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New Thinking on "Shareholder Primacy"

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Abstract

By the beginning of the twenty-first century, many observers had come to believe that U.S. corporate law should, and does, embrace a "shareholder primacy" rule that requires corporate directors to maximize shareholder wealth as measured by share price. This Essay argues that such a view is mistaken.

As a positive matter, U.S. corporate law and practice does not require directors to maximize "shareholder value" but instead grants them a wide range of discretion, constrained only at the margin by market forces, to sacrifice shareholder wealth in order to benefit other constituencies and the firm itself. Although recent "reforms" designed to promote greater shareholder power have begun to limit this discretion, U.S. corporate governance remains director-centric.

As a normative matter, several lines of theory have emerged in modern corporate scholarship that independently explain why director governance of public firms is desirable from shareholders' own perspective. These theories suggest that if we want to protect the interests of shareholders as a class over time—rather than the interest of a single shareholder in today's stock price—conventional shareholder primacy thinking is counterproductive. The Essay reviews five of these lines of theory and explores why each gives us reason to believe that shareholder primacy rules in public companies in fact disadvantage shareholders. It concludes that shareholder primacy thinking in its conventional form is on the brink of intellectual collapse, and will be replaced by more sophisticated and nuanced theories of corporate structure and purpose.

KEYWORDS: corporate governance, shareholder value, agency theory, entity theory, financialisation, corporate law and economics, theory of the firm

JEL Classification Codes: G30, K22, P48, D23

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Introduction: The Rise of Shareholder Primacy Thinking

Of all the controversies in U.S. corporate law, one has proven most fundamental and enduring. This is, of course, the debate over the proper purpose of the public corporation.[1] Should the public company seek only to maximize the wealth of its shareholders (the so-called "shareholder primacy" view)? Or should public corporations be run in a manner that considers the interests of other corporate "stakeholders" as well, including employees, consumers, even the larger society?

The Great Debate (as it has been characterized by two sitting and one former member of the Delaware judiciary)[2] dates back at least to the initial emergence of the public corporation as a powerful business form in the early twentieth century.[3] For several decades afterwards, the two sides in the controversy seemed evenly matched, with perhaps a slight advantage to the "managerialist" view that corporations should be run in the interests of not just shareholders, but also stakeholders and society at large.

This changed in the 1970s with the rise of the Chicago School of economists. Prominent members of the School argued that economic analysis could reveal the proper goal of corporate governance quite clearly, and that goal was to make shareholders as wealthy as possible. Thus Nobel-prize winner Milton Friedman argued in the pages of the *New York Times* Sunday magazine that because shareholders "own" the corporation, the only "social responsibility of business is to increase its profits." [4] In more-academic writings, Michael Jensen and William Meckling published their influential paper on the theory of firm, describing

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[1] See e.g., William W. Bratton & Michael L. Wachter, "Shareholder Primacy's Corporatist Origins: Adolph Berle and the Modern Corporation", 34 J. Corp. L. 99 (2008). Before the emergence of the publicly-held company the question of corporate purpose was far less salient. The reason is simple: one can safely assume that a corporation with a controlling shareholder will be managed, for good or for ill, in a fashion that is agreeable to that shareholder. See infra text accompanying note 31 (discussing importance of distinguishing publicly-held firms from firms with controlling shareholders)

[2] William T. Allen, et al., "The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide", 69 Chi. L. Rev. 1007 (2002).

[3] In 1932, Adolph A. Berle engaged in a spirited debate in the pages of the Harvard Law Review with Harvard Professor E. Merrick Dodd over the proper purpose of the new business entity. According to Berle, "all powers granted to a corporation or to the management of a corporation … [are] at all times exercisable only for the ratable benefit of the shareholders …" Adolph A. Berle, "Corporate Powers as Powers in Trust", 45 Harv. L. Rev. 1049 (1932). Dodd disagreed, instead favoring "a view of the business corporation as an economic institution which has a social service as well as a profit-making function." E. Merrick Dodd, "For Whom are Our Corporate Managers Trustees?" 45 Harv. L. Rev. 1144, 1148 (1932).

[4] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits", New York Times Sunday Magazine, September 13, 1970, at 33-32 and 122-26. See Jean-Philippe Robé, "Being Done with Milton Friedman", *Accounting, Economics and Law: A Convivium* 2 (2012), this issue.

shareholders in a corporation as principals who hire corporate officers and directors to act as their agents.[5] According to this thesis, corporate managers' only job was to maximize the wealth of the shareholders (the firm's supposedly sole "residual claimants") by every means possible short of violating the law. Directors and officers who pursued any other goal only reduced social wealth by increasing "agency costs."

Such arguments appealed to a number of groups for a number of reasons. To legal scholars, the application of economic theory lent an attractive patina of scientific rigor to the shareholder side of the longstanding "shareholders versus stakeholders" dispute. To the popular press and business media, shareholder primacy offered an easy-to-explain, sound-bite description of what corporations are and what they are supposed to do. To businesspeople and reformers seeking a way to distinguish between good and bad governance practices, the shareholder-centric view promised a single, easily-read measure of corporate performance in the form of share price.

The end result was that the Chicago economists significantly shifted the balance of opinion in the Great Debate. By the 1990s, most scholars and regulators, and even many business practitioners, had come to accept shareholder wealth maximization as the proper goal of corporate governance. Some commentators continued to argue valiantly for a more stakeholder-friendly view of the public corporation, but they were increasingly dismissed as sentimental, sandals-wearing leftists whose hearts outweighed their heads. Shareholder primacy became widely viewed as the only intellectually respectable theory of corporate purpose, and "maximize shareholder value" the only proper goal of boards of directors.

