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OWNERSHIP AND THE BUSINESS FIRM: IMPLICATIONS FOR CORPORATE GOVERNANCE AND SOCIAL RESPONSIBILITY

Science vs. Ideology: A Comment on Lynn Stout's New Thinking on "Shareholder Primacy"

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Science vs. Ideology: A Comment on Lynn Stout's New Thinking on "Shareholder Primacy"

Jean-Philippe Robé

Abstract

I have never met Lynn Stout. Of course, just like any person even remotely interested in corporate governance and US corporate law, I know her insightful writings. But I do not know her personally. I know for a fact, however, that Lynn Stout is a nice person. And an excessively nice person she must be. Her paper on New Thinking on "Shareholder Primacy" talks about the surge of a new paradigm in corporate law. This is an excessively generous thesis. For we are not witnessing the takeover of an old science by a new one explaining facts better than the old stuff. We are witnessing the surge of a scientific analysis of the legal structure of the firm -and of the role of corporations to structure firms- which is replacing an ideology; not a science. This comment will comment on this ideology and the insightful critique developed by Lynn Stout in her paper.

KEYWORDS: shareholder primacy, shareholder value, corporate law, corporate governance, corporate social responsibility, agency theory

JEL Classification Codes: G30, G34, M14

I have never met Lynn Stout. Of course, just like any person even remotely interested in corporate governance and US corporate law, I know her insightful writings. But I do not know her personally. I know for a fact, however, that Lynn Stout is a nice person. And an excessively nice person she must be. Her paper on *New Thinking on "Shareholder Primacy"* talks about the surge of a new paradigm in corporate law. This is an excessively generous thesis. For we are not witnessing the takeover of an old science by a new one explaining facts better than the old stuff. We are witnessing the surge of a scientific analysis of the legal structure of the firm -and of the role of corporations to structure firms- which is replacing an *ideology*;[1] not a *science*.

Stout explicitly refers to Thomas Kuhn's *The Structure of Scientific Revolutions*. Kuhn has demonstrated that faulty scientific theories have no difficulty surviving the existence of contradictory facts. Demonstrating that facts do not fit a theory has never been enough to challenge a theory. Only a new (better) theory can replace a (faulty) theory.

Stout therefore implicitly takes the view that shareholder value proponents were on the side of science, promoting a paradigmatic scientific theory, while stakeholder proponents were sentimental leftists arguing using the inappropriate tools of morality, injustice, etc.

There is no question that shareholder value proponents held the higher ground in terms of formalistic justification of their position and that stakeholder theorists have been lacking proper theoretical foundations to back their positions.

But shareholder value proponents do not deserve being treated as the defenders of an outdated scientific theory about to be replaced by a new one. For shareholder value proponents have *never* been scientists in the first place. What they defended -and still defend- is not a scientific analysis: it is an ideology.

In this respect, we have to take them up to their words. One must remind, for example, the predictions of Hansmann & Kraakman in their article on *The End of History for Corporate Law* (noting *in passim* that it certainly took some bravado to use such a title). Hansmann & Kraakman wrote:

[1] In the text of her article, Lynn Stout writes that "… shareholder primacy <u>ideology</u> can keep public corporations from doing their best for either their investors, or society as a whole" [emphasis added]. Stout is thus well aware we are not dealing with two scientific schools of thought trying to be at their best to explain facts. What is at stake is the end of an ideology and the dawning of a dispassionate rational understanding of the firm, the corporation, and the proper rules to abide by in their governance. My hypothesis is that the rules of academic life lead Lynn Stout to show an excessive amount of respect for renowned authorities in corporate law which then leads her to analyze new developments in the research on corporate law as an indication that we are experiencing a change in scientific paradigm. The nice thing, when you have not committed your economic survival to the ruthless world of academia is that you do not need to be … nice. You don't feel like you are breaching some informal rule when you are remembering people the somewhat less than clever things they wrote.

> "The triumph of the shareholder oriented model of the corporation over its principal competitors is now assured. ... the ideological and competitive attraction of the standard model will become indisputable, even [?] among legal academics. And as the goal of shareholder primacy becomes second nature to politicians, convergence in most aspects of the law and practice of corporate governance is sure to follow.[2] […] Moreover, the new activist shareholder-oriented institutions are today acting increasingly on an international scale. As a consequence, their influence now reaches well beyond their home jurisdictions. We now have not only a common ideology supporting shareholder-oriented corporate law, but also an organized interest group to press that ideology."[3] [The question mark and emphasis are mine]

Those of us living on the other side of the Atlantic were reading with a mix of amusement and anxiety that an ideological machine advancing group interests had been put in place to conquer and rule the world. The amusement did not last. They meant business. It was the advancement of *partial interests*, not the furtherance of the general interest, which was advocated. It was *ideology*, not science, which was praised.

