Shareholder Primacy: Myths and Truths

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During the twentieth century, economies across the globe moved toward corporate capitalism, as large corporations with disparate shareholders began to control significant amounts of private capital. In order to address this development, the legal and financial sectors developed the idea of "shareholder primacy," which posits that managers of corporations and similar organizations should operate them primarily for the benefit of shareholders. Legally, this structure was intended to protect investors from the "agency problem," which was created by management control over large amounts of capital that belonged to shareholders. Economically, primacy was viewed as efficient, because it focused management on creating profits, which were thought to represent economic efficiency-- Milton Friedman famously said that the social responsibility of corporations was the creation of profits.

While corporate law differs from jurisdiction to jurisdiction, the law of many jurisdictions either incorporates shareholder primacy, or is heavily influenced by it, as shown by a series of papers recently drafted by experts in more than 30 countries in response to a 2015 questionnaire prepared by Professor Robert Eccles of the Harvard Business School. The questionnaire was answered for the U.S. by American Bar Association's Task Force on Sustainable Development. That response concluded that:

> *The United States is a "shareholder primacy" jurisdiction, meaning that the primary focus of corporations is to return profit to shareholders. If stakeholder needs are considered, they are a secondary concern.*

B Lab and others have argued that shareholder primacy leads to the misapplication of societal resources, and limits the ability of corporations to raise money in mainstream capital markets while operating in a responsible and sustainable manner. B Lab has promoted the adoption of "benefit corporation" law, which provides an option that allows corporations to reject shareholder primacy, and to place the interests of stakeholders (including employees, the community and the environment) on par with the interests of shareholders.

The move to adopt legislation has been quite successful: 32 U.S. jurisdictions, including Delaware, have adopted the legislation, as has one European nation, and several nations in Europe, South America and the Pacific Rim are considering legislation, as well. In the U.S., more than 4,500 companies have become benefit entities. Nevertheless, there are continuing assertions that adoption of the form is unnecessary or unwise. Below are the myths behind such assertions, and the truths that belie them.

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Myth: There is no conflict between shareholder primacy and sustainable and responsible governance, because in the long term, the interests of stakeholders and shareholders coincide.

Truth: Corporations can of course "do well by doing good," but it is simply naïve to believe that there will never be trade-offs between shareholder value and environmental and social impact. While it is certainly true that responsible corporate behaviors (such as green environmental practices and fair compensation of employees) can lead to long term shareholder value, there are also instances in which irresponsible behavior can benefit shareholders at the expense of the environment and society. That is, sometimes corporations can make money for their shareholders by externalizing costs (for example, by emitting excess carbon) without directly paying any price in the future. Two Nobel prize-winning economists recently wrote a book, Phishing for Phools, which discussed the momentum towards this type of behavior in free markets.

Myth: A close read of U.S. corporate law shows that the courts have not really adopted shareholder primacy.

Truth: While some commentators make this claim, this is more of an academic, theoretical construct than an actual analysis of the legal doctrine set out in U.S. laws and statutes, as followed by practicing lawyers and applied by courts. Indeed, the ABA project quoted above (drafted by the main professional organization of practicing lawyers in the U.S.) found that the U.S. was a "'shareholder primacy' jurisdiction." Similarly, the Chief Justice of the Delaware Supreme Court, the top corporate court in the country, recently wrote that "the object of the corporation is to produce profits for its stockholders and . . . the social beliefs of managers . . . cannot be their end in managing the corporation." Or as the former Chancellor of Delaware held in one recent case, "I cannot accept as valid . . . a corporate policy that specifically, clearly, and admittedly seeks not to maximize the value of a for-profit Delaware corporation for the benefit of its stockholders."

Myth: Directors have sufficient flexibility under the "business judgment rule" to address any concern that they would be unable to elevate stakeholder interests over those of shareholders—that is, corporations can act responsibly toward the environment and society, and claim that, in the long run, those actions will benefit shareholders through reputational and similar effects, whether or not they believe shareholders really will so benefit.

