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On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)

Lynn A. Stout*

I. INTRODUCTION: BERLE AND MEANS AND THE PUBLIC CORPORATION

In their 1932 opus *The Modern Corporation and Public Property*, Adolf Berle and Gardiner Means famously documented the evolution of a new economic entity—the public corporation.¹ What made the public corporation “public,” of course, was that it had thousands or even hundreds of thousands of shareholders, none of whom owned more than a small fraction of outstanding shares. As a result, the public firm’s shareholders had little individual incentive to pay close attention to what was going on inside the firm, or even to vote. Dispersed shareholders were rationally apathetic. If they voted at all, they usually voted to approve whatever course of action was recommended by the company’s incumbent directors, including the re-election of the directors themselves.

The result, as Berle and Means put it, was a “separation of ownership and control” in public firms.²

[T]he position of ownership has changed from that of an active to that of a passive agent. In place of actual physical properties over which the owner could exercise direction and for which he was responsible, the owner now holds a piece of paper representing a set of rights and expectations with respect to an enterprise. But over the enterprise and over the physical property—the instruments of production—in which he has an interest, the owner has little control.³

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1. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (rev. ed. 1967).

2. *Id.* at 6. Berle and Means recognized that, as a legal matter, shareholders do not in fact own corporations, see *infra* Part IV, but rather have ownership of shares of stock, which are essentially contracts with the corporate entity that give shareholders only very limited rights, BERLE & MEANS, *supra* note 1, at 244–45, 305.

3. BERLE & MEANS, *supra* note 1, at 64.

Berle and Means concluded that "we have reached a condition in which the individual interest of the shareholder is definitely made subservient to the will of a controlling group of managers."⁴

Interestingly, Berle and Means were not terribly worried about this state of affairs. They recognized the possibility that entrenched managers might try to use their control over the corporate enterprise to serve themselves, a problem often described today as the "agency cost" problem.⁵ But they also believed there was an alternative to either a private company, where a single shareholder or small group of shareholders exercised real power over the board, and a public corporation, whose unaccountable managers indulged in "corporate plundering."⁶

As Berle and Means explained,

This third alternative offers a wholly new concept of corporate activity. Neither the claims of ownership nor those of control can stand against the paramount interests of the community. . . . Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of the profits from the owners of passive property . . . the interests of passive property owners would have to give way. . . . It is conceivable—indeed it seems almost essential if the corporate system is to survive—that the "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.⁷

II. THE MANAGERIALIST ERA

Murray Weidenbaum and Mark Jensen have described *The Modern Corporation and Public Property* as "one of those enduring classics that many cite but few read."⁸ This may explain why many contemporary experts still view as a problem the "separation of ownership and control" in public companies that Berle and Means merely documented. Most might be surprised to learn that Berle and Means themselves were not troubled by shareholder powerlessness in public firms. To the contrary, while they understood that shareholder weakness might lead to managerial self-dealing, they thought it more likely—"almost essential"—that

4. *Id.* at 244.

5. *Id.* at 7; see generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

6. BERLE & MEANS, *supra* note 1, at 311.

7. *Id.* at 312-13.

8. *Id.* at ix.

professional managers (Berle and Means's "technocrats") would run public firms in the interests of not just shareholders, but also employees, consumers, and the broader society.

History suggests that Berle and Means's 1932 prediction proved largely correct. For the next half-century, boards and executives of public corporations embraced a philosophy that has been called "managerial capitalism" or "managerialism."⁹ Rather than seeing themselves as mere agents of shareholders, corporate directors and professional executives—who usually worked for fixed fees and owned relatively little stock in the company—viewed themselves as stewards or trustees charged with guiding a vital social and economic institution in the interests of a wide range of beneficiaries.¹⁰ Certainly they looked out for investors' interests, but they looked out for the interests of employees, customers, and the nation as well.

The system was hardly perfect.¹¹ But the proof of the pudding is the tasting. Judged by that standard, managerial capitalism seemed to generate good results. American corporations dominated the global economy, producing innovative products for their consumers, secure jobs for their employees, and corporate tax revenues for their government. And—especially notable—they produced outstanding investment results for public shareholders. Between 1933 and 1976 (a period that includes the infamous bear market of 1973–1974),¹² shareholders who invested in the S&P 500 enjoyed inflation-adjusted compound average annual returns of 7.5%.¹³ This compares very favorably indeed with the sorts of returns shareholders have received more recently.¹⁴

In other words, managerial capitalism worked surprisingly well for dispersed and powerless shareholders. To understand why, it is important to recognize that while neither state nor federal law requires directors to use their corporate powers to maximize shareholder wealth, it does prevent them from using their powers to maximize their own.¹⁵ The doctrine known as the business judgment rule allows disinterested directors and

9. GERALD F. DAVIS, *MANAGED BY THE MARKETS: HOW FINANCE RE-SHAPED AMERICA* 63 (2009); see also ROBIN MARRIS, *THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM* (1964); Alfred D. Chandler, *The Emergence of Managerial Capitalism*, 58 *BUS. HIST. REV.* 473 (1984).

