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Law

PROFIT MAXIMISATION vs. WEALTH MAXIMISATION

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ABSTRACT The paper draws a distinction between profit maximisation and shareholder maximisation, and highlights which would be the better approach to be followed by companies for their smooth functioning. The scope of this paper is restricted to the finding of whether wealth maximisation is an efficient theory to be followed by a company for its growth rather than profit maximisation or if the vice-versa is to be applicable. It's stated that directors, while exercising their duties, must exercise them in the best interest of the company, in good faith and should be loyal to the company at all times. There is an interest for the company to give good returns to shareholders who risk their assets to provide company capital.

The paper shall be restricted to mainly 2 parts where the first part shall highlight and emphasise on wealth maximization and second part shall deal with profit maximization. The paper shall finally be concluded with suggestions and recommendations which directors may resort to, for resolving the conflict of between the shareholders and stakeholders.

KEYWORDS : Profit Maximisation,Shareholder wealth Maximisation, Stakeholders.

INTRODUCTION

Shareholder wealth maximization is a norm[1] of corporate governance that encourages a firm's board of directors to implement all major decisions such as compensation policy, new investments, dividend policy, strategic direction, and corporate strategy with only the interests of shareholders in mind.[2] There is strong support for the idea that shareholder wealth maximization should be the primary norm underlying the governance of for-profit corporations. The corporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders.[3]

Shareholder wealth maximization is also prominent in "theoretical" models of corporate law. For example, in a principal–agent model of corporate law, shareholders are viewed as the owners of the corporation and the board of directors and executive officers are their agents: Enterprises choose the corporate form over other types of business organization to realize the gains produced by the separation of ownership from control. This separation enables a specialization of function: Shareholders supply capital and bear the risk that comes with their claim to the firm's residual product, and managers act as shareholders' agents, using their expertise to deploy the principals' capital in various ventures.

Directors' duties were originally articulated by the courts as a matter of common law.[4] The Michigan Supreme Court in ***Dodge v. Ford***[5], stated: "*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 directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself*"

If the law does not obligate management to focus exclusively on the maximization of the stockholders' profits, there is nonetheless a mechanism which ensures that management's conduct is at least somewhat responsive to shareholders' wishes: the stock market. If a corporation is managed in a way that is congenial to current and potential shareholders, the result will be a higher stock price. If management departs from what shareholders want, the stock price will suffer and management will be punished either through the operation of equity-based compensation, or, in more extreme cases, because a depressed stock price makes the corporation a takeover target.

One area of increasing confusion for directors is therefore finding the 'balance' between maximising long term profit for shareholders and creating benefits for stakeholders such as employees, customers and the wider community.

The conflict between maximising shareholder value verses stakeholder goals is one that goes to the very heart of the role of directors within the modern marketplace. On the one hand, since shareholders 'own' the corporation, it seems natural that their interests should be at the forefront of directors' minds. Alternatively, since corporations have an impact on people other than shareholders (such as employees, customers, suppliers and the broader community), there is a view that directors should also consider these interests whenever deciding on a course of action.[6]

The paper will thereby give an overview on both wealth maximisation and profit maximisation and will conclude on how to balance conflicting interests.

OBJECTIVES

- **'Enlightened shareholders value'** where shareholders interest should prevail which is the inclusive approach
- Secondly, directors should balance potentially conflicting interests, without giving automatic priority to shareholders.

This shall promote fair and transparent functioning of the company taking into account the interests and needs of the various classes of the society.

HYPOTHESIS

Wealth maximisation is considered a better concept than profit maximisation as it takes into consideration the interests of a larger portion of the society i.e. stakeholders who have an equal impact on the functioning of the company just like the shareholders.

RESEARCH QUESTION

Which is a better approach: Profit Maximisation or Wealth Maximisation to be followed by directors of a company?

PROFIT MAXIMISATION OR WEALTH MAXIMISATION: BETTER ONE?

On the conceptual plane, the argument for profit maximization is based on the notion that the shareholders, as owners of the corporation, are entitled to expect that their assets would be deployed to this end. The only "social responsibility" of business is "to make as much money for their stockholders as possible,[7] for reasons that include the fact that "the corporation is an instrument of the stockholders who own it."[8]

It is important to recognize that the notion that shareholders are the "owners" of the corporation cuts both ways in the debate about corporate social responsibility and, in particular, can be invoked in support of a demand for responsibility by the shareholders themselves.

The arguments from ownership correspond to a theory of corporate personality known as the "aggregate" theory. According to the aggregate theory, the corporation is to be regarded as an extension of its shareholders,[9] corporate property is the property of the shareholders in special form, and corporate acts are acts on behalf of the shareholders. Corporate personality is, on this view, merely a fiction adopted by the law for convenience.