Truth: The business judgment rule provides that courts do not interfere with business decisions that are disinterested and rational, so that directors have extremely broad discretion in managing a corporation. So it is true that corporations can act responsibly and claim that such actions will benefit the shareholders in the long run. But we should not run our capital markets on the basis of dissembling, nor could directors really be comfortable making decisions on the basis of an agreed-upon fiction. Moreover, the business judgment rule does not even apply in change in control transactions, which involve some of the most critical decisions in the lifetime of a corporation. But more critically, while the aggressive use of the business judgment rule might allow corporations to act responsibly in many situations, it would not require it. Without the accountability created by such a requirement, shareholder primacy thinking is likely to dominate the boardroom. For all these reasons, the business judgment rule simply does not provide the benefits of stakeholder governance.

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Myth: ***Shifting from shareholder primacy to stakeholder governance will harm shareholders through "trade-offs" between stakeholder and shareholder value.***

Truth: It is true that stakeholder governance, in order to have some meaning, necessarily implies that there will be situations in which a corporation must make a choice that provides less value to shareholders than another option, and that such a decision would represent a "trade-off." But shareholders who make concessions need not be concessionary investors. Trade-offs necessarily harm shareholders only from a static, isolated perspective. In fact, many observers believe that corporations with stakeholder governance are able to make stronger commitments to important constituencies, including workers and communities, and that such commitments induce firm-specific commitments in return, creating value that would not be obtainable in a shareholder primacy setting. The advantage of being to build such reciprocal relationships has been described by Lynn Stout, a well-known law professor at Cornell, in her book, *The Shareholder Value Myth*, and by Colin Mayer, a leading finance professor at Oxford's Said Business School, in his book, *Firm Commitment.*

More importantly, shareholders do not own just one company: most investors are diversified, and have broad shareholdings across the entire market. (This is particularly true when one focuses on the ultimate beneficiaries of the institutional asset owners that dominate the market. These pensions, mutual funds, insurance companies, endowments and foundations all have as ultimate beneficiaries a broad swath of the population that is diversified through such asset owners.) These "universal owners" earn most of their return not by successfully picking stocks that "beat the market," but by being invested in a healthy market: generally, about 80% of an investor's return comes from the behavior of the market. Accordingly, investors are actually hurt when a company in which they are invested tries to improve the return to its shareholders by externalizing costs in a manner that hurts the market. For example, universal owners who owned shares in financial companies were hurt by the "value-maximizing" activities of those companies that created the market crash in 2008. Moreover, these investors have non-financial interests as well: they would prefer to live in a world that is peaceful, prosperous, and stable, and such a world is much more likely to exist if corporations are not externalizing costs and risks in order to increase the financial return of a single company.

Myth: ***Stakeholder governance cannot work, because there are too many interests for corporations to reconcile; this will allow managers to simply act in their own interest, because there will be no clear standards.***

Truth: The fact is that managers must constantly think about all of their stakeholders in order to efficiently manage a business; the legal change merely allows them give those interests a priority not available in shareholder primacy settings. But directors of benefit corporations are not able to ignore shareholder interests because shareholders retain all their corporate governance rights—including the right to elect the board that controls the management of the corporation.

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Myth: ***Creating corporations that specifically are designated as stakeholder friendly will give greater license to traditional corporations to act irresponsibly, and create negative impacts on society and the environment.***

Truth: Traditional corporations already have such license, and many take advantage of it, underpaying workers, polluting the environment and ignoring the destabilizing effects of their operations. As long as such activities are not illegal, the only path to improving corporate behavior is market pressure. The creation of benefit corporations lies on a critical path to increase that pressure, by highlighting the legal distinction between companies that are legally required to protect their stakeholders, and those whose treatment of such stakeholders is always contingent on shareholder value. Denying corporations the opportunity to legally prioritize societal interests will only serve to slow any such market pressure.

Final Myth: ***The adoption of benefit corporation law by jurisdictions and corporations will solve the problems created by shareholder primacy.***

Truth: Benefit corporation law is a critical tool to allow private capital to be invested in a manner that creates shared and durable value for everyone. But a tool is only as good as the person who uses it. Shareholders must understand the value of firm commitment, and, more importantly, the ultimate source of wealth for universal investors, which is thriving financial markets and a healthy, peaceful and prosperous planet. These goals can only be attained and maintained for the long term if private capital is allocated and invested in a manner that creates value for everyone. So investors must learn to use benefit corporation law as a tool to require the companies they own to create value in a responsible and sustainable manner.