growing shadow over the economic landscape. The new “public” companies sold stock to hundreds or even hundreds of thousands of small investors who had no interest in being involved in the company’s daily affairs. Control and authority in firms like American Telephone and Telegraph (AT&T), General Electric (GE), and the Radio Company of America (RCA) rested not in controlling shareholders’ hands, but in boards of directors who hired full-time executives to run their companies.

Who or what should these professional corporate managers serve? Almost from its inception, the public corporation inspired impassioned debate over what its purpose ought to be. Some observers thought that (as we teach today) the corporation’s only goal should be maximizing its shareholders’ wealth. This “shareholder primacy” view was countered, however, by a “managerialist” philosophy that taught that corporations should be professionally managed to serve not just shareholders, but also employees, customers, and the broader society. By mid-century, the managerialist view dominated. Fifty years ago, if had you asked a director or executive what the purpose of the corporation was, he was likely to answer that the firm had many purposes: to produce satisfactory returns for investors, but also to provide good jobs to employees, make reliable products for consumers, and to be a good corporate citizen.

All this changed in the 1970s with rise of the Chicago School of free-market economists. According to the Chicago School, economic analysis revealed the proper purpose of the public corporation: to make money for its dispersed shareholder “owners.” If corporate managers pursued any other goal, they were misbehaving “agents” imposing inefficient “agency costs” on both shareholders and society. A strong share price was proof of economic efficiency.

Lawmakers, consultants, and would-be reformers now had a three prescriptions for every corporate ill: (1) give shareholders more power, (1) give boards of directors less power, and (3) “incentivize” executives and directors by tying their pay to share price. According to the dogma of shareholder value, any suffering company would improve with this medicine.

The Chicago School’s theories began to influence actual corporate practice. During the 1990s, the Securities Exchange Commission (SEC) adopted rule changes to encourage boards to pay closer attention to shareholder demands. Meanwhile, activist shareholders and would-be reformers pushed for changes in corporations’ internal governance structures, especially the elimination of “staggered” boards that made hostile takeovers more difficult – thus to “unlock shareholder value.” Finally, shareholder value thinking came to appeal to self-interested executives. In 1993, Congress amended the tax code to encourage corporations to tie executive compensation to stock price as a means of “tying pay to performance.” Equity-based compensation rose from an average of zero percent of the median executive’s pay at Fortune 500 firms in the 1980s, to account for 60% of the median pay in 2001.

**Time to Question Shareholder Primacy**

By the close of the millennium, most scholars, regulators and businesspeople had come to accept without question that shareholders “own” public corporations and that the corporation’s proper purpose is to maximize its shareholders’ wealth. Shareholder primacy had become dogma.

Today questions seemed called for. Corporate America’s mass embrace of shareholder value thinking over the past two decades should have greatly improved the business sector’s performance. But this has not happened. For most of the twentieth century, American public corporations were the engine of a thriving economic system that benefited investors, employees, and the broader society. But in recent years our business sector has stumbled. We have suffered a daisy chain of costly corporate scandals and disasters, from massive frauds at Enron, HealthSouth, and Worldcom in the early 2000s, to the near-collapse of the financial sector in 2008, to the BP Gulf oil spill disaster in 2010.

**How Shareholder Value Thinking Gets the Law Wrong**

It has become routine for journalists, economists, and business experts to claim as undisputed fact that U.S. corporate law requires directors of public companies to try to maximize shareholder wealth. This perception lacks any solid basis in actual corporate law. The corporate code of Delaware, where the majority of Fortune 500 businesses are incorporated, states that corporations can be formed for any lawful purpose. Similarly, the typical public company charter broadly defines the company’s purpose as “anything lawful.” Where, exactly, can the legal requirement that directors maximize shareholder value be found?

When pressed, shareholder primacy advocates typically cite the nearly century-old case *Dodge v. Ford*, in which the Michigan Supreme Court famously observed that “a business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed for that end.” This remark, however, was what lawyers call “mere dicta,” an offhand remark that was not needed for the court to reach its desired result in the case, and that does not create binding precedent. More importantly, modern courts—especially Delaware courts—simply do not follow this element of *Dodge v. Ford*. To the contrary, thanks to a vital legal doctrine known as the business judgment rule, directors of public companies enjoy virtually unfettered legal discretion to determine the corporation’s goals.

