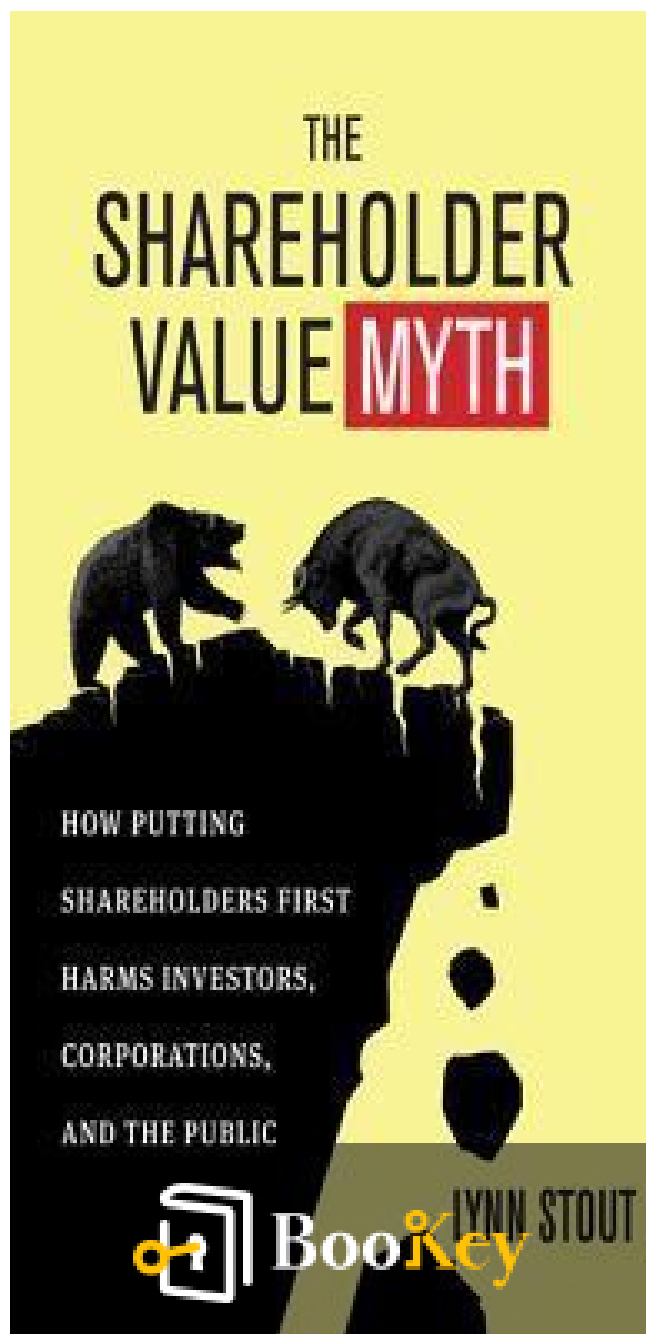


# The Shareholder Value Myth PDF (Limited Copy)

Lynn A. Stout



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# **The Shareholder Value Myth Summary**

Challenging the assumption of profit above all else.

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## About the book

In "The Shareholder Value Myth," Lynn A. Stout challenges the dominant belief that maximizing shareholder value should be the primary goal of corporate governance. Through incisive analysis and compelling arguments, Stout dismantles the notion that prioritizing shareholder interests necessarily leads to sustainable business success, revealing the detrimental effects this ideology can have on all stakeholders—including employees, customers, and the broader community. By illuminating the flaws in conventional wisdom and presenting a compelling case for a more equitable and holistic approach to corporate purpose, Stout invites readers to rethink the very foundations of our economic system and the role of corporations within it, compelling them to reconsider what true value in business looks like.

