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Why We Should Stop Teaching Dodge v. Ford

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WHY WE SHOULD STOP TEACHING *DODGE v. FORD*

Lynn A. Stout[†]

INTRODUCTION	164
I. <i>DODGE v. FORD</i> ON CORPORATE PURPOSE	164
II. <i>DODGE v. FORD</i> AS WEAK PRECEDENT ON CORPORATE PURPOSE	166
III. THE LACK OF AUTHORITY FOR <i>DODGE v. FORD</i> 'S POSITIVE VISION OF CORPORATE PURPOSE	168
IV. THE LACK OF AUTHORITY FOR <i>DODGE v. FORD</i> 'S NORMATIVE VISION OF CORPORATE PURPOSE	172
V. ON THE PUZZLING SURVIVAL OF <i>DODGE v. FORD</i>	174
CONCLUSION	176

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INTRODUCTION

WHAT is the purpose of a corporation? To many people, the answer to this question seems obvious: corporations exist to make money for their shareholders. Maximizing shareholder wealth is the corporation's only true concern, its *raison d'être*. Devoted corporate officers and directors should direct all their efforts toward this goal.

Some find this picture of the corporation as an engine for increasing shareholder wealth to be quite attractive. Nobel Prize-winning economist Milton Friedman famously praised this view of corporate purpose in his 1970 *New York Times* essay, "The Social Responsibility of Business Is to Increase Its Profits."¹ To others, the idea of the corporation as a relentless profit-seeking machine seems less appealing. In 2004, Joel Bakan published *The Corporation: The Pathological Pursuit of Profit and Power*, a book accompanied by an award-winning documentary film of the same name.² Bakan's thesis is that corporations are indeed dedicated to maximizing shareholder wealth, without regard to law, ethics, or the interests of society. Thus, as Bakan argues, corporations are "dangerously psychopathic" entities.³

Whether viewed as cause for celebration or for concern, the idea that corporations exist only to make money for shareholders is rarely subject to challenge. Although there is a tradition of scholarly debate among legal academics on this point, it has attracted little attention outside the pages of specialized journals.⁴ Much of the credit, or perhaps more accurately the blame, for this state of affairs can be laid at the door of a single judicial opinion: the 1919 Michigan Supreme Court decision in *Dodge v. Ford Motor Company*.⁵

I. *DODGE V. FORD* ON CORPORATE PURPOSE

The facts underlying *Dodge v. Ford* are familiar to virtually every student who has taken a course in corporate law. Famed industrialist Henry Ford was

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1. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 33.
 2. JOEL BAKAN, *THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER* (2004).
 3. *Id.* at 2.
 4. See Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189–90 (2002) (noting the 1932 Berle-Dodd debate regarding the proper purpose of the corporation, as well as more modern scholarly disagreement on the subject).
 5. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

the founder and majority shareholder of the Ford Motor Company.⁶ Brothers John and Horace Dodge were minority investors in the firm.⁷ The Dodge brothers brought a lawsuit against Ford claiming that he was using his control over the company to restrict dividend payouts, even though the company was enormously profitable and could afford to pay large dividends to its shareholders.⁸ Ford defended his decision to withhold dividends through the provocative strategy of arguing that he preferred to use the corporation's money to build cheaper, better cars and to pay better wages.⁹ The Michigan Supreme Court sided with the Dodge brothers and ordered the Ford Motor Company to pay its shareholders a special dividend.¹⁰

In the process, the Michigan Supreme Court made an offhand remark that is regularly repeated in corporate law casebooks today:

There should be no confusion . . . A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of means to attain that end, and does not extend to . . . other purposes.¹¹

As will be discussed in greater detail below, this was merely judicial dicta, quite unnecessary to reach the court's desired result. Nevertheless, this quotation from *Dodge v. Ford* is cited almost invariably as evidence that corporate law requires corporations to have a "profit maximizing purpose"¹² and that "managers and directors have a legal duty to put shareholders' interests above all others and no legal authority to serve any other interests"¹³ Indeed, *Dodge v. Ford* is routinely employed as the *only* legal authority for this proposition.¹⁴

6. *Id.* at 671.

7. *Id.* at 670.

8. *Id.* at 670–71.

9. *Id.* at 671.

10. *Id.* at 685.

11. *Id.* at 684.

12. ROBERT CHARLES CLARK, CORPORATE LAW 678 (1986).

13. BAKAN, *supra* note 2, at 36.

14. See, e.g., *id.*; CLARK, *supra* note 12, at 679; MARJORIE KELLY, THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY 52–53 (2001); Lawrence E.

But what if the opinion in *Dodge v. Ford* is incorrect? What if the Michigan Supreme Court's statement of corporate purpose is a misinterpretation of American corporate doctrine? Put bluntly, what if *Dodge v. Ford* is bad law?

This Essay argues that *Dodge v. Ford* is indeed bad law, at least when cited for the proposition that the corporate purpose is, or should be, maximizing shareholder wealth. *Dodge v. Ford* is a mistake, a judicial "sport," a doctrinal oddity largely irrelevant to corporate law and corporate practice. What is more, courts and legislatures alike treat it as irrelevant. In the past thirty years, the Delaware courts have cited *Dodge v. Ford* as authority in only one unpublished case, and then not on the subject of corporate purpose, but on another legal question entirely.¹⁵

Only laypersons and (more disturbingly) many law professors continue to rely on *Dodge v. Ford*. This Essay argues we should mend our collective ways. Legal instructors and scholars should stop teaching and citing *Dodge v. Ford*. At the least, they should stop teaching and citing *Dodge v. Ford* as anything more than an example of how courts can go seriously astray.

II. *DODGE V. FORD* AS WEAK PRECEDENT ON CORPORATE PURPOSE

Let us begin with some of the more obvious reasons why legal experts should hesitate before placing much weight on *Dodge v. Ford*. First, the case is approaching its one hundredth anniversary. Henry Ford, John Dodge, and Horace Dodge have long since died and turned to dust, along with the members of the Michigan Supreme Court who heard their dispute. In fact, *Dodge v. Ford* is the oldest corporate law case selected as an object for study in most corporate law casebooks. This observation should provoke concern, for case law is a bit like wine: a certain amount of aging is desirable, but after too many years it goes bad—and it is a rare vintage that is still drinkable after a century. Why rely on a case that is nearly one hundred years old if there is more modern authority available?

A second odd feature of *Dodge v. Ford* is the court that decided it. The state of Delaware—not Michigan—is far and away the most respected and

Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 601 (1992).

