

Companies Should Maximize Shareholder Welfare Not Market Value

Luigi Zingales

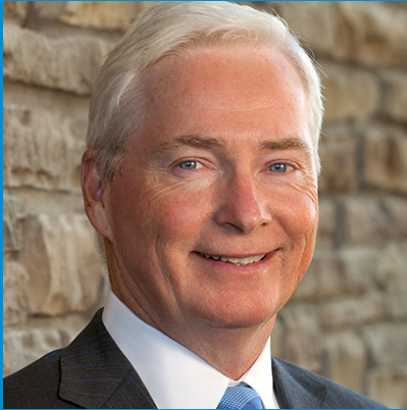
University of Chicago

August 2019

based on work with Oliver Hart



Ed Stack's Decision

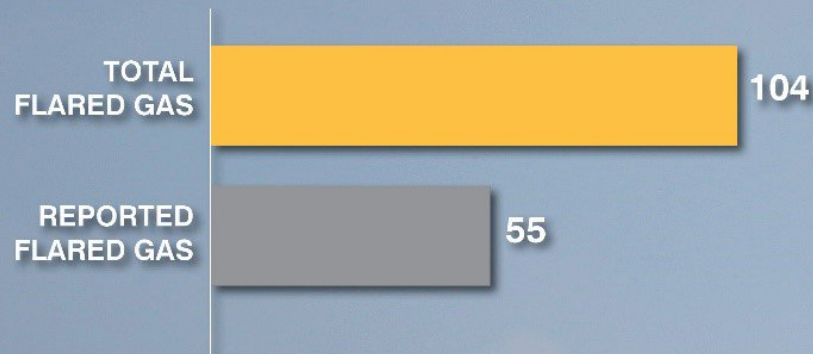


“I don’t really care what the financial implication is”

The Social Cost of Flaring



Gas flaring in the Texas Permian Basin is nearly **2X higher** than what companies report



Flaring volumes in billion cubic feet

Source: NOAA Satellite, RRC flaring data



... And Carl Icahn's lobbying



Markets

Icahn-Backed Refiner Saves \$189 Million on EPA's Biofuel Tweaks

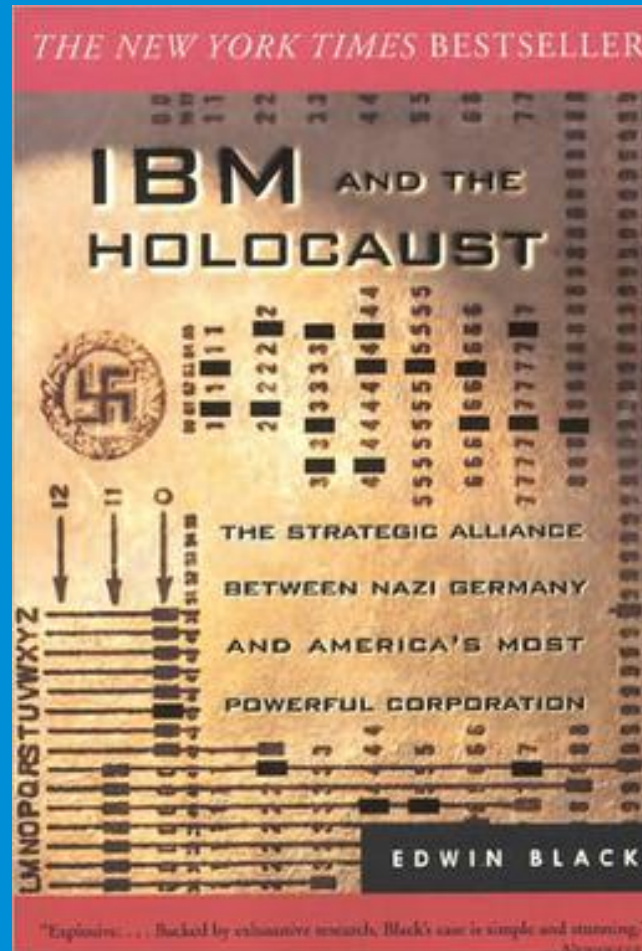
By [Mario Parker](#) and [Jennifer A Dlouhy](#)

February 22, 2019, 2:59 PM CST

Questions

1. Should Dick's Sporting Good stop selling guns even if this reduces value?
 2. Should Marathon Oil eliminate flaring even if this reduces shareholders value?
 3. Should Icahn abstain from lobbying even if this reduces value?
- Is there any moral limit to value maximization?

IBM Case



IBM case seems extreme but ...

- General Dynamics Land Systems-Canada



Corporate Purpose

- Most important question in modern capitalist systems:
 - in whose interests should companies be run?
 - what goals should asset managers pursue?
- Question that is becoming increasingly important for Millennials

Old Question

- In 1932, Harvard Law Review published a debate on this subject
 1. Adolph Berle argued in favor of the idea corporations should be run in the interest of its shareholders -> "shareholder primacy"
 2. Merrick Dodd argued for "a view of the business corporation as an economic institution which has a social service as well as a profit-making function-> "stakeholders perspective"

Managerial Perspective

- In 1981: “corporations operate within a web of complex, often competing relationships which demand the attention of corporate managers.”
- In 1997: “The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners”
- In 2019: “We share a fundamental commitment to all of our stakeholders.”

