CHAPTER 23

Shareholder Wealth Maximization

DUANE WINDSOR
Lynette S. Autrey Professor of Management, Jesse H. Jones Graduate School of Business, Rice University

INTRODUCTION

The shareholder wealth maximization (SWM) principle states that the immediate operating goal and the ultimate purpose of a public corporation is and should be to maximize return on equity capital. The SWM specification of what is often termed the corporate objective makes operating goal and ultimate purpose the same: Managers and investors should focus narrowly on SWM.

The question of whether the corporate objective can be a strict emphasis on SWM or must recognize significant differences between the operating goal for managers and investors and the ultimate social purpose of the public corporation lies at the intersection of three literatures. In economics and finance literature, SWM is a standard assumption. This SWM operating goal is expected to yield the most socially efficient allocation of capital. Business ethics, corporate social responsibility, and stakeholder theory literature emphasizes significant differences between an operating goal of SWM and the ultimate social purpose of the public corporation. Corporation law addresses duties, responsibilities, and rights of both financial and nonfinancial stakeholders. In the United States, the business judgment rule and in various states corporate constituency statutes permit relaxation in SWM as an operating goal in favor of stakeholder and social considerations.

This chapter addresses ethical considerations concerning the SWM principle and its managerial implications. A key factor in understanding SWM is that the public corporation is simultaneously private property, a web or nexus of contracts, a governmentally licensed and traded securities registrant, a social benefits entity, and a locus of stakeholder relationships.

This introduction explains some basic points of general relevance. The second section discusses the historical background of SWM and some technical considerations including measurement issues. The third section explains justifications for SWM. The fourth, fifth, and sixth sections explicate three critiques of SWM arising from (1) business ethics and corporation law, (2) corporate social responsibility (CSR), and (3) stakeholder theory. The chapter concludes with a summary of the arguments for and against SWM and their implications for managers.
Shareholder wealth maximization focuses on the motives and behaviors of financial stakeholders. The thesis of separation of ownership and control (Berle and Means 1932) posits that principals (or shareowners) employ agents (or management) who must have some reasonable discretion (e.g., the business judgment rule). At law, officers and directors have a fiduciary duty to safeguard the financial interests of the shareholders (or shareowners). The SWM principle can be stated, however, in two forms.

The stronger form argues that, within any set of legal and ethical constraints, the corporate objective is and should be strictly SWM. The operating goal and ultimate purpose of the public corporation are the same. Fiduciary duty ought therefore to be tightly focused on SWM. From this viewpoint, CSR activity is inappropriate wealth-decreasing altruism unless it yields future positive returns to the firm. This strong form associates with the views that legal and ethical constraints on corporate activity ought to be minimal and that institutions (including common law and social norms) should be market-facilitating. A multinational corporation may be able to select sets of legal and ethical constraints, varying by country, within which it will operate.

There may be a significant difference between management’s operating goal and the ultimate social purpose of the public corporation. A weaker form therefore relaxes the strict formulation to a more nuanced argument that the corporate objective is and should be primarily SWM. A relaxation admits, beyond legal and ethical constraints, consideration of CSR and interests of nonfinancial stakeholders. The relaxation understands that managerial responsibility is more complicated than mere fiduciary duty. The relaxation accepts that legal and ethical constraints are and ought to be stronger than minimalist (Windsor 2008).

One must decide which view to accept. One way to combine strong and weak forms is to argue that shareowners can and do make pragmatic choices that best protect their financial interest. A combined approach retains the financial goal and market context of the strong form but expects shareowners to figure out how best to address agents, nonfinancial stakeholders, and gatekeepers (Boatright 2007). The shareowners may decide to act in accord with the weak form in order to advance the SWM goal posited in the strong form.

This chapter explains three key objections to a strong SWM formulation of the corporate objective. These objections are logically admitted by any nuanced statement of SWM as a primary rather than as a singular goal for managers. As previously explained, a goal and a purpose need not be the same. The narrow (but socially penultimate) goal of investors is to maximize financial return. The broader (and ultimate) purpose of a public corporation, a rationale for government licensing, is generation of social benefits. Both corporate social performance (CSP) and financial performance should be positive. The three objections are as follows. First, business ethics functions as a set of supralegal constraints on managerial conduct to avoid wrong acts and social harms. Second, CSR is a justification for corporate contribution of social goods in addition to legal compliance and business ethics. Third, stakeholder theory argues that any business must be a multiple-constituency and a social entity. A continuing debate concerns whether these three objections (business ethics, CSR, and stakeholder theory) justify basic changes in corporate governance principles and/or corporate purpose.
Two competing views about multiple principles can be articulated. A monotonic SWM view is that any two or more principles must be strictly hierarchical (Jensen 2001). Legal and ethical constraints can be antecedent conditions. “Sometimes the aims of the business and rational self-interest will clash with ethics, and when they do, those aims and interests must give way” (Economist 2005). Considerations of CSR and stakeholder satisfaction would be subordinate to SWM and function as strategic variables only (Husted and Salazar 2006). A competing view is that two or more corporate goals should be pursued simultaneously. The firm serves a diverse set of social goals. Either there is some win-win combination of goals or else multiple goals must be balanced in some way. An ongoing controversy concerns whether observable varieties of capitalism, addressing these matters differently, will converge or continue to diverge.