10. See, e.g., E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 *HARV. L. REV.* 1145 (1932).

11. See, e.g., JOHN KENNETH GALBRAITH, *THE NEW INDUSTRIAL STATE* (1967) (criticizing managerial capitalism as leading to excessive concentrations of power).

12. See *infra* text accompanying notes 22–23.

13. ROGER L. MARTIN, *FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL* 63 (2011).

14. See *infra* text accompanying notes 49–51.

15. See generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 *VA. L. REV.* 247 (1999) (discussing duties of care and loyalty).

executives to sacrifice corporate profits to pursue any lawful corporate objective, including creating good jobs, providing quality products, and protecting creditors.¹⁶ But the duty of loyalty ensures that when directors and executives act self-interestedly in a financial sense—when they try to use their corporate powers to line their own pockets—shareholders can bring derivative suits in which the burden is on the defendant director or executive to demonstrate the ultimate fairness of his or her actions.¹⁷ And the federal disclosure requirements imposed by the Securities Act of 1933 and the Securities Exchange Act of 1934 made it easier for shareholder-plaintiffs to identify potential breaches of the duty of loyalty.¹⁸

Thus, during most of the managerialist era, state and federal law deprived executives and directors of public corporations of opportunities to use their corporate powers for their own direct financial gain. (The managerialist era was free from the modern infatuation with “pay for performance,” which has allowed so many contemporary corporate executives to enrich themselves, quite legally, by managing the metrics to which their pay is tied.)¹⁹ Limited in their ability to serve themselves, directors and executives instead chose to spend a fair amount of their time and energy serving their firms.²⁰ At least, that is what seems to have occurred.²¹

III. MANAGERIAL CAPITALISM BECOMES VULNERABLE

But by the early 1970s, managerial capitalism began to run into headwinds. The most challenging may have been the bear market of 1973–1974, during which the Dow Jones Industrial Average lost nearly half its value. This decline was almost certainly not caused by managerialism—which after all had been around for decades—but by President Nixon’s decision to abandon the gold standard in 1971, which triggered inflation, as well as the 1973 OPEC oil embargo, which quad-

16. *Id.* at 299–305.

17. *Id.* at 298–99.

18. See Securities Act of 1933, Pub. L. No. 73-38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a–aa); Securities Exchange Act of 1934, Pub. L. No. 73-404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a–pp).

19. See *infra* text accompanying notes 40–43.

20. Put differently, during the managerialist era there were relatively few restraints on managers “shirking” (withholding effort), but there were significant and effective restraints on self-dealing and other blatant forms of theft.

21. See Blair & Stout, *supra* note 15, at 315–16 (“[C]orporate law seems to presume that so long as directors are limited in their ability to use their positions to benefit themselves, they may instead choose to use their positions to benefit others by promoting the joint welfare of all the stakeholders who together comprise the corporation. . . . As untidy as this notion may seem, a parallel argument has long been accepted as the standard explanation for nonprofit enterprise.”).

rupted oil prices between 1973 and 1974.²² (Imagine the effect on our economy today if oil were to rise suddenly from its current market price of \$90–\$110 per barrel to over \$400 per barrel.) Nevertheless, the stock market's poor performance during the early 1970s made it more acceptable to question the efficacy of managerial capitalism. And at least one influential group—finance economists—was ready to criticize.²³

In 1976, economist Michael Jensen and business school dean William Meckling published an article that was destined to become the most frequently cited paper in the management literature.²⁴ Ambitiously titled “Theory of the Firm,” Jensen and Meckling’s article did not view the “separation of ownership from control” with the cautious optimism that Berle and Means had expressed four decades earlier.²⁵ To the contrary, Jensen and Meckling saw the passivity of dispersed shareholders in public corporations as a serious weakness that invited professional managers to neglect shareholders’ interests in the pursuit of their own, leading managers to shirk or even steal from the firm. The result was the dread “agency costs” whose lurking presence in public corporations has haunted many finance economists and corporate governance experts ever since.²⁶

Ideas can matter, and the idea that shareholder powerlessness in public corporations was a serious problem turned out to be an idea that mattered quite a lot. In the decades following the publication of Jensen and Meckling’s article, managerial capitalism fell into academic disrepute. It was replaced by a new business theory: the theory of “shareholder primacy.” According to shareholder primacy theorists, the only legitimate purpose of the corporation was to maximize shareholder value. And the best way to secure this objective was to make managers more accountable to shareholders, for example by giving shareholders greater control over boards or by tying executive pay to share price.²⁷

22. *OPEC Oil Embargo 1973–1974*, DEP’T OF STATE, <http://history.state.gov/milestones/1969-1976/OPEC> (last visited Nov. 28, 2012).