My use of the past tense is not inadvertent. This essay argues that the shareholder primacy view, as conventionally understood, has reached its zenith and is poised for decline. The classic shareholder-oriented model of the firm is being rapidly undermined by new developments in corporate theory, as well as changes in business practice and recent empirical studies. These developments make clear that shareholders are not a homogeneous mass with a homogeneous interest in maximizing today's share price. To the contrary, shareholders' interests are divided along many fault lines, including schisms between investors with short versus long holding periods; between investors eager to make ex ante commitments to stakeholders and those eager to opportunistically renege on those commitments ex post; and between asocial investors who care about only their own material returns and prosocial investors concerned about the fates of others, future generations, and the planet. To survive, shareholder primacy theory must address and account for these differences in shareholder interest, and evolve into a more complex and far more subtle understanding of what shareholders truly "value" and what they seek

[5] Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure", 3 J. Fin. Econ. 305 (1976).

from corporations *as a class and over time*. In the process, it will likely come to resemble its former rival, the stakeholder model, far more closely. In many cases the two may merge. Although the Great Debate may not be resolved entirely, the distance between the two sides in the debate seems destined to shrink dramatically.

1. Shareholder Primacy Reaches Its Apogee

The high-water mark for traditional shareholder primacy thinking was perhaps set early in 2001, when Professors Reinier Kraakman and Henry Hansmann—leading corporate scholars from the Harvard and Yale law schools, respectively—published an essay entitled "The End of History for Corporate Law."[6] Echoing the title of Frances Fukayama's book about the overwhelming triumph of capitalist democracy over communism,[7] Hansmann and Kraakman argued that shareholder primacy thinking similarly had triumphed over other theories of corporate purpose. "[A]cademic, business, and governmental elites," they wrote, shared a consensus "that ultimate 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; ...and the market value of the publicly traded corporation's shares is the principal measure of the shareholders' interests."[8] As a result "there is no longer any serious competitor to the view that corporate law should ... strive to increase ... shareholder value."[9] What's more, Hansmann and Kraakman observed, this "standard shareholder-oriented model" not only dominated U.S. discussions of corporate purpose, but conversations abroad as well. In their

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[6] Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law", 89 Geo, L. J. 439 (2001).

[7] Frances Fukayama, *The End of History and the Last Man* (1992).

[8] Hansmann and Kraakman, "The End of History", supra note 6 at 440-41.

[9] Id. at 439. I have omitted from this quote two fundamental qualifications that appear in the original article, which reads "there is no longer any serious competitor to the view that corporate law should *principally* strive to increase *long-term* shareholder value" (emphasis added). I have left out the qualifiers "principally" and "long-term" because the more one tries to rely on them, the more they undermine and indeed destroy Hansmann's and Kraakman's main thesis as they express it elsewhere: that managers should be directly accountable "only" (not merely "principally") to shareholders' interests, and that the "market value of the publicly traded corporations shares"—meaning, presumably, today's market value, not yesterday's or tomorrow's—"is the principal measure of its shareholders' interests." Id. at 440-41. With apologies to Professors Hansmann and Kraakman, I emphasize their more-unqualified expression of the shareholder primacy thesis in this Essay because I think it better represents the dominant form of shareholder primacy thinking at the turn of the millenium, and so offers the best foil for my arguments. I agree, however, with their highly-qualified version, as the balance of this Essay attests.

words, "the triumph of the shareholder-oriented model of the corporation is now assured" not only in the U.S., but the rest of the civilized world.[10]

Hansmann and Kraakman were quite correct in observing that, as a descriptive matter, the ideas that corporations should be run to maximize shareholder wealth as measured by share price, and that shareholders should enjoy ultimate control over public companies, dominated corporate law discussions in early 2000. There were several ironic aspects, however, to their prediction this state of affairs would prove permanent. For one thing, it was only a few months later that Enron's collapse provided a dramatic object lesson in the perils of management obsession with share price. But there were more subtle and important ironies in the timing of their announcement.

In particular, even as shareholder primacy thinking was embraced with near-consensus, three ironic realities of business law, practice, and theory were becoming clear. First, around the same time Hansmann's and Kraakman's "End of History" essay appeared, several prominent legal scholars published articles detailing how U.S. corporate law does not, in fact, follow the shareholder primacy model. Contrary to the predictions of the shareholder-oriented model, shareholders do not either own or control public corporations, nor are corporate directors obligated to maximize share price. Second, the corporate world in general, and equity investors in particular, gave every sign of preferring this state of affairs. Although the enabling and state-based nature of U.S. corporate law allows corporate promoters a great deal of leeway to select corporate rules that come closer to the shareholder primacy ideal by giving shareholders greater power, it was becoming increasingly apparent that promoters generally chose to go in the opposite direction, choosing rules that weakened shareholder authority—and shareholders were enthusiastically endorsing this approach by opening their wallets and buying the promoted shares. Third and perhaps most striking, important developments in the theoretical literature on shareholders' interests began to highlight how conventional shareholder primacy rested on shaky foundations, and might be intellectually incoherent. After all, the idea of "maximizing shareholder value" implicitly assumes that shareholder have but one "value," today's share price. Yet if different shareholders have different values—and, as we shall see, they inevitably must—shareholder primacy in its conventional form crumbles.

The rest of this Essay examines each of these ironies in turn. In the process, it lays the foundation for several important lessons to be learned from the new thinking on shareholder primacy.

