The Corporation and the Law[1]

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I have a secret: I love corporations. I study them and I love them, just as Jane Goodall studies and loves chimpanzees. It makes me terribly sad that corporations are so misunderstood.

I'd like to help people understand my beloved corporations a little bit better. I think corporations are misunderstood because—please pardon this observation—we have too many economists talking about corporations, and not enough corporate lawyers. Corporations are legal creatures. With due apologies to all the nice economists out there, the fact is that most of you didn't go to law school. Therefore you don't really understand corporations the way that corporate lawyers can. I'm here to help.

What I want to do in particular is debunk some very common but dangerous myths about corporations that have become endemic in the business world. There are two myths that I especially want to address.

The First Myth: Corporate Law Requires Directors to Maximize Shareholder Value

The first myth is the widely held belief that the directors of a corporation have some sort of legal duty to "maximize shareholder value" (often treated as synonymous with share price) and that directors can be sued for damages if they fail to do this. This is utter myth. Nevertheless, you'll see it widely repeated, including by business journalists. It seems to be traceable to an old case that comes out of Michigan almost 100 years ago called *Dodge v. Ford*. Whenever you ask someone to give you some legal authority for the proposition that directors have a fiduciary duty to maximize shareholder value, they seem to drag out poor, old, dusty *Dodge v. Ford* and put it on the table as Exhibit A.

1 Read 16 November 2013, as part of a symposium on American corporations.

As a corporate lawyer, I want to advise you that you are in trouble if the best precedent you can find for a proposition is a case that is almost 100 years old and comes from a state that's a bit of a backwater for corporate law. (The big state for corporate law is Delaware; that's where the majority of large firms are incorporated.) Moreover, it turns out that *Dodge v. Ford* is not really a case about directors' duties to shareholders at all. It's actually a case about a conflict between shareholders. Henry Ford was the majority shareholder in Ford Motor Company. The Dodge brothers were minority shareholders in Ford who were trying to start up their own auto business, eventually known as Dodge Motors. Henry Ford wanted to prevent Ford Motors from paying big dividends because he wanted to starve the Dodge brothers of any economic return from their Ford Motors stock in hopes of crushing a potential competitor.

This makes *Dodge v. Ford* not only a very old case from the wrong state, but also a very odd case that does not shed much light on the duties of directors. Please—let's take *Dodge v. Ford* behind the barn and put it out of its misery.

If you look at modern corporate law, and especially Delaware corporate law, you will find there is no enforceable duty to maximize shareholder value because of a fundamental doctrine called the *business judgment rule*. What the business judgment rule says, in essence, is that as long as the directors of the company are not taking the company's assets for themselves—not stealing, in effect—and as long as they spend a decent amount of time poring over the papers that are presented to them, they can pretty much do what they darn please as long as they say that what they're doing is in the "long-run interests of the corporation."

Despite my somewhat cynical description, I believe the business judgment rule is a very wise rule for a variety of reasons, including the fact that if people could sue directors willy-nilly, corporations couldn't accomplish anything very useful. This is why you can find some version of the business judgment rule in almost every developed legal system in the world.

But whether you like the business judgment rule or not, the rule makes pretty clear that corporate directors have the legal discretion to decline to maximize profits or share price, and instead run corporations with other objectives, such as producing great products, making great scientific innovations, taking care of employees, contributing to the community, or strengthening the nation. All directors have to do is say, "We are doing this because we think it is in the best long-run interests of the corporate entity." (As Professor Sylla just described, during the managerialist era, it was very common for the managers of

corporations to be quite explicit in publicly describing corporate objectives this way.)

But the business judgment rule is still around, even though managerialism has given way to the ideology of shareholder value in most of the business world. If you doubt the continued existence of the business judgment rule, you might want to consider the recent Delaware case of *Air Products v. Airgas*. In that case, the stock of Airgas Corp. was trading at $40 to $50 per share. Another company called Air Products came along and offered to buy Airgas for $70 a share, an event that would pretty clearly increase shareholder value. But the directors of Airgas said: "No, thank you very much. We don't think selling our company is in the best long-run interests of the corporate entity." And the Delaware judge in that case said that the Airgas directors' decision was protected by the business judgment rule.

As this modern Delaware case illustrates, the business judgment rule means that there is no legally enforceable duty to maximize shareholder value. This pattern can also be seen in corporate charters. When you create a corporation, you have to file a charter. It's the equivalent of a corporate constitution. Since at least the nineteenth century, the law has allowed you to put in your corporate charter any restrictions you want on the corporation's purpose. There is no reason why, when you are creating a corporation, you can't put in the charter that "the purpose of this corporation is to maximize shareholder value." I have looked at a lot of corporate charters trying to find anything like that sort of language, and I have never found it. Instead, the vast majority of corporate charters today say simply that the corporation's purpose is "to do anything lawful."

