Octobre 2013
N° 2

CEPN
Centre d'économie de l'Université Paris Nord

CEPN Policy Brief

Questions about the shareholder value view of the firm

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The corporation has been one of the major institutions of capitalism since the end of the 19th century. It was the central instrument in the industrial development of Western economies and then the rest of the world. Today more than ever, the characteristics and behaviour of corporations have considerable economic, social, environmental and even political consequences. The conditions under which these companies are managed, the objectives they pursue and the interests defended by their managers are therefore of prime importance.

Shareholder primacy and shareholder value

The transformations that swept our economies from the 1980s, marked by the rise of finance and free-market principles, were accompanied by profound changes in corporate structures and modes of functioning, particularly in the large public limited companies[1]. The shareholder view of corporate governance lies at the heart of these transformations. This view is expressed in the doctrine of shareholder primacy, which was presented in a famous article by two leading US legal academics as "the end of history for corporate law"[2]. This doctrine combines two principles: (1) stock companies should be managed solely (or first and foremost) in the interests of their shareholders; and (2) the market value of the shares is the most important measure of shareholders' interests. This has led to the doctrine of shareholder value that has guided most large firms over the last twenty years: the maximization of shareholder value must be the priority objective for the managers of these companies.

It would be difficult to overestimate the impact of these principles - combined with the growing activism of institutional investors and investment funds – on the functioning of companies. This is well-illustrated by some examples from recent news. In 2012, a hedge fund manager tried to make Apple pay out a large part of its cash, deemed to be too abundant, to shareholders[3]. More recently, the financier Carl Icahn asked Apple to use its resources to buy back 150 billion dollars of its own shares[4], following a now-classic method to push share prices up, precisely in application of the principle of shareholder value. The possibility of using the cash accumulated by the firm for investment or research, or of distributing some of it to the employees, does not appear to have ever been envisaged. In France, an "activist fund" (TCI) recently asked EADS to sell its stake in Dassault, explaining that if "EADS was now a "normal company" in terms of governance, which aims at maximizing profit and shareholders' interests", then it should not delay in carrying out this operation[5].

So a "normal company" is held to be one that pursues the interests of the private shareholders. Today, this view is considered self-evident in the business world, as it is by the majority of "standard" economists. And yet there is certainly nothing evident about it. It has only really become established since the 1990s, with the affirmation of a view of the firm quite contrary to the managerial view that dominated most of the 20th century. Before 1980, as Holmstrom and Kaplan point out, "management was loyal to the corporation, not to the shareholders"[6]. Does the transition to a strictly shareholder-centred view have solid foundations? Many people now doubt it.

Shareholder ideology called into question

This evolution in the modes of governance of large companies came in for increasing criticism during the 2000s, notably after repeated scandals like the Enron scandal and then after the crisis of 2008. This may have encouraged the will to reform modes of governance, but it has hardly ever caused the shareholder view to be really called into question. The dominant tendency has been rather to call for the strengthening of shareholders' powers of control.

[1] See O. Weinstein, *Pouvoir, finance et connaissance. Les transformations de l'entreprise capitaliste entre XXe et XXIe siècle*. La découverte, textes à l'appui/économie, Paris, 2010.

[2] H. Hansmann et R. Kraakman, "The End of History for Corporate Law", *Georgetown Law Journal*, 89, 2001, pp. 439-468.

[3] See *Les Echos*, 25 Feb. 2013.

[4] *See Les Echos*, 16 Aug. 2013.

[5] *See Les Echos*, 5 Aug. 2013.

[6] B. Holmstrom et S. N. Kaplan, « Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s », *Journal of Economic Perspectives*— Volume 15, Number 2—Spring 2001—Pages 121–144.

However, it now appears useful, or even necessary, to re-examine the very foundations of the shareholder value ideology, as a certain number of recent writings have done[7]. Essentially, there are two types of justification for shareholder primacy, the first legal and the second economic.

The legal justification is apparently quite simple. The shareholders are the owners of the company, and they delegate the task of running it to the managers, who are therefore under the obligation to serve the interests of the shareholders, to whom alone they are accountable. The problem is that in the sort of large stock companies that have existed since at least a century, this argument loses all relevance. The shareholders have neither the power to sell the company, nor the right to intervene directly in its management, nor the right to determine the dividends they receive on their shares. So the shareholders cannot be considered to be the owners of the company (and indeed, this is explicitly acknowledged by some upholders of agency theory or property rights theory), nor are they the owners of the company's assets (which are owned by the company itself); they are simply the owners of a security and the rights attached to it (the right to dividends, voting rights at the shareholders' general meeting)[8]. To determine the extent (if at all) to which corporate law recognises a duty of managers to be at the service of shareholders, one must examine the legal developments more closely. Here, let us simply observe that in the United States (and most English-speaking countries), it has been argued most convincingly that corporate law justifies director primacy rather than shareholder primacy[9] and recommends that managers should act in the interests of the company.