[10] Hansmann and Kraakman, "The End of History", supra note 6 at 468.

2. The Positive Case Against Shareholder Primacy

Even as shareholder primacy thinking gained traction among laypersons and the business media in the 1980s and 1990s, it was becoming increasingly clear to legal specialists that U.S. law historically did not, and still does not, actually follow the "standard" shareholder-oriented model. (Hansmann and Kraakman implicitly recognized this in their essay when they suggested shareholder primacy thinking would lead to the "reform" of corporate law.)[11] I have discussed this factual reality in great detail elsewhere,[12] as have many others,[13] so I will not offer more than a brief survey here. The most important points are obvious to any corporate lawyer. Shareholders do not own corporations: corporations are independent legal entities that own themselves. Nor do shareholders control public corporations; this job is delegated to a board of directors whom public shareholders influence only indirectly, if at all.

Commentators often blithely assert that shareholders are the corporation's ultimate "owners," but this is a patently incorrect. Corporations are independent legal entities that own themselves, just as human beings own themselves. Just as humans can, corporations can own property, commit crimes, pay taxes, and negotiate contracts. One type of contract that corporations frequently (but not always)[14] negotiate is the sale of equity shares. Equity investors who purchase shares from a corporation gain certain rights, just as investors who buy corporate bonds gain certain rights. In particular, equity investors typically purchase the right to vote on certain matters, the right to sue in certain circumstances, and the right to sell their shares to other investors. But these legal rights are of remarkably little value to shareholders seeking to force directors of a public company to act as their "agents" and serve only their interests.

Consider first shareholder voting rights. As a matter of law these are severely limited in scope, principally to the right to elect and remove directors. Shareholders have no right to select the company's CEO; they cannot require the company to pay them a single penny in dividends; they cannot vote to change or preserve the

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[11] Hansmann and Kraakman, "The End of History", supra note 6 at 439.

[12] See, e.g., Margaret Blair & Lynn A. Stout, "A Team Production Theory of Corporate Law", 85 Va. L. Rev. 247 (1999); Lynn A. Stout, "Bad and Not-So-Bad Arguments for Shareholder Primacy", 75 S. Cal. L. Rev. 1189 (2002); Lynn A. Stout, "The Mythical Benefits of Shareholder Control", 93 Va. L. Rev. 789 (2007).

[13] See, e.g., Allen et al., supra note 2 at 1202; Margaret Blair, *Ownership and Control* (1995); Einer Elhauge, "Sacrificing Corporate Profits in the Public Interest", 80 N.Y.U.L. Rev. 733 (2005). For a recent article in the legal-economic literature in the same vein, see Jean-Philippe Robe, "The Legal Structure of the Firm", 1 (1) *Accounting, Economics and Law: A Convivium* (2011). DOI: http://dx.doi.org/10.2202/2152-2820.1001

[14] Nonprofit corporations typically operate without equity shareholders.

company's line of business; they cannot stop directors from squandering revenues on employee raises, charitable contributions, or executive jets; and they cannot vote to sell the company's assets or the company itself (although they may in some cases vote to veto a sale or merger proposed by the board). The rules of voting procedure further limit exercise of the shareholder franchise. Delaware law, for example, presumes only directors have authority to call a special shareholders' meeting, and shareholders who wait for the regularly-scheduled annual meeting to try to elect or remove directors must pay to solicit proxies. Finally and perhaps most significant, in a public firm with widely-dispersed share ownership, shareholder activism is a public good, and shareholders' own rational apathy raises an often-insurmountable obstacle to collective action. As Robert Clark has put it, a cynic could easily conclude that shareholder voting in a public company is "a mere ceremony designed to give a veneer of legitimacy to managerial power."[15]

What about shareholders' right to sue corporate officers and directors for breach of fiduciary duty if they fail to maximize shareholder wealth? Here, too, shareholders' "rights" turn out to be illusory. The fiduciary duty of loyalty precludes officers and directors from using their corporate positions to line their own pockets. They remain free, however, to pursue other goals unrelated to shareholder wealth under the comforting mantle of the business judgment rule. As I have pointed out in writings with Margaret Blair, courts consistently permit directors "to use corporate funds for charitable purposes; to reject business strategies that would increase profits at the expense of the local community; to avoid risky undertakings that would benefit shareholders at creditors' expense; and to fend off a hostile takeover at a premium price in order to protect employees or the community."[16] Contrary to the shareholder primacy thesis, shareholders cannot recover against directors or officers for breach of fiduciary duty simply because those directors and officers favour stakeholders' interests over the shareholders' own.

Finally, a shareholder's right to sell her shares sometimes can protect an individual investor who wants to express her unhappiness with a board by "voting with her feet." But disappointed shareholders cannot sell *en masse* without driving down share price, making selling a Pyrrhic solution. An important exception to this rule arises when shareholders as a group have the opportunity to sell to a single buyer who, because he does not face collective action problems, can depose an incumbent board more readily. During the 1970s and early 1980s, as the Chicago economists' arguments began to gain steam and changes in the banking industry made hostile takeover bids more feasible, it appeared that just such a lively "market for corporate control" might develop. A series of legal developments, however, soon brought hostile takeovers to an effective halt. The list is legion, but prominent examples

[15] Robert C. Clark, *Corporate Law* 95 (Little, Brown 1986).
[16] Blair & Stout, supra note 12 at 303.

include the passage by almost every state of some form of antitakeover statute; the invention of the "poison pill" defence by *uber*-corporate lawyer Martin Lipton; and the effective reversal of the Delaware Supreme Court's 1986 *Revlon* ruling (which seemed to require boards facing a hostile offer to maximize shareholder wealth) by subsequent opinions issued only a few years later.[17] By the mid-1990s, U.S. corporate law may have insulated incumbent directors from the pressures of the market for control even more effectively than it did in 1970, when Milton Friedman trumpeted shareholder primacy in the pages of the *New York Times*.

