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ARTICLE

RADICAL SHAREHOLDER PRIMACY

DAVID MILLON*

Shareholder primacy, a term familiar to all corporate law academics, is the idea that corporate management's primary responsibility is to promote the economic interests of shareholders. Regard for the corporation's various non-shareholder constituencies—including workers, creditors, suppliers, consumers, and the local communities in which the company operates—or for society more generally must not compromise the primary obligation to its shareholders. This conception of management's role and of the shareholders' privileged place among the firm's many stakeholders contrasts with other models. For example, some have argued that management's job is to balance or mediate the potentially conflicting interests of the different stakeholder groups.[1] Others would emphasize the importance of minimizing social costs.[2] It can also be argued that corporations have an affirmative duty to contribute to the improvement of society, even if that comes at the expense of corporate profits and shareholder wealth.[3] All of these theories share a rejection of the idea that shareholder interests should take priority over those of other stakeholders or of society more generally.

In this article, I argue that there are two versions of the shareholder primacy idea. I label one version "radical shareholder primacy" because it makes an extreme claim about the nature of the shareholders' privileged position within the corporation. This version of shareholder primacy asserts that corporate management is the agent of the shareholders and as such

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1. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (taking issue with the principal-agent model of corporate governance and the shareholder wealth maximization objective).

2. *See generally* Andrew Johnston, *Facing up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFFITH L. REV. 221 (2011) (arguing that the label corporate social responsibility should be reserved for the process by which corporations voluntarily identify and correct the social costs of their operations).

3. The literature on corporate social responsibility is vast. *See, e.g.*, THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY (Andrew Crane et al. eds., 2008) (discussing the social and ethical responsibilities of business).

owes them a duty to maximize the return on their investments.[4] This generally means maximization of current value to shareholders, even at the expense of possibly greater long-term value. Agents do not act as diligently for their principals as they do when they are working for themselves because as agents they do not capture the full value of their efforts. This slack and the expenses incurred by shareholders in attempting to monitor the performance of their agents are termed "agency costs." According to this version of shareholder primacy, therefore, the key problem for corporate law is to minimize agency costs so as to maximize shareholder wealth. There is a difference of opinion among scholars committed to this model as to whether corporate law should more effectively empower shareholders to exert pressure on management to perform optimally or whether instead market mechanisms reduce agency costs to acceptable levels, obviating the need for law reform. While they might disagree about the extent to which law is needed, proponents of radical shareholder primacy—who include most of the biggest names in the corporate law academy—all accept the agency characterization and the shareholder wealth maximization injunction.[5]

Radical shareholder primacy differs from another version of shareholder primacy, which I term "traditional shareholder primacy." This model also claims to privilege shareholders, but its commitment to them is significantly weaker than under the radical version. Under the traditional model, which emerged in the last years of the nineteenth century and was embodied in corporate law and widely accepted for much of the twentieth century, management enjoys broad discretion and is largely immune from shareholder control.[6] While it is assumed that a business corporation is organized in order to generate profit and, as a practical matter, a corporation that regularly loses money cannot survive long-term, there is no expectation that management must maximize current share price to the exclusion of competing objectives. These can include regard for the interests of non-shareholder constituencies under circumstances management deems to be appropriate, as well as long-term investments that reduce current earnings for the sake of future gains. Certainly there is no sense that an agency relationship exists between management and shareholders. The normative boost to shareholder empowerment that the agency idea provides, therefore, is lacking under the traditional model.

This article begins in Part I with a brief history of the emergence of the "shareholder primacy" idea, a term that appears in U.S. law reviews only at the very end of the 1980s. Part II then explains the origins of the radical shareholder primacy concept at the University of Chicago Law School in the late 1970s, before the advent of the term "shareholder primacy." The

4. *See infra* text accompanying notes 22–31.

5. *See infra* text accompanying notes 32–40.

6. *See infra* text accompanying notes 41–55.

key notion is the assertion of an agency relationship between management and shareholders, which contrasts with the traditional, significantly more modest version of shareholder primacy accepted for much of the twentieth century. Part III then surveys the status of radical shareholder primacy today. Though not grounded in legal doctrine, its agency idea and the focus on agency costs shapes much of today's prominent corporate law scholarship. It is also observed in actual business practice, though not as a direct result of the work of its academic partisans. Rather, social norms cultivated in the leading business schools, in board rooms, and in the business press, coupled with strong pressure from institutional shareholders, lead corporate management to behave as if it is the agent of the shareholders and as such is obliged to maximize current share price to the exclusion of competing objectives.

I. "Shareholder Primacy" in the Law Reviews

The term "shareholder primacy" first appears in the law reviews in early 1989, in articles published contemporaneously by me and my friend and Washington and Lee colleague Lyman Johnson. He and I had been discussing the idea of shareholder primacy and employing that phrase in our daily conversations about current corporate law topics, particularly the policy challenges presented by the then high incidence of hostile takeover activity. My paper included a discussion of the emergence during the early twentieth century of the idea that "management's broad discretion with respect to conduct of corporate affairs must be exercised solely for the benefit of the shareholders."[7] Professor Johnson's article, cited in my piece, analyzed the emerging disjunction between state judicial and legislative regulation of target management responses to hostile takeovers.[8] We analyzed the shareholder primacy idea extensively in a co-authored article published in 1989.[9] We continued to use the term in a number of subsequent publications, some co-authored,[10] some written individually.[11]

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7. David Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 Wash. & Lee L. Rev. 903, 904 (1988). *See also id.* at 918 (referring to "the requirement that management diligently devote itself to maximizing shareholder wealth rather than other possibly conflicting objectives"). Patrick Ryan's article, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 Ga. L. Rev. 97, 173 (1988), published very soon after mine, used the term "shareholder primacy" in passing on the seventy-sixth page of an eighty-seven-page article. There may have been earlier uses of the term in books as opposed to law review articles but, if so, we were then and are now unaware of them.

8. Lyman Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. Corp. L. 35 (1988).

9. Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 Mich. L. Rev. 1862, 1899–1907 (1989).

