

## The Danger of Shareholder Primacy

---

### Harm to stakeholders, shareholders, and the well-being of the corporation

*The shareholder primacy model has been increasingly used to manage corporations, even though U.S. and Canadian corporate law does not require it. This paper analyzes three major arguments for using this model. The first relies upon contract law, the second appeals to concerns regarding agency costs, and the third focuses on property. In spite of these pervasive arguments, the adverse consequences of shareholder primacy are much greater than its benefits. Three adverse consequences include clashing interests between shareholders and creditors; the inadequacy of this model to address the interests of different shareholders; and the model's inefficient and inequitable effects on stakeholders and the corporation. Instead of pitting the interests of stakeholders against each other, we should be developing a model whereby the value of each stakeholder to the corporation is calculated according to each corporation's unique financial and social situation.*

**Keywords:** agency theory, contract law, corporate law, property law, shareholder primacy

Although North American corporate law does not legally require corporate directors and managers to use the shareholder primacy model in managing their corporations (Stout, 2002; Stout, 2013), it has become the norm. Shareholder primacy implies that the interests of the shareholders are the most important interests in a publicly traded corporation, and thus managers must work to maximize shareholder value above all. As Lynn Stout (2012) explains, “according to the doctrine of shareholder value, public corporations ‘belong’ to their shareholders, and they exist for one purpose only, to maximize shareholders’ wealth. Shareholder wealth, in turn, is typically measured by share price—meaning share price today, not share price next year or next decade” (p. x). Three major arguments for using this model draw upon contract law, agency theory, and property law respectively. Despite the perceived benefits of a shareholder primacy model, the negative consequences of shareholder primacy are

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

much greater. Three consequences of this model include clashing interests between shareholders and creditors, the inadequacy of this model to address the interests of different shareholders, and the model's inefficient and inequitable effects upon stakeholders and the corporation. Instead of pitting the interests of stakeholders against each other, there should be attempts to develop a model whereby the value of each stakeholder to the corporation is calculated according to each corporation's unique financial and social situation. The debate surrounding shareholder primacy is important as corporations are increasingly influential in social, economic, and environmental spheres. With increasing corporate scandals and financial crises, the public is becoming more educated on these issues and is beginning to express the will to hold multinational corporations responsible.

Agency theory explores the relationship between a person or group of people, known as the principal, who delegates tasks and the authority to make decisions to a person or people known as the agent(s). An example is the relationship between an employer and the employee. It acknowledges the problem of clashing interests between different parties such as the interests of managers versus those of shareholders, among shareholders themselves, and shareholders against other stakeholders (Armour, Hansmann, Kraakman, & Pargendler, 2017). It can include all social relations that involve economic interactions, such as a set of contracts between agents and principals that ensure that interests are properly aligned (Fligstein, 2002). The principal-agent problem is caused by interdependence between different actors such as the owners, the board of directors, managers, and employees (Fligstein, 2002). Accordingly, there are three different types of internal control problems to resolve (Fligstein, 2002). Firstly, there is the relationship between managers and employees. Secondly, there is the separation of ownership and control. Lastly, the division of labour between different levels of management is an internal control problem.

Christine Mallin (2013) argues that the delegation of work from a principal, such as an owner, to an agent, such as a director, can be disadvantageous. Agents can work in their own interest by not taking the appropriate risk in pursuing the principal's interests. This might occur because agents view the risk as inappropriate, or because they misuse their access to more information. There is also the further problem that as utility-maximizing individuals, the agents may pursue their own pecuniary gain at the expense of the shareholder and the corporation. This is where shareholder primacy seeks to resolve the issue by insisting that a corporation's board of directors should only be seeking to maximize the interests of shareholders. Shareholder primacy exists along a spectrum and has the single goal of maximizing shareholder interests. Shareholder primacy advocates argue that adopting and applying this model maximizes the wealth of all members of society, because increasing share value tends to imply an increase in the value and profitability of the

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

corporation itself, which in turn is assumed to benefit third parties in the community and the broader economy.