And ideology it is. The first version of the fairytale runs like "shareholders own the firm so those who run the firm must obey the owners' orders (they are their 'agents') and their purposes must be to maximize 'shareholder value', *i.e.* today's present value of the share price." Of course, as should be obvious to any lawyer at least half awake, shareholders do not own firms. They own shares.[4] And owning shares does not make of them the firms' owners in any way, shape or form. I will not go into details here as I have done it, for example, in an earlier

[2] Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 Georgetown L. J. 439 (2001), at 468.
[3] *Id.* at 453.
[4] Lynn Stout also agrees that "Shareholders do not own corporations". But she explains this by writing that "corporations are independent legal entities that own themselves". I am not sure about this but I do not think this is right. My own view is that corporations are not owned by anyone. More importantly –irrespective of what could be a very interesting theoretical debate- we do not need to go through this detour to deny the existence of the shareholders' title over the corporation: shareholders own shares. Full stop. But it shows how difficult it is to free oneself from the language of ownership when one thinks about firms and corporations. Irrespective of whether corporations own themselves or not, shareholders don't own them. So the theoretical debate is somewhat irrelevant. On this as well, Lynn Stout is aware of the issue as she wrote that "it is misleading to use the language of ownership to describe the relationship between a public firm and its shareholders"; see Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189 (2001-2002), at 1191.

paper published in this journal.[5] And I will expand on some related issues in a soon to be published other article, also in this journal.[6] Just one ironical comment, though: in a "free market society" an owner is responsible for his acts and things and for the damages they create.[7] But as everybody knows, shareholders enjoy limited liability for the damages created in connection with the firm's activity. Hence the genius of the shareholder supremacists: they treat shareholders as owners of the firm while leaving shareholders isolated from any liability or responsibility deriving from the firm's activities. They advocate a governance system in which the "owners" interests are paramount while these "owners" are not responsible for the "thing" they are deemed to own and the damages it can generate. "Corporate governance", as they advocate it, is based on the exact opposite of one of the pillars of a "free market society": the self-proclaimed advocates of a "free market society" have created irresponsible owners! We should all pause with admiration.

The second version of the fairytale runs like: "in a free market society, businessmen's job is to create value and political institutions allocate its use; businessmen doing anything else but maximize value (meaning 'shareholder value'; meaning in turn the present value of the shares) act as 'politicians', raising taxes on various constituents with no political mandate to do so. They undermine the institutions of a free society".

This version of the charade is based on two assumptions. The first is that the contracts linking the contributors of resources to the firm via the business corporation are assumed to be perfect, *i.e.* they are assumed to perfectly represent the informed agreement of equal parties; and the second is that we live in a perfect normative environment that integrates "social" demands and, in particular, internalizes in the cost of producing goods and services (and thus, ultimately, in prices), via mandatory norms (laws, regulations, taxes, etc.) all the "negative externalities". The first assumption does not correspond to reality but it does make some sense as it treats all of us as responsible individuals to be held accountable for their acts, including the contracts they execute. But the second one is absurd: it implies the existence of political institutions operating perfectly in a totally closed political and economic system. Has anybody ever encountered such an institutional setting?

These two fables can be traced back to Friedman's (in)famous 1970 article[8] and their fortunes (and our misfortunes) have been enormous. A

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[5] "The Legal Structure of the Firm", *Accounting, Economics, and Law*: Vol. 1: Iss. 1, Article 5, Available at: http://dx.doi.org/10.2202/2152-2820.1001.
[6] "Being Done with Milton Friedman", *Accounting, Economics, and Law*, forthcoming (2012).
[7] Milton Friedman, "The Social Responsibility of Business is to increase its Profits", *The New York Times*, September 13, 1970.
[8] *See supra*, note 7.

