



CHAPTER 3

How Shareholder Primacy Gets Corporate Economics Wrong

The idea of shareholder primacy has gained enormous traction among laymen, journalists, economists, and business leaders. But as we have just seen, American law does not actually mandate shareholder primacy. Many legal experts acknowledge this misfit.⁴⁹ For example, Hansmann and Kraakman recognized the yawning gap between shareholder value ideology and the actual rules of corporate law in their influential “End of History” essay when they suggested that shareholder value thinking would lead to the eventual “reform” of corporate law, implicitly conceding that the law in its current “unreformed” state falls far from the shareholder primacy ideal.⁵⁰

Nevertheless, many legal scholars today passionately embrace shareholder value as a normative goal. They believe that even though the law does not require managers to maximize shareholder wealth, it *ought* to. The perceived superiority of the shareholder-oriented model has inspired a generation of would-be reformers to work tirelessly at thinking up new ways to “improve” corporate governance so that managers will focus more on shareholder value. For example, there is now a small academic cottage industry in churning out proposals for tying directors’ and executives’ compensation to share

price performance.⁵¹ Another popular argument is that corporations should be forced to abandon anti-takeover defenses like “staggered boards” and “poison pills,” which help directors of firms like Airgas to fend off a hostile takeover bidder offering a premium price.⁵² Yet another idea in fashion is that public corporations need more “shareholder democracy,” and should be forced to eliminate classified share structures that give some shareholders superior voting rights, or even give dissident shareholders access to corporate funds to mount proxy contests to remove incumbent directors.⁵³

Intellectual Origins of Shareholder Primacy: The Principal-Agent Model

Where did the notion that American corporate governance is defective come from? How did maximizing shareholder value get elevated to the level of Mom and apple pie as an American ideal? Shareholder value thinking cannot be explained as a reaction to recent corporate scandals and disasters, as it dates back much earlier, at least to Milton Friedman’s 1970 ode to shareholders in the pages of Sunday *New York Times*.⁵⁴ The assumption that corporations should maximize shareholder wealth was already widespread in economic and legal circles by the early 1980s, well before Enron and AIG became household names. Rather than being driven by recent business scandals, the shift to the shareholder-oriented model occurred much earlier, and seems to have been inspired not by experience or evidence but by the seductive appeal of an *idea*: the principal-agent model of the corporation.

The principal-agent model of the corporation is associated with a classic *Journal of Finance* article published in 1976 by business school dean William Meckling and finance economist Michael Jensen. Ambitiously titled “The Theory of the Firm,” the article described the economic problem that arises

when the owner of a business or “firm” (the principal) hires someone else (the agent) to manage the business on a day-to-day basis. Because the agent/manager does all the work while the owner/principal gets all the profits from the business, a self-interested agent/manager can be expected to shirk, or even steal, at the owner’s expense. The result is a separation of ownership from control that creates “agency costs.”

Jensen’s and Meckling’s article, the most frequently cited article in business academia today,⁵⁵ assumed without discussion that shareholders in corporations played the role of principal/owner, while “managers” (directors and executives) are the shareholder’s agents. Yet Jensen and Meckling were economists, not businessmen or corporate lawyers. We shall soon see how their article failed to capture the real economic structure of public companies with directors, executives, shareholders, debtholders, and other stakeholders. Nevertheless, the principal-agent model was enthusiastically embraced by the emerging Law and Economics school as the perfect way to bring the rigor of economic theory to the messy business of corporate law. As early as 1980, Richard Posner of Chicago Law School and Kenneth Scott of Stanford Law School published and edited a volume called *The Economics of Corporate Law and Securities Regulation* that included Jensen’s and Meckling’s work.⁵⁶ The principle-agent model embedded itself still more deeply into scholarly thought in 1991, when Frank Easterbrook and Daniel Fischel (also both from Chicago Law School) published the *The Economic Structure of Corporate Law*, an influential primer still in use today.⁵⁷ By 2001, Hansmann and Kraakman were ready to declare that the standard shareholder-oriented model of the corporation had achieved “ideological hegemony.”⁵⁸

Basic Assumptions Underlying the Principal-Agent Approach

The “standard” principal-agent model is associated with three core assumptions about the economic structure of corporations. These are:

1. Shareholders own corporations;
2. Shareholders are the residual claimants in corporations, meaning they receive all profits left over after the company’s contractual obligations to its creditors, employees, customers, and suppliers have been satisfied;
3. Shareholders are principals who hire directors and executives to act as their agents.

