

Does shareholder primacy lead to a decline in managerial responsibility?

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Abstract – This paper argues that shareholder primacy, rather than gatekeeper failure, is directly responsible for the crisis of financial markets of the Enron-era. To defend this thesis, we turn back to Berle and Means (1932) who stressed the instable nature of shareholder primacy. Indeed, this mode of governance requires an “exteriorisation” of control, giving all responsibilities to actors that are, by their very nature, outside the firm. At the same time, *ex ante* financial requirements are imposed on listed companies. These requirements lead corporate executives to pursue highly risky strategies. Hence the paradox: the growing implementation of shareholder primacy results in a decline in managerial responsibility. This critic leads us to prospect the basic premises of an alternative corporate governance mode, considering the corporation as an institution rather than as an object of ownership.

Key words: shareholder primacy; Enron-era financial scandals; theory of the firm; board of directors; Berle and Means.

JEL classification: D23, G30, L20

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1. Introduction

By the end of the year 2000, the doctrine of “shareholder primacy”² seemed to be unchallengeable. It was winning ground in business circles, while most of economics and legal scholars depicted it as an efficient corporate governance mode. Besides, the “jurisdiction” the most receptive to this model, the U.S.A., exhibited exceptional economic performances, at the peak of the so-called “New Economy”. In continental Europe, the growing activity of financial markets as well as the rise to power of (Anglo-Saxon) institutional investors were not favourable to the traditional model of corporation, where shareholders’ interest is only one among others. As Hansmann and Kraakman (2001) provocatively stated: “*Since the dominant corporate ideology of shareholder primacy is unlikely to be undone, its success represents the ‘end of history’ for corporate law*” (p.89).

However it is striking to note that the unprecedented series of accounting irregularities of champions of U.S. and (to a lesser extent) European stock markets, following Enron disaster in December 2001, did not result in a reconsideration of this normative “consensus”. The standard thesis explaining this major confidence crisis of financial markets stresses the failure of the supervising (controlling) actors, external (mainly the auditors and the securities analysts) and internal (the board of directors)³. In this article, we challenge this thesis, by arguing that the real issue is the final goal pursued by corporations rather than their supervision. More precisely, we will show that the generalisation of shareholder primacy as a corporate governance mode is the main driver beyond the crisis.

In section II, the core of the shareholder primacy doctrine is portrayed. Section III presents and criticises the standard interpretation of the crisis, which points to the control failures. Section IV reveals the paradoxical nature of shareholder primacy, starting from a new reading of the seminal book by Berle and Means (1932). This paradox might be termed in the following way: the more the corporate executives are held responsible toward the stockholders in a context of liquid stock market, the freer they are to pursue their own interest. We interpret the crisis as an actualisation of this paradox. Section V offers the basic premises of a new conception for the corporation and its governance – once again by relying on Berle and Means. Section VI concludes.

² We also refer to “shareholder sovereignty” or “shareholder value”.

³ See, for example, Coffee (2002) and Gordon (2002).

2. The doctrine of shareholder primacy

The shareholder primacy doctrine defends the idea that the sole responsibility of managers is to best serve the interests of stockholders. This doctrine might be grounded in two different (yet complementary) ways. From a legal point of view, it is possible to consider that stockholders are the owners of the corporation. In this case, shareholder primacy fully protects private ownership, cornerstone of a free market economy. From an economic point of view, one may argue that shareholders, as residual claimants, are the only risk-bearers in the firm; therefore, they need to be in control. As we will see, these two arguments deserve careful examination.

According to the proponents of this doctrine, corporate governance deals primarily, if not exclusively, with the relations between shareholders and managers, and these relations are conceived in a strictly hierarchical fashion. The emergence and expansion, since the 1960s, of the ‘contractarian’ approach of the firm⁴, in economics as well as in legal (corporate law) studies (Cheffins, 2004), gave a formal shape to this idea: managers are considered as the “agents” of the shareholders, who are the “principals”. More precisely, the concept of “agency relationship” was introduced in corporate governance debates by the Positive Agency Theory⁵. Borrowed from legal analysis, “*the agency relation differs from other fiduciary relations in that it is the duty of the agent to respond to the desires of the principal*” (Reuschlein and Gregory, 1979, p.11).

Today, and inside the ‘contractarian’ approach, the number of authors who still explicitly espouse the Positive Agency Theory is limited. Nevertheless, Law and economics scholars continue to privilege the agency relationship concept when addressing the question of corporate governance. The review of the literature on corporate governance by Shleifer and Vishny (1997) is a good example: “*Our perspective on corporate governance is a straightforward agency perspective*” (p. 738). It must be noted that reliance on this concept of agency relationship leads to the adoption of shareholder primacy as the reference model. Qualifying the relationship between shareholders and managers as an agency relationship entails the belief that it is the duty

⁴ Prior to the 1970s, most of the economic scholars tend to consider the firm as a “black box”, a simple channel between different markets (labour, capital and product markets). Pioneered by Coase (1937), the contractarian approach defends, on the contrary, the idea that market mechanisms (i.e. voluntary agreements between rational agents) are an essential part of intra-firm coordination. Describing the firm as “a nexus of contracts”, the contractarian approach puts forward the incentive (rather than cognitive) aspect of the coordination.