In sum, as a positive matter, the standard shareholder-oriented model simply fails to describe the legal reality of U.S. public companies. But the positive weaknesses of the shareholder primacy model do not stop here. Even as U.S. corporate law stubbornly refuses to follow the dictates of shareholder primacy, common corporate practices in many firms weaken shareholders' power and influence still further. Public investors themselves seem to be perfectly content with this result.

To understand this point it is important to understand that U.S. corporate law is "enabling," meaning that corporate promoters can to a great extent choose the rules that apply to their firms. They can do this in at least two ways. First, they can select a state of incorporation. (Under the "internal affairs" doctrine, corporations are governed by the rules of the state in which the promoter chooses to incorporate). Second, they can add customized provisions to the corporate charter that enhance, or dilute, either directors' or shareholders' power. For the past two decades, promoters have been taking advantage of the enabling nature of U.S. corporate law to select governance rules that insulate boards from shareholder influence. Studies have found, for example, that states that offer directors strong protection against hostile takeovers seem more successful in attracting new incorporations and in retaining existing firms than states whose laws are more "shareholder friendly."[18]

The trend away from shareholder primacy is even more obvious when we examine charter provisions. Most states allow or require a company's charter to include an affirmative statement describing and limiting the corporation's purpose. If a company's founders thought such a charter provision would appeal to equity investors, they could easily put in the charter that the company's purpose is to "maximize shareholder value." I have never seen such a provision; instead, the overwhelming majority of charters simply state that the corporation's purpose is to do anything "lawful." Even more compelling, when promoters do tinker with shareholder rights in the charter, they almost always move in the opposite direction, weakening shareholder influence. For example, many firms (Google, LinkedIn, Zynga) "go public" with dual-class voting structures that disenfranchise public

[17] See Stout, "Bad and Not-So-Bad", supra note 11 at 1204.
[18] See Stout, "Bad and Not So Bad", supra note 12 at note 53 (citing studies).

shareholders almost entirely. In contrast, charter provisions that make it easier for shareholders to force directors to do their bidding "are so rare as to be almost nonexistent."[19]

Such empirical realities set the stage for the third irony associated with Hansmann's and Kraakman's 2001 declaration that shareholder value thinking had triumphed. Even as shareholder primacy model was achieving the status of received truth, experts were beginning to question not only its positive accuracy, but its theoretical foundations.

To use the phrase Thomas Kuhn made famous in his classic 1962 book *The Structure of Scientific Revolutions,* by 2001 the shareholder primacy model had become the "dominant paradigm" for understanding the purpose of the corporation. But it failed to explain at least two important empirical anomalies. First, the default rules of U.S. corporate law simply refused to treat shareholders as "owners," "principals," or "residual claimants." Unlike owners, shareholders lacked the ability to control how the corporation used its assets and outputs. Unlike principals, shareholders lacked the power to command the board. And unlike residual claimants, shareholders were not entitled to demand to receive even a penny of the corporation's profits, assuming the company had "profits" in the first place. (Although the point may be obvious, it is perhaps worth reminding readers that profit is an accounting concept that depends on expenses as well as revenues, with the result that the amount of profit earned by a company to a great degree is determined by its board)[20].

The second anomaly that could not be easily explained by the standard model was that corporate promoters bringing new firms to market often took advantage of the enabling nature of U.S. law to weaken shareholders' already-weak position in the firm even further. This observation was especially puzzling because it suggested that *shareholders themselves* did not object to director control over corporate assets and corporate purpose. After all, prospective investors who are thinking of buying shares in an IPO can easily determine the company's state of incorporation and the nature of its charter. If they are troubled by governance structures that dilute shareholder rights, they should discount their willingness to pay accordingly. Corporate promoters cannot pull the wool over shareholders' eyes at the IPO stage. If they structure the firm in a fashion that harms investors, it is the promoters themselves who should pay the price, because they have devalued the very shares they are trying to sell.

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[19] John C. Coates IV, "Explaining Variation in Takeover Defenses: Blame the Lawyers", 89 Cal. L. Rev. 1301, 1397 (referring specifically to provisions that restrict directors' ability to employ poison pills).

[20] For a further development on accounting and the theory of the firm, see Yuri Biondi, "The Firm as an Entity: Management, Organization, Accounting" (August 2, 2005). Università degli Studi di Brescia Working Paper No. 46. URL: http://ssrn.com/abstract=774764

As Kuhn famously observed, wherever one finds persistent empirical anomalies inconsistent with a dominant theory's predictions, one eventually finds at least a few free-thinking (or foolhardy) souls who want to understand and explain those anomalies. Eventually these free spirits may develop a new, alternative theory. When they do, the battle begins: many of the intellectual leaders who built their careers on the original paradigm can be expected to fight tooth and nail to kill off the newcomer. But if the new theory is sound—if it does a better job of explaining what we observe in the real world than the old theory does—it will win hearts and minds, and ultimately prevail. Of course, the process may be slow. In science, it is said that intellectual progress is made "one funeral at a time."