These three assumptions reveal a basic problem with the standard principal-agent model of the corporation. Put bluntly, *the model is wrong*. Not wrong in an ethical or moral sense: there’s nothing objectionable about a principal hiring an agent. But it’s patently and demonstrably wrong, as a descriptive matter, to claim that Jensen’s and Meckling’s simple model captures the economic reality of a public corporation with thousands of shareholders, scores of executives, and a dozen or more directors. The standard model may describe some kinds of “firms,” especially sole proprietorships, or closely held corporations with a single shareholder and no debt. But it grossly misstates the economic structure of public corporations. To see why, let’s revisit each of the model’s core assumptions.

The First Mistaken Assumption: Shareholders Own Corporations

Laypersons and journalists, and even the occasional economist like Milton Friedman, often casually assert that shareholders “own” corporations. Sometimes even law professors—who know better—find themselves reflexively repeating the phrase. But from a legal perspective, shareholders do not, and cannot, own corporations. *Corporations are independent legal entities that own themselves*, just as human beings own themselves.

Adult humans can hold property in their own names, bind themselves to perform contracts, and be held liable for committing torts. Corporations can do all these things, too. Nonlawyers may find it hard to wrap their heads around the notion that an intangible and abstract institution like a corporation is a “juridical person.” But law has long been used to create—to make “corporate”—institutions that interact on equal legal footing with natural persons. Examples include not only business corporations, but also nonprofit entities like universities, trusts, towns and municipalities, and the Roman Catholic Church. (Each of these legal entities, it is worth pointing out, manages to function despite lacking shareholders.)

What, then, do shareholders own? The labels “shareholder” and “stockholder” give the answer. Shareholders *own shares of stock*. A share of stock, in turn, is simply a contract between the shareholder and the corporation, a contract that gives the shareholder very limited rights under limited circumstances. (Owning shares in Apple doesn’t entitle you to help yourself to the wares in the Apple store.) In this sense stockholders are no different from bondholders, suppliers, and employees. All have contractual relationships with the corporate entity. None “owns” the company itself.

Indeed, once we recognize that corporations and shareholders contract with each other, the “ownership” argument for shareholder primacy disintegrates in the face of economic theory itself. Only three years after Milton Friedman championed the idea of shareholder ownership in the *New York Times*, Nobel-prize winners Fischer Black and Myron Scholes published their famous paper on options pricing, which provides the foundation for modern options theory.⁵⁹ Black and Scholes proved that once a corporation issues debt, one can just as correctly say the debtholder has purchased the right to the corporation’s future profits from the corporation while also selling a call option (the right to any increase in the company’s value above a certain point) to the shareholders, as say the shareholders purchased the right to the corporation’s profits from the company but have also bought a put option (the right to avoid any loss in the company’s value below a certain point) from the debtholders. In other words, from an options theory perspective, shareholders and debtholders alike have equal—and equally fallacious—claims to corporate “ownership.”

How, then, can one describe corporations—especially public corporations that issue debt—as being owned by shareholders? One cannot and should not. Corporations own themselves, and enter contracts with shareholders exactly as they contract with debtholders, employees, and suppliers.

The Second Mistaken Assumption: Shareholders Are the Residual Claimants

A second common idea that has persuaded many experts that shareholder primacy is normatively desirable is the idea that shareholders are the “residual claimants” in corporations. In economics, a residual claimant is the party that is entitled to keep all the residual profits left over after a business has

met its basic legal obligations (e.g., paying interest due to creditors, contract wages due to employees, and taxes due to governments). According to shareholder primacy theory, shareholders are the only residual claimants in public corporations. Other stakeholders, like employees, customers, creditors, or suppliers, are entitled to receive from the corporation only the minimum the law and their formal contracts require. Shareholders and only shareholders (or so it is assumed) get everything left over after these legal and contractual obligations have been met.

The belief that shareholders are the residual claimants in corporations leads naturally to the belief that maximizing shareholder wealth will maximize overall social wealth as well. After all, if the interests of other stakeholders in the corporation are fixed and predetermined, the only way to increase the value of the shareholders' residual interest is to increase the value of the corporation itself.⁶⁰ Conversely, when the value of the shareholders' interests decreases, this must mean the value of the company has declined.

The idea is elegant, appealing—and wrong. To understand why, it's useful to start by recognizing that the "shareholders are the residual claimants" idea has its roots in bankruptcy law, where courts distributing the assets of liquidated companies are assumed to pay stockholders last, and only after the claims of employees, debtholders, and other creditors have been paid in full. But even in bankruptcies, influential UCLA scholar Lynn LoPucki has shown, courts often require creditors to share in equity holders' losses to some extent.⁶¹ More important, we should not judge the function of a living, profit-generating corporation by the way we treat a company being liquidated in bankruptcy court. Living corporations are different entities with fundamentally different purposes than dead corporations, just as living horses (which we employ as competitive athletes and family pets) have fundamentally

different purposes from dead horses (which we use, if at all, for glue and pet food).