⁵ Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983).

of the latter to satisfy the desires of the former, in other words, that the managerial team has been ‘hired’ by the shareholders to best serve their interests.

Yet this doctrine has to cope with one essential characteristic of stock markets, at least in the U.S.: their liquidity. This liquidity leads to a dispersion of stock ownership. In turn, as Berle and Means (1932) early recognised, the managerial team enjoys great freedom and *de facto* power. Here resides a tension, which constitutes the matrix of the shareholder primacy doctrine: stockholders are considered as the legitimate possessors of power within the firm, but this power is supposed to be wrested from them by the corporate executives, leading to ‘agency costs’. In other words, “*the dominant corporate ideology of shareholder primacy*” (Hansmann and Kraakman, 2001; cf. *supra*) is rooted in a philosophy of *dispossession*. From this situation comes an exclusive focus on the question of control: how can the lost power be recovered? The answer is by encouraging managers (with their potential for misbehaviour) to act in the interests of the shareholders and by establishing safety mechanisms capable of detecting and curbing managerial misconduct.

The economic translation of this agency perspective is the following: the objective of the managers is reduced to maximising the utility of the pool of shareholders. Nevertheless, the hypothesis of opportunism, at the heart of the contractarian approach, requires analysts to acknowledge that managers will do everything in their power to divert value. Shareholders must therefore ensure that incentive contracts are signed, in order to reduce conflicts of interest to the lowest possible level. If we denote V as the utility function of the group of shareholders, U the utility function of the manager, \bar{U} the manager’s reserve utility, w his/her salary, and $e(w) = \{e^+; e^-\}$ his/her effort ($e^+ > e^-$), then the firm’s programme can be written as follows:

$$\begin{aligned} & \underset{w}{\text{Max}} V(w) \\ & \text{subject to } U(w; e^+) \geq \bar{U} \qquad \text{participation constraint} \\ & \qquad \qquad U(w; e^-) \geq U(w; e^+) \qquad \text{incentive constraint} \end{aligned}$$

To simplify, the stock market price is often used to represent V , as it incorporates, in theory, expected gains in capital and future distributions in dividends. From this model we can deduce that the firm behaves in an optimal (second best) way when it maximizes the well-being of the shareholders. This is precisely the message of shareholder primacy doctrine.

In this framework, all the mechanisms which favour aligning managers’ interests with those of the shareholders will improve the efficiency of the firm. Among these mechanisms, stock option

schemes play a decisive role for these schemes directly link the remuneration of managers to stock market prices. Besides, it is useful to distinguish between *external* and *internal* mechanisms of governance:

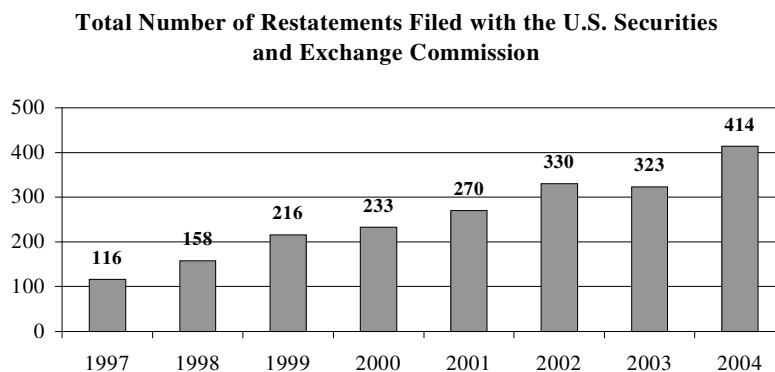
- *External* mechanisms support the disciplinary role of financial markets, that rests on two pillars. First, it is necessary that stock market prices inform investors of the quality of the management. A set of actors might help to reduce informational asymmetries between investors and insiders (the executives) (Black, 2001): external auditors, securities analysts and ratings agencies. Those “gatekeepers” are held responsible for verifying the honesty and the relevance of financial statements and for using the information to give the best advice possible to investors. Second, managers should be directly threatened by depreciating share prices. This is the role of hostile takeover (Manne, 1965). Proper regulation must be designed in order to promote these operations.
- The board of directors constitutes the main *internal* supervising device. Following Fama and Jensen (1983), the board is depicted as an institution whose function is to reduce agency costs by monitoring and ratifying the actions of the managerial team on behalf of the shareholders. Thus exclusive control of the board of directors by the stockholders constitutes an efficient arrangement. This vision of the board as a ‘disciplinary’ tool (Charreaux, 2000), rather than as a strategic body accompanying management in its choices, has a direct consequence: directors’ independence from the firm is recognised as a cardinal value, preventing conflicts of interests. Almost all codes of good corporate governance attempt to define the “independence” of directors and the proportion of independent directors that a board should contain.

