The Shareholder Value Myth

By Lynn A. Stout

Shareholder primacy theory is suffering a crisis of confidence. In *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* Lynn Stout discusses how the traditional managerial focus on the shareholder's interest can be harmful for the corporation and even for shareholders themselves and how it is more valuable to spread the focus over several objectives**.**

Shareholder Value and its Disappointments

By the end of the 20th century, a broad consensus had emerged in the Anglo-American business world that corporations should be governed according to the philosophy often called shareholder primacy. Shareholder primacy theory taught that corporations were owned by their shareholders; that directors and executives should do what the company's owners/shareholders wanted them to do; and that what shareholders generally wanted managers to do was to maximize "shareholder value," measured by share price.

Today this consensus is crumbling. As just one example, in the past year no fewer than three prominent New York Times columnists have published articles questioning shareholder value thinking.[1] Shareholder primacy theory is suffering a crisis of confidence. This is happening in large part because it is becoming clear that *shareholder value thinking doesn't seem to work, even for most shareholders*.

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Consider the example of the United States. The idea that corporations should be managed to maximize shareholder value has led over the past two decades to dramatic shifts in U.S. corporate law and practice. Executive compensation rules, governance practices, and federal securities laws, have all been "reformed" to give shareholders more influence over boards and to make managers more attentive to share price.[2] The results are disappointing at best. Shareholders are suffering their worst investment returns since the Great Depression;[3] the population of publicly-listed companies has declined by 40%;[4] and the life expectancy of Fortune 500 firms has plunged from 75 years in the early 20th century to only 15 years today.[5]

Correlation does not prove causation, of course. But in my book *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*,[6] I explore the logical connections between the rise of shareholder value thinking and subsequent declines in investor returns, numbers of public companies, and corporate life expectancy. I also show that shareholder primacy is an abstract economic theory that lacks support from history, law, or the empirical evidence. In fact, the idea of a single shareholder value is intellectually incoherent. No wonder the shift to shareholder value thinking doesn't seem to be turning out well — especially for shareholders.

Debunking the Shareholder Value Myth: History

Although many contemporary business experts take shareholder primacy as a given, the rise of shareholder primacy as dominant business philosophy is a relatively recent phenomenon. For most of the twentieth century, large public companies followed a philosophy called managerial capitalism. Boards of directors in managerial companies operated largely as self-selecting and autonomous decision-making bodies, with dispersed shareholders playing a passive role. What's more, directors viewed themselves not as shareholders' servants, but as trustees for great institutions that should serve not only shareholders but other corporate stakeholders as well, including customers, creditors, employees, and the community. Equity investors were treated as an important corporate constituency, but not the only constituency that mattered. Nor was share price assumed to be the best proxy for corporate performance.[7]

Go back further, to the very beginnings of business corporations, and we see even greater deviations from shareholder primacy. Many corporations formed in the late eighteenth and early nineteenth centuries were created specifically to develop large commercial ventures like roads, canals, railroads, and banks. Investors in these early corporations were usually also customers. They structured their companies to make sure the business would provide good service at a reasonable price – not to maximize investment returns.[8]

So where did the idea that corporations exist only to maximize shareholder value come from? Originally, it seems, from free-market economists. In 1970, Nobel Prize winner Milton Friedman published a famous essay in the New York Times arguing that the only proper goal of business was to maximize profits for the company's owners, whom Friedman assumed (incorrectly, we shall see) to be the company's shareholders.[9] Even more influential was a 1976 article by Michael Jensen and William Meckling titled the "Theory of the Firm."[10] This article, still the most frequently cited in the business literature,[11] repeated Friedman's mistake by assuming that shareholders owned corporations and were corporation's residual claimants. From this assumption, Jensen and Meckling argued that a key problem in corporations was getting wayward directors and executives to focus on maximizing the wealth of the corporations' shareholders.

Jensen and Meckling's approach was eagerly embraced by a rising generation of scholars eager to bring the "science" of economics to the messy business of corporate law and practice. Shareholder primacy theory led many to conclude that managerialism must be inefficient and outmoded, and that corporations needed to be "reformed" from the outside. (There is great irony here: free-market economist Friedrich Hayak would have warned against such academic attempts at economic central planning.)[12] Shareholder primacy rhetoric also appealed to powerful interest groups. These included activist corporate raiders; institutional investors; and eventually, CEOs whose pay was tied to stock price performance. As a result, shareholder primacy rose from arcane academic theory in the 1970s to dominant business practice today.[13]

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Debunking the Shareholder Value Myth: Law

Yet it is important to note that shareholder primacy theory was first advanced by economists, not lawyers. This may explain why the idea that corporations should be managed to maximize shareholder value is based on factually mistaken claims about the law.