HISTORICAL BACKGROUND AND TECHNICAL CONSIDERATIONS

The first important joint stock company was London-based Muscovy Company, which was chartered in the sixteenth century to trade with Russia (Sasse and Trahan 2007, 30). Adam Smith, in *The Wealth of Nations* (1776), commented adversely on Honourable East India Company’s (HEIC, 1600–1874) governance problems and the handling of monopoly rule in India. The Dutch East India Company (VOC, 1602–1800) was likely the first to issue public stock (i.e., shares traded on a stock exchange as distinct from a private placement). There was not much attention to corporate governance until the passage of the Joint Stock Companies Act in 1844 in the United Kingdom, and the United Kingdom introduced limited liability only in 1862 (Cadbury 2006, 16). Legal liability of public corporation shareowners today remains limited to capital invested. Bismarck introduced mandatory supervisory boards (i.e., today’s two-tier board system) for joint stock companies in Germany in 1870 (Cadbury 2006, 16).

The SWM principle is relatively recent (Englander and Kaufman 2004). The traditional underpinning of public corporations has always been an appreciation of private property rights as the foundation of market capitalism: in theory, capital investors organize firms and hire agents to manage them. This underpinning aims at prudent conservation. The classical statement occurred in *Harvard College and Massachusetts General Hospital v. Francis Amory* (9 Pick., 26 Mass. 446, 461, 1830, Supreme Court of Massachusetts, for Suffolk and Nantucket, Judge Samuel Putnam): “Do what you will, the capital is at hazard.” Trustee Armory, trading in riskier business stocks rather than investing in bonds or real property, lost much of a corpus bequeathed to Harvard College (an annual dividend being paid to the donor’s widow) and was sued for recovery. Modifying stricter English common-law standards requiring virtually absolute conservation of capital, the court accepted greater flexibility in the conduct of trustees. The court articulated the guiding principle as follows: “These trustees are not to be made chargeable but for gross neglect and wilful mismanagement.”

The capital stock of any for-profit enterprise is divisible into ownership shares for legal definition of duties, responsibilities, and rights, and for purposes of theorizing. The exact form of the enterprise and the related division into shares is
a matter of law. Large, publicly traded corporations typically have many owners
and diffused ownership, even with large blocks of institutional investors. A share-
owner, or shareholder, is an individual or entity owning an equitable interest. The
interest (or financial stake), consisting of one or more shares, conveys to the holder
limited rights (and liability) to control the entity and to the residual revenues (or
profits), if any. A shareowner risks capital in order to obtain return on investment.
Rights to control and residual revenues are held jointly by (distributed among)
the owners in some proportion to number of (and sometimes type of) shares held.
Issues of majority versus minority shareholder rights and types of shares (preferred
versus common, voting versus nonvoting) are not the concern of this chapter. The
discussion of SWM here proceeds from a basic, idealized conception of the public
corporation as a large set of shareholders holding approximately equal rights to
control and to profits.

New underpinnings for today’s SWM principle developed in the twentieth
century. One underpinning is agency theory, positing the separation of legal own-
ership and effective control. Another underpinning is economic efficiency in real
and financial markets: Investors contribute capital to firms in expectation of earn-
ing the relatively highest return on investment (Lea 2008). Another underpinning
is an understanding of the corporation as a web or nexus of contracts (Lea 2008).
This contractual view is the dominant one in economics and finance literature.
Managers in a publicly owned corporation with a separation of ownership and
control are agents in a position of trust, which is defined as having a fiduciary
duty to the principals. This fiduciary duty is to safeguard the assets of the owners.
The fiduciary duty is not, however, necessarily to maximize shareholder wealth in
the sense of return in addition to safeguarding assets. The fiduciary’s first respon-
sibility and concern is always to safeguard corporate assets. Shareholder wealth
maximization is a norm for prescribing what the fiduciary should do once asset
safety is reasonably assured. Both return and risk are involved in SWM. Higher
return implies greater risk.

Shareholder wealth can be defined, at any time, as the market capitalization
of the public corporation. This market cap is the number of equity shares out-
standing multiplied by the share price at the time of calculation. Market cap is an
estimate, by capital markets, of the net worth of the firm. The market cap reflects
the firm’s tangible assets plus the future expected residual revenues, which may be
distributed as dividends or kept as retained earnings. The estimate thus includes
the future expected dividend stream. Higher earnings per share (EPS) of common
stock (i.e., equity) will tend, ceteris paribus, to increase the market price of each
share (and thus the market value of the firm) and to permit in principle either
additional investments in profitable projects or higher dividends.

A problem inherent in the market cap definition is that it involves an artificial
dimension of subjective valuation by buyers and sellers. There can be artificial bub-
bles, particularly for real estate and commodities. In a bubble, the price-to-earnings
ratio rises, often rapidly. The SWM principle effectively encourages investors to
demand, and management to supply, actions that will increase share price over
time. There is a significant difference between these management actions and the
process of subjective valuation in capital markets. Free cash flow, defined as net
operating cash flow minus capital investments, occurs in product markets; and
management has direct control of decisions affecting free cash flow, which is then
available to exploit opportunities to enhance shareholder value. Real free cash flow
is more difficult to manipulate than accounting profit. But capital markets independently evaluate the estimated worth of free cash flow or earnings per share or any other relevant measure. This evaluation process might be influenced by management actions and information, but it is not under direct control of management. (Management itself is subject to being disciplined or even replaced by what is termed the market for control of the firm itself.)

