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The Corporate Objective Revisited

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The stock market convulsions and corporate scandals of 2001 and 2002 have reignited debate on the purposes of the corporation and, in particular, the goal of shareholder value maximization. We revisit the debate, re-examine the traditional rationales, and develop a set of new arguments for why the preferred objective function for the corporation must unambiguously continue to be the one that says "maximize shareholder value." We trace the origins of the debates from the late nineteenth century, their implications for accepted law and practice of corporate governance in the United States, and their reflection in shareholder versus stakeholder views in the organization studies literature and contractarian versus communitarian views in the legal literature. We address in detail possible critiques of the shareholder value maximization view. Although we recognize certain boundary constraints to our arguments, we conclude that the issues raised by such critiques and constraints are not unique to the shareholder value maximization view, but will exist even if the firm is managed on behalf of nonshareowning stakeholders.

Key words: shareholder value; stakeholder theory; corporate goal; corporate governance

Governing the corporation requires purposeful activity. All purposeful activity, in turn, requires goals. The corporation itself, as Talcott Parsons argues, is an entity whose "... defining characteristic is the attainment of a specific goal or purpose" (1960, p. 63). However, debates surrounding the appropriate corporate objective are far from finished. Scholars and courts have long argued over the purposes of the corporation, and still hold differing views. In the field of finance, the logic of shareholder value maximization is accepted as being so obvious that textbooks just assert it, rather than argue for it. Deviation from this objective is cast as an agency problem resulting from the separation of ownership and control, and failure to meet this goal is assumed to be corrected by corporate boards, shareholder voice, shareholder exit, and the market for corporate control.[1] Management and strategy scholars have, in recent years, leaned toward one of two overlapping perspectives that are at odds with the finance view. One perspective is that governance should be understood using a stakeholder lens (e.g., Freeman and McVea 2001). The other view is that rather than debating whether stakeholders or shareholders matter, corporations should juggle multiple goals (e.g., Quinn 1980, p. 7; Drucker 2001, pp. 17–18). In the fields of law and ethics, the intellectual struggle between the stakeholder and the shareholder, contracts and communities, and public and private conceptions of the corporation have similarly been manifest in numerous debates.[2]

The stock market decline of 2001 and 2002 and the related corporate scandals have sharply reignited the debate. Concerns such as those raised by Bratton (2002) about the "dark side of shareholder value," or by Blair (2002, pp. 10–11) that the "... study of corporate governance must focus on more than just how to get management to maximize value for shareholders" as a response to these events once again raise legitimate challenges to the shareholder value maximization rule. The challenges compel a response.

We revisit the debate on the corporate objective. We re-examine the classic arguments, and develop a set of new arguments for why the preferred objective function for the corporation must continue to be the one that says, "maximize shareholder value." Shareholder value maximization should be the preferred corporate goal not because it is law, not because it may be, as some argue, the ethical thing to do, nor because it is expedient because it is based on an observable and measurable metric. Our argument is that it should be the goal because it is the best among all available alternatives, and thus the preferred goal for managers formulating and implementing strategy. We recognize that the multifaceted issue of corporate goals has been examined from a multitude of organizational, legal, and financial theoretical perspectives. Our analysis is somewhat more narrowly focused on managers and the criteria they must bring to bear in the decisions they must make as agents of the shareholders, and more broadly, stakeholders.[3]

The first section briefly traces the origins of the governance debate from the late nineteenth century, and its implications for accepted corporate law and practice in the United States. The second section examines the

stakeholder perspective and identifies the reasons why this perspective cannot be a valid model for corporate governance. The third section presents arguments for the primacy of shareholder value maximization as the preferred objective function. The final section examines critiques and boundary conditions of the shareholder value maximization norm, provides counterarguments that must be addressed by its critics, and offers concluding thoughts.

Evolution of Corporate Goals (and Arguments Thereof) in the United States: A Brief History

Opposing views on the purpose and accountability of the corporation—contracts versus communities, or private (property) versus public (social and political entity) conceptions of the corporation—have been manifest in numerous debates during the past 150 years. The one-or-the-other view of the corporation has cyclically gained ascendancy during various periods in this time (see Bradley et al. 1999, Matheson and Olson 1992).

During the first part of the nineteenth century, each instance of incorporation required a special act of the state legislature, and only stakeholders mattered (Millon 1990, p. 206). As a creation of the state, the corporation was viewed as a socially useful instrument for the state to carry out its public policy goals and as an entity whose powers must be kept in check.[4] The legal norm was the ultra vires doctrine, which limited the ability of a corporation to pursue activities beyond its original charter or state of incorporation.[5] Toward the end of the nineteenth century, allowance by states of general incorporation resulted in explosive growth in corporations for private business purposes and to erosion of state attempts to proscribe their behavior through the ultra vires doctrine. Soon, the earlier concerns for stakeholder welfare gave way to the notion of managing the corporation for shareholders' profits.

The event that led to the clearest articulation of the primacy of the shareholder value maximization in the United States was the ruling by the Michigan State supreme court in Dodge vs. Ford Motor Company, 1919. Henry Ford wanted to invest Ford Motor Company's considerable retained earnings in the company rather than distribute it to shareholders. The Dodge brothers, minority shareholders in Ford Motor Company, brought suit against Ford, alleging that his intention to benefit employees and consumers was at the expense of shareholders. In their ruling, the Michigan court agreed with the Dodge brothers: "The business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end."

This legal norm found two influential intellectual underpinnings. The publication of *The Modern Corporation and Private Property* by Berle and Means (1932) highlights the problems of managerial discretion and self-dealing that shareholders face given the separation of ownership and control that characterize the widely held corporation (see Bratton 2001 for a comprehensive reassessment of Berle and Means). Based on assumptions of property rights, they argue that managing on behalf of the shareholders was the sine qua non of managerial decision making, because shareholders were property owners. The other was the article The Nature of the Firm, by Coase (1937), which asks the question, why do firms exist when market can perform similar functions? Coase argues that firms are a nexus of contracts to minimize transactions costs of markets, which leads to the rationale for the existence of a firm that has nothing to do with state benevolence. These legal and intellectual developments paralleled important regulatory developments. As Bradley et al. (1999) point out, "...the primary focus of this regulatory activity was on capital providers to the firm" (1999, p. 24). This era witnessed the Securities and Exchange Act of 1934, the Glass-Steagall Act of 1932, and the Investment Company Act of 1940.