Economic Point of View

- The decision right should belong to the stakeholders that are residual claimants
- While in modern corporations shareholders are not the only one whose payoff is affected by decisions
- They are still the ones whose payoff is most affected by decisions
- Thus the group most at risk of being expropriated

Legal Point of View

1. Leo Strine theory that “function is form”

2. eBay vs Newmark (2010)

“Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The “Inc.” after the company name has to mean at least that.”

3. The creation of a new entity: the Benefit Corporation

Friedman Conclusions

“Conduct the business in accordance with their <stockholders> desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom”

"The social responsibility of business is to increase its profits."

Understanding Friedman

- It does not ignore workers needs or desires
- It does not ignore customers needs or desires
- It does not ignore the law
- It does not even ignore customs
- It allows for strategic objectives

Assumptions underpinning Friedman

1. Companies should be run in the interest of shareholders
2. Shareholders care only about money
3. If 2 does not hold, donating their dividends shareholders can reverse any corporate wrongdoing at no extra cost.

Corporate Charity

- 3 holds
- Better to maximize profits, distribute them as dividend and let the shareholders donate to their preferred charity
- Nothing is lost in term of output
- But utility is increased

Implications of Friedman Conclusion

1. It prevents managers from expropriating shareholders for their own social objective
 - No taxation without representation
2. It extends the Fisher Separation Principle
 - corporate goal independent from shareholders
 - separation in asset managers

2 does not hold

- Large amount of equity owned by foundations who have explicit social objectives
- Ed Stack's decision
- Italian entrepreneurs' suicides
- Introspection
- Millennials

3 does not hold either

- It is cheaper not to pollute than to pollute and clean up.
- It is cheaper not to sell assault weapons than to sell them and spend resources to protect all the public places.
- It is cheaper not to sell arms to the Saudi, than sell them and then fight to protect Yemen

Implications

- In these situations, it is more efficient for companies to adopt shareholders' social objectives such as protecting the environment and reducing crime.

=> corporate boards should maximize shareholder welfare, not just their monetary return.

Exit vs. Voice

1. Indexed investors cannot sell
2. Divesting may achieve the opposite outcome.
 - If all environmentally conscious investors were to divest from oil stocks, oil companies would end up in the hands of investors who do not care about the environment

Who should choose?

- “Business judgment” rule
- These are not business decision, but social trade-off decisions
- Business managers have no expertise nor legitimacy to make these decisions
- Taxation without representation

Corporate Democracy

- Historically, the U.S. democracy has been modeled on corporate democracy
 - Virginia Corp.
 - Massachusetts Bay Co.
- Why today shouldn't we model corporate democracy after the U.S. democracy?

Cost bigger than benefits?

- We have learned in the democratic arena that the cost of aggregating preferences is high
- Arrow's impossibility theorem
- Not obvious that the optimum is to put zero weight on all social preferences
- Historically it was not true: result of
 1. Globalization
 2. Portfolio diversification
 3. Capital market pressure

Why Needed

1. Failure of the state
2. In part created by the very corporate lobbying
3. Corporate market power
4. Constitutional limits
5. National limits

In their own words

- Dov Seidman, CEO of LRN

“The world is fused. So there are no places anymore to stand to the side and claim neutrality — to say, ‘I am just a businessperson’ or ‘I am just running a platform.’ ...the business of business is no longer just business. The business of business is now society.”

- Larry Fink, CEO of Blackrock

“We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges.”

Why is not taking place now?

