A 50-YEAR-OLD FALLACY

THE ONE-LEGGED STOOL OF SHAREHOLDER PRIMACY

Ed Chambliss

Full disclosure: I'm fortunate enough to be a shareholder.

I own some stock directly as well as through mutual funds as part of my retirement savings. So, I'm speaking from personal experience when I say this:

There's a certain arrogance to shareholders.

We don't actually work for the companies in which we own stock. We don't give up our nights and weekends to ensure projects stay on track. We don't come up with new products that will ensure future success. We don't necessarily even buy the companies' products, generating revenue.

All we do is loan them our money. Just like putting it into a savings account at a neighborhood bank.

Yet, while today's typical bank savings accounts pay just 0.06% APR,[1] as shareholders, we demand at least *100 times* that in return. (Oh and, by the way, if that return isn't consistent, we're dumping the stock.)

It's a rather entitled perspective for someone who doesn't actually contribute any of their personal time and talent to the enterprise.

Kinda makes you wonder, "Who the hell do we think we are?"

Well, since the 1970s, the answer has been the "principal." That is, the person who hires someone else (called the "agent") to act on their behalf, doing things the principal can't or doesn't want to do.

The 1970s is, of course, when the shareholder primacy movement started. But it's also when economists and political scientists were defining the relationship between principals and their agents and, most relevantly, the so-called "principal-agent problem," which is when the agent acts in a way that isn't in the principal's best interest.[2]

First identified by Stephen Ross and Barry Mitnick at the University of Pennsylvania,[3] the principal-agent problem arises from two underlying causes:

> First, the principal and agent are different people, performing different roles, with inherently different interests. As such, the two parties will sometimes want different outcomes.
>
> Second, as the person doing the work, the agent has access to more information than the principal, which makes it difficult for the principal to determine whether the agent is always acting in the principal's best interest or if they're pursuing their own interest instead.

Ross likened the problem to the agent trying to buy an ice cream cone for the principal without knowing what the principal prefers.[4] The agent, who is at the ice cream parlor, can see all the available flavors, while the principal cannot.

So, when the agent shows up at the principal's office with Rocky Road, the principal doesn't know if the agent thought it was the best available flavor for the principal or if the agent merely picked it because it's the agent's favorite flavor, or because it was cheaper.

The solution to the principal-agency problem is seen as twofold: better information about what the principal wants, and incentives to ensure the agent is putting the principal's interests first.[5]

So, when the shareholder primacy movement was born in the 1970s, this emerging principal-agent theory was used as justification.[6] Shareholders declared themselves as the principals and corporate leaders as their agents, who they had hired to run their companies.

As we've seen, these newly minted principals quickly clarified that the primary purpose of business was to pay them. Additionally, shareholders instituted stock-based incentives to ensure corporate leadership was aligned with shareholder interests.

It's a rather entitled perspective for someone who doesn't actually contribute any of their personal time and talent to the enterprise.

To put it another way, shareholders solved the ice cream cone problem by proclaiming that ice cream parlors should only focus on one flavor of ice cream–the one that shareholders liked (let's call it vanilla). Furthermore, they mandated that corporate executives should only eat vanilla if they wanted to keep their jobs. It was one heck of a power play, laying the foundation for how business has been run for the last 40 years.

There's only one problem.

Shareholders aren't the principals.

"Wait," you might say. "Shareholders own the company. Why aren't they the principals?"

Yeah. About that.

As much as it challenges what most of us currently take for granted, shareholders don't actually own the corporation. They own shares in a corporation, which is very different from owning the corporation itself.

Yes, I know that sounds pedantic. But it's actually quite relevant.

Bear with me.

Back in 2012, Vanderbilt Law professor Margaret Blair examined this distinction,[7] rigorously documenting reasons why shareholders can't be considered principals or even "owners."

First and foremost, corporations are legal entities, entirely separate from their founders, directors, employees or even shareholders. Indeed, when a corporation is formed, its founders give up certain rights in order to receive the significant benefits that come from incorporating.

This separation reinforces the idea that corporations are distinct legal persons–not just an extension of natural persons such as you and me. (Remember that legal personhood was granted to corporations in 1886 with the outcome of *Santa Clara County v. Southern Pacific Railroad Company*.) As a result, shareholders (or anyone else for that matter) can't "own" a corporation. To do so would be a violation of the of the Thirteenth Amendment to the U.S. Constitution that prohibits slavery.

Legally, corporations own themselves.