However, stakeholder concerns regained ground again. In the wake of the 1929 stock market crash and the Great Depression, scholars reevaluated the shareholder value maximization viewpoint. The most widely recognized arguments are attributed to Dodd (1932), who argues that if the corporation can be viewed as an entity that is separate from its shareholders, then it has citizenship responsibilities. The role of management could not be restricted to that of carrying out its shareholder responsibilities, but rather would be that of a trustee with citizenship responsibilities on behalf of all constituencies, even if it meant a reduction in shareholder value.[6] In the subsequent decades, legislative developments paralleled this sense of corporate responsibility toward non-shareholding stakeholders arising from such an "entity" view of the corporation. Bradley et al. (1999, pp. 24–29) chronicle the legislative moves toward such entity status, reflected in shifts away from capital providers and toward constituencies such as labor, consumers, and the natural environment, well into the 1970s (see, in particular, Footnotes 94 through 128, where they detail at least 32 such legislative acts). This was also the period when courts granted First, Fourth, and Fifth Amendment rights to corporations (they had previously granted Fourteenth Amendment rights). The three-decade burst of pro-shareholder sentiment during the early part of the twentieth century had been replaced by four decades of pro-stakeholder sentiment.

In the last two decades of the century, despite state-level legislative efforts to the contrary, the pendulum swung back to the shareholder. Beginning with the work of Milton Friedman, and his view that the sole social responsibility of business is to increase profits (Friedman 1970), corporate social responsibility arguments came

under increasing intellectual attack. Agency theory arguments (Alchian and Demsetz 1972, Jensen and Meckling 1976, Fama and Jensen 1983), as well as the notion of the corporation as a nexus of contracts, as put forth by the law and economics scholars (e.g., Easterbrook and Fischel 1991), bolstered this attack. The upswing in the market for corporate control and hostile takeovers starting with the 1980s and lasting nearly two decades (Holmstrom and Kaplan 2001), the unstoppable globalization in product and capital markets (Bradley et al. 1999), the return to focus and deconglomeration that reversed the corporate practices of the 1950s and 1960s (Davis et al. 1994), the ascendance of Reagan-Thatcher capitalism (and the fall of communism) in the political realm, the Internet-communications-biotechnology revolution in the technological realm (both sustaining and sustained by the bull market of the 1990s in the capital markets realm), and the apparently inexorable trend that the world was beating a path to the Anglo-American model in the governance realm, all converged to solidify the ascendance of the shareholder view of the firm. This view—the corporation as a shareholder value maximizing economic entity; emphasizing contractual exchanges, with the role of law to promote contractual freedom; with discipline forced by the invisible hand, the market for corporate control; and competition in product, labor, and capital markets—seemed to have all but trumped the alternative (Bradley et al. 1999).

There surely were regulatory counterattacks to this march of shareholder dominance. By the early 1990s, 30 states in the United States had enacted stakeholder statutes (also called constituency statutes; McDaniel 1991, Orts 1992) that allowed directors to consider the interests of nonshareholder constituencies in corporate decisions. However, the net effect of these statutes was marginal. Studies concluded that they did little to alter the centrality of shareholder primacy in U.S. corporate law (Singer 1993, Springer 1999). Indeed, one comprehensive assessment suggested that, "Directors appear to invoke constituency statutes more as a rationalization for deferring to their discretion than as a principled justification for consideration of constituent interests" (Springer 1999, p. 122), and that, if anything, they have detracted from the need for real changes in corporate law that address stakeholder needs.[7]

The shareholder value maximizing ideology so clearly dominated the discourse in corporate governance that a famous jurist and scholar, Chancellor Allen of the Delaware Chancery Court observed that "[o]ne of the marks of a truly dominant intellectual paradigm is the difficulty people have in even imagining any alternative view" (Allen 1993, p. 1395). However, such a view exists.

The Stakeholder Argument

The stakeholder movement and its uneasy coexistence with the goal of shareholder value maximization has been prevalent for as long as the modern corporate form has been in existence. It is only relatively recently that the stakeholder view has increased in prominence in organization studies. Scholars credit Freeman's (1984) pioneering work linking stakeholders with strategic management as the proximate starting point (e.g., Mitchell et al. 1997). A common theme is that firms should treat stakeholders as ends and should attend to the interests of all stakeholders, not just shareholders (Jawahar and McLaughlin 2001). Freeman and McVea describe stakeholder management as follows:

> The stakeholder framework does not rely on a single overriding management objective for all decisions. As such it provides no rival to the traditional aim of "maximizing shareholder wealth." To the contrary, a stakeholder approach rejects the very idea of maximizing a single-objective function as a useful way of thinking about management strategy. Rather, stakeholder management is a neverending task of balancing and integrating multiple relationships and multiple objectives (2001, p. 194).[8]

Stakeholder theory attempts to address the question of which groups of stakeholders deserve or require management's attention. Arguments advanced are often normative, such as "the interests of key stakeholders *must* be integrated into the very purpose of the firm, and stakeholder relationships *must* be managed in a coherent and strategic fashion" (Freeman and McVea 2001, p. 193, italics ours). Clarkson (1995, p. 112), for instance, argues that "the economic and social purpose of the corporation is to create and distribute wealth and value to all its primary stakeholder groups, without favoring one group at the expense of others."