10. *See, e.g.*, Lyman Johnson & David Millon, *Missing to the Point about State Takeover Statutes*, 87 Mich. L. Rev. 846, 848 (1989); Lyman Johnson & David Millon, *Does the Williams Act Preempt State Common Law in Hostile Takeovers?*, 16 Sec. Reg. L.J. 339, 353 (1989); Lyman Johnson & David Millon, *The Case Beyond Time*, 45 Bus. Law. 2105, 2116 (1990);

Since then, the term "shareholder primacy" has become a basic element of corporate law discourse. It is used routinely in academic discussions about corporate purpose and about the appropriate beneficiaries of management's discretion. This is the case not only among U.S. scholars[12] but abroad as well.[13]

In one of our early articles, Professor Johnson and I explained that the shareholder primacy idea is subject to two quite different interpretations.[14] The core notion is that shareholder interests should dominate competing claims by other stakeholders, but corporate law can operationalize that idea in either of two ways. On the one hand, the shareholder primacy idea can serve as an injunction to management, defining its duty in relation to the corporation's various stakeholders. As such, shareholder primacy instructs management to prioritize shareholder interests over competing non-shareholder interests. In that article, we referred to this as the "shareholder protection" version of shareholder primacy.[15] Corporate law promotes shareholder financial interests by defining management's obligations with reference to them. The relation between management and shareholder is roughly equivalent to that between a trustee and its beneficiaries, with the trustee enjoying broad power and discretion to advance the beneficiaries' interests and the beneficiaries themselves being essentially passive.

Alternatively, the shareholder primacy idea can lead to the view that shareholders should themselves be able to decide important questions regarding their economic interests. We referred to this as the "shareholder

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Lyman Johnson & David Millon, *Corporate Takeovers and Corporate Law: Who's in Control?*, 61 GEO. WASH. L. REV. 1177, 1179 (1993).

11. *See, e.g.*, Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 871 (1990); Lyman Johnson, *Sovereignty Over Corporate Stock*, 16 DEL. J. CORP. L. 485, 489 (1991); Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992); Lyman Johnson, *New Approaches to Corporate Law*, 50 WASH. & LEE L. REV. 1713, 1713 (1993); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 220–25; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 225 (1991); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1374 (1993).

12. *See, e.g.*, Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909 (2013); Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW. 45 (2002); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002); Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. REV. 141 (2002); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998).

13. *See, e.g.*, Paul Krüger Andersen & Evelyne J. B. Sørensen, *The Principle of Shareholder Primacy in Company Law from a Nordic and European Regulatory Perspective*, *in* THE EUROPEAN FINANCIAL MARKET IN TRANSITION (Hanne Birkmose, Mette Neville & Karsten Engsig Sørensen eds., 2011); Malcolm Anderson et al., *Shareholder Primacy and Directors' Duties: An Australian Perspective*, 8 J. CORP. L. STUD. 161 (2008); Paddy Ireland, *Shareholder Primacy and the Distribution of Wealth*, 68 MOD. L. REV. 49 (2005) (U.K.); John Armour, Simon Deakin & Suzanne Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 BRIT. J. OF INDUS. REL. 531 (2003) (U.K.).

14. Johnson & Millon, *supra* note 9, at 1882–86.

15. *Id.* at 1883.

autonomy" version of shareholder primacy.[16] According to this view, shareholders should be able to exert pressure on management to maximize their financial interests and should have the power to replace underperformers. There is a loose analogy to the principal-agent relation.

Professor Johnson and I illustrated this distinction with reference to differing judicial interpretations of the federal Williams Act's[17] regulation of target company management's power to resist hostile takeovers.[18] One might argue that shareholders of the target ought to enjoy the right to decide for themselves whether to accept the consideration offered to them by the hostile bidder. This can be seen as a matter of personal autonomy and the right of a property owner to decide whether and on what terms to dispose of his or her property, here corporate stock. Alternatively, defensive measures denying shareholders that choice might be justified on the ground that management knows better than the shareholders themselves about the long-term value of their shares; therefore, shareholders need to be protected from mistakenly reaching for the seductive but actually inadequate premium offered by the bidder. These approaches have very different implications for the question of managerial authority, but each can be grounded on the shareholder primacy idea.[19]

In today's corporate law discourse, the "shareholder protection" version of shareholder primacy resonates with Professor Stephen Bainbridge's "director primacy" theory of corporate law.[20] According to this view, the corporation's board of directors' job is to pursue shareholder wealth maximization, but the board possesses broad discretion with respect to the means to that end and is largely immune from direct shareholder control. Bainbridge argues that his conception accurately describes the current state of the law; he also asserts that it is desirable from a normative point of view because of the value of managerial discretion.

As explained in the next section, what I term the radical version of shareholder primacy amounts to an extreme version of the "shareholder autonomy" conception of the balance of power between management and shareholders. The emphasis is on the shareholders' right to more directly influence corporate direction and policy. Professor Lucian Bebchuk's "shareholder empowerment" agenda exemplifies this position, taking for

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16. *Id.*

17. Willams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended by Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977)) (requiring disclosure of information regarding cash tender offers and providing procedural protections for offerees).

18. Johnson & Millon, *supra* note 9, at 1882–89.

19. Note also that defensive measures might be justified with reference to a duty to protect non-shareholders or to protect the "corporate enterprise" as an entity.

20. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (exploring the basic concepts of director primacy).

granted that shareholders should possess the ability to demand of management that it act according to their preferences.[21]

II. Radical Shareholder Primacy

A. *Radical Versus Traditional Shareholder Primacy*

1. *The Agency Idea*

The key feature of radical shareholder primacy is its description of the relation between shareholders and management in terms of agency. Corporate management acts as the agent of a principal, which collectively is the company's shareholders. This means that management's job is to act on behalf of the shareholders, using its managerial authority to advance their interests. No such agency relation exists as to the corporation's other stakeholders, such as employees, creditors, suppliers, and customers. As to them, management's sole responsibilities are to honor contractual obligations and to observe relevant legal rules that regulate those relationships. Nor is there any more general duty to society as a whole.

As the agent, management's duty is to maximize the shareholders' return on their investments in the corporation. This means maximization of the value of their residual claims on the corporation's assets and revenues, which ordinarily requires maximization of corporate profits. The maximization injunction is assumed even though it does not necessarily follow from the agency idea that management must advance shareholder financial interests to the fullest extent possible. An agent's job is simply to perform the task defined by the principal, acting on his or her behalf.[22] In the corporate context that could mean various things, such as realizing a "reasonable" return on investment while fostering productive, efficiency-enhancing relationships with other stakeholders. Or it could mean promotion of the long-term sustainability of the corporate enterprise. Moreover, radical shareholder primacy assumes a unitary body of shareholders all having the same interest in maximizing financial return.

