

If Dividends Are Tips (Are Shareholders Entitled to the Residual?) **Daniel Greenwood - 1 Mar 06 - Brooklyn Law School**

A fuller version of this talk will be published as *The Dividend Problem*, 32:1 J. CORP. L. (forthcoming 2006);
<http://ssrn.com/abstract=799144>

Dividends are tips.

A waiter serves you, without a prior enforceable agreement as to what he'll be paid for doing so. Afterwards, the customer decides how much to pay, and the waiter has no legal recourse if unsatisfied. To be sure, there are clear social norms enforced by peer pressure among customers (and their dates). But an economist using a rational maximizer model would expect to find serious free rider issues and an omnipresent specter of a market for lemons.

Why would a rational, amoral, profit-maximizer ever pay for a service already rendered? Why would a rational service provider be willing to take the risk of being stiffed? If the system works at all, wouldn't payments reflect the hold-up value of the waiter's implicit threat to refuse future service, rather than the marginal cost or benefit of past services rendered? If so, is there any reason to think that price will reflect cost or supply balance demand? If waiters are the enforcers, why would they make the individual sacrifice to punish, at the cost of another tip, rather than hoping like Charlie Brown, that this time Lucy won't misbehave?

Rational maximization models may illuminate some of these issues at the margin. The central story, however, revolves around internalized social norms and their creation. Not maximizing but Trust, duty, character and loose social sanctions. Most customers tip where rational maximizers clearly would free ride, and waiters routinely trust where anyone using an rational maximizer model of customers would not.

Dividends present each of these problems, but more so.

Like waiters, shareholders apparently expect to be paid after the fact, based on some estimate of the value of the services they've provided. Like waiters, they have no legally enforceable right to any payment at all. **Unlike** waiters, they don't even have a clear social norm specifying the amount they ought to receive.

Maximizing explanations of tips and dividends alike require some explanation of why payors don't free ride. Reputation is the most obvious one.

But **Enforcement by reputation** is likely to be difficult, if only because

- * shareholders are an anonymous and rapidly changing mass less likely to be able to take its revenge than an angry maitre'd at a oversubscribed hotspot, and

- * many dividend payors, especially the solid, established companies that most commonly pay them, are unlikely to need to sell new issues of stock on a regular basis, and

- * the actual human decision-makers who decide whether to pay dividends are top managers who will nearly always be in or near an end-game in which they will be tempted to exploit a prior reputation, and

- * the actual human decision-makers operating institutional shareholders are always tightly constrained to short-term time frames that will make it difficult for them to consider long-term investing in punishment when they could simply free-ride.

To be sure, the stock market, unlike waiters, has an additional enforcement mechanism: **Hostile takeover**. If the market concludes that the company is withholding dividends, stock prices may drop, making it a target for someone that plans to give a larger slice of the corporate pie to equity investors. But the stock market is not as allergic to low dividend stocks as it once was, under the influence of Miller & Modigliani. And the hostile takeover market is not what it was in the period after the invention of junk bonds and before the judicial acceptance of poison pills and the just-say-no defense.

In short, free riding in a rationally maximizing stock market would quickly lead to market for lemons, with even those companies willing to commit to dividends unable to find shareholders willing to believe them.

But that isn't the worst of the dividend puzzle. In a competitive market, producers should not be able to sell their product or services for **more than marginal cost**. Since dividends are not legally required, the marginal cost of equity capital is zero. Any company that pays dividends should find itself underpriced by a company that decides to renege on its implicit promises to equity investors.

In short, given the structure of the actual rights (none of them contractual) that shareholders have, **in a world of rational maximizers**, shareholders would rarely receive dividends. Anticipating this, they would even more rarely be willing to purchase shares. If the world worked like this, we would see a market for lemons, not 10% average returns. The economic rational maximizer theories must be missing something fundamental.

So let's try some other perspectives. More lawyerly ones – based on normative notions of what is right, rather than how maximizers would behave.

Corporate law ideology often claims that shareholders are entitled to the residual because they are the **residual risk bearers**. This, of course, is nonsense in fact.

When Asbestos companies failed, their tort victims were the biggest losers.

If Indian Point were to go nuclear, the shareholders would lose no more than their investment – in most cases pretty little. The real risk bearers are the downwinders.

When Enron failed, diversified portfolio shareholders suffered far less than employees who lost the value of Enron's long term commitments to them.

When American steel manufacturers invested in the wrong technology in the 1980s, or American car manufacturers committed to SUVs in this decade, the downside risk of their decision was largely borne by the unionized employees.

The nexus of contracts understanding of the firm makes quite clear that the very notion of **residual** is wrong. All firm participants engage in more or less continuous renegotiation of the terms of their participation in the firm (that is why Alchian and Demsetz, in the seminal article setting out the nexus theory could claim that the firm could be understood in market terms). This is true, as pension holders repeatedly discover, even when the contracts purport to be long term. But if terms are always subject to renegotiation, then allocation of risk is always subject to renegotiation as well.

Who bears the residual risk will simply be a function of relative market power at

any given time.

Shareholder activists, in contrast, often prefer a **metaphor of ownership**. Shareholders own the firm, they assert, even though they have few or none of the attributes of ownership, and so they are entitled to the residual as a matter of moral right and perhaps “agency” or “trust” law as well. But this metaphor is as difficult as the nexus of contracts one.

Shareholders are not owners in any normal sense of the word.