Today, however, the economic argument is the primary justification for the principle of shareholder value maximization. Based on the contractual view of the firm, and more particularly on agency theory, it affirms, in short, that the most economically efficient mode of organisation is one where the managers are considered the agents of the shareholders, and incentive systems are used to align the managers' interests with those of the shareholders. The problem is that there does not exist, to our mind, any strict demonstration of this proposition. In particular, it presupposes both that the maximization of shareholder value leads to the maximization of the total value created by the firm, and that the financial markets provide the "true value" of securities, and therefore an accurate measure of the value created for the shareholders. This entails that the financial markets are efficient. Let us simply remark here that these theories are extremely fragile, to say the least[10]. The whole analysis is based, in particular, on an assumption made at the very outset, namely that what matters is the organisation of relations between the directors of the company and the shareholders, completely overlooking the other stakeholders. Even from the approach that theorizes the firm as a "nexus of contracts", the most coherent viewpoint would be to consider that the managers are the agents not only of the shareholders but of all the different stakeholders, and that their function is to coordinate the different contributors of resources (including first and foremost, of course, the employees) and to share between them the value created by the firm. This entails a complete rethinking of the principles of corporate governance.

Beyond shareholder value: what prospects?

Criticism of the shareholder value doctrine has led to the development of proposals that diverge more or less strongly from the shareholder view of corporate governance. There are three main lines of reflection.

The least radical proposals reject the principle of maximizing shareholder value, especially over the short term, without really questioning the primacy of the shareholder. It is still the managers' duty to defend the shareholders' interests, but *over the long term*, and taking into consideration the interests of the different sorts of stakeholders[11]. From this perspective, the interests of the company and the interests of the shareholders are identical (assuming that the long-term maximization of company value and shareholder value are equivalent, which is a rather bold hypothesis). Moreover, some authors explain that under these conditions, the managers should be led to take into consideration the interests of the different stakeholders, or the dimension of corporate social responsibility, to the extent that this is in the clear interest of the company and its shareholders. From a similar perspective, some authors suggest that the way to counteract the negative effects of the shareholder value principle is to rely on long-term investors[12].

A serious challenge to the shareholder view can only be made by going much further, in the direction of a partnership-based view of the firm. This raises several questions, one of the most important of which concerns the place given to

[7] Among these numerous works, let us cite a recent book by Lyn Stout, who provides a very complete and well-reasoned synthesis of all the criticisms that can be levelled at the "conventional" shareholder-centred view: L. Stout, *The Shareholder Value Myth*, Berrett-Koehler, San Francisco, 2012. See also M. M. Blair "In the Best Interest of the Corporation: Directors' Duties in the Wake of the Global Crisis", in T. Clark and D. Branson, *The SAGE Handbook of Corporate Governance*, SAGE, 2012.

[8] See for example : Robé, J.-P., "The Legal Structure of the Firm", *Accounting, Economics*, and Law: Vol. 1: Iss. 1, Article 5, 2011.
Available at: http://dx.doi.org/10.2202/2152-2820.1001

[9] See in particular : Blair, M. M. et L. Stout, "A Team Production Theory of Corporate Law", *Virginia Law Review*, vol. 85, 1999.
And: Bainbridge, S. M., « Director Primacy : The Means and Ends of Corporate Governance », *UCLA School of Law Research Paper* N° 02-06, 2002.

[10] For a critique, see for example, M. Blair (op. cit.) and O. Weinstein, « Firm, Property and Governance: From Berle and Means to the Agency Theory, and Beyond », *Accounting, Economics, and Law*. Volume 2, Issue 2, ISSN (Online) 2152-2820, Juin 2012.
DOI: 10.1515/2152-2820.1061

[11] This is, we believe, the viewpoint defended by Lyn Stout (op. cit.). It is sometimes called the "enlightened shareholder value principle", an expression used to describe the reform of corporate governance principles implemented in the UK by the Companies Act of 2006.