15. See *Blackwell v. Nixon*, Civ. A. No. 9041, 1991 WL 194725, at *4 (Del. Ch. Sept. 26, 1991).

influential source of corporate case law, a fact that reflects both Delaware's status as the preferred state of incorporation for the nation's largest public companies and the widely recognized expertise of the judges on the Delaware Supreme Court and Delaware Court of Chancery. California and New York have produced their share of influential corporate law cases, as has Massachusetts with regard to close corporations. Michigan, however, is a distant also-ran in the race among the states for influence in corporate law.¹⁶

Finally, a third limiting aspect of *Dodge v. Ford* as a source of legal authority on the question of corporate purpose is the important fact, noted earlier, that the Michigan Supreme Court's statements on the topic were dicta. The actual holding in the case—that Henry Ford had breached his fiduciary duty to the Dodge brothers and that the company should pay a special dividend—was justified on entirely different and far narrower legal grounds. Those grounds were that Henry Ford, as a controlling shareholder, had breached his fiduciary duty of good faith to his minority investors.¹⁷

As the majority shareholder in the Ford Motor Company, Henry Ford stood to reap a much greater economic benefit from any dividends the company paid than John and Horace Dodge did. Ford had other economic interests, however, directly at odds with those of the Dodge brothers. First, because the Dodge brothers wished to set up their own car company to compete with Ford (as they eventually did), Ford wanted to deprive them of liquid funds for investment.¹⁸ Second, Ford wanted to buy out the Dodge brothers' interest in the Ford Motor Company (as he eventually did) at the lowest price possible. Withholding dividends from the Dodge brothers was an excellent, if underhanded, strategy for accomplishing both objectives.¹⁹

16. See Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002).

17. See *Dodge v. Ford*, 170 N.W. at 685; see also Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 772–75 (2005) (explaining why profit-maximization proponents' reliance on *Dodge v. Ford* is misplaced); Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New Lex Mercatoria*, 83 DEN. U. L. REV. 101, 135–36 (2005) ("Ultimately, the Michigan Supreme Court ruled for the Dodge brothers not because of some generalized duty to maximize shareholder value, but rather, because of the right of dissenting minority shareholders to be free from unreasonable oppression."); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 320 (1998) ("The court did not think it was enunciating a meta-principle of corporate law. Rather, the court thought it was merely deciding a dispute between majority and minority shareholders in a closely held corporation . . .").

18. See Oman, *supra* note 17, at 135.

19. See Elhauge, *supra* note 17, at 774.

Thus *Dodge v. Ford* is best viewed as a case that deals not with directors' duties to maximize shareholder wealth, but with controlling shareholders' duties not to oppress minority shareholders. The one Delaware opinion that has cited *Dodge v. Ford* in the last thirty years, *Blackwell v. Nixon*, cites it for just this proposition.²⁰

Finally, not only is the Michigan Supreme Court's statement on corporate purpose in *Dodge v. Ford* dicta, but it is much more mealy-mouthed dicta than is generally appreciated. As Professor Einer Elhauge has emphasized, the Michigan Supreme Court described profit-seeking in *Dodge v. Ford* as the "primary," but not the exclusive, corporate goal.²¹ Indeed, elsewhere in the opinion the court noted that corporate directors retain "implied powers to carry on with humanitarian motives such charitable works as are incidental to the main business of the corporation."²²

III. THE LACK OF AUTHORITY FOR *DODGE V. FORD*'S POSITIVE VISION OF CORPORATE PURPOSE

Dodge v. Ford suffers from several deficiencies as a source of legal precedent on the question of corporate purpose. The case is old, it hails from a state court that plays only a marginal role in the corporate law arena, and it involves a conflict between controlling and minority shareholders that independently justifies the holding in the case while rendering the opinion's discourse on corporate purpose judicial dicta. Nevertheless, one might still defend the continued teaching and citing of *Dodge v. Ford* if the discussion of corporate purpose found in the case were an elegant, early statement of a modern legal principle.

Here we run into a second problem: shareholder wealth maximization is *not* a modern legal principle. To understand this point, it is important not to rely on the unsupported assertions of journalists, reformers, and even the occasional law professor as sources of legal authority, but instead to look at the actual provisions of corporate law. "Corporate law" can itself be broken down into three rough categories: (1) "internal" corporate law (that is, the requirements set out in individual corporations' charters and bylaws); (2) state corporate codes; and (3) corporate case law.

20. *Blackwell*, 1991 WL 194725, at *4.

21. Elhauge, *supra* note 17, at 773 (quoting *Dodge v. Ford*, 170 N.W. at 684).

22. *Id.*

Let us first examine internal corporate law, especially the statements of corporate purpose typically found in corporate charters (also called “articles of incorporation”). Most state codes permit, or even require, incorporators to include a statement in the corporate charter that defines and limits the purpose for which the corporation is being formed. If the corporation’s founders so desire, they can easily include in the corporate charter a recitation of the *Dodge v. Ford* view that the corporation in question “is organized and carried on primarily for the profit of the stockholders.”²³ In reality, corporate charters virtually never contain this sort of language. Instead, the typical corporate charter defines the corporate purpose as anything “lawful.”²⁴

What about state corporation codes? Do they perhaps limit the corporate purpose to shareholder wealth maximization? To employ the common saying, the answer is “not just ‘no,’ but ‘hell no.’” A large majority of state codes contain so-called other-constituency provisions that explicitly authorize corporate boards to consider the interests of not just shareholders, but also employees, customers, creditors, and the community, in making business decisions.²⁵ The Delaware corporate code does not have an explicit other-constituency provision, but it also does not define the corporate purpose as shareholder wealth maximization. Rather, section 101 of the General Corporation Law of Delaware simply provides that corporations can be formed “to conduct or promote any lawful business or purposes.”²⁶

This leaves case law as the last remaining hope of a *Dodge v. Ford* supporter who wants to argue that, as a positive matter, modern legal authority requires corporate directors to maximize shareholder wealth. On first inspection, corporate case law does provide at least a little hope. Contemporary judges do not cite *Dodge v. Ford*, but some modern cases contain dicta that echo its sentiments. Consider, for example, the Delaware Chancery’s statement in the 1986 case of *Katz v. Oak Industries* that “[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders”²⁷

23. *Dodge v. Ford*, 170 N.W. at 684.

24. See JEFFREY D. BAUMAN, ALAN R. PALMITER, AND FRANK PARTNOY, CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 171 (6th ed. 2007).

25. See Mitchell, *supra* note 14, at 579–80 (describing the statutes); *id.* at 579 n.1 (listing the twenty-eight jurisdictions having a constituency statute at the time of publication).

26. DEL. CODE ANN. tit. 8, § 101 (2008).

27. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

This statement is about as *Dodge v. Ford*-like a description of corporate purpose as one can hope to find in contemporary case law. Many other modern cases, however, contain contrary dicta indicating that directors owe duties beyond those owed to shareholders. For example, just a year before the Delaware Court of Chancery decided *Katz*, the Delaware Supreme Court handed down its famed decision in *Unocal Corporation v. Mesa Petroleum Company*.²⁸ In *Unocal*, the court opined that the corporate board had a “fundamental duty and obligation to protect the corporate enterprise, which includes stockholders,”²⁹ a formulation that clearly implies the two are not identical.³⁰ The court went on to state that in evaluating the interests of “the corporate enterprise,” directors could consider “the impact on ‘constituencies’ other than shareholders (that is, creditors, customers, employees, and perhaps even the community generally).”³¹

Just as important, even shareholder-oriented dicta on corporate purpose of the *Katz* sort does not actually impose any legal obligation on directors to maximize shareholder wealth. The key to understanding this is the qualifying phrases “attempt” and “long-run.” As a number of corporate scholars have pointed out, courts regularly allow corporate directors to make business decisions that harm shareholders in order to benefit other corporate constituencies.³² In the rare event that such a decision is challenged on the grounds that the directors failed to look after shareholder interests, courts shield directors from liability under the business judgment rule so long as any plausible connection can be made between the directors’ decision and some

28. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

29. *Id.* at 954.

30. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 293–94, 301 (1999) (arguing that directors should be viewed as owing fiduciary duties to the corporation itself, in addition to any duties they might owe to shareholders, and that duties to the company can include non-shareholder interests).

31. *Unocal*, 493 A.2d at 955.

32. See, e.g., CLARK, *supra* note 12, at 681–84 (noting the difficulty of establishing any long-run difference between public and private interests); Blair & Stout, *supra* note 30, at 303 (giving examples of how modern corporate law departs from “the norm of shareholder primacy” and noting that “case law interpreting the business judgment rule often explicitly authorizes directors to sacrifice shareholders’ interests to protect other constituencies”); Elhauge, *supra* note 17, at 763–76 (describing corporate discretion to refrain from legal profit-maximizing activity); Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors’ Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 437–39 (2002) (identifying doctrine that allows a corporation’s directors to consider other interests at the expense of the shareholder).

possible future benefit, however intangible and unlikely, to shareholders. If the directors lack the imagination to offer such a “long-run” rationalization for their decision, courts will invent one.

A classic example of this judicial eagerness to protect directors from claims that they failed to maximize shareholder wealth can be found in the oft-cited case of *Shlensky v. Wrigley*.³³ In *Shlensky*, minority investors sued the directors of the corporation that owned the Chicago Cubs for refusing to install lights that would allow night baseball games to be played at Wrigley Field.³⁴ The minority investors claimed that offering night games would make the Cubs more profitable.³⁵ The corporation’s directors refused to hold night games, not because they disagreed with this economic assessment, but because they believed night games would harm the quality of life of residents in the neighborhoods surrounding Wrigley Field.³⁶ The court upheld the directors’ decision, reasoning, as the directors themselves had not, that a decline in the quality of life in the local neighborhoods might in the long run hurt property values around Wrigley Field, harming shareholders’ economic interests.³⁷

Shlensky illustrates how judges routinely refuse to impose any legal obligation on corporate directors to maximize shareholder wealth. Although dicta in some cases suggest directors ought to attempt this (in the “long run,” of course), dicta in other cases take a broader view of corporate purpose, and courts never actually sanction directors for failing to maximize shareholder wealth.

There is only one exception to this rule in case law: the Delaware Supreme Court’s 1986 opinion in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*³⁸ *Revlon* is a puzzling decision, not least because the Delaware Supreme Court decided the case the same year it handed down its apparently contradictory decision in *Unocal*. In *Revlon*, the board of a public company had decided to take the firm private by selling all of its shares to a controlling shareholder.³⁹ In choosing between potential bidders, the board considered, along

33. *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968).

34. *Id.* at 777.

35. *Id.*

36. *Id.* at 778.

37. *Id.* at 780.

38. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

39. *Id.* at 177–79.

with shareholders' interests, the interests of certain noteholders in the firm.⁴⁰ This was a mistake, the Delaware Supreme Court announced; where the company was being "broken up" and shareholders were being forced to sell their interests in the firm to a private buyer, the board had a duty to maximize shareholder wealth by getting the highest possible price for the shares.⁴¹

Upon first inspection, *Revlon* appears to affirm the notion that maximizing shareholder wealth is the corporation's proper purpose. In the years following the *Revlon* decision, however, the Delaware Supreme Court has systematically cut back on the situations in which *Revlon* supposedly applies, to the point where any board that wants to avoid being subject to *Revlon* duties now can easily do so. The case has become nearly a dead letter. Accordingly, while the Delaware Supreme Court has not explicitly repudiated *Revlon* (at least not yet), for practical purposes the case is largely irrelevant to modern corporate law and practice.⁴²

In sum, whether gauged by corporate charters, state corporation codes, or corporate case law, the notion that corporate law as a positive matter "requires" companies to maximize shareholder wealth turns out to be spurious. The offhand remarks on corporate purpose offered by the Michigan Supreme Court in *Dodge v. Ford* lack any foundation in actual corporate law.

IV. THE LACK OF AUTHORITY FOR *DODGE V. FORD*'S NORMATIVE VISION OF CORPORATE PURPOSE

Dodge v. Ford usually plays the role of Exhibit A for commentators seeking to argue that American law imposes on corporate directors the legal obligation to maximize profits for shareholders.⁴³ It is important to recognize, however, that many experts teach and cite *Dodge v. Ford* in a more subtle, and less obviously erroneous, fashion. To these experts, *Dodge v. Ford* is not evidence that corporate law actually requires directors to maximize shareholder wealth. Rather, many observers believe it is evidence that corporate directors *ought* to maximize shareholder wealth. In other words, many legal instructors teach *Dodge v. Ford* not as a positive description of what corporate

40. *Id.* at 178–79.

41. *Id.* at 182.

42. See Stout, *supra* note 4, at 1204.

43. See BAUMAN ET AL., *supra* note 24, at 87.

law actually is, but as a normative discourse on what many believe the proper purpose of a well-functioning corporation should be.

This is a far more defensible position. Nevertheless, the switch from using *Dodge v. Ford* as a source of positive legal authority to using *Dodge v. Ford* as a source of normative guidance carries its own hazards. Most obviously, it begs the fundamental question of what the proper purpose of the corporation should be.

It is not enough to state that *Dodge v. Ford* represents an important perspective on corporate purpose simply because many people believe it represents an important perspective on corporate purpose. This argument borders on tautology (that is, “*Dodge v. Ford* is influential because people think *Dodge v. Ford* is influential”). Perhaps many people do share the Michigan Supreme Court’s view that it is desirable for corporations to pursue only profits for shareholders. But why do they believe this is desirable?

At least until fairly recently, many corporate experts found the answer to this question in economic theory. Not too long ago, it was conventional economic wisdom that the shareholders in a corporation are the sole residual claimants in the firm, meaning shareholders are entitled to all the “residual” profits left over after the firm has met its fixed contractual obligations to employees, customers, and creditors. This assumption suggests that corporations are run best when they are run for shareholders’ benefit alone, because if other corporate stakeholders’ interests are fixed by their contracts, maximizing the shareholders’ residual claim means maximizing the total social value of the firm.⁴⁴

Time has been unkind to this perspective. Advances in economic theory have made clear that shareholders generally are not, and probably cannot be, the sole residual claimants in firms. For example, modern options theory teaches that business risk that increases the expected value of the equity interest in a corporation must simultaneously reduce the supposedly “fixed” value of creditors’ interests.⁴⁵ Another branch of the economic literature focuses on the contracting problems that surround specific investment in “team production,” suggesting how a legal rule requiring corporate directors

44. See Stout, *supra* note 4, at 1192–95 (critiquing the residual claimants argument for shareholder primacy).

45. See Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 411–14 (2001). See generally Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999).

to maximize shareholder wealth ex post might well have the perverse effect of reducing shareholder wealth over time by discouraging non-shareholder groups from making specific investments in corporations ex ante.⁴⁶ Yet a third economic concept that undermines the wisdom of shareholder wealth maximization is the idea of externalities: when the pursuit of shareholder profits imposes greater costs on third parties (for instance, customers, employees, or the environment) that are not fully constrained by law, shareholder wealth maximization becomes undesirable, at least from a social perspective.⁴⁷

Finally, it is becoming increasingly well-understood that when a firm has more than one shareholder, the very idea of “shareholder wealth” becomes incoherent.⁴⁸ Different shareholders have different investment time frames, different tax concerns, different attitudes toward firm-level risk due to different levels of diversification, different interests in other investments that might be affected by corporate activities, and different views about the extent to which they are willing to sacrifice corporate profits to promote broader social interests, such as a clean environment or good wages for workers. These and other schisms ensure that there is no single, uniform measure of shareholder “wealth” to be “maximized.”