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## About the author

Lynn A. Stout was a prominent law professor and a leading expert in corporate governance, best known for her critical examination of shareholder primacy and its implications for business and society. As the Frances and Daniel Peart Professor of Corporate and Business Law at UCLA School of Law, Stout dedicated her career to analyzing the legal and ethical dimensions of corporate finance and the role of corporations in the modern economy. Her influential work, including 'The Shareholder Value Myth,' argued against the prevailing belief that maximizing shareholder value should be the paramount goal of corporations, advocating instead for a broader perspective that considers the interests of employees, customers, and the community. Stout's scholarship, characterized by rigorous legal analysis and a commitment to social justice, has left a lasting impact on the field of corporate law and the ongoing debate about the purpose of corporations in society.

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# chapter 1 Summary: The Rise of Shareholder Value Thinking

## ### Chapter 1: The Rise of Shareholder Value Thinking

The concept of public corporations emerged in the late 19th to early 20th centuries when companies began to issue stock to a vast number of small investors, marking a shift from privately held to publicly traded entities. These shareholders, typically uninvolved in daily operations, entrusted management and boards of directors with corporate governance. Thus, public corporations adopted a new structure, which led to the pivotal question of their purpose: should they primarily serve the interests of shareholders by maximizing profits, or do they hold broader responsibilities to other stakeholders and society at large?

The debate over corporate purpose intensified in the early 20th century, particularly through the exchange between Adolph Berle and Merrick Dodd over whether corporations should exist solely to increase shareholder wealth or should also consider broader societal benefits. Berle championed the idea of "shareholder primacy," arguing that corporations are bound to act for the benefit of shareholders, while Dodd contended that businesses should provide job security, quality products, and contribute to society. By the mid-20th century, Dodd's view gained traction, suggesting public

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corporations had an obligation beyond profit-making.

However, the 1970s saw a resurgence of shareholder-centric thinking led by the Chicago School of economics, where scholars like Milton Friedman reignited the debate by asserting that a corporation's primary social responsibility is to increase its profits. This perspective gained credibility through influential theories framed by economists Michael Jensen and William Meckling, who depicted shareholders as "principals" who hire managers as "agents." This dichotomy emphasized that the sole aim of managers should be the financial gain of shareholders, often disregarding other stakeholders' interests as irrelevant.

The attractiveness of this shareholder-focused ideology quickly permeated law, media, and corporate governance practices, leading to reforms that favored increased shareholder power and executive compensation tied to stock performance. By the late 1990s, this paradigm had become almost universally accepted within corporate governance. Shareholder primacy was entrenched in corporate culture and policy, viewed as a simple, clear-cut solution to managerial problems.

By the dawn of the 21st century, the prevailing corporate philosophy centered around shareholder value maximization was so dominant that even leading legal scholars like Reinier Kraakman and Henry Hansmann declared it the undisputed convention in corporate law discussions, stating that

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management's obligation is to operate in the interests of shareholders above all else. Ironically, shortly after this declaration, the Enron scandal highlighted the dark consequences of an excessive focus on shareholder value, revealing the shortcomings and potential hazards of this ideology.

As scholars began examining the limitations of the shareholder primacy doctrine, critiques arose, suggesting that U.S. corporate law does not necessitate the maximization of shareholder value—a revelation that hinted at a shift in the understanding of corporate governance and purpose. The chapter illustrates the evolution of corporate thought from a focus on broad responsibility towards stakeholders to a narrow interpretation of profit maximization, which culminated in historical events that challenged its validity.

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## chapter 2 Summary: How Shareholder Primacy Gets Corporate Law Wrong

### Chapter 2: How Shareholder Primacy Gets Corporate Law Wrong

In contemporary discussions about corporations, a prevailing misconception has emerged: that U.S. law mandates corporate directors to prioritize shareholder wealth above all else. Journalists and business commentators often assert this as a fact, claiming directors face legal obligations to maximize profits. This widespread belief is pivotal in explaining the dominance of shareholder-value thinking in the corporate landscape today. Many believe that if they could be held liable for failing to prioritize shareholder wealth, it's understandable they would engage in practices like taking on excessive debt or reducing workforce costs to improve stock prices.

