

# Shareholder Theory – How Opponents and Proponents *Both* Get It Wrong

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*Shareholder wealth maximization is accepted by most financial economists as the appropriate objective for financial decision-making. Recently, wealth maximization has been criticized by a growing array of opponents for condoning the exploitation of employees, customers, and other stakeholders, and encouraging short-term managerial thinking. Although these critics are misguided, proponents of shareholder theory have helped to create this confusion by exhorting managers to maximize the firm's current stock price. Because a firm's stock price can be manipulated in the short-term, incentives to increase a firm's current stock price can distort operating and investment decisions. When wealth maximization is properly defined as a long-term goal, it is not as narrowly focused as critics believe. The main prescription of shareholder theory—invest in all positive net present value projects—benefits not only shareholders, but also key stakeholders including employees and customers.*

■ Shareholder theory defines the primary duty of a firm's managers as the maximization of shareholder wealth (Berle and Means, 1932; Friedman, 1962). The theory enjoys widespread support in the academic finance community and

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*Danielson and Heck gratefully acknowledge financial support from the Pedro Arupe Center for Business Ethics at Saint Joseph's University.*

is a fundamental building block of corporate financial theory. However, the shareholder model has been criticized for encouraging short-term managerial thinking and condoning unethical behavior. Smith (2003) notes that critics believe shareholder theory is “. . . geared toward short-term profit maximization at the expense of the long run.”<sup>1</sup> Freeman, Wicks, and Parmar (2004) assert that shareholder theory “. . . involves using the prima facie rights claims of one group—shareholders—to excuse violating the rights of others.”

This paper explains why such critiques of shareholder theory are misguided yet understandable. They are misguided because wealth maximization is inherently a long term goal—the firm must maximize the value of all future cash flows—and does not condone the exploitation of other stakeholders (Jensen, 2002; Sundaram and Inkpen, 2004a). The criticisms are understandable because many proponents of shareholder theory, in a stylized version of the model, exhort managers to maximize the firm's current stock price (Keown, Martin, and Petty, 2008; Lasher 2008; Ross, Westerfield, and Jordan, 2008; Brealey, Myers, and Marcus, 2007; Melicher and Norton, 2007). This notion underlies the formal (e.g., stock options) and informal (e.g., pressure from the investment community and corporate boards) incentives that reward managers if a firm's stock price continually increases.<sup>2</sup> By

<sup>1</sup>For example, Freeman, Wicks, and Parmar (2004) criticize managers for pursuing policies designed to continually increase a firm's stock price. Fuller and Jensen (2002) criticize managers for focusing undue attention on whether a firm meets analyst earnings forecasts each quarter, to avoid stock price declines.

<sup>2</sup>Although incentive stock options typically vest over several years and can have long maturities, the presence of stock options also encourages managers to pursue policies designed to increase the stock price in the short-term (especially as the expiration date approaches). Danielson and Press (2006) argue that these incentives can create agency costs whenever the stock price falls below the option exercise price.

focusing on the current stock price, which can be manipulated in the short-term by unscrupulous managers, proponents of shareholder theory open up the model to criticism.

Opponents of shareholder theory often recommend that firms balance the interests of shareholders against those of employees, customers, and other stakeholders when making business decisions (Freeman, 1984). However, unless the interests of *future* stakeholders are explicitly considered, the stakeholder model can lead to the same type of short-term thinking that shareholder theory has been accused of encouraging. Indeed, the shareholder model, when viewed from a long-term perspective, provides a better framework than stakeholder theory in which to protect the interests of both current and future stakeholders. Thus, stakeholder theory is not superior to shareholder theory from an ethical perspective.

## I. Should Firms Maximize the Current Stock Price?

In the shareholder model, the goal of the firm is to maximize the present value of future cash flows. If the cash flow a firm is expected to pay shareholders (in the form of dividends or stock repurchases) in year  $n$  is  $CF_n$ , and the required return on equity is  $r$ , the intrinsic (per share) value of the firm's equity today ( $V_0$ ) is defined by Equation (1).

$$V_0 = \sum_{n=1}^{\infty} \frac{CF_n}{(1+r)^n} \quad (1)$$

To maximize the value of Equation (1), managers should invest in all positive net present value (NPV) projects (Brealey and Myers, 2003). The right-hand side of Equation (1) highlights the long-term nature of this goal: shareholder wealth depends on the firm's cash flows in all future years.<sup>3</sup>

The shareholder model is difficult to implement because the estimated cash flow stream on the right-hand side of Equation (1) cannot be observed. Thus, proponents of shareholder theory often assert that a firm's current stock price ( $P_0$ ) equals its intrinsic value ( $V_0$ ) and instruct managers to maximize the firm's current stock price. This is the stylized form of the shareholder model.