There is reason to hope the pace in corporate theory be more brisk. Even as Hansmann and Kraakman were announcing the triumph of the shareholder wealth maximization paradigm in 2001, corporate theorists--including Hansmann and Kraakman themselves--were busily at work exploring not just one, but several, alternative theoretical models of shareholder interest that might explain why equity investors seemed content to cede control over corporate assets and purpose to boards of directors. In today's literature one can identify multiple lines of thought that challenge the traditional shareholder primacy paradigm, while simultaneously offering to explain the twin anomalies of director control in the default rules of U.S. law, and promoter preference for even greater director control at the IPO stage.

This Essay provides a guide to five of the most promising alternative new theories being offered by today's experts in law, business, and economics. These five theories have two important elements in common. First, as noted earlier, as a historical matter, challenges to shareholder primacy have focused on the fear that what is good for shareholders might be bad for other corporate stakeholders (customers, employees, creditors), or for the larger society. The new theories surveyed here focus on the possibility that *shareholder value thinking harms shareholders themselves,* collectively and over time.

Second, the new theories raise this counterintuitive possibility by showing how "the shareholder" is an artificial and misleading construct. Most corporate equity is ultimately held by human beings, either directly or indirectly through pension funds and mutual funds. Where "shareholders" are homogeneous, people are diverse. Some plan to own their stock for short periods, and care only about tomorrow's stock price, while others expect to hold their shares for decades and worry about the company's long-term future. Some need immediate liquidity, while others can afford to "lock in" their investments. Some buy shares in new ventures and want their companies to make commitments that attract the loyalty of customers and employees, while others who buy shares later want the company to renege on those commitments. Some investors are highly diversified, and worry how the company's actions will affect the value of their other interests, while others are undiversified and unconcerned. Finally, many people are "prosocial," meaning they are willing to sacrifice at least some profits to allow the company to act in an ethical and socially responsible fashion. Others care only about their own material returns.

In urging corporate managers to focus only on "maximizing shareholder value" (share price), conventional shareholder primacy ideology assumes away all these differences between and among the human beings who own any company's stock.[21] *It ignores the fact that different shareholders have different values.* Instead, it assumes a monolithic shareholder who cares only about one company's stock price, only today. This approach reduces investors to their lowest possible common human denominator: impatient, improvident, opportunistic, self-destructive, and psychopathically indifferent to others' welfare. As a result, shareholder primacy ideology can keep public corporations from doing their best for either their investors, or society as a whole.

The balance of this Essay is devoted to exploring these five emerging theories of diverging shareholder interests and director control. Given space constraints I cannot do them justice, and I urge interested readers to consult the primary sources that develop these arguments in detail. But even a cursory glimpse at corporate scholarship at the turn of the millennium offers a number of important observations. Most important, the new theories promise to advance our understanding of corporate purpose far beyond the old, stale "shareholders-versus-stakeholders" and "shareholders-versus-society" debates. By revealing how a singled-minded focus on share price endangers shareholders themselves, they also demonstrate how the perceived gap between the interests of shareholders and those of stakeholders and the broader society may be far narrower than commonly understood.

3. The Theoretical Case Against Shareholder Primacy: What Do Shareholders Really Value?

3. 1. Market Inefficiency and Divide Between Short-Term Speculators and Long-Term Investors

Of all the weaknesses of the "standard" model described by Kraakman and Hansmann, one in particular has captured the attention of the business community

[21] As UCLA law professor Iman Anabtawi has noted, this approach allows shareholder primacy theorists to characterize shareholders "as having interests that are fundamentally in harmony with one another." Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 U.C.L.A. L. Rev. 561, 564 (2006).

almost from the beginning of the model's ascendance. This weakness is the standard model's need to assume the stock market is "fundamental value efficient."

The literature on market efficiency is enormous. Nevertheless, the basic idea can be easily summarized. In brief, a stock market is deemed "fundamental value efficient" to the extent the market price of a company's stock incorporates all the information relevant to its value so effectively that the market price reflects the best possible estimate of the stock's fundamental economic value in terms of its likely future risks and returns. In such a market, there is no need for an investor to stay up late trying to figure out what a particular stock is really worth, because the market has already done her valuation homework for her. Nor is there any need to worry about whether today's stock price reflects the firm's long-run value. In a fundamental value efficient market, the long run and the short run merge, because there only one accurate way to measure a stock's future risks and returns: by today's market price.

Even during the 1970s and 1980s--the heyday of efficient market theory and the period during which the shareholder primacy model came to dominate academic thinking about corporate law—many experienced business people believed stock prices often failed to reflect reasonable estimates of fundamental value. (Renowned corporate lawyer Marty Lipton advanced this argument in 1979 in an early and famous challenge to shareholder primacy thinking.) [22] Since the Crash of 1987 and the bursting of the 1990s Internet bubble, doubts have become even more widespread. This is true even among finance theorists, the original inventors of efficient market theory and once its most vocal supporters. Finance economists are now developing ideas and producing empirical studies that challenge the theoretical and empirical validity of efficient market theory, including heterogeneous expectations asset pricing models; an emerging literature on the limits of arbitrage; and the behavioral finance literature.[23]

If, as the growing "New Finance" literature suggests, stock prices can depart significantly from rational estimates of fundamental value, the possibility arises that business strategies that raise share price in the short term can harm firm value and shareholder wealth over the long term. The result is a conflict of interest between relatively short-term investors (e.g., hedge funds that hold shares only a few months or even only a few minutes) and investors who expect to hold shares for longer

[22] See Martin Lipton, "Takeover Bids in the Target's Boardroom", 35 Bus. Lawyer 101 (1979).