Freeman defines a stakeholder as "any group or individual who can affect or is affected by the achievement of the organization's objectives" (Freeman 1984, p. 46). Intentionally broad, Freeman's objective was to develop a literary device that calls into question the emphasis on shareholders. Clearly, such a broad definition raises some practical concerns. How should a manager identify the important stakeholders and on what basis should other stakeholders be classified as unimportant? Who should determine the criteria that distinguish important and unimportant stakeholders—The board? The CEO? The stakeholders themselves? In attempting to answer these questions, Mitchell et al. (1997) reviewed the literature and developed a list of 27 different definitions of stakeholders. The definitions were sorted along dimensions such as basis for legitimacy, power dependence, and urgency. Although the authors develop a theory of stakeholder salience, they conclude that the attempt to define relevant stakeholders along these dimensions is "somewhat overwhelming" (Mitchell et al. 1997, p. 862). Jones (1995) makes clear that the term stakeholder applies not only to groups such as customers or employees, but also to subgroups of customers (e.g.,

buyers of over-the-counter medicine versus buyers of shampoo) and employees (e.g., shopworkers and middle managers) who might have distinct and competing interests, thus implying that some stakeholders are more important than others. In contrast to such a hierarchy, Clarkson (1995) argues that the interests of all legitimate stakeholders have intrinsic value and that no particular interests should dominate those of the others.

The literature has also attempted to link stakeholder management with firm performance. Mitchell et al. (1997), for example, state that "stakeholder theory, we believe, holds the key to more effective management" (p. 800). Jones (1995), in his discussion of instrumental stakeholder theory, argues that if firms contract with their stakeholders on the basis of mutual trust and cooperation, they will have a competitive advantage over firms that do not. Donaldson and Preston (1995) state, "Corporations practicing stakeholder management will, other things being equal, be relatively successful in conventional performance terms" (p. 67). Altman (1998) finds that many "executives believe that community involvement is a business imperative, often creating a competitive advantage" (p. 222). Despite such claims, the purported relationship is largely unsupported by empirical results. For example, Berman et al. (1999) claim to have found a link between stakeholder management and firm performance. However, their results find that only two of five stakeholder posture variables (employee and customer relationships) are significant; community, diversity, and the natural environment have no impact. Contrary to expectations, they find that stakeholder relationships do not drive strategy. In another study, Agle et al. (1999) find no relationship between stakeholder salience and corporate performance, but find a stakeholder class system with shareholders classified as "privileged." Griffin and Mahon (1997) review 51 studies over 25 years that explore the empirical relationship between corporate social performance and corporate financial performance and conclude that no consensus exists. In one of the few studies to link stakeholder orientation to firm outcomes, Hillman and Keim (2001) find that stakeholder management is complementary to shareholder value creation. They also find that participating in social issues beyond a point adversely affects the creation of shareholder value. Moreover, they conclude, "The emphasis on shareholder value creation today should not be construed as coming at the expense of the interests of other primary stakeholders" (Hillman and Keim 2001, p. 136). Based on a detailed review of 95 empirical studies linking corporate social and financial performance (spanning 30 years of research), Margolis and Walsh (2001) conclude that any conclusion "...indicating that a positive relationship exists between social performance and financial performance must be treated with caution" (p. 13).

Freeman and McVea (2001) suggest that

> Diverse collections of stakeholders can only cooperate over the long run if, despite their differences, they share a set of core values. Thus, for a stakeholder approach to be successful it must incorporate values as a key element of the strategic management process (p. 194).

What this means is that managers must identify these core values and use them as the basis for decision making. Whose values should be represented in such management decision making? As Harrison and Freeman (1999) concede, researchers have focused on broad typologies and have ignored the differences within stakeholder groups. It is problematic to discuss groups such as employees as if there is one employee set of values. The task of establishing core values such as what a company stands for, and doing this in a manner that takes into account concerns across and within heterogeneous stakeholder groups imposes an unrealistic expectation of managers.

Arguments for the Primacy of Shareholder Value Maximization

Our argument for why shareholder value maximization should be the preferred corporate goal has five parts: (1) The goal of maximizing shareholder value is pro-stakeholder. (2) Maximizing shareholder value creates the appropriate incentives for managers to assume entrepreneurial risks. (3) Having more than one objective function will make governing difficult, if not impossible. (4) It is easier to make shareholders out of stakeholders than vice versa. (5) In the event of a breach of contract or trust, stakeholders, compared with shareholders, have protection (or can seek remedies) through contracts and the legal system.

Maximizing Shareholder Value Maximizes the Value of the Whole Firm

Much of the debate has revolved around shareholders versus nonshareowning stakeholders. Such a debate is incorrectly framed, because the goal of maximizing shareholder value can be manifestly pro-stakeholder. Cash flows from share ownership are purely residual claims. These claims are due only after all other committed corporate claims (e.g., payments to suppliers, wages and salaries to employees and management, and interest and principal payments to bondholders) have been met. How does this relate to firm value maximization? In situations where outputs result from team production efforts, maximization of output occurs when control rights are assigned to the residual claimant (Alchian and Demsetz 1972). Only residual cash flow claimants have the incentive to maximize the total value of the firm. Claimants to committed cash flows have no incentive to increase the value of the firm beyond the point at which their commitments are assured.

This argument was most compellingly articulated by Easterbrook and Fischel:

> As residual claimants, shareholders are the group with the appropriate incentives ... to make discretionary decisions .... Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project .... [B]ecause shareholders ... bear the risk at the margin, they are more likely than bondholders to have the appropriate incentives and thus are the more appropriate holders of discretionary powers. The right to vote (that is, the right to exercise discretion) follows the residual claim (1983, p. 403).

Extending this argument, Macey (1989, 1991) points out that control rights should go to shareholders because, as residual claimants, they are the constituency that will value this right most. Shareholders have the greatest incentive to induce firms to engage in activities that fixed claimants would consider excessively risky, because they gain all of the benefits from the success of risky activities, but stand to lose only the amount of their initial capital investment. Fixed claimants do no better whether the firm performs "spectacularly well" or just "well." Recognizing that, they will adjust the price they pay for their fixed claims to compensate themselves for the prospect that the firm will undertake activities that lead to wealth transfer. Thus, it will be the shareholders, not fixed claimants, who bear the costs of any anticipated excessive risk taking. Thus, managing on behalf of shareholders forces managers to go beyond satisficing effort levels that would suffice were they were to manage the firm on behalf of just fixed or quasi-fixed claimants. By going beyond the requirements of such committed claims, managers increase the size of the pie for all constituencies.