A major legal precedent for shareholder primacy was the early case of *Dodge v. Ford Motor Co.* (1919). The Dodge brothers argued that profits in the form of dividends belonged to shareholders and Ford should not have given that money to customers. The trial judge agreed and it was established that directors have a legal duty to put all shareholders' interests before the other stakeholders. The following three arguments provide support for shareholder primacy.

One of the main arguments is that while contracts already provide protection for stakeholders (Zhao, 2012), it is unlikely that contracts can foresee every event that will affect stakeholders due to the limited nature and benefits of the contract in terms of the task or event specific criteria to which it applies. A contract is transactional and makes it difficult for the parties involved to see the bigger picture. Shareholders are seen as "residual unspecified claimants" while other stakeholders receive their fixed claims. Also, shareholders are only paid what is left after the fixed claimants are paid. Therefore, shareholder primacy seeks to fill the gap between shareholders and corporations where contracts lack the speed and simplicity to respond to swift changes in the corporate world.

A second argument in favour of shareholder primacy addresses agency costs. Since shareholders are liable to suffer the consequences of the poor decisions of directors, they should be allowed to instruct directors with respect to their duties. While this argument is central to agency theory in its attempt to resolve incongruity between the interests of agents and principals, it nonetheless fails to address the effects of poor management on other stakeholders, such as employees, suppliers, customers, and members of the surrounding community.

The third argument is based on property law. Zhao (2012) states "the shareholders are owners of the company and elect the directors to run the business on their behalf and hold them accountable for its progress" (p. 16). Proponents of shareholder primacy models further constrain this argument by stating that shareholders are the only providers of capital to the corporation and thereby the only "proper" stakeholders. However, proponents do not acknowledge that employees also provide human capital to the corporation and are also stakeholders. This property-based approach is problematic because corporate law establishes a corporation as a separate legal entity that cannot be owned by anyone. Shareholders are widely dispersed with limited rights that do not control corporate assets, and limited liability which alleviates them of responsibility to creditors and responsibility for corporate actions. Indeed, shareholders do not decide what to take from the corporate purse, and rather receive payment from profits (i.e., dividends if and only when the corporation has acquired sufficient profit and/or the directors decide to declare the profit) (Stout, 2002).

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

Stout (2013) offers persuasive arguments as to how shareholder primacy causes greater problems than the ones it seeks to resolve. Firstly, shareholder primacy has created a new problem between creditors and shareholders. Debt contracts cannot account for all actions of the board of directors. Creditors' remedies need to be expanded against third parties by creating notice procedures such as those used by secured creditors (Stout, 2012; Stout, 2013). Additionally, shareholders are residual claimants only within the realm of bankruptcy law. This means that shareholders have the right to residual assets available only after all other costs have been paid. Outside of this realm, the corporation is a legal entity and it is its own residual claimant with legal title to its own profits where shareholders are only legally entitled to the dividends that the board of directors might declare (Stout, 2013).

Secondly, Stout (2013) argues that shareholder primacy cannot address the different interests of shareholders themselves because as a group they are neither fixed nor static. Shareholders hold shares for different time periods depending on their goals. By solely focusing on share price, directors may be negatively targeting long-term shareholders because the short-term shareholders sell their shares before damage in the corporation becomes apparent. Shareholder primacy may also be disadvantageous for individual investors who are overpowered by institutional investors that actively manage large pools of capital such as hedge funds and mutual funds. In addition, by paying managers based on how the stock performs, there is personal incentive to focus on short-term share prices rather than being concerned with the company's long-term goals. This causes managers to think like short-term investors and make decisions that they would not have made otherwise. For instance, a Chief Financial Officer (CFO) might reject a project that would produce profit in the long term if she or he were required to meet certain expectations for next quarter (Stout, 2012; Stout, 2013).