For the last twenty years, shareholder primacy has deeply influenced the evolution of corporate governance regulations and practices, in the United States and, to a lesser extent, in European Union. The rights of (minority) stakeholders got stronger everywhere, primarily through federal law in the U.S. and trans-national law in the EU (Cioffi and Cohen, 2000). Besides, institutional investors (mainly pension funds) activism has promoted best practices closely akin to shareholder primacy. The growing success of a shareholder value oriented approach to managing a business might be observed at least at three levels. First, the presence of “independent” directors, mostly in the *ad hoc* committees (audit, nomination and remuneration), is now the rule rather than the exception. Second, stock options are increasingly used as remuneration device: whereas stock options accounted for less than 25% of average S&P500 Chief Executive Officer (CEO) pay package at the beginning of the 1990’s, this part stabilized around 50% since 1999 (Jensen and Murphy, 2004). Last but not least, “Value-Based Management” – that is the use of management tools for measuring the creation of ‘shareholder

value”– is now a common practice for listed companies (Cooper, Crowther, Davies and Davis, 2000). To conclude, for most of the commentators, at least before December 2001, “managerial capitalism”, as described by Williamson (1964) or Galbraith (1967), was over.

3. The gatekeepers’ failures thesis

On 2 December 2001, Enron was placed under bankruptcy protection according to Chapter 11 of the Bankruptcy Code. At \$63 billion in assets, this has been the largest bankruptcy in U.S. history. The various investigations will show that accounting irregularities were systematic⁶: heavy recourse to off-balance-sheet accounting and creative accounting on the income statement contributed to the misuse of value for the benefit of few executives. Astonishing as it sounds, it was not an isolated case. In the months that followed Enron’s collapse, massive scandals of listed companies in the United States followed one after the other. The telecommunications sector was hit especially hard by the bankruptcies of Qwest, Global Crossing, and WorldCom. WorldCom’s June 2002 bankruptcy even surpassed Enron’s in scale (\$104 billion in assets, \$41 billion in liabilities). But all sectors were involved. According to a report published by the General Accounting Office in October 2002, between January 1997 and June 2002, nearly 10 % of listed companies in the United States restated their earnings at least once due to accounting irregularities. Moreover, a recent study held by the Huron group demonstrates that earnings restatements following financial irregularities are on an upward trend⁷: they reached a pick in 2004, with a total number of 414 (see graph below). Ultimately, the 1990s and the first half of the 2000s witnessed a dramatic increase in financial irregularities.



Source: Huron Consulting Group, “2004 Annual Review of Financial Reporting Matters”, March 2005.

⁶ The Powers Report (2002) remains the authoritative reference. See also Bratton (2002).

⁷ Cited by Coffee (2005).

The last decades also witnessed a huge rise in executive compensations. According to Holmström and Kaplan (2003) overall CEO compensation increased by a factor of six during the 1980s and the 1990s. Most of this increase took the form of incentive pay – primarily stock options, as we have seen. This process has resulted in a deepening of intra firm inequalities, of which the *Business week* pay executive survey, regularly carried out, gives an idea: in 1980, the average income of the CEO of the largest firms in the U.S. was 40 times the average salary of a worker. In 1990, it was 85 times greater, and in 2003, it jumped to 400 times greater. From a strict economic standpoint, such an increase raises serious concern: it is hard to explain on the basis of incentive factors alone, despite the effort made by some authors (see in particular Jensen and Murphy, 2004). Rather, a process of rent extraction by corporate managers seems to be at work here (Bebchuk and Fried, 2004; Bratton, 2005). As such, this process might be considered together with the wave of financial scandals and accounting irregularities. Both are the most visible marks of a structural phenomenon: a decline in corporate management accountability.

The standard explanation of this phenomenon (at least of corporate scandals) points to the responsibility of the “gatekeepers”. Coffee (2002) provides the most convincing sketch of this thesis. The (external) auditors, who verify and certify companies’ accounts, and the financial analysts, who compile information in order to make buy-and-sell recommendations on securities, are those whose responsibility has been the most emphasised. This failure of auditors and analysts is explained, for a large part, by the conflicts of interest in these professions. Concerning auditors, the conflicts arose over the course of the 1990s as audit firms began to provide consulting services to their clients (beyond auditing). Conflicts of interest are also presented as the main driver of analysts’ drift: securities analysts most often work for investment banks offering advisory services to the corporations they analyse.

Besides the gatekeepers’ dysfunctional, Enron-era scandals revealed the weaknesses of the board of directors, as some commentators judiciously noted (see for example Gordon 2002). In the Enron case, independence did not prevent misbehaviour: Enron’s board, composed of 12 “independent” directors of a total of 14, saw nothing, and made themselves richer in the process. Such (mis)behaviour might be observed in most of the other scandals.

