THE SHAREHOLDER PRIMACY ISSUE

Appendix, Kent M. Keith, *Servant Leadership in the Boardroom: Fulfilling the Public Trust* (Westfield, Indiana: The Greenleaf Center for Servant Leadership, 2011)

Greenleaf believed that board members should consider the interests of all stakeholders. He said that board members should be concerned with everyone that an organization touches—employees, customers, business partners, shareholders or members, and communities. Board members "are accountable to all parties at interest for the best possible performance of the institution in the service of the needs of all constituencies—including society at large. They are holders of the charter of public trust for the institution."168

However, many disagree. They argue that in for-profit corporations, shareholders deserve primary consideration over all other stakeholders. According to Lynn A. Stout, Paul Hastings Professor of Corporate and Securities Law at the University of California at Los Angeles School of Law:

> Of all the controversies in U.S. corporate law, one has proven most fundamental and enduring. This is, of course, the debate over the proper purpose of the public corporation. Should the public company seek only to maximize the wealth of its shareholders (the so-called 'shareholder primacy' view)? Or should public corporations be run in a manner that considers the interests of other corporate 'stakeholders' as well, including employees, consumers, even the larger society?169

A review of the law and related research suggests that shareholder primacy is not the position taken by most state legislatures and courts, and it is a position that can result in unethical behavior. The better view is "board primacy" or "director primacy."

Dodge v. Ford Motor Company

D. Gordon Smith, Associate Professor of Law at Northwestern School of Law of Lewis & Clark College, described the shareholder primacy norm as follows: "Corporate directors have a fiduciary duty to make decisions that are in the best interests of the shareholders."170 The case most often quoted by scholars in this regard is a 1919 case, *Dodge v. Ford Motor Company*, in which the Michigan Supreme Court upheld a lower court decision requiring the Ford Motor Company to pay additional dividends to shareholders. In its discussion of the case, the court said:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote

> them to other purposes.171

This is the statement that is often quoted to support shareholder primacy. However, this statement did not determine the court's decision.

The lawsuit was brought by the Dodge brothers, who were shareholders in the Ford Motor Company. They began as suppliers to Ford, and then became competitors of Ford when they began producing their first Dodge Brothers cars in 1914.

The board of directors of Ford Motor Company was dominated by Henry Ford, who was the largest shareholder, with 58% of the shares. Henry Ford was willing to pay dividends to shareholders. In fact, he was paying regular dividends of 5% per month—60% per year—on the original invested capital stock of $2 million. He also paid a total of $41 million in special dividends between 1911 and 1915. Shareholders had received a return far, far greater than their original investments.

Henry Ford continued paying regular dividends, but decided to stop paying special dividends, in order to achieve his business goals. The public press in Detroit quoted him as saying:

> My ambition…is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business.172

In addition to expanding the company's production facilities and hiring more employees, Henry Ford wanted to continue to raise the wages of company employees, and sell cars at lower and lower prices, so more people could afford to buy them.

The company had grown rapidly since its founding in 1903, and the profits were piling up. During 1916, the company earned a profit of $60 million, and had $52 million cash on hand. The Dodge brothers sued to force the distribution of the profit to shareholders. They wanted an injunction to prevent the Ford Motor Company from investing in expansion; a decree requiring that at least 75 percent of the profit be distributed to shareholders; and a decree that in the future, the company be required to distribute *all* of the earnings to shareholders, except small amounts needed for emergency purposes. In short, the Dodge Brothers not only wanted money, they wanted to stop Ford's growth as a competitor.

The court made it clear that it would not normally interfere with the decisions of a board regarding dividends, and it is not a violation of the law to allow profits to accumulate and be reinvested in the business. The court also said that it did not want to interfere with the business expansion that was being planned by the Ford Motor Company. However, the Ford board had gone too far in this case, by accumulating so much cash and sharing so little of it with the stockholders. The court affirmed the lower court ruling that $19 million must be paid out as dividends.

The interesting point to note is that the court awarded *less than 40%* of the surplus to the shareholders, while allowing Ford to keep most of the money—more than $30 million. That $30 million was available to the company to raise wages, expand the business, and lower prices. In short, the court gave the plaintiff shareholders only part of what they wanted.