How to define the SWM norm as a specific corporate objective and how to measure that objective concretely in order to show an increase or decline in wealth remains a matter of disagreement. There are three different approaches to thinking about measurement: accrual accounting, cash flow, and market value added. The traditional profit-maximization model of the firm embeds the accrual concept of net income (i.e., profit). Accrual profit is a declaration, in accordance with accounting principles, of the difference between revenues and expenses over an accounting time period (such as a quarter or a year). Accounting declaration is subject to manipulation of revenues, expenses, and net income.

The wealth of an investor is more related to cash flows than to accrual profits. The cash-flow model of the firm uses free cash flow computed as net operating cash flow less capital expenditures without respect to specific accounting time periods. One can think of a cash flow return on investment. This real measure avoids accounting distortions or manipulations. Free cash flow can also be computed as net income plus amortization and depreciation less changes in working capital less capital expenditures. Negative cash flow might signal large investments in the firm’s future success.

The market value model focuses on the share price of a publicly traded company. For example, Warren Buffett—one of the world’s wealthiest billionaires who built Berkshire Hathaway into a major publicly owned investment manager—initially bought some stock in a small company in 1962 at reportedly $7 per share. In October 2006, each share of Berkshire Hathaway was worth about $100,000. Whether that change in wealth was, strictly speaking, maximization (i.e., the most that could have been created over the time period involved) is a different matter.

Stock price, however, may not fully reflect the worth of the shares. There can be unrelated fluctuations in the stock market and other considerations that inflate or deflate a stock’s price relative to some true value (which is an estimate by buyers and sellers). Maximization, in this context, requires relatively strong conditions such as efficient capital markets, negligible social costs (i.e., negative externalities), full protection of bondholders from expropriation, and nonappropriation by managers.

Of the three approaches, stock price has the strongest claim to approximating shareholder wealth. Aggregate shareholder wealth, measured as market capitalization or market value, is then the value (i.e., market price) of each share times the number of shares outstanding. The formula for this measurement can be stated as follows:

\[ MV = V \times S \]

where \( MV \) = market value
\( V \) = value of each share (i.e., of common stock)
\( S \) = number of shares outstanding (i.e., of common stock)
If \( V \) (i.e., share price) rises, at a constant \( S \) (i.e., number of shares outstanding), then \( MV \) rises. The management should focus on getting share price to rise over time. If management issues additional shares, however, then \( V \) could fall in response.

One can relate market value to accrual profits or cash flows in the following manner. To grow wealth, managers can increase earnings per share (EPS). \( MV \) is the present value of expected future profits or expected future cash flows, which are discounted over time at the equity shareholder’s required rate of return \( r_e \). If we let \( \Pi \) stand for either accrual profits or cash flows, depending on the prediction we want to apply, then the formula for this measure can be constructed basically as follows (where successive time periods \( t \) are summed from 1 to infinity):

\[
MV = \sum_{t=1}^{\infty} \prod_t / (1 + r_e)^t
\]

The market value added (MVA) of a firm is the difference between the value of equity and net debt and the book value of capital invested. If net debt is equal to book value, then the difference between market capitalization and book value of the shareholders’ equity is the market value added. The MVA concept is a way of measuring gain over book value.

Stern Stewart & Co. developed in 1989 a concept of economic value added (EVA) to measure wealth generation. EVA measures whether a firm is earning more than its true (i.e., economic) cost of capital. In effect, EVA subtracts a charge for the opportunity cost of capital from net operating profit in order to estimate return on the invested capital. (The opportunity cost of a resource is always the next best return it could earn. The opportunity cost of an equity stock is a risk-free government bond; an equity stock must earn more than the bond in order to show an economic profit.) This EVA is computed as a return on investment less the opening capital (debt and equity) times the weighted average cost of capital (for debt and equity). If debt is \( D \), equity is \( E \), net operating profit after tax is NOPAT (as a notion of return on investment), and weighted average cost of capital is WACC, then the formula is basically as follows:

\[
EVA = NOPAT - (D + E) \times WACC
\]

Economic profit begins only when capital cost is recovered. A firm could show accrual profit and be losing economic value. An investment project should return more than its cost of capital in order to be profitable (on an economic basis) and increase shareholder wealth.

The SWM principle can be dangerous in three ways. First, as illustrated by Enron and other recent corporate frauds, management may undertake illegal actions to prop up or increase stock prices that have no basis in economic reality. Second, management may trade future economic value for short-term earnings targets. Economic value added, which is effectively net gains after recovering cost of capital invested, may be a superior way of evaluating investment choices. Third, the market for corporate control may not discipline managers but rather exert strong pressure to maximize earnings or short-term share price (Vives 2008,
A survey of 401 financial executives and in-depth interviews with an additional 20 financial executives found that a majority of the firms involved view earnings, especially earnings per share (EPS), as the key metric for external audiences, even more important than cash flows (Graham et al. 2005). A majority of the executives would avoid initiating a positive net present value (NPV) investment project if the result would fall short of the current quarter consensus earnings. More than 75 percent would exchange economic value for smooth earnings. Their belief is that missing an earnings target or reporting volatile earnings reduces stock price, because investors and analysts have a preference against uncertainty. Managers can decrease this uncertainty to some degree by making voluntary disclosures that reduce information risk. But voluntary disclosure is limited by the need to avoid disclosure precedents that may prove difficult to maintain in the future.