23. See DAVIS, *supra* note 9, at 81–83 (discussing academic economists’ critique of managerialism in the 1970s).

24. MARTIN, *supra* note 13, at 11.

25. See generally Jensen & Meckling, *supra* note 5.

26. George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 NOTRE DAME L. REV. 955, 974 n.86 (2007) (“The agency cost problem has been discussed extensively in the legal and economic literature.”).

27. J.W. Vercet, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 318 (2010) (“Shareholder primacy theory includes two bedrock principles: 1) maximizing long-term shareholder value is the only legitimate objective of the corporation, and 2) designing ways to assist shareholders in exerting control . . . will minimize the agency costs that result from the separation of ownership from control in publicly traded and diffusely held corporations.”).

IV. THE INTELLECTUAL ORIGINS AND INTEREST-GROUP APPEAL OF SHAREHOLDER PRIMACY

The intellectual roots of shareholder primacy lie in finance economists' claim that shareholders are the ultimate "owners" and sole "residual claimants" in corporations, which implies that economic efficiency is served when corporate directors and executives maximize "shareholder wealth" (typically measured by stock price).²⁸ As others and I have argued elsewhere at length, these arguments rest on faulty legal assumptions.²⁹ Shareholders cannot own corporations because corporations are legal entities that own themselves. What shareholders really own is a contract with the corporation, called a "share of stock," which carries very limited rights. Similarly, corporations are their own residual claimants, with boards of directors enjoying the legal discretion to either retain the residual or use it to benefit many different groups, including not just shareholders but also creditors, employees, customers, and the community.³⁰

Nevertheless, however weak the foundations of shareholder primacy theory, it was an idea that was useful to, and quickly taken up by, at least five influential groups. The first group, at least chronologically, was other academics. To professors in the classroom, shareholder primacy offered a simple story about corporate structure and purpose that could be easily taught to students who innocently asked the complex question, "what are corporations for?" To tenure-seeking scholars, especially in law, shareholder primacy provided an elegant and seemingly scientific explanation of corporations that fit nicely into the law and economics methodology that, beginning in the 1980s, had begun to dominate elite law schools.³¹ And to empirical researchers, it offered an exceedingly simple way to measure corporate performance—whether the stock price went up or down—thus creating a seemingly solid basis for a generation of work in so-called empirical corporate governance.³²

28. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 36–37 (1991).

29. See, e.g., Blair & Stout, *supra* note 15; Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

30. LYNN A. STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS AND THE PUBLIC* 36–44 (2012).

31. See STEVEN M. TELES, *THE RISE OF THE CONSERVATIVE LEGAL MOVEMENT: THE BATTLE FOR CONTROL OF THE LAW* 216 (2008) (describing law and economics as "the most successful intellectual movement in the law of the past thirty years").

32. See Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006) (critiquing this approach); Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law*, 3 BERKELEY BUS. L.J. 43 (2005) (same).

Second, shareholder primacy ideology proved personally profitable for activist corporate raiders in the 1980s and then activist hedge funds in the 1990s and early 2000s.³³ These activists typically would buy shares in a public company, pressure the board to disgorge cash (usually raised by adding debt, cutting expenses, or selling all or part of the company), and then sell their interest and move on to the next target.³⁴ Faced with incumbent boards' protests that taking on debt, cutting necessary expenses, and selling vital assets caused long-term harm to the firm, activists used shareholder primacy rhetoric to dismiss these protests as the self-serving claims of entrenched, wayward agents who refused to "unlock shareholder value."³⁵

Third, shareholder primacy was eagerly embraced by an interest group that Yale corporate law expert Roberta Romano has dubbed "policy entrepreneurs"³⁶: academics and consultants eager to try their hands at improving American corporate governance, sometimes for personal profit. For example, influential activist investor Robert Monks created a business called Institutional Shareholder Services (ISS), which ranked individual companies on whether they had "good" or bad" governance structures and advised institutional investors such as mutual funds and pension funds accordingly on how to vote the shares in their investment portfolios.³⁷ (Monks later sold his interest in ISS, presumably for a tidy profit, to the Thompson Group).³⁸ Another well-known policy entrepreneur is Lucian Bebchuk, a professor at Harvard Law School who received national attention by founding "The Shareholder Rights Project." The project has played a significant role in pressuring many public companies to abandon staggered board structures designed to ward off corpo-

33. See Joe Nocera, *Down with Shareholder Value*, N.Y. TIMES (Aug. 10, 2012), <http://www.nytimes.com/2012/08/11/opinion/nocera-down-with-shareholder-value.html> (describing use of shareholder primacy rhetoric by 1980 raider T. Boone Pickens).

34. See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1401 (2007) ("Activist hedge funds look for four things in their targets—potential sale of the whole, potential sale of a part, free cash, and cuttable costs.").