1. Information problems

2. Regulation

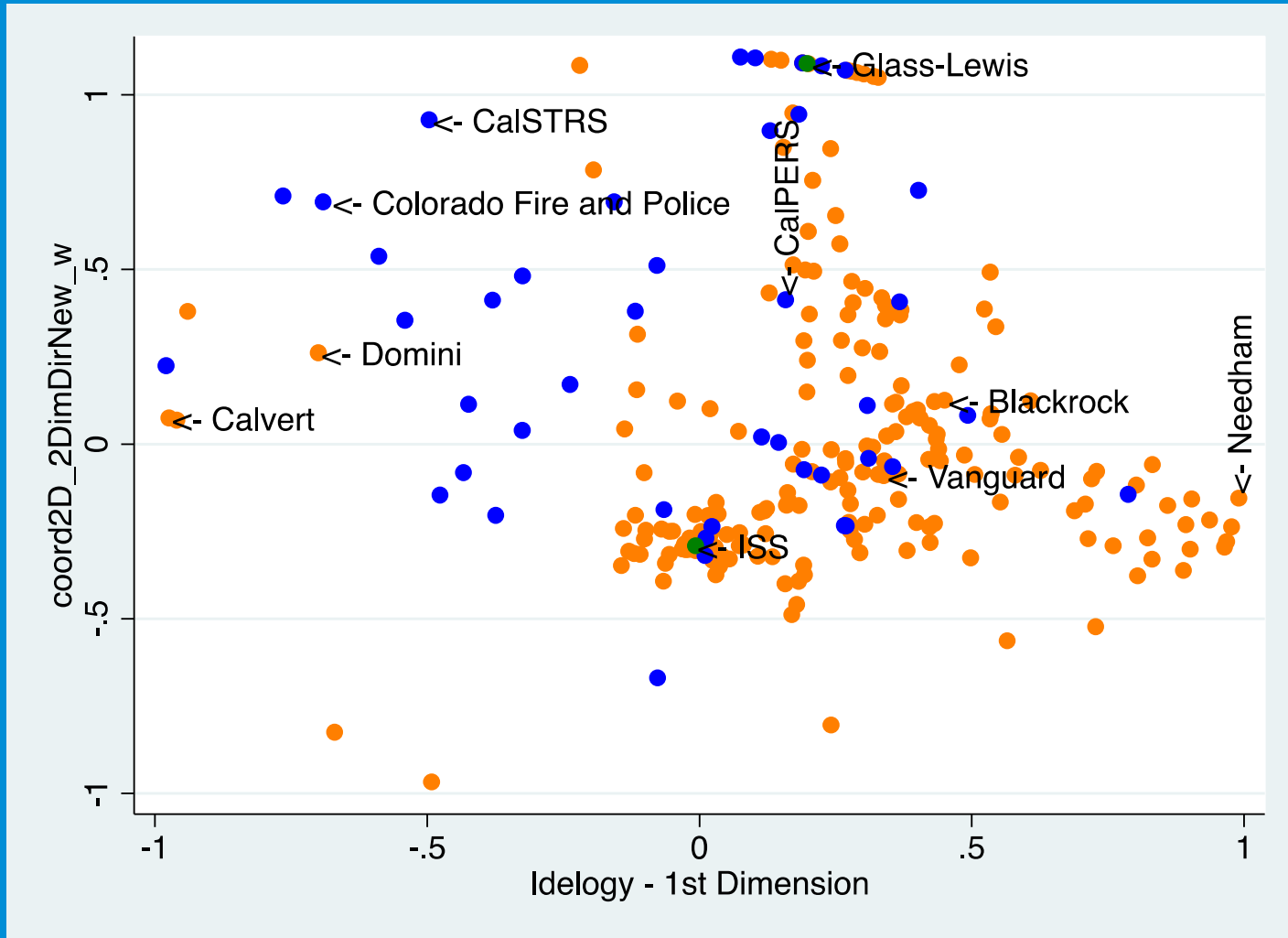
Information problem

- In modern democracies problem solved by delegation
- Mutual funds can play that role
- It only shifts the problem by one degree: how to choose mutual funds?
- In democracy problem solved by ideology
 - A vote is ideological when positions are predictable across a wide set of issues (Converse, 1964).
- Can we measure a mutual fund ideology?

Bolton et al. (2019)

- They use a standard political economy model to extract ideology from votes
 - Funds choose between alternatives characterized by attributes that are unobserved to the researchers, but observed (and acted upon) by them.
 - Fund preferences are assumed to be *single-peaked and symmetric*, and they assume funds vote for the alternative *closer* to their peak (ideal point), allowing for some error.
-

Bolton et al. (2019)



Bolton et al. (2019)

- In pension funds: the more socially minded are also the more management disciplinarian.
- In mutual funds, the more socially responsible funds, like Nuveen and Grantham, Mayo, are more management-friendly,
 - while GAMCO is more profit-oriented and more of a management-disciplinarian.

Effects

- In mutual funds now investors can choose with their feet
- In pension funds and endowments this is not possible.
- Hence there should be a vote of the constituencies on this two dimensions

Regulation

- After the Sandy Hook shooting, Trinity Church asked Walmart to hold a shareholders vote on its gun policy
- Management opposed this request
- SEC granted a no action letter
- Federal District Court in Delaware reversed decision
- The Court of Appeals sided with Walmart

Regulation -2

- Current proxy regulation contains an “ordinary business” exception, when a shareholder proposal relates to the management’s ability to run a company on a day-to-day basis.
- The cases of non-separability identified by Hart and Zingales (2017) refer to ordinary business
- There is a need to trade off profits with social value.

Regulation -3

- Institutional investors need to be more demanding on this front
- They will do only under pressure from their ultimate investors
- In Europe it is already happening
- In the USA it is coming

Conclusions

- Investors do not care only about money
- In the last 50 years investors' social objectives have been largely ignored
- There is a growing demand to address them
- This goal raises new challenges
 - Measuring these objectives
 - Aggregating them
 - Auditing the results along these dimensions

If you want to learn more ...