[23] For a survey see Lynn A. Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance", 28 J. Corp. L. 635 (2003). See also Lynn A. Stout, "Risk, Speculation, and OTC Derivatives" An Inaugural Essay for *Convivium, Accounting, Economics, and Law: A Convivium.* 1 (1) (January 2011), commented by Yuri Biondi, "Disagreement-Based Trading and Speculation: Implications for Financial Regulation and Economic Theory", *Accounting, Economics, and Law: A Convivium.* 1 (1) (January 2011), and Pierre-Charles M. Pradier, "Administering Systemic Risk vs. Administering Justice: What Can We Do Now that We Have Agreed to Pay Differences?", *Accounting, Economics, and Law: A Convivium.* 1 (1) (January 2011).

periods (e.g., mom-and-pop investors saving for retirement or a child's college tuition).

One possible solution to the conflict is for both groups to cede control to a board of directors that has the authority to pursue business strategies that preserve long term value, even if these strategies don't produce immediate gains in share price (e.g., investing in research and development, or in employee or community relations). This idea supports arguments raised over the years by a variety of governance experts who have suggested that director authority can sometimes benefit shareholders by protecting long-term value, even while short-term share price languishes.[24]

3. 2. Capital "Lock In" and Differences in Shareholders' Demands for Liquidity

Corporations have traditionally been defined as entities with the standard attributes of limited shareholder liability, centralized management, perpetual life, and freely transferable shares. In recent years, however, a variety of scholars, including Harold Demsetz, Margaret Blair, and Hansmann and Kraakman themselves,[25] have argued that corporate entities are also marked by a fifth essential attribute that Blair dubs "capital lock in" and Hansmann and Kraakman call corporate "asset shielding." These phrases capture the notion that equity investors in a corporation, unlike investors in a partnership or proprietorship, cannot unilaterally withdraw their capital from the firm. If they want their money back, they cannot simply demand the corporation return it. Their only hope is to find another investor willing to buy their shares in the secondary market.

Why would investors be willing to sacrifice liquidity this way? Blair has emphasized how capital lock-in protects equity investors from the risk their fellow equity holders might want, or need, to withdraw their investment from the firm, triggering a dissolution or "fire sale" of corporate assets. Thus lock-in is essential for pursuing long-term corporate projects that require large amounts of firm-specific assets (e.g., building a railroad, manufacturing plant, or brand name) that cannot be easily liquidated or sold without harming their value. Hansmann and Kraakman have

[24] See, e.g., Richard E. Kihlstrom & Michael L. Wachter, "Corporate Policy and the Coherence of Delaware Takeover Law", 152 U. Pa. L. Rev. 523 (2003); Reinier Kraakman, "Taking Discounts Seriously", 88 Colum. L. Rev. 891 (1988); Lipton, supra note 21; Lynn A. Stout, "Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law", 99 Yale L. J. 1235 (1990).

[25] See Margaret M. Blair, "Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century", 51 U.C.L.A. L. Rev. 387 (2003); Harold Demsetz, *The Economics of the Business Firm: Seven Critical Commentaries* 50-51 (1995) (discussing "the absence of a repurchase condition"); Henry Hansmann and Reinier Kraakman, "The Essential Role of Organizational Law", 110 Yale L. J. 387 (2000).

argued that what they call corporate asset shielding may also encourage creditors to lend the firm, by similarly protecting their interests from impecunious (or opportunistic) shareholder demands for a return of capital.

For a variety of reasons, explicit contracts often cannot lock in capital effectively. Incorporation offers an alternative means of achieving lock in, because the corporate entity becomes the legal "owner" of the firm's specific assets and control of the firm rests in the hands of a board. Thus lock in supports the claim that director control can serve investor interests ex ante even as it weakens investor control ex post, by reassuring both creditors and other equity investors they can safely invest in or lend to the firm. In the process, it provides normative support for board decisions that benefit shareholders and creditors alike by shielding the firm's specific assets from shareholder attempts to withdraw capital.

3. 3. Team Production Theory and the Problem of Ex Post Shareholder Opportunism

Like lock-in theory, team production theory[26] focuses on the economic importance of firm specific investment. Team production theory recognizes, however, that creditors and equity investors are not the only groups whose resources can be converted into firm specific assets. Employees, for example, may make specific investments by putting in time and effort far beyond the minimum their contracts require, or by developing knowledge, skills, and relationships of greater value to the firm than any other potential employer. Customers may invest time and effort becoming familiar with the firm's products. Local communities may build roads, schools, and other specialized infrastructure to support the firm's manufacturing plant or headquarters.

It is often in shareholders' ex ante interest to encourage such firm-specific stakeholder investments. For example, in order to succeed, a railroad company needs more than investor money to build tracks and buy rail cars; it also needs local employees with specialized skills, commuters who live and work along the rail line, and municipal governments to build and support the infrastructure in the towns along the line. However, once these stakeholder investments have been made, the shareholders in the railroad company might profit from opportunistic strategies that threaten to destroy their value, e.g., by threatening to fire loyal railroad employees unless they take a pay cut, or threatening to close a station unless the local government promises more tax breaks. Formal contracts may provide inadequate protection against such shareholder opportunism. As an alternative, shareholders might reassure stakeholder investors and encourage their specific investment by ceding control to a board that cannot personally profit (as shareholders can) from

[26] See Blair & Stout, supra note 12.

business strategies that enhance shareholder wealth by opportunistically threatening the value of other stakeholders' specific investments. Again, the team production approach supports a director-centric governance structure that serves shareholders' ex ante interests by giving boards broad ex post discretion to favour other constituencies.