Today, it is accepted law that:

> ...The mere fact that a corporation has a large surplus will not justify interference by the court, at the instance of a minority stockholder, to compel declaration of a dividend. A corporation has the right to choose to retain its surplus earnings to insure its financial stability and for the effectuation of internal policies and programs if it does so in good faith… While the action of the directors may be reviewed by the courts upon a proper showing, it will be set aside only in case of bad faith or when arbitrary, oppressive, manifestly erroneous, or such as clearly to constitute an abuse of their discretion, an overstepping of their powers, or a disregard of their official duty. Relief is refused where such grounds do not clearly appear, irrespective of adverse effects of the corporate policy on complaining stockholders.173

Smith pointed out that what is significant about the "shareholder primacy" statement found in the *Dodge v. Ford Motor Company* court opinion is that it applied to a dispute between minority and majority shareholders in a closely-held corporation:

> …The shareholder primacy norm was first used by courts to resolve disputes among majority and minority shareholders in closely held corporations. Over time this use of the shareholder primacy norm has evolved into the modern doctrine of minority oppression. This application of the shareholder primacy norm seems incongruous today because minority oppression cases involve conflicts among shareholders, not conflicts between shareholders and nonshareholders. Nevertheless, when early courts employed rules requiring directors to act in the interests of *all* shareholders—not just the majority shareholders—they were creating the shareholder primacy norm.174

The idea was, simply, that majority shareholders should not oppress minority shareholders in closely-held corporations. The idea was not that shareholders have primacy over all other stakeholders.

Since conflicts between majority and minority shareholders in publicly traded companies are far less common than in closely-held corporations, "the shareholder primacy norm is nearly irrelevant to the ordinary business decisions of modern corporations."175 One reason is the business judgment rule. Under the business judgment rule, a board of directors acting in good faith, with reasonable care, is not liable for making mistakes of judgment.

The board is therefore not likely to be held liable for a decision that favors stakeholders who are not shareholders. According to Smith, "the universal application of the business judgment rule makes the shareholder primacy norm virtually unenforceable against public corporations' managers…It is nearly an iron-clad shield for directors of public corporations."176

Shareholders are not owners of the corporation

Shareholder primacy has been promoted by economists during the past forty years. The "Chicago School" of economists argued that the proper goal of corporate governance was "to make shareholders as wealthy as possible."177 In 1970, Milton Friedman published an article in *The New York Times Magazine* entitled, "The Social Responsibility of Business Is to Increase its Profits."178 In that article, he argued that corporate executives were responsible to the owners of the business "to make as much money as possible while conforming to the basic rules of society."179 He assumed that the shareholders of the corporation were the owners of the business. Professor Stout disagreed, saying:

> Milton Friedman is a Nobel Prize-winning economist, but he obviously is not a lawyer. A lawyer would know that the shareholders do not, in fact, own the corporation. Rather, they own a type of corporate security commonly called 'stock.' As owners of stock, shareholders' rights are quite limited. For example, stockholders do not have the right to exercise control over the corporation's assets. The corporation's board of directors holds that right. Similarly, shareholders do not have any right to help themselves to the firm's earnings; the only time they can receive any payment directly from the corporation's coffers is when they receive a dividend, which occurs only when the directors decide to declare one. As a legal matter, shareholders accordingly enjoy neither direct control over the firm's assets nor direct access to them. Any influence they may have on the firm is indirect, through their influence on the board of directors…It is misleading to use the language of ownership to describe the relationship between a public firm and its shareholders.180

Professor Stout also rejected the argument that shareholders are the sole residual claimants of a corporation, entitled to payment after the firm has paid its employees, managers, and creditors to fulfill its contractual commitments to them. In fact, shareholders are only allowed to receive payments when the corporation has enough retained earnings or profits, and the board of directors decides to declare a dividend. In short, "shareholders of a public corporation are entitled to receive nothing from the firm *unless and until the board of directors decides that they should receive it*."181

Shareholders have the right to vote, the right to sue, and the right to sell their shares. However, in regard to their voting rights:

> As a matter of law these are severely limited in scope, principally to the right to elect and remove directors. Shareholders have no right to select the company's CEO; they cannot require the company to pay them a single penny in dividends; they cannot vote to change or preserve the company's line of business; they cannot stop directors from squandering revenues on employee raises, charitable contributions, or executive jets; and they cannot vote to sell the company's assets or the company itself (although they may in limited circumstances vote to veto a sale or merger proposed by the board).182

If corporate officers and directors fail to maximize shareholder wealth, shareholders can sue. However:

> …Courts consistently permit directors to use corporate funds for charitable purposes; to reject business strategies that would increase profits at the expense of the local community; to avoid risky undertakings that would benefit shareholders at creditors' expense; and to fend off a hostile takeover at a premium price in order to protect employees or the community. Contrary to the shareholder primacy thesis, shareholders cannot recover against directors or officers for breach of fiduciary duty simply because those directors and officers favor stakeholders' interests over the shareholders' own.183

