



# Issues in GOVERNANCE STUDIES

Number 48

June 2012

## The Problem of Corporate Purpose

Lynn A. Stout



Lynn A. Stout is the Distinguished Professor of Corporate and Business Law, the first endowed professorship in the Clarke Business Law Institute at Cornell School of Law.

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.”<sup>1</sup>

In my book *The Shareholder Value Myth*, I demonstrate how this “shareholder primacy” theory can be hazardous to the health of investors, companies, and the public alike.<sup>2</sup> 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, there is good reason to suspect that 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 the interests of only a narrow subgroup of shareholders, those who are 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 reports at the expense of long-term performance; discourage investment

and innovation; harm employees, customers, and communities; and 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 20<sup>th</sup> 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 shareholder or shareholders wanted it to be. Some controlling shareholders might care only about profits, but others worried about the welfare of their employees, consumers, and communities, and about the growth and 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.<sup>3</sup>

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 clearly dominated.<sup>4</sup> 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 prominent members of the Chicago School, economic analysis revealed the proper purpose of the public corporation clearly, and that purpose was to make money for its dispersed shareholder “owners.” If corporate managers pursued any goal other than maximizing shareholder value, they were misbehaving corporate “agents” imposing inefficient “agency costs” on both shareholders and society.<sup>5</sup> An increase in share price was viewed as proof of greater economic efficiency.

---

Almost from its inception, the public corporation inspired impassioned debate over what its purpose ought to be.

---

The Chicago School's approach proved irresistibly attractive to a number of groups for a number of reasons. To tenure-seeking law professors, the Chicago School's application of economic theory to corporate law lent an attractive patina of scientific purity to the messy business of corporate law. The idea that business performance could be measured through the single metric of share price enticed a generation of economists and business school professors to produce innumerable empirical studies testing the relationship between share price and variables like board structure, capitalization, mergers, state of incorporation, and so forth, in the quest to uncover the secret to "good corporate governance." To the popular press and the business media, shareholder primacy provided an easy sound-bite explanation of the firm and, better yet, an obvious villain for every disaster and scandal: wayward corporate "agents" taking advantage of their "shareholder principals."

Finally, lawmakers, consultants, and would-be reformers now had a simple prescription for every corporate ill. The prescription had three ingredients: (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, this medicine could be given to any suffering company and better performance was sure to follow.

The Chicago School's theories began to influence actual corporate practice. During the 1990s, the Securities Exchange Commission (SEC) adopted a number of individually-modest but collectively-significant rule changes designed 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, in order to "unlock shareholder value." Finally, shareholder value thinking came to appeal to executives through the direct route of self-interest. In 1993, Congress amended the tax code to encourage corporations to tie the bulk of their executive's 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.<sup>6</sup>

## **Time to Question Shareholder Primacy**

By the close of the millennium, most scholars, regulators and businesspeople had come to accept without question that shareholders "owned" public corporations and that the proper purpose of the corporation was to maximize its shareholders' wealth. Shareholder primacy had become dogma, a belief system that was seldom questioned, rarely justified, and so commonplace most of its followers could not even recall where they had first learned of it.

---

Shareholder returns have been disappointing at best—the past ten years are now known as “the lost decade” for investors.

---

Today questions seemed called for. The dogma of shareholder primacy predicts that Corporate America’s mass embrace of shareholder value thinking over the past two decades should have greatly improved the business sector’s performance. This prediction plainly has not been borne out. For most of the twentieth century, American public corporations were the engine of a thriving economic system that worked to benefit 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, to the Walmart bribery scandal unfolding today. The number of U.S. public companies is decreasing, from 8,823 in 1997 to only 5,401 in 2009.<sup>7</sup> Shareholder returns have been disappointing at best—the past ten years are now known as “the lost decade” for investors.

We have been dosing our public corporations with the medicine of shareholder value thinking for at least two decades now. The patient seems, if anything, to be getting worse. And with good reason. Closer inspection reveals that the idea that public corporations are run well when they are run to maximize share price is a myth, and a dangerous myth at that.

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

One of the most striking symptoms of how shareholder primacy thinking dominates contemporary discussions of corporations is the way 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. As one editor of *Business Ethics* put it, “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.”<sup>8</sup>

This common and widespread 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.<sup>9</sup> Similarly, the typical public company charter broadly defines the company’s purpose as “anything lawful.” (Although it is perfectly possible for a corporate charter to state that the company’s purpose is to maximize shareholder value, virtually no public company charter does so.) This leaves advocates of shareholder primacy in something of a bind. Where, exactly, can the supposed 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.”<sup>10</sup> 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.