Stakeholder Management Distorts Entrepreneurial Risk-Taking Incentives

Managers often bear undue amounts of nondiversifiable risk in one asset, the firm for which they work. Even though they might be diversified in their personal investment portfolio, it might not be sufficient to compensate for the effect of poor diversification, because their human capital and financial capital (in the form of stock compensation, or investments in retirement wealth) are tied up in the firm's assets. This can lead them to focus on the total risk characteristics of the firm's cash flows, when what actually matters for shareholder value maximization is risk that cannot be diversified away, i.e., the systematic risks in a well-diversified portfolio that shareholders own. Put simply, shareholders care about the systematic risks of a firm's cash flows in the context of a diversified portfolio and are risk neutral at the margin; poorly diversified managers care about the systematic plus unsystematic risks of the firm's cash flows, and thus tend to be more risk averse than shareholders. Such entrepreneurial risk aversion can lead to overreliance on decisions to stabilize cash flows, such as survival or market share maximization. Entrepreneurial risk aversion can lead to unrelated diversification, excessive hedging, and avoidance of high-growth investment opportunities.

Managing on behalf of fixed claimants exacerbates the incentive for entrepreneurial risk aversion because fixed claimants are also driven to minimize total risk. Bondholders base decisions on the bankruptcy risk in a firm's cash flows (i.e., based on assessments of total risk), not on its value-maximizing potential from free cash flows discounted at the risk-adjusted cost of capital. Employees prefer the prospect of permanence from cash flow stability, rather than the prospect of job layoffs that more volatile cash flows bring from the greater risks. Suppliers do not get paid in full, and commitments to the community to which the firm belongs (e.g., contributions to local charities, hospitals, schools, and so forth) cannot be met if the firm goes into bankruptcy. All constituencies, except residual cash flow claimants, have incentives to dissuade managers from taking excessive entrepreneurial risks. This compounds the managerial incentive to avoid risks from poorly diversified wealth and human capital. In the process, the firm runs the risk of forgoing investments in new opportunities for growth, in new markets and products, in new technologies, and in cutting-edge areas of economic activity, all of which will erode the firm's ability to innovate and, hence, stay competitive.

Having More Than One Objective Function Is a Recipe for Confusion

Many stakeholder theorists suggest that managers should manage on behalf of multiple constituencies and juggle multiple goals. However, having more than one objective function creates the potential for confusion and dithering in decision making. As Jensen (2001) argues, "multiple objectives is no objective," because

> [I]t is logically impossible to maximize in more than one dimension at the same time unless the dimensions are monotone transformations of one another. The result will be confusion and lack of purpose that will fundamentally handicap the firm in its competition for survival (p. 10).[9]

A basic problem with the stakeholder view is that the question of *which* stakeholder should matter is left unanswered. To suggest that managers must juggle multiple goals in a complex hierarchy is wishful thinking. Even if managers could decide on a single stakeholder, there is differentiation within stakeholding groups—e.g., different classes of employees, seniority levels for bondholders, tiers for suppliers, community groups whose objectives might be in conflict with those of other community groups, and so forth. Even within carefully parsed or defined stakeholding groups on which everyone could agree there arises the question in a global firm of whether it is the domestic or nondomestic constituency whose goals should predominate. The alternative is to suggest that the manager should choose,

because that is, after all, what a leader is required to do. What is the social, economic, and political legitimacy of a manager to choose? Who oversees and legitimates these choices? Even if such a manager is benevolent, what reasonable investor would be willing to supply capital at a competitive cost to such a firm?

In summary, it is not possible to manage on behalf of multiple constituencies when their goals are in conflict. Even if it were possible to do so, it may not be socially desirable to allow managers the unfettered freedom to do so. Shareholder value, on the other hand, is a single-valued metric that is also observable and measurable.

Nonshareowning Stakeholders Can Become Shareholders, but the Reverse Is Not Easy

There is no reason why nonshareowning stakeholding groups concerned about the potential abuses of shareholder value maximization could not demand or choose to become shareholders themselves. Employees, suppliers, and customers can be (and often are) given stocks. Nothing prevents bondholders from becoming stockholders in the firm. Even local communities, such as pension funds managing the retirement wealth of public sector workers, can become shareholders. In the case of a publicly traded firm, these constituencies can buy shares in the open market, thereby becoming shareholders and availing themselves of all shareholder rights.

The preponderance of employee stock-ownership plans, employee stock option plans, and public pension funds are examples of stock ownership by stakeholders. In many instances, such share owners exercise important and credible voice in corporate governance in countries such as the United States (Millstein and MacAvoy 1998). Perhaps the most interesting development recently is the increasing role played by unions voting as shareholders. In the 1990s, unions as labor-shareholders (given their role as shareholder trustees of company pensions) became visible players in the shareholder movement, rivaling traditional institutional shareholders such as pension and mutual funds (Schwab and Thomas 1996, Thomas and Martin 1998). Although their success rates were low, O'Connor (1997) finds that, as a group, labor-shareholders submitted one of the largest numbers of shareholder resolutions, and that they had one of the highest success rates in obtaining passage of their proposals.

Making the reverse happen is not easy: It is difficult, if not impossible, for a shareholder to become a stakeholder. It is fairly obvious that even if (s)he wants to, a shareholder cannot just become, or demand to become, an employee, a supplier, or the member of a local community of a firm in which (s)he owns shares. That being the case, shareholders would be denied the opportunity to participate in the governance process in those firms that manage on behalf of such constituencies.

The Law Fills the Judicial Void for Stakeholders

Nonshareowning stakeholders have explicit contracts with the firm, whereas a shareholder's contract is implicit (because all it amounts to is a claim on the firm's residual cash flows). The interests of stakeholders such as employees, suppliers, bondholders, communities, and customers are protected by contract law and by regulation (Bradley et al. 1999, pp. 24–29; Ramseyer 1998; Hansmann and Kraakman 2000, p. 10). Shareholders have no recourse through contract law. U.S. employees, for instance, have contractual provisions in their favor, covering areas such as pensions, health and safety, antidiscrimination, and other forms of labor law. Payment of interest and principal on bonds, adherence to bond covenants, and relations with trade creditors are obligations of the firm and are covered by contract law and banking and commercial laws. The same holds true for the firm's relations with its suppliers and consumers (e.g., warranty laws, product safety laws, product liability laws, antitrust law, and laws governing disclosure of product contents). Communities and involuntary creditors protect themselves through numerous laws aimed at corporations, covering such areas as environmental pollution and law of torts. Where law is inadequate or cannot foresee all contingencies, the judicial system routinely steps in to fill the void and to interpret the terms of the original contract.