If we focus on successful, operating companies, it quickly becomes apparent that as a descriptive matter, the claim that shareholders are corporations' residual claimants is simply incorrect.⁶² Outside the bankruptcy context, it is grossly misleading to suggest that shareholders are somehow entitled to—much less actually receive—everything left over after a company's legal obligations have been met. To the contrary, shareholders cannot get any money out of a functioning public corporation unless two conditions are satisfied. First, under the standard rules of corporate law, a company's board of directors only has legal authority to declare dividends to shareholders when the company is doing well enough financially, as measured by whether it has (in accounting terms) sufficient "retained earnings" or "operating profits."⁶³ Second, no dividends can be paid unless the board decides to actually exercise its authority by declaring a dividend.⁶⁴

It is essential to recognize that neither contingency is met *unless the board of directors wants it to be*. Focusing on the firm's financial health and legal ability to pay dividends, "retained earnings" and "profits" are accounting concepts over which directors have enormous control. Both depend not only on how much money the company brings in (earnings), but also on how much money it spends (expenses). Directors can't always increase earnings, but they can increase expenses. If a company is raking in cash, its directors have the option of allowing accounting profits to increase. They also have the option of raising executives' salaries, starting an on-site childcare center, improving customer service, beefing up retirement benefits, and making corporate charitable contributions. Thus, even when a company is minting money, it is the board that decides how much of the new wealth will show up in the company's financial statements in a form that can be paid to shareholders.

Second, even when a corporation has enough profits or retained earnings to legally pay a dividend, directors are under no obligation to declare one, and often don't. It is standard operating practice for U.S. corporations to pay only small dividends or no dividends to their shareholders, retaining the lion's share of earnings for future projects. If this practice boosts the company's stock price, shareholders enjoy an indirect economic benefit. But the benefit is only indirect, and vulnerable to the board's decisions. If the board decides to run the firm in the interests of customers, employees, or executives—or simply run it into the ground—the earnings will become expenses, and stock price will decline.

This means it's simply incorrect, as a factual matter, to describe the shareholders of a public corporation that is a going concern as the company's residual claimants. Shareholders are only one of several groups that—at the board of directors' discretion—are residual claimants and risk bearers in corporations, in the sense that they gain and lose as the company's health fluctuates. When a corporation does well, its board may indeed declare bigger dividends for shareholders. But the directors may also decide, in addition or instead, to give rank-and-file employees raises and greater job security, to provide executives with a company jet, or to retain the cash so bondholders enjoy increased protection from the risk of corporate insolvency. Conversely, stakeholders suffer along with shareholders when times are bad, as employees face layoffs, managers are told to fly coach, and debtholders find their bonds downgraded. Directors use their control over the firm to reward many groups with larger slices of the corporate pie when the pie is growing, and spread the loss among many when the pie shrinks. The corporation is its own residual claimant, and it is the board of directors that decides what to do with the corporation's residual.

The Third Mistaken Assumption: Shareholders Are Principals and Directors Are Their Agents

Finally, a third fundamental belief associated with the principal-agent model of the corporation is that shareholders and directors are just that—principals and agents. Again, this premise is wrong.

In law, the word “principal” normally refers to someone who hires another person (an “agent”) to serve his interests. Thus the principal exists prior to, and independent of, the hiring of the agent. Yet when a corporation is formed, the first thing that must happen is that the firm’s “incorporator” must appoint a board of directors to act on the corporation’s behalf. Only after the board exists does the corporation have the power and ability to issue stock and so contract to acquire stockholders.⁶⁵ Both the corporation itself and its board of directors (the supposed “agents”) must exist prior to, and independent of, the stockholders (the supposed “principals”).

Even more significant, a hallmark of agency is that the principal retains the right to control the agent’s behavior.⁶⁶ Yet one of the most fundamental rules of corporate law is that corporations are controlled by boards of directors, not by shareholders.⁶⁷ This does not mean that corporate law does not grant shareholders certain rights that can give them influence over boards. Indeed, shareholders have three—the right to vote, the right to sue, and the right to sell their shares. But all three rights have remarkably little practical value to shareholders seeking to make directors of public companies do their bidding and serve their interests.