Problems with shareholder primacy

One problem with shareholder primacy is fairness. Most shareholders today have contributed literally nothing to the firms whose shares they hold. Let's say that Ms. Jones bought shares of stock when the company was starting up or was issuing new shares to finance expansion. By buying those shares, Ms. Jones indeed contributed to the success of the firm—she invested money that helped the firm to grow. But then Ms. Jones sold her shares to Mr. Smith, who later sold his shares to Ms. Kim, who then sold her shares—and on and on. Most shareholders buy as speculators or investors, hoping to make money or improve their financial assets. Of course they want the company to produce strong financial results, so that the price of company shares will remain high. But these speculators and investors have *not contributed to the company*. They have not created value. They simply hope to make money off the company's performance.

Meanwhile, employees come to work at the company every day, producing the programs, products, and services that the company sells. They are giving their daily lives to the firm. They are creating value. Without them, there would be nothing for the company to sell. Then there are the customers who keep buying the programs, products, or services. Without them, the business would go out of business, and shares would have no value at all. Then there are the business partners who reliably supply materials and services so that the company and its employees can perform well. The business could not succeed without them. And then there are the local communities where the company has offices or production facilities. The company takes advantage of local infrastructure and services provided by local governments. Some companies create adverse impacts on their local communities that cost those communities far more than the taxes that the companies pay.

Employees, customers, business partners, and communities are all *stakeholders*. They all have a stake in the success or failure of the corporation. And without their contributions, corporations cannot succeed. “Promoters” who start corporations realize this. In drafting corporate charters, they almost never include statements giving primacy to shareholders. Shareholders have no problem with that—they are still happy to invest in the new corporation. Professor Stout suspects that the reason is that “if the firm did mandate shareholder primacy in its charter, it would find it far more difficult to attract qualified, motivated, and loyal employees, managers, and even creditors.”184 Shareholders want the corporation to succeed, and they know that other stakeholders are crucial to success.

Stakeholders such as creditors, employees, managers, and local governments may receive direct compensation, but they also have expectations about the future that are not reduced to writing. It is in the shareholders’ interests to encourage these non-shareholders to continue their contributions after the corporation is up and running. Over the long term, the corporation will be most successful, and the share price is likely to remain the strongest, if all stakeholders continue to contribute to its success. Stakeholders are more likely to do so if their contributions are taken into account in corporate decision-making. Professor Stout wrote:

> …The ideal rule for corporate directors to follow is not to require them to focus solely on maximizing shareholders’ current wealth. Rather, the ideal rule of corporate governance, at least from an efficiency perspective, is to require corporate directors to maximize the sum of *all* the risk-adjusted returns enjoyed by *all* of the groups that participate in firms. These groups include not only shareholders, but also executives, employees, debtholders, and possibly even suppliers, consumers, and the broader community.185

Giving primacy to shareholders can have very negative impacts on other stakeholders. For example, the company may pay low wages, and lay off thousands of workers, in order to push up the price of the stock to benefit shareholders. Or the company may sell out to investors who offer the highest price per share but plan to dismantle the company, with devastating impacts on employees, families, and communities. Or the company may pollute the environment and harm local communities, in order to save money and increase shareholder value. Obviously, there are cases in which what is good for the shareholders is not good for other stakeholders or society at large.

As we will discuss below, the law does not require boards to give primacy to shareholders. Unfortunately, many board members don’t know that, and may make unethical decisions as a result. Research conducted by Jacob Rose on corporate directors and social responsibility concluded that "directors favor shareholder value over personal ethical beliefs and social good because they believe that current corporate law requires them to pursue legal courses of action that maximize shareholder value."186

The participants in Rose's study were 34 active directors of U.S. *Fortune* 200 corporations, each of whom had served on an average of six boards and had an average of 20 years of management experience. The directors were divided into two groups—one group of 17 were asked to act as directors, and the second group of 17 was asked to act as partners in non-traded firms that did not have responsibilities to shareholders. Both groups were presented two case studies in which loopholes in the law would allow the corporation to cut down old-growth trees and emit a toxin at a high level that would threaten human health. In both cases, the unethical decision would increase earnings per share. Sixteen of the 17 directors voted to cut down the forest, and 15 of the 17 directors voted to emit the toxin and threaten human health, because doing so would improve earnings per share for shareholders. The results were different for the directors who were asked to take the perspective of partners without shareholders. Only 10 of the 17 directors voted to cut down the forest, and only 3 of the 17 voted to emit the toxin.187 The belief in shareholder primacy was thus a major factor leading the directors to make unethical decisions that were harmful to the environment and to the health of human beings.