This chapter challenges the underlying assumption that the U.S. corporate law necessitates the maximization of shareholder wealth. It argues that there is, in fact, no enforceable legal duty for directors and executives to do so. The genesis of this belief is often traced back to the Michigan Supreme Court's 1919 decision in *Dodge v. Ford Motor Company*, which is frequently cited as the authoritative legal basis for shareholder primacy. However, the case revolved around the relationship between controlling and

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minority shareholders in what was effectively a closely held company, not public corporations.

In *\*Dodge v. Ford\**, Henry Ford, the majority shareholder of Ford Motor Company, sought to withhold dividends, choosing instead to reinvest the profits into expanding the business and increasing employee wages, decisions he argued were for the greater good. The Dodge brothers, minority shareholders, sued for dividends, and the court ruled in their favor, but also permitted Ford's broader corporate goals. The court's remark emphasizing that a corporation is primarily for the profit of shareholders is often misconstrued as the law requiring shareholder primacy. However, this statement is merely "dicta," a comment made in passing and not essential to the decision, hence not binding in future cases.

Additionally, most corporate charters do not specify that the purpose of the company is solely to serve shareholders. In fact, many state laws, especially Delaware's, allow corporate charters to articulate broader purposes, explicitly enabling directors to consider other stakeholders, such as employees and the community. Moreover, in various court opinions, judges have indicated that directors owe duties to both the corporation and its shareholders—suggesting that these are different entities and that directors may take actions beneficial to the corporation that do not align with maximizing shareholder wealth.

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A critical legal doctrine known as the "business judgment rule" further complicates the assumption of shareholder primacy. This rule protects directors from legal scrutiny as long as they act reasonably and without personal conflicts of interest, allowing them significant autonomy in decision-making that may not prioritize immediate shareholder profits. Courts typically do not impose liability on directors for business decisions that prioritize long-term corporate health or other stakeholders over short-term shareholder gains. An important case illustrating this is *\*Air Products Inc. v. Airgas, Inc.\**, where Airgas's board successfully resisted a buyout offer while emphasizing its commitment to long-term goals.

The landmark case of *\*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.\** is often cited as a rare instance where failure to maximize shareholder value resulted in director liability. However, this case is an exception as it involved a public company transitioning to a private entity, signifying a unique context where directors must prioritize shareholder interests.

The conclusion of this chapter is that American corporate law does not necessitate prioritizing shareholder value, but rather allows for a multitude of potential corporate objectives. Directors can choose to focus on societal contributions or other lawful goals without infringing upon their legal obligations, underscoring the notion that the chase for shareholder wealth is more of a strategic choice than a mandatory condition.

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The following chapter will delve into the normative arguments for shareholder value thinking, questioning if, regardless of its legal standing, it indeed serves as the best philosophy for corporate management in maximizing economic contributions to society.

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## Critical Thinking

**Key Point:** The misconception of shareholder primacy is not mandated by law.

**Critical Interpretation:** This realization can inspire you to challenge long-held beliefs about corporate responsibilities and embrace a broader view of business purpose. By understanding that the law allows for diverse corporate objectives, you might feel empowered to advocate for practices that benefit not just shareholders but also employees, communities, and the environment. This shift in perspective can lead you to support businesses that prioritize sustainability and social responsibility, ultimately contributing to a more equitable and just economy.

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# chapter 3 Summary: How Shareholder Primacy Gets Corporate Economics Wrong

## Chapter 3 Summary: How Shareholder Primacy Gets Corporate Economics Wrong

The concept of shareholder primacy—asserting that corporations exist primarily to maximize shareholder wealth—has become widespread among business leaders, journalists, and legal experts, despite not being mandated by American law. Scholars like Hansmann and Kraakman have identified a disconnect between the ideology of shareholder primacy and actual corporate law, acknowledging that while no formal legal requirement exists to prioritize shareholder value, many advocate for it as an ethical standard.