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.*<sup>11</sup> Air Products wanted to acquire Airgas, whose stock had been trading in the \$40s and \$50s, at a price of \$70 per share. Airgas’ board refused Air Products’ amorous advances, even though many Airgas shareholders supported the sale as a way to make a quick profit. The Delaware Court supported the Airgas boards’ decision to reject the offer, stating that the board “was not under any per se duty to maximize shareholder value in the short term.”<sup>12</sup> As *Airgas* and many other cases show, disinterested and informed directors are free to reduce profits and share price today when they claim to believe this will help the corporation in “the long run.” They are also free 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.<sup>13</sup> This 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<sup>14</sup>—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. Among other advantages, it gave a clear answer to the murky question of corporate purpose, because it taught that the best way to maximize the total value of the company was to focus on maximizing share price, which represented the shareholders’ interest as the firm’s supposed “residual claimant.”

There is one serious problem with this analysis, however. 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.

This becomes readily apparent if we consider the three factual claims that lie at the heart of the principal-agent model. The first incorrect factual claim is that shareholders “own” corporations. 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? The label “shareholder” gives the answer. Shareholders own shares of stock, and shares in turn are contracts between the shareholder and the corporation that give 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. All have contractual relationships with the corporate entity. 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.” (If a company is minting cash, its directors have the option of allowing accounting profits to

---

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.

---

increase, but they could also raise executives' salaries, improve customer service, increase employee benefits, or make corporate charitable contributions.) The corporation is its own residual claimant, and its board of directors decides which groups get what share of the corporation's residual.

Finally, the third fundamental but mistaken belief associated with the principal-agent model is that shareholders and directors are just that—principals and agents. Again, this premise is wrong. 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*. Although in theory shareholders have the right to elect and remove directors, in practice the costs of mounting a proxy battle combined with dispersed shareholders' "rational apathy" raises near-insurmountable obstacles to organized shareholder action in most public firms.<sup>15</sup> 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 the ability to sell her shareholdings sometimes can protect a disgruntled individual investor who wants to express her unhappiness with a board by "voting with her feet," when disappointed shareholders in public companies sell *en masse*, they 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 in ways that make it impossible to fit the square peg of the public corporation into the round hole of the principal-agent model. Of course, one could always argue that shareholder powerlessness is exactly the problem that needs to be remedied, and that corporations would work better if shareholders acted more like principals and if directors acted more like shareholders' agents. Yet this argument leaves shareholder primacy dogma at its most vulnerable. 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. That evidence is notably 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

---

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.

---

---

on performance, some found a mild negative effect, and some a mild positive effect. At least one study found that dual share classes greatly improved performance—exactly the opposite of what shareholder primacy advocates would predict.<sup>16</sup>

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.”)<sup>17</sup> 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,

---

This means the idea of a single “shareholder value” is intellectually incoherent, because different shareholders value different things.

---



who typically own shares either directly or through pension and mutual funds. Human beings inevitably have many different values and interests.<sup>18</sup> 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.)<sup>19</sup> 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 many and possibly most are "prosocial," and prefer their companies not earn profits by harming third parties or breaking the law.<sup>20</sup>

This means the idea of a single "shareholder value" is intellectually incoherent, because different shareholders value different things. It also means that business strategies designed to raise share price help some shareholders primarily by hurting others.

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 in the form of dividends instead of retaining 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, it is essential to 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: short-sighted, 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-dimensional 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.<sup>21</sup> 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 to do a perfect job of balancing the competing interests of different shareholders, 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, and abandoning the quixotic and ultimately self-defeating idea that corporate success can and should be measured by a single objective metric, 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,

---

Indeed, decently satisfying several sometimes-competing objectives, rather than trying to "maximize" one, is the rule and not the exception in human affairs.

---


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 to 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<sup>22</sup> 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. Not only does shareholder value ideology fail on inductive grounds, it is riddled with deductive flaws as well, especially its premise that the only shareholder whose values should count is the shareholder who is myopic, untrustworthy, self-destructive, and without a social conscience.