Consider first Friedman's erroneous belief that shareholders "own" corporations. Although laymen sometimes have difficulty understanding the point, corporations are *legal entities that own themselves*, just as human entities own themselves. What shareholders own are shares, a type of contact between the shareholder and the legal entity that gives shareholders limited legal rights. In this regard, shareholders stand on equal footing with the corporation's bondholders, suppliers, and employees, all of whom also enter contracts with the firm that give them limited legal rights.[14]

A more sophisticated but equally mistaken claim is the residual claimants argument. According to this argument, shareholders are legally entitled to all corporate profits after the fixed contractual claims of creditors, employees, suppliers, etc., have been paid. If true, this would imply that maximizing the value of the shareholders' residual interest in the company is the same thing as maximizing the value of the company itself, which usually benefits society. But the residual claimants argument is also legally erroneous. Shareholders are residual claimants only when failed companies are being liquidated in bankruptcy. The law applies different rules to healthy companies, where the legal entity is *its own* residual claimant, meaning the entity is entitled to keep its profits and to use them as its board of directors sees fit. The board may choose to distribute some profits as dividends to shareholders. But it can also choose instead to raise employee salaries; invest in marketing or research and development; or make charitable contributions.[15]

Which leads to the third legal error underlying shareholder primacy: the common but misleading claim that directors and executives are shareholders' "agents." At law, a fundamental characteristic of any principal/agent relationship is the principal's right to control the agent's behavior. But shareholders lack the legal authority to control directors or executives. Traditionally, shareholders' governance rights in public companies are limited and indirect, including primarily their right to vote on who sits on the board, and their right to bring lawsuits for breach of fiduciary duty. As a practical matter, neither gives shareholders much leverage. Even today it remains very difficult for dispersed shareholders in a public corporation to remove an incumbent board.[16] And shareholders are only likely to recover damages from directors in lawsuits involving breach of the duty of loyalty, meaning the directors were essentially stealing from the firm. Provided directors don't use their corporate powers to enrich themselves, a key legal doctrine called the "business judgment rule" otherwise protects them from liability.[17]

The business judgment rule ensures that, contrary to popular belief, the managers of public companies have no enforceable legal duty to maximize shareholder value.[18] Certainly they can choose to maximize profits; but they can also choose to pursue any other objective that is not unlawful, including taking care of employees and suppliers, pleasing customers, benefiting the community and the broader society, and preserving and protecting the corporate entity itself. Shareholder primacy is a managerial choice – not a legal requirement.

Debunking the Shareholder Value Myth: Evidence

Which leads to the question of the empirical evidence. As noted above, the law does not require corporate managers to maximize shareholder value. But this certainly is something managers can opt to do. And certain corporate governance strategies — putting more independent directors on boards, tying executive pay to share price, removing "staggered" board structures that make it harder to oust sitting directors — are widely recognized as effective means to make managers embrace raising share price as their primary objective. If shareholder primacy theory is correct, corporations that adopt such strategies should do better and produce higher investor returns than corporations that don't. Does the evidence confirm this?

Surprisingly, the answer to this question is "no." Researchers have spent decades and produced scores of studies seeking to prove that shareholder primacy generates superior business results. Yet there is a notable lack of replicated studies finding this.[19] For example, one survey looked at more than a dozen studies of supposedly shareholder-hostile companies that used dual-class share structures to disenfranchise public investors. Some studies found dual-class structures had no effect on corporate performance; some found a mild negative effect; and some studies found a positive effect (in one case, a strongly positive effect), exactly the opposite of what shareholder primacy theory predicts.[20]

But more important, studies that examine whether supposedly shareholder value-maximizing strategies improve the performance of an individual company for a year or two are looking in the wrong place and at the wrong time period. Individual shareholders may perhaps care only about their own investing returns in the near future. But policymakers and governance experts should care about public equity returns to investors as a class, over longer periods. As already noted, if we look at returns to public equity investors as a class, over time, the shift to shareholder primacy as a business philosophy has been accompanied by dismal results.

Why? The answer may lie in recognizing that shareholder value-increasing strategies that are profitable for one shareholder in one period of time can be bad news for shareholders collectively over a longer period of time. The dynamic is much the same as that presented by fishing with dynamite. In the short term, the fisherman who switches from using baited lines to using dynamite sees an increase in the size of his catch. But when many fishermen in the village begin using dynamite, after an initial increase, the collective catch may diminish steadily. Shareholders may experience the same regrettable result when they push managers to "maximize shareholder value."

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There Is No Single Shareholder Value

To understand why shareholder primacy can be compared to fishing with dynamite, it is useful to start by recognizing an awkward reality: there is no single "shareholder value." Shareholder primacy looks at the world from the perspective of a Platonic shareholder who only cares about one company's share price, at one moment in time. Yet no such Platonic entity exists.

