

Daniel JH Greenwood - Are Shareholders Entitled to the Residual? Hofstra University College of Law 2/8/06

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For close to a generation, the dominant economic model of the corporation – associated with Jensen and Meckling– has contended that shareholders are the **residual risk bearers**. That means they receive the marginal returns of the firm, which, in turn, purportedly aligns their interests with those of the firm, and, given reasonably effective markets, society as a whole. Shareholder primacy, then, follows from shareholder supremacy: it is right to run the firm for shareholders precisely because shareholders receive the firm’s profits.

An older theory – associated with Berle and Means – told a different and somewhat contrary story. Shareholders, it contended, are the “true” owners of the firm, entitled to its profits just like any other owner, even though they lack the control that allows ordinary owners to take what is theirs.

Both theories agree that the purpose of the firm is to maximize shareholder return. So do such academic variants as the agency-cost theory, which claims that directors are agents of the shareholders, their principals; or the *Dodge v. Ford/Revlon* line of cases, holding that the only legitimate function of the firm is to maximize shareholder return. Even the nexus of contracts theorists, for whom the firm is no more than convenient shorthand for a series of bilateral contracts in which no participant can have more power than any other, contend that the shareholder contract entitles shareholders to the firm’s variable returns.

This paper challenges the shared premise of these shareholder centered constructs. Shareholders are not the residual risk bearers of the firm. They do not receive its marginal returns or its economic profit. Standard economic theory of the sort that underlies the Jensen & Meckling, agency cost and nexus of contract theories makes clear that one should expect shareholders to receive the residual only under unusual circumstances, and that they have no entitlement to it:

Shareholder returns are rents, and no one is entitled to rents in a competitive market economy. Shareholders, **the purely fungible providers of a purely fungible commodity**, are particularly unlikely to be able to command a share of economic profits in anything resembling a competitive market. Indeed,

since the contribution of shareholders to the firm is a sunk cost, in a competitive market shareholder would earn no return at all. Accordingly, market-based analyses of the firm should conclude that shareholder returns result only from market distortions: monopoly power or other inefficiencies.

Similarly, standard legal theory of the sort that underlies Berle and Means makes clear that shareholders are neither owners nor “principals” nor even “trust beneficiaries” of the firm and lack the basic ownership right to appropriate the residual.

Now, while these claims are surprising if you are used to the rhetoric, as opposed to concentrating on the reasoning, of standard analyses, they also reflect the results of simple observation. I’m not an empiricist of any variety, and you should be properly suspicious of my empirical claims as of most law professors: examples are no substitute for statistics. So I offer these only as suggestions of plausibility, not as evidence. My theoretical claim is that there is little reason to expect that shareholders will receive the residual. My empirical claim is that we all know dramatic instances where they do not.

First, consider the problem of broken promises. The major American mass production firms paid a significant part of their wage bills since WWII in the form of unfunded pension promises. Periodically, major sectors renege on those promises (Studebaker in the 1950s, Steel cos in the 1970s, currently auto and airlines). Another part of the wage bill in that sector was in the form of lifetime employment on good behavior promises; those promises as well were unfunded and ultimately unkept. (IBM, Jack Coffee’s old article *Strains in the Web*).

The major players in those industries paid dividends over a period of years in which they were not, in fact, paying the full wages they had promised. Thus, assuming the wage promises were in fact necessary to keep the company going, as the long history of hostile labor/management relations suggests, the shareholders of these companies were extracting **MORE** than the residual.

The reverse can also happen, as the dot.com boom made clear: both companies that appear to have made large profits, such as Microsoft, and ones that never showed an accounting profit, paid unusually large salaries to top (and

sometimes other) employees while paying little or anything to shareholders. The easiest explanation is that surplus (and sometimes more than surplus) was being distributed not to shareholders but to options-wielding employees.

If shareholders regularly receive more or less than the surplus, they cannot be bearing the residual risk of the firm. In each of these cases, employees clearly bear a significant part of the risk of industry and company specific success and failure. When Microsoft did well, its employees shared in the gains beyond anything that can be considered mere wages based on the employee's next available opportunity. Conversely, when foreign competition and/or managerial failure to innovate led to business setbacks in the car, steel and airline industries, shareholder dividends were stable for a longer period than the present value of long term promises to employees.

In the paper, I proceed more carefully than I can here to support the view that shareholders have no economic or legal entitlement to the residual.

The economic argument is simple: **shareholders are a sunk cost, because they have no legal right to dividends. The marginal cost of shareholders, that is, is zero.**

In competitive markets, that's the end of the story. In a competitive market, in which the firm earns only its marginal cost of production, the firm will be unable to charge consumers for the cost of payments to shareholders and will have no fund from which to pay them. (Any firm that makes voluntary dividend payments or their equivalent will have higher costs than its competitors and will be driven out of business).