Nevertheless, as described in the Brookings study, shareholder primacy continues to be taught in our nation's law schools, business schools, and economics departments. Meanwhile, firms run according to the mantra of shareholder value cut safety corners (BP), outsource jobs and exploit workers (Apple), and indulge in criminal misbehavior (Walmart). If we want our corporations to perform better for investors and the rest of us as well, we need to re-visit the wisdom of shareholder value thinking.

  
**Governance Studies**

The Brookings Institution  
1775 Massachusetts Ave., NW  
Washington, DC 20036  
Tel: 202.797.6090  
Fax: 202.797.6144  
[www.brookings.edu/governance.aspx](http://www.brookings.edu/governance.aspx)

**Editor**

Christine Jacobs

**Production & Layout**

Stephanie C. Dahle  
Susan Schipper

**Email your comments to [gsccomments@brookings.edu](mailto:gsccomments@brookings.edu)**

The views expressed in this piece are those of the authors and should not be attributed to the staff, officers or trustees of the Brookings Institution.

## Endnotes

- 
- <sup>1</sup> Darrell West, *The Purpose of the Corporation in Business and Law School Curricula* (Brookings, July 18, 2011) [www.brookings.edu/-/media/Files/re/papers/2011/0719\\_corporation\\_west/0719\\_corporations\\_west.pdf](http://www.brookings.edu/-/media/Files/re/papers/2011/0719_corporation_west/0719_corporations_west.pdf), 17-18.
- <sup>2</sup> Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (San Francisco: Berrett-Koehler Publishers, 2012).
- <sup>3</sup> Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New Brunswick, U.S.A. and London: Transaction Publishers, 1991, originally published 1932).
- <sup>4</sup> Adolf A. Berle, *The 20<sup>th</sup> Century Capitalist Revolution* (New York: Harcourt, Brace, 1954) 169.
- <sup>5</sup> Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," Vol. 3, No. 4 *Journal of Financial Economics* (October, 1976) 305.
- <sup>6</sup> Brian J. Hall, "Six Challenges in Designing Equity-Based Pay," 15 *Accenture Journal of Applied Corporate Finance* (2003) 23, cited in Jill E. Fisch, "Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy," 21 *Journal of Corporation Law* 639 n.5 (Spring 2006).
- <sup>7</sup> David Weild and Edward Kim, "A Wake-Up Call for America," Grant Thornton Capital Market Series (November 2009) 1.
- <sup>8</sup> Marjorie Kelly, *The Divine Right of Capital: Dethroning the Corporate Aristocracy* (San Francisco: Berrett-Koehler Publishers, 2001, 2003) 54.
- <sup>9</sup> Delaware General Corporation Law, Section 102 (2011).
- <sup>10</sup> *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).
- <sup>11</sup> *Air Products and Chemicals, Inc. v. Airgas Inc.*, Civ. 5249-CC, 5256-CC (Del. Ch., Feb. 15, 2011).
- <sup>12</sup> *Id.* 92, citing *Paramount Communications Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1990).
- <sup>13</sup> Jensen and Meckling, *supra*.
- <sup>14</sup> Roger Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (Boston, Massachusetts: Harvard Business Review Press, 2011) 11.
- <sup>15</sup> Lucian A. Bebchuk, "The Myth of the Shareholder Franchise," 73 *Virginia Law Review* 675 (2007).
- <sup>16</sup> Renee Adams and Daniel Ferreira, "One Share-One Vote: The Empirical Evidence," 12 *Review of Finance* 51 (2008).
- <sup>17</sup> Roberta Romano, "The Sarbanes Oxley Act and the Makings of Quack Corporate Governance," Vol. 114 *Yale Law Journal* 114 (2005).
- <sup>18</sup> Iman Anabtawi, "Some Skepticism About Increasing Shareholder Power," 53 *University of California Los Angeles Law Review* 561 (2006).
- <sup>19</sup> Lynn A Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance," 23 *Journal of Corporation Law* 635 (2003); John Quiggen, *Zombie Economics: How Dead Ideas Still Walk Among Us* (Princeton, New Jersey and London: Princeton University, 2010).
- <sup>20</sup> Lynn Stout, *Cultivating Conscience: How Good Laws Make Good People* (Princeton and Oxford: Princeton University Press, 2011) 98.
- <sup>21</sup> Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," Vol. 12 *Business Ethics Quarterly* (April, 2002) 238.
- <sup>22</sup> *Business Roundtable et al. v. Securities Exchange Commission*, No. 10-1305 (D.C. Cir., July 22, 2011).