People who create corporations are perfectly free to create companies that have the sole purpose of maximizing shareholder value. For some reason, they quite clearly are not doing that.

The Second Myth: Even Though the Law Does Not Require It, Directors Ought to Maximize Shareholder Value

Now, let us turn to the second myth that should be debunked. This myth is more common among relatively sophisticated people who recognize that the law doesn't require directors to maximize shareholder value. According to the second myth, even though the law doesn't require directors to maximize shareholder value, it's a good idea for directors to be required to do this because maximizing shareholder value is the best thing not only for shareholders but also for society as a whole.

This is another case in which economists who had never gone to law school have gotten it all wrong. The myth that corporations serve society best when they are run to maximize shareholder value can be traced to the so-called "Chicago School" of economic thinking, especially the influential writings of dear old Uncle Milton Friedman. The fatal flaw in the Chicago School approach is that it fails to appreciate what corporations really are. This can be seen in the way Friedman and other economists writing about corporations tend to analogize a corporation to a gigantic sole proprietorship (something that is relatively easy for non-lawyers to understand). This analogy underlies legally mistaken statements such as, "Corporations are owned by their shareholders" (how many times have you heard that phrase?), or the more sophisticated but equally mistaken statement that "shareholders are the principals and directors are the shareholders' agents." Yet another relatively sophisticated but legally incorrect argument sometimes made to support the notion that maximizing shareholder value benefits society is that shareholders are the sole "residual claimants" in corporations.

These sorts of statements are the foundations for the so-called "agency cost" approach to understanding the corporation that has been so widely taught in our economics departments, business schools, and (sad to say) even many law school classrooms for the past 20 or 30 years. Yet as a matter of law, these statements are clearly incorrect.

Please allow me to clarify for the non-lawyers in the audience what corporations really are, who really owns them, and who their residual claimants really are. You don't have to take my word for it. You can take the word of the U.S. Supreme Court. As that court recently reminded us in *Citizens United v. FEC*, corporations are legal persons. This is fundamental to understanding corporations. Corporations are sometimes called "legal fictions," but this phrase is frustratingly misleading. It's true that corporations are invisible, but they are not fictions. After all, gravity is also invisible. But gravity is not a fiction. Similarly, Exxon is not a fiction. Pfizer is not a fiction. Bank of America is not a fiction. These legal persons are very real entities and very real forces, just as gravity is a real force.

That corporations are legal persons means at least two things. The first is that shareholders cannot own corporations. As legal persons, corporations own themselves, or perhaps like human persons, they can be said to have no owners at all. But it is absolutely clear beyond any reasonable dispute that under the law, shareholders do not own corporations. What shareholders own is something called *shares*. A share of stock is nothing more than a contract between the human shareholder

and the corporate entity, just as an employment contract is a contract between the human employee and the corporate entity, and a corporate bond is a contract between a human creditor and the corporate entity. A share of stock is nothing but a contract with the corporation.

Similarly, corporate personhood undermines the notion that shareholders are "principals" and directors are shareholders' "agents." In the law, the hallmark of an agency relationship is that the principal can tell the agent what to do. But just because you're a shareholder of Apple doesn't mean you get to give orders to Steve Jobs. Corporate directors have no obligation to fulfill shareholders' requests, because directors are not agents but rather fiduciaries for both the corporate entity and its shareholders (and even, in some circumstances, other corporate stakeholders such as creditors). Any good lawyer would regard it as dangerously misleading to reduce the complexities of corporate fiduciary duties to the simple but mistaken notion that shareholders are principals and directors are their agents.

Finally, legal personhood means that shareholders are not the residual claimants of corporations. In economic parlance, the residual claimant of a business is the lucky person who gets all the profits that are left over after the business pays for all the expenses the business has to pay by law or contract. For example, corporations have to pay bondholders a fixed amount of interest; pay employees their agreed-upon wages; and pay the government the taxes imposed by law. All the corporate profits that are left over (the argument goes) belong to the residual claimant.

Economists often describe shareholders as the residual claimants in corporations. This notion is quite wrong, but if you believe that this is true, you can see how you would get an argument that maximizing the shareholders' interests is the same thing as maximizing the total value of the firm. After all, if the interests of other corporate stakeholders are fixed and predetermined, increasing the value of the company means increasing the wealth of the shareholders and vice versa.