What shareholders do own is a "share" of the distributed profits of a corporation, as well as having very limited voting rights when it comes to things such as electing a board of directors, sale of the company, or a stock split.[8] Think of this "share" as a contract they own, the same as an employee "owns" a pension claim, or bondholder "owns" a corporate bond.

But shareholders have nothing even close to the *carte blanche* that a true "owner" has over their property.

Shareholders have no direct control over the day-to-day operations of "their" company, nor can they dictate the activities of "agents" such as the CEO. Any attempts to do so must go through the board of directors.

And while a true owner is legally responsible for the damage caused by something they own, shareholders enjoy limited liability protection, so they're not held responsible for actions the corporation takes that cause harm.

Lastly, by definition, an agent is employed by the principal. But, as we all know, corporate executives aren't employed by shareholders. They're employed by the corporation and, legally, must answer to it and its board of directors.

So not only does the corporation own itself, it's also the principal, employing executives and other employees as agents to serve *its* interests.

Without "ownership" and without "principal" status, the premise for shareholder primacy evaporates, leaving no reason for shareholders to be elevated above the corporation or for shareholders to be treated any differently than other stakeholders.

Indeed, picking *any* one stakeholder and declaring it to be the only one that matters is both illegitimate and impractical. Just like you can't start removing legs from a multi-legged stool and expect it to stand up, let alone be stable.

Picking *any* one stakeholder and declaring it to be the only one that matters is both illegitimate and impractical.

In the same way, business is designed in a way that works best with all of its stakeholder "legs" attached and firmly on the ground.

As a result of these missteps, we've spent the last 40 years focused on the wrong problem. The primary concern isn't the "principal-agent problem" (i.e., how to get one person what they want). It's what's called the "team production problem" (i.e., how to get people to work together).

First identified by economists Armen Alchain and Harold Demsetz in 1972,[9] the "team production problem" recognizes that when individuals work together to create something, it's often difficult to determine each party's specific contribution to the value of the final product–which, in turn, makes pricing products or determining compensation challenging.

This uncertainty doesn't exist just because it's hard to measure a person's contribution in a complex, interactive environment, but also because of the synergistic nature of teamwork. Teamwork can improve the quality and, therefore, the overall value of the final product, so that it is worth more than the sum of the participants' individual contributions.

In fact, it's this magical multiplying power of teamwork that often draws us to participate in joint enterprises. We, as individuals, know that our work product is improved when we collaborate with others, especially when they specialize in areas where we do not. These other team members not only contribute their own expertise, but they also challenge our preconceptions, offer alternatives, and provide support.

Importantly, team production theory suggests that *everyone* on the team feels this way. For a company, that means it's not just shareholders who hope to benefit from joining the enterprise. All stakeholders do, including employees, customers, suppliers, and the community.

As such, all stakeholders should realize that eliciting support and cooperation from *all* parties is important to the success of the joint enterprise which, of course, leads to success for the individual.

Just as with the "principal-agent problem," the key to solving the "team production problem" is alignment. All stakeholders need to have clear information on what purpose they're serving plus an incentive to reach that goal.

But, unlike the "principal-agent problem" the "team production problem" brings one other need. Since all stakeholders are equal in their importance, no one stakeholder is "in charge." No one is the boss, with the authority to mediate and resolve disputes that are bound to occur when different perspectives come together.

In the shareholder primacy model, the shareholder was the principal and, as such, had the last say on all disputes and decisions, with an eye toward whatever would make the most money. But, as we've seen, shareholders can't be the principal because the corporation is its own principal.

So, from a practical standpoint, how does a corporation express its interests, make decisions, and resolve disputes? After all, the corporation isn't a "natural person," only a legal one, so it can't walk into a room, listen to situation, and voice a decision.

This role must be played by one or more actual human beings. An agent who objectively represents the corporate principal's interest without a conflict of interest.

That's a pretty tall order since every single stakeholder has a built-in conflict of interest.

So, who can be that agent?

In their 1999 paper, "A Team Production Theory of Corporate Law," Blair and her co-author, Cornell law professor Lynn Stout, proposed that the board of directors already fits the bill, able to act as a "mitigating hierarchy" to all parties involved.