**JUSTIFICATIONS FOR SHAREHOLDER WEALTH MAXIMIZATION**

The descriptive, instrumental, and normative dimensions of the SWM principle are mutually supporting. The descriptive dimension concerns a particular empirical view of laws, markets, motives, and behaviors. The view posits relatively efficient markets, market-oriented institutions, and self-interested economic rationality. Descriptively, the view posits that management (i.e., officers and directors) has strong fiduciary duties on behalf of shareholders, which are established by law and enforced by the market for corporate control. The instrumental dimension concerns the prescriptively best approach to managing a public corporation on behalf of shareholders and handling the interests of multiple stakeholders in the corporation and its activities. The prescription is that SWM will most efficiently and effectively advance the interests of shareholders and stakeholders and thus social welfare in a market economy.

The normative dimension concerns duties, responsibilities, and rights of the various stakeholders, with particular attention to the fiduciary and stewardship roles of management. Normatively, management should have strong fiduciary duties toward shareholders. There are three normative bases for strong fiduciary duties. One basis is that the agent contracts voluntarily with the principal to act in the principal’s best interests and to be trustworthy in this regard. A second basis lies in property rights. The principal is the owner of the tangible assets and residual revenues of the firm. The manager is a trustee for this property. A third basis lies in utilitarianism. This utilitarian interpretation is that free mobility of capital should promote economic development and growth, benefiting everyone in the long run more than other approaches. The empirical evidence over the past two centuries, in this regard, generally (if imperfectly) bears out Adam Smith’s prediction in *The Wealth of Nations* (1776) that relatively free markets will outperform alternative approaches for wealth creation (Jensen 2001).

A “primary” goal of shareholder value creation is “a little vague” (Ross et al. 2002, 15). Managers tend to maximize corporate wealth, under their control, rather than shareholder wealth (Ross et al. 2002, 16). “The available evidence and theory are consistent with the ideas of shareholder control and shareholder value maximization. However, there can be no doubt that at times corporations pursue
There are four key questions concerning the SWM principle. Two intertwined questions are normative. One question concerns the ultimate purpose of a business: In principle, what should a business strive to do? Financial economics theory posits that the ultimate purpose (and immediate operating goal) of any business is to maximize its market value. This corporate objective should, under certain conditions, maximize social welfare. This specification of the corporate objective reflects utilitarianism in the sense that everyone should gain over the longer run from freer markets if the necessary conditions obtain. Nonutilitarian business ethics, corporate social responsibility, and stakeholder theory provide different answers concerning ends and means of business activity. (There are several different theories of business ethics. Utilitarianism, a specific type of teleological or consequentialist ethics, is most closely aligned with market economics. Deontological ethics, best represented by Kant’s conception of rational duty, is more closely aligned with CSR and normative stakeholder theory.)

A second normative question concerns property ownership and corporate governance: Who has rights to control or influence the objective function of the corporation? These rights might be moral as well as legal. Linked to SWM as a corporate objective is a particular understanding of the firm, in a capitalist market economy, as attracting and employing capital. (Capital owners need not be the organizers of a firm. Anyone, such as an entrepreneur, might organize a firm and then seek capital.) Allocation of capital is a key dimension of the functioning of the market economy.

A third question is instrumental: What are the practical alternatives for maximizing the firm’s value and the shareholders’ value—and over what relevant time horizon? And are these alternatives equally satisfactory? Key stakeholders, in addition to shareholders and executives, are customers and employees. A balanced approach to value creation, defined as one empirically treating multiple constituencies as if effectively equal, might perform better in the marketplace than an approach asserting a purely normative theorem.

A fourth, and final, question is descriptive: What are the conditions external to the firm affecting the normative and instrumental answers? Germany, Japan, the United Kingdom, and the United States do not share the same varieties of capitalism. The United States is the prime example of a strongly shareholder-oriented business system. The prevailing assumption is that SWM will tend most efficiently and effectively to resolve stakeholder issues and contribute to social welfare. The public firm is directed by a board of directors elected solely by the shareholders. In Germany, a dual board system and workers’ councils reflect a greater degree of attention, in theory at least, to stakeholder management. Depending on conditions prescribed by law, a management board reports to a supervisory board that includes both shareholder and labor representatives. In Japan, although there is a single board like the United States and unlike Germany, banks are important capital sources, and there is an effort to obtain cooperative management-labor relations, as in Germany. The United Kingdom, although more like the United States than Germany or Japan, is arguably an independent development of corporate governance principles and practices. This variation in institutional
context significantly affects both normative and instrumental dimensions in each country. Whether globalization will increase convergence or maintain such divergence in descriptive, normative, and instrumental dimensions remains a matter of debate.

Agency is a relationship in which one person or entity (the agent) acts for another (the principal) and typically under conditions of information asymmetries favoring the agent. This principal-agent relationship is ubiquitous in human activities (Mitnick 2008, 44). “At present there is no unified, coherent ‘theory of agency’”—which appears in various social and business fields (Mitnick 2008, 45). In public corporations, agency involves potentially conflicting fiduciary and stewardship roles. The fiduciary role involves the relationship between management and shareowners. The stewardship role involves the relationship between management and the organization as an entity and the multiple stakeholders involved with the organization (Preston 1998).