35. See Lee Brodie, *Carl Icahn Attempting to Unlock Value in CVR Energy*, CNBC FAST MONEY (Feb. 14, 2012), <http://www.cnbc.com/id/46388674> ("Again, Carl Icahn is agitating to unlock shareholder value, this time by demanding CVR Energy put itself up for sale.").

36. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

37. About ISS, INSTITUTIONAL S'HOLDER SERVS., <http://www.issgovernance.com/about> (last visited Nov. 28, 2012); *Governance Risk Indicators*, INSTITUTIONAL S'HOLDER SERVS., <http://www.issgovernance.com/grid-intro> (last visited Nov. 28, 2012).

38. Biography of Robert Monks, NEW SCHOOL, <http://www.newschool.edu/sccpa/conferences/2010/US%20Corporation/Monks%20bio.pdf> (last visited Nov. 28, 2012).

rate raiders and activist hedge funds by making it more difficult to remove an incumbent board of directors.³⁹

Fourth, shareholder primacy ideology proved extremely profitable for many CEOs and other top corporate executives. During the managerialist era, professional executives typically received most of their compensation in the form of flat salaries and modest bonuses that seem shockingly reasonable compared to the amounts they receive today.⁴⁰ In 1993, however, Congress amended the tax code to require that top executives' pay at public corporations be tied to "objective" performance metrics in order to be a deductible expense.⁴¹ Shareholder primacy suggested that the obvious metric should be stock price, and stock price turned out to be something that was relatively easy for executives to manipulate, at least in the short run.⁴² Thus, shareholder primacy thinking led directly in the 1990s and 2000s to skyrocketing executive pay, increased earnings inequality, and more than a few spectacular accounting frauds.⁴³

Finally, business journalists embraced shareholder primacy rhetoric. Like professors in the classroom, journalists wanted a simple story of corporate purpose that could be easily explained to their readers. The idea that corporations existed only to maximize shareholder wealth answered that want. Even better, it offered up easily identifiable villains for the string of spectacular corporate scandals and disasters (Enron, Worldcom, HealthSouth) that began to receive attention on the front pages of the newspapers in the late 1990s. The problem was always

39. *Illinois Public Pension Fund Opposes Staggered Boards*, CHI. TRIB. (Aug. 10, 2012), http://articles.chicagotribune.com/2012-08-10/business/ct-biz-0810-chicago-law-20120810_1_pension-fund-shareholder-rights-project-corporate-governance.

40. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 1 (2006) (noting that the ratio of CEO pay to average employee pay rose from 140 times in 1991 to about 500 times in 2003); Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN. 21, 23 (noting that while in 1984 equity-based compensation accounted for 0% of median executive compensation, it accounted for 66% by 2001).

41. I.R.C. § 162(m) (2011).

42. See, e.g., Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1122 (2011).

43. See, e.g., Margaret M. Blair, *Shareholder Value, Corporate Governance, and Corporate Performances: A Post-Enron Reassessment of the Conventional Wisdom*, in *CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY* 53, 61–62 (Peter Cornelius & Bruce Mitchel Kogut eds., 2003) (discussing how stock-based compensation encourages executives to pursue risky strategies, manipulate accounting figures, and indulge in "earnings management"); Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 44–45 (Harv. Bus. Sch., Negotiations, Orgs. & Mkts. Working Paper No. 04-28, 2004), available at <http://ssrn.com/abstract=561305> (discussing how equity-based compensation led to unwise acquisitions, increased risk, aggressive accounting, and even corporate fraud).

greedy managers taking advantage of the “separation of ownership and control” to exploit hapless shareholders.⁴⁴

V. SHAREHOLDER PRIMACY’S RAPID ASCENT

This combined enthusiasm for shareholder primacy ideology among academics, hedge funds, policy entrepreneurs, executives, and journalists, goes a long way toward explaining how shareholder primacy managed so swiftly to mature from provocative academic theory to conventional wisdom. After guiding the business world for at least half a century—arguably, for as long as public companies had existed—the philosophy of managerial capitalism came to be viewed by many experts as a dusty relic, an ancient approach that everyone knew (without bothering to look too hard for empirical evidence) had proven a failure. Shareholder primacy was now the only proper business philosophy. By 2001, it was possible for Reinier Kraakman and Henry Hansmann, leading corporate scholars from Harvard and Yale law schools, respectively, to conclude that “academic, business, and governmental elites” all agreed:

[U]ltimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; . . . and the market value of the publicly traded corporation’s shares is the principal measure of the shareholders’ interests.⁴⁵

The shift in philosophy was accompanied by significant and parallel shifts in business behavior. In the 1990s and early 2000s, shareholder primacy ideology led to a number of individually modest but collectively significant changes in corporate law and practice that had the practical effect of driving directors and executives in public corporations to focus on share price as their guiding star. These changes included the tax code’s imposition of “pay for performance” requirements (mentioned above); changes in various SEC rules intended to increase the power of hedge funds and other activist investors so as to enhance director “ac-

44. See, e.g., Daniel Akst, *Why Rules Can't Stop Executive Greed*, N.Y. TIMES (Mar. 5, 2006), www.nytimes.com/2006/03/05/business/yourmoney/05cont.html.

45. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440–41 (2001).

countability”;⁴⁶ and activist-driven changes in governance patterns in public firms, including many large companies’ removal of staggered board structures that had insulated incumbent directors from electoral challenge.⁴⁷

Equally important, shareholder primacy values were internalized as the dominant norms of a rising generation of business leaders, investors, academics, journalists, and lawmakers.⁴⁸ Shareholder primacy became dogma: an omnipresent belief system that was seldom questioned, rarely justified, and so widely accepted that many of those who embraced it could not even recall when they first encountered it.

VI. SIGNS THAT SHAREHOLDER PRIMACY IS FAILING

Shareholder primacy thinking has changed public corporations. Shareholders now have more influence over boards, and executives now are more focused on share price, than at any time in business history. According to shareholder primacy theory, this shift should have significantly improved corporate performance and significantly increased investors’ returns from holding public equity. What have been the actual results?

Despite the rapid ascent of shareholder primacy, from arcane economic theory in the 1970s to dominant business philosophy in American public firms by the end of the 1990s, the objective results have been disappointing at best. Shareholder primacy may have enriched some CEOs and hedge fund managers. But it seems to have done little or nothing for the dispersed shareholders whom it was supposed to benefit. Roger Martin has calculated that between 1933 (the year after *The Modern Corporation and Private Property* was originally published) and 1976 (the year Jensen and Meckling’s article on agency costs appeared), shareholders who invested in the S&P 500 enjoyed real compound average annual returns of 7.5%. After 1976, this average dropped to 6.5%.⁴⁹ The downward trend is even more obvious after 2000. We are now entering our second “lost decade” of low or nonexistent investor returns from holding

46. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1274–83 (2008) (cataloging changes that have increased shareholders’ influence over boards).

47. See Steven M. Davidoff, *The Case Against Staggered Boards*, N.Y. TIMES DEALBOOK (Mar. 20, 2012), <http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/> (noting a dramatic decline in staggered boards as a result of pressures from policy entrepreneurs).

48. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1529 (2007) (stating that by the late 1990s, “the maximization of shareholder value as the core test of managerial performance had seeped into managerial culture”).

49. MARTIN, *supra* note 13, at 63.

shares in public companies.⁵⁰ Over the past three decades, bonds have by some measures outperformed stocks as investments for the first time in nearly 150 years.⁵¹

Meanwhile, public corporations themselves are disappearing. The total number of corporations filing tax returns in the United States increased by more than 20% between 1997 and 2008.⁵² But consulting firm Grant Thornton reports that during this same period the number of companies publicly listed on U.S. exchanges declined by nearly 40%, from 8,823 to 5,401.⁵³ Public companies are disappearing because some are failing and being acquired by rivals (consider the financial sector in 2008), while other formerly public companies (Dunkin' Donuts, Toys "R" Us) are going private.⁵⁴ In fact, the life expectancy of companies in the S&P 500 has declined from around fifty to seventy-five years in the middle of the twentieth century, to only about fifteen years today.⁵⁵ At the same time, many emerging enterprises are avoiding IPOs, preferring not to sell shares to public investors.⁵⁶ If the American public corporation were a species, we would label it endangered.⁵⁷

Correlation is not causation, of course. Yet there is ample reason to believe that the rise of shareholder primacy has played a role both in di-

50. MARTIN J. PRING ET AL., *INVESTING IN THE SECOND LOST DECADE: A SURVIVAL GUIDE FOR KEEPING YOUR PROFITS UP WHEN THE MARKET IS DOWN* (2012).

51. Cordell Eddings, *Say What? In 30-Year Race, Bonds Beat Stocks*, BLOOMBERG (Oct. 31, 2011), <http://www.bloomberg.com/news/2011-10-31/bonds-beating-u-s-stocks-over-30-years-for-first-time-since-19th-century.html>.

52. U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, *STATISTICAL ABSTRACT OF THE UNITED STATES*: 2012, at tbl. 744 (2012), available at <http://www.census.gov/compendia/statab/2012/tables/12s0744.pdf>.

53. David Weild & Edward Kim, Grant Thornton LLP, *A Wake-Up Call for America*, CAPITAL MARKET SERIES, Nov. 2009, at 1, available at http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call_.pdf.