Recognizing other stakeholders and the public good

The need to recognize stakeholders other than shareholders was foreseen long ago. In 1932, Adolph Berle and Gardiner Means published their business classic, *The Modern Corporation & Private Property*. As they looked into the future, they could see a "third alternative" for corporate governance, beyond the choice between shareholders (whom they described as owners of passive property) and the control exercised by managers. They said:

> Neither the claims of ownership nor those of control can stand against the paramount interests of the community…It remains only for the claims of the community to be put forward with clarity and force...Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of the profits from the owners of passive property [the shareholders], and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way. Courts would almost of necessity be forced to recognize the result…It is conceivable,—indeed, it seems almost essential if the corporate system is to survive,—that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of

> public policy rather than private cupidity.188

Kent Greenfield, professor of law at the Boston College Law School, argued in *The Failure of Corporate Law* that it is time to revise corporate principles and policies. He said:

> No corporation, even one making money for its core constituents, should be allowed to continue unchallenged and unchanged if its operation harms society…The corporation is an instrument whose purpose is to serve the collective good, broadly defined, and if it ceases to serve the collective good, it should not be allowed to continue its operation, at least not in the same way. If we knew that all corporations, or corporations of a certain type, or even an individual corporation created more social harm than good, no society in its right mind would grant incorporation to those firms.189

Greenfield said that the ultimate purpose of corporations should be to serve the interests of society as a whole, not just shareholders, and a corporation's wealth should be shared fairly among all those who contribute to its creation, not just shareholders.190 Charters are granted to corporations for the public good, and the definition of public good needs to be broadened, as a matter of law and public policy.

In an article published in the *MIT Sloan Management Review*, Henry Mintzberg, Robert Simons, and Kunal Basu criticized the "fabrication" that corporations exist to maximize shareholder value. They wrote:

> Corporations used to exist… to serve society. Indeed, that was the reason they were originally granted charters—and why those charters could be revoked. Corporations are economic entities, to be sure, but they are also social institutions that must justify their existence by their overall contribution to society. Specifically, they must serve a balanced set of stakeholders…191

The Carver Policy Governance® Model

In the Carver Policy Governance® Model, boards take all stakeholders into account when they make decisions, but boards take them into account in different ways. Carver argues that the board owes an "ownership obligation" to shareholders and an "ethical obligation" to all other stakeholders. This resolves the shareholder primacy issue in a way that fulfills requirements for both performance and ethics. John Carver and Caroline Oliver stated:

> We assert that companies exist first and foremost for producing value for owners. In other words, an organization is *for* whatever its owners want it to be for…Therefore each board needs not only to be clear about who its owners are but to have some degree of dialogue with them before it can specify the kind of value their company should produce…A company also has responsibilities to

> people other than owners…All obligations other than to provide value to owners are means issues rather than ends issues. Therefore a board will choose whatever degree of care it wishes with regard to stakeholders other than owners…192

Carver and Oliver acknowledged that the board will meet its legal obligations regarding public policies such as minimum wages and safety standards. The board will also recognize its responsibility to act ethically. Consumers, employees, and suppliers are to be treated with the proper respect. Finally, the corporation may make voluntary contributions to benefit society. "The company does not exist to fulfill such an obligation, but the board may still decide to make such contributions as a means of enhancing the company's long-term interests or fulfilling the board's interpretation of ethical social behavior."193

Considering all stakeholders can benefit shareholders

The argument that all stakeholders should be considered because that turns out to be best for shareholders, seems to be the position described in *The Corporate Director's Guidebook*, produced in 2007 by the American Bar Association (ABA) Committee on Corporate Laws. It stated:

> A number of state corporation statutes expressly allow the board to consider the interests of employees, suppliers, and customers, as well as the communities in which the corporation operates and the environment. Although the board may consider the interests of these other constituencies, the board is accountable primarily to shareholders for the performance of the corporation. Nonshareholder constituency considerations are best understood not as independent corporate objectives but as factors to be taken into account in pursuing the best interests of the corporation. Being responsive to stakeholder interests and concerns can help to contribute positively to a corporation's workplace culture as well as its reputation for integrity and ethical behavior.194

Considering the interests of other stakeholders may be in the best interests of the corporation, and therefore, presumably, in the best interests of shareholders.