In economics and finance, the key agency concern is contracting and monitoring to align the financial interests of directors, executives, and employees with those of the shareowners. One view of management appropriation of value is that the mechanisms of value diversion do not really matter. The argument is that self-dealing or insider trading, for example, does not reduce shareholder wealth because such mechanisms are simply substitutes for alternative compensation forms that would otherwise be paid to managers by shareholders. In other words, compensation extracted by management is constant at the end of the day, and all that actually varies is the form of transfer. Bebchuk and Jolls (1999) question this view. Their counterargument is that the form of compensation can and does affect the incentives for management effort at enhancing shareholder value. If so, then self-dealing would generate less shareholder wealth than some substitute mechanism yielding the same compensation to management. Ultimately, the question is empirical, if difficult to test. The testable hypothesis is that compensation form does not matter in association with shareholder wealth.

One can argue that transparent, disclosed backdated stock options are simply one form of compensation. Management openly is permitted to select the date for pricing options. Looking backward, management picks the lowest permissible price over some time period in order to obtain the highest feasible compensation. In theory, this self-selection opportunity may be a motivation to improve future shareholder wealth. However, one must then explain why managers engaged in such backdating have frequently kept the activity secret from the shareholders. Basically, to be legal in the United States, backdated options must be fully disclosed (i.e., transparent), approved by the shareholders, and properly treated for accounting and tax purposes. Options that are in-the-money when awarded, for instance, involve taxes due. There are significant financial incentives, therefore, not to disclose backdated options. Backdating may make the company appear to have more money than it really does.

That managers are being sued and prosecuted over backdating secrecy does not accord with the view that backdating is simply one form of compensation. In 2006, William McGuire, chair and CEO of UnitedHealth Group (Minnesota), was forced out in a backdating scandal. In December 2008, a federal judge gave preliminary approval to a settlement in a civil suit by the shareholders. UnitedHealth Group would pay $895 million and Mr. McGuire $30 million to the shareholders.
financial analyst predicted that an ordinary investor would be thousands of times more likely to contract mad cow disease than to experience the profits bestowed by the backdated insider stock options" (Houston Chronicle 2007). These posited assumptions, or claims, concerning SWM are best regarded as a prescriptive formulation concerning what shareholders’ rights ought to be in some idealized conditions. Contracts, incentives, and monitoring ought to assure that the board of directors and top executives are reliable agents who undertake to maximize shareholders’ value (Stout 2002, 1195). The costs of assurance may be less than the benefits of assurance. However, the cost-benefit relationship is a purely empirical matter.

CRITIQUE FROM BUSINESS ETHICS AND CORPORATION LAW

The SWM principle is prescriptive in the sense that it is a proposed standard of conduct for officers and directors. This prescription is the dominant, and also a convenient modeling, assumption in the economics and finance literature. The prescription aligns with the neoclassical theory of the firm operating in weakly regulated markets (Coase 1937). The legal duty of officers and directors is to safeguard corporate assets by prudent conduct, not necessarily to increase their own wealth. In practice, officers and directors legally and morally must have some degree of discretionary judgment. In part, such discretion is unavoidable because how to prioritize the competing interests of multiple stakeholders may be conditional and fluid. Management may need to give attention to the preferences of employees, for instance, over the SWM preferences of investors (Jensen 2001). Salience of a specific stakeholder group, including shareholders, may vary over time and by decision situation. An extreme illustration of such conditional and fluid competition of interests has been reported for the Eurotunnel company (Vilanova 2007), which changed its name in 2007.

Whether SWM is or should be a binding legal rule rather than simply a primacy norm is much debated in the U.S. corporation law literature. U.S. legal doctrine affords considerable discretion to officers and directors with respect to conduct of a business. This discretion is known as the business judgment rule. Basically, that rule does not defend SWM as the binding requirement for managers. On the contrary, managers must be able to handle the conflicting interests just explained. Corporate constituency statutes in a majority of the American states, adopted mostly as antitakeover deterrence, reinforce that discretion. Basically, SWM is a prescriptive standard of conduct for guiding and evaluating corporate officers and directors. Perhaps even much of the time, SWM is a reasonable standard; but such a standard cannot be made a binding rule of law or conduct for all of the times tough decisions have to be made by managers. Shareholder value is arguably a control principle (who) and not a corporate purpose (why) (Koslowski 2000). At most, shareholder wealth is a goal of shareholders. The merit, or defect, of the prescription depends on the behaviors and outcomes that result.

Stout (2002) argues that, at law, shareholders do not “own” a public corporation and are not the sole residual claimants. “Milton Friedman is a Nobel Prize–winning
economist, but he obviously is not a lawyer. A lawyer would know that the shareholders do not, in fact, own the corporation” (Stout 2002, 1191). Shareholders own stock shares (i.e., equity securities), possessing quite limited rights. The board of directors exercises control over corporate assets. The Berle-Means separation thesis (i.e., the separation of widely dispersed ownership and effective management control) means that shareholder influence is both indirect and, on the board of directors, effectively negligible (Stout 2002, 1191). The ownership notion applies at best to a closely held firm with a single controlling shareholder (Stout 2002, 1191).

“Like the ownership argument, the residual claimants argument for shareholder primacy is a naked assertion, and an empirically incorrect one at that” (Stout 2002, 1193). The directors declare a dividend, and that declaration is conditional typically on the firm’s financial performance (Stout 2002, 1193). The residual claimant condition obtains only in actual bankruptcy (Stout 2002, 1193), when creditors have priority over shareholders, who receive only what (if anything) is left over after satisfying legal claims of the creditors. For dispersed shareholders to influence the board of directors is a costly action (Stout 2002, 1194). Maximizing the firm’s value (or price) is legally binding only at change of corporate control, and then only when the sale is effectively inevitable. This position was emphasized in Revlon Inc. v. MacAndrews & Forbes Holdings Inc. (506 A.2d 173, 1986, Delaware Supreme Court). When an external party offers to acquire a publicly traded company, then the directors have a duty to ensure that the offer price is fair. Typically, a purchase offer of this type will include some premium over the current market price of shares. A purchase offer is public information, so sometimes there will be a competing bid by another external party.