The Sarbanes-Oxley Act (SOA), promulgated on July 2002, is the explicit response to the loss of confidence in U.S. security markets. This text addresses two main issues. First, the SOA

strengthens the gatekeepers' regulation in order to limit conflicts of interests. From now on, audit firms are forbidden from providing certain services to the companies they are auditing. Note that despite their ineffectiveness as gatekeepers from 1997 to 2001, securities analysts are the objects of fairly inconsequential clauses aimed principally at preventing conflicts of interests. Second, the SOA reaffirms the disciplinary role of the board of directors. The most significant rule concerns the audit committee. The Securities Exchange Commission is authorized to strike a company off the exchange if its audit committee is not *entirely* composed of independent members⁸.

Despite increasingly virulent criticism, the subject of stock options is not even broached⁹. In short, the SOA can be summed up as follows: shareholder primacy is good, but its monitoring system failed. As a consequence, controlling devices accountable to the shareholders must be strengthened. For example, rather than concluding from the Enron case that independency of directors is problematic, it is called for a reinforcement of independency. This account appears to be both rather *weak* in its explicative power and somewhat *paradoxical*.

Even if the United States were particularly affected by scandals related to the management of listed companies, European countries did not escape unscathed. Various affairs can be cited, though none having the magnitude of the U.S. crisis: Vivendi and France Télécom in France, Ahold in the Netherlands, and Parmalat in Italy all contributed to varying degrees in undermining confidence in financial markets. Yet gatekeepers are, by their very nature, national. They consist of actors and procedures defined by national regulations. To explain the crisis in the United States by gatekeeper failure alone, attributing the failure to local (national) factors, is either to ignore the difficulties outside of the United States or to render the gatekeeper thesis so general as to dilute its message. Monitoring would thus be untrustworthy in every respect, everywhere. However, given such a level of gatekeeper incompetence, would it not be better (more logical) to turn attention to the intrinsic motivations of agents, to the conduct of firms

⁸ Note that even if the text does not specifically anticipate the obligation to put an audit committee into place, it does specify that in the absence of such a committee, all clauses dealing with this committee (notably the independence of its members) must be applied to the board of directors as a whole. The constrictive character of this clause leads one to conclude that the majority of listed companies will create an audit committee.

⁹ In the different scandals, the stock options looked more like the means of personal enrichment, encouraging every manipulation that might give a favourable short-term financial market valuation, than the lever of a well-thought-out strategy. Once again, Enron's case is striking: in the first two months of 2001, the year of bankruptcy, the Chief Executive Officer of the company made \$9.6 million from stock options; the Chief Financial Officer made \$3 million.

themselves? To use a metaphor, the gatekeeper thesis would attribute violence in society to the incompetence of the forces of law and order without questioning the root cause of that violence.

Moreover, it is paradoxical that the governance model in the U.S.A., focused entirely on stacking up mechanisms of control for the last twenty years, failed so spectacularly in controlling corporate actors. Put differently, never have managers been as powerful, or at least well-remunerated, as they have been since the return in force of the shareholders. This is this paradox, at the very heart of a finance-led capitalism, that we will try to solve now. To do so, we turn to Berle and Means (1932), who had, in fact, already given us some powerful insights to make sense of this phenomenon.

4. Shareholder primacy, control and financial demands

Few books have caused as much stir as *The Modern Corporation and Private Property*, written in 1932 by Berle and Means. The “separation of ownership and control” still is a key concept in corporate governance debates. Yet it might be argued that the crux of their thesis is today misunderstood, both in its positive and normative levels.

Berle and Means examined the way in which the rise to power of the stock company had affected private property, the main driving force of U.S. economic dynamics in the nineteenth century. From a survey of the 200 largest, non-financial corporations in the United States (presented in Book I), the two authors noted the following empirical fact: 44 % of firms were under managerial control. For these firms, the equity capital was so dispersed that shareholders had little opportunity or incentive to get involved in the internal affairs of the company. The U.S. economy had arrived at a new stage in its development, one characterized by a “*separation of ownership and control*”. The “liberal conception of ownership” (see Honoré, 1961) – where the owner is both the beneficiary of the wealth created by the object owned and the sole person capable of transforming (controlling) its substance – no longer applied to the real situation of shareholders. According to Berle and Means, shareholders of public corporations were just owners of an equity stake in a company. This ownership gave them certain rights: for example, the right to vote in general assemblies on the nomination of directors. Nevertheless, these rights were no longer sufficient to provide shareholders with control of the company. In practical terms, therefore, the shareholders were no longer owners of firms.