54. Thomas Heath, *Dunkin' Donuts Brings Private Equity Firms A Sweet Profit*, WASH. POST (Aug. 18, 2011), http://www.washingtonpost.com/value-added-dunkin-brings-private-equity-firms-a-sweet-profit/2012/08/16/2d82857c-e5d0-11e1-8741-940c3f6dbf48_story.html (noting that Dunkin' Donuts went private in 2005); Parija Bhatnagar, *Group to Buy Toys 'R' Us for \$6.6B*, CNN MONEY (Mar. 17, 2005), <http://money.cnn.com/2005/03/17/news/fortune500/toysrus/index.htm> (noting Toys "R" Us was taken private in 2005).

55. See Steve Denning, *Peggy Noonan on Steve Jobs and Why Big Companies Die*, FORBES (Nov. 19, 2011), <http://www.forbes.com/sites/stevedenning/2011/11/19/peggy-noonan-on-steve-jobs-and-why-big-companies-die/>.

56. Weild & Kim, *supra* note 53.

57. See generally *The Endangered Public Company*, ECONOMIST (May 19, 2012), <http://www.economist.com/node/21555562>. The abrupt and substantial decline in the number of public companies versus private firms is perhaps the best evidence available to us that the publicly held firm is becoming a relatively dysfunctional business form. This is because if governance structure is endogenous (meaning firms can elect to be either public or private, depending on what best promotes business success) we should not expect to see obvious differences at the individual firm level between the operational performance of the two types.

minishing investors' returns, and in shrinking the population of public companies. The pressure to keep share price high drives public companies to adopt strategies that harm long-term returns: hollowing out their workforce; cutting back on product support and on research and development; taking on excessive risks and excessive leverage; selling vital assets; and even engaging in wholesale fraud.⁵⁸ And the desire to avoid activist hedge funds and shareholder-value thinking has been cited as a reason why many companies are going private or staying private.⁵⁹

Given such disappointing results, it is perhaps not surprising that the once-hegemonic idea that corporations should be managed solely to maximize shareholder wealth as measured by stock price has itself recently come under attack.⁶⁰ Even Jack Welch, the iconic CEO who ran GE from 1981 until 2001 and who was one of the first and most vocal proponents of shareholder primacy, recently described the modern focus on shareholder value as "the dumbest idea in the world."⁶¹

The philosophy of shareholder primacy seems poised to fall, perhaps even more quickly than it ascended. This should hardly be surprising. After all, shareholder primacy thinking did not evolve from the demands of the business world itself: corporate promoters did not put stronger shareholder rights in the charters of new firms because they believed this would allow companies to be run more effectively, nor did investors shun companies with corporate governance structures that shareholder primacy enthusiasts deemed "bad."⁶² To the contrary, as discussed below, promoters have responded to the rise of shareholder primacy by structuring the governance rules of new companies to weaken public shareholders' rights, and investors have eagerly bought shares in these new companies.⁶³

Rather than evolving naturally from the collective needs of those who have a long-term stake in the business world—entrepreneurs, executives, employees, creditors, and the majority of investors deciding

58. See generally STOUT, *supra* note 30, at 63–94.

59. Emily Thornton et al., *Going Private*, BUSINESSWEEK (Feb. 26, 2006), <http://www.businessweek.com/stories/2006-02-26/going-private>.

60. See, e.g., Joe Nocera, *Down with Shareholder Value*, N.Y. TIMES (Aug. 10, 2012), <http://www.nytimes.com/2012/08/11/opinion/nocera-down-with-shareholder-value.html>; Steve Denning, *The Dumbest Idea in the World: Maximizing Shareholder Value*, FORBES (Nov. 28, 2011), <http://www.forbes.com/sites/stevedenning/2011/11/28/maximizing-shareholder-value-the-dumbest-idea-in-the-world/>. See generally STOUT, *supra* note 30.

61. Francesco Guerrera, *Welch Condemns Share Price Focus*, FIN. TIMES (Mar. 12, 2009), <http://www.ft.com/cms/s/0/294ff1f2-0f27-11dc-ba10-0000779fd2ac.html#axzz25JzTiMrN>.

62. See Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PENN. L. REV. 667, 698–702 (2003).

63. See *infra* text accompanying notes 69–75.

whether or not to buy shares—the philosophy of shareholder primacy was an attempt at top-down “intelligent design” by a small cadre of academics and policy entrepreneurs. This cadre was aided and abetted by journalists and hedge fund managers, as well as some CEOs who saw in shareholder primacy rhetoric a tempting opportunity to increase their own wealth. The result was a significant shift in the actual practice of business at large public companies and the adoption of “maximize shareholder value” as a business mantra. But just as Freidrich Von Hayek might have predicted,⁶⁴ this experiment in central planning in corporate governance has not worked out well. This raises the question: Where will the American corporation go from here?