<sup>3</sup>A large portion of shareholder wealth is often tied to cash flows to be received in the distant future. For example, if the firm is expected to pay a \$1 dividend next year, and the dividend is expected to grow at a 4% rate per year (forever), the stock price today is \$25 if the required return is 8% ( $= \$1/(0.08 - 0.04)$ ). In this example, dividends during the next 10 years only account for 31.4% of the stock price ( $= \$7.86/25$ ), leaving 68.6% of the value to be realized in years 11 through infinity. Clearly, shareholder wealth maximization is not a short-term goal.

Although shareholder theory directs managers to maximize shareholder wealth, managers face formal and informal incentives to *increase* the firm's current stock price. For example, incentive stock options will provide a positive payoff to managers only if the firm's stock price increases from the grant date level. In addition, some managers face pressure from corporate boards and the investment community to continually increase firm value (Jensen, 2005). However, maximizing and increasing shareholder wealth are two very different objectives. If the business conditions facing a firm change unfavorably (through perhaps no fault of management), a firm's maximum possible value can decrease. This is not an unusual or unlikely occurrence; Jensen (2005) notes that future events could reveal that the stock prices of perhaps 50% of all firms are too high (because a stock price is a function of a distribution of possible outcomes).

As the business conditions facing a firm change, a firm's stock price can diverge from its intrinsic value because information is not instantaneously and continuously communicated to the market. If business conditions change unfavorably,  $P_0$  will exceed  $V_0$  and the stock will be (temporarily) overvalued.<sup>4</sup> To implement the shareholder model correctly, the firm should continue to invest in all positive NPV projects (which are now less valuable than the market originally expected), and the stock price will eventually decrease to the new intrinsic value. However, if managers (who will typically know that business conditions have changed before the rest of the market) are incentivized to increase the stock price, Jensen (2005) and Danielson and Press (2006) argue that efforts to further inflate (or to maintain) the stock price may destroy long-term value. These actions could include delaying new investments (even if the NPV is positive), reducing discretionary spending (e.g., advertising, R&D, maintenance, quality control, etc.), accounting manipulation, or adopting fraudulent business practices.

Jensen (2005) uses Enron to illustrate the agency costs of overvalued equity. At Enron's peak market value of \$70 billion, Jensen estimates the company was only worth \$30 billion. He notes that Enron's managers tried to justify the excess valuation of \$40 billion by ". . . trying to fool the markets through accounting manipulations, hiding debt through off-balance sheet partnerships, and over hyped new ventures such as their broadband futures effort." Clearly, these efforts were not designed with the long-term interests of the firm in mind, and they did not pay off for Enron's shareholders. Thus, the case of Enron does not provide evidence against shareholder theory. But this experience does

<sup>4</sup>Although deviations between  $P_0$  and  $V_0$  can arise in the short-term even in efficient markets, evidence in Summers (1986) and Cornell (2001) suggest that such deviations can persist for prolonged periods.

show that efforts to increase a firm's current stock price can be harmful if these policies are detached from strategies designed to maximize the firm's long term cash flows.

## II. Does Stakeholder Theory Promote a Long-Term Focus?

Because of the perceived deficiencies of shareholder theory, stakeholder theory has gained popularity in recent years and is now used to guide the business decisions of a wide range of firms (Donaldson and Preston, 1995; Jorg, Loderer, and Roth, 2004; and Kaler, 2006). One of the goals of stakeholder theory is to promote "an enhancement of distributive justice within the confines of a basically capitalist structure . . ." (Kaler, 2006). Along these lines, the 1988

Sloan Colloquy in its "Consensus Statement on Stakeholder Model of the Corporation" recommends that firms "attempt to distribute the benefits of their activities as equitably as possible among stakeholders, in light of their respective contributions, costs, and risks."<sup>5</sup> To do this, Blair and Stout (1999) argue that the board of directors should split a firm's economic surplus (i.e., investment returns in excess of the risk-adjusted cost of capital) between shareholders, employees, customers, and other stakeholders.

If a firm is forced to allocate a portion of its economic surplus to employees (by paying wages in excess of the employees' marginal productivity) or to customers (by reducing prices), these stakeholders will benefit in the short-term. However, these policies could stifle future innovation, hurting shareholders, stakeholders, and society in the long-run. For example, US employees in the steel industry, the auto industry, and the airline industry benefited in the short-term from lucrative union contracts negotiated in the latter half of the twentieth century. But these contracts ultimately contributed to financial difficulties at the firms, reducing job security and compensation for today's employees. Similarly, the current customers of pharmaceutical companies would benefit greatly if patent laws were revoked, and all drugs were then sold at a price equal to production costs plus, for

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example, 10%. However, this policy would reduce both the funds available to invest in research and development and the incentive for firms to do so. Thus, future customers would not benefit from potential life-saving products that might otherwise have been developed.

The following example illustrates the potential problem. Assume that a firm operates in a simple one-period world. The entrepreneur invested \$100 in the firm at  $t = 0$ , and the

firm produces a cash flow of \$160 at  $t = 1$ . If the required return is 10%, the economic surplus of the firm is \$50 (= \$160 - \$100(1.10)). Because the firm has a realized investment return of 60%, stakeholder advocates might argue that the shareholders' profits are excessive. From their perspective, an equitable distribution of the economic surplus might be to increase wages or decrease prices, reducing the investment return toward the required return of 10%. But, this outcome would not be fair to

the entrepreneur unless the policy were known before the investment decision was made.