The most important aspect of ownership in a free society is the sphere of privacy property creates, in which an owner is entitled to act without regard for the opinions of mankind, to do what she thinks is right or amusing even if no one else agrees. If I own this pencil, that means I can use it or abuse it with minimal regard for your views.

But individually and collectively, the stockholders of a publicly traded Delaware corporation have no legal right to control the firm, no right to use or appropriate its assets, no right to destroy it, no right to make unconventional decisions. And, as we have seen, no right to the residual.

The only significant legal rights they have are the right to vote for the board of directors on the basis of one-share, one-vote, the right to a pro-rata share of any distribution the board chooses to declare, and the right to ratify certain limited board decisions. **These are political rights, not ownership rights.**

Nor are shareholders principals in a **principal/agent** relationship. Principals have the right to control their agents; but directors are legally required to exercise independent judgment and risk personal liability if they defer to shareholder wishes. And principals have the inalienable right to terminate the relationship at any time for any reason. Shareholders have only the political right to vote at appropriate times and places.

If they are not principals, perhaps they are the opposite: **trust beneficiaries**. I’m not a trust expert, and perhaps those who understand trust better than I do will

correct me. To my naive eyes, the difference between corporations and trusts are significant. Trusts normally end at some time and normally the beneficiary must have some entitlement to receive the corpus or its income at some point. Shareholders have no such rights. They do not even have an enforceable equitable interest in having the corporation managed in their interests except in limited circumstances (Revlon) – ordinarily, Delaware repeats its statutory language, which directs that the directors act in the interest of the “corporation,” and then uses the business judgment rule to express what is, in effect, administrative deference for the autonomy of the corporation as an independent agency governed almost exclusively by its internal political processes.

The answer to the question of my title is No. Shareholders are not entitled to the residual. Residuals are, by definition, rents: the surplus to cooperation that is the reason the firm is able to out-compete a market. In capitalist systems, no one has an ex ante right to rents. Rents are what we negotiate over.

More than that. Shareholders are not even in a particularly good position to bargain over these rents: they are **purely fungible providers of a purely fungible commodity in our most competitive market**, and so one would expect that the price they can command would be marginal cost, nothing more. And since equity is a **sunk cost, marginal cost approaches zero**.

But shareholders do receive dividends, so something is wrong in the picture I’ve painted. We need an alternative explanation outside the economic framework. Shareholders receive dividends, even if not the residual, for reasons of political power and, especially, **ideology**, not market.

Shareholders receive dividends, NOT because of the nature of the market, and NOT because they are legally or morally entitled to them. Instead, first and foremost, because managers and directors think they should get them. That is, corporate law, the legal field most successfully colonized by economists, centrally

revolves around constructed normativity, not efficiency.

As I hope I've shown, the leading normative explanations for why shareholders SHOULD receive dividends are no stronger than the maximizer explanations for why they DO.

This raises an interesting question – Why have directors and managers found these unpersuasive stories so persuasive. And here the answer is, paradoxically, because the shareholder centered account of the firm is the best available defense of managerial self-interest.

Publicly traded corporations have no clear owners. But one thing is quite clear. Managers are not the owners. Managers clearly are agents, not principals; employees not owners. So, while CEOs apparently have the market power to take the bulk of the proceeds under their control, they don't have a good explanation of why they are entitled to use their power in this way. Simply taking 8 or 9 figure pay because you can looks too much like corruption.

Shareholder value maximization, and the related lionizing of the CEO who “creates” shareholder value serves as the smokescreen. We've created a powerful normative structure based on praising the stockmarket for its efficiency that ends by vindicating the efficiency of paying CEOs for giving the shareholders what they cannot take for themselves. Shareholders, that is, receive dividends as a side-effect of huge managerial pay-offs.

So, to point to some consequences:

A little one: Reformers who seek to restrain the rise in CEO salaries before it absorbs all our economic growth are looking in the wrong place if they delegate that task to shareholders. The stock market will not reduce CEO salaries at least so long as CEOs remain faithful to the task of extracting the maximum value from employees and continue to share at least some of it with investors.

And a bigger one: If dividends reflect not marginal productivity but claims of duty based on particular, and somewhat peculiar, cultural understandings of how

firms should work, then they are as contingent on the continued persuasiveness of particular cultural political views as on profit.

This means, first, that if you are, as I am, counting on the stock market to provide for your retirement, you had better hope that investors as a group find my analysis unpersuasive. If I am right, the only reason that shareholders receive dividends is because managers find it convenient to think that they should. That is a powerful reason – but it is far less powerful if, as I've claimed in other papers, the ideology supporting it is both inconsistent and destructive of its own underpinnings.

CEOs already have most of the attributes of ownership. If they succeed in convincing the rest of us that they are entitled to use the power they have, they will have no reason to share with the public shareholders at all. After all, in a capitalist society, those who create value are entitled to keep it.

This is not an attractive possibility. We should worry about the corrosive impact of an ideology that invites managers to think of themselves not as fiduciaries for the public good but as rational maximizers entitled to ever larger payments to do their jobs. This way leads, I fear, to looting, not building.

Finally, and more hopefully. On this analysis, the current distribution of the corporate pie, with the bulk of the surplus to cooperative production going to a coalition of investors and managers, is not the result of efficient markets but ideological conviction and political struggle.

Progressives need not worry that productivity or economic growth is tied to the status quo distribution of corporate surplus. Instead, we have a degree of political freedom to determine how to use the proceeds of capitalism that has seemed unthinkable in the last generation. All we need is a better story.