VII. MANAGERIALISM RETURNS, IN THE CLOSET

As Yogi Berra supposedly observed, making predictions is always hard, especially about the future. Predictions are also potentially embarrassing if they are not borne out. But to the scientific mind, the very point of making predictions is to see whether they are borne out or not. If they are, the theory upon which one bases one’s predictions survives for the moment, perhaps to be tested another day. If one’s predictions fail, then one’s theory has been proven false, and it is time for another theory.⁶⁵

In that spirit, this discussion closes with an observation and with a prediction. The observation is perhaps obvious: it can be argued that the theory of shareholder primacy, with its two “bedrock principles” that corporations should seek to maximize shareholder value and that enhancing shareholder control in public firms serves this goal,⁶⁶ has been largely falsified. Shareholder primacy may be elegant and intellectually appealing. But after thirty years of “improvements” in corporate governance practices and enhancements in shareholders’ rights, there is little or no evidence to suggest it actually works better, even for the dispersed shareholders whom it is supposed to serve.⁶⁷ The predictions of shareholder primacy theory have not been borne out. Perhaps it is time to move on to another theory.

The alternative prediction offered here (albeit with caution) is that American corporations are likely to respond to the disappointments of shareholder primacy by returning to what worked for more than half a century: some form of managerial capitalism. Of course, the current gen-

64. See FREIDRICH A. VON HAYEK, *THE ROAD TO SERFDOM* (1944).

65. See generally THOMAS S. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* (1962) (describing the process of scientific advancement).

66. Verret, *supra* note 27.

67. STOUT, *supra* note 30, at 47–60 (discussing how empirical evidence does not support shareholder primacy).

eration of corporate experts has been taught to deplore managerialism for the supposedly enormous “agency costs” it was assumed (based on remarkably little evidence) to have unnecessarily generated.⁶⁸ Thus the corporate philosophy likely to replace “maximize shareholder value” in the not-too-distant future is unlikely to be called managerial capitalism. But it will bear the hallmarks of managerialism. Enormous firms will be created, and their shares will be owned by dispersed, passive investors with little or no influence over the firms’ affairs. These firms will be run by professional managers who are almost entirely insulated from shareholders’ demands, whose compensation is based on something other than share price alone, and who themselves own relatively little of the firms’ equity. And these professional managers—Berle and Means’s “technocrats”—will often view their objective as something more than maximizing tomorrow’s share price. Rather, they may view the corporation’s purpose as serving the long-term interests of the firm, serving its customers and employees, or even serving society.

These neo-managerialist firms are already appearing. Fewer private corporations are opting to go public. But of those that do, an increasing number are opting to go public with multiple share classes that allow the firms’ founders and executives to retain voting control, while public investors receive only highly diluted and in many cases functionally valueless governance rights.⁶⁹ Google may have started the trend, at least among technology firms, when it went public in 2004 with a multiclass structure that reserved voting power primarily for the firm’s founders and executives. It justified this explicitly on the need to allow the firm to focus on its “number one priority” of “serving our end users.”⁷⁰ By 2009, more than 8% of firms going public had multiple classes of shares, and by 2012 this figure had risen to more than 12%.⁷¹ Public investors have

68. Apart from the 1973–1974 bear market discussed earlier, *see supra* text accompanying notes 22–23, the other primary basis for critiquing managerialism seems to have been its tolerance for large conglomerates. DAVIS, *supra* note 9, at 81–87. It seems clear that “busting up” a conglomerate can produce a higher stock market valuation for the firm’s component parts, probably because conglomeration reduces the dispersion of investors’ opinions. *See* Edward Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1162–64 (1977); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1259–75 (1990). However, there is little evidence that conglomerates were inefficient from an operational (rather than stock market valuation) perspective.

69. *See* Adam Brown, *Calpers Strategy Could Avoid IPOs with Dual Class Share Structures*, INSIDE INVESTOR REL. (Aug. 21, 2012), <http://www.insideinvestorrelations.com/articles/ipos-private-share-markets/18938/calpers-could-avoid-dual-class-ipos/>.

70. *See* 2004 Founders’ IPO Letter, GOOGLE, <http://investor.google.com/corporate/2004/ipos-founders-letter.html> (last visited Nov. 28, 2012).

71. *Thoughts on IPOs with Multi-Class Share Structures*, ALLEN LATTA’S THOUGHTS ON PRIVATE EQUITY, ETC. (Aug. 20, 2012), <http://www.allenlatta.com/1/post/2012/08/thoughts-on-ipos->

proven not only willing but eager to buy shares in these firms, including Kayak, LinkedIn, Yelp, and Zillow.⁷² This trend should continue.

Another form of what might be called closet managerialism that has appeared is the phenomenon of large private equity firms that are themselves publicly held—again with multiple share classes that disempower their public shareholders. An early precursor was Warren Buffett's Berkshire Hathaway. Berkshire Hathaway is one of the largest public corporations in the world, and it has been investing in both public and private firms and turning in excellent results for decades despite a multiclass structure that effectively disenfranchises its public investors.⁷³ More recently, a number of other large private equity firms have made initial public offerings, including Blackstone, Carlyle Group, KKR, and Apollo, all of which sold stock with governance structures that disenfranchised public investors.⁷⁴ Some institutional investors have protested that this is bad corporate governance, but the willingness of large numbers of other investors to purchase shares in these private equity firms is remarkable.⁷⁵ It suggests, again, that the shareholder-value ideology that dominates many American public companies has become dysfunctional, to the point that public shareholders are willing to

with-multi-class-share-structures.html (noting that in 2009 one in twelve IPOs had multiple share classes and that this year the figure has risen to one in eight).

