



CHAPTER 2

How Shareholder Primacy Gets Corporate Law Wrong

One of the most striking symptoms of how shareholder-primacy thinking has infected modern discussions of corporations is the way it has become routine for journalists, economists, and business observers to claim as undisputed fact that U.S. law legally obligates the directors of corporations to maximize shareholder wealth. Business reporters blithely assert that “the law states that the duty of a business’s directors is to maximize profits for shareholders.”²⁸ Similarly, the editor of *Business Ethics* states that “courts continue to insist that maximizing returns to shareholders is the sole aim of the corporation. And directors who fail to do so can be sued.”²⁹

The widespread perception that corporate directors and executives have a legal duty to maximize shareholder wealth plays a large role in explaining how shareholder value thinking has become so endemic in the business world today. After all, if directors and executives can be held personally liable for failing to maximize shareholder wealth, one can hardly fault them for trying to raise the company’s share price by taking on massive debt, laying off employees, or spending less on research and development. Radicals and reformers can debate whether shareholder wealth maximization is good for society

as well as shareholders. (Canadian law professor Joel Bakan has argued that the alleged legal imperative to maximize profits makes corporations act like psychopaths.)³⁰ But making philosophical critiques of the wisdom of American corporate law is well above the pay grade of most directors, executives, and employees in corporations. They reasonably assume that if the law requires them to maximize shareholder value, that's what they should do.

There is one fatal flaw in their reasoning. The notion that corporate law requires directors, executives, and employees to maximize shareholder wealth simply isn't true. There is no solid legal support for the claim that directors and executives in U.S. public corporations have an enforceable legal duty to maximize shareholder wealth. The idea is fable. And it is a fable that can be traced in large part to the oversized effects of a single outdated and widely misunderstood judicial opinion, the Michigan Supreme Court's 1919 decision in *Dodge v. Ford Motor Company*.³¹

Why *Dodge v. Ford* Isn't Good Law on Corporate Purpose

Industrialist icon Henry Ford was the founder and majority shareholder of the Ford Motor Company, which produced the renowned Model T automobile. Horace and John Dodge were minority shareholders of Ford Motor who had started a rival car manufacturing company, the Dodge Brothers Company. The Dodge brothers wanted money to expand their competing business, and they thought their Ford Motor stock should provide it. (Ford Motor had for years paid its shareholders large dividends.) Henry Ford, well aware of the Dodge brothers' plans, thought differently. Even though Ford Motor was awash in cash, Henry Ford began withholding dividends. He claimed, with apparent glee in his own altruism, that the company needed to keep its money in order to offer lower prices to consumers and to pay employees higher wages. The Dodge

brothers were not amused; they sued. The Michigan Supreme Court sided with Horace and John Dodge, and ordered Ford Motor to cough up a dividend. (It was not as large a dividend as the Dodge brothers had hoped for, and the court allowed Henry Ford to continue with his plan to expand employment and reduce prices.)³²

As this description makes clear, *Dodge v. Ford* was not really a case about a public corporation at all. It was a case about the duty a controlling majority shareholder (Henry Ford) owed to minority shareholders (Horace and John Dodge) in what was functionally a closely held company—a different legal animal altogether. (Shareholders in public corporations, unlike the Dodge brothers, have no legal power to demand dividends.) Nevertheless, while ordering Ford Motor to pay the Dodge brothers a dividend, the Michigan Supreme Court went out of its way to dismiss Henry Ford's claims of corporate charity with an offhand remark that is still routinely cited today to support the idea that corporate law requires shareholder primacy: "There should be no confusion . . . 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."³³

This remark, it is important to emphasize, was what lawyers call "mere dicta"—a tangential observation that the Michigan Supreme Court made in passing, that was unnecessary to reach the court's chosen outcome or "holding." It is holdings that matter in law and that create binding precedent for future cases. Dicta is not precedent, and future courts are free to disregard it. It is also worth noting that the Michigan Supreme Court's remark about the purpose of the corporation was not only dicta but mealy mouthed dicta: note the qualifier "primarily." Nevertheless, nearly a century later, this language from *Dodge v. Ford* is routinely offered as Exhibit A in the case for shareholder value thinking. Indeed, *Dodge v. Ford* is often cited as the only legal authority for the

proposition that corporate law requires directors to maximize shareholder value.³⁴

