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The Shareholder Primacy Myth and Deflected Moral Compasses

Corporate, Securities, and Governance

In late February 2019, I had the pleasure of lecturing to a class of graduate business students at the Simon School of Business at the University of Rochester. I kicked off the lecture with a “Business Law 101” quiz that asked the students to use audience response devices to indicate whether the following statements were true or false:

- As a matter of law, the shareholders are “owners” of the corporation.
- As a matter of law, directors and corporate executives are the shareholders’ “agents.”

- Directors and executives of publicly owned corporations are legally obligated to maximize profits and share price.

Almost all the students indicated that these statements were “true” when, in fact, they are all “false.” After providing the correct answers to each question, I offered the following brief recitation of the law.

As a matter of law, the shareholders are “owners” of the corporation. (False)

Shareholders do not “own” corporations. Instead, they own stock, which is a contract with the corporation that provides them limited rights. Shareholders have no greater ownership interest in the corporation than creditors, employees, suppliers, customers, or anyone else that has a contractual relationship with the corporation. As a matter of law, corporations own themselves.

As a matter of law, directors and corporate executives are the shareholders’ “agents.” (False)

In law, a “principal” is normally someone who hires another person (an “agent”) to serve his interests. This means that the principal must exist prior to and independent of the hiring of the agent. However, when a corporation is formed, the first thing that must happen is for the incorporator to appoint a board of directors. Only after the board is in place does the corporation have the power to issue stock and subsequently contract to acquire shareholders. Shareholders have the right to vote, the right to sue, and the right to sell their shares, but they do not have the right to “control” corporate directors’ and executives’ business decisions. As a matter of law, directors and executives are not the shareholders’ agents. Instead, their fiduciary duty of care and loyalty is owed to the corporation, not the shareholders.

Directors and executives of publicly owned corporations are legally obligated to maximize profits and share price. (False)

US corporate law does not impose, and never has imposed, any enforceable legal duty on corporate directors or executives to maximize profits or share price. To the contrary, the “business judgment rule” provides that if directors and executives are informed, and do not use their power to enrich themselves, they have a wide range of autonomy in deciding what to do with corporate earnings and assets. Maximizing profits and share price is not a managerial obligation — it is a managerial choice.

I further expanded on my answer to the third question by sharing the significant implications of the business judgment rule for corporate directors and executives. Specifically, I observed that unconflicted and informed directors and business executives are free to pursue almost any goal other than enriching themselves. Without consulting shareholders, they can:

- Donate corporate funds to charity;
- Reject profitable business strategies that might harm the community;
- Refuse risky projects that benefit shareholders at creditors’ expense;
- Fend off hostile takeover bids in order to protect the interests of employees or the community;
- Refuse to pay dividends even when shareholders demand them; or
- Choose to maximize profit and share price.

I wasn't particularly surprised that the students failed the short Business Law 101 quiz. Such misunderstandings are common in the business community. They are a symptom of the "shareholder primacy myth" that shareholder interests trump the interests of all other corporate stakeholders. I confirmed that this myth was alive and well with the Simon School students when I asked them whether they agreed or disagreed with the following two statements:

- Today, the standard form of corporate governance is one in which shareholder interests are primary and the objective of the firm ought to be the maximization of shareholder wealth.
- Consistent with the "shareholder primacy" model of corporate governance, my highest moral obligation as a corporate director or executive is to maximize profits and share price.

All the students agreed with both these statements, illustrating how the shareholder primacy myth can, and often does, deflect moral compasses. When business professionals act on a mistaken belief that their top moral obligation is to maximize profit and share price, they run the risk of failing to give due consideration to other moral obligations like protecting fundamental human rights, safety, honesty, fairness, lawfulness, and environmental stewardship. This can, and often does, result in business practices that are akin to "fishing with dynamite" to generate a short-term windfall at the expense of the ecosystem their business relies upon to grow and thrive over the long term.

As Raj Sisodia observes in his book *Conscious Capitalism*:

> *Shareholder value thinking causes corporate managers to focus myopically on short-term earnings reports at the expense of long-term performance; discourages investment and innovation; harms employees, customers, and communities; and causes companies to indulge in reckless, sociopathic, and socially irresponsible behaviors. It threatens the welfare of consumers, employees, communities, and investors alike.*

Your company likely comprises business professionals that, like the students I spoke to at the Simon School, believe the shareholder primacy myth. The resulting deflection of your colleagues' moral compasses can exacerbate the ever-present temptation for otherwise law-abiding business professionals to rationalize unethical or illegal practices to achieve business goals. The unending parade of business scandals that frequently make headlines is proof that this can and does happen at many of the world's most prestigious firms. To reduce the risk that your company will join these ranks, you might consider taking the following steps to reset your colleagues' moral compasses to true north:

- Administer the Business Law 101 quiz detailed above to ensure they have a clear understanding of the law.
- Teach them the business judgment rule to help them understand that they have the legal elbow room to run the business in a manner that benefits all stakeholders, not just shareholders' short-term interests.
- Seek to build a consensus among your colleagues that the firm will never maximize profit and share price at the expense of other more important moral values like fundamental human rights, safety, honesty, fairness, lawfulness, or the environment.

Although this is a simple prescription, you can anticipate some significant headwinds if you attempt to administer this medicine. The shareholder primacy myth is deeply entrenched in the business community and is very difficult to counter, especially when variable compensation is tied to achieving specified, short-term financial goals. But, if you succeed in at least raising awareness about how the shareholder primacy myth deflects moral compasses, you might help your leaders set a better course in the future.

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