Consider first shareholders’ voting rights. As a matter of law these are severely limited in scope, primarily to the right to elect and remove directors. Shareholders in public corporations have no right to select the company’s CEO; they cannot require the company to pay dividends; they cannot stop directors from squandering revenues on

employee health care, charitable contributions, or executive jets; and they cannot vote to sell assets or the company itself (although they can sometimes veto a sale or merger proposed by the board). Voting procedures further limit the shareholder franchise. Delaware law, for example, assumes only directors have authority to call a special shareholders' meeting, and shareholders who wait for the annual meeting to try to elect or remove directors must pay to solicit their own proxies. Perhaps most importantly, shareholder activism is the classic example of a "public good." In a public firm with widely-dispersed share ownership, shareholders' own "rational apathy" raises an often insurmountable obstacle to collective action. In the words of corporate law guru Robert Clark, a cynic could conclude that shareholder voting in a public company is "a mere ceremony designed to give a veneer of legitimacy to managerial power."⁶⁸

What about shareholders' right to sue corporate officers and directors for breach of fiduciary duty if they fail to maximize shareholder wealth? As we saw in Chapter 2, here too, shareholders' rights turn out to be illusory. Executives and directors owe a fiduciary duty of loyalty to the corporation that bars them from using their corporate positions to enrich themselves at the firm's expense. But thanks to the business judgment rule, unconflicted directors remain legally free to pursue almost any other goal. Directors can safely donate corporate funds to charity; reject profitable business strategies that might harm the community; refuse risky projects that benefit shareholders at creditors' expense; fend off hostile takeover bids in order to protect the interests of employees or the community; and refuse to declare dividends even when shareholders demand them.⁶⁹ Contrary to the principal-agent model, shareholders in public companies cannot successfully sue directors simply because those directors place other stakeholders' or society's interests above shareholders' own.

Finally, the right to sell shares sometimes can protect a disgruntled individual investor who wants to express her unhappiness with a board by “voting with her feet.” But when disappointed shareholders in public companies sell en masse, they drive down share price, making selling a Pyrrhic solution. An important exception to this rule arises in the case of hostile takeovers, where a public company’s shareholders may have a collective opportunity to transform the company into a private firm by selling their shares to a single buyer who, because she does not face collective action problems, can remove an uncooperative board cheaply and quickly. During the 1970s and early 1980s, as the Chicago economists’ arguments began to gain steam and changes in the banking industry made hostile takeover bids more feasible, it appeared that just such a lively “market for corporate control” might develop. But a series of quick legal reactions soon brought most hostile takeovers to a halt. These include the passage by almost every state of some form of antitakeover statute; the invention of the “poison pill” antitakeover defense by *uber*-corporate lawyer Martin Lipton; and the practical reversal of the Delaware Supreme Court’s 1986 *Revlon* ruling (which at first seemed to require boards to maximize shareholder wealth) by cases decided only a few years later.⁷⁰ The end result is that the economic and governance structure of public corporations continues to insulate boards of directors from dispersed shareholders’ command and control in ways that make it impossible to fit the square peg of the public corporation into the round hole of the “standard” principal-agent model.

So Why Embrace the Principal-Agent Approach?

It thus turns out that, when examined more closely, all three basic assumptions about corporate structure typically associated with shareholder value thinking—the assumptions that the shareholders own the corporation, that they are its

residual claimants, and that they are principals who hire directors as their agents—are factually incorrect. This raises the question of why, as Hansmann and Kraakman observed in 2001, we have seen a “rapid convergence on the standard shareholder-oriented model as a *normative* view of corporate structure and governance.”⁷¹ If shareholders are not really owners, residual claimants, or principals in corporations, why should we want to run corporations as if they are?

To the extent an answer to this fundamental question is found in the literature on corporate theory, the answer seems to be that shareholder primacy is believed to be desirable because it is thought to offer the best solution to the agency cost problem described by Jensen and Meckling. After all, directors and executives are only human. If given a broad range of discretion to run firms in the interests not only of shareholders but also stakeholders and possibly even society at large, they might be tempted to use their autonomy to serve themselves. As Frank Easterbrook and Daniel Fischel described the argument in 1991, “a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.”⁷² As Mark Roe of Harvard Law School put it more recently, shareholder value maximization may be the best rule of corporate governance because “a stakeholder rule of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own.”⁷³

In Jensen’s and Meckling’s terms, director discretion leads to agency costs. And as Jensen and Meckling also argued, agency costs can be reduced when an alert principal exists to measure and monitor the agent’s performance. To the current generation of corporate experts and business leaders, it seems obvious that shareholders should be that principal. It also seems obvious that if we focus on shareholder

value and especially on share price in measuring corporate performance, it becomes harder for managers to claim that they are doing a good job for the firm, when in fact they are merely doing well for themselves.

But this is all *in theory*. If agency costs are really as large an economic drain on corporations as shareholder primacy advocates assume, and if changing corporate governance rules to make boards more accountable to shareholders and more focused on increasing shareholder wealth is really as effective a solution, we should see evidence of this in the business world. Adopting shareholder value maximization as corporate goal should improve corporate performance.

And it is here that shareholder primacy theory finds itself most vulnerable. We have seen how, as a descriptive matter, shareholder primacy ideology is inconsistent with both corporate law and with the real economic structure of public corporations. Next we shall see how it is inconsistent with the empirical evidence as well.