Opinion **Inside Business**

Revisiting the principle of 'shareholder primacy'

Elizabeth Warren's proposed new law would force big US companies to broaden their mission

SUJEET INDAP

US senator Elizabeth Warren wants companies to help reduce income inequality and promote more sustainable corporate profitability © AP

Sujeet Indap in New York SEPTEMBER 24 2018

Lynn Stout passed away in April at the age of 60. A longtime legal scholar most recently at Cornell University, Stout was an iconoclast. She passionately argued against the bedrock principle that corporations must be run to maximise the wealth of stock investors, a view that had been not only endorsed by corporate America but also by most of her fellow academics. In her 2012 book *The Shareholder Value Myth*, she carefully punctured the arguments for so-called "shareholder primacy", explaining that it could and should be part of the mission of business to promote the wellbeing of workers and the community.

Just a few months after her death, another legal academic from the American Northeast has seized on Stout's views. However, this professor — Elizabeth Warren — happens to be a US senator. In August, Ms Warren introduced the Accountable Capitalism Act, laws that

would force big US companies to broaden their missions in an effort to help reduce income inequality and promote more sustainable corporate profitability. Ms Warren's proposed legislation gives the opportunity to revisit how shareholder primacy came to dominate and whether a different business philosophy could become ascendant.

The idea is that shareholders own the corporation because they own the "residual claim" — the cash flow of the business after all other claimholders such as employees and creditors have been paid. Shareholders elect the board, who then run the corporation for their benefit. For all its centrality, that companies are run for the benefit of shareholders is not really written down anywhere. Rather, shareholder primacy is a reflection of common law, the accumulation of judicial decisions that become doctrine over time.

Shareholder primacy took off in the 1970s, starting with a Milton Friedman essay in The New York Times in which the economist argued that it was inappropriate for boards to focus on anything other than maximising shareholder value. From there, professors such as Michael Jensen set the stage for the 1980s leveraged buyout craze, arguing that companies should ruthlessly find the management teams that could wring the most efficiency out of assets.

Importantly, the courts have mostly stayed out of second-guessing corporate decisions — the famous "business judgment" rule in Delaware dictates that as long its actions are in good faith, decisions by the board are up to them.

Senator Warren's legislation would make incorporation for large companies a federal matter, overriding the present systems where companies domicile for corporate law purposes in states. These federally chartered companies would be mandated to consider the interests of a list of stakeholders, from investors to employees to customers and communities. These groups could then sue if they deemed the company had breached their duties.

However, corporate law courts have already found it is nearly impossible to referee disputes under the existing shareholder primacy system: hence the rise of the business judgment rule. Expanding constituencies would be a larger nightmare, making this part of the Capitalism Accountability Act unrealistic to regulate.

But if boards still win the day, how about fixing the board? The most defensible part of Senator Warren's legislation calls for 40 per cent of directors to be elected by employees.

A company where employees own a lot of stock — say, Silicon Valley tech groups — could chose to adopt a strategy to maximise the stock price. Another company — a retailer or fast-food chain — with low-wage employees could decide to pay higher salaries.

These theories of the purpose of the corporation that academics such as Stout have fought over in conferences and in journal articles are either fascinating or tedious — but ultimately not practically important. The rise of the environmental, social and governance (ESG) movement and passive managers such as Vanguard, who are trying to be more thoughtful about corporate behaviour, indicate that the Wild West era of the 1980s may be fading.

But the premise remains that regulating ordinary business decisions is a way to promote social policy such as higher wages and curtailing excessive executive compensation. It is easier for legislators to push these tough decisions on to companies when Washington cannot get it done itself. As Delaware Supreme Court Justice Leo Strine, a frequent antagonist of Stout, wrote in 2015: “[A] more effective and direct way to protect interests such as the environment, workers and consumers would be to revive externality regulation ...But lecturing others to do the right thing without acknowledging the actual rules that apply to their behaviour, and the actual power dynamics to which they are subject, is not a responsible path to social progress.”

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