3. 4. Undiversified Shareholders Versus Universal Investors

The standard shareholder primacy model assumes that shareholder wealth is best maximized by maximizing the price of a particular company's shares. In other words, it looks at the question of shareholder wealth from the perspective of a hypothetical shareholder with only one asset, equity shares in Firm A.

Very often, however, directors and executives can increase the share price of Firm A by pursing strategies that impose costs on Firm B. For example, Microsoft might pursue monopolistic acquisitions or anticompetitive strategies that allow it to charge its corporate customers higher prices for lower-quality software. Alternatively, a board might embrace risky projects that raise Firm A's share price at the expense of Firm A's bondholders. Consider Enron's decision to load up on risky energy derivatives, or BP's decision to cut safety corners in off-shore drilling in the Gulf of Mexico.

Classic shareholder primacy thus invites an investing "tragedy of the commons" where shareholders seeking to maximize their returns from particular investments create external costs that harm their value of their own, and other investors,' interests. This tragedy of the investing commons is of special concern to the so-called universal investor – the highly diversified pension or mutual fund that owns stocks and bonds in many different firms. Moreover, pension and mutual funds are fiduciaries for individual beneficiaries who are themselves customers and employees of firms, and who are also biological organisms that depend on their environment. One can question whether such fiduciaries truly serve their individual beneficiaries' interests by supporting business strategies that raise share price by harming employees or hurting customers, or by creating an unhealthful environment.

Proponents of the universal investor idea (most notably, investor activist Bob Monks[27] and business professors James Hawley and Andrew Williams)[28] have tended to focus on the notion that the best way to overcome the tragedy of the investing commons and to get corporations to serve the interests of the universal investor rather than the hypothetical undiversified shareholder is to increase the political power of diversified pension funds and mutual funds. This idea has value, but diversified pension and mutual funds like all diversified investors tend toward rational apathy,

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[27] Robert A.G. Monks, *The New Global Investors* (2001).
[28] James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism* (2000)

and may not serve as an adequate brake against the demands of hedge funds and other undiversified shareholders that push corporate boards to pursue "rob Peter to pay Paul" business strategies. Nor is there reason to think many pension or mutual fund managers would feel legally comfortable trying to balance their beneficiaries' interests as fund investors against their other human interests (e.g. as employees).

Director control of public corporations offers another, albeit imperfect, vehicle for protecting the interests of universal investors. This is because directors have no innate interest in favoring the interests of undiversified shareholders over the interests of the universal investor who is also a shareholder. As a result, directors who are free to pursue corporate goals other than maximizing share price are also free to pursue strategies that ultimately benefit the universal investor who is also a creditor, a shareholder in other firms, an employee, a customer, and an organism dependent on its environment.

3. 5. Director Control and the Interests of Prosocial Shareholders

To be a universal investor, one must still be a shareholder, either directly or through a diversified pension or mutual fund. But what of the interests of employees and customers who do not also hold stock in a particular company? What of community and environmental concerns above and beyond those that affect the health and wealth of the moneyed "investing class?"

Conventional shareholder primacy theory presumes that investors, universal or not, care only about themselves. There is a substantial body of evidence from the social sciences, however, including extensive evidence from experiments with human subjects, that documents that most people are to some degree altruistic and "prosocial."[29] Prosocial shareholders are willing to sacrifice at least some corporate profits in order to benefit, or at least avoid harming, employees, consumers, society, or the environment. Direct evidence for this can be found in the significant and growing investor interest for "social" investment funds.[30]

Einer Elhauge has employed the idea of pro-sociality as an interesting platform for yet another theory of how director control benefits shareholders.[31] This theory recognizes that, just as shareholders face structural obstacles bringing corporations to heel to serve their economic interests, they face obstacles making firms serve their altruistic desires. For a host of reasons—including lack of access, lack of time, lack of information, and their own rational apathy—shareholders often find it difficult to determine whether and to what extent the corporations they invest

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[29] See generally Lynn Stout, *Cultivating Conscience: How Good Laws Make Good People* (2011).
[30] See Cynthia William, "The Securities Exchange Commission and Corporate Social Transparency", 112 Harv. L. Rev. 1197 (2000).
[31] See Elhauge, supra note 13.

in are reaping profits from socially harmful behavior. Directors stand in a much better position to make such judgments. Also, anonymous shareholders are largely insulated from shaming or other "social sanctions" that follow corporate misbehavior, where directors are not. The end result is that corporations run by directors who enjoy a range of authority to sacrifice profits in the public interest may end up serving investors' interests—including investors' altruistic, prosocial interests--better than corporations run according to the "standard model" would.

Conclusion: Some Lessons from the New Thinking

Until recently, it has been commonplace to conceptualize the debate over the purpose of the public corporation as a duel between those who think directors ought to run corporations only to maximize shareholder wealth as measured by stock price, and those who think boards ought to consider the interests of others in society as well. The first group has been associated with economic theory, and the second with political agendas.

By the turn of the millennium, shareholder primacy thinking shows signs of becoming far more subtle. Scholars increasingly argue that, for a variety of reasons, *shareholders themselves* might prefer that public corporations be controlled primarily by boards of directors, and also prefer that these boards enjoy a wide range of discretion to consider the interests of stakeholders and the broader society. These new interpretations of what different shareholders truly "value" offer to explain a number of otherwise-puzzling empirical realities of corporate law and practice. Along the way, they also offer a number of interesting and potentially useful insights into the proper purpose of the business corporation.