Finally, Stout (2012; 2013) effectively demonstrates that shareholder primacy cannot be both efficient and equitable. It was found that shifting to a shareholder-centric model only increases shareholder wealth once while eroding the long-term ability of the corporation to produce profit. Several studies now reveal the correlation between the increase in shareholder primacy doctrine and the growth of wealth inequality (Ireland, 2005; Lazonick, 2009; Lysandrou, 2011).

Courts in both Canada and the United States are also ruling against shareholder primacy as they see its drawbacks. In the case of *Peoples Department Store v. Wise* (2004), as discussed below, shareholder-focused legal duty is not necessary since shareholders can replace the board of directors and ensure that the board focuses on their interests. Although proponents of shareholder primacy assert that the interests of non-shareholders may be adequately protected through contractual specifications or extended regulations, it has not been proven (Lee, 2005). Some scholars believe, however, that while the Supreme Court of Canada had an opportunity to clarify directors' duties in *Peoples v. Wise* (2004), much ambiguity remained (Waitzer &

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

Jaswall, 2009). What is evident, however, is that there is no clear mandate that demands that directors act to maximize shareholder value at the expense of the corporation or other constituents.

In *Peoples v. Wise* (2004), the Court acknowledged that directors owe duties to more than just the corporation. Section 122(1)(a) of the Canada Business Corporations Act of 1985 (2015) establishes a duty to the corporation. This case expanded the beneficiaries to include creditors under section 122(1)(b). The court recognized other relevant factors in determining what directors should consider in managing the best interests of the corporation (Lee, 2005). Canadian law has been seen as focusing on the duty to the corporation whereas advocates of shareholder primacy argue that American law focuses on shareholder primacy. This is a contested claim, however, as some legal scholars have begun pointing to a long history of director-centric rulings in Delaware, where the majority of Fortune 500 corporations are incorporated (Bainbridge, 2006).

*Peoples v. Wise* (2004) also established an objective standard of care for directors while rejecting the subjective standard. Previously, the director's standard of care was subject to the individual capabilities and competence. *Peoples v. Wise* (2004) established a tougher objective standard of care that applies to directors. The two-pronged business judgment rule focuses on results and the process, which is similar to the Delaware two-pronged test. Firstly, the court analyzed whether the director followed a reasonable decision-making process. Secondly, the court analyzed whether the result of the decision was reasonable. There are many aspects of the process to analyze such as whether the directors spent an adequate amount of time on the decision; whether they understood the issue; whether the information was tested or accepted at face value; whether the issues were debated openly and candidly (Koehnen, 2004).

Ian Lee (2005) explains that the only discussion the court failed to acknowledge was the normative debate with regard to shareholders. Firstly, as a conceptual debate, proponents of shareholder primacy see shareholders as owners entitled to expect their assets to be used solely for the purposes of furthering their interests. This argument is easily dismissed because shareholders only own shares that give them rights determined by corporate law and the corporate charter and assets of the corporation. Secondly, the debate is centred on whether the power of managers is better channeled by imposing legal duties to serve only the interests of the shareholders or by considering the broader impact of their activities (Lee, 2005). The one-dimensional goal of shareholder primacy can hurt other stakeholders. On the other end of the spectrum, managerialism can allow for managers to get away with mistakes as they are trying to find the right balance between everyone's interests.

Although shareholder primacy proponents advocate that directors have less leeway to escape responsibility when they solely focus on share price, there are already attempts to quantify the exact value of other stakeholders. Corporate

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

directors and managers should not focus solely on the interests of shareholders but rather find a way to balance the interests of all stakeholders. Thomas Smith argues for the expansion of the concept of shareholder value to investor value by including the market value of a firm's debt in empirical measures of firm value (Fisch, 2006). Michael Jensen also proposes to include "the sum of the values of all financial claims on the firm—debt, warrants, preferred stock and equity" (as cited in Fisch, 2006, p. 669). Additionally, Jeffrey Gordon is working on finding a method of incorporating employee value into the corporation's value (Fisch, 2006, p. 669). These methods suggest that we can find ways of measuring the value of different stakeholders to the firm in order to establish a more objective method for directors to account for stakeholders in their decision-making, not just dismissing other stakeholders because share price is the easiest to measure.