Book II was devoted to an analysis of the jurisprudence of the time. This analysis demonstrated that U.S. jurisprudence did not apprehend the full measure of the transformations presented in Book I. Thus, the U.S. judicial system continued to cling to the liberal, classical, concept of ownership. The legal order therefore reaffirmed shareholder primacy. This revealed a certain lag in the legal order in relation to the social and economic reality, as well as it underscored the failure of the legal order to discipline corporate managers. Indeed, detailed analysis of the jurisprudence showed that the stacking of legal measures, with the aim of ensuring shareholder control despite the dispersion of equity capital, was totally insufficient for restoring shareholder power:

“As the power of the corporate management has increased, and as the control of the individual has sunk into the background, the tendency of the law has been to stiffen its assertion of the rights of security holder. The thing that it has not been able to stiffen has been its regulation of the conduct of the business by the corporate management. And this omission has resulted, not from lack of logical justification, but from lack of ability to handle the problems involved. The management of an enterprise is, by nature, a task which courts can not assume; and the various devices by which management and control have absorbed a portion of the profit-stream have been so intimately related to the business conduct of an enterprise, that the courts seem to have felt not only reluctant to interfere, but positively afraid to do so” (p. 296).

This quotation clarifies the reasons behind the legal system’s incapacity to control effectively the misappropriation of corporate wealth by managers: these misappropriations proceed, for the most part, from the very process of management itself. It is, for example, by choosing to take over a given firm or to invest in a given market that the executives increase their wealth and power at the expense of shareholders. Managers can always justify their choices by invoking industrial strategy, a justification that is practically impossible for the law to contest. And the reason is simple: courts are *exterior* to the firm as much as the shareholders concerned with preserving the liquidity of their shares. Ultimately, cases of pure embezzlement, objectively perceptible by the law (insider trading, for example, or misuse of corporate property), are relatively rare.

This analysis of the courts’ structural inability to discipline managers did not retain much attention by subsequent commentators, as compared to the free riding problem stemming from the dispersion of ownership. However, it has profound insights for current debates on corporate governance. Berle and Means (1932) did not only emphasise the difficulty for ‘liquid’

shareholders to control corporate executives; they also underlined the intrinsic limits of a purely *external* control. Courts, because they are remote from day-by-day business conduct, are unable to re-establish the link between the subjects of property (the shareholders) and the object of property (the firm). This logical argument can directly be extended to the case of gatekeepers: just as courts, these actors are *exterior* to the firm. Outside the firms, they have little to say in managerial decisions. They can only monitor a firm's behaviour *ex post*, the limits of which were evident in the Enron-era financial scandals.

In these circumstances, the effectiveness of control relies for a large part on the internal monitoring device, the board of directors. Without surprise, the board is at the heart of debates on corporate governance reforms. In order to prevent collusion between the controllers (board members) and the controlled (managers), the independence of the former came to be a cornerstone of a shareholder-oriented model of governance. There is no longer one code of "good governance" that does not strive to offer an operational definition of what "independency" could be. In the end, this independency can be expressed by one word: exteriority. As much as possible, board members are required to have no links with management. In concentrated sectors, this most often means having no links with either the sector or the profession. The assessment of the board of directors offered by the doctrine of shareholder primacy is therefore paradoxical in that it advocates an increasing *exteriority* for this *internal* mode of control. This exteriority, however, has a price: incompetence. The more distant the directors are from the firm, the less knowledge they have on the business and the less effective is their control¹⁰.

The conclusion is that the weakness of control is a congenital defect of shareholder primacy, rather than a failure than can be corrected. The fundamental reason is the innate contradiction at the heart of this doctrine, i.e. the will to combine liquidity and sovereignty. Liquidity, as the ability of selling an asset as quickly as possible without loss of value, requires the slightest possible commitment. Put differently, liquidity *specifically* supposes complete separation between the person and the property. Berle (1963) expresses this idea most clearly:

"To accomplish this liquidity, it is necessary that the property [...] have no relation whatever to its owner except that relation arising from the owner's capacity to transfer it. Nothing can be liquid if any value assigned to it depends upon the capacity or effort or will

¹⁰ Such a balance between independency and competence has been put forward by Richard (2005) in the case of auditors.

of the owner. Marble would stop being readily salable if its value depended on having the sculptor transferred along with it” (p.25).

As such, liquidity implies maintaining a distance and is synonymous with exteriority. And exteriority is hardly compatible with effective control and sovereignty.

Yet shareholders’ inability to control management effectively should not lead to underestimate the growing influence of shareholders on listed companies since the 1970s. Essentially, the power of financial markets is expressed by the imposition of constraining criteria of financial returns. The competition among investment funds to attract collective savings is transferred onto the companies, which are judged by these funds on the basis of their ability to meet the financial demands imposed on them. This power is conferred by stock market liquidity, which allows a continuous process of public evaluation of companies (Orléan, 1999; Deakin, 2005). In turn, this evaluation impacts on corporate management mainly through the threat of hostile takeovers and the use of share option schemes.