Perhaps the first lesson is that conventional shareholder primacy is no longer the only intellectually respectable game in town. Indeed, shareholder primacy theory suffers from a potentially fatal weakness. As Stephen Bainbridge has pointed out, the chief criterion for any model of the corporation must be the model's ability to predict the separation of ownership and control that is the hallmark of the public firm.[32] The standard shareholder-oriented model fails this basic criterion.[33] In contrast, each of the five theories discussed in the Essay can explain the twin anomalies of substantial director autonomy under the default rules of corporate law, and promoter preference for enhancing director power in firms going public. In the process, they undermine the conventional wisdom that directors and executives who fail to focus obsessively on rising a company's share price are somehow at fault or remiss in their duties. This

[32] See Stephen M. Bainbridge, "The Board of Directors as a Nexus of Contracts", 88 Iowa L. Rev. 1, 3 (2002).
[33] See Stout, "The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance", 152 U. Pa. L. Rev. 667 (2003).

common notion, embraced in most corporate law and business classes and also in many boardrooms and the pages of the financial press, may be not only incorrect, but hazardous to investors' collective health.

Second, each of these five theories explains the empirical observation that investors purchasing stock in public companies seem to prefer their companies be governed by a board of directors largely insulated from shareholders' command and control, even as this makes it more difficult for shareholders to stop the board from pursuing strategies that benefit stakeholders or society at the expense of share price. In particular, each of the theories suggests that shareholders, like the mythic hero Ulysses, benefit from "tying their own hands" and ceding control over corporate assets and earnings to boards. This idea offers insights into such notions as the claim that a business strategy that decreases share price nevertheless benefits shareholders "in the long run," or the idea that action that harms shareholders nevertheless helps "the firm." They also illustrate how conventional shareholder primacy papers over the very real schisms between different shareholders' interests and values by reducing shareholders to their lowest common human denominator, implicitly assuming they are uniformly short-sighted, impecunious, opportunistic, self-destructive, and psychopathically indifferent to the fates of others, future generations, and the planet.

Third, by drawing attention to differences in shareholder interests and values, these theories suggest how director governance of public companies that benefits most investors most of the time can nevertheless cut against the interests of certain shareholders at certain times. The theories thus suggest how boards can play a crucial role in mediating between different shareholders' demands, and steer the corporate ship of state in directions that decently satisfy the needs of most rather than maximizing the interests of a narrow subgroup. The theories also predict–in accord with what we actually observe–that even while investors remain happy to purchase shares in director-run public companies ex ante, for example at the IPO stage, certain shareholder groups are equally happy to protest, and even try to overturn, director governance rules ex post.[34] Although such protests and "reform proposals" do not necessarily serve the interests of investors as a class, they can serve the interests of particular subgroups of investors in particular situations.[35]

A fourth and related point is that U.S. regulators and policymakers should not reflexively respond to every business crisis or scandal *de jour* by trying to "reform" corporate law to give shareholders greater power. The assumption often seems to be that anything that gives shareholders greater leverage necessarily serves investors' interests. The new scholarship severs this supposed linkage. While the elimination of staggered boards, the creation of a new shareholder right to vote on executive

[34] See Robert Daines and Michael Klausner, "Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs", 17 J.L. Econ. & Org. 83 (2001).
[35] See generally Anabtawi, supra note 20 (discussing conflicts of interest between shareholders).

compensation, etc., can all attract political support by promising an immediate windfall to certain types of shareholders, there is every reason to suspect such "shareholder democracy"-enhancing rules may ultimately work against the interests of the investing class as a whole.

Fifth, this analysis cautions even more strongly against attempts to export the "standard shareholder-oriented model" abroad. During the 1970s, many experts argued that U.S. corporations could learn from the example of highly-successful, stakeholder-friendly German and Japanese firms. With the decline of the Japanese and German economies and the bubble-fuelled ascendancy of the U.S. stock market during the 1990s, however, the advice tended to flow the other way. Corporate governance experts trumpeted the success of the "U.S. model" and counselled other countries to follow our lead by moving their corporate law rules closer to shareholder primacy. A few nations actually heeded this advice, sometimes with disastrous results.[36] The new literature suggests at least two reasons why governance experts who tout the "U.S. model" abroad may, in fact, be exporting damaged goods. First, as already noted, the standard shareholder-oriented model does not actually describe U.S. law, and this is no accident: the "standard" model in fact does not benefit investors in public companies. Second, the U.S.'s director-centric governance rules evolved to solve the problems of companies with widely-dispersed share ownership, not functionally "private" companies with controlling shareholders. Accordingly, we may do other nations whose companies tend to have controlling shareholders a grave disservice by urging them to adopt rules that are not designed for that share ownership pattern.

Finally, by suggesting how director governance rules ultimately serve public shareholders' interests better than shareholder-centred governance rules would, the five theories of director governance examined here may go a long way toward resolving the debate over corporate purpose. Each of the five theories suggests different and increasingly broad reasons why shareholders might not only want to grant boards the sort of authority that permits them to serve other stakeholders at shareholders' expense, but *actually prefer that boards do this*. Because the five theories provide different accounts of exactly what range of "outside" interests shareholders would like directors to consider—creditors? employees? society as a whole?--the area of dispute that remains in the Great Debate will depend to some extent on exactly how many, and which, theories of director primacy one subscribes to. But to the observer who finds merit in all five—and, as I have argued, all five have merit—the Great Debate, if not entirely resolved, is at least diminished in scope and importance.

[36] See, e.g., Bernard S. Black, Reinier Kraakman & Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong", 52 Stan. L. Rev. 1731 (2000).

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