Surely, however, shareholders can bring derivative and class action suits. Early evidence (see, e.g., Jones 1981) suggests that although such suits are uncommon and the numbers are exaggerated because multiple suits are brought on the same claim, a vast majority (about 75%) are settled out of court in the plaintiff's favor. In the few that go to trial the success rate for plaintiffs is small—courts largely rule in the defendant's favor (see also Romano 1991). The preponderance of subsequent evidence is that shareholders do not profit from such suits, and that they are filed because attorneys stand to gain substantial benefits (Coffee 1985, Romano 1991, Macey and Miller 1991, Munson 2001). Indeed, the incentive to settle, combined with the overwhelmingly low ratio of litigated victories, suggests that such suits are brought for their nuisance value, driven by the fact that, if settled, the corporation pays the legal fees of both parties (Coffee 1985, pp. 15–16 and p. 22; Munson 2001, pp. 459–460). Even if shareholders do win in derivative suits, the damages are paid not to them, but to the corporation, with any gains being indirect, resulting from either an increase in share prices or a change in management behavior. In recent years, class-action suits by shareholders—also called representative shareholder suits because one or a few self-appointed shareholders and their lawyers claim to represent all investors—have become more prominent. However, empirical evidence with such class-action suits is similar (Alexander

1991). During the 1990s, 83% of the cases were settled, with the average proportion of settlement amounts to claimed damages being 14% (Martin et al. 1999, p. 123). Most investors remain passive and are unaware that litigation is even going on and that attorney interests can often diverge from client interests (Macey and Miller 1991). Multiple lawsuits are often filed for the same wrong (Jones 1981, Romano 1991, Thompson and Thomas 2003). Suits tend to be filed by a small number of law firms, with repeat plaintiffs in lawsuits across multiple firms. Thompson and Thomas (2003), for instance, cite evidence that the law firm Milberg and Weiss alone accounted for 31.4% of class action suits filed between 1996 and 1998, and that since 1995 the firm has accounted for 43.8% of all federal securities suits filed and 51.5% of all settlements. Most suits are filed very quickly, often within hours or days of an event (Thompson and Thomas 2003).[10]

Evidence also shows that the announcement effects of shareholder suits are zero (Fischel and Bradley 1986) or negative (Bhagat et al. 1998; see also Bhagat and Romano 2002). In addition, the Business Judgment Rule provides another layer of protection to boards and officers. Because of the Rule, courts will seldom second-guess the boards' decisions (Ramseyer 1998).

Add to all this the issue that minority shareholders might not receive the same protection as blockholders or controlling shareholders, and it becomes obvious why fiduciary duties of boards are required by law to be owed to shareholders. Essentially, as Macey and Miller (1991) argue, the legal system derives the fiduciary system for filling gaps that arise in the terms of shareholders' implicit contracts with management. Our contention is not that stakeholders have all the contracting power they need or that shareholders have no judicial recourse whatsoever. Rather, it is simply that stakeholders have greater ability to explicitly contract with the firm and thereby have the backing of the judicial system to step in to fill voids in that explicit contract.

Problems with the Shareholder Maximization View?

Each one of our propositions invites critiques. Some, such as the role of stakeholder statutes, the role of shareholder suits, the role of board fiduciary obligation, and the question of which stakeholders should matter if multiple goals are pursued we have already addressed. However, larger issues loom. The most obvious issue is that our proposition, that maximizing shareholder value maximizes the value of the whole firm, begs distributional implications. In other words, managers might simply transfer value to shareholders from other stakeholders rather than create value and increase the size of the pie.

In response, we raise two questions: (1) In an environment in which global capitalism impels a focus on efficiency, can a firm afford not to focus on shareholder value? (2) Will the incentive to transfer value be limited to a firm that is managed on behalf of stakeholders rather than shareholders? Given the association between efficiency and shareholder value, decisions to increase the latter are often motivated by the former, even though in some instances pursuit of efficiency imposes costs on other stakeholders. Efficiency concerns, in turn, result from the competitive nature of the business environment. Firms that compete in competitive markets for capital, raw material inputs, employees, products, technologies, and corporate control often have no choice but to focus on efficiency. Managing inefficiently in an era of global capitalism risks corporate suicide. Equally, unless the market for corporate control is outlawed, an acquirer will end up doing to the incumbent's stakeholders what incumbents were unwilling to do. Put simply, in a market-driven economic system a manager realizes that, if the firm is not efficiently managed, such efficiency will be imposed. On the question of value transference, we contend that it can occur regardless of which constituency's concerns predominate. Managing on behalf of, say, employees does not preclude the possibility of value transference from suppliers, consumers, bondholders, shareholders, or the natural environment. Indeed, managing on behalf of certain types of employee (e.g., unionized or permanent workers) can be at the expense of other types of employee (e.g., nonunionized or temporary workers).[11]

More importantly, there is no evidence that firms in relatively stakeholder-oriented corporate economies such as those in Europe or Japan are more responsible corporate citizens, or less prone to stock market bubbles and managerial malfeasance than the more shareholder-oriented U.S. firms. If anything, there is evidence to the contrary. Bennett (1998) finds that corporate donations are smaller in Europe than in the United States, whereas Langlois and Schlegelmich (1990) observe that European companies are less likely to use ethics codes than are U.S. firms. Maignan and Ralston (2002) compare the extent and content of businesses' communications about corporate social responsibility in France, the Netherlands, the United Kingdom, and the United States. They find that French and Dutch businesses are not as eager as U.S. firms to convey good citizenship images in their corporate communications and suggest that this is because U.S. firms are expected to play a leadership role in the communities in which they operate. In contrast, the French and the Dutch do not have a tradition of encouraging such involvement, implying that they are not confronted with the same community leadership expectations as are, perhaps, U.S. firms.