Most investments offer risky outcomes; it is likely that the entrepreneur did not know with certainty that the project's  $t = 1$  payoff would be \$160 when the initial \$100 investment was made at  $t = 0$ . Assume that at time  $t = 0$ , the investment had an equal 50% probability of paying either \$160 or \$60 at  $t = 1$ . If so, the expected payoff at  $t = 1$  was \$110, and the project had a net present value of 0 (=  $110/1.10 - 100$ ). On an ex-ante basis the project was acceptable, but it did not create an economic surplus.

Once the future outcome is revealed, it would not be ethical to change the rules of the game and split the excess return (\$160 - \$110) between shareholders and other stakeholders. If the entrepreneur had known at  $t = 0$  that the project would only yield, for example, \$150 in the good outcome, the entrepreneur would not have made the \$100 investment. Thus, proposals to split the realized economic surplus among various stakeholder constituencies have the potential for reducing future investment, harming society (and potential future stakeholders) in the long run.

Stakeholder theory, of course, does not advocate that firms be managed in the interests of current stakeholders at the expense of future ones. Instead, Freeman (1994) recommends that a corporation ". . . be managed as if it can continue to serve the interests of stakeholders through time." Similarly,

<sup>5</sup> This statement is reprinted in the appendix to Marcoux (2000).

DesJardins and McCall (2005) argue that a corporation should be managed as a social institution, providing benefits to stakeholders both now and in the future.

However, the question of how a manager might balance the interests of current and future stakeholders has received very little attention in the stakeholder literature. One notable exception is Mitchell, Agle, and Wood (1997), who argue that managers should consider the urgency of various stakeholder claims when making decisions. But this approach would encourage managers to adopt a short-term focus when implementing stakeholder theory: the needs and requirements of current stakeholders will always be more “urgent” than those of future stakeholders.

### III. The Shareholder Model and Long-Term Stakeholder Interests

One drawback of stakeholder theory is that the identity of the individual stakeholders is constantly changing. Thus, the customer or employee who extracts excess benefits from a firm during the current period is not the same person who loses future benefits. The identity of shareholders will also change over time, but there is a key difference. A large portion of any investor’s return (even a short-term trader) will depend on the firm’s stock price on the date of sale. Because an investor must find a person who believes the firm will produce sufficient cash flows to justify the prevailing market price, shareholder wealth maximization (when defined properly as a function of all future cash flows) is inherently a long-term goal. And, because a firm must continue creating value for employees and customers to generate future cash flows, the maximization of a firm’s long-term cash flow stream should not harm the firm’s stakeholders. Indeed, the interests of future stakeholders can only be satisfied if the firm remains financially strong.

### IV. Conclusion

In the aftermath of financial scandals at Enron, Worldcom, and Global Crossing, shareholder theory faces increased scrutiny and criticism. As stated by Freeman, Wicks, and

Parmar (2004), “It is hard to imagine how anyone can look at the recent wave of business scandals, all of which are oriented toward ever increasing shareholder value at the expense of other stakeholders, and argue that this philosophy is a good idea.” However, proponents of shareholder theory point out that policies adopted by Enron, Worldcom, and Global Crossing clearly did not benefit the firms’ shareholders in the long-run, and thus are not evidence against shareholder theory (Sundaram and Inkpen, 2004b).

Before dismissing critics of shareholder theory outright, it is important to recognize that supporters of shareholder theory often emphasize the model’s short-term implications when defining the theory. Indeed, many leading finance texts equate shareholder theory with the maximization of a firm’s *current* stock price, and executive compensation (e.g., incentive stock options) frequently rewards managers for increasing the stock price. Thus, it should not be surprising that some critics of the shareholder theory might (incorrectly) view it as being a short-term goal.

We disagree, however, with those who would use the deficiencies of the stylized model as a reason to abandon shareholder theory in favor of stakeholder theory. Despite its current popularity, stakeholder theory provides little guidance about how to balance the often competing interests of various stakeholder groups (Marcoux, 2000; Jensen, 2002). In addition, stakeholder theory can encourage managers to adopt a short-term focus (much like the stylized version of the shareholder model) to the detriment of a firm’s long-term health.

The shareholder model—when viewed from a long term perspective—still provides the best framework in which to balance the competing interests of various stakeholders (including both current and future stakeholders) when making business decisions. However, proponents of shareholder theory must recognize that it matters how the theory is defined and implemented. In particular, the goal of financial managers should be to invest in all positive net present value projects, regardless of whether these decisions will cause an immediate increase in the firm’s stock price. To focus managerial attention on this goal, corporate incentive structures should reward managers for maximizing a firm’s value in the long run rather than increasing its stock price in the short term. ■



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