Accordingly, most contemporary experts understand that economic theory alone does not permit us to safely assume that corporations are run best when they are run according to the principle of shareholder wealth maximization. Not only is *Dodge v. Ford* bad law from a positive perspective, but it is also bad law from a normative perspective. This gives rise to the question of how to explain *Dodge v. Ford*’s enduring popularity.

V. ON THE PUZZLING SURVIVAL OF *DODGE V. FORD*

Simple inertia may provide an answer, to some extent. Corporate law casebooks have included excerpts from *Dodge v. Ford* for generations, and it would take a certain degree of boldness to depart from the tradition. But there is more going on here than inertia. Casebooks change, but *Dodge v. Ford* remains. This suggests *Dodge v. Ford* has achieved a privileged position in the

46. See Blair & Stout, *supra* note 30; Margaret M. Blair & Lynn A. Stout, *Specific Investment and Corporate Law*, 7 EUR. BUS. ORG. L. REV. 473 (2006).

47. See Elhauge, *supra* note 17, at 738–56.

48. See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA. L. REV. 561 (2006).

legal canon, not because it accurately captures the law (as we have seen, it does not) or because it provides good normative guidance (again, we have seen it does not), but because it serves law professors' needs.

In particular, *Dodge v. Ford* serves professors' pressing need for a simple answer to the question of what corporations do. Law professors' desire for a simple answer to this question can be analogized to that of a parent confronted by a young son or daughter who innocently asks, "Where do babies come from?" The true answer is difficult and complex and can lead to further questions about details of the process that may lie beyond the parent's knowledge or comfort level. It is easy to understand why many parents faced with this situation squirm uncomfortably and default to charming fables of cabbages and storks. Similarly, professors are regularly confronted by eager law students who innocently ask, "What do corporations do?" It is easy to understand why professors are tempted to default to *Dodge v. Ford* and its charming and easily understood fable of shareholder wealth maximization.

After all, explaining the true purpose of corporations is even more challenging and uncertain than explaining reproduction. From a positive perspective, public corporations are extraordinarily intricate institutions that pursue complex, large-scale projects over periods of years or even decades. They have several directors, dozens of executives, hundreds or thousands of employees, thousands or hundreds of thousands of shareholders, and possibly millions of customers. Corporations resemble political nation-states with multiple constituencies that have different and conflicting interests, responsibilities, obligations, and powers. Indeed, the very largest corporations (such as Wal-Mart, ExxonMobil, or Microsoft) have greater economic power than many nation-states do. These are not institutions whose behavior can be accurately captured in a sound bite.

The problem of explaining proper corporate purpose is just as off-putting from a normative perspective. Even the seemingly simple directive to "maximize shareholder wealth" becomes far less simple and perhaps incoherent in a public firm with many shareholders with different investment time frames, tax concerns, outside investments, levels of diversification, and attitudes toward corporate social responsibility. The normative question of what corporations ought to do becomes even more daunting when the answer involves discussions of avoiding externalities, maximizing the value of returns to multiple residual claimants, and encouraging specific investment in team production.

Faced with this reality, it is entirely understandable why a legal instructor or legal scholar called upon to discuss the question of corporate purpose might be tempted to teach or cite *Dodge v. Ford* in reply. Despite its infirmities,

Dodge v. Ford at least offers an answer to the question of corporate purpose that is simple, easy to understand, and capable of being communicated in less than ten minutes or ten pages. It is this simplicity that has allowed *Dodge v. Ford* to survive over the decades and to keep a place—however undeserved—in the canon of corporate law.

CONCLUSION

Simplicity is not always a virtue. In particular, simplicity is not a virtue when it leads to misunderstanding and mistake.

It might be perfectly fine for a Midwestern farmer to believe the world is flat. Although this simple model of the world is inaccurate, it is easy to understand and apply, and its inaccuracy is of no consequence for someone who travels only rarely and in short distances. A simple model of a flat world, however, might prove catastrophically inaccurate for a ship captain attempting to navigate from one continent to another. For the ship captain, a more complicated model that acknowledges the globe's spherical shape is essential to avoid disaster.

When it comes to corporations, lawyers are ship captains. Corporations are purely legal creatures, without flesh, blood, or bone. Their existence and behavior is determined by a web of legal rules found in corporate charters and bylaws, state corporate case law and statutes, private contracts, and a host of federal and state regulations. For lawyers, an accurate and detailed understanding of the corporate entity and its purpose is just as essential to success as an accurate understanding of geography and navigation is to a ship captain, or an accurate and detailed understanding of brain anatomy and function is to a neurosurgeon.

This is why lawyers, and especially law professors, should resist the siren song of *Dodge v. Ford*. We are not in the business of imparting fables, however charming. We are in the business of instructing clients and students in the realities of the corporate form. Corporations seek profits for shareholders, but they seek others things, as well, including specific investment, stakeholder benefits, and their own continued existence. Teaching *Dodge v. Ford* as anything but an example of judicial mistake obstructs understanding of this reality.

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A CLOSE READ OF AN EXCELLENT COMMENTARY ON *DODGE v. FORD*

Jonathan R. Macey†

INTRODUCTION	177
I. WHY NOBODY DOES ANYTHING ABOUT <i>DODGE v. FORD</i>	180
II. AN ETHICAL PERSPECTIVE: HOW TO ADVISE THE CLIENT	181
III. RESIDUAL CLAIMS AND PROFIT MAXIMIZATION.....	184
CONCLUSION.....	189

INTRODUCTION

IN her delightful and provocative essay, *Why We Should Stop Teaching Dodge v. Ford*,¹ Professor Lynn Stout manages simultaneously to make too much and too little of the famous decision thwarting Henry Ford's apparent effort to steer the powerful automobile company he controlled away from the pursuit of profit maximization as the single-minded purpose of the corporation.

Professor Stout makes too much of the case when she asserts that “[m]uch of the credit, or perhaps more accurately the blame, for this state of affairs can be laid at the door of . . . the 1919 Michigan Supreme Court decision in *Dodge v. Ford Motor Company*.”² This is wrong, since the Michigan

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1. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. BUS. REV. 163 (2008).