72. *Id.* An interesting exception is the recent IPO of Facebook, which has been something of a failure, suggesting that public investors are willing to hold shares in managerialist firms only when they in fact have confidence in the skills and faithfulness of the firm's professional managers. See Walter Hamilton & Jessica Guynn, *Is Mark Zuckerberg in Over His Hoodie as Facebook CEO?*, L.A. TIMES (Aug. 17, 2012), <http://articles.latimes.com/2012/aug/17/business/la-fi-zuckerberg-future-20120817>; see also Analytical Chemist, *Booking First Class, Stuck in Steerage: Beware the Dangers of Dual-Class Stocks*, SEEKING ALPHA (Aug. 13, 2012), <http://seekingalpha.com/article/803661-booking-first-class-stuck-in-steerage-beware-the-dangers-of-dual-class-stocks> (emphasizing the importance of management quality in multiclass firms).

73. Justin Sharon, *Do Dual-Class Stocks Make for Second Class Shareholders?*, MINYANVILLE (Aug. 22, 2012), <http://www.minyanville.com/trading-and-investing/stocks/articles/dual-class-stocks-stocks-facebook-ipo/8/22/2012/id/43394> (discussing the examples of Facebook and Berkshire Hathaway).

74. See Steven M. Davidoff, *In Private Equity I.P.O., a Shareholder Fear of Losing Favor*, N.Y. TIMES DEALBOOK (Mar. 12, 2012), <http://dealbook.nytimes.com/2012/03/13/in-private-equity-i-p-o-a-shareholder-fear-of-losing-favor/> (discussing recent IPOs of Carlyle and KKR, and noting that Carlyle and others sold only shares with reduced voting rights to the public); *Companies Where Shareholders Have No Power – At All*, 24/7 WALL ST. (June 4, 2012), <http://247wallst.com/2012/06/04/companies-where-shareholders-have-no-power-at-all/> (noting that Blackstone has dual-class structure); Apollo Global Mgmt., LLC, Final Prospectus (initial public offering) (Mar. 29, 2011), available at <http://www.sec.gov/Archives/edgar/data/1411494/000119312511082478/d424b4.htm> (noting limited share voting rights).

75. See Brown, *supra* note 69 (discussing Calpers pension fund's objections to dual-class structures). Similarly, although many institutional investors argue that staggered board structures that make it more difficult for shareholders to remove directors are "bad" corporate governance, an increasing percentage of firms going public are adopting staggered boards. Davidoff, *supra* note 47.

pay the cost of hiring intermediaries and give up virtually all their governance rights to have a chance of investing in private companies instead.

VIII. CONCLUSION

Far more than we realize, our affairs and our behavior are influenced by beliefs about the world we form not from our own observations and experiences, but from what our teachers and peers have repeatedly told us must be so.⁷⁶ Sometimes what we learn from teachers and peers turns out to be useful and accurate—consider the periodic table of elements, for example. But sometimes, especially with regard to social institutions like markets and corporations, the ideas we absorb from others about how these institutions work can turn out to be perilously untethered from reality.

Like the supposed economic superiority of communism (an idea that much of the world once embraced), the business philosophy of shareholder primacy is an example of just such an untethered yet influential idea. Hatched in the ivory tower, it escaped into the larger world where it was nurtured by a few small but powerful interest groups, including hedge fund activists and some CEOs who saw opportunities for personal gain from promoting it. Within a few decades, it had become so widely accepted that anyone who dared to question it ran the risk of being accused of delusion, self-interestedness, or worse.

Yet no matter how passionately a theory may be embraced for a period of time, ideas that are not firmly grounded in the realities of the world—including ideas about business that are not grounded in the realities of business—are doomed to fail. Communism failed as an economic system, in both the Soviet Union and China. (Although the so-called Communist Party governs China, it has embraced “capitalism with Chinese characteristics.”)⁷⁷ Similarly, a corporate sector premised on the notion that corporations are run well when they are run to “maximize shareholder value” may be doomed to fail, if it is not failing already. We do not know with certainty what system will rise to replace it. But one strong candidate is some form of managerial capitalism. After all, busi-

76. JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* (1936) (“The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. . . . Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist.”).

77. *See generally* YASHENG HUANG, *CAPITALISM WITH CHINESE CHARACTERISTICS: ENTREPRENEURSHIP AND THE STATE* (2008).

ness history suggests that it has the potential to actually work, for investors and perhaps for the rest of us as well.