convergence with common sense and the scientific varnish of mathematical formulas accompanying elegant curves led even the brightest legal minds to write sentences like: "... the classic agency problem ... goes to the heart of corporate law ...: how do <u>principals</u> -the shareholders- ensure that their <u>agents</u> -the managers- behave faithfully".[9] But shareholders are not the managers' "principals": the "corporation", as an autonomous legal person, is; and the managers are not their "agents": they act on behalf of the corporation and not of the shareholders. And there is a difference between the interest of the shareholders and those of the corporation. Guess why? Precisely because shareholders have limited liability. Those advocating the opposite, *i.e*. that there is no difference between the corporation's interests and those of the shareholders should be coherent and hold shareholders responsible for their "property". Of course, would they do this, they would lose the numerous benefits of using corporations to legally structure businesses. But it is not possible to have it both ways, as shareholder value proponents have succeeded so far, with the logical disastrous consequences which ensued. The class of "irresponsible owners" which has been created can force the taking of excessive risks and the creation of massive negative externalities. They ripe the profits deriving from irresponsible firm management but are not accountable when consequential disasters, in their many forms, make their appearance. If shareholders want to be owners of businesses and do whatever they want with them, they are fully entitled to make this choice. But then they have to accept unlimited liability for the consequences. With limited liability, the only thing they own are the shares issued by the legal person used to structure the business (the corporation); the shares isolate them from the corporation's and the firm's misfortune and, as a consequence, the business cannot be run as if it were their property. This is the reason why they end up being isolated from the firm's management, that directors -who are not their agents- get involved to oversee management, which cannot look after the maximization of their sole interests

One of the proponents of shareholder value maximization, Jean Tirole, has actually recognized that "shareholder-value maximization is … very much a second-best mandate [and] in view of some imperfections in contracts and the laws, extremist views on shareholder value are distasteful."[10] His intellectual honesty (although I still struggle with the notion of what it means to be "very much second best" and what you do with "distasteful views") brings us back to

[9] Roberta Romano, *Foundations of Corporate Law* 85 (1993), emphasis added. *See also* Jensen & Meckling for whom "Since the relationship between the stockholders and manager of a corporation fits the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency..."; in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, J. Fin'l Econ. 305 (1976), at 309-310.

[10] Jean Tirole, *The Theory of Corporate Finance*, Princeton U. Press (2006), at 61.

square one in terms of scientific understanding of the firm and of the role of the corporation and of corporate and firm governance –not square "two" as Stout generously puts it when she considers that we are shifting gears and changing scientific paradigm.

For Stout, the Great Debate turns over the "proper purpose of the public corporation". In the early twentieth century, "managerialist" views had the upper hand: there was at least one school of thought (Merrick Dodd, for example) who considered that "corporations" should be run in the interests of not just shareholders but also other stakeholders. But not much guidance was given as to how conciliating the various interests involved. Then came the Chicago school of economics and shareholder primacy theories (under the guise of "agency theory"): the proper role of corporate governance is simple: let's make irresponsible-owner-shareholders as wealthy as possible. Stout's criticism is that (a) this is actually contrary to corporate law, (b) business promoters go the other way in the legal structuring of businesses; and (c) the theory assumes shareholders all share only one value –maximizing today's share value. She develops the idea that shareholders' interests are actually not that different from stakeholder's interests and that the difference between the two theories is slowly fading away.

Five alternative new theories (or perhaps hypotheses) would evidence the emergence of a new paradigm against shareholders primacy:

(1) The idea that the market for shares is "fundamental value efficient" is false. I'm not quite sure this idea deserves the title of "theory" as the notion should be quite obvious: if markets for shares were efficient, nobody would be making a buck on Wall Street. Equity markets are normally good at providing liquidity; but that's about it.
(2) Capital lock-in is essential. This is quite right. But it only emphasizes that shareholders are not owners of the firm or the corporation and certainly not of the corporation's assets because it is precisely essential to have an autonomous legal person to own these assets, isolating the shareholders from them, from the business and from its management. But one cannot derive from this how firms should be managed as a consequence.
(3) Then there is the "team production theory" of the corporation: shareholders are not the only ones whose resources can be converted into "firm-specific assets". Other members of the "team" also do it and have to be induced to make such investments. As a consequence, shareholders reassure the other "stakeholders" by ceding control to a Board of directors. This is an interesting theory but there are several problems with it. The first one is that in a firm structured using a listed corporation, shareholders are simply not part of anything which can be called a "team". It might be different for a *controlling* shareholder, but it is not the case for a minority