Radical shareholder primacy posits further that the principal has the authority to determine the relevant time horizon within which shareholder wealth maximization is to occur. As explained more fully below,[23] today's institutional shareholders, who dominate the stock markets, tend to focus sharply on quarterly accounting results as the relevant benchmark for a corporation's financial performance. A corporation's failure to reach earnings targets can result in large-scale sell-offs and consequent declines in share prices.[24] If share price falls too far, executives face the prospect of job

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21. *See infra* text accompanying notes 32–37.

22. *See* Restatement (Third) of Agency § 1.01 (2006).

23. *See infra* text accompanying notes 146–47.

24. *See, e.g.*, Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio*, 7 Rev. Acct.

loss,[25] pay cuts,[26] or reduced bonuses.[27] Equity-based compensation schemes also encourage an emphasis on share price.[28] Corporate management therefore confronts strong incentives to concentrate on quarterly results. This can mean a willingness to forego expenditures that reduce earnings in the short-term even though there may be potential long-term pay-offs.[29] From the perspective of radical shareholder primacy, management would violate its duty as agent of the shareholders if it were to pursue some other objective that had the effect of reducing quarterly earnings, such as the long-run sustainability of the corporation or some kind of social responsibility agenda.

By relying on agents to maximize the financial return on their investments, shareholders face the inevitable fact that management will not devote itself as fully to their interests as it would if it were itself to reap the full benefits of its efforts. Management may use its position to divert corporate assets to itself, or it may simply put forth less than optimal effort. In either case, shareholders earn less than they would if their agent performed its work with greater fidelity and commitment. Shareholders, therefore, must monitor the activities of management, either themselves or relying on other agents. Management may also attempt to provide guarantees (or "bonds") that it will act in the shareholders' best interests. Drawing on economic analysis,[30] legal theorists use the term "agency costs" to describe the sum of the lost value that is inherent in any agency relationship, together with the additional costs of monitoring by shareholders and bonding by management.[31]

2. *Normative Implications*

Viewed from this agency cost perspective, the primary role of corporate law is to enhance management's accountability to the shareholders. Ideally, accountability should provide the incentives needed to ensure that management acts in the best interests of the shareholders, defined according to the shareholders' preferences. Traditionally, corporate law has addressed

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STUD. 289 (2002) (providing research showing that "growth" or "glamour" stocks produce a much larger negative response to earnings disappointments than other stocks).

25. John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 28 (2005) (quoting an executive as saying, "I miss the target, I'm out of a job.").

26. *See* Andrew C.W. Lund & Gregory D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 695 (2011) (indicating that CEO terminations can be linked to share price performance).

27. Steven R. Matsunaga & Chul W. Park, *The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus*, 76 ACCT. REV. 313 (2001).

28. *See* Lund & Polsky, *supra* note 26, at 695–97.

29. *See, e.g.*, Graham, *supra* note 25, at 32–35.

30. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

31. *See infra* text accompanying note 96.

this problem in two ways. First, it imposes legal duties on management—expressed in terms of open-ended fiduciary duties of care and loyalty—that are enforceable by the shareholders through derivative actions. The prospect of personal liability for careless or deliberate wrongdoing ought to discourage those kinds of misbehavior. Second, corporate law also confers on the shareholders the power to replace the board of directors (which appoints and monitors the corporation's senior officers) through the annual electoral process. Here the threat of job loss should deter shirking or dishonesty.

For proponents of radical shareholder primacy, the question then becomes whether these existing accountability mechanisms adequately minimize the costs of the agency relationship. No one claims that shareholder voting rights or fiduciary duties enforceable by derivative suits are fully sufficient by themselves to minimize agency costs. Due to the high costs involved in mobilizing shareholder support, it is exceedingly difficult to oust incumbent management via the annual election; actual challenges therefore are rare.[32] Fiduciary duties are difficult to enforce for a number of reasons. The business judgment rule insulates directors from liability except in cases of self-dealing or deliberate disregard of duty.[33] Exculpation provisions included in most corporate charters eliminate money damages liability for duty of care breaches by directors.[34] The derivative action's demand requirement presents a substantial hurdle to shareholder litigation.[35]

Some scholars therefore argue for law reforms that would provide shareholders with greater power vis-à-vis management. For example, Professor Bebchuk advocates conferring on shareholders the power to initiate structural changes to the balance of power between shareholders and management.[36] These could include the elimination of staggered boards or reincorporation in a state that provides shareholders with stronger governance authority or remedies for management misconduct. Under current law, shareholders lack the power to initiate reincorporation or amendment to the articles of incorporation. Bebchuk also argues for empowerment of shareholders with respect to certain decisions to merge or dissolve a corporation or to distribute cash or other assets to the shareholders. Such power would counteract management's typical bias in favor of maintaining the corporation's existence and retaining its earnings within the corporate treasury. Bebchuk and others have also proposed that shareholders seeking to challenge management at the annual meeting should be able to propose rival

32. Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Law. 43, 45–46 (2003).

33. Stephen M. Bainbridge, Corporation Law and Economics 269 (2002).

34. *See generally* Del. Code Ann. tit. 8, § 102(b)(7) (2013) (providing for opt-in exculpatory provisions in articles of incorporation).

35. Bainbridge, *supra* note 33, at 393.

36. *See* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005).

nominees for inclusion in management's proxy solicitation materials, a change that could greatly reduce the costs of proxy solicitation contests.[37]

Others who see management as the shareholders' agent acknowledge existing corporate law's limitations as a mechanism for reducing agency costs, but assert the efficiency of the current legal regime based on its near universal adoption as the framework of choice for organization of large-scale production. From this perspective, the "separation between ownership and control" characteristic of publicly held corporations—despite the attendant agency cost problem—flourishes because it reflects an efficient division of labor, allowing those with capital but without managerial expertise or inclination to invest in a number of different firms while leaving managerial functions to full-time business professionals.[38] Rather than calling for legal reform designed to confer greater power on shareholders to monitor and discipline management and participate in decision making, these scholars are more likely to emphasize the importance of existing non-legal incentives as mechanisms for reducing agency costs to efficient levels. These include product or service markets, which demand managerial diligence in order to avoid firm failure, and the market for executive employment, which rewards corporate managers for strong performance and punishes them for sub-par results. Equity-based compensation arrangements, widely used, align the interests of senior officers with the shareholders' desire for high stock prices. Perhaps most important, the "market for corporate control" could encourage current share price maximization in order to discourage potential hostile takeovers that would result in displacement of incumbent management.[39] Here, though, corporate law has evolved in ways that effectively shield management from unsolicited changes in control. Accordingly, even those scholars who are disinclined to favor legal intervention in markets advocate law reform that would stimulate an active takeover market.[40]

3. *Traditional Shareholder Primacy*

In contrast to what I term "radical shareholder primacy" is another model, which I term "traditional shareholder primacy." Under the tradi-

37. Bebchuk, *supra* note 32, at 47. Note that much of the shareholder empowerment agenda is already present in U.K. corporate law. *See* Christopher M. Bruner, CORPORATE GOVERNANCE IN THE COMMON-LAW WORLD: THE POLITICAL FOUNDATIONS OF SHAREHOLDER POWER ch. 3 (2013).

38. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 11 (1991) (describing the separation of risk bearing from management).

39. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965).

40. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194–1204 (1981) (arguing for a rule of managerial passivity when confronted with a tender offer); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 865–90 (1981) (advocating "role allocation rule" to address concerns about the allocation of authority between management and shareholders).

tional conception of shareholder primacy, one does not find the relationship between management and shareholders described in terms of agency. This different perspective was the dominant way of thinking about corporate governance from the turn of the twentieth century until the advent of radical shareholder primacy, which as I explain below is of quite recent origin.

Under traditional shareholder primacy, the agency characterization is descriptively inaccurate because of corporate law's assignment of broad discretion to management and its weak commitment to accountability to shareholders. For purposes of the comparison I seek to draw here, it is the nearly complete inability of the shareholders to control management that bears primary emphasis. As discussed above, voting rights and fiduciary duties exert pressure on management only in cases of severe incompetence or obvious malfeasance. In Professor Bainbridge's words, "Shareholder control rights are so weak that they scarcely qualify as part of corporate governance."[41] Hostile takeovers—a potentially powerful tool for holding management accountable to shareholders—do not pose a serious threat because of the broad power conferred by the Delaware judiciary on incumbent management to resist unwelcome challenges to its control.[42]

In light of the corporate law's systematic disempowerment of shareholders, it makes no sense to describe their relationship to management in terms of agency because one of the essential attributes of an agency relationship is the principal's right of control over the actions of the agent. This is stated clearly in the most recent Restatement of the law of agency,[43] as it was in the Restatement's previous two incarnations.[44] Law professors familiar with agency law reject the relevance of the legal idea of agency to the relationship between shareholders and management.[45] Professor Victor Brudney also notes that dispersed shareholders lack the knowledge of man-

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41. Bainbridge, *supra* note 20, at 569.

42. The *Unocal* and *Time/Warner* decisions in particular confer broad discretion on corporate management to resist hostile overtures that are inconsistent with management's vision for the corporation's future. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The *Revlon* case does impose a duty on management to maximize current share price, but it is important to appreciate that the circumstances in which the *Revlon* duty applies only arise as a result of a voluntary decision by management to initiate an auction, to sell the company to a buyer that will break it up, or to enter into a change of control transaction. *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

43. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

44. RESTATEMENT (THIRD) OF AGENCY § 1(1); RESTATEMENT (FIRST) OF AGENCY § 1.

45. *See* Robert C. Clark, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 56–59 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1428–30 (1985).

agement's conduct and the firm's performance necessary for exercise of control even if they were inclined to do so and possessed the necessary legal tools.[46]

Not only do shareholders lack the control powers that are at the heart of a true agency relationship, it is not even clear that management's duty is to maximize shareholder wealth. As discussed more fully below,[47] there is virtually no statutory or common law authority for that claim. Even the oft-cited *Dodge v. Ford* case, the standard and often the only citation offered for the maximization claim, does not on its face demand maximization.[48] As far as shareholder primacy is concerned, the best that can be made of that decision is the principle that management may not prioritize non-shareholder interests over those of shareholders. In any event, the case is anomalous and has had no significant influence on Delaware corporate law.

In light of the descriptive inaccuracy of the agency characterization, normative claims that are readily assumed to follow from the agency idea are problematic and controversial. Law reform proposals that seek to strengthen the position of shareholders in relation to management cannot rest solely on the idea that management is the agent of the shareholders. The shareholder empowerment agenda of Professor Bebchuk and others needs a different justification, which typically is not forthcoming. So too does the critique of Delaware law authorizing defensive tactics against hostile takeovers, which is based on the idea that the threat of an unsolicited tender offer encourages management to maximize current share price.[49]

The traditional model's commitment to managerial accountability is so weak that some would reject the suggestion that this amounts to shareholder primacy at all. Notably, Professor Bainbridge uses the term "director primacy" to describe the traditional legal model, emphasizing the expansive governance authority of the board of directors and the shareholders' corresponding impotence.[50] As a descriptive matter, he is surely correct on the question of the primary locus of power within the corporation as between management and shareholders. Indeed, managerial discretion, broadly even if not entirely shielded from shareholder oversight, is arguably the foundational principle of Delaware corporate law.

Even if shareholder primacy does not accurately express the balance of power between shareholders and management, it nevertheless still makes sense to use the term shareholder primacy to describe the traditional model

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46. Brudney, *supra* note 45, at 1429–30.

47. *See infra* text accompanying notes 120–34.

48. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

49. *See, e.g.*, Easterbrook & Fischel, *supra* note 40; Gilson, *supra* note 40; Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Jonathan R. Macey, *Auction Theory, MBOs, and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85 (1990).

50. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550–52 (2003).

as long as one is clear about what one is talking about. Shareholders do enjoy a special place within the corporate governance structure in relation to its other constituencies or stakeholders. Shareholders alone elect directors except in extraordinary circumstances. They alone have a right of access, albeit limited, to corporate books and records including the list of shareholders. Only shareholders can bring derivative lawsuits against directors or officers to redress harm done to the corporation. They are singled out for special mention in Delaware's traditional specification of fiduciary duties being owed to "the corporation and its shareholders."[51] Shareholders are commonly, even if inaccurately, referred to as the "owners" of the corporation.[52]

These features of corporate law, singling out shareholders for special status among the corporation's various stakeholders, are vestiges of old, long since discarded conceptions of the legal status of the corporation's shareholders. At least until the middle of the nineteenth century, most businesses were operated as sole proprietorships or partnerships.[53] Firms organized as corporations because of capital needs generally were closely held and employed one or a few salaried managers.[54] Because of these corporations' functional similarities to partnerships, it was plausible as a descriptive matter to analogize shareholders' governance authority and property rights within the corporation to those of partners in a general partnership.[55] The shareholders, or at least a majority of them, typically participated directly in control over the business' activities and enjoyed the legal right to do so. As owners of the firm's assets, they could at least loosely be described as "owners" of the corporation. And it made sense to describe managers, directors, and lower-level employees who worked for the business as the shareholders' agents because the idea of the corporation as a distinct legal person (and therefore as the agents' principal) was not yet well established.[56]

Ironically, therefore, during much of the nineteenth century the agency characterization of the relation between managers and shareholders was legally accurate. By the end of the century, however, as corporations grew in size and complexity and the number of their shareholders increased, the

51. Loft, Inc. v. Guth, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd sub nom*. Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

52. Bainbridge, *supra* note 33, at 29; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 So. Cal. L. Rev. 1189, 1190-92 (2002).