But corporate personhood means that shareholders are not, in fact, the residual claimants in corporations unless the corporation is being liquidated in bankruptcy (something sensible corporate directors do their best to avoid). In an *operating corporation*, the corporation is its own residual claimant. Corporate profits belong to the corporate entity, not to its shareholders. And it is the directors of the company—not the shareholders—who decide how those profits will be used. The directors could pay out some of those corporate profits to the shareholders in the form of dividends, and directors often do. But under the business judgment rule, the directors could also decide to (a) use corporate

profits to invest in research and development that will produce great technologies, (b) increase employee salaries and benefits, (c) make charitable contributions in the corporation's name, and (d) even pay corporate taxes rather than lobbying Congress to create new tax loopholes.

The Rise of Shareholder Value Ideology and its Unfortunate Effects

I hope I have been able to give you some sense of what my beloved corporations are really like. Despite widespread belief to the contrary, corporate law does not require boards of directors to maximize shareholder value, and the typical economic justifications for requiring this turn out to be based on serious mistakes about corporate law. Nevertheless, I am sorry to report that these pernicious and legally mistaken ideas have seriously infiltrated the business world and changed actual business practice.

Thanks to the influence of the Chicago School, the reflexive assumption that corporations should be run to maximize shareholder value—what I call *shareholder value thinking*—has been embraced for two decades or more in academia, where economists, business professors, and even law professors have taught this ideology to an entire generation of business leaders. Worse, shareholder value thinking has been "hardened" into modern business practice through several individually modest but collectively significant changes in tax law and federal securities law. Thus, even though corporate law itself does not require or support shareholder value maximization, thanks to ideology and regulatory shifts outside of corporate law, managers today as a practical matter run public corporations with more of a focus on share price than ever before. The result has been to drive my beloved public corporations away from the managerialist ethos that Professor Sylla described and to cause them to embrace, instead, the idea that they should raise share price at all cost. As I am about to describe, this development has caused many harms, not least to shareholders themselves.

Let us start by considering some of the regulatory changes that have hardened shareholder value ideology into modern business practice. One of the most important was the change to the tax code that Congress made in 1993 to require public companies to base the pay of top executives on so-called "objective" performance metrics to get full tax deductibility. What objective metric did everyone latch onto? Share price, of course. This is why 1993 was a watershed year in which corporate executives began to abandon the managerialist ethos *en masse* for the brave new world of shareholder value.

There were other legal changes as well around this time. In 1992, the SEC changed the proxy rules to make it easier for large shareholders to coordinate with each other to challenge incumbent boards. This legal change gave rise to one of the most powerful forces pushing shareholder value ideology today: activist hedge funds. Hedge funds control 10% or more of the shares of public companies. They are now among the most powerful forces influencing managers' behavior, and they relentlessly pressure managers to raise share price.

Yet a third important change occurred in 2003, when the SEC said that mutual funds must publicly disclose how they vote the shares they hold in their investment portfolios. Before 2003, mutual fund managers routinely voted to support incumbent directors of public companies. After 2003, in what we shall politely call an excess of caution, mutual fund managers thought it might be a good idea to outsource the whole messy business of voting shares to somebody else. This gave rise to the notorious "proxy advisory" business known as Institutional Shareholder Services, or ISS. Between 80% and 90% of all shares held by institutional investors are now voted as ISS recommends, and ISS loves the idea of maximizing shareholder value. For example, ISS was one of the earliest and most enthusiastic supporters of stock options as a form of executive compensation.

So, how has corporate America's pivot from managerialism to the ideology of shareholder value been working out? In theory, today's public corporations should be producing soaring share prices and a host of other social benefits. In practice, not so much. If you judge the performance of public companies by their numbers, by their life expectancy, by the employment opportunities that they provide, by the taxes they pay, or by the ethics of their executives, all seem to be declining. But even more ironically, the returns public companies provide equity investors have also been declining. Shareholder value thinking may be harming shareholders themselves.

Experienced business people can tell you why. They know that companies that want to thrive need to produce high quality and innovative products; attract and keep loyal and skilled employees; maintain good relationships with their creditors, suppliers, and community; and invest in their own futures. None of these essential business strategies is consistent with always maintaining the highest possible share price.

This explains why the ideology of shareholder value did not arise in the business world itself. Instead, shareholder value thinking came mostly from ivory tower economists and federal regulators who often seem unaware of, and certainly unappreciative of, the beauties of corporate law. Yet corporations are nothing if they are not creatures of

corporate law. Thus it is perhaps no surprise that the embrace of shareholder value thinking, based as it is on mistaken notions of what corporations are and what corporate law requires, has not led to better corporations.