The Economic Value Added (EVA) / Market Value Added (MVA) model – invented and copyrighted by the Stern & Stewart consulting firm at the beginning of the 1990s – is emblematic of shareholder primacy. If all the listed companies have not adopted this model as such, it has nonetheless, by virtue of its widespread dissemination¹¹, contributed to legitimating and to theoretically grounding the investment funds’ demands for financial returns (Plihon and al. 2002). As such, this model deserves careful examination.

The assumption that there are no tax deductions or exceptional results simplifies the calculation, so that the current result merges with the net result. Lets denote R_o the operating result, D the book value of debts, r their average costs, EC the book value of equity capital, k the equilibrium return on equity capital as determined by the Capital Asset Pricing Model (CAPM)¹² and K the total book value of the assets ($D + EC$). Then we have the following expressions for the net result (R) and the weighted average capital cost ($WACC$):

$$R = R_o - r.D \quad (1)$$

$$WACC = k.EC / K + r.D / K = k - (k - r).D/K \quad (2)$$

¹¹ See special issues of the *Journal of Applied Corporate Finance* for the U.S.A., Cooper, Crowther, Davies and Davis (2000) for the UK and Hossfelds and Klee (2003) for German and French firms.

¹² The CAPM, developed in the 1960s (Sharpe, 1964; Lintner, 1965), permits the calculation of the premium which rational investors expect for holding risky assets (with high volatility).

The simplest expression of a company's EVA is the n the following:

$$EVA = R - k.EC \quad (3)$$

By denoting *ROE* the return on equity (R / EC) and *ROA* the return on assets (R / K), expression (3) rewrites:

$$EVA = (ROE - k).EC = (ROA - WACC).K \quad (4)$$

Equation (3) brings out the specific nature of the EVA¹³: while the wealth going to shareholders is normally measured by net return (R , that is the profit once the employees have been paid and the debts serviced), the EVA indicator is based on the assumption that value actually created for shareholders comes from surpluses relative to the profitability demanded by the capital market ($k.EC$). In other words, if the effective return on investment is the rate k , which correspond to the equilibrium market return for that class of risk, then the EVA model considers that no value has been created. Likewise, if the investment is ultimately remunerated at a rate n with $0 < n < k$, then there is destruction of value: there is some return on investment, but less than the market has the right to expect. The difference is identified as a loss, even if shareholders are paid for their investment. The market return at equilibrium becomes a *minimal* return or an opportunity cost, "always to be exceeded" (Batsch, 1999, p. 36). It has two far-reaching consequences.

On the one hand, the systematization of the EVA model results in a profound modification of the shareholders' status. As Lordon (2000) notes, creation of value means that shareholders are paid twice: once at the opportunity cost k and again at the EVA. Through the EVA, residual creditors therefore become privileged creditors, as if they were lenders. They acquire guarantees of returns on their investments (k) and although these guarantees are not contractual, they are no less real. This change, it should be noted, undermines the ultimate economic justification for shareholder sovereignty (see *supra*): risk-taking.

On the other hand, the creation of shareholder value thus originates in a logic of imbalance transformed into a permanent objective. The macro-economic inconsistency of this principle is obvious: all the (listed) companies cannot create value for their shareholders, whatever the quality of their management. At micro-economic level, methods for doping financial returns beyond what the companies' economic potential would permit are sustained by elevated stock-exchange prices. These methods combine the increase of the debt-to-equity ratio (financial leverage), the asset-light strategy and the repurchase of shares. If the interest rate is below k , an

¹³ MVA is just defined as the discounted total (using the WACC) of expected EVA.

increase in the debt-to-equity ratio reduces the WACC (see equation 2) and thus raises the EVA (see 4). The asset light strategy ($\Delta K < 0$) automatically raises the return on assets (*ROA*), while the repurchase of shares increases the return on equity (*ROE*). Both result in a rise in the EVA (see equation 4).

All of these methods have been extensively used by Enron's officers. Clearly, none of them are sustainable at medium-long term. These are short term strategies aiming at fostering financial returns beyond the market equilibrium. As such, they are highly risky and encourage bold innovations flaunting acceptable standards of caution. Enron's executives claimed to follow the asset light strategy as a permanent (recurring) strategy for ensuring long term profit (Chatterjee, 2003). That financial market actors did not fully address the paradoxical nature of this claim is but one of the striking features of the wave of financial scandals.

To sum up, the growing implementation of the doctrine of shareholder primacy has two consequences. On the one hand, it results in high financial demands, with a logic of imbalance. These demands reflect the power acquired by shareholders through stock market liquidity. On the other hand, shareholder primacy leads to an exteriorisation of supervising devices, which means a rather weak form of control. As a consequence, capital markets are able to command results but are structurally unable to control the way these requirements are met. This contributes to make managerial power less responsible: accounting irregularities multiply and executive remunerations explode. Shareholder primacy fails exactly where it intends to succeed: it reinforces the discretionary power of managers rather than limiting it.