In addition, U.S. firms have been subject to rules governing questionable payments abroad for almost three decades longer than have firms in the European Union or Japan. U.S. firms provide annual data on compliance

with environmental regulations, unlike firms in Germany and Japan. U.S. courts, including the U.S. Supreme Court, have allowed numerous suits to be brought in the United States by foreign stakeholders affected by the conduct of U.S. corporations (e.g., through the Alien Tort Claims Act), whereas countries such as Germany and Japan have instead felt the need to create a supranational court to deal with such disputes, perhaps reflecting inadequacies in their own courts. In the shareholder-primacy era of the past two decades, U.S. firms have been far more successful in creating employment than firms in Germany or Japan: For instance, employment grew significantly in the United States during the 1980s and 1990s (and overall unemployment fell), but it stayed flat in the European Union and in Japan (and unemployment increased). Indeed, at one point the unemployment rate in Japan exceeded that of the United States, and the German rate was more than twice the U.S. rate. In most industries of the future—e.g., Internet, biotechnology, communications, computers, nanotechnology, to name a few—U.S. firms (and their highly developed environment for entrepreneurial finance) stand out relative to German and Japanese firms in their ability to assume entrepreneurial risks. Similarly, stock market bubbles and corporate scandals have not been unique to the shareholder-oriented U.S. system. As has just about every major country in Europe and Asia, Germany and Japan have had their share of major scandals and governance crises during the 1990s. Compared with the slightly less than 50% decline (from peak to trough, as of the time of writing) of the U.S. market, the German stock market has been down 68%, and the Japanese market a stunning 79% from their respective peaks (measured in respective home currencies; calculations on file).

Another critique of shareholder value maximization often deals with the implications of contract failures from the imposition of externalities on parties outside the direct contract. However, such imposition of third-party externalities is by no means unique to shareholders. Externalities can be imposed on anyone outside any contract regardless of who is party to the contract. Renegotiating terms with any group of stakeholders implicitly or explicitly alters the terms not only with other stakeholders, but also with parties outside the direct contracting process. Paying employees more, or not downsizing to preserve employment, might mean creating greater financial distress risk that makes bondholders worse off (consider, for instance, the U.S. airline industry in 2003). Renegotiating terms with one group of stakeholders can lead to higher prices, making consumers worse off. Renegotiating terms with one group of bondholders can create externalities for another group of bondholders. Offering more-generous terms to suppliers might mean that less is available to pay employees, and so forth.

Blair and Stout (1999) critique shareholder value maximization using a theory of team production. Using the same tools of analysis as those used by law and economics scholars to justify the shareholder view, they consider the distributional implications of governance. They view the corporation not as a nexus of contracts, but as a nexus of inputs provided by a team of shareholders and stakeholders who come together to earn a return higher than the input cost. They ask, How can we fairly allocate the rents from a nonseparable output? They conclude that most mechanisms to do so engender rent-seeking behavior that destroys value. In particular, assigning control rights to shareholders results in alienation of other team members, especially those whose exit option is limited because of their firm-specific human capital. This produces suboptimal effort provision by such team members and, thus, suboptimal value creation. Their solution is to provide to a third-party—specifically, an independent board of directors—the authority to monitor inputs and to allocate rents (Blair and Stout 1999, pp. 274–276), and they suggest that an appropriate reading of U.S. law suggests that it would allow directors that discretion (p. 303).

However, their analysis suffers from weaknesses. They do not examine the trade-off between the loss from suboptimal provision of efforts by team members and the gains from assigning control rights to the residual claimant. If the latter overwhelms the former, then the Alchian and Demsetz (1972) view still stands. Moreover, are there incentives to counter suboptimal effort provision—e.g., Why not compensate all team members with a claim to the residual output or output-contingent bonus payments? Could residual claim-based payments for all team members counteract the incentive for suboptimal effort provision and enhance the effect of gains from assigning control rights to the residual claimant? Blair and Stout (1999) also fail to consider the implications of residual claimants continuing to have the exit option. If the firm does not provide their required rate of return, they will sell their shares and thus lower the value of the team's output. The cost to the residual claimants of having to sell their shares at lowered prices could be smaller than the loss that would result from suboptimal effort provision (Millon 2000, p. 1028). As to their argument of the wasteful rent-seeking behavior, it seems to us that it will simply be displaced, and will be redirected at the board. Also, the distributional role assigned to a group of outsiders in the name of an independent board is troublesome. Who decides on the qualifications of this board? Who hires them? Who fires them? And finally, their interpretation of U.S. law as being enabling with respect to giving directors the discretion, under the Business Judgment Rule, to allocate output to nonshareowning stakeholders has been challenged by legal scholars (Millon 2000, Bainbridge 2002).

Yet another critique of shareholder value maximization views performance-contingent payments such as bonuses as substitutes for stocks and options. If they truly were substitutes, shareholders would welcome the prospect. However there are problems. Although certain categories of stakeholder (e.g., employees or suppliers) can be given performance-contingent payouts, it is not clear that others (e.g., nonconvertible debtholders, customers, communities) can be given such payouts. Furthermore, are such payments substitutes for, or complements to, their fixed compensation? If stakeholders are also compensated with fixed payouts, then performance contingence is a complement: The incentives revert to those that are similar to those for fixed claimants. Shareholders are, however, different in this respect. Their claim derives solely from residual cash flows. If the firm produces zero residual cash flows they get nothing. Unless claims of stakeholders are based solely on residual cash flows, the argument—that shareholders are the claimants with the greatest incentive to maximize the value of the residual claims—holds.