2. *Id.* at 164 (citing *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919)).

Supreme Court is merely the messenger here. As Professor Stout rightly points out, the Michigan Supreme Court has not innovated much in the world of corporate governance,³ and this case is no exception. The court certainly cannot rightly be credited (or, if Professor Stout is to be believed, blamed) for *inventing* the idea that the purpose of the public corporation is to maximize value for shareholders.

Professor Stout makes too little of the case with her claim that the opinion is “a mistake, a judicial ‘sport,’ a doctrinal oddity largely irrelevant to corporate law and practice.”⁴ The case is not a doctrinal oddity. *Dodge v. Ford* still has legal effect, and is an accurate statement of the form, if not the substance, of the current law that describes the fundamental purpose of the corporation. By way of illustration, the American Law Institute’s (“ALI”) *Principles of Corporate Governance* (“*Principles*”),⁵ considered a significant, if not controlling, source of doctrinal authority, are consistent with *Dodge v. Ford*’s core lesson that corporate officers and directors have a duty to manage the corporation for the purpose of maximizing profits for the benefit of shareholders. Specifically, section 2.01 of the *Principles* makes clear that “a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.”⁶

Significantly, the *Principles* specify that the goal of the corporation is shareholder wealth maximization. According to Professor Mel Eisenberg, Reporter for the ALI’s Principles of Corporate Governance Project, shareholder wealth maximization is used because “the market is usually more accurate” and is less susceptible to manipulation than other measures of corporate performance.⁷ Moreover, the ALI expressly emphasizes shareholder wealth rather than corporate wealth, and specifically excludes labor interests as something that should be maximized, contrary to Professor Stout’s apparent preferences on this matter.⁸

The *Principles* contain only three rather minor exceptions to the shareholder wealth maximization norm. Corporations can ignore shareholder wealth maximization in order to: (1) comply with the law; (2) make charitable

3. *Id.* at 167 (citing Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002)).

4. *Id.* at 166.

5. PRINCIPLES OF CORPORATE GOVERNANCE (1994) [hereinafter PRINCIPLES].

6. *Id.* § 2.01.

7. Symposium, Waseda Institute for Corporation Law and Society, *A Talk with Professor Eisenberg* 21, http://www.21coe-win-cls.org/english/activity/Eisenberg_e.pdf (last visited Apr. 7, 2008).

8. *See id.*

contributions; and (3) devote a “reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.”⁹ In other words, the only exceptions permitted to the shareholder wealth maximization norm are those necessary to ensure that corporations be given sufficient latitude to act like responsible community members by complying with the law and supporting charities and other worthy causes.

Professor Stout makes the observation that “[a] large majority of state [corporation] codes contain so-called other-constituency provisions that explicitly authorize corporate boards to consider the interests of not just shareholders, but also employees, customers, creditors, and the community, in making business decisions.”¹⁰ Professor Stout makes much too much of this corporate governance factoid. For the sake of completeness, she should have pointed out that these statutes cannot rationally be construed to permit managers to benefit non-shareholder constituencies at the expense of shareholders. Rather, these statutes are mere tie-breakers, allowing managers to take the interests of non-shareholder constituencies into account when doing so does not harm shareholders in any demonstrable way.

In this Essay, first I will examine in a bit more detail Professor Stout’s claim that corporations have some purpose other than profit maximization. Next, I will argue that though she is wrong on the legal doctrine, her argument contains only a minor, essentially semantic error that reflects a modest bit of confusion about the legal landscape.

Nevertheless, Professor Stout’s excellent essay captures two very important points about corporate law. First, because the corporation is a contract-based form of business organization, maximizing shareholder gain is only a default rule. Shareholders could opt out of this goal if they so desired. Shareholders, however, have indicated very little, if any, propensity to alter the application of the default rule that the public companies in which they invest should do strive to maximize profits on their behalf.

The second important point captured by Professor Stout’s essay is that *Dodge v. Ford* is interesting not because it establishes the proposition that directors should maximize shareholder wealth as a matter of law, but rather as “a normative discourse on what many believe the proper purpose of a well-functioning corporation should be.”¹¹ This observation is meaningful and important, but incomplete. Professor Stout’s assertion that *Dodge v. Ford* is a mere normative description of what corporate law ought to be, rather than a

9. PRINCIPLES, *supra* note 5, § 2.01.

10. Stout, *supra* note 1, at 169.

11. *Id.* at 173.

positive account of what corporate law actually is, does not account for the inconvenient fact that the shareholder maximization ideal actually drives the holding and is not mere dicta.

Still, Professor Stout invokes an extremely important truth: there are no cases other than *Dodge v. Ford* that actually operationalize the rule that corporations must maximize profits. The goal of profit maximization is to corporate law what observations about the weather are in ordinary conversation. Everybody talks about it, including judges, but with the lone exception of *Dodge v. Ford*, nobody actually does anything about it.

Next, I will expound on the implications of the fact that shareholder wealth maximization is widely accepted at the level of rhetoric but largely ignored as a matter of policy implementation. In the following section, I will explain why *Dodge v. Ford* is generally ignored. I will then discuss what I believe is the most interesting aspect of *Dodge v. Ford*: the implications of the case from an ethical perspective. Here, I will make the radical and irreverent assertion that the reason we have never seen, and in all probability will never see, another case quite like *Dodge v. Ford* is because CEOs who testify in depositions and trials are better coached and more willing to dissemble than Henry Ford was. If other CEOs actually told the truth about how they put their own private interests ahead of those of the shareholders, the case might not stand in such splendid isolation.

In the final section, I will take issue with Professor Stout's assertion that advances in economic thinking have made it clear that shareholders are not the sole residual claimants in the firm, as well as its implication that corporate managers should be free to maximize the wealth of all of the corporation's constituencies and not just the wealth of the shareholders.

I. WHY NOBODY DOES ANYTHING ABOUT *DODGE V. FORD*

Maximizing value for shareholders is difficult to do. There is no simple algorithm, formula, or rule that managers can employ to determine what corporate strategy will maximize returns for shareholders. Competition is fierce. The world changes quickly. Even extremely dedicated and able managers preside over business ventures that fail. A strategy that leads to great success in one venture may result in financial catastrophe in another venture. The world of business is more than uncertain: it is chaotic and unpredictable.

Thus even though I believe, contrary to Professor Stout, that corporate law requires directors to maximize shareholder value, I also recognize that it simply is not possible or practical for courts to discern ex post when a

company is maximizing value for shareholders and when the officers and directors are only pretending to do so.

Shareholder wealth maximization, however, is still at least the law on the books, if not in practice. It is the law, just as it is the law that cars should not drive more than fifty-five miles per hour on Connecticut's Merritt Parkway. The speed limit is clearly posted and well understood. In reality, however, it is extremely rare to locate a car traveling at less than seventy miles per hour, and eighty miles per hour is closer to the norm. I presume that Professor Stout would agree with me about what the law says with respect to the speed limit on the Merritt Parkway.