5. The institutional nature of the corporation: back to Berle and Means?

Let's come back to Berle and Means (1932). The two *positive* studies – one on the structure of ownership (Book I), and the other on the effectiveness of jurisprudence (Book II) – are followed by a *normative* assessment, which concludes *The Modern Corporation*. Book IV opens with the following passage:

“The shifting relationships of property and enterprise in American industry [...] raise in sharp relief certain legal, economic, and social questions which must now be squarely faced. Of these the greatest is the question in whose interests should the great quasi-public corporations [...] be operated” (p. 294).

Berle and Means identified two alternative answers, corresponding to two different doctrines still vivid today: the managerial sovereignty and the shareholder sovereignty¹⁴. The *managerial sovereignty* doctrine took cognizance of the concentration of power in the hands of the managers, observing that it was the result of a strictly contractual process: the shareholders have accepted to lose control of the company in exchange for greater liquidity. In other words, they have traded control for liquidity. Therefore, they can no longer legitimately demand control of the company; managers should be free to exercise power as they see it. Berle and Means expressed concerns about this approach, for it gives almost dictatorial power to the managers. The *shareholder sovereignty* was the doctrine implicitly supported by the U.S. jurisprudence at the beginning of the 1930s – as we have seen. Besides the fact that this doctrine refuses to acknowledge the trade-off between control and liquidity, we have already underlined the reservations expressed by Berle and Means (1932) against it: they argued that the concentration of power in the firm cannot be fought against in the name of shareholder primacy unless shareholders agree to renounce the liquidity of their stake.

Berle and Means' position is very briefly presented in the very last chapter. This chapter begins with a long quotation from Walther Rathenau, industrialist, statesman in the Weimar Republic and social theorist, describing the German conception of the public limited company in the following terms:

“The depersonalization of ownership, the objectification of enterprise, the detachment of property from possessor, leads to a point where the enterprise becomes transformed into an institution which resembles the state in character” (p.309).

Likewise, in the new introduction for the 1967 edition of the *Modern Corporation and Private Property*, Berle wrote:

“There is an increasingly recognition of the fact that collective operations, and those predominantly conducted by large corporations, are like operations carried on by the state itself. Corporations are essentially political constructs.”(p.xxvi).

To understand the solution recommended by Berle and Means, it is useful to distinguish between two logics:

- In the logic of *ownership*, the (legal) world is divided between owners (legal persons, be they human or non-human) and objects of ownership. The owner of an object has “subjective” power over that object, which means he/she has the right (the power) to do whatever he/she

¹⁴ See also O’Sullivan (2000), pp. 96-97.

wants with it (see Robé, 1999). Note that shareholder sovereignty and managerial sovereignty both analyse corporation through this logic: the company is an object of property. The difference is the identity of the owners. According to the shareholder sovereignty, the only legitimate owners are the stockholders. According to the managerial sovereignty, the ownership has been traded off in favour of liquidity, so that managers are the real owners.

- In the logic of *institution*, the holder of power should not be free to exercise it in its interest (subjectively), but in the interests of those affected by it. The reference to the State in Rathenau's and Berle's quotations is significant at this level: the distinctive feature of a (democratic) State resides in the fact that the concentration of power within the State apparatus, necessary for its efficiency, is counterbalanced by limits placed on that power. The exercise of power is subjected, by means of various procedures, to the will of the people.

Hence, the idea defended by Berle and Means is that the liquidity of stock markets calls for a rethinking of the nature of power within large companies. The firm is no longer an object of property, but an *institution* that must be governed as such. Accordingly, it is necessary to set limits on managerial power to ensure that it is exercised on behalf of the company's constituents: shareholders, certainly, but also workers and, even further, the communities in which these companies thrive. Managers should not be accountable solely to the shareholders; they must be made accountable to all the stakeholders in the firm. In this regard, Berle and Means observed a certain lead in Germany's legal, political and economic orders, in recognising the specifically institutional nature of the firm. The same is true today: the co-determination system, provided for by corporate law and labour law, is the sign of the prevalence of an institutional vision of the corporation.

The idea that negotiability or tradability of stocks tend to "autonomize" the corporation from its shareholders is even more accurate today (Aglietta and Rebérioux, 2005). On the one hand, the liquidity and depth of financial market are considerably higher today than they were in the 1960s and even the 1930s. On the other hand, the growing mediation of institutional investors increases the mass of funds invested through delegation. The distance between final investors (households) and corporations is enhanced by the extension of delegation chains¹⁵.