"Shareholders" actually are human beings who happen to own shares, and human beings have different interests and different values. Some shareholders plan to hold long-term, to save for retirement; others are speculators, eager to reap a quick profit and sell. Some shareholders want companies to make long-term commitments that earn the loyalty of customers, employees and suppliers; others may want to profit from opportunistically exploiting stakeholders' commitments. Some investors are undiversified (think of the hedge fund manager whose human and financial capital are both tied up in the fate of one or two securities). Most are diversified, and worry about the performance of multiple companies as well as their own health, employment prospects, and tax burdens. Finally, some shareholders may not care if their companies earn profits by breaking the law, hurting employees and consumers, or damaging the environment. But others are "prosocial," willing to sacrifice at least some investment returns to ensure the companies they invest in contribute to, rather than harming, society.

It is these divisions between shareholders' interests that allow some shareholders to profit by pushing companies to adopt strategies that harm other shareholders. The divisions make it possible for shareholders to "invest with dynamite," as it were.

Investing With Dynamite

As an example, consider the conflict between short-term and long-term investors. It was once believed (at least by academic economists) that the market price of a company's stock perfectly captured the best estimate of its long-term value. Today this idea of a perfectly "efficient" stock market has been discredited, and it is widely recognized that some business strategies can raise share price temporarily while possibly harming the company's long-term prospects. Examples include cutting expenses for marketing or research and development; siphoning off cash that might otherwise be invested for the future through massive dividends or share repurchase plans; taking on risky leverage; and selling off all or part of the company. Hedge funds and other activist investors are famous for pushing boards to adopt such strategies. (Consider Carl Icahn's recent efforts to get Transocean to pay out dividends rather than reducing its debt.)[21] This is profitable for the activists, who typically sell immediately after the share price rises. But over time, this kind of activism diminishes the size and health of the overall population of public companies, leaving investors as a class with fewer good investing options.

A similar dynamic exists when it comes to how companies treat stakeholders like employees and customers. Shareholders as a class want companies to be able to treat their stakeholders well, because this encourages employee and customer loyalty ("specific investment").[22] Yet individual shareholders can profit from pushing boards to exploit committed stakeholders — say, by threatening to outsource jobs unless employees agree to lower wages, or refusing to support products customers have come to rely on unless they buy expensive new products as well. In the long run, such corporate opportunism makes it difficult for companies to attract employee and customer loyalty in the first place. Some investors profit, but again, the size of the total investing "catch" declines.

"Shareholders as a class want companies to be able to treat their stakeholders well, because this encourages employee and customer loyalty ("specific investment")."

Conflicts of interest between diversified and undiversified shareholders raise similar problems. For several years, BP paid large dividends and kept its share price high by cutting safety corners to keep expenses down. Undiversified investors who owned only BP common stock benefited, especially those lucky enough to sell before the Deepwater Horizon disaster. But when tragedy finally struck, the BP oil spill damaged not only of the price of BP shares, but also BP bonds, other oil companies operating in the Gulf, and the Gulf tourism and fishing industries. Diversified investors with interests in these other ventures would have preferred that BP focused a bit less on maximizing shareholder value. Similarly, consider the irony of a pension fund portfolio manager whose job is to invest on behalf of employees pushing companies to raise share prices – by firing employees. This harms not only investors who are also employees, but all investors, as rising unemployment hurts consumer demand and eventually corporate profits.

Finally, consider the differing interests of asocial investors who do not care if companies earn profits from illegal or socially harmful behaviors, and prosocial investors who don't want the companies they invest in to harm others or violate the law. The first group wants managers to "unlock shareholder value" at any cost, without regard to any damage done to other people or to the environment. The second group does not. Asocial investing – one might even call it sociopathic investing[23] – may not harm corporate profits in the long run. Thus it presents a different problem from other shareholder value strategies, discussed above, that reduce long-run investing returns. But it presents ethical, moral, and economic efficiency problems of its own.

Which Shareholders and Whose Values?

Closer inspection thus reveals the idea of a single "shareholder value" to be a fiction. Different shareholders have different values. Many, and probably most, have concerns far beyond what happens to the share price of a single company in the next year or two.

Some shareholder primacy advocates might nevertheless argue that we need to embrace share price as the sole corporate objective, because if we judge corporate performance more subjectively or use more than one criterion, managers become unaccountable. This argument has at least two flaws. First, we routinely judge the success of endeavors by multiple, often subjective, criteria. (Even eating lunch in a restaurant requires balancing cost against taste against calories against nutrition.) Second, the philosophy of "maximize shareholder value" asks managers to focus only on the share price of their own company, in the relatively near term. In other words, it resolves conflicts among shareholders by privileging the small subset of shareholders who are most shortsighted, opportunistic, undiversified, and indifferent to ethics or others' welfare — the lowest common human (perhaps subhuman) denominator. This seems a high price to pay for the convenience of having a single metric against which to measure managerial performance.

