Book Review Symposium on “Shareholder Value Myth” by Lynn Stout

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The Troubling Question of Corporate Purpose

Abstract: What is the purpose of the corporation? This fundamental question has troubled generations of corporate scholars. It troubles them still, as witness the thoughtful and thought-provoking pieces by Thomas Clarke, Faith Stevelman and Olivier Weinstein gathered together in this issue of the CONVIVIUM. In this brief essay, I do not comment, in any detail, on Clarke’s, Stevelman’s, or Weinstein’s articles. Rather, I seek to defend their work, and my book as well, from the predictable charge that we have not offered a common theory of corporate purpose to “beat” shareholder primacy theory. In doing this, I exercise the lawyer’s prerogative and defend against the “it takes a theory” accusation by arguing in the alternative. First, I argue that sometimes a theory can be so misleading that it should be abandoned, even if no good alternative is available. Second, I argue more tentatively that there may be in fact a superior alternative theory of corporate purpose implicit in the literature critiquing shareholder primacy, including the articles by Clarke, Stevelman, and Weinstein. This theory, which might be dubbed the multifunction theory, recognizes that the corporation is only an organizational form, a means that can be (and is) employed by different individuals to serve different ends. Clark, Stevelman, Weinstein, and I have all at different times adopted slightly different perspectives on what the ends of the corporation ought to be. We may all, from our own perspectives, be correct.

Keywords: corporate governance, theory of the firm, corporate law, corporate social responsibility, shareholder value

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1 Introduction

What is the purpose of the corporation? This fundamental question has troubled generations of corporate scholars. It troubles them still, as witness the thoughtful and thought-provoking pieces by Thomas Clarke, Faith Stevelman and Olivier Weinstein gathered together in this issue of *Convivium*.

Many legal experts, especially those who cut their academic teeth during the heyday of the law-and-economics school in the 1980s and 1990s, believe that the only proper purpose of the corporation is to “maximize shareholder value.” I argue against this notion in my 2012 book *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Stout, 2012). Clarke, Stevelman, and Weinstein share my skepticism. They, and I, are a part of a growing minority (perhaps now approaching majority) of corporate experts who question the empirical validity of the assumptions that underlie the conventional “shareholder primacy” approach to understanding the corporate purpose. These questionable assumptions include: that shareholders either own or are the sole residual claimants of corporations; that shareholders are principals who benefit from being able to control their director–agents; that the law requires directors to maximize “shareholder value;” that shareholder value is fully captured in the market price of the company’s stock; and that external costs can be adequately controlled through norms and regulation. Clarke, Stevelman, and Weinstein each question some or all of these assumptions, and each conclude (as have I) that the view that corporations should be run only to maximize shareholder value lacks good support from law, history, logic, economic theory, or the available empirical data.

But what is missing, both from my book and from the articles by Clarke, Stevelman, and Weinstein, is a shared alternative account of what the purpose

of the corporation *ought* to be, if not to maximize shareholder value. To be sure, there are common themes in my work and in Clarke's, Stevelman's, and Weinstein's. These themes include but are not limited to: the dangers of believing in a single shareholder value when shareholder interests are heterogeneous; the economic importance of recognizing the interests of stakeholders like employees, suppliers, and consumers; and the problem of controlling external costs and ensuring corporations act in a socially responsible fashion. But it is fair to say that someone who reads my book and these articles will not immediately see a unified and overarching theory of corporate purpose to compete with "maximize shareholder value."

This apparent lack of a unified theory leaves our collective critique of the shareholder primacy approach open to the charge that we have failed to supply a clear alternative. Legal scholars, especially those of a law-and-economics bent, sometimes say "it takes a theory to beat a theory."¹ Defenders of shareholder value thinking might similarly argue that shareholder primacy remains the best approach to understanding corporate purpose, because no widely accepted alternative theory has arisen to replace it.

In this brief essay, I do not comment in any detail on Clarke's, Stevelman's, or Weinstein's articles. Rather, I seek to defend their work and my book as well from the predictable charge that we have not offered a common theory of corporate purpose to "beat" shareholder primacy theory. In doing this, I exercise the lawyer's prerogative and defend against the "it takes a theory" accusation by arguing in the alternative. First, I argue that sometimes a theory can be so misleading that it should be abandoned even if no good alternative is available. Second, I argue more tentatively that there may be in fact a superior alternative theory of corporate purpose implicit in the literature critiquing shareholder primacy, including these articles by Clarke, Stevelman, and Weinstein. This theory, which might be dubbed the multifunction theory, recognizes that the corporation is only an organizational form, a means that can be (and is) employed by different individuals to serve different ends. Clark, Stevelman, Weinstein, and I have all at different times adopted slightly different perspectives on what the ends of the corporation ought to be. We may all, from our own perspectives, be correct.

¹ Dan Farber has described this aphorism as "the last ditch defense" of rational choice theory (Farber, 2001).

2 It doesn't always take a theory

Let us return to the scholarly aphorism that “it takes a theory to beat a theory.” Taken on its own, this phrase begs a rather obvious question. Beat it at what?