If the diagnosis of a "separation of ownership and control" deeply influenced law and economics scholars, Berle and Means' normative thesis did not meet such a success. Indeed, the

¹⁵ For example, more than one third of pension funds' assets are currently managed, in the U.S., by mutual funds, through delegation.

contractarian (incentive-based) model, that dominates the debates since the 1970s, strongly advocates the principle of shareholder primacy through the agency model (see *supra*). Accordingly, it is striking to observe that the most recent works inside the contractarian approach tend to give credence to the idea defended, seventy years ago, by Berle and Means (1932). Indeed, Zingales (1998; 2000) and Blair and Stout (1999) offer new insights inside the contractarian model, by relying on a theory of the firm as “*a nexus of specific investments*” (Rajan and Zingales, 1998). These papers emphasise contractual incompleteness and “team production” as distinctive features of public corporations. When contracts are incomplete, protection of specific, non-redeployable investments cannot be achieved beforehand by the establishment of a contract providing for every possible contingency. The issue becomes even more complex when considering the synergies that come into play between the investments of the different stakeholders. Since individual contributions cannot easily be inferred from the output (team production), it is difficult to profit from these synergies. Zingales (1998) and Blair and Stout (1999) then argue that the issue of corporate directors and managers’ accountability should be considered in the light of these conditions (contractual incompleteness and team production). Indeed, in this case, the allocation of rights of control over the board of directors (and so over managers) plays a decisive role. This allocation will determine how the organisational quasi-rent is divided up. In turn, each stakeholder will be more or less motivated to commit to the firm, and this will influence the very level of the organizational quasi-rent. Zingales (1998) and Blair and Stout (1999) propose a solution that moves away from the doctrine of shareholder primacy: the various stakeholders should delegate their powers to an independent third party – the board of directors – whose objective is to serve the best interest of the entity. The directors are no longer simply the agents of the shareholders; their fiduciary duties must be exercised towards the whole firm. Thus, the assets of the firm must be managed in the interest of the firm itself. We find here a conclusion close to the one defended by Berle and Means (1932) in *The Modern Corporation*, arguing that the corporate accountability should extend beyond the sole interests of its stockholders. Thus, a microeconomic, contractarian reasoning, focusing on the process of value creation inside the firm, supports the conclusion achieved by Berle and Means in the 1930s through a more legal approach¹⁶.

The revival of non-contractarian, cognitive-based theories of the firm – with the resource-based approach or the evolutionary theory – goes in the same way. Cognitive approaches explore the

¹⁶ Zingales (2000) goes one step further in an article of a very prospective nature entitled *In Search of New Foundations*: “*In the current environment, where human capital is crucial and contracts are highly incomplete, the primary goal of corporate governance system should be to protect the integrity of the firm, and new precepts need to be worked out*” (p. 1645).

way in which the firm constructs, maintains and develops tacit and collective productive knowledge. The competitiveness of the firm then depends on the quality of this ‘cognitive’ process, that is of a collective (organizational) learning. The fact that such an approach, emphasising the collective nature of the firm, leads to a rejection of shareholder primacy (see for example O’Sullivan 2000; Aglietta and Rebérioux, 2005) should come as no surprise.

6. Conclusion

In this paper, we argued that shareholder primacy is directly responsible for the decline of corporate responsibility for the last two decades. To buttress up this argument, we turned back to Berle and Means (1932) who stressed, seventy years ago, the instable nature of shareholder primacy as a corporate governance mode in a context of liquid stock markets. On the one hand, shareholder sovereignty requires an “exteriorisation” of control, that should rest on actors that are, by their very nature, outside the firm: courts, gatekeepers (auditors, securities analysts and ratings agencies) and independent (i.e. external) board members. The scandals that have shaken confidence in financial markets demonstrate that these external surveillance devices, however sophisticated they may be, have intrinsic limits. On the other hand, the power of capital market runs through the imposition of *ex ante* financial requirements. These requirements lead corporate executives to pursue highly risky strategies. Hence the paradox: the greater the implementation of shareholder sovereignty, the less corporate executives are effectively accountable. The standard thesis explaining the crisis, that points to the failure of control, therefore miss the crucial point: instability is a congenital defect of shareholder primacy. This defect reflects a deep contradiction, inherent to finance-led capitalism: the will to combine sovereignty and liquidity.

But if shareholder primacy must be rejected, then what would be an alternative mode of corporate governance? Again, we turned back to Berle and Means (1932) to provide a first answer. According to these authors, the growth of the liquidity of stock markets implies a fundamental transformation for the corporation: this latter “leaves” the order (logic) of ownership to become an institution. This change is far-reaching: the power should not be exercised by managers in the sole interests of stockholders, but in the interest of the firm, as a collective entity. The Enron-era financial scandals as well as the dramatic increasing of executive remunerations are a manifestation of the denial of this institutional nature of the corporation.

Some perennial questions in the field of corporate governance and corporate law are observable. Managerial accountability is one of those – if not the most important. As Cheffins (2004) notes, there is something cyclical on that issue, that casts doubts on the idea that corporate law and, more broadly, the theory of the firm is on a constant progressive trend. From this point of view, new developments in the theory of the firm, together with current evolution in corporate practices and business conduct, may well deeply influence the way we understand corporate accountability... after a long domination of the shareholder primacy principle.

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