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In brief, the business judgment rule holds that so long as a board of directors is not tainted by personal conflicts of interest and makes a reasonable effort to become informed, courts will not second-guess the board’s decisions about what is best for the company—even when those decisions predictably reduce profits or share price. Consider the recent Delaware case of *Air Products, Inc. v. Airgas, Inc*. Air Products wanted to acquire Airgas, whose stock had been trading in the $40s, at a price of $70 per share. Airgas’ board refused Air Products’ amorous advances, even though many Airgas shareholders supported the sale to make a quick profit. The Delaware Court accepted the Airgas boards’ decision to reject the offer, stating the board “was not under any per se duty to maximize shareholder value in the short term.” Directors are free to reduce profits and share price today when they claim to believe this will help the corporation in “the long run” – and to decide what is in the corporation’s “long run” interests.

**How Shareholder Value Thinking Gets the Economics Wrong**

Even if the law does not require directors to maximize shareholder value, it is of course still possible to argue it ought to. In other words, shareholder primacy can be defended not as a legal requirement, but as a superior philosophy for managing corporations to ensure they contribute the most to the economy and to our society. Many advocates of shareholder value maximization do indeed seem to believe this rule ensures corporations provide the maximum possible benefits to society: an increase in share price is viewed as tantamount to an increase in overall economic efficiency. This belief, in turn, seems based not on experience or hard evidence but on the seductive appeal of a theory, the principal-agent model of the corporation.

The principal-agent model is associated with a 1976 article published in the Journal of Financial Economics by business school dean William Meckling and finance theorist Michael Jensen. The article, titled “The Theory of the Firm,” explored in economic terms the problem that arises when the owner of a business (the so-called principal) hires an employee (the agent) to run the firm on the owner’s behalf. Because the agent does all the work while the principal gets all the profit, we can expect the agent to shirk or even steal at the principal’s expense. Thus undesirable “agency costs” are created when ownership is separated from control.

Jensen and Meckling’s article--the most frequently-cited article in business academia today—assumed without discussion the “principals” in public corporations were the shareholders, and directors were the shareholders’ “agents.” Yet Jensen and Meckling were economists, not lawyers, and this assumption (as we shall see below) fundamentally mistakes the real economic and legal relationships among shareholders, executives, creditors, and directors in public corporations. Nevertheless, the principal-agent model was eagerly embraced by a generation of academics in law, business, and economics as a simple way of understanding the complex reality of public corporations.

Put bluntly, the principal-agent model is wrong. Not wrong in a normative sense; there’s nothing objectionable about a principal hiring an agent. But it’s clearly incorrect, as a descriptive matter, to say the principal-agent model captures the reality of modern public corporations with thousands of shareholders, scores of executives, and a dozen or more directors.

Consider the three factual claims that lie at the heart of the principal-agent model. The first factual claim that shareholders “own” corporations is false. As a legal matter, shareholders do not own corporations. Corporations are independent legal entities that own themselves, holding property in their own names, entering their own contracts, and committing their own torts. What do shareholders own? They own shares of stock, and shares in turn are contracts between the shareholder and the corporation giving shareholders limited rights under limited circumstances. (Owning shares in Ford doesn’t entitle you to help yourself to the car in the Ford showroom). In a legal sense, stockholders are no different from bondholders, suppliers, and employees. None “owns” the company itself.

The second mistaken factual claim underlying the principal-agent model is that shareholders are the sole residual claimants in corporations. Corporate “stakeholders” like employees, customers, and creditors are assumed to receive only the benefits their formal contracts and the law entitle them to (fixed salaries, interest, and so forth), while shareholders supposedly get all profits left over after the firm has met those fixed obligations. Again, this assumption is patently incorrect. The only time shareholders are treated anything like residual claimants is when a company falls into bankruptcy. In operating firms, shareholders only get money when the directors decide the shareholders should get money, which the board can arrange either by declaring a dividend (a decision entirely in the board’s discretion) or by choosing to limit expenses so the company builds up accounting profits and “retained earnings.” The board of directors decides which groups get what share of the corporation’s residual.