Corporate law views a board of directors "as more than mere 'agents,'" the authors note. "Rather, they are a unique form of fiduciary who more closely resemble trustees and whose duties are imbued with a similar moral weight. Trustees are expected to serve their beneficiaries' interests unswervingly and to settle conflicts between beneficiaries with competing interests fairly and impartially."[10]

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Furthermore, existing corporate law "encourages directors to serve their firms' interests by severely limiting their abilities to serve their own."[11] Specifically, directors "can bring home their agreed upon (and publicly reported) compensation, which may be quite substantial, but beyond this compensation they cannot use their corporate positions to expropriate assets or returns that belong to the firm."[12]

Of course, today's boards of directors are often populated with individuals who own a significant amount of stock in the corporation, which inherently taints their ability to act as a fiduciary. But shareholder status is not a legal requirement for being a director, so removing this conflict is not an insurmountable challenge as the corporation assumes its proper role as its own principal.

Examples of this type of "selfless" board of directors are all around us in the form of nonprofit organizations. Directors at nonprofits not only don't receive any compensation for their service, but they also often have to *pay* to be on the board. Indeed, directors at nonprofit organizations are frequently drawn to these positions as a way to help society and are willing to pay for that privilege.

Once seated, these directors focus not on extracting value for shareholders (since there are none), but rather on stewarding the enterprise toward fulfilling its defined (nonfinancial) purpose.

This "non-distribution constraint," as it was called by Yale law professor Henry Hansmann, sends a powerful signal to all stakeholders.[13] Since there's no way for these directors to financially benefit from their own actions, they are often considered beyond reproach and are trusted to objectively guide the organization.

Similarly, a for-profit corporation with a board composed of non-shareholders could also benefit from this same elevated level of trust, even if the board received some other non-share-based compensation. All stakeholders could look to them to provide clarity and objectively mediate disputes, as everyone pursues the corporation's defined purpose.

So, what is the purpose of a corporation?

Well, Milton Friedman would say (and did say) that the purpose of a corporation is to "make as much money as possible" for its shareholders.[14] Many people share this belief, or at least believe that U.S. law requires companies to focus on maximizing shareholder value.

But this, too, is a myth.[15]

On the contrary, corporate law and the courts give directors broad discretion on how their companies are run and what goals the pursue. This legal doctrine is called the "business judgment rule," which states that as long as the board of directors doesn't use its power to enrich itself, courts won't second-guess their decisions about what is best for the company, even when those decisions seem to harm shareholder value.[16]

This means that shareholder primacy isn't the law. It's a choice. And, as such, managers can choose a purpose other than "maximizing profit." Profit, after all, isn't really a purpose. It's a *result* that comes from being successful in a given pursuit.

Corporate purpose used to be clearly defined from the moment of corporate birth in the company's charter, granted by royalty or the legislature. This legally enforced focus left no doubt concerning what interest was being served by everyone involved.

Of course, limitations, while providing clarity, can also be restrictive. Over time, companies that were chartered with a specific purpose found themselves unable to take advantage of changes in technology and society. So, in the late 19th century, New Jersey (in 1896) and Delaware (in 1899) adopted more permissive "enabling" incorporation laws as a way of attracting more businesses (and tax revenue) to their states.[17] These laws removed much of the specificity from corporate charters, allowing companies to be chartered for "any lawful purpose," a phrase that is commonly used in articles of incorporation today.

As beneficial as this change was in allowing corporations to pursue opportunities that would help them remain competitive, it did remove inherent focus, increasing confusion around exactly why a joint venture existed, what the objective was, and how everyone would know when they got there.

For example, hundreds of disparate corporations, including AIG, Carter's, Caterpillar, Chevron, Dunkin Donuts, FedEx, John Deere, Motorola, Northrop Grumman, PayPal, Pitney Bowes, and YogaWorks all share the exact same corporate purpose, "to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware."

So, as long as it's legal in Delaware, it's on-strategy. Not a lot of focus there.

Shareholder primacy isn't the law. It's a choice.

In the absence of a legally chartered (and enforced) purpose, many companies have tried filling this void with a mission statement to provide focus and engage employees. These documents are often lofty and well-intentioned, describing how the company cares about the bigger picture. But, unfortunately, once created, mission statements are rarely utilized as the constant compass they are designed to be. Instead, they are frequently set aside as short-term profit pressures conflict with long-term aspirations.

This is not a failure of vision. It's a failure of alignment with the world of shareholder primacy.

But in a world where the board of directors is no longer subservient to shareholders, extracting value based solely on the shareholder definition of success, the corporation can right itself and pursue a broader purpose. One that the corporation was specifically created for.

To benefit people.

Real, flesh-and-blood, natural human beings like you and me. All of them—not just a privileged few.