shareholder buying a couple of shares and reselling them a few seconds, hours, weeks or even years after. In the meantime, this shareholder has done *nothing* for the firm. He has never been a member of the team. Again, it might be different for a controlling shareholder; but not making the difference between "a" shareholder and "a controlling" shareholder is a killer for the team theory of the firm. Also, shareholders do not actually invest in "firm-specific assets". Corporations do, through internal and external sources of financing, share issuance included. And in terms of contribution, one should differentiate between the *primary* and the *secondary* markets for shares. It is only on the *primary* market for shares that shareholders contribute *something* to the corporation (assets or cash) which will then be used in the operation of the firm. The assets might be "firm specific" or the cash might be converted into "firm specific assets". But in exchange for their contribution, *the shareholders get liquid shares they can immediately and at all times convert into cash*. The (small) shareholder of a public corporation benefits from something most of the other contributors of resources do not have: liquidity. In a sense, the shareholder is the contributor of resources invested in one of the less "firm specific assets" of all: shares freely transferable on an organized market. Not so good for the "team production theory". But things get even worse when one considers the *secondary* market for shares. A shareholder buying shares on the secondary market is of course no more a member of the "team" than a shareholder active on the primary market. But in addition, the shareholder buying on the secondary market does not contribute *anything* to the firm or the corporation: he only pays a price to a selling shareholder and the corporation or firm gets *nothing*. Just like Ferrari S.p.A. is not getting anything when the inheritor of a 1962 GTO makes 20 million dollars when selling daddy's car purchased 18.000 dollars at the time.

(4) and (5) The last two alternative theories (the fact that a universal investor suffers from an excess of negative externalities and the fact that there are prosocial shareholders) are of course interesting in that they give a richer view of the ideal-type shareholder who is not always the maximizing psychopath shareholder supremacy theorists have in mind. But the jury is still out on the importance of these factors.

If one really wants to conduct a scientific analysis of the firm and corporate governance and put the "Great Debate" into its proper perspective, one in fact has to start with this difference both economists and lawyers, willingly or not, avoid making: the *firm* is not the same thing as the *corporation*. The persistent confusion between the two is mind boggling because it is only by making the distinction that one can start thinking straight. In this perspective, the issues and new theories presented by Stout in her article are very relevant but should be put in a broader perspective.

The firm (or enterprise) -not to be confused with the "corporation"- is an organization within which power is exercised to coordinate the production and/or distribution of goods and services. It is legally structured using a network of contracts and other legal arrangements connecting resource holders to the corporation and, in the case of large firms, to the various corporations forming part of the group of corporations used to legally operate the firm. Lynn Stout wrote it: "Shareholders alone cannot make a firm –creditors, employees, managers, and even local governments often must make contributions in order for an enterprise to succeed."[11] That's right. But all these contributors of resources are not "part" of the corporation. They have contracts with it or are in its legal environment. In large firms, the key assets used by the firm are owned by legal fictions or devices having legal personality *i.e*. corporations. The corporation has to be used to own the key assets and to be the counterparty to the other providers of resources to the firm for a wealth of reasons explained elsewhere.[12] But what is key to understand in any case is the fundamental difference between a "firm" and a "corporation". The firm is an organization. It has no existence at law as a separate legal person. The corporation, in contradistinction, is a legal instrument which is granted "legal personality". It is used to legally structure firms. It is entitled to operate in the legal system by owning, contracting, suing and being sued; and it is subject to the laws and regulations of the legal system. The firm is none of this. It is neither a legal object nor a legal subject. Having no legal existence as such, it does not operate in the legal system and does not buy, sale, lease, rent, etc. anything. The (large) firm, as an organization, can do all these things only through the corporation(s). The corporations are the legal persons which will have the ownership of the assets, capital, contracts, etc. required for the firm's operations.

Then the real issue is the management of the *firm* which includes what the managers can do with the corporation's assets. If we take the large firm legally structured using a corporation having issued listed shares, the corporate structure (usually a group of corporations) is nothing more than the legal backbone of the firm. The CEO of the holding entity has two very different roles. His most important role is to manage the *firm*, not the corporation, which is not "managed" and is only a legal device to collect, and serve as a vehicle to control, legal entitlements and resources required for the firm's operations. The CEO is at the head of the "team" which operates the firm. And the team does not comprise the (non-controlling) shareholders and not even the non-executive directors. The CEO

[11] Stout, *supra* note 4, at 1195.
[12] *See supra*, note 6.

fulfills his role with a management team which can use fiat thanks to the authority obtained via the contracts executed with the resources holders' whose contribution has been contracted for in connection with the operation of the firm. The firm uses capital (real assets). To buy them, it either borrows or gets equity contributions. That's the role of shareholders active on the primary market for shares. And the shareholders appoint directors to control and supervise management. But shareholders (as such) are not members of the firm. They have made no investment in "firm specific assets" (not more than any American citizen purchasing Euros prior to touring Europe in 5 days would be making an investment in a "European specific asset"). Management (not directors or shareholders) is at the center of the matter. This is because managers (not directors or shareholders) exercise fiat, power and authority towards a wealth of contributors to the firm, using capital and assets in part supplied by shareholders.