Finally, the third fundamental but mistaken belief of the model is that shareholders and directors are principals and agents. The hallmark of an agency relationship is that the principal retains the right to control the agent’s behavior. Yet one of the most fundamental rules of corporate law is that corporations are controlled by boards of directors, not by shareholders. In theory shareholders elect and remove directors; in practice, the costs of mounting a proxy battle to collectivize “rationally apathetic” shareholders raises near-insurmountable obstacles to organized shareholder action in most public firms. Thanks to the business judgment rule, shareholders also can’t successfully sue directors who place stakeholders’ or society’s interests above the shareholders’ own. Finally, while disgruntled shareholders can sell their shares and “vote with their feet,” their sales drive down share price, making selling a Pyrrhic solution.

The economic structure of public corporations insulates boards of directors from dispersed shareholders’ command and control, making it impossible to fit the square peg of the public corporation into the round hole of the principal-agent model. If changing corporate governance rules to make boards more shareholder-oriented really improves corporate performance, we should see evidence of this in the business world – the evidence is missing.

**How Shareholder Value Thinking Gets the Evidence Wrong**

Over the past two decades, legal and economic scholars have generated dozens of empirical studies testing the statistical relationship between various measures of corporate performance and supposedly shareholder-friendly elements of corporate governance like director independence, a single share class, or the absence of staggered boards and poison pills. These tests have produced mostly confusion. For example, one recent paper surveyed the results of nearly a dozen empirical studies of what happens when companies use dual share classes to reduce or eliminate public shareholders’ voting rights, a governance structure the principal-agent model predicts should harm corporate performance by increasing agency costs. The survey concluded that some studies found no effect on performance, some found a mild negative effect, and some a mild positive effect.

This lack of empirical support for the supposed superiority of the shareholder-oriented model has captured at least some scholarly attention. (Roberta Romano of Yale Law School has famously called some shareholder-oriented governance reforms “quack corporate governance.”) But the evidence in support of shareholder primacy is even weaker than it appears. This is because most empirical studies focus only on how giving shareholders greater power effects economic performance at the level of the individual company, typically measured over a few days or at most a year or two. These studies may be looking in the wrong place, for the wrong time period. It is not only possible, but probable, that raising the share price of individual firms relative to the rest of the market in the short run reduces aggregate shareholder wealth over time.

To understand this counterintuitive idea, imagine trying to empirically test the best method for catching fish. On first inspection, one reasonable method would be to study the individual fishermen who fish in a particular lake, comparing their techniques with the amount of fish they catch. You might find that fishermen who use worms as bait get more fish than those who use minnows, and conclude fishing with worms is more efficient.

But what if some fishermen start using dynamite in the lake, and simply gather up all the dead fish that float to the surface after the blast? Your statistical test would show that individuals who fish with dynamite catch far more fish than those who use either worms or minnows, and also show that fishermen who switch from baited hooks to dynamite see an initial dramatic improvement in their fishing “performance.” But as many real-world cases illustrate, communities that fish with dynamite see long-run declines in the size of the average haul, and eventually total collapse of the fish population.

Fishing with dynamite is a good strategy for an individual fisherman, for a while. But in the long run, it is very bad for fishermen collectively. There is reason to suspect the same can be said for shareholders, when corporations are driven to “maximize shareholder value.”

**There is No Single “Shareholder Value”**

To understand how encouraging corporate directors to maximize shareholder value can hurt

shareholders themselves, we must begin by recognizing that “shareholder” is a fictional noun. The principal-agent model presumes shares in public companies are held by homogeneous entities that care only about the firm’s share price. Yet no such homogenous entities exist.

When we think of shareholders, we are really thinking of human beings, who typically own shares indirectly through pension and mutual funds. Human beings inevitably have many different values and interests. For example, some want to hold their shares for only a short time, and care only about tomorrow’s stock price. Others may be investing for retirement or to pay a child’s college tuition, and care about long-term returns. (The old “efficient markets” idea that stocks prices perfectly measure future returns has been discredited.) Some want their firms to make informal commitments that build employee and customer loyalty that will pay off in the future; others who plan to sell soon want firms to opportunistically renege on such commitments. Some hold widely diversified portfolios and worry about how the corporation’s behavior affects the value of their other assets and interests; others are relatively undiversified and unconcerned. Finally, some shareholders may care only about their own material wealth. But according to studies of investor preference, many and possibly most are “prosocial” and prefer their companies not earn profits by harming third parties or breaking the law. The idea of a single “shareholder value” is intellectually incoherent.

Suppose, for example, Anne and Betty each own shares in Apple Corporation. Anne is an asocial hedge fund manager who seeks only to “buy low and sell high,” who takes positions in only two or three companies at a time, and who churns her investment portfolio two or three times annually. Betty is a prosocial, diversified, buy-and-hold investor saving toward her retirement, who works as an elementary school teacher in California .

Anne wants her Apple investment to generate immediate profits in the form of dividends or quick stock appreciation. She has incentive to pressure Apple’s board to pay out all its cash as dividends and not retain earnings to reinvest in innovative future products that the stock market can’t easily value today—even though retaining earnings might increase Betty’s future returns. Anne also wants Apple to reduce its expenditures on customer support and product quality. In the long run, this will likely hurt employee and customer loyalty and Apple sales, but Anne expects to have sold her Apple shares and moved on to her next investment long before these long-run harms are reflected in Betty’s stock price. Anne also wants Apple to outsource as many jobs as possible to areas of the world where labor is cheap and taxes are low, even though cutting Apple’s employment rolls and tax payments in California may harm California’s public education system (and Betty’s job). Finally, Anne is happy when Apple violates labor laws to make a few more pennies of profit on each iPad it sells. Prosocial Betty is not.

Clearly, Anne’s and Betty’s interests and values are different. Unfortunately, the idea that Apple’s directors should only focus on raising Apple’s stock price resolves these differences and conflicts of interest by simply assuming--without evidence or justification--that Anne’s interests must always trump Betty’s. And Anne is perfectly happy to fish with dynamite, because she gets all the benefits of short-term strategies that (perhaps temporarily) bump up Apple’s share price, while Betty bears the costs.

Privileging Anne’s interests over Betty’s creates a kind of investing “Tragedy of the Commons.” Individual investors do best by pursuing short-term, opportunistic, external-cost-generating corporate strategies, but investors as a group suffer over time when all pursue this strategy.

**Revisiting the Idea of Corporate Purpose**

To avoid the trap of shareholder value thinking, we must recognize that even if shareholders are the only participants in corporations whom we care about, it is still unwise to reduce shareholders’ interests to the single metric of today’s share price. The idea that one can “maximize” shareholder value rests on an impossible abstraction of the shareholder as a Platonic entity that cares only about the market price of a single corporation’s equity. This reduces shareholders to their lowest possible common human denominator: shortsighted, opportunistic and untrustworthy, happy to impose external costs that reduce the value of other assets, and psychopathically indifferent to the welfare of other people, future generations, and the planet. Such a single-dimensioned conception of the shareholder is not only unrealistic, but dysfunctional.

Advocates for shareholder value thinking sometimes argue that without a single, objective metric to judge how well directors and executives are running firms, these corporate “agents” will run amok. This argument ignores the obvious human capacity to balance, albeit imperfectly, competing interests and responsibilities. Parents with more than one child routinely balance the interests of competing siblings (not to mention balancing their children’s welfare against their own), just as judges routinely balance justice against judicial efficiency and professors balance teaching against research and scholarship. The fact that balancing interests is sometimes difficult does not mean it cannot be done. Indeed, decently satisfying several sometimes-competing objectives, rather than trying to “maximize” one, is the rule and not the exception in human affairs. Although we should not expect directors and executives to do a perfect job of balancing the competing interests of different shareholders and other constituents, there is no reason to think they can’t do it well enough that shareholder interest-balancing is preferable to serving only the interests of the most short-sighted, opportunistic, undiversified, and unethical shareholders.

Accepting directors’ obligation and authority to mediate between different shareholder interests allows us to understand a host of otherwise-puzzling realities of corporate law and practice. Perhaps the most obvious is how the U.S. public corporation managed to thrive for most of the twentieth century. Thanks to dispersed shareholders’ rational apathy and the business judgment rule, directors of public companies who avoided personal conflicts of interest enjoyed virtually unfettered discretion to set corporate policy, even over some shareholders’ vocal objections. This undoubtedly increased “agency costs,” but it did not stop public corporations from producing excellent results for investors, employees, and communities. More recently, as shareholder value thinking has gained traction, boards have lost some of their ability to resist shareholder demands. Perhaps in consequence, aggregate shareholder returns have eroded and the numbers of public companies have been declining.

That possibility carries at least two important implications. The first is that policymakers and would-be reformers should stop reflexively responding to every business crisis or scandal by trying make managers pay more attention to “shareholder value.” For over two decades, the Congress, the SEC, and various policy entrepreneurs have successfully pushed through a number of individually modest but collectively significant regulations designed to make managers focus more on increasing shareholder wealth as typically measured by stock price. These supposed reforms have done nothing to improve investor returns or shareholder satisfaction. Similarly, there is no reason to think that promoting “shareholder democracy” through rules like the SEC’s controversial proxy access proposal will serve shareholders’ collective welfare. Such regulatory changes may provide an immediate windfall to certain types of shareholders (for example, undiversified hedge funds that want to pressure boards to do share repurchases or asset sales). But they may ultimately work against the interest of shareholders as a whole.

The second and more important lesson is that investors and business leaders need to liberate themselves from the tyranny of shareholder value thinking. While regulatory shifts have helped to move Corporate America closer to the shareholder value ideal, a far more important factor has been the business world’s own intellectual embrace of shareholder primacy. In the interest of maximizing shareholder value, corporate directors have voluntarily de-staggered boards, adopted stock-based compensation schemes, outsourced jobs, and cut back on research and development to meet quarterly earnings estimates. In the interest of shareholder value, pension and mutual funds have joined with hedge funds to pressure boards to “unlock value” through repurchases and asset sales, while turning a blind eye to questions of corporate responsibility and ethics. This has happened not because of regulatory requirements, but because investors and managers alike have come to accept shareholder value thinking as a necessary evil in the world.

John Maynard Keynes famously said that “the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.” Shareholder value ideology shows all the signs of a defunct economists’ idea. It is inconsistent with corporate law; misstates the economic structure of public companies; and lacks persuasive empirical support.

**Scavenger Hunt – Cisco CSR Report**

Let’s consider a somewhat typical “corporate social responsibility” report of an important multi-national corporation, Cisco. The following questions ask to you to read this report and discover what the company says – and perhaps what is really behind the report.

1. Go to the Cisco CSR Report ([Executive Summary](http://www.cisco.com/web/about/citizenship/reports/pdfs/CSR-Report-2012-Executive-Summary.pdf)). Please read the CEO’s message (p 3). Have you heard of Cisco? What is its role in the Internet?
2. What are the five pillars of Cisco’s CSR reporting (p 4)? What seems to be the theme of CSR for Cisco?
3. According to the Cisco CSR report, “stakeholders” in 2011 asked for Cisco to set out its CSR vision more clearly. Can you identify what Cisco’s “governance” vision is (pp 5-10)
4. According to the Cisco CSR report, Cisco is concerned about sustainability practices in its “supply chain.” What does Cisco expect of its suppliers (pp 9-14)?
5. According to the Cisco CSR report, Cisco is interested in having its employees “feel that working at Cisco is more than just a job.” How does Cisco seek to do this (pp 15-18)?
6. According to the Cisco CSR report, Cisco is committed to “society,” mostly be making its Internet technologies more widely available. What has been Cisco’s performance in this area and how well has it met its objectives (pp 19-24)?
7. According to the Cisco CSR report, Cisco is committed to the “environment” –both in reducing negative externalities and creating positive externalities. How is the company trying to reduce its carbon footprint (pp 25-29)?

1. Overall, did you think that Cisco is engaged in “greenwashing” or a sincere effort to engage in sustainability practices? Did the recognition and awards that Cisco has received have any meaning to you (p 7)?