The human mind has evolved to seek out patterns in data, to the point where people often see patterns that aren't really there (Shermer, 2000). As a species we find uncertainty disquieting; we are primed to want to understand the world around us, and uncomfortable with simply “not knowing.” This explains how a theory with no empirical validity may be widely accepted as an explanation for some phenomena, for no other reason than that it is widely accepted and it explains. Thus, in many parts of the world at different times, the theory that witches caused disease “beat out” having no theory about what caused disease. This was not because witches actually caused disease. It was because it was psychologically more comforting to have a bad theory about what caused disease, than no theory at all.

But are widespread acceptance and psychological comfort all we should look for in a theory? If we want our theories to guide our decisions in helpful ways – if we want them to be useful – then we must recognize that sometimes a bad theory is worse than no theory. This is because a bad theory guides behavior in destructive directions. Assume, for example, we want a theory about what causes disease so that we can reduce morbidity and mortality. During the Middle Ages, the belief that witches cause disease sometimes led to the torture and execution of people thought to be witches. The result was a higher level of human morbidity and mortality from having a bad theory of disease, than would have prevailed had there been no theory of disease at all.

It doesn't take a theory to beat a really bad theory. A really bad theory can beat itself, because following a really bad theory leads to bad results.

As an empirical matter, it should be obvious that the business world's embrace of shareholder value maximization as a theory of corporate purpose over the past two decades has not been accompanied by any notable improvement in corporate performance for shareholders (or anyone else for that matter, except perhaps a few CEOs and hedge fund managers). To the contrary, at least in the United States, the shift to what Ed Rock dubs the “new shareholder-centric reality” (Rock, 2013), has been accompanied by reduced investor returns, diminished corporate life expectancy, and a declining population of public corporations in which shareholders can invest (Stout, 2013). Of course, this correlation does not prove in any statistical sense that embracing shareholder primacy theory caused these unfortunate results. Probably no statistical proof is possible, given the small sample size and large number of variables involved. But it should at least prompt us to hesitate before assuming shareholder primacy must be a good theory, simply because it is a theory.

3 The multifunction corporation

The reader may recall, however, that I am arguing in the alternative against the “it takes a theory” defense of shareholder primacy. Thus, let us put aside for the moment the question of whether it takes a theory to beat a (really bad) theory, and simply assume it does. Shareholder primacy still is under threat. This is because the work of shareholder primacy critics like Clarke, Stevelman, and Weinstein suggests, somewhat indirectly, an alternative and possibly superior model of corporate purpose. This alternative is the model of the corporation as a multifunctional tool, an organizational form that can be put to different uses.²

As already noted, the factual assumptions used to justify adopting maximizing shareholder value as the only proper corporate goal – like the assumptions that shareholders “own” corporations and are their sole residual claimants, that stock market prices always capture long-term value, that externalities can be controlled through norms and regulation, etc. – are not empirically accurate. What is indisputably accurate, at least as a positive matter, is that the corporation is an organizational form that can be legally employed (as the vast majority of modern corporate codes and individual corporate charters quite clearly state) to do “anything lawful.”

This observation suggests that the corporate form may be something like a Swiss army knife; a tool that can be employed by different people to serve different purposes. History teaches as much. In the United States, during most of the twentieth century and especially during the “managerialist” era before the 1980s, many business leaders viewed the corporation from a stakeholder perspective, believing firms should serve not only shareholders but also customers, suppliers, employees, and the nation (Davis, 2009). During the eighteenth and nineteenth century, corporations were often formed to serve the consumer interests of shareholders who were also customers or beneficiaries of corporate infrastructure projects like railroads, bridges, and highways (Hansmann & Pargendler, 2013). These early firms were organized not to maximize profits but to provide goods and services at a reasonable cost. Today, highly centralized nations like China and Malaysia view many business corporations as extensions of the state whose primary purpose is to advance the state’s interests.

In other words, just as the purpose of a Swiss Army knife depends on the purpose of the person who picks it up and wields it (is the knife user trying to open a bottle, drive a screw, or cut off a piece of cheese?), the purpose of the

² I owe this clear expression of the basic idea of the multifunctional corporation to Judy Samuelson, director of the Aspen Institute Program on Business and Society.

corporation will vary, depending on the perspective of the different individuals who interact with it.

Consider, for example, the different purposes a company's founders might have in mind when first incorporating the firm and purchasing equity shares. Some individuals who create corporations may simply want to maximize their own future investment income. But as already noted, in the eighteenth and nineteenth century, many corporations were founded by what were essentially consumer groups seeking to ensure access to certain goods and services. And eponymous corporations – Ford, Hewlett-Packard – suggest some founders seek not only money but recognition.