While retaining the focus on shareholder primacy, the ABA Committee noted that the law is changing. Indeed, in most states today, the decisions of the board do not have to benefit shareholders. According to Micklethwait and Wooldridge, "during the 1980s, about half of America's fifty states introduced laws that allowed managers to consider other stakeholders alongside shareholders. Connecticut even introduced a law that required them to do so."195

The law supports director primacy

Professor Stout argued that, when given the choice between shareholder primacy and director primacy, most managers, shareholders, judges, and legislators choose *director* primacy. A study of the behavior of boards of directors conducted in 1989 by Jay Lorsch and Elizabeth MacIver found ambivalence about the shareholder primacy norm. The majority of directors saw themselves as accountable to more than one constituency.196

As for judges, the laws of Delaware are significant, since approximately half of all publicly traded companies are located in Delaware. "Delaware gives directors free rein to pursue strategies that reduce shareholder wealth while benefitting other constituencies," Stout noted.197 An exception may occur when the directors seek to sell the company. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* the Delaware Supreme Court held that the board had a duty to maximize shareholder wealth by getting the best possible price, even if the impact of the sale would have negative impacts on other stakeholders.198 However, state legislatures did not agree with the Delaware court. "Although Delaware pruned back *Revlon* by case law rather than by statute, in the wake of *Revlon,* over thirty other states have passed 'constituency' laws that expressly permit corporate directors to sacrifice shareholders' interests to serve other stakeholders."199

B Corporations and the Caux Roundtable

It is noteworthy that B Corporations (beneficial corporations) are now being established to address several problems, one of which is "the existence of shareholder primacy which makes it difficult for corporations to take employee, community, and environmental interests into consideration when making decisions."200 The B Corporation legal framework expands the responsibilities of the corporation to include the stakeholder interests of their employees, communities, and the environment. The Declaration of Interdependence of B Corporations states:

> We envision a new sector of the economy which harnesses the power of private enterprise to create public benefit. This sector is comprised of a new type of corporation—the B Corporation—which is purpose-driven and creates benefit for all stakeholders, not just shareholders. As members of this emerging sector and as entrepreneurs and investors in B Corporations, we hold these truths to be self-evident:
>
> - That we must be the change we seek in the world.
> - That all business ought to be conducted as if people and place mattered.
> - That, through their products, practices, and profits, businesses should aspire to do no harm and benefit all.
> - To do so requires that we act with the understanding that we are each dependent upon another and thus responsible for each other and future generations.201

Similar sentiments have been expressed by business leaders who developed the Caux Round Table's "Principles for Business," which are a worldwide vision for ethical and responsible corporate behavior. The three ethical foundations are responsible stewardship, living and working for mutual advantage, and the respect and protection of human dignity. The first of the seven principles is to "respect stakeholders beyond shareholders." This principle is elaborated as follows:

> • A responsible business acknowledges its duty to contribute value to society through the wealth and employment it creates and the products and services it provides to consumers.
> • A responsible business maintains its economic health and viability not just for shareholders, but also for other stakeholders.
> • A responsible business respects the interests of, and acts with honesty and fairness towards, its customers, employees, suppliers, competitors, and the broader community.202

The Caux Roundtable has also established stakeholder management guidelines. In introducing the guidelines, the Caux Roundtable stated:

> The key stakeholder constituencies are those who contribute to the success and sustainability of business enterprise. Customers provide cash flow by purchasing goods and services; employees produce the goods and services sold; owners and other investors provide funds for the business; suppliers provide vital resources; competitors provide efficient markets; communities provide social capital and operational security for the business; and the environment provides natural resources and other essential conditions.
>
> In turn, key stakeholders are dependent on business for their wellbeing and prosperity. They are the beneficiaries of ethical business practices.203

While shareholder primacy has been a popular concept for decades, legislatures, courts, many business leaders, and even shareholders today understand what Greenleaf understood, that for-profit corporations have a public purpose, and their board should take into account *all* the people that their organizations touch—employees, customers, business partners, and communities, as well as shareholders.

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Notes for the Appendix: The Shareholder Primacy Issue

168 Greenleaf, *Trustees as Serv*ants, 15.

169 Stout, “New Thinking on ‘Shareholder Primacy,” 2.

170 Smith, “The Shareholder Primacy Norm,” 278.

171 *Dodge v. Ford Motor Company*, 684.

172 Ibid., 671.

173 *American Jurisprudence*, 169-171.

174 Smith, “The Shareholder Primacy Norm,” 279.

175 Ibid.

176 Ibid., 286.

177 Stout, “New Thinking on ‘Shareholder Primacy,’” 3.

178 Milton Friedman, “The Social Responsibility of Business Is to Increase Its Profits.”

179 Ibid.

180 Stout, “Bad and Not-So-Bad Arguments for Shareholder Primacy,” 1191.

181 Ibid., 1194.

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