To be clear, I'm not talking about a charitable pursuit. I'm talking about a for-profit company being financially successful by focusing on creating and delivering value to human beings, regardless of what stakeholder group they belong to.

After all, humanity is the common thread that ties all stakeholders together, so it only makes sense to base corporate purpose on satisfying human needs.

Let's start with customers.

Customers are the sole source of revenue for any company. So, while they're not the only stakeholder that matters, they are "first among equals," because they are fundamental to the entire concept of trade.

This status was more eloquently expressed by management consultant Peter Drucker in his 1954 book *The Practice of Management*:

If we want to know what a business is, we have to start with its purpose. And the purpose must lie outside the business itself. In fact, it must lie in society, since a business enterprise is an organ of society. There is only one valid definition of business purpose: to create a customer … The customer is a foundation of a business and keeps it in existence. The customer alone gives employment. And it is to supply the customer that society entrusts wealth-producing resources to the business enterprise.[18]

As human beings, customers have a long list of diverse needs, which provides an almost limitless number of opportunities for companies to create something that satisfies those needs in exchange for compensation.

Of course, to satisfy those needs, a company must create something that customers value. And that takes employees to do the work, suppliers to provide materials, and even shareholders to provide the necessary capital to help the company grow. Building the stool of satisfaction requires all of the legs (i.e., all of the stakeholder groups).

And since all of these necessary stakeholder groups are also entirely composed of human beings, their needs, too, can't be distilled down to just one simplistic element. Just as customers want more than to buy things, employees want more than a paycheck, suppliers want more than a sale, communities want more than tax revenue, and shareholders want more than a return on their investment.

In fact, even members of the same stakeholder group may have wildly different needs. A 25-year-old shareholder contributing to their 401(k) has very different investment goals than a 65-year-old facing the need for steady income in retirement. Yet, they are both "shareholders."

To make matters more challenging, it's rare that a person only fits into one stakeholder group. More often, they are "universal owners," playing multiple roles in society and, as such, they have conflicting interests needs that can't be satisfied by focusing on just one aspect.

As a result, while focusing on one stakeholder role may yield a payoff in that facet of their life, it may cost them dearly in other aspects that are just as important to them.

Building the stool of satisfaction requires all of the legs (i.e., all of the stakeholder groups).

Lynn Stout illustrated this in describing the 2010 *Deepwater Horizon* disaster, the largest maritime oil spill in history:

Consider someone who owns not only BP stock, but also holds BP bonds; owns shares in other oil companies; owns a beach home on the Florida Panhandle; has a job in the Gulf tourism industry; and values his own human capital, including his good physical health and social connections in a thriving coastal community. By skimping on safety corners, BP may have given this investor several years of above-average share performance. But by causing an enormous oil spill in the Gulf, BP's risk-taking imposed much greater "external costs" on the investor's other interests. As a result of the Deepwater Horizon disaster, the U.S. government imposed a moratorium on exploratory drilling in the Gulf that idled not only BP's operations but those of other oil companies as well. The spill hurt the value of BP bonds, which were downgraded in the disaster's wake. The value of beachfront property in the Gulf declined, and its tourism and fishing industries suffered. The Gulf ecosystem was harmed, and its ability to provide healthy seafood and safe recreation degraded.[20]

People are complicated so they require a more sophisticated value proposition than reductive solutions dominated by finance. Fortunately, as Stout points out, corporate executives are also human and have the "capacity to balance, albeit imperfectly, competing interests and responsibilities."[21]

And isn't that the job corporate boards and leaders should be focused on? Isn't that what they should be paid for?

To adjust *all* the legs the stool was designed with, so it is as sturdy as possible?

Endnotes

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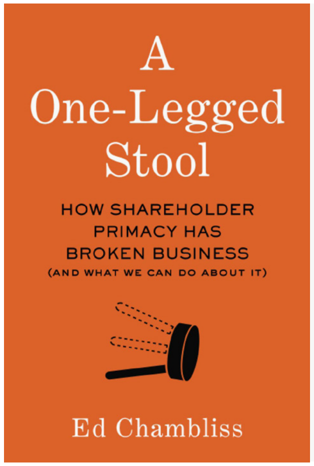

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ABOUT THE AUTHOR

Ed Chambliss has spent over 35 years in marketing, watching his otherwise smart clients make increasingly poor decisions that damage their companies - just so they could extract more money for their shareholders. In 2018, he walked away from being a CEO to figure out why business was on such a destructive path and what could be done to change it. The result is this book.

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This document was created on April 13, 2022 and is based on the best information available at that time.