Even if we look only at the intentions of a company's founders, we cannot safely assume that “maximizing shareholder value” is necessarily the only thing they had in mind. But there is no reason we should limit the purpose of the corporation only to the purposes of its founders. (If this is not obvious while the founders are living, it surely becomes obvious after they are dead.) A thriving company requires support not only from those who purchase its equity, but also from the citizens of the state that provides the law of incorporation, the employees who work for the corporation, and the consumers who buy its products. Other groups may not contribute to the company in any obvious fashion, but find their welfare nevertheless affected by the company's actions. As a result, each of these interest groups has its own, quite legitimate, perspective on what the purpose of the company ought to be. Citizens may want companies to pay taxes and contribute to economic growth. Employees may want corporations to provide a return on their own investments in firm-specific human capital. Consumers may want them to produce quality products at a reasonable price. Local populations may want them to avoid activities that cause environmental degradation.

In my book *The Shareholder Value Myth*, I deliberately embrace the perspective of the long-term, diversified, prosocial equity investor in judging the question of corporate purpose. But as Clarke, Stevelman, and Weinstein correctly point out at various points in their work, one could also judge the purpose of the corporation from the perspectives of voters concerned about its role in the political system, employees worried about their employment prospects, or populations threatened by environmental degradation. Each of these groups has its own preferences about what the corporation should do. Sometimes these preferences are in harmony: for example, when a company pleases consumers by producing quality products that earn profits, this can benefit investors and employees as well. Sometimes these preferences conflict: violating environmental regulations can harm local populations while benefiting shareholders. But each group's interests are real interests that can be promoted, or harmed, by the corporation. As in Einstein's theory of relativity, how one perceives the purpose

of the multipurpose corporation depends on the perspective from which one interacts with it.

4 Conclusion

The analysis above leads us to the primary puzzle posed by a multifunction theory of corporate purpose. Once we acknowledge that the corporate form can be used to satisfy the preferences of many different groups that either contribute to or are affected by corporations, what are we to do when different groups have different preferences for how the corporation should behave?

One of the most appealing, if sometimes unacknowledged, benefits of adopting “maximize shareholder value” as a theory of corporate purpose is that it neatly evades the difficult issue of how to resolve conflicts among the preferences of different groups who care about what corporations do. It accomplishes this by using the intellectual shortcut of assuming only shareholder preferences count – and only the preferences of the most short-term, undiversified, opportunistic, and asocial subset of shareholders, at that.

A multifunction theory of corporate purpose requires considerably more cognitive work, much of which remains to be done. *The Shareholder Value Myth* makes a somewhat modest contribution to that project by suggesting that at the very least, our theory of corporate purpose should permit directors to make long-term investments, and pursue prosocial policies that may depress today’s share price but ultimately benefit most investors as well as employees, customers, and society. This approach in some ways echoes the Pareto criterion, which judges an action to be superior if it benefits at least one person while harming no one.³ In its pure form, the Pareto criterion is too strict to be of much use in the corporate context. *The Shareholder Value Myth* makes a weaker version of the Pareto move by suggesting that corporate policies that benefit the vast majority of shareholders, as well as millions of employees, suppliers, customers, and communities, are preferable to shareholder value-oriented policies that benefit only a handful of CEOs and hedge fund managers.

A bolder approach might be to adopt the perspective of the welfare economist, and assume that the proper purpose of the corporation is to provide as much benefit as possible for society as a whole. This approach resembles the Kaldor–Hicks criterion in economics, which ranks an action superior if it maximizes total social wealth.⁴ It also echoes the views of stakeholder theorists and

³ See Barnes and Stout (1992), discussing the Pareto criterion.

⁴ *Id.* at 16–17, discussing Kaldor–Hicks approach.

advocates of corporate social responsibility who point out, quite reasonably, that if corporations affect the welfare of many different groups, it does not make economic sense to ignore this reality in addressing the question of corporate purpose.

Yet, whatever set of interests one chooses to consider in addressing corporate policy, and whatever approach one argues for in resolving conflicts among those interests, the project inevitably remains relativistic and subjective in nature. One might address the question of corporate purpose only from the perspective of the most short-term, opportunistic, undiversified, and asocial subset of shareholders – in which case the goal of “maximize shareholder value” makes sense. One could also adopt the perspective of the company’s long-term shareholders (“enlightened shareholder value”) or shareholders together with corporate participants like employees, consumers, and suppliers (some version of stakeholder theory). At a still broader level, one could argue that socially responsible corporations should promote the welfare of the nation, or even of humanity and all its future generations.

Whichever perspective one chooses, the starting point is to some degree subjective, and to some degree determines the ultimate conclusion. Thus, a multifunction model of corporate purpose may not give outside observers, like academics or lawmakers, clear guidance on what goal any particular corporation at any particular time should pursue.⁵ But it does at least demand greater clarity in identifying whose interests do and do not count, and why, when one is arguing for any particular vision of corporate purpose for either an individual company or the corporate sector as a whole. Whether or not the multifunction model amounts to a “theory,” if the object is to develop a useful approach to the question of corporate purpose, it may be a better strategy than embracing the bad theory that corporations should always maximize shareholder value.

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⁵ This may explain why the law in fact allows corporations to pursue any lawful goal. Clarke (2013) describes this as “an unfortunate lacuna in corporate law,” but it may actually be a fortunate recognition of the need to preserve flexibility in multifunction corporations.

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