Today we see that methods of firm management are shifting. For instance, sharing economy corporations such as Airbnb and Uber have a fundamentally different set of stakeholders, and thus cannot be managed in the same way that older multinational companies have run in the past. These companies often tend to be transparent about the way they are run with the public, and media exposure ensures that the public is more interested in the way they are run. If they are funded by investors or crowdfunded, they have the dual obligation of catering to the interests of both shareholders and customers. As the sharing economy expands, and new companies evolve from small startups to multi-million-dollar corporations, a new body of scholarship will be necessary to examine whether there are shifts in the shareholder primacy doctrine, and what the consequences of these shifts might be on broader social welfare.

## REFERENCES

- Armour, J., Hansmann, H., Kraakman, R., & Pargendler, M. (2017). What is corporate law? In *Anatomy of corporate law: A comparative and functional approach* (pp. 1-28). Oxford: Oxford University Press.
- Bainbridge, S. M. (2006). Director primacy and shareholder disempowerment. *Harvard Law Review*, 119, 5-25.
- Canada Business Corporations Act of 1985, R.S., 1985, c. C-44, s. 1; 1994, c. 24, s. 1(F) (2015).
- Fisch, J. (2006). Measuring efficiency in corporate law: The role of shareholder primacy. *Journal of Corporate Law*, 31, 637-674. doi:10.2139/ssrn.878391
- Fligstein, N. (2002). *The architecture of markets: An economic sociology of twenty-first-century capitalist societies*. Princeton: Princeton University Press.
- Ireland, P. (2005). Shareholder primacy and the distribution of wealth. *The Modern Law Review*, 68(1), 49-81. doi:10.1111/j.1468-2230.2005.00528.x

## Harm to Stakeholders, Shareholders, and the Well-Being of the Corporation

- Koehnen, M. (2004). Peoples v. Wise: A turning point for directors' duties. Retrieved from <http://www.mondaq.com/canada/x/29701/>
- Lazonick, W. (2009). The explosion of executive pay and the erosion of American prosperity. *Entreprises et histoire*, 57(4), 141-164.
- Lee, I. (2005). Peoples Department Stores V. Wise and the "best interests of the corporation." *Canadian Business Law Journal*, 41(212), 212-22.
- Lysandrou, P. (2011). Global inequality, wealth concentration and the subprime crisis: A Marxian commodity theory analysis. *Development and Change*, 42(1), 183-208. doi:10.1111/j.1467-7660.2010.01680.x
- Mallin, C. (2013). *Corporate governance* (4<sup>th</sup> ed.). Oxford: Oxford University Press.
- Peoples Department Stores Inc. (Trustee of) v. Wise, SCC 68, 3 SCR 461 (2004).
- Stout, L. (2002). Bad and not-so-bad arguments for shareholder primacy. *Southern California Law Review*, 75, 1189-1209. doi:.2139/ssrn.331464
- Stout, L. (2012). *The shareholder value myth: How putting shareholders first harms investors, corporations and the public*. San Francisco: Berrett-Koehler.
- Stout, L. (2013). The toxic side effects of shareholder primacy. *University of Pennsylvania Law Review*, 161(7), 2003-2023.
- Waitzer, E., & Jaswal, J. (2009). Peoples, BCE, and the Good Corporate "Citizen." *Osgoode Hall Law Journal*, 47(3), 439-496.
- Zhao, D. (2012). The curious case of shareholder primacy norm: Calling for a more realistic theory. *International Trade and Business Law Review*, 15, 1-25.