It is argued, for example, that the interests of shareholders and non-shareholders are often aligned,"[10] both because in a profitable corporation the claims of creditors, employees and other non-shareholders are more secure[11] and because cooperation is usually a profit-enhancing strategy when there are unlimited future periods.[12] Moreover, as noted above, the demands of consumers and business partners for corporate social responsibility will often provide a profit-oriented reason for the corporation to act responsibly. If all else fails, external regulation-including legal liability-can be used as a method of aligning the interests of shareholders and the requirements of social responsibility."[13]

Since the middle of the last century, economists have emerged as the leading theorists of the corporation, and the "nexus of contracts," or "contractarian" conception has become the dominant metaphor among academic corporate lawyers.[14] The contractarian conception focuses on the microeconomic aspects of the arrangements entered into between the various participants in the corporation shareholders, other investors, the board of directors, management, employees, suppliers, customers, and so on. The corporation is merely the "nexus" of all of these voluntary arrangements, or "contracts," as the legal economists refer to them. The nexus-of-contracts conception has two ambitions: to interpret the conduct of corporate participants and to provide a normative justification for corporate law.

Shareholder profit maximization is not an essential feature of a contractual relationship. It is not even an essential feature of a contract of investment. It is sufficient that when the corporation harms third parties, it does so for the purpose of earning profits for the stockholders, and that shareholders invest willingly, thereby voluntarily assuming their role as the beneficiaries of the corporation's activities. As such, they incur some responsibility for the impact of those activities.

Shareholders employ directors and officers to run the company on their behalf and therefore these agents' goal should be shareholder wealth maximization. The results of corporate decisions that do not focus on shareholder wealth maximization are referred to as agency costs.[15] Hence, corporate law should be structured to minimize such costs.[16]

Alternatively, under a nexus of contracts or "contractarian" model of the corporation, shareholders are not perceived to own the corporation but are considered to be only one of many parties that contract with the corporation.[17] Nevertheless, the board of directors still has fiduciary duties to maximize shareholders wealth.[18]

A board of directors has a legal obligation to manage according to shareholder interests.[19] Such a legal obligation is enforced through the fiduciary duties of care and loyalty that a board of directors and its executive management owes to their shareholders.[20]

This is a result of the hypothetical bargain struck between shareholders and the other parties in the corporation.[21] In this hypothetical bargain, shareholders would argue that since they are the least contractually protected versus other parties, they deserve shareholder wealth maximization as the gap filler in their corporate contract.[22]

In the models just described, a board of directors has a legal obligation to manage according to shareholder interests. The authority of the board of directors to manage the corporation can be modified by provision in a corporate charter.

Directors, however, are subject to fiduciary duties whose ultimate goal is commonly articulated as the maximization of firm value (as opposed to social welfare).[23] Moreover, these duties are frequently articulated as requiring directors to act in the best interests of the corporation through maximizing returns to the residual claimants: the common stockholders.[24]

The best model a company can follow is entity maximisation and sustainability model which focuses on the company as an entity or enterprise, that is, the company is an institution in its own right. Maximisation of the company's wealth is not always measured by how much profit has been made by the company in a given period. At the same time as maximising wealth, directors have to ensure that the company survives-that is, it does not fall into an insolvent position from which it cannot escape, but is able to stay afloat and pursue the development of the company's position.

The model thus has two elements to it: maximising the entity's wealth and contemporaneously ensuring the entity's financial sustainability. The directors will owe a fiduciary duty to the company as an entity, and, therefore, their duty is to act to promote its best interests. Undoubtedly, there is room for directors to act opportunistically or to shirk, but this is also the case with companies operating under shareholder primacy. Shareholder primacy prides itself as providing the best answers to the agency problem.

As against this, under the shareholder primacy approach the directors have a duty to act in the best interests of the company and this is taken, effectively, to mean the shareholders.[25] This duty involves focusing on maximising shareholder interests.

If directors fail to do so, they are in breach. Shareholders have been given the right for many years under common law to bring derivative actions against directors where they have breached their duties. Some have even said that this right is provided because the shareholders are perceived as the owners of the company.[26] The most frequently argued reason for granting shareholders the right to take action is that they are the residual claimants to the income generated by the company.[27]

CONCLUSION AND SUGGESTIONS

The creation and application of corporate law involves an enduring struggle to find the optimal amount of decision-making autonomy that should be provided to the board of directors. Such an optimal point will lead to the most efficient decision-making in the context of maximizing shareholder wealth. Statutory corporate law tries to achieve this optimal point by providing a large number of default rules and relatively few mandatory rules.

The entity maximisation and sustainability model provides that a company should be managed in such a way as to maximise the wealth of the company and ensure that it is sustained financially over the long term. It has been noted that providing an enforcement mechanism has been problematic for the stakeholder theory.

It focuses on the company as a separate legal entity and maintains that the objective of the company is to maximise the wealth of the entity as an entity and, at the same time, to ensure that the company is sustained financially. The theory involves directors endeavouring to increase the overall long-run market value of the company as a whole, taking into account the investment made by various people and groups. But it maintains that maximisation must be combined with aiming to ensure entity survival and feasible development. The theory values the broad range of people and groups who invest in the company and maintains that they should benefit from their investment. Undoubtedly, the directors, as in all models, play a critical role in this system, for they are seen as the guardians of the enterprise objectives, which are sustainability and growth; they have to determine what action is required to ensure that the company's wealth is maximised at the same time as securing that the company remains a viable going concern.

The prime difficulty in devising resolutions to the problem is that there are no hard and fast rules concerning how directors are to act and whose interests must be taken into account.

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