The roots of shareholder primacy can be traced back to influential economic theories, particularly the principal-agent model introduced by William Meckling and Michael Jensen in their 1976 article "The Theory of the Firm." They posited that when a principal (the owner) hires an agent (the manager) to run a business, a conflict of interest arises, leading to agency costs. This framework inadvertently positioned shareholders as "owners" and managers as their subordinates, promoting the idea that corporations should focus on maximizing shareholder wealth.

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However, this principal-agent perspective rests on three flawed assumptions. First, the claim that shareholders "own" corporations overlooks the legal reality that corporations are independent entities, akin to "juridical persons," which own themselves. Instead, shareholders merely possess shares, contracts granting them certain rights but not ownership of the corporation itself.

Second, the notion that shareholders are residual claimants—entitled to profits only after all other obligations are met—is misleading. In reality, the distribution of profits depends heavily on the decisions made by the board of directors, who have significant control over whether dividends are declared or how profits are utilized. Thus, shareholders cannot reliably expect to receive all profits generated by the corporation.

Third, the classification of shareholders as principals and directors as agents misrepresents their roles within the corporate structure. In law, the corporation's board of directors governs, while shareholders' rights are limited to voting for or against directors, with appreciable constraints on their ability to influence management decisions directly.

Despite these inaccuracies, many scholars and practitioners argue for shareholder primacy as a pragmatic solution to agency costs—believing that a focus on shareholder interests reduces managerial discretion and aligns executives with shareholder goals. However, this perspective is chiefly

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theoretical. Empirical evidence does not consistently demonstrate that prioritizing shareholder wealth directly enhances corporate performance, raising questions about the validity and effectiveness of the shareholder primacy model in practice.

The chapter establishes that the foundational beliefs underpinning shareholder primacy are fundamentally flawed, signaling a need for critical reevaluation of how corporations are governed and the real economic relationships at play within them. The exploration of this topic will continue in the next chapter, which will examine how these theoretical deficiencies correlate with actual corporate outcomes.

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## Critical Thinking

**Key Point:** The importance of reevaluating corporate governance beyond shareholder primacy.

**Critical Interpretation:** Imagine stepping into a world where you and your colleagues at work are empowered to make decisions that benefit not just shareholders, but all stakeholders—employees, customers, and the community. By realizing that the deeply ingrained belief in shareholder primacy is based on flawed assumptions, you can inspire a transformative approach in your professional life. You may advocate for policies that prioritize sustainable practices, employee well-being, and innovation, encouraging a corporate culture that values collaboration and ethical responsibility over mere profit maximization. This shift could lead to a more fulfilling work environment and a positive impact on society, as you champion a model that connects business success with holistic stakeholder value.

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# chapter 4: How Shareholder Primacy Gets the Empirical Evidence Wrong

## Chapter 4: How Shareholder Primacy Gets the Empirical Evidence Wrong

In Chapters 2 and 3, we explored how the concept of shareholder primacy—the idea that a corporation should primarily focus on maximizing shareholder value—is not mandated by law nor reflective of the actual dynamics of public corporations. Although corporations are allowed to adopt shareholder primacy goals if they choose, the evidence suggesting that adhering strictly to this model enhances economic performance is sparse and unreliable.

Shareholder primacy proponents recommend several strategies to align corporate governance with shareholder interests, such as streamlined board independence, simplified equity structures, and the removal of anti-takeover defenses. The expectation is that companies employing these practices would outperform those that do not, yielding higher profits, growth rates, and share prices. This presents an opportunity to empirically test the validity of shareholder primacy; however, the results are far from conclusive.

Numerous empirical studies have investigated the relationship between shareholder-friendly governance practices—like board independence and

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share class structures—and corporate performance metrics. Nevertheless, findings are inconsistent: while some studies indicate that these governance structures have no impact, others suggest negative or even positive effects on performance. Notably, research on dual-class share structures has shown both detrimental and unexpectedly beneficial outcomes, contradicting the presumption that simpler, more democratic structures are universally superior.

The critiques extend further, as academic commentators have labeled some of these governance reforms as ineffective, noting a general inability to demonstrate consistent positive correlations between governance structures and corporate performance. Notably, findings during the 2008 financial crisis indicated that firms operating under strict shareholder primacy principles performed worse than others.