53. *See* Alfred D. Chandler, The Visible Hand 36, 50 (1977).

54. *Id.* at 37, 41–42, 48, 60, 68.

55. Similar ideas animated thinking about nineteenth-century English corporate law. *See* Jonathan Mukwiri, *Myth of Shareholder Primacy*, 24 European Bus. L. Rev. 217 (2013); Paddy Ireland, *Company Law and the Myth of Shareholder Ownership*, 62 Modern L. Rev. 32 (1999).

56. Millon, *Theories of the Corporation*, *supra* note 11, at 213–14. Earlier in the nineteenth century, courts and commentators had noted that corporations differed from partnerships in requiring an act of the state for their formation, but this did not lead to claims that corporations rather than their shareholders were principals under the law of agency.

now well-known separation between ownership and control became increasingly typical.[57] Corporate law and legal theory adjusted to the fact that most shareholders no longer had the expertise or the inclination to participate directly in control of the business or exercise supervision over those who were responsible for control. Most notably, the relation between shareholders and management was reconceived such that the powers of the board of directors were now said to be "original and undelegated,"[58] an express repudiation of the older idea that shareholders conferred authority on directors.[59] It followed from this that the directors were now deemed to be agents of the corporation as a legal person rather than of the shareholders,[60] an idea that itself depended on a developed theory of the corporation as an entity existing separately from its shareholders.[61] The relationship between directors and shareholders was reconceived in terms of trusteeship rather than agency,[62] signaling a shift from shareholder control to managerial discretion. The development of the business judgment rule further enhanced managerial autonomy at the expense of accountability to shareholders.[63] Voting and informational rights survived as vestiges of an older age when shareholders, like partners, controlled their firms, even as these traditional mechanisms lost much of their practical significance. If the agency conception of the relation between management and shareholders lost currency in the early years of the twentieth century, where did radical shareholder primacy's agency model came from?

B. *The Recent Origins of Radical Shareholder Primacy*

Radical shareholder primacy originated at the University of Chicago Law School during the later 1970s. As such it was part of the remarkably rapid emergence and spread of Law and Economics at Chicago. While economists had taught at the Law School for decades, Chicago scholars began systematically to apply economic analysis to virtually all areas of law after the arrival at Chicago of Professor (now Judge) Richard Posner in

57. *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

58. *See, e.g.*, Manson v. Curtis, 223 N.Y. 313, 322 (1918); People ex rel. Manice v. Powell, 201 N.Y. 194 (1911); Hoyt v. Thompson's Ex'r, 19 N.Y. 207, 216 (1859).

59. *See* Sabrina Bruno, *Directors' Versus Shareholders' Primacy in U.S. Corporations Through the Eyes of History: Is Directors' Power "Inherent"?*, 9 EUROPEAN COMPANY & FIN. L. REV. 421, 431–34 (2012) (explaining prevalence of view of directors as agents of shareholders in nineteenth-century U.S. law).

60. *See, e.g.*, Dixmoor Golf Club, Inc., v. Evans, 325 Ill. 612, 616 (1927); People *ex rel.* Manice v. Powell, 201 N.Y. 194, 200 (1911); Beveridge v. N.Y. El. R. Co., 112 N.Y. 1, 22–23 (1889).

61. Millon, *Theories of the Corporation*, supra note 11, at 215.

62. *See, e.g.*, Kavanaugh v. Kavanaugh, 226 N.Y. 185, 193 (1919); Powell, 201 N.Y. at 200–01; Cass v. Manchester Iron & Steel Co., 9 F. 640, 642 (W.D. Pa. 1881).

63. *See* Rodman Ward & Paul J. Lockwood, *Corporate Law*, *in* DELAWARE SUPREME COURT GOLDEN ANNIVERSARY 1951–2001 82 (R. Holland & H. Winslow eds., 2001) (tracing origins of business judgment rule concept).

1969 and the publication of the first edition of his landmark *Economic Analysis of Law* in 1973.[64] In the field of corporate law, the key players were Professor Daniel Fischel and Professor (now Judge) Frank Easterbrook. First Fischel, and then Easterbrook and Fischel writing together, articulated the idea that management is the agent of the shareholders and then assumed its foundational relevance for their analysis of the entire field of corporate law. Importantly, they drew the agency idea—and the key concept of agency cost—not from corporate law itself, but rather from the field of financial economics. Since then, the agency idea and the focus on agency costs as corporate law's central problem have been taken for granted by most economically-oriented corporate law scholars despite the absence of an actual legal mandate.

1. Law and Economics at Chicago

Long before the emergence of Law and Economics at the University of Chicago Law School as a distinctive approach to the analysis of legal rules and institutions, there was already a long tradition of economists teaching at the Law School.[65] In 1933, Aaron Director and Henry Simons began offering courses in economics.[66] By 1939, Simons had been appointed to the law school faculty and Director received a similar appointment in 1946.[67] Later, renowned economists Gary Becker, Ronald Coase, Milton Friedman, and George Stigler would also teach at the Law School.[68]

The "new" Law and Economics is generally said to have emerged around 1960.[69] Scholars at the University of Chicago's Economics Department and Law School played a pivotal role.[70] Coase's article *The Problem of Social Cost*[71] could be read as arguing that private contracting efficiently resolves externality problems as long as property rights are adequately specified and there are no transaction costs.[72] The article was important not only for its novel analysis and its attention to the importance of transaction costs but more generally because it illustrated how economic analysis might illuminate elements of private law.

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64. Richard A. Posner, Economic Analysis of Law (1st ed. 1973).

65. Robin I. Mordfin & Marsha Ferziger Nagorsky, *Chicago and Law and Economics: A History*, The Record Online (Fall 2011), *available at* http://www.law.uchicago.edu/alumni/magazine/fall11/lawandecon-history (last visited Jan. 1, 2014).