What about the alleged malfeasance by (and collapse of) corporate highflyers in 2001 and 2002? Is this not the type of stakeholder abuse that shareholder-focused corporate behavior can create? These events have undeniably resulted in a value loss for stakeholders. However, we suggest that it is difficult to reconcile these events with the notion that these firms were, indeed, managed on behalf of shareholders. Although the pension wealth of many employees is worthless, it is important to note that, with some exceptions, most employees willingly overinvested in their companies' stock and did not diversify. For the shareholder, these events represent massive wealth transfers from the public at large to employees and insiders during the course of their many successful stock market years. (In many instances, suppliers and corporate customers were enriched from allocations of friends-and-family stocks to which the public shareholder did not have access.) Although top managers undeniably bear a disproportionate share of the blame, it is nearly certain that more than just a few top managers were collectively involved—by silence or consent—in the decisions leading up to these events.[12] Suppliers and creditors will not get all that is due to them, but the bankruptcy process ensures they get something back. As for customers, there is no evidence that the collapse of firms such as Enron has had any long-term impact on energy prices, nor that the collapse of telecommunications and information technology companies has affected the availability, pervasiveness, and affordability of telephone services or the Internet. The one constituency whose claims remain completely wiped out in all these instances is the shareholder.

An implicit premise in many arguments for shareholder value maximization, including ours, is the lack of distinction between the short run and the long run. Traditional theories of finance and contracting obviate the need for such a distinction by assuming market efficiency, whereby optimality in the long run is simply the result of a series of optimal short-run decisions. However, in a world in which the efficiency of markets might be under serious intellectual and empirical attack (see the considerable work in the area of behavioral finance, as well as Shiller 2000), and one in which managerial incentives such as stock options have been structured to benefit managers from short-horizon share price reactions, it is right to ask whether the long run is simply a series of optimal short runs. The ability of better-informed managers to shift value by arbitraging across horizons based on information that investors do not have (or were misled on) raises troublesome questions about the viability of true long-run shareholder value maximization.[13] We side with the underlying thrust of U.S. corporate law on this issue: Corporate law has long made a distinction between the two horizons (see the excellent survey of this question by Allen 1992; see also the notes to the corporate goals in §2.01 the *ALI Principles of Corporate Governance*, American Law Institute 1994), and generally recognizes that what matters for shareholders is value creation in the long run. Everything we have said thus far should be seen in this light. We do not endorse incentives and systems that give managers the ability to arbitrage across horizons at the expense of long-run shareholder value creation. That is not value maximization; rather, it could lead to insider enrichment that destroys true shareholder value.

All this said, there are two substantive boundary conditions to our arguments. We raise them here with the caveat that space constraints preclude fully addressing their ramifications. The first condition concerns incentives for entrepreneurial risk taking that morph into incentives for excessive risk taking. In particular, the use of stock options to compensate managers—with the supposed intent of reversing their risk aversion—is puzzling. We are unaware of either credible empirical evidence or theoretical reasoning that supports the view that their provision is in the shareholders' interests, and yet their use has become commonplace. If we recognize that call options are simply the equivalent of giving managers a risk-free loan to buy the firm's stock (with a free hedge during its life thrown in), it is not at all clear why their provision is consistent with the goals of a diversified shareholder. Moreover, as Bebchuk et al. (2002) convincingly point out, the processes that produce such compensation arrangements leave managers with considerable power to shape their own pay, and are tantamount perhaps to little more than rent-extraction mechanisms. We agree. We would go as far as to suggest that the excessive use (and inadequate policing) of such compensation schemes helped fuel the corporate crises of 2001 and 2002, and must be reined in.

A second and related boundary condition involves top management pay. Surely there is a point at which the level of top management pay becomes incompatible with society's norms of fairness. In particular, CEO-pay levels in the multiples of hundreds of average employee pay quite possibly breach society's outrage constraint.[14] As Roe (2002) argues, such a constraint imposes cultural, social, and political limits on the economic model of the firm, and its breach can lead to a set of responses from inside the organization via degradation of employee motivation, and from the outside via political or regulatory backlash. These responses can result in a less productive, deteriorating organization that works to the shareholders' and stakeholders' detriment.

Conclusion

Over the past 150 years, there have been significant stretches of time when stakeholder views have dominated not only discourse, but also managerial practice, law, and public policy toward corporations. The events of the early part of the twenty-first century portend the likelihood that we might be, arguably, at the cusp of a new such era. Our position, however, is that there is no need to jettison the goal of shareholder value maximization. We argue that it is unambiguously the preferred goal among available alternatives. Moreover, concern about the deleterious consequences of the shareholder maximization logic must recognize that the traditional critiques, such as value-transference incentives and implications of contract failure are by no means unique to shareholders, but exist regardless of the stakeholder on whose behalf the corporation is managed. Failures commonly attributed to the shareholder value maximization view have less to do with shareholders than with the nature of contracts. Managing on behalf of stakeholders does not somehow lead to fewer contracting problems. Indeed, it might create even more problems, such as those resulting from lack of incentives to increase the value of the firm, from distorting risk-taking incentives, from creating confusing objectives, and so forth.

Our position is by no means that firms should ignore other stakeholders or that there are no boundary conditions to the manner in which shareholder value creation logic has been applied in practice. We believe that shareholder value as the objective function will lead to decisions that enhance outcomes for multiple stakeholders. We obviously reject the view that managers will somehow end up being negligent in their moral (and legal) duty to stakeholders if they actively and vigorously pursue a fiduciary responsibility to shareholders. We are also skeptical of the argument that a stakeholder approach to governance leads to either competitive advantage or better behavior. As to the boundary conditions, we believe that a redesign of incentive systems to orient the manager's objective toward that of a diversified, long-horizon shareholder is clearly necessary not just for stakeholders, but, equally importantly, for shareholders.

The heart of our argument has been a case for why the shareholder value maximization view is, at its core, inconsistent with exploitation or alienation of the firm's other constituencies. Such strategies offer no basis for long-run value creation. Those who propose an alternative viewpoint must, at the very least, answer three very basic questions: Can a firm create and sustain long-run shareholder value just via transfers from its nonshare-owning stakeholders? Can such an alternative viewpoint be made compatible with external mandates that competition and regulation impose upon managers? If managing on behalf of stakeholders is the desired goal, how can we make the stakeholder objective compatible with naturally occurring incentives, impulses, and imperatives of the market-based economy in democratic-capitalist societies?