Moreover, the focus of most empirical studies on individual company performance limits their relevance, obscuring broader market trends and long-term implications. This approach can lead to misleading conclusions akin to examining fishing methods among individual fishermen without considering the effects on fish populations overall. A metaphorical scenario demonstrates this point: while using dynamite might yield immediate results for individual fishermen, it ultimately devastates the fishing community. This serves as a cautionary tale about the pitfalls of prioritizing short-term shareholder gains at the expense of collective welfare.

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As we analyze recent trends in shareholder behavior and returns, the shift towards greater shareholder-oriented practices in U.S. corporations coincides with disappointing investor returns. From the mid-1990s onward, average annual returns have declined, raising questions about the efficacy of prioritizing shareholder value. Regulatory changes have encouraged companies to pursue shareholder interests, yet the anticipated improvements in shareholder wealth have not materialized, indicating a need to reevaluate corporate governance assumptions.

A broader examination reveals a significant decline in the number of public companies, prompting speculation about whether contemporary regulatory and shareholder value ideologies might deter companies from maintaining public listings. This trend contributes to a shrinking market for average investors, who face diminishing choices and opportunities in an environment increasingly dominated by private firms.

Additionally, instances of dual-class share frameworks—where insiders retain control while public shareholders lack voting power—suggest a disinterest among investors in strong shareholder rights. Remarkably, even in regions where shareholder primacy is more rigorously enforced, such as the UK, observable success of public corporations has not emerged, challenging the presumption of superiority within the shareholder-oriented model.

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The evidence compels us to reconsider the ramifications of shareholder primacy, as it appears to falter under scrutiny and is unlikely to be the panacea it has been made out to be. The emergent need for new paradigms in corporate governance becomes evident, particularly those that consider the diverse interests of actual shareholders and their potential implications for overall corporate performance and stakeholder well-being. The subsequent chapters will delve deeper into these alternative theories of corporate purpose, seeking to uncover a better understanding of what shareholders truly value in the evolving landscape of corporate governance.

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# chapter 5 Summary: Short-Term Speculators versus Long-Term Investors

## ### Chapter 5: Short-Term Speculators versus Long-Term Investors

This chapter grapples with the pressing issue of corporate management prioritizing short-term stock price increases at the expense of long-term company health. The core concern here arises from the prevailing corporate philosophy of "maximizing shareholder value," which can lead to decisions that bolster short-term profits, such as cutting research and development or slashing customer service, thereby degrading the firm's future potential. This phenomenon is referred to as corporate myopia, where a company focuses narrowly on immediate gains while ignoring its long-term sustainability.

Traditionally, many finance economists, bolstered by the Efficient Market Hypothesis (EMH), believed that such myopia was a non-issue. The EMH suggests that stock prices always reflect a company's fundamental value, incorporating all relevant information. Thus, market participants could trust that today's stock price encapsulated the firm's future risks and opportunities. However, this view was dramatically shaken on October 19, 1987, when a sudden market crash revealed the fragility of this belief. Subsequent financial crises and scandals, including the tech stock bubble and corporate collapses like Enron, further eroded confidence in market

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efficiency.

Today, even seasoned economists acknowledge that stock prices do not always reflect intrinsic company value. As the chapter outlines, various alternative theories have emerged, such as heterogeneous expectations and behavioral finance, which explore how investor sentiment can distort pricing and trading behaviors.

The chapter also sheds light on the evolving landscape of stock trading, noting a significant shift towards short-term trading practices. In the 1960s, the average stock holding period was about eight years, but by 2010, this had diminished to mere months. This surge in short-term trading can be attributed to deregulation, advances in technology, and the increasing influence of institutional investors, like hedge funds and mutual funds, who often pressure companies to deliver quick returns. This puts pressure on fund managers to achieve short-term performance benchmarks at the cost of fostering sustainable corporate growth.

