Stockholder Capitalism. Fighting against Prejudice

Because of the ongoing debate about the activities of private equity & hedge funds, a wide range of views on stockholders, businesses and markets is expressed in various media. Many of those views suffer from a lack of understanding about what a (listed) company really is. It is the purpose of this contribution to clear up some of the misperceptions.

**Stockholder capitalism**
Imagine by way of experiment that employees in a company would only receive their salaries after all the other participants in the company had been paid their dues. The amount of salaries is equal to whatever is left after paying these other participants. Labor unions will not be very enthusiastic about this compensation scheme. It entails far too much risk for the workers. Yet someone in the company has to be willing to be in such a position.

A company is an organizational tool to produce goods and services and sell those on the market. To be able to do this, several inputs are needed. Labor is needed to do the actual work. Brainpower is needed for making decisions. And capital is needed for financing the investments. These three inputs are the core of any business enterprise. In a sole proprietorship, these three inputs are provided by one person, the entrepreneur. This is not the case in a (listed) company. Here we witness a sophisticated division of tasks between workers, managers and stockholders. This division of roles over various agents is the very cause of much of the prevailing misunderstanding. To eliminate this misunderstanding it may help to briefly discuss the origins of the company form.

When the scale of business activities expands, there will be a point where the required capital can no longer be provided by one person. Multiple investors may be needed. With many investors involved, it is no longer practical to involve all of them in daily decision making. Too many commanders would immobilize the organization. Decision making is therefore delegated to a board of managers, specifically appointed for this task. It is however not likely that investors would entrust managers with their resources if as stockholders, they also risk loosing money not invested in the company should it fail. The solution to this is the concept of limited liability. Limited liability for stockholders requires the business to become a legal body, with its own legal rights and obligations. The fact that the business now is a legal entity, in the corporate form, leads to the understandable but fundamentally wrong perception of seeing the company as an entity with its own goal or purpose. Because of this misguided ‘personalization’ of the company Rijkman Groenink, former CEO of ABN AMRO, could say that it would not be in the bank’s interest if the company were to be split up after a takeover. But whose interest is that? Who is the bank? Of course, ABN AMRO as a legal entity exists. Its corporate records are registered. But this is merely a legal fiction, a legal front if you will, behind which the interest of various stakeholders are at play. Employees, stockholders and others have their own identifiable and sometimes conflicting interests. The legal entity has no, and can not have interests of its own. The legal entity serves as a nexus for drawing up contacts between those stakeholders involved in the business activities. These stakeholders will try to get favorable terms when negotiating contracts. Ultimately, these contracts determine how the business’ revenues and risks are divided between the stakeholders. By its very nature, a business activity involves risk. There is no way to tell beforehand how successful a product will be on the market. It is therefore not
possible to give exact contractual promises to all stakeholders as to how much they 
will receive because it is not sure whether the contract can be honored. There have 
to be stakeholders who are willing to let the business risk be an explicit element of 
their contractual relationship. Someone must be willing to forego payments from the 
company when times get rough. Someone must sustain possible losses. In the 
company, this duty is performed by the stockholders. The stockholders have a rather 
simple contract with the company. They can only claim anything from the business 
proceeds and assets after the obligations towards all other participants have been 
met. If indeed ‘something’ remains, accountants say the company made a profit 
which is then the reward for the stockholders. Because stockholders are last in line 
when business proceeds are divided and can only hope for a possible surplus 
(residual income), it becomes logical that management should try to make this 
surplus as large as possible. This is the core of stockholder capitalism and has 
brought us an unprecedented growth of prosperity over the last century or so. Yet 
there is a lot of animosity towards this model of economic organization. There are a 
number of reasons for this.

Future perspectives
Firstly, stockholder capitalism is often associated with going after short term gains. 
This is an unfair and unjust characterization. The value of a share does not only 
depend on the profits of this year or quarter but of all expected future profits. If 
management would decide to boost this year’s profit by postponing vital investments 
this appears to be in the stockholders (short term) interests. The opposite is true. 
Since future profitability becomes endangered, the value of the contract (the share) 
that the stockholder holds will be negatively affected. Also it is often stated that 
stockholders can not have a long term perspective since they can sell their shares at 
any given moment. Some critics go as far as to say that there should be a minimum 
term for investments in a company’s stock. This is of course a gross infringement on 
economic freedom and will increase overall cost of capital and ultimately lead to 
lower prosperity. Of course there are investors who invest for a short period of time. 
There is nothing against this. They can only sell their stock on favorable terms if the 
new owners have sufficient confidence in the future perspectives of the business. 
Consecutive ownership, made possible by a well functioning stock market, ensures 
the long term perspective can not be ignored without consequence, even when 
individual investors only hold their shares for a short period of time.

Creating a larger pie
A second, maybe even more profound reason for the animosity mentioned above, is 
the statement that management’s chief duty is to create stockholder value. It sounds 
unsympathetic to many because it makes it seem as if stockholder interests override 
those of all others. This is not true. Stockholder value can only be created if and 
when other stakeholders continue to contribute to the activities of the business. This 
will only happen if also their interests are being recognized and respected. Yet, many 
feel that creating shareholder value is unfair towards other stakeholders. These 
critics tend to see the proceeds from a business as a given amount of money. Give 
more to stockholders and less is left for everybody else. This is not the way it works. 
The business result is not some predetermined size pie. Rather, the size of the pie 
depends on a multitude of decisions and courses of action. We could also say that 
the managerial goal should be to make the total pie as large as possible. Since the 
size of the slices promised to most of the other stakeholders is more or less
predetermined by way of contracts, this effectively means trying to maximize the surplus on top of these slices. And if certain stakeholders feel their slices are not large enough, they can (and do) renegotiate their contracts when the time comes. The managerial goal of creation of stockholder value is there, not because stockholders are more important than others, but because stockholders are the residual claimholders. And as we argued above, residual claimholders are vital to a company’s survival.

Let’s return to the experiment we described at the beginning of this article. The employees bear the business risks and become residual claimholders. Stockholders receive a fixed and contractual compensation on their investment, much like interest on a loan. In this model it would have to be management’s goal to achieve the highest possible income for the employees since now salaries are the residual income. This will sound attractive to labor unions and other critics of stockholder capitalism. They will like the practical implications less however. It also means that there will be years when no salaries can be paid. Employees simply can not bear such risks since they need a stable and reliable income and cannot diversify the risk over many companies. Thanks to well functioning capital markets, stockholders can. These markets reduce the risk of stock investments and thus contribute to financing ideas and businesses and economic growth.

Creative destruction
Growth can be painful. Striving for stockholder value means that when a certain activity can be done more efficiently than before, certain people may lose their jobs in the company. This can be a dramatic experience for those involved and a reason for others to wave the banner against capitalism in general and stockholders in particular. For the larger society however, the elimination of non productive jobs is useful because the released labor may be put to use in other or even totally new areas of activity. The quest for stockholder value directs scarce inputs where they are of most use. It’s the mechanism that the economist Schumpeter has called ‘creative destruction’. It’s true that without this mechanism many of the agricultural workers of old would have kept their jobs. It’s also true that without this mechanism there wouldn’t be many other employment opportunities either.

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Senior Lecturer Finance & Accounting, Fontys University of Applied Science
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