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Endnotes

[1]See, for example, Rappaport (1986, p. 13), Brealey and Myers (2001, pp. 24–26), Ross et al. (2002, pp. 15–17), and Bodie and Merton (2000, pp. 10–12).

[2]We will not attempt to provide a detailed list of references for these two opposing conceptions of the corporate form of organization, because they have been dealt with in a substantial amount of legal scholarship (see, e.g., Ruder 1965; Eisenberg 1983; Bratton 1989a, b; McDaniel 1991; Minow 1991; Millon 1990, 1991, 1995; Hazen 1991; Allen 1992; Blair and Stout 1999). For a comprehensive set of references and citations, see Bradley et al. (1999). The communitarian conception of the corporation is closely identified with the stakeholder and corporate social responsibility viewpoints and has its origins in the pioneering work of Etzioni (1988, 1993).

[3]Early organization theory scholars espoused views that are consistent with our focus. Williamson (1981) ably summarizes the early organization theory literature and notes that although efficiency is not a central theme in much of the literature, the classic works of Barnard (1938) and Simon (1957) reveal precisely such a concern. Barnard emphasizes the role of rationality in internal organization, whereas Simon extends the notion of rationality to develop a distinction between intendedly rational behavior and its (constrained) manifestation in practice, limited rationality (see also Simon 1964). The notion of limited rationality and its implications were, of course, more fully developed by Williamson's subsequent work on transaction cost economics and the idea of bounded rationality. That said, many others have offered alternate conceptualizations of

corporate goals. In early views, Drucker (1958) emphasizes organizational survival rather than rational profit maximization as the central goal the managers must pursue. Quinn (1980, p. 7) cautions against narrowly construing the goal as that of profit maximization and suggests that corporations should have "... multiple goals ... in a complex hierarchy." Similarly, Drucker (2001, pp. 17–18) argues: "Top management of the future will need to balance three dimensions of the corporation: as an economic organisation, as a human organisation, and as a ... social organisation." However, as we make clear later in the paper: (1) The firm cannot escape its central role as an economic organization with, at the very least, intendedly rational behavior in democratic capitalist societies. (2) The pursuit of multiple goals is unrealistic and inadvisable. (3) The pursuit of a goal such as survival might, in fact, jeopardize the very pursuit of that goal.

[4]Most of the early incorporations that were allowed were quasi-public, such as charitable organizations, municipalities, public utilities, banks, and insurance companies. Incorporation for the pursuit of private objectives was uncommon, and would typically be organized as partnerships or proprietorships (Hurst 1970).

[5]It was not until well into the twentieth century that the ultra vires doctrine was abandoned by courts, to be replaced by the business judgment rule. This rule, the currently prevailing norm that guides board activities in the United States, states that a corporate manager is not liable for an action that is within the powers of the corporation and the management's authority, when it is carried out with due care and according to applicable fiduciary duties (see any well-known corporate law textbook, e.g., Clark 1986).

[6]Dodd's article was in response to the article by Berle (1931), whose thesis was that the powers of the corporation must be exercised solely to benefit shareholders. The debate, which lasted over two decades, was finally conceded to Dodd by Berle in 1954 (see Weiner 1964 for a detailed summary of the Berle-Dodd debate).

[7]Specifically, Springer concluded: "Constituency statues are red herrings .... [T]he fact that these statutes are invoked by directors casually, perhaps sometimes even cynically, does little to advance the case for consideration of constituent interests in corporate law" (1999, p. 122).

[8]Stakeholder theory does not completely ignore profitability concerns. Some (e.g., Jones and Wicks 1999) explicitly acknowledge that firms must be profitable and viable if they are to serve any stakeholders at all.

[9]This argument invokes the Arrow Impossibility Theorem (Arrow 1950): Under certain conditions for "fair" decision making, there is no consistent method of making a fair choice among three or more alternatives—i.e., there is no majority-voting procedure that can always fairly decide an outcome when more than two alternatives are involved. For example, apart from shareholders, if there are multiple classes of stakeholders, then there is no fair way to democratically decide on whose behalf the board should vote to manage the firm.

[10]Thompson and Thomas (2003) examine class-action suits filed in 1999 and 2000 in Delaware and find, however, that the evidence is somewhat more mixed with regards to the proportion of settlement dollars claimed by attorney fees and the size of the settlements in acquisition-related class-action suits.

[11]Coff's (1999) examination of stakeholder bargaining power provides the example of the team that, by virtue of its unique capabilities and high replacement cost, captures above-normal wages, implying that other stakeholders with less bargaining power appropriate less value.

[12]Lewis (2002), citing the work of Blasi et al. (2003) notes, "...[the authors] combed through the record of stock option sales by ordinary employees of the 100 biggest New Economy–type companies. And they found that, while the executives of these companies made off with great wads of cash, the ordinary employees, as a group, did far better. Through the boom, investors forked over $78 billion to the regular employees of 100 start-ups. The grunts of the bankrupt Excite@Home, for instance, made off with an estimated $600 million before their company went under."

[13]We mean true shareholder value in the sense of a considerable finance literature (including the behavioral finance literature) that has been published in the past decade (see, e.g., Rotemberg and Scharfstein 1990). Specifically, under imperfect information, if investors are incorrectly informed about future profitability, the expected discounted value of profits need not be the same as the current share price. Firms (and managers) can increase current profits at the expense of future profits by forgoing positive net present value (NPV) projects, thus giving them the opportunity to arbitrage across horizons. If investment is unobservable and firms vary according to their inherent profitability, high current profits lead investors to believe that the firm is inherently more profitable even when it might not be. The earliest clearly articulated ideas in this regard are probably Miller and Rock (1985) and Stein (1989). It is important to note that this distinction does not imply that markets are inefficient: The assumption of semistrong efficiency is consistent with this dichotomy.

[14]Krugman (2002) reports that in 1999 the average annual real compensation of a Fortune 100 CEO ($37.5 million) was over 1,000 times the average annual pay of an ordinary worker.

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