There are two competing interpretations in the legal literature. One interpretation is SWM is little more than a residual target: If management does not have some reasonable business rationale for doing otherwise, then it should try to create value. Dodge v. Ford Motor Co. (204 Mich. 459, 170 N.W. 668, 1919, Michigan Supreme Court) supported the business judgment rule and appreciated trade-offs between immediate profitability and a continuing venture. There is no plain legal duty to SWM, and such a legal rule would be bad public policy and inefficient. The case’s specific ruling in favor of a special dividend demanded by the plaintiffs is therefore effectively “a dead letter” (Stout 2008). Management can typically come up with a business rationale for why a special dividend should not be paid, and the courts will likely support management’s judgment (Nunan 1988).

The competing interpretation is that the SWM norm remains legally strong. The American Law Institute (ALI) Principles of Corporate Governance (1994) provides only three “minor exceptions” to SWM: legal compliance, charitable contributions, and a “reasonable amount of resources” for nonbusiness purposes including public welfare (Macey 2008, 178–179). Practicality is the difficulty: “Maximizing value for shareholders is difficult to do. There is no simple algorithm, formula, or rule that managers can employ to determine what corporate strategy will maximize returns for shareholders” (Macey 2008, 180).

The SWM norm is ineffectual and rhetorical. Management discretion to sacrifice corporate profits in the public interest is necessary, independent of law; and SWM, actually practiced, would override social and moral sanctions on corporate misconduct (Elhauge 2005). An illustration is provided by an answer
that Jeff Skilling, later CEO of Enron, reportedly gave in class at the Harvard Business School. He allegedly supported the position that he would keep selling a potentially, but not definitely, harmful (potentially even fatal) product unless government prohibited the product (Fusaro and Miller 2002, 28). The possibility is not hypothetical: Peanut Corp. of America allegedly kept shipping salmonella-tainted peanut products. That company declared bankruptcy in early 2009, and its CEO took the Fifth Amendment before a Congressional hearing.

**CRITIQUE FROM CORPORATE SOCIAL RESPONSIBILITY**

Firms are expected to practice “corporate citizenship” by engaging in significant community and social philanthropy programs (Sasse and Trahan 2007). The question of whether public corporations should do so is riddled with conflicting opinions concerning strategy and ideology. Friedman (1970) attacked voluntary CSR as agent misconduct. (He noted that a private company can properly operate as a philanthropic enterprise.) Citing the example of Timberland CEO Jeffrey Swartz, Sasse and Trahan (2007) resurrect the unintended results argument of Friedman that corporate philanthropy compromises “distinct roles” that business and government should play in market democracies and tends toward socialism. However, Friedman’s formulation posits “rules of the game” of law and ethical custom constraining SWM. Adam Smith, in *The Theory of Moral Sentiments* (1759, 339), distinguished between citizenship and good citizenship. The former is simply legal compliance; the latter involves promotion of the general welfare.

An analysis of a sample of 384 U.S. companies, using data pooled from 1998 through 2000, concludes that worse performers in the social domains of environmental issues and product safety are more likely to make larger charitable contributions (Chen et al. 2007). No significant association was found between corporate philanthropy and employee relations. This evidence supports the suggestion that corporate philanthropy involves effort at corporate social legitimization as distinct from corporate social responsibility.

A corporate board cannot exceed its authorized powers (i.e., the legal doctrine termed *ultra vires*) (Hardee 1962, 107). Corporate authority to make charitable contributions was supported under a common-law test of validity, meaning direct benefit to the corporation, in the English case of *Hutton v. West Cork Railway* (23 Ch. Div. 654, 1883) (Hardee 1962, 105). The case concerned distribution of purchase funds following sale of a company at a price determined by arbitration. Upon dissolution, the general meeting determined to pay some of the funds to the company officials for loss of employment and to directors for past services. The officials had no legal claim; the directors had never received any remuneration. Two of the three judges disallowed the payments, on grounds that the company had been dissolved. However, the opinion effectively supported philanthropy for a going concern where there is some direct benefit to the company. By the Insolvency Act of 1986, s.187, and the Companies Act of 2006, s.247, an insolvent UK company can today consider employees’ interests.

In the United States, *A. P. Smith Manufacturing Co. v. Barlow* (13 NJ 145, 98 A.2d 581, 1953), a New Jersey state case concerning a $1,500 donation to the annual
fund of Princeton University by a New Jersey company, expanded the notion of benefit to be determined by the board of directors. The board of Union Pacific Railroad decided to increase its corporate citizenship activities (Hardee 1962, 105). The company organized test litigation in Utah with formation of a foundation and stimulated passage of a new state law based on a model statute prepared by the American Bar Association. The Supreme Court of Utah, reversing a trial court, sustained the company on common-law grounds while declining to pass, on purely technical grounds, on the new statute. The technical issue (that the statute did not apply to preexisting corporations) was corrected by a new business corporation law in 1961 (Hardee 1962, 105–107).

