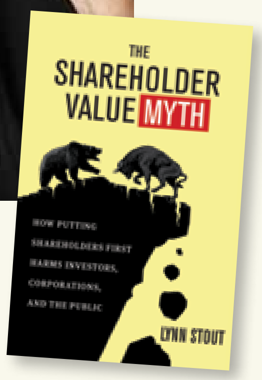
SHAREHOLDER VALUE: A MYTH?

Corporate governance expert **Lynn Stout** discusses why the shareholder value movement is an alarming mistake.

By Matt Brusch

Professor Lynn Stout



"Shareholder value is the dumbest idea in the world."

This quote from former shareholder value proponent and former GE CEO Jack Welch is the title of the introduction to **The Shareholder Value Myth,** a provocative book by Lynn Stout, distinguished professor of corporate and business law, Clarke Business Law Institute, Cornell Law School.

Attendees at the 2013 NIRI Senior Roundtable were fortunate to hear Professor Stout's arguments for debunking "the shareholder value myth" in her session on that topic. *IR Update* chatted with Professor Stout following her session to learn more.

IRU: Why did you write this book?

Stout: I wrote the book because I've come to the conclusion that running a company strictly to maximize shareholder value as measured by share price is harmful to shareholders. There is alarming evidence to support this, and we've all seen it.

American companies are disappearing. There are 50 percent fewer publicly held companies than 15 years ago. The life expectancy of large corporations has declined – from 75 years in the 1920s (for Fortune 500 companies), to 15 years today, and falling. ROI, by many measures, has seriously declined over the past 20 years. So this says to me that embracing shareholder value has not led to better results for shareholders as a class over time.

I believe that shareholder value thinking leads management teams to focus primarily on quarterly results, and discourages the type of research and development and capital investments necessary for long-term corporate health. I contend that the shareholder value doctrine jeopardizes employees, consumers, and our communities as well.

This is all critical in understanding that the notion is false that corporations ought to be run to maximize shareholder value.

IRU: It is quite a leap from suggesting that shareholder value isn't necessarily the best business strategy, to declaring that it is false. Aren't boards required by law to maximize share price?

Stout: This is a hard pill for many of us to swallow because shareholder value is a cherished myth, as you've just reiterated, but it *is* false.

U.S. corporate law does not, and never has, required corporations to maximize either share price or shareholder wealth. As such, boards are not required to maximize share price or profits.

Proponents typically cite *Dodge v. Ford Motor Company* as the case law supporting shareholder value. This nearly 100-year old case -- from a state that is relatively unimportant in corporate law (Michigan) -- is actually not even about corporate purpose. In fact, the state that *does* matter in corporate law – Delaware – has never cited *Dodge v. Ford* with the proposition that boards must maximize profits and share price.

In more recent cases, Delaware courts have held that, under normal circumstances, the "business judgment rule" applies to board decisions, and the business judgment rule gives directors wide latitude in their decision making. Shareholder value maximization is a choice, not a legal requirement.

The argument that this is the best way to run companies from an economic perspective is also wrong. To grasp this, you must understand that shareholders don't own corporations. I know that based on what we've all been taught it sounds like heresy, but U.S. law states that, in fact, corporations are legal entities that own themselves.

The Supreme Court's 2010 *Citizens United* decision correctly reminded us of this. Corporations own themselves, and the profits earned belong to the corporate entity, not the shareholders. Shareholders simply own a contract between themselves and the corporation.

Many also believe that shareholders are the corporate principals and directors are their agents. This is legally incorrect. Shareholders do not get to control directors, and such control is one of the hallmarks of a principal-agent relationship. Corporate law is very clear that shareholders cannot tell directors how to run the firm.

Another mistaken assumption is that shareholders are the residual claimants in corporations, meaning they are entitled to all profits after the business has met its basic legal obligations. The bottom line here is that the corporation (rather than the shareholder) is its own residual claimant, and the board may exercise its discretion in determining what to do with the corporation's residual.

This is an *extremely* abridged version, and I encourage anyone interested to read the book for a more comprehensive discussion.

IRU: What led to this movement?

Stout: It hasn't always been this way. To be sure, since the birth of U.S. public companies in the early 1900s, there has been a debate over the proper purpose of

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these corporations. On one side are "shareholder primacy" proponents who hold that publicly held corporations should serve only the shareholders' interests, and directors and executives should focus solely on maximizing shareholders' wealth through dividends and higher stock prices.

On the other side are those with a "managerialist" view who believe that corporations have a broader social purpose beyond simply maximizing shareholder wealth, a purpose that includes serving the interests of other stakeholders such as customers, employees, and society as a whole. The managerialists had the upper hand in the first half of the 20th century.

But in the 1970s, prominent members of the so-called Chicago School of free-market economists began again arguing loudly for shareholder primacy. As others began piling on, the movement took hold across academia, business schools, government regulators, and ultimately, corporate boardrooms.