The CEO and his team have duties towards the corporation and its shareholders. The reason is simple: they are not managing the firm using their own money. They should not steal, seize corporate opportunities for themselves, etc. and it is the duty of the Board of directors to check that such is the case. This is "corporate governance" in the proper sense of the word. But the remaining question is whether in the *firm* management, in the management of the team of contributors who may have made "firm specific" contributions, they also have duties towards (a) constituents of the firm (which do not comprise shareholders or directors) as well and (b) the natural and social environments. If one looks only at the corporation, which involves executives, directors and shareholders, this is in a sense somewhat irrelevant. But if one looks at the economic organization which really matters (the firm) and which is run by the corporate executives, under the direction and supervision of the Board, the question becomes very important. In connection with the management of the *firm*, managers may very well have *additional* duties towards the *firm's* constituents and its environment. And directors may need to verify they are fulfilling these duties *as well*. And shareholders (at least *controlling shareholders*) may very well have a duty *not to prevent* management from fulfilling their duties in this regard. Or else take the risk of losing their limited liability. But to properly think about these issues, one needs to make the paradigmatic shift of understanding the difference between the firm and the corporation. None of the prevailing theories of the firm (the nexus of contract approach,[13] the property rights analysis of the firm,[14] the firm as a team,[15]

[13] For Fama, "The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs"; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980) at 290; for Fama & Jensen "an organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers"; Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, J. L. & Econ. 301, 302 (1983). *See also* Harold Demsetz, *The Theory of the Firm*

the firm as a nexus of firm specific investments,[16] the firm as a collection of assets[17]) does this.[18]

The message to shareholder supremacists is therefore not: “hey, watch out, we’ve improved the rigor of our analysis and we are really not worlds apart because we are converging towards a new paradigm”. The message is: “sorry grandpa, the era of ideology is over”. “Collectivism” is over but the myth that we are living in a “market society” is over too. We are in fact living in a society of large organizations, of “private” governments, often effective on a world scale. These organizations have powers which affect individuals, society and the natural environment. They are not “owned” and cannot be thought about in terms of ownership and individuals’ autonomy in the pursuit of their personal ends. They have to be thought in terms coherent with what they are: organizations exercising power. State power has historically been made subservient to rules to protect individuals and society from it. Now is the time to think about protecting individuals and society -and the natural environment- from all the organizations having power; and that includes first and foremost firms.

Yes, one may hope that a new scientific paradigm is emerging. But it is not replacing an old fashioned scientific analysis. It is putting an end to an ideological manipulation of concepts to foster special interests in the governance of the firm. It requires stopping making a classical but disastrous confusion between the concepts of “firm” and “corporation”. Only then can we start thinking about the real new topic of interest in the “Great Debate” which is “firm”, as opposed to “corporate”, governance.

For economist, the new paradigm will force them to give up the idea that we live in a market economy: the firm is an organization which cannot be reduced to a set of contracts, or of property rights, etc.. For lawyers, it will force them to give up the idea that State law is the only form of law: the firm is a “legal order”

Revisited, J. of L. Econ. & Org. 141 (1988). As noted by Zingales, one of the major shortcomings of this approach is that it is unable to explain why firms merge at all. If the firm is simply a collection of contracts, the results achieved through a merger could be more simply obtained by writing a contract combining the two separate firms. *See* Luigi Zingales, *In Search of New Foundations*, J. of Fin. 1623, 1637 (2000).

14 *See* Jensen & Meckling, *supra*, note 9.

15 *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 Am. Econ. Rev. 777 (1972).

16 *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, Virginia L. Rev. Vol. 85, No. 2 (1999).

17 *See* Sanford Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, J. of Pol. Econ. 691 (1986) (they “define a firm to consist of those assets that it owns and over which it has control”; *see* at 693) and Oliver D. Hart & John Moore, *Property rights and the Nature of the firm*, J. of Pol. Econ. 1119 (1990).

18 *But see* Yuri Biondi, Arnaldo Canziani & Thierry Kirat (eds.), *The Firm as an Entity – Implications for economics, accounting and the law*, Routledge (2007).

creating its own mandatory internal rules. For political scientists, it will force them to analyze the firm as a political institution and they have no clue how to do this.

In the meantime, Stout -who is *that close* from having made the paradigmatic shift- is right: it would be nice indeed to refrain from exporting damaged goods.

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