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

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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

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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.

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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

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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.

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32. (.4 × $20) + (.2 × $50) + (.4 × $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 × $0) + (.2 × $30) + (.4 × $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 × $10) + (.9 × $100) = $91. Project 4 will have an expected return of $19 for creditors, as (.1 × $10) + (.9 × $20) + (.4 × $80) = $19. It will have an expected return of $72 for shareholders, as (.1 × $0) + (.9 × 80) = $72.

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

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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.