What is the Value of an ‘Enlightened’ Shareholder?

Understanding the diverging interests of a company

Thomas Rigg, LL.M. – Doctoral Candidate

Introduction

“Why firms exist, what determines the number of firms, what determines what firms do... are not questions of interest to most economists.” – Ronald Coase, 1988

• Theory of the firm – nexus of contracts
  – How does one view a company?
• Shareholder wealth maximisation
  – What is the purpose of this maxim?
• Enlightened shareholder value
  – How does one evaluate shareholder ‘Enlightenment’?

Theory of the Firm

What is a company?
Theory of the Firm

Why do companies exist?

• Transaction cost theory
  − Cost of the market’s price mechanism.
  − Entrepreneur seeks to minimise these costs by creating the firm/company.

• Team production (monitoring costs)
  − Individuals shirk to maximise their own utility/value.
  − Team production – a means of monitoring to ensure that production is more efficient and of higher quality.

Theory of the Firm

Nexus of Contracts

• Legal and economic nature of the company
  − One must be careful not to equate the two.
  − Company as a ‘legal fiction’.
  − Meaning of ‘Contracts’.

• Economically...
  − The entrepreneur forms its nucleus.
  − Little distinction between ‘internal’ and ‘external’.
  − Separate legal personality reflects protections/advantages afforded to companies.

• Principal-Agent Dichotomy
  − Separation of ownership and control
Shareholder Wealth Maximisation
Explaining diverging interests
• Interest of shareholders
  – Neo-classical goals – Share Price ↑ = Value ↑.
  – Diversified risk portfolios & limited liability promote greater risk-taking and emphasis on short-term gain.
• Interest of directors
  – Concerns of job security inherently promote risk-aversion.
  – Greater focus on long-term gain and personal benefits.
• Other constituents – creditors, employees, society etc.

Shareholder Wealth Maximisation
Means and ends of Corporate Governance
• Ends
  – Identifying the primary beneficiaries of corporate value.
  – Shareholders’ interests trump those of the board.
• Means
  – Seeking to bring about a convergence of interests.
  – Through means, utility/value reaches the proper ends.

Shareholder Wealth Maximisation
Efficacy of wealth maximisation
• Why shareholders?
  – Residual claimants – ultimate monitors.
  – Shareholder wealth equated to company wealth.
  – Bargaining power of the shareholders.
• Negative externalities of the maxim
  – Short term emphasis.
  – Relegates stakeholders to secondary beneficiaries (if at all).
  – Eliminates consideration of positive externalities of company.
• Accuracy?
Enlightened Shareholder Value
As prescribed by law

- Section 172(1) Companies Act 2006
  - “A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…”
  - What constitutes the enlightenment of the shareholder?
    - Long-term consequences;
    - Employees;
    - Need to foster business relationships;
    - Impact on community and environment;
    - Reputation;
    - Need to act fairly between members.

Enlightened Shareholder Value
Another legal fiction?

- Shareholder Value: “The dumbest idea in the world” – Jack Welch, CEO General Electric, 2009
  - Shareholder value myth (Lynn Stout, 2012)?
- ESV – Vehicle through which companies should pursue shareholder wealth with a long-run orientation.
  - Inclusion of the influence of stakeholder theory.
- As a model of shareholder
  - Accuracy – how well does it reflect the interests of shareholders?

Enlightened Shareholder Value
As a matter of means and ends

- A widening of means
  - The push for long-termism.
  - Directors have discretion to satisfy long-term goals without breaching fiduciary duty.
- A change of ends?
  - How far does the enlightened shareholder model extend to other corporate constituents?
  - How effective is this in changing the ends of corporate governance?
Enlightened Shareholder Value
A conglomeration of interests

Thank you for your time and attention.

Thomas Rigg
Doctoral candidate – University of Edinburgh
thomas.rigg@ed.ac.uk
s1364991@sms.ed.ac.uk