66. *Id.* at 1.

67. *Id.* at 2.

68. *Id.* at 2–5.

69. Herbert Hovenkamp, *Law and Economics in the United States: A Brief Historical Survey*, 19 Cambridge J. Econ. 331, 334 (1995); Ejan Mackaay, *History of Law and Economics, in* Encyclopedia of Law & Economics 65, 72 (1999); Richard A. Posner, *The Economic Approach to Law*, 53 Tex. L. Rev. 757, 759 (1975).

70. Hovenkamp, *supra* note 69, at 334.

71. Ronald Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

72. Hovenkamp, *supra* note 69, at 334–35.

A focus on the efficiency of legal rules, procedures, and institutions contrasted with an earlier Law and Economics movement, a robust tradition of economic analysis of legal policy that flourished during the Progressive Era.[73] Later, after World War II, a number of economists studied the influence of law on the operation of markets.[74] Coase described this work as the study of "the effect that the working of the legal system has on the working of the economic system."[75] Focusing on the impact of law on markets, this research tended to concentrate on areas such as antitrust, utility and common career regulation, labor law, and taxation.[76]

Posner's initial contribution was to show that it was possible to apply economic analysis to virtually any area of law. Acknowledging the influence of Becker, Posner saw that neoclassical economics offers a set of tools that can illuminate most areas of human existence.[77] With respect to law, Posner effectively reoriented Law and Economics from the study of markets to the question of the efficiency of legal rules, procedures, and institutions, deploying economic analysis over a remarkably wide range of subject areas. The first edition of *Economic Analysis of Law* applied economics to virtually every area of public and private law, effectively encouraging economically-oriented scholars to pursue research in whatever substantive area of law they might be interested in.[78] For this reason, Posner's long-time Chicago colleague Professor Richard Epstein, himself a leading practitioner of Law and Economics, describes the first edition as "a manifesto [because it] brought economic analysis to nearly every area of law."[79]

Taking up Posner's challenge, in the wake of the publication of the first edition of *Economic Analysis of Law* Posner and his Chicago colleagues produced a broad and rich panoply of law review articles applying economic analysis to various legal areas. Writing by himself,[80] with econo-

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73. Herbert Hovenkamp, *The First Great Law and Economics Movement,* 42 STAN. L. REV. 993, 1031–58 (1990).

74. *See, e.g.*, Sophie Harnay & Alain Marciano, *Posner, Economics and the Law: From 'Law and Economics' to an Economic Analysis of Law*, 31 J. HIST. ECON. THOUGHT 215 (2009) (discussing Posner's economic analysis of the law and its antecedents).

75. Richard A. Epstein et al., *The Roundtable Discussion*, 64 U. CHI. L. REV. 1129, 1138 (1997).

76. Posner, *supra* note 69, at 758.

77. *See* Richard A. Posner, *The Law and Economics Movement*, 77 AMER. ECON. REV. 1 (1987).

78. POSNER, *supra* note 64.

79. Mordfin & Nagorsky, *supra* note 65, at 4.

80. *See, e.g.*, Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEG. STUD. 399 (1973); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. Rev. 499 (1976); Richard A. Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEG. STUD. 411 (1977); Richard A. Posner, *An Economic Theory of Privacy*, 2 REGULATION 19 (1978); Richard A. Posner, *The Economics of Privacy*, 71 AM. ECON. REV. 405 (1981); Richard A. Posner, *Toward an Economic Theory of Federal Jurisdiction*, 6 HARV. J. L. & PUB. POL. 41 (1982).

mist William Landes,[81] a member of the Law School faculty, and with others,[82] Posner published a number of papers on a range of substantive and procedural topics. Other Chicago colleagues wrote about torts,[83] contracts,[84] civil procedure,[85] patent law,[86] privacy,[87] and international trade.[88]

2. *Economic Analysis of the Corporation*

As Chicago professors were at work applying economics to a wide array of legal topics, it was to be expected that someone would turn to corporate law. Daniel Fischel took the lead, using cutting edge economic theory to analyze the legal regulation of hostile takeovers in an article published in the *Texas Law Review* in 1978.[89] Fischel had graduated from the University of Chicago Law School only a year earlier, where he had compiled an outstanding academic record.[90] Following graduation he clerked for Chief Judge Thomas E. Fairchild on the United States Court of Appeals for the Seventh Circuit and then for Justice Potter Stewart on the United States Supreme Court. After a year of private practice in Chicago, he joined

81. *See, e.g.*, William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEG. STUD. 1 (1975); William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J. L. & ECON. 875 (1976); William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J. L. & ECON. 249 (1976); William M. Landes & Richard A. Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 J. LEG. STUD. 83 (1978); William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEG. STUD. 235 (1979); William M. Landes & Richard A. Posner, *Joint and Mujltiple Tortfeasors: An Economic Analysis*, 9 J. LEG. STUD. 517 (1980); William M. Landes & Richard A. Posner, *Legal Change, Judicial Behavior, and the Diversity Jurisdiction*, 9 J. L. STUD. 367 (1980); William M. Landes & Richard A. Posner, *An Economic Theory of Intentional Torts*, 1 INT'L REV. L. & ECON. 127 (1981).

82. *See, e.g.*, Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 257 (1974); Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEG. STUD. 83 (1977).

83. *See, e.g.*, Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEG. STUD. 151 (1973); Richard A. Epstein, *Defense and Subsequent Pleas in a System of Strict Liability*, 3 J. LEG. STUD. 165 (1974); Richard A. Epstein, *Intentional Harms*, 4 J. LEG. STUD. 391 (1975); Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563 (1988).

84. *See, e.g.*, Anthony T. Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEG. STUD. 1 (1978); Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978).

85. *See, e.g.*, Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEG. STUD. 47 (1975); Geoffrey P. Miller, *An Economic Analysis of Rule 68*, 15 J. LEG. STUD. 93 (1986).

86. *See* Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J. L. & ECON. 265 (1977).

87. *See* Frank H. Easterbrook, *Privacy and the Optimal Extent of Disclosure under the Freedom of Information Act*, 9 J. LEG. STUD. 775 (1980).

88. *See* Alan O. Sykes, *Countervailing Duty Law: An Economic Perspective*, 89 COLUM. L. REV. 199 (1989).

89. Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

90. *Daniel R. Fischel*, UNIVERSITY OF CHICAGO LAW SCHOOL, http://www.law.uchicago.edu/faculty/fischel (last visited Jan. 16, 2014).

the faculty of the Northwestern University School of Law, returning to the University of Chicago as a faculty member and director of the Law and Economics Program in January 1984. Fischel later served as dean of the Law School.

In his 1978 *Texas Law Review* article, Fischel criticized federal and state law that interfered with hostile takeovers.[91] Relying on the efficient capital market theory, Fischel asserted that share prices accurately reflect all public information about a corporation's current performance and future prospects.[92] The stock of poorly managed companies, therefore, would trade at a lower price than it would if more competent managers were running the same company. This presented an opportunity for an outsider to acquire a controlling interest at the depressed price, replace the incumbent management team with a better one, and thereby boost the share price and make a profit.[93] This would not only result in more efficient utilization of the target corporations' assets; the very threat of a hostile takeover would motivate all managers to do what they could to achieve optimal performance in order to maximize current share price and thereby discourage hostile tender offers.[94]

Fischel was not the first to argue that a robust market for corporate control would be beneficial for shareholders, both those of companies targeted for takeover and also those that were not. Professor (later Dean) Henry Manne had suggested as much in an article published in 1965.[95] Fischel's contribution was to argue in detail that the Williams Act[96] and state legislation regulating hostile takeovers, together with the defensive measures available to target company management, "frustrate the effective functioning of the market for corporate control to the detriment of all shareholders."[97]

Fischel's argument assumed that the interests of shareholders were the primary criterion by which to evaluate the functioning of the hostile takeover market. This was by no means obvious. Other metrics exist that can justify restrictions on the ability of bidders to seize control of target companies. According to the Delaware Supreme Court, the harmful effects of hostile takeovers on employees, creditors, local communities, and other non-

91. Fischel, *supra* note 89, at 9–45.

92. *See id*. at 4.

93. *See id.* at 4–5.

94. *See id*. at 4.

95. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965).

96. Willams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended by Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977)) (requiring mandatory disclosure of information regarding cash tender offers and providing procedural protections for offerees).

97. Fischel, *supra* note 89, at 2.

shareholder constituencies might warrant defensive measures.[98] The same court has also emphasized the importance of managerial discretion to determine the corporation's future.[99] Hostile tender offers can present a conflict between the power of management and shareholders; if allowed free rein to accept a bidder's offer, the shareholders can in effect decide the corporation's future by accepting an offer from a bidder that intends to change the company's capital structure or strategic direction. According to the Delaware Supreme Court, this is a power that management may not delegate to the shareholders by stepping aside and letting them decide for themselves how to respond to a hostile bid.[100]

In Fischel's view, the focus on shareholder financial interests to the exclusion of other conflicting values was based on his claim that corporate managers were the agents of the shareholder principals.[101] Unlike a closely-held firm, in which the owners of the corporation's stock (or at least some of them) were typically directly involved in management of the company, publicly held corporations were characterized by what Berle and Means had referred to as a separation between ownership and control.[102] The "owners" of the corporation did not exercise control over it.[103] Viewed from this perspective, the functional division between provision of capital and active management of the business implied that shareholders had delegated managerial authority to the board of directors and senior officers, who were therefore expected to act on the shareholders' behalf. Although it does not necessarily follow from the fact of separation itself, this presumed agency relationship was taken to entail that management's duty is to maximize shareholder wealth.

Reliance on this agency relationship was potentially costly to the shareholder principals. Unlike a business owner who runs the firm himself or herself, managers of publicly held companies do not gain the full benefits of hard work or bear the full costs of subpar effort. This inevitable divergence of interest between managers and shareholders was a cost borne by shareholders, who also incurred monitoring costs. Fischel referred to the sum of these costs, plus bonding expenditures by management, as the "costs of the agency relationship."[104]

Fischel emphasized that the market for corporate control was particularly important "in creating incentives for management to maximize the

98. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (holding that directors may oppose a tender offer in order to protect the corporate enterprise).

99. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

100. *Id.* at 1154.

101. Fischel, *supra* note 89, at 4.

102. BERLE & MEANS, *supra* note 57, at 4.

103. Common as it is, it is a misnomer to refer to the shareholders as the "owners" of the corporation or of its property. The most that can be said accurately is that they own the corporation's stock.

104. Fischel, *supra* note 89, at 25 n.26.

welfare of shareholders."[105] Various other market mechanisms also operated to minimize agency costs.[106] Management had reputational incentives to perform well in order to increase the demand for their services. Commonly used equity-based compensation arrangements, such as stock options, aligned the interests of managers and shareholders, and competition in product markets likewise encouraged effective management.

Fischel seemed to take for granted the characterization of management as agents of the shareholder principals, even though there is no legal justification for it. Senior officers and the board of directors are agents of the corporation, not of the shareholders,[107] and their fiduciary obligations run to "the corporation and its shareholders," not to the shareholders alone.[108] Nor, as noted above, do shareholders enjoy the legal right or the practical power to control management, a hallmark of an authentic agency relationship.[109] Received opinion also tended to emphasize managerial autonomy from shareholder control, the central feature of the "managerialist" model of corporate governance that was ascendant for much of the twentieth century.[110]

Fischel's introduction of the agency idea was rapidly assimilated among leading corporate law scholars. Agency costs emerged as the central problem for corporate law. Fischel's analysis deserves to be seen as an important and surprising innovation in legal scholarship. It would not be hyperbole to suggest that it was revolutionary. Where did the agency idea come from?

Fischel drew the agency idea from then recent scholarship in financial economics. The key source was an article published only two years earlier by two Chicago-trained economists, Professor Michael Jensen and Professor (later Dean) William Meckling.[111] In the Chicago Law School environment, energized by Law and Economics' rapid infiltration of virtually all areas of law, it is no surprise that Fischel would have turned to cutting edge, Chicago-influenced financial economics literature to illuminate the legal problem he was interested in. He was one of the first law professors to cite this article in a law review.[112]

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105. *Id.* at 4.

106. *Id.* at 4–5.

107. For discussion of the agency status of officers, see Lyman Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005).

108. Loft, Inc. v. Guth, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd sub nom.* Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

109. *Supra* text accompanying notes 43–44.

110. *See, e.g.*, CHANDLER, *supra* note 53, at 484–500 (1977) (describing the history of management for much of the twentieth century); PETER F. DRUCKER, THE PRACTICE OF MANAGEMENT (1954) (discussing management's role post-World War II).

111. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

112. *See also* Leon Gabinet & Ronald J. Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895,

As economists, it does not appear that Jensen and Meckling had in mind the legal relation of principal and agent.[113] They defined an agency relationship more loosely, as one in which one or more persons (the principals) engage another (the agent) "to perform some service on their behalf which involves delegating some decision making authority to the agent."[114] According to them, the relationship between shareholders and corporate management "fit [sic] the definition of a pure agency relationship."[115] No legal authority for the characterization was cited; nor was there any effort to demonstrate how as a matter of actual practice shareholders had the power to control management or might be thought to have "engaged" corporate management to work on their behalf. Jensen and Meckling seem instead to have been thinking more generally of situations in which one person acts on behalf of another. These can be agency relationships in the eyes of the law if other attributes are present—particularly the power of control, the presence of consent, and fiduciary obligation—but they need not be. Importantly, however, they took for granted an idea shared by most financial economists, the belief that corporate management's primary responsibility is to maximize shareholder wealth. This assumption appears to have been grounded in traditional ideas about shareholder property rights and more recent, widely held disapproval of the broad discretion characteristic of the "managerialist" model of corporate governance.[116]

While Jensen and Meckling appeared to use the term agency in the non-legal sense of "acting on behalf of," once legal academics appropriated the agency idea in this context it took on a life of its own and became the foundation of what I am terming "radical shareholder primacy." Fischel and those who came after him seem to have taken the agency idea more seriously than it was intended in the economics literature. From a traditional legal perspective, the agency characterization implied a relationship in which the shareholders, as principals, enjoyed the power to control management, the agent. It also implied fiduciary obligation running from management directly to the shareholders and to them alone. This perspective provided normative leverage wherever law or practice seemed to disadvantage shareholder financial interests. It also made it inevitable that agency costs would be seen as a problem of central relevance.

Following Fischel's introduction of the agency idea to the legal academy in his 1978 *Texas Law Review* piece, Fischel then went on to co-author, with Professor Easterbrook, a series of important articles applying the agency cost framework to a broad range of corporate law topics. Easter-

903 n.30 (1977); Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 758 n.61 (1978).

113. *See supra* text accompanying notes 43–44.

114. Jensen & Meckling, *supra* note 111, at 308.

115. *Id.* at 309.

116. *See* RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS 317–18 (2007).

brook had also graduated from the University of Chicago Law School, in 1973, and had been a member of the faculty since 1978.[117] Prior to his collaboration with Fischel, his previous work had been in antitrust, privacy, and civil procedure.[118] The first of the articles co-authored with Fischel was a widely cited piece advocating target management passivity in the face of hostile takeovers published in the *Harvard Law Review* in 1981.[119] Successive articles, some co-authored, some published independently, culminated in the publication in 1991 of their book *The Economic Structure of Corporate Law*.[120] This is certainly, along with Berle and Means' *Modern Corporation and Private Property*,[121] one of the two most influential books about corporate law published during the twentieth century. Describing the corporation as a nexus of contracts and viewing management as agent of the shareholders obligated to maximize shareholder wealth, the Easterbrook and Fischel vision of the corporation and corporate law has largely defined the agenda for mainstream, economically-oriented corporate law scholarship. As noted above, there is disagreement about the actual magnitude of agency costs and how best to reduce them, but the agency cost problem as a drag on shareholder wealth maximization is widely assumed to be the central question for corporate law scholarship.

The nexus-of-contracts theory of the corporation views corporations as nothing more than webs of contracts among the firm's various constituents, who include managers and lower-level employees, shareholders, lenders, suppliers of materials, and others.[122] The primary point is to reject the idea that a corporation is an "entity" of some kind existing separately from the people who constitute it through their contractual interrelationships.[123] Though of central importance to their subsequent work, the nexus-of-contracts idea was not present in Fischel's and Easterbrook's earliest articles. Fischel first referred to the idea in 1982, citing an article published by University of Chicago economist Eugene Fama published in 1980.[124] As with

117. *Frank H. Easterbrook*, UNIVERSITY OF CHICAGO LAW SCHOOL, http://www.law.uchicago.edu/faculty/easterbrook (last visited Jan. 15, 2014).

118. *See generally* Frank H. Easterbrook, *Due Process in Selective Service Appeals*, 39 U. CHI. L. REV. 331 (1972); Frank H. Easterbrook, *Toehold Acquisitions and the Potential Competition Doctrine*, 40 U. CHI. L. REV. 156 (1972); Frank H. Easterbrook, William M. Landes, and Richard A. Posner, *Contribution Among Antitrust Defendants: A Legal and Economic Analysis*, 23 J. L. & ECON. 331 (1980); Easterbrook, *supra* note 87.

119. Easterbrook & Fischel, *supra* note 40.

120. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). For a critical assessment, see Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992).

121. BERLE & MEANS, *supra* note 57.

122. *See, e.g.*, BAINBRIDGE, *supra* note 33, at 27–33.

123. *Id.* at 27.

124. Daniel R. Fischel, *The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 917 & n.26, 918 & n.27 (1982) (citing Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980)). *See also* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV.

Jensen and Meckling's *Theory of the Firm* article,[125] Fischel again was a pioneer in drawing upon cutting edge economics literature to illuminate questions of corporate law.[126]

The nexus-of-contracts theory added weight to the agency conception of the relation between shareholders and corporate management. According to the contractual theory, shareholders, as passive investors in several different firms lacking the incentives or the expertise to engage in management themselves, rely on professional managers to maximize the returns on their investments.[127] Conceiving of the relationship in contractual terms strengthens the idea that management's job is to promote the shareholders' financial interests. Rejection of the notion of the "corporation" as anything more than a "legal fiction"[128] also neatly disposes of the possibility that management might owe duties to the corporate entity rather than simply to the shareholders. The language of voluntary assent also implies that the arrangements that structure business activity in the corporate form are efficient. Therefore, legal intervention, in the form of corporate governance reform or external regulation, is at least presumptively undesirable.

III. Radical Shareholder Primacy's Current Importance

A. *Radical Shareholder Primacy in the Academy*

There is no legal authority for the radical shareholder primacy conception of the relationship between corporate management and the company's shareholders. As noted above, corporate law's specification of the shareholders' power vis-à-vis management does not fit the legal definition of an agency relationship, which emphasizes the power of control.[129] While the current legal regime often is sufficient to subject managers of small-scale, closely held corporations to actual shareholder control (in the typical case some or all of the managers are shareholders themselves), that is not the