The influence of these short-term investors is profound; many corporate financial officers report a willingness to cut marketing and development budgets to meet quarterly earnings targets, knowing these actions might harm long-term performance. This alignment of incentives leads to a dangerous cycle where corporate strategy prioritizes immediate price spikes, often ignoring the negative ramifications for employee morale, consumer

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loyalty, and product development.

Moreover, the chapter highlights the contrasting interests between short-term shareholders, who may advocate for aggressive cuts or financial engineering, and long-term investors, who prefer stable growth strategies. Academic research supports the notion that these conflicting priorities create a dilemma for corporate boards, who must choose between strategies that please short-term speculators and those that benefit the company's future.

To illustrate these tensions, the author references a study on activist hedge funds, which typically seek immediate financial gains through measures like cost-cutting or asset sales, rather than long-term investments. The dilemma becomes even more pronounced when considering how mutual funds, often governed by external proxy advisory services focused on short-term metrics, tend to side with these immediate profit-seeking strategies.

Finally, the chapter examines an inherent conflict in corporate governance, where executive compensation linked to stock performance exacerbates this issue. Executives may feel compelled to prioritize stock price fluctuations over the company's operational health, leading to practices like "earnings management" to manipulate quarterly results temporarily. Highlighting the case of Kraft Foods, the author illustrates how pressures to split or restructure companies can benefit short-term speculators but may not lead to real improvements in operational effectiveness or long-term shareholder

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value.

In conclusion, the chapter asserts that the disparity between short-term and long-term investor interests raises critical questions about corporate governance. Driving toward immediate financial gains may yield short-lived profits for some but imperil the broader economy and long-term investor returns, akin to fishing with dynamite—favorable for a few but disastrous in the long run.

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## Critical Thinking

**Key Point:** Prioritizing long-term value over short-term gains

**Critical Interpretation:** Imagine a world where you embrace the mindset of long-term value instead of mere instant gratification. As you navigate your career and personal decisions, prioritize actions that contribute to sustainable growth and development, even if they require more time and effort. This approach cultivates resilience, fosters deeper relationships, and ensures that the foundations you build today will pay dividends in the future, ultimately leading to a more fulfilling life where rushes of success do not overshadow your potential for lasting achievement.

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## chapter 6 Summary: Keeping Promises to Build Successful Companies

### ### Chapter 6: Keeping Promises to Build Successful Companies

In this chapter, we explore the inherent conflicts faced by shareholders of public corporations, particularly focusing on their intentions to make commitments to stakeholders versus the temptation to break those commitments later on, similar to the mythological dilemma faced by Ulysses when passing the Sirens.

Ulysses, the hero of the \*Odyssey\*, finds himself drawn to the enchanting songs of the Sirens—beautiful creatures who lure sailors to their doom. To prevent his crew from succumbing to this fatal temptation, Ulysses has them block their ears with wax while he ties himself to the mast of the ship, ensuring that he cannot act on his desire to jump overboard. This story serves as an allegorical lens through which to view corporate governance, particularly the challenges shareholders face regarding investment commitments.

When investors purchase stock in public corporations, they find their capital "locked in." Unlike partnerships—which allow investors to withdraw their share upon demand—corporate investments remain with the company, and

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shareholders cannot reclaim their money if they choose to sell their shares. This "capital lock-in" feature is crucial for corporations, enabling them to undertake long-term projects that require commitment from investors, thereby preventing opportunism among shareholders.

Harold Demsetz, an economist, highlighted the risks and constraints of share ownership in public companies, emphasizing that removing investor access to firm assets is essential for maintaining reliable commitments. This corporate structure protects both financial and non-financial investments, preventing shareholders from destabilizing the business as a result of personal financial crises or opportunistic behavior.

The implications of these dynamics are significant: without capital lock-in, stakeholders—including employees, suppliers, and the community—may hesitate to commit their resources or skills to a corporation. As a specific example, a factory is not merely physical assets; it requires human resources and community infrastructure, which can't be easily recovered if an investor pulls out.