The lack of any apparent means to enforce the de jure speed limit on the Merritt Parkway is largely due to the fact that the terrain makes it extremely difficult to set up speed traps. This, in turn, makes it difficult for the police to detect wrongdoing. The same is true for the rule of corporate law that corporate fiduciaries are obligated to maximize profits for shareholders. The law is clear. It is not merely a "normative discourse," as Professor Stout argues.¹² The problem is not the lack of clarity of the rule. The problem is lack of enforceability.

The enforceability problem is exacerbated by hindsight bias. When a company fails (or simply has deeply disappointed shareholders), it will inevitably appear that managers were not acting in the shareholders' interests, even if they were. In fact, because shareholders are residual claimants who may hold fully diversified portfolios of securities, maximizing profit for shareholders often requires significant risk-taking. Thus, ironically, companies that are engaged in shareholder wealth-maximizing, risk-taking activities may wind up in financial distress. On the other hand, companies that are pursuing strategies that primarily serve the interests of workers, such as expanding only to increase market share or acquiring other companies in unrelated fields to reduce risk, may never become insolvent. However, these strategies often do not maximize value for shareholders.

II. AN ETHICAL PERSPECTIVE: HOW TO ADVISE THE CLIENT

The prior discussion raises an interesting question about *Dodge v. Ford* itself. If I am correct that the profit maximization rule is so difficult to enforce as a practical matter, then how did the court in *Dodge v. Ford* manage to enforce it? After all, as Professor Stout accurately (though perhaps a bit bluntly) observes, unlike the Delaware courts, the Michigan courts are not

12. See *id.*

exactly known for their expertise or sophistication in matters of corporate law.¹³ Michigan is indeed “a distant also-ran in the race between and among the states for influence in corporate law.”¹⁴ This is true not only in comparison with Delaware, but even in comparison with other states, such as California, New York, Massachusetts, Maryland, and Virginia.

The reason that the Michigan Supreme Court held against Mr. Ford is simple. Ford gave them no choice when he asserted that he was pursuing some strategy other than wealth maximization for shareholders. As Professor Stout observes, Henry Ford did not acknowledge the validity of the minority shareholders’ claim that the corporation had fiduciary obligations to them. Rather, Ford “argu[ed] that he preferred to use the corporation’s money to build cheaper, better cars, and to pay better wages.”¹⁵

Henry Ford’s frank admission raises an important question. Where was Henry Ford’s lawyer when Mr. Ford was losing the case for himself by claiming no hint of an obligation to maximize shareholder value? Instead, Mr. Ford testified that he did not plan to make any dividend payments to the shareholders, convincing the court that the CEO had “the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give.”¹⁶

A fascinating thing about *Dodge v. Ford*, and a compelling reason why it is an excellent teaching vehicle, is how easy it would have been for Mr. Ford to have won this case. Suppose Mr. Ford simply had gotten on the stand and testified (contrary to the truth, apparently) that he was keenly interested in maximizing value for shareholders. Suppose further that Mr. Ford took the position (as many CEOs have done) that, in his view, the best way to benefit the shareholders was to increase the market share of the business, and that reducing the price of cars was critical to his strategy of expanding the company. Also suppose that Mr. Ford took the eminently reasonable position that the company required loyal, experienced, and skilled workers to succeed, and that his plan to raise wages was necessary to accomplish this end.

In sum, suppose that Mr. Ford simply had testified that his plans were consistent with the goal of profit maximization for shareholders. As the court observed in *Dodge v. Ford*, while corporations are “organized and carried on primarily for the benefit of the stockholders[,] . . . [t]he discretion of the directors is to be exercised in the choice of means to attain that end”¹⁷ In

13. See *id.* at 166–67.

14. *Id.* at 167.

15. *Id.* at 165 (paraphrasing *Dodge v. Ford*, 170 N.W. at 671).

16. *Dodge v. Ford*, 170 N.W. at 683.

17. *Id.* at 684.

other words, *Dodge v. Ford* itself stands for the proposition that as long as the goal of the corporation is profit maximization, the directors have virtually unfettered discretion to choose the strategies to be employed to that end, which the court described aptly as “the infinite details of business.”¹⁸ The court specifically noted that the issues in the case, including (but presumably not limited to) employee wages, working hours and conditions, and product pricing are at the discretion of the directors.¹⁹ Consistent with common contemporary corporate practice, the court even suggests that declining to distribute dividends is fine, so long as the retained earnings are used to benefit the stockholders and not devoted to “other purposes.”²⁰

In other words, what mattered in this case was not what Mr. Ford did, but what he said he was doing. Mr. Ford said that he was putting the interests of other constituents ahead of the interests of the shareholders. If he had *lied* and said that his motivation was to maximize profits rather than to benefit workers and other non-shareholder constituencies, he would have won the case. The court acknowledges that the problem in this case was Mr. Ford’s frank articulation of the motives for his behavior and that of his directors, as he had attempted to argue that directors’ motives are irrelevant, as long as their actions “are within their lawful powers.”²¹

The court did not dispute that the actions taken by the directors were within their lawful powers. The problem the court had was that the directors attempted to justify their actions by claiming that they were motivated by a desire to benefit some constituency other than the shareholders. If Henry Ford had decided to articulate a different, shareholder-centric motivation for his behavior, he would have prevailed in this litigation.

This raises the interesting question of how Mr. Ford’s attorneys might have better counseled their star witness. The rules of professional responsibility are clear. Lawyers have a duty to do everything possible to prevent a client from lying, and they must not knowingly call any witness who plans to lie while testifying.²² Lawyers who believe that a client is going to give untruthful testimony are required to take remedial measures, including disclosure to the tribunal if necessary, rather than permit such conduct in the proceeding.²³

Mr. Ford’s lawyers had a responsibility not to allow him to lie on the stand. They certainly had an ethical responsibility not to coach him to do so.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. MODEL RULES OF PROF’L CONDUCT R. 3.3(a)(3) (2003).

23. *Id.* at R. 3.3(b).

Thus, this case tells us something important about the practical ramifications of the rules of professional conduct, as they may well have been outcome-determinative. Unless Mr. Ford lied about the motivations for his actions, he would lose the case.

Suppose, however, that Mr. Ford's lawyers had said something like the following: "We cannot advise you to lie. In fact, our professional responsibilities as lawyers require that we insist that you tell the truth. Be aware, however, that if you insist on testifying that your motivations in formulating your dividend policy and other corporate strategies are to benefit your employees and society rather than your company's shareholders, you are going to lose this case. On the other hand, if you can honestly testify that you think that what you are doing is in the overall best interest of the Ford Motor Company and its shareholders, then you should say so, and you will be able to do as you please regarding salaries, expansion of production facilities, and product pricing. The plaintiffs will have no chance of winning this case if you testify that you are doing what you are doing to maximize value for your company's shareholders."

Mr. Ford, not being a complete idiot, would undoubtedly get the point if it was presented to him in this fashion, and undoubtedly it would have been. The more vexing question is whether Mr. Ford's lawyers should have advised Mr. Ford that the outcome of the case would depend on the way he characterized his own motives. This is one of the things that make *Dodge v. Ford* so intriguing. Because there is no sure way to tell what Mr. Ford's real motives were, it is impossible to know whether he was lying when he testified, and an unethical lawyer could have advised Mr. Ford to lie without fear of repercussion.