CRITIQUE FROM STAKEHOLDER THEORY

Since likely there will be a continuing gap between laws and markets, varying by country, a key role of nonfinancial stakeholders is action to expand one or both (Vives 2008, 229). Management and labor are more likely than investors to view a public corporation as a social entity, whose value and growth strategy cannot be summed up entirely by the current equity price (Strine 2007). Stakeholder, team production, and corporate republic views (Blair and Stout 1999; Englander and Kaufman 2004; Strine 2006) favor this interpretation. The basic argument is that the firm is a multiple-constituency organization whose wealth creation is more broadly definable than financial performance (Preston and Donaldson 1999). Critiques are available in Boatright (1996) and Meese (2002).

Jensen (2001, 297) argued that maximization in more than one dimension is logically impossible. If a single-valued objective function must be chosen to guide corporate activities, then in a market economy SWM will maximize social welfare. This prescription has, however, very strong conditions. There must be no externalities and no monopoly; and all goods must be priced. Total market value must include the market values of all financial claims. A key constraint is that SWM is not truly motivational for employees and managers, whose sentiments can affect their productivity efforts. Maximizing short-term financial performance (e.g., profits or earnings per share) can destroy long-term value (Jensen 2001, 309). Under these conditions, “no constituency can be given full satisfaction if the firm is to flourish and survive” (Jensen 2001, 309). The government must resolve externality and monopoly issues (Jensen 2001, 308–309).

The business corporation is a wealth-seeking organization (Jensen 2001). It buys and sells, or trades, in a marketplace in order to obtain return on invested capital. There are two minimum conditions for this activity to continue over time. One condition is that the corporation engages in some socially legitimate business. Certain drugs, such as cocaine, heroin, and marijuana, are legally prohibited. Whether such prohibition is sound or effective public policy is not relevant to this chapter. The drug trade is regarded, properly or not, as socially illegitimate. Tobacco products are presently permitted, under certain conditions, but that social legitimacy is being challenged and may ultimately be withdrawn. A second condition is that the corporation creates value in some form. Judge Ben F. Tennille, in First Union Corporation, Wachovia Corporation, and First Union National Bank v. SunTrust Banks, Inc., citing Coase (1937), wrote: “Corporations exist to create value. In purely economic terms, if they do not do that, they cease to exist.” As Tennille
(Special Superior Court Judge for complex business cases) points out, in a case concerning the proposed merger of Wachovia and First Union banks, corporations create different types of value: stock price, jobs, community contributions, cheaper and better goods and services, employee or founder personal goal fulfillment, and so forth (Tennille 2001, 4–5).

These two minimum conditions point out a basic problem in assessing SWM. The corporation is both private property and a social institution (Tennille 2001, 5–6, citing Allen 1992). William T. Allen, formerly Chancellor (chief judge) of the Court of Chancery of Delaware (1985–1997), characterizes this duality in terms of a schizophrenic competition between two inconsistent conceptions (Allen 1992, 264–265). One conception views the corporation as the private property of the shareowners. This “property conception of the corporation” or “contract model” bundles wealth-seeking of the principals with the fiduciary duty of the agents. Both terms might be used, because there has been an historical evolution from a private property view dominant in the nineteenth century to a nexus-of-contracts view dominant in the twentieth century (Lea 2008, 1919). The competing conception views the corporation as a social institution, licensed by the government to promote the general welfare. There is thus some duty of loyalty to all concerned with a particular corporation. The legal entity has a public as well as a private purpose. “This view could be labeled in a variety of ways: the managerialist conception, the institutionalist conception, or the social entity conception” (Allen 1992, 265). This view might be characterized as a communitarian theory of the firm (Lea 2008, 1919).

Variations in the forms of capitalism were noted earlier. Judge Tennille (2001, 6–7) characterizes three competing systems for corporate value creation: (1) the Japanese keiretsu (a business group comprising a set of companies with interlocking business relationships and shareholdings); (2) the European approach involving strong (or close) ownership, strong influence by financial institutions, and state-controlled companies; and (3) the U.S. approach of diverse capital ownership resulting in separation of ownership and control. In Europe, ownership is more concentrated, there are pro-stakeholder institutions, and employment protection is more rigid (Gelter 2009). However, the world is more complicated: There is considerable variation, and the United Kingdom is likely now an independent development. But for present purposes, these three systems will serve. The UK Companies Act facilitates stakeholder interests (Gelter 2009). Each system addresses four tasks differently: (1) defining and ranking corporate values; (2) combining and using financial capital; (3) combining and using human capital; and (4) combining financial capital and human capital.

An open question is whether the U.S. system outperforms the Japanese and European approaches. Judge Tennille (2001, 7) answers favorably for the U.S. system to date. Historically, over the past two centuries, relatively free market systems have performed well at economic development and growth, supporting Adam Smith’s prediction in *The Wealth of Nations* (1776). However, the recent global recession, originating in the U.S. subprime mortgage sector and following various corporate scandals there and elsewhere, raises significant questions about
a strongly positive answer for the U.S. approach. Yoshimori (2005) suggests that
the corporate performance of Toyota and Canon is superior to the corporate per-
formance of GM and Xerox, due partly to the emphasis of the latter on SWM as
distinct from sustainable strategy development and corporate governance. Leav-
ing aside the question of whether Yoshimori is in fact correct, it is conceivable that
various approaches, rooted in different societal contexts (Tennille 2001, 8), will all
perform sufficiently well that the truth of which is strictly better is not a dominating
consideration (Henisz and Williamson 1999).