Margaret Blair's theory of "team production" further supports the necessity of long-term commitment. This concept explains how multiple stakeholders must collaborate and contribute their "firm-specific" investments to generate successful outcomes. When stakeholders sense that their contributions are secure, they are more likely to invest their efforts productively.

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When public corporations embrace shareholder primacy — prioritizing immediate shareholder returns — they risk alienating stakeholders, which hampers long-term ambitions and innovation. This may lead to a decline in employee loyalty and a reduced number of public companies as they seek more favorable environments that safeguard investors' contributions.

The chapter highlights a paradox where despite the prevalence of shareholder primacy, some investors still choose to buy shares in companies with restrictive governance rules. This behavior suggests a recognition that certain governance structures may bolster the likelihood of completing complex projects dependent on collective effort and stakeholder investment.

Lastly, we see how shareholder opportunism — driven by interests in immediate profits — can erode trust among stakeholders. When stakeholders feel exploited, they may withdraw their valuable investments, further perpetuating the cycle of disengagement and decline in collaborative success.

In conclusion, Chapter 6 illustrates the critical balance that must be struck between shareholder interests and the sustaining commitments owed to broader stakeholders. Firms that recognize the need for team production and cultivate long-term relationships are more likely to thrive, ultimately inviting a more harmonious operation and fostering productive growth in their

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respective industries.

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# chapter 7 Summary: Hedge Funds versus Universal investors

## Chapter 7: Hedge Funds versus Universal Investors

In this chapter, the discussion centers on the fundamental misconception regarding corporations and their shareholders. While many view corporations as intangible entities devoid of personal characteristics, shareholders are often regarded as real individual entities with specific, human interests. However, this perspective misrepresents the reality: corporations, despite being invisible, hold tangible assets, engage in real contracts, and can exist indefinitely. Shareholders, on the other hand, often refer to human beings who, while possessing shares in corporations, have diverse interests beyond mere stock performance.

The standard corporate performance measure known as shareholder primacy is flawed; it assumes there exists a Platonic shareholder solely focused on maximizing the market price of shares. Yet, in reality, most investors are "universal owners," meaning their financial well-being is tied to a wide array of assets and interests, including employment, health, and environmental conditions. For example, a person owning stock in a company like BP may also have investments in real estate or be employed by an industry affected by corporate decisions. When BP engages in risky practices that lead to

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disasters like the Deepwater Horizon oil spill, the resulting harm extends beyond the immediate economic impact on BP's stock price to affect this individual's broader financial portfolio and quality of life.

Yet, despite this understanding, many diversified investors fail to advocate for their own universal interests because of structural limitations. Retail investors, often holding only small amounts of stock and maintaining diversified portfolios, tend to be apathetic and overlook the interconnections affecting their overall wealth. They focus primarily on stock prices without grasping how corporate actions may externalize costs detrimental to their other assets.

Similarly, institutional investors such as mutual funds and pension funds, which manage large portfolios, have a responsibility to act as stewards for these universal owners. However, they often fall short due to a focus on maximizing portfolio value within a narrow timeframe. Institutional funds are not legally bound to consider their beneficiaries' broader interests (like environmental health or job security), leading to decisions that can inadvertently undermine those interests.

The rise of hedge funds complicates this dynamic even further. Hedge funds, known for their concentrated and often aggressive investment strategies, tend to disregard the wider implications of their actions. Managers of these funds, who typically focus on only a few securities, exert pressure on

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companies to maximize short-term stock prices, sometimes to the detriment of universal owners' broader interests. For instance, an activist hedge fund manager, such as Carl Icahn, may successfully push a company towards a buyout that boosts immediate shareholder value while disregarding the potential longer-term losses incurred by other investors.