It would be wonderful to know what advice Mr. Ford's lawyers gave him before he testified so helpfully for the plaintiffs who were suing him. Perhaps this case represents the apogee of legal ethics in American law practice. Perhaps Mr. Ford was not told what the implications of his testimony might be. Or perhaps Mr. Ford was advised about the implications of his testimony, and, out of arrogance or pride, decided to tell the truth anyway, in spite of his lawyers. We will never know, but speculating certainly is fun.

III. RESIDUAL CLAIMS AND PROFIT MAXIMIZATION

Professor Stout challenges the proposition that shareholders are the sole residual claimants in the firm.²⁴ Professor Stout thinks that by showing that shareholders are not the sole residual claimants in a company, she has

24. See Stout, *supra* note 1, at 173.

somehow shown that profit maximization for shareholders is a bad idea. In my view, it is here that Professor Stout begins to err.

The basic problem is that Professor Stout's analysis reflects more than just a rejection of the goal of shareholder wealth maximization contained in *Dodge v. Ford* (and elsewhere, including the ALI's Corporate Governance Project and Delaware's corporate law jurisprudence). It also appears to reject, at least implicitly, the observation that the modern corporation is a nexus of contracts.²⁵ Because the firm is a voluntary organization in which relationships are characterized by the contracts that define the firm itself, it would seem that rights, obligations, and power within the firm should be allocated according to contract. Seen from this perspective, there is a simple explanation for what the firm does—or, perhaps more accurately, what the firm should do. The corporation acts (or should act) so as to perform its obligations under the myriad contracts it has with its various constituents.

At least to me, the default rule is clearly that the corporate contract calls for the firm to maximize value for shareholders consistent with its other obligations under the law, as well as to employees, suppliers, customers, and other firms and individuals with which the firm is in contractual privity. The goal of profit maximization for shareholders is the law, but it is only a default rule. If the shareholders and the other constituents of the corporate enterprise could agree on some other goal for the corporation, then the law clearly should not interfere. Thus, to the extent that *Dodge v. Ford* is articulating a default rule, I believe that the decision was and is correct. To the extent that *Dodge v. Ford* purports to reflect a mandatory rule, however, I agree with Professor Stout that the opinion is not a correct articulation of the law.

Professor Stout claims that “[n]ot too long ago, it was conventional economic wisdom that the shareholders in a corporation are the sole residual claimants in the firm, meaning that shareholders are entitled to all the ‘residual’ profits left over after the firm has met its fixed contractual obligations to employees, customers, and creditors.”²⁶ Professor Stout is right to observe that shareholders are not the only residual claimants in the firm. It would be impossible to prevent workers, customers, suppliers, and other constituencies (including local communities) from benefiting in many “residual” ways when the corporation flourishes, and to prevent these

25. For the origins of this concept, see Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. FIN. ECON.* 305, 310–11 (1976) (noting that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals).

26. Stout, *supra* note 1, at 173.

constituencies from being harmed when the corporation is in distress. Contracting parties often benefit in various ways when their counter-parties flourish and suffer when their counter-parties fail.

Thus, shareholders are not distinguished by being the only corporate constituents with residual claims to the profits of the firm. What distinguishes shareholders is that they are the only claimants to the cash flows of the firm whose *only* economic interests in the firm are residual. This, as Professors Easterbrook and Fischel pointed out long ago, explains a peculiar feature of corporate law that Professor Stout conveniently ignores: shareholders, as residual claimants, almost always have exclusive voting rights in the firm.²⁷

Professor Stout also goes on to claim that “modern options theory teaches that business risk that increases the expected value of the equity interest in a corporation must simultaneously reduce the supposedly ‘fixed’ value of creditors’ interests.”²⁸ This claim is more or less correct, subject to a couple of important qualifications. First, it is worth noting that under certain conditions, shifting to new projects can increase the value of shareholders’ interests without reducing the value of the creditors’ interests even where business risk increases.

For example, suppose that a firm with \$20 in debt is thinking of shifting from Project 1, which has an expected value of \$54, to investment 2, which also has an expected value of \$54. Project 1’s expected value of \$54 is based on the assumption that there is a 20% chance the firm will earn \$20, a 60% chance that the firm will earn \$50, and a 20% chance that the firm will earn \$100 during the relevant time frame.²⁹ Project 2 also has an expected value of \$54, based on the assumption that there is a 40% chance the firm will earn \$20, a 20% chance that the firm will earn \$50, and a 40% chance that the firm will earn \$90 during the relevant time frame.³⁰ Each of these projects provides an expected value of \$20 for the firm’s fixed claimants and \$34 for the firm’s equity investors.³¹

The risk of these two projects can be assessed by comparing the standard deviation of the two projects. Because the standard deviation of the second project (66.15) is higher than that of the first project (65.05), the shareholders might prefer the first project to the second, depending on a host of factors.

27. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983).

28. Stout, *supra* note 1, at 173.

29. $(.2 \times \$20) + (.6 \times \$50) + (.2 \times \$100) = \54 .

30. $(.4 \times \$20) + (.2 \times \$50) + (.4 \times \$90) = \54 .

31. With both projects creditors have a 100% chance of being repaid the funds that are owed to them. Project 1’s shareholders have an expected return of \$34, as $(.2 \times \$0) + (.6 \times \$30) + (.2 \times \$80) = \34 . Project 2’s shareholders also have an expected return of \$34, as $(.4 \times \$0) + (.2 \times \$30) + (.4 \times \$70) = \34 .

Corporate law provides no guidance as to which of these two projects should be selected, even where shareholder wealth maximization is the goal, because the second project offers both greater upside potential and greater risk to the shareholders. It is clear, however, that the choice between Project 1 and Project 2 is a matter of complete indifference to the firm's fixed claimants, because the creditors will be repaid in full regardless of which of the two projects is chosen.

Thus, contrary to Professor Stout's assertions, finance theory also teaches that increasing business risk does not always result in a diminution in the value of a firm's fixed claims. There are many business decisions that increase the value of a firm's equity claims without decreasing the value of the firm's fixed claims. For example, suppose that the firm is offered a third project. Pursuing this project also entails the firm selling \$20 in fixed claims, but this project has an expected value of \$58. Project 3's expected value of \$58 is based on the assumption that there is a 40% chance the firm will earn \$20, a 20% chance that the firm will earn \$50, and a 40% chance that the firm will earn \$100 during the relevant time frame.³² This project provides an expected value of \$20 for the firm's fixed claimants but a \$38 expected return for the firm's equity investors.³³

Just as the fixed claimants were indifferent between Project 1 and Project 2, they are also indifferent among the firm's choices of Project 3 or Projects 1 or 2. Professor Stout offers no reason for why a rational fixed claimant would pay anything for the rights to participate in the decision about which of these three projects to pursue.