Even when the firm, due to a competitive failure in its product markets, is able to earn economic rents, it is highly unlikely to distribute them to shareholders. Rents earned by the corporation belong to the corporation. Only less-than-fungible factors of production in less-than-fully competitive markets should have the market power to cause the firm to pay its rents to them. This will rarely be shareholders. Shareholders participate in one of the most competitive of our markets and are, as mentioned above, fully fungible. It would be irrational for a

corporation to pay more for their services than the market price, which should be the risk adjusted cost of money (for new share sales) and zero for existing shareholders.

The standard theory avoids this conclusion by inconsistently reverting to an older image of shareholders as “owners” rather than factors of production. Owners, of course, receive the residual by operation of law: it is theirs. Moreover, they help generate the residual they seize—the entrepreneurial contribution is not fungible.

But shareholders in public firms are not “owners” in either of these senses. They do not own the firm’s surplus, have no power to appropriate it, and contribute no entrepreneurial skills to the firm.

Actually, public shareholders are much more like waiters—they expect to be paid, after the fact, without a legally enforceable agreement, based on a social understanding that a certain size **tip** is appropriate.

Tips, famously present a difficult puzzle for rational maximizer models of the economy: rationally maximizing customers would free-load rather than pay for a service already rendered, and rational waiters would predict this and refuse to work for tips. If the system worked at all, tips would be based—contrary to ordinary experience—on hold-up value (the waiter’s threat to refuse future service) alone.

Shareholders present a similar problem, but more so: being entirely anonymous, they are less likely to be able to credibly threaten future punishment; they lack a clear social norm explaining the appropriate size of the tip; and companies are neither drinking nor seeking to impress dates when they make the tip decision.

In short, public shareholders can expect any return at all only if the standard model (or its competition assumption) is wrong.

Since shareholders do seem to receive some returns, even if not enough to

warrant current stock prices, I suggest several possibilities, none overwhelmingly convincing, of where the model might fail.

For the decade or so between the invention of the junk bond financed hostile takeover and the quashing of the hostile takeover by the poison pill and its statutory equivalents, the stock market DID have actual power to force company management to follow its will, and residual memories of that traumatic time may give the stock market power it wouldn't have in a more rational world.

Most important, managers now own a significant percentage of the outstanding shares of our public corporations and, at least in the short run, they may find that gifting corporate assets to shareholders is in their own interest – although if managerial interests were the only issue, there would be more efficient ways of extracting corporate assets.

The key, I believe, does in fact begin with managers. Managers clearly do have the political and economic power to seize a substantial portion of any corporate rents.

However, raw power is difficult to exercise without ideological justification, and in this case, managers have a particularly difficult case to make. Managers are generally understood to be employees of the firm, and therefore its agents and fiduciaries. For an agent to simply take his principal's assets is breach of trust and theft; agency norms require that the agent work for, not exploit, his principal.

Accordingly, managers need an alternative role or a special justification for appropriating corporate assets. The article contends that shareholder-centered ideology, paradoxically, is the best available justification for managerial appropriation of corporate surplus.

Shareholders, that is, receive some of the residual **not** because it is efficient or as payment for risk-bearing services rendered, but as a side-effect of the ideological cover the shareholder-centered theory of the firm provides for the reality of CEO seizure of corporate rents.

In a capitalist system, no one has an *a priori* claim to rents. Once we recognize that the corporate residual—the economic returns to the firm as such—belong to the firm, not the shareholders, it follows automatically that all firm participants have an equal claim to a share.

Accordingly, shareholders win some of the corporate surplus not by market right or moral entitlement, but due to a (possibly temporary) ideological victory in a political battle over economic rents.

Surprisingly, since conventional wisdom portrays corporate law as a conflict between shareholders and top management, those conflicts are dwarfed by the common interests of the two groups. Shareholder returns are largely the consequence of managers finding the share-centered ideologies useful as an ideological justification for a tremendous shift of corporate wealth from employees to the CEO/shareholder alliance.

Taking the corporation's political nature seriously, in contrast, leads to a series of new questions. If the struggle over corporate surplus is a political struggle over economic rents, why should only one side, the shareholders, have the vote? In a democratic society, why should those votes be allocated on a per-dollar basis, instead of a per-person basis?

In the last several decades, virtually all corporate gains from productivity have gone to shareholders and CEOs, while ordinary employee wages have remained flat or declined. This system is obviously not well designed to generate employee loyalty to the firm (and the firm productivity that follows): employees not given a fair share of the wealth they help produce are likely eventually to notice, and employees who view themselves as exploited are unlikely to cooperate fully in their exploitation. Nor is the rapidly growing gap between the elite and the rest of us healthy for republican democracy: if the rich really are different from the rest of us, the common enterprise of nationhood fails.

If shareholders have no special claim to corporate rents, then existing

corporate governance is not only unfair but simply dysfunctional.

All is not lost, however. If the share-centered corporation is not the inevitable result of ineluctable economic law, we are free to adopt different corporate governance rules giving other participants more power, making firms both more just and more likely to succeed in their basic wealth-creation task.