This pattern makes any good corporate lawyer deeply suspicious. Law is a bit like wine. A certain amount of aging adds weight and flavor, but after too many years, law tends to go bad. A legal opinion that is nearly a century old is likely to be an undrinkable vintage. Moreover, *Dodge v. Ford* hails from Michigan, which has become something of a backwoods of corporate jurisprudence. For historical reasons, the jurisdiction that really counts today on questions of corporate law is Delaware, where more than half of Fortune 500 companies are incorporated. One of the reasons Delaware has become so popular is that Delaware judges (called “chancellors”) are renowned for their expertise on corporate law. And in the past 30 years, the Delaware court has cited *Dodge v. Ford* exactly once—not on the question of corporate purpose, but on the question of controlling shareholders’ duties to minority shareholders.³⁵

The Real Law on Corporate Purpose

So, *Dodge v. Ford*’s description of corporate purpose is mere dicta in an antiquated case that did not involve a public corporation, and that has not been validated by today’s Delaware courts. Is there other solid legal authority to support the proposition that the law requires directors of public corporations to maximize shareholder value?

The answer is, no. Corporate law generally can be found in three places: (1) “internal” law (the requirements of a particular corporation’s charter and by-laws); (2) state codes and statutes; and (3) state case law. (Federal securities laws require public corporations to disclose information to investors, but the feds mostly take a “hands-off” approach to internal corporate governance, leaving the rules to be set by the states; this division of labor has been reinforced by court decisions slapping down Securities Exchange Commission

(SEC) rules that interfere too directly with state corporate law.)³⁶ None of the three sources of state corporate law requires shareholder primacy.

Let us begin with internal corporate law. Most states allow or require a company's charter or articles of incorporation—the founding document of every corporation and the equivalent of its constitution—to include an affirmative statement describing and limiting the corporation's purpose.³⁷ If a company's founders wanted to, they could easily put a provision in the articles stating (to parrot *Dodge v. Ford*) that the company's purpose is “the profit of the stockholders.” Such provisions are as rare as unicorns. The overwhelming majority of corporate charters simply state that the corporation's purpose is to do anything “lawful.”³⁸

State statutes similarly refuse to mandate shareholder primacy. To start with the most important example, Delaware's corporate code does not say anything about corporate purpose other than to reaffirm that corporations “can be formed to conduct or promote any lawful business or purposes.”³⁹ A majority of the remaining state corporate statutes contain provisions that reject shareholder primacy by providing that directors may serve the interests not only of shareholders but of other constituencies as well, such as employees, customers, creditors, and the local community.⁴⁰

Finally, let us turn to the third important source of corporate law, judicial opinions from state courts, like *Dodge v. Ford*. There are many modern cases in which judges have offhandedly remarked, again in dicta, that directors owe duties to shareholders.⁴¹ Most judicial opinions, however, describe directors' duties as being owed “to the corporation and its shareholders.”⁴² This formulation clearly implies the two are not the same.⁴³ Moreover, some cases explicitly state that directors can look beyond shareholder wealth in deciding what is best for “the corporation.” For example, in the 1985 opinion *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme

Court stated that in weighing the merits of a business transaction, directors can consider “the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally).”⁴⁴

As in *Dodge v. Ford* itself, however, such judicial musings remain mere dicta. If we really want to know what the law requires when it comes to corporate purpose, we have to look beyond dicta at holdings—will a court actually hold a board of directors liable for failing to maximize shareholder wealth? Here, to use Sherlock Holmes’s famous analysis, the important legal clue is the dog that is not barking. Judges may say different things about what the public corporation’s purpose should be. But they uniformly refuse to actually impose legal sanctions on directors or executives for failing to pursue one purpose over another. In particular, courts refuse to hold directors of public corporations legally accountable for failing to maximize shareholder wealth.