Of course, Professor Stout might respond to this criticism by pointing out that there are plenty of other projects that the firm might pursue that transfer wealth from the fixed claimants to the equity claimants by increasing the standard deviation of the expected returns in such a way as to lower the probability that the creditors' claims will be repaid in full. This is true. Creditors, however, can fully protect themselves from this risk by contract. Not only can creditors refuse to extend credit, or charge very high rates of interest to compensate themselves for the perceived risks of an investment, they can also bargain for protections such as the conversion rights, which allow them to convert their claims from fixed claims to equity claims, or put option rights, which permit them to sell their fixed claims back to the firm under contractually specified conditions.

32. $(.4 \times \$20) + (.2 \times \$50) + (.4 \times \$100) = \58 .

33. Project 3's creditors have a 100% chance of being repaid the funds that are owed to them. Project 3's shareholders have an expected return of \$38, as $(.2 \times \$0) + (.2 \times \$30) + (.4 \times \$80) = \38 .

In other words, there are business decisions that simply do not involve the fixed claimants, because there are business decisions in which the fixed claimants do not have a stake. Because shareholders' only claims are residual claims, all decisions made by the firm that affect either risk or return affect the shareholders.

Most tellingly, while Professor Stout recognizes that business risks that increase the expected value of the equity interests may reduce the value of a firm's fixed claims, she does not appear to recognize that the reverse is true. Business risks that increase the value of a firm's fixed claims (that is, by reducing risk) reduce the value of a firm's equity claims. For example, suppose that a firm embarked on Project 4, in which there was a 90% chance that the firm would make \$100 during the relevant time period, but a 10% chance that the firm would go bankrupt and be able to return only half of the \$20 owed to creditors. This investment would have an expected value of \$91, including \$72 for the shareholders and \$19 for the creditors.³⁴ Suppose further that the firm was choosing between this project and an alternative Project 5 with a 100% chance of returning \$50 at the end of the relevant investment period. This alternative project would have a value of \$20 for creditors but only \$30 for the shareholders.³⁵

It is true that if equity claimants gained control of a company that was pursuing the project with the \$50 expected value (100% chance of \$50), they would quickly shift the firm's resources to the alternative project that reduced the value of the fixed claims by nine percent, or from \$100 to \$91. It is also true, however, that if the fixed claimants somehow obtained control of a company that was pursuing the project with the \$91 expected value, they would quickly steer the firm in the direction of the project with the \$50 expected value, which would increase the expected value of their claims from \$19 to \$20.

Thus, what we actually know by combining corporate finance with the Coase Theorem is the following. First, one cannot determine whether fixed claimants' interests are being sacrificed for the benefit of equity claimants or whether the reverse is happening unless one knows the baseline understanding of the parties when they made their initial investments. If the parties invested thinking that the firm would pursue Project 4, a shift to Project 5 would benefit the firm's shareholders and harm the firm's fixed claimants. On the other hand, if the parties invested thinking that the firm

34. $(.1 \times \$10) + (.9 \times \$100) = \$91$. Project 4 will have an expected return of \$19 for creditors, as $(.1 \times \$10) + (.9 \times \$20) + (.4 \times \$80) = \19 . It will have an expected return of \$72 for shareholders, as $(.1 \times \$0) + (.9 \times 80) = \72 .

35. $1.0 \times \$50 = \50 . This Project will have an expected return of \$20 for creditors, as $1.0 \times \$20 = \20 . It will have an expected return of \$30 for shareholders, as $1.0 \times \$30 = \30 .

would pursue Project 5, a shift to Project 4 would benefit the firm's fixed claimants and harm the firm's shareholders. Without knowing the original understanding of the parties, we simply do not know who is ripping off whom.

Second, from a societal perspective, legal rules should be organized to (a) cause the firm to internalize fully the costs of its operations; and, having done that, (b) pursue the projects that maximize the overall value of the firm. Thus, as between Project 4 and Project 5, the firm clearly should pursue Project 4, which maximizes economic output and societal wealth. Fixed claimants can easily be compensated for moving from Project 5 to Project 4, because Project 5 is only worth \$50 (\$20 for the fixed claimants and \$30 for the shareholders), while Project 4 is worth \$91 (\$19 for the fixed claimants and \$72 for the shareholders). Thus, both classes of claimants, fixed and residual, could be made better off by a move from Project 5 to Project 4, accompanied by a side-payment from the equity claimants to the fixed claimants of some amount greater than \$1 but less than \$42.³⁶

Third, while fixed claimants may sometimes have an incentive to maximize the value of the firm, shareholders, as the residual claimants, always have the incentive to maximize the value of the firm. Thus, shareholders, not creditors, should be put in charge of making the marginal decisions that affect the overall value of the firm (subject, of course, to the ability of the fixed claimants to protect themselves through the contracting process).

These are the default rules in corporate law, subject to modification by the various participants in the corporate enterprise, of course. The single, uniform measure of wealth to be maximized is the overall value of the firm, and the shareholders are in the best position to do this, subject to the possibility of making side bargains with other constituencies.

CONCLUSION

As a narrow legal matter, *Dodge v. Ford* stands for the proposition that if a CEO testifies that he and his board were engaging in certain actions for reasons unrelated to maximizing shareholder value, they would lose a lawsuit challenging those actions, especially if they exhibited indifference to the interests of those shareholders.³⁷ On the other hand, if the CEO engaged in

36. On the other hand, there is no way for the fixed claimants to pay the shareholders to move from Project 4 to Project 5, because the gains to the fixed claimants (\$1) are much smaller than the losses to the equity claimants (\$61).

37. For a modern version of *Dodge v. Ford*, see *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986), another case whose outcome turns on the CEO's motivation for taking a particular corporate action and in which the CEO lost merely because he

precisely the same actions but claimed that doing so was for the purpose of maximizing shareholder value, they would win the same lawsuit.

In other words, I agree with Professor Stout's essential claim that the corporate law principle of wealth maximization for shareholders as articulated and enforced in *Dodge v. Ford* is a rule that is hardly ever enforced by courts. Professor Stout and I disagree, however, about the reason why this is the case. Professor Stout attributes the lack of other cases like *Dodge v. Ford* to the fact that the legal rule articulated in the case is not good law.³⁸ Perhaps this is true, but I do not think so.

In my view, the holding in *Dodge v. Ford* is attributable to the fact that the rule of wealth maximization for shareholders is virtually impossible to enforce as a practical matter. The rule is aspirational, except in odd cases. As long as corporate directors and CEOs *claim* to be maximizing profits for shareholders, they will be taken at their word, because it is impossible to refute these corporate officials' self-serving assertions about their motives. Nonetheless, fully understanding the futility of the holding in *Dodge v. Ford* can provide an interesting and important lesson about the ability of corporate law to provide much of value to investors.

Dodge v. Ford is a great metaphor for the complex and gargantuan mass of corporate law that has been piling up on the legal landscape at both the state and federal level since the beginning of the twentieth century. While these rules undoubtedly enrich the platoons of corporate lawyers who plan for and litigate with corporations, they do not do much for shareholders.

implied (indeed expressed) "threats" to oppose certain transactions that "could be determined by the board to be in the best interests of all the stockholders." *Id.* at 278.

38. See Stout, *supra* note 1, at 165.