Corporate governance structures in Europe and Japan are more favorable to
stakeholder-oriented firms. It may be true that a shareholder board will outper-
form a stakeholder board and that the purpose of a corporation should be narrowly
efficiency rather than broadly social benefits (Williamson and Bercovitz 1996). A ra-
tional person should then arguably select the director-primacy model of corporate
governance over competing proposals (such as a stakeholder board) as improv-
ing social welfare for everyone except the CEO (Dent 2008). However, a recent
analysis by three finance professors suggests that stakeholder-oriented firms have
advantages and disadvantages, such that the case in favor of shareholder-oriented
firms is not automatic or decisive (Allen et al. 2007). The study concludes that
stakeholder-oriented firms may have lower output and higher prices—which com-
bination could result in greater value to the firm. (The reason, as the authors note,
is effectively an increase in monopoly power, to the potential harm of consumers.)
Additionally, consumers (notwithstanding the increase in monopoly power) may
prefer to buy goods and services from stakeholder firms; if so, the number of such
firms will tend to increase over time. (The study uses a mathematical model of
stakeholder governance involving a duopoly of two hypothetical firms selling in
competition.)

It is possible that (1) better relations with primary stakeholders (e.g., employ-
ees, customers, suppliers, and communities) could increase shareholder wealth,
while (2) social initiatives (i.e., CSR activities) not related to primary stakehold-
ers could decrease shareholder wealth (Hillman and Keim 2001). An instrumental
stakeholder strategy, by which better stakeholder management results in both
greater shareholder wealth and greater benefits for other stakeholders, seems to be
a nondebatable win-win thesis.

Several answers may address the social initiative problem. One answer is
that the empirical evidence is disputed and arguably contingent on particular
circumstances (Margolis and Walsh 2003). The weight of evidence suggests that
the average relationship between corporate social and financial performance is
basically neutral or mildly positive (Becchetti et al. 2008). If so, limited CSR activ-
ities are not likely to endanger corporate earnings materially (Roman et al. 1999,
121). A case does not have to be made that social initiatives are profitable, only
that social initiatives are not markedly unprofitable (Bird et al. 2007). Even a thin
difference leaves discretion to corporate strategy. A second answer is that social
initiatives may serve to enhance or protect corporate reputation as an intangi-
ble asset in ways difficult to measure. Market value may depend on intangibles
like brand value and reputation (Vives 2008, 205, n. 9). A third answer is that a
firm ought to avoid doing wrong and causing social harms; the effort to avoid
wrong and social harms may be strengthened by engaging in some social goods
(Greenfield 2008).
CONCLUSION

The view that the corporate objective is and should be shareholder wealth maximization (SWM) is a prescriptive, standard assumption in the economics and finance literature. There are normative foundations for the principle in utilitarianism and property rights. The strong form of the principle is arguably not descriptively or instrumentally defensible. There is reason to think that markets in which stock prices are set are seriously imperfect. The principle does not correspond with the actual legal duties of officers and directors. There are objections to strict SWM from business ethics and corporation law, corporate social responsibility, and stakeholder theory (or close variants such as team production and corporate republic conceptions). The corporate objective is better understood as constrained maximization in principle, relaxed to constrained wealth seeking in practice (Jensen 2001). The debate is then over constraints and influences.

The constraints can be understood as a set of antecedent conditions defined by law and ethics. From a deontological perspective, the corporation should commit no wrongs (Greenfield 2008). (An idealized standard may have to be relaxed to a more realistic standard of avoiding or minimizing wrongs.) From a teleological perspective, the corporation should commit no social harms. (Again, an idealized standard may have to be relaxed to a more realistic standard of avoiding or minimizing harms.) This condition is not necessarily one of doing social good, other than as a by-product (i.e., positive externality) of market activities. From a purely financial perspective, wrong conduct may prove very costly to the firm through fines and civil liabilities, loss of reputation and trust, and increased compliance costs occasioned by erosion of integrity. The Foreign Corrupt Practices Act (1977) and the Sarbanes-Oxley Act (2002) are illustrations.

Given compliance with these antecedent conditions, then management should attempt to maximize the sustainable economic value of shareholders’ investments over time. Time horizon is a matter of strategic judgment. The shareholders must be concerned to minimize misappropriation of this economic value by management acting as self-interested (i.e., opportunistic) agents. And such agents may undermine efforts at meeting the antecedent conditions.

This corporate objective is further constrained by three strategic considerations bearing on management choices. First, some purpose other than money may be a better strategy and may better enhance employee productivity and stakeholder loyalty (George 2001). Second, sufficient stakeholder satisfaction to ensure loyalty (rather than exit or voice) is strategically valuable. Third, doing some social good (some corporate social responsibility or corporate citizenship) beyond avoidance of wrongs and harms may prove to be a smarter long-run strategy, and may be increasingly demanded or expected by important stakeholders.

REFERENCES


**ABOUT THE AUTHOR**

**Duane Windsor**, BA (Rice), PhD (Harvard), is editor of the quarterly journal *Business & Society*, sponsored by the International Association for Business and Society (IABS). He has published a number of books or monographs, as well as scholarly papers appearing in journals, edited books, and proceedings or as conference presentations. His recent work focuses on corporate social responsibility and stakeholder theory. His articles have appeared in *Business & Society, Business Ethics Quarterly, Cornell International Law Journal, Journal of Corporate Citizenship, Journal of International Management, Journal of Management Studies, Journal of Public Affairs, and Public Administration Review*. 