How “The Business Judgment Rule” Rules Out Shareholder Primacy

The reason can be found in an important corporate law doctrine called the “business judgment rule.” 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 seem to harm shareholder value. In one famous case, for example, the corporation that owned the Chicago Cubs refused to hold night games at Wrigley Field. Although holding night games would likely have increased attendance and profits, the president of the corporation, chewing-gum heir Philip K. Wrigley, believed that baseball should be a “daytime sport” and that installing

lights would disturb the peace of the surrounding neighborhood. Philip Wrigley also supposedly admitted that he was not particularly interested in the financial consequences for the Cubs. Nevertheless, the court ruled that that under the business judgment rule, it could not disturb the Cubs board's decision to stick to daytime ball, absent evidence of fraud, illegality, or conflict of interest.⁴⁵

An even more important example of how the business judgment rule gives directors discretion to pursue goals other than shareholder value can be found in the recent Delaware case of *Air Products Inc. v. Airgas, Inc.* Airgas' stock had been trading in the \$40s and \$50s. Nevertheless, the directors of Airgas refused the amorous takeover advances of Air Products, which wanted to purchase Airgas by paying its shareholders \$70 a share. Many of the Airgas' shareholders supported the sale as an easy opportunity to increase their wealth. But the Delaware court held that, so long as Airgas' directors wanted Airgas to remain a public company, the Airgas board was "not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover."⁴⁶ Disinterested and informed directors were free to ignore today's stock price in favor of looking to the "long term"—and also free to decide what was in "the corporation's" long-term interests.

Indeed, there is only one significant modern case—the 1986 case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁴⁷—where a Delaware court has held an unconflicted board of directors liable for failing to maximize shareholder value. (In addition to the dusty *Dodge v. Ford*, Revlon is the second case shareholder primacy advocates typically cite in support of shareholder wealth maximization.) A closer look at the unique facts of *Revlon* shows it is the exception that proves the rule. The directors of Revlon had decided that Revlon, a public corporation, would be sold off to a private group of shareholders, thus becoming a private company. In other words, Revlon's board planned to "go private," and require the public shareholders of

Revlon to give up their interests in the company and receive cash or other securities in return for their Revlon shares. That meant there would be no public corporation whose long-term interests the board might consider. The Delaware Supreme Court held that, under the circumstances, the business judgment rule did not apply and Revlon's directors had a duty to get the public shareholders (soon to be ex-shareholders) the best possible price for their shares.

In other words, it is only when a public corporation is about to stop being a public corporation that directors lose the protection of the business judgment rule and must embrace shareholder wealth as their only goal. Subsequent Delaware cases have made clear that, so long as a public corporation intends to stay public, its directors have no Revlon duty to maximize shareholder wealth.⁴⁸ This is why the Airgas board, which did not want to take the company private, was able to claim the protection of the business judgment rule and reject Air Products' offer to buy Airgas at a premium that would have substantially increased Airgas shareholders' wealth.

The business judgment rule thus allows directors in public corporations that plan to stay public to enjoy a remarkably wide range of autonomy in deciding what to do with the corporation's earnings and assets. As long as they do not take those assets for themselves, they can give them to charity; spend them on raises and health care for employees; refuse to pay dividends so as to build up a cash cushion that benefits creditors; and pursue low-profit projects that benefit the community, society, or the environment. They can do all these things even if the result is to decrease—not increase—shareholder value.

If Not Shareholder Value, Then What?

It is time to exorcise the ghost of *Dodge v. Ford* from contemporary discussions of corporate purpose. Contrary to the

conventional wisdom, American corporate law (case law, statutes, and corporate charters) fiercely protects directors' power to sacrifice shareholder value in the pursuit of other corporate goals. So long as a board can claim its members honestly believe that what they're doing is best for "the corporation in the long run," courts will not interfere with a disinterested board's decisions—even decisions that reduce share price today.

As far as the law is concerned, maximizing shareholder value is not a requirement; it is just one possible corporate objective out of many. Directors and executives can run corporations to maximize shareholder value, but unless the corporate charter provides otherwise, they are free to pursue any other lawful purpose as well. Maximizing shareholder value is not a managerial obligation, it is a managerial choice.

But might it be the best choice? Even if the law doesn't require directors and executives to maximize shareholder value, could pursuing that objective be the best way to serve the interests of shareholders, and possibly society as a whole?

The next chapter looks at the normative case for shareholder value thinking. That is, it looks at the claim that whatever the law may require, maximizing shareholder value remains the best philosophy of corporate management because it ultimately is the best way to maximize corporations' economic contributions to society. As we shall see, there is every reason to believe this belief also is mistaken, for it rests in turn on a fundamentally mistaken idea in economic theory: the "principal-agent" model of the corporation.