[12] This is the case for Michel Aglietta. See: M. Aglietta et S. Rigot, *Crise et rénovation de la finance*, Odile Jacob, 2009.

employees[13]. This question has reappeared today mainly in relation to the knowledge economy, where human capital is of growing importance to the firm. Thus, Rajan and Zingales consider that this has led to changes in the "nature of the Corporation" and the need to rethink our ideas on corporate governance. The main function of the board of directors is then to protect the "integrity of the enterprise" and motivate the employees. It then remains to determine how corporate governance could be transformed. It is possible to move in very different directions: either with measures aimed at highly-skilled employees, such as stock options (which is what Rajan and Zingales propose), or by changes to the composition and powers of the governing bodies (board of directors or supervisory board), accompanied by a reduction in the shareholders' power to intervene; or by more radical changes to the legal form of the company itself, moving towards partnership structures.

And that leads us to the most radical proposal: challenging the primacy of the corporation as the principal form of industrial organisation. This is proposed, notably, by Segrestin and Hatchuel[14], who argue that we must "radically reform the company" and its legal structure, by considering it as a system of collective creation. From this perspective, it is important to return to a global reflection on the different corporate forms of organisation of production. This cannot be done without a parallel rethinking of the financial system and the relationship between finance and industry.

[13] R. G. Rajan et L. Zingales, « The Governance of the New Enterprise », in *Corporate Governance, Theoretical § Empirical Perspectives*, X. Vives ed., Cambrige University Press, 2000 One may wonder whether this represents a return to something like the managerial view of the post-war decades.

[14] Segrestin et A. Hatchuel, *Refonder l'entreprise*, Seuil et La république des idées, 2012.

Séminars & Conferences

17-18 oct. 2013 - University Lumière Lyon 2 –Colloquia room: Second symposium on "the relationship between finance and industry" (Co-Organised by the CEPN) - (http://finance-indus.sciencesconf.org/)

17 oct. 2013 – 14:00-17:00 – MSH Paris Nord – CEPN Seminar: On the distribution of the Age of Enlightenment: two historical examples and some reflections on the contemporary world" (Discussion introduced byPascal Petit, CNRS & CEPN)

- DOMINIQUE TADDEI (Ex U-Paris 13) - *"La pensée politique des révolutionnaires corses (1729-69)"*.
- MOTOICHI TERADA (Nagoya City University) "*Diderot et la critique du colonialisme européen dans l'Histoire des deux Indes de l'Abbé Raynal. Quels enseignements pour l'avènement d'un développement durable à l'époque contemporaine*".

18 oct. 2013 – 14:00-17:00 – Maison des Sciences Économiques (106-112 boulevard de L'Hôpital) - Seminar on Health Political Economy (SEPOSA, co-organized by STRAS-CEPN): AMANDINE RAULY (Regards, University of Reims Champagne-Ardenne) – *"Formes institutionnelles et progrès technique : une application à la télémédecine".*

7-9 nov. 2013 – Campus of Bobigny (IUT): 25th EAEPE Annual Conference:

"Beyond Deindustrialisation: The Future of Industries".

Local organizers : NATHALIE COUTINET (CEPN) & PHILIPPE ABECASSIS (CEPN) - (www.eaepeparis2013.com)

21 nov. 2013 – 12:45-14:00 – Campus of Villetaneuse - K301 – CEPN Lunch Seminar: LÉONARD MOULIN (CEPN) – "*Régime par répartition dans l'enseignement supérieur: fondements théoriques et estimations empirique".*

13 déc. 2013 – 14:00-17:00 – Maison des Sciences Économiques (106-112 boulevard de L'Hôpital) - Seminar on Health Political Economy (SEPOSA, co-organized by STRAS-CEPN): Bernard FRIOT (IES) – "*Financer la couverture santé par une hausse de la cotisation ou par un mixte CSG/régime complémentaire professionnel ?".*

Presentations by CEPN Members

- 24-25 oct. 2013 - Workshop "Digital Piracy: Understanding and assessing policy and business response", University of Rennes 1: Presentation of FRANÇOIS MOREAU - *"Information asymmetry and contracts in the recording music industry"*.
- 7 NOV. 2013 - Séminar "Statistics for social science and demography", University of Geneva: Presentation of LÉONARD MOULIN *"Frais d'inscription, ségrégation et inertie dans les parcours étudiants : le cas de l'université Paris 9 Dauphine" (co-authors : David Flacher and Hugo Harari-Kermadec).*
- 23-25 NOV. 2013 - 2013 Southern Economic Association Conference, Tampa (Florida, USA): Presentation of FRANÇOIS MOREAU - *"Digitization, Information Asymmetry and Contracts in the Recorded Music Industry"*
- 29 NOV. 2013 - Intervention at the China–Europa Center, Hong Kong Polytechnic University: Presentation of PASCAL PETIT *" The Future of the European Social Project in the Context of the Current European Crisis "*.

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