This thinking has been very influential over the last 20 years. Everyone's been taught shareholder value maximization, and we've changed the law and business practice to move in that direction. For example, Congress changed the tax code to require executive pay to be tied to an objective metric, and everyone picked stock price as that metric. The U.S. Securities and Exchange Commission (SEC) has implemented a number of changes designed to give shareholders more power over boards and make it easier for them to cooperate with each other to vote. We've also seen corporate boards and management teams embrace shareholder value ideology over this period.

So, as a result, we should be seeing more corporations that are more profitable, people flocking to the United States to form companies, and investors experiencing higher returns, right? The reality is that we are, unfortunately, left with the very disturbing real-world results that I've already described.

IRU: How do you recommend we fix this situation?

Stout: Corporate boards and management teams must move beyond a single-minded focus on share price. The assumption that raising the stock price will please all shareholders is a fallacy because it assumes that all shareholders have the same objective. Investor relations professionals know, possibly better than anyone else, that this is not true. Just as there is no single investment style or investment objective, there is no single metric (i.e., stock price) by which management teams should be measured.

The award-winning documentary, *The Corporation*, argued that because corporate managers believe they must maximize shareholder wealth, a corporation is a "psychopathic creature" that can "neither recognize nor act upon moral reasons to refrain from harming others." Now, some investors may be psychopaths who aren't concerned if corporations engage in behavior that exploits child labor, deceives consumers, harms employees, pollutes, and so forth, in order to generate a superior stock price, but scientific data actually indicates that the vast majority of us would tolerate slightly lower returns in order to avoid these intolerable social outcomes.

So boards should recognize and rely on the discretion that corporate law grants them in running corporations. Use this discretion to focus on the long term as well as the short term, and make decisions that factor in all of the firm's stakeholders. *All* stakeholders ultimately contribute to the corporation's success, and its enduring value.

IRU: You made an interesting observation regarding Congress, the SEC, and a variety of "private policy entrepreneurs," that their governance reform efforts have failed to make improvements for all shareholders.

Stout: These groups are part of the problem and must, therefore, be part of the solution. I believe it is a mistake to react to every corporate scandal with another layer of regulation intended to "improve" corporate governance by making directors and managements more "accountable" to certain shareholder demands.

As your readers know, over the last 20 years, these groups have enacted changes that, in totality, have pushed corporations to focus on shareholders and shareholder wealth maximization. The result of this "shareholder democracy" movement has been broadly lower shareholder returns.

Many of these "reforms" certainly seem to benefit specific investor types (especially undiversified activist hedge funds), but ultimately do not benefit all shareholders as a class. I would also note that the U.K. is further down the "shareholder democracy" road than we are, and investment returns there are worse than in the United States.

IRU: Who are these private policy entrepreneurs? ISS? They certainly exert a strong influence. What would you counsel companies to do in the face of their pressure? Corporate boards dismiss them at their peril.

Stout: ISS has influence because many mutual fund managers vote their shares based on ISS polices, which are biased toward the short term.

If executives, and especially boards of directors, want to truly promote "shareholder value," they need to embrace the discretion that corporate law grants them to use their power and authority to mediate among the various (and often conflicting) views of shareholders. This is preferable to a board slavishly responding only to the concerns of the most short-sighted, opportunistic, and undiversified subset of shareholders.

IRU: What is the investing community's responsibility in this?

Stout: Investors need to move beyond the mindset that anything that raises stock price is necessarily good for all investors. The new scholarship on the nature and purpose of the corporation severs this supposed linkage. Short term, temporary stock price increases do not necessarily help all investors, and there is reason to believe that such strategies ultimately hurt the investing class a whole.

I also believe investors' stock holding periods are too short, so a change to the tax code to increase capital gains from one year to maybe seven years would be helpful.

IRU: What else can be done to address the issues you've raised?

Stout: I would also advocate for more academicians to take up this cause because business leaders can't fix this by themselves.

IRU: It feels like your book refutes most of what business schools have taught over the past 20 or 30 years about ownership of publicly traded companies. If it is all wrong, why haven't we heard more about it?

Stout: It's more pervasive than just business schools. I learned in law school in the early 1980s that the purpose of corporations is to maximize shareholder value. And schools continue to teach it. But there are other academics supporting my position, and there are more articles in the press questioning this dogma.

I think that a rising generation of business and legal scholars don't buy shareholder value thinking. However, the concept is still fairly ingrained in business and law schools, and there is a saying in academia that 'academic change comes one funeral at a time.' So significant change will probably take some time.

IRU: What do you see as the implications for investor relations professionals?

Stout: IR has an opportunity to help evangelize this message throughout its sphere of influence. IROs can also help shareholders understand that there is more to the company than tomorrow's share price.

But the biggest obstacle I see is ISS, whose out-of-date corporate governance ideas lead mutual funds and other investors to focus on short-term stock price performance. For instance, ISS routinely recommends that corporations de-stagger their boards to make hostile takeovers easier, and has historically supported pay-for-performance schemes linking executive compensation to share price.

Executive compensation is also a real problem. As long as 80 percent of executive comp is tied to stock price, it will be hard to fix. We've basically aligned management incentives with activists' interests. IRU

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