In summary, while universal investors are aligned with diverse interests that transcend individual corporate stocks, hedge funds and the prevailing shareholder primacy mindset exert disproportionate influence on corporate strategies. This creates a dangerous cycle where the aggressive tactics of hedge funds can undermine the value and sustainability of the broader economic ecosystem that universal investors are part of. As the chapter poignantly concludes, universal investors must confront the ways in which their own pursuit of maximized shareholder value may inadvertently lead to self-destructive outcomes.

| Key Concepts             | Summary  |
|--------------------------|--|
| Corporate Misconceptions | Corporations are often viewed as intangible entities, while shareholders are seen as real individuals with specific interests, which misrepresents reality.                |
| Shareholder Primacy      | This measure is flawed as it assumes a single type of shareholder focused only on share price maximization, ignoring the diversified interests of real investors.          |
| Universal Owners         | Most investors are straddled by diverse interests, affected by corporate behaviors beyond just stock performance and prices, impacting their overall financial well-being. |

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| Key Concepts            | Summary  |
|-------------------------|--|
| Investor Apathy         | Diverse retail investors often overlook broader interconnections affecting wealth due to apathy and a focus solely on stock prices.  |
| Institutional Investors | Pension and mutual funds should act as stewards for universal owners but often prioritize short-term value, neglecting broader beneficiary interests.  |
| Hedge Funds' Impact     | Hedge funds employ aggressive strategies focusing on few securities, exerting pressure that prioritizes short-term stock price without considering long-term impacts on universal investors. |
| Conclusion              | Universal investors must recognize how the pursuit of shareholder value can lead to damaging outcomes for themselves and the broader economic ecosystem.                                     |

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# chapter 8: Making Room for Shareholder Conscience

## Chapter 8: Making Room for Shareholder Conscience

This chapter challenges the prevalent notion of shareholder primacy, arguing that it leads to self-defeating investment strategies for a diverse group of individuals—universal investors—who own stocks either directly or through mutual funds and pensions. While about 54% of Americans invest in the stock market, the focus on the interests of these investors neglects important stakeholders, including those without stock ownership, future generations, and the environment.

The chapter contends that traditional economic theories, especially the homo economicus model—which views individuals as rational and self-interested—fail to reflect actual human behavior. Instead, growing consensus indicates that most people possess a natural inclination toward prosociality, the willingness to make sacrifices for the benefit of others. Behavioral economics studies reveal that in controlled environments, individuals often choose cooperation over self-serving strategies, showing that most people are capable of ethical behavior.

Despite this inclination, there are systemic issues that hinder investors from acting on their prosocial tendencies. The author highlights two main

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obstacles: First, diversified investors typically lack knowledge about the day-to-day operations of the companies they invest in, leaving them unaware of potentially harmful corporate practices. This detachment can lead uninformed shareholders to prioritize stock prices over social responsibility. For instance, many investors of companies involved in environmental disasters (like the Exxon Valdez spill) might not perceive their role in contributing to such incidents.

Second, prosocial investors face the collective action problem akin to the "Tragedy of the Commons." Choosing socially responsible investment funds often results in lower returns, leading individuals to question the efficacy of aligning their investments with their values. While they may prefer to invest in ethical companies, the belief that their individual actions make little difference can disincentivize prosocial behaviors.

The chapter also discusses the psychology behind investor behavior, positing the "Jekyll-Hyde Syndrome," whereby people's responses to social cues can shift between altruistic and self-serving actions. Shareholder primacy ideology exacerbates this phenomenon, pressuring investors to act as though they lack ethical considerations. This environment positions investors in a moral dilemma, where pursuing maximum profits can trigger harmful corporate behaviors, even if the underlying shareholders possess moral inclinations.

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The author references Joel Bakan's documentary "The Corporation," which characterizes corporations as "psychopathic" due to profit-maximizing mandates that ignore ethical implications. While shareholders are often blamed for this behavior, evidence suggests that the majority would prefer a corporate landscape that considers ethical practices over sheer profit maximization.

Overall, the chapter calls for a reexamination of shareholder interests, advocating for a broader conception that includes social responsibilities. By addressing the structural impediments to prosocial investing, the chapter argues, we could align investor behaviors more closely with the ethical values that a significant majority likely holds.

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