There may be a better alternative: replace corporate maximizing with corporate "satisficing."

The Satisficing Alternative

Milton Friedman and other late twentieth-century academic economists were obsessed with optimizing: picking a single objective, then figuring out how to maximize it. This preference for analyzing problems from an optimizing perspective may reflect a taste for reductionism. It may also reflect a taste for mathematics. (Although math can help you figure out how to maximize a single variable, it is much less useful for telling you how to pick and choose among several.)

But optimization is rarely the best strategy for either organisms or institutions. For example, if biology favored optimizing a single objective, humans would not need to drag around the weight of an extra kidney. And if people made decisions by optimizing, we would not find ourselves debating between taste, calories, and nutrition in choosing what to eat for lunch. Similarly, Nobel Prize winning economist Herman Simon argued more than a half-century ago that corporations need not try to optimize a single objective. Rather, firms can pursue several objectives, and try to do decently well (or at least sufficiently well) at each rather than maximizing only one. Simon called this "satisficing," a word that combines "satisfy" with "suffice."[24]

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"The disappointing results of shareholder primacy suggest the satisficing approach may be better not only for shareholders, but for the rest of us as well."

Satisficing has many advantages as a corporate decision-making strategy. Most obviously, it does not try to resolve conflicts among different shareholders by maximizing only the interests of the small subset who are most short-term, opportunistic, undiversified, and asocial. It allows managers instead to try to decently (but not perfectly) serve the interests of many different shareholders – including long-term shareholders; shareholders who want the company to be able to keep commitments to customers and employees; diversified shareholders who want to avoid damaging their other interests as investors, employees, and consumers; and prosocial shareholders who want the company to earn profits in a socially and environmentally responsible fashion.

When managers are allowed to satisfice, they can retain earnings to invest in safety procedures, marketing, and research and development that contribute to future growth. They can eschew leverage that threatens the firm's stability. They can keep commitments that build customer and employee loyalty. They can protect their shareholders' interests as employees, taxpayers and consumers by declining to outsource jobs, lobby for tax loopholes, or produce dangerous products. Finally, they can respect the desires of their prosocial shareholders by trying to run the firm in a socially and environmentally responsible fashion.

Of course, if managers don't also earn profits, they won't be able to do these things for long. But the satisficing approach recognizes that while earning profits is necessary for the firm's long-term survival, it is not the *only* corporate objective. Once profitability is achieved, the firm can focus on satisfying other goals, including future growth, controlling risk, and taking care of its investors, employees, customers, even society. Our recent experience with the disappointing results of shareholder primacy suggest this approach may be better not only for shareholders, but for the rest of us as well.

About the Author

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School. Professor Stout is an internationally-recognized expert in corporate governance, financial regulation, and moral behavior who has published numerous articles and books and lectures widely. Her most recent books are *The Shareholder Value Myth: How Putting Shareholders First Harms Investors*, Corporations and the Public (Berrett Koehler Publications, 2012; winner, Media Consortium Award), and *Cultivating Conscience: How Good Laws Make Good People* (Princeton University Press, 2011). She has also taught at Harvard, NYU, Georgetown, UCLA, and George Washington University. She is an independent director of the Eaton Vance family of mutual funds.

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13. Rock, supra note 2 and Stout, supra note 3.
14. Stout, supra note 6, at 37-38.
15. Stout, supra note 6, at 38-41.
16. Bebchuk, "The Myth of the Shareholder Franchise," 93 *Virginia Law Review* 675 (2005).
17. Stout, supra note 6, at 42-44.
18. The only context in which courts require directors to maximize shareholder value is when the directors of a public company determine to sell the company to a private owner, in essence deciding to force public shareholders out of the firm. At this point shareholders are uniquely vulnerable to exploitation, and perhaps need the legal protection of the so-called Revlon doctrine. However, directors have no obligation to sell a company to a private bidder, even at a premium price. In other words, as long as a public company wants to stay public, directors have

no legal obligation to maximize either profits or share value.
19. About the only empirical finding that has been reliably replicated is that when governance changes cause directors to sell a company, the buyer pays a premium over market price. This increases the wealth of shareholders in target companies. Unfortunately, it also often depresses the stock prices of bidding companies by an equal or greater amount, suggesting that mergers and acquisitions do not increase the wealth of shareholders as a class. One study has concluded that the net result for all shareholders of all mergers and acquisitions done between 1980 and 2001 was to reduce aggregate market value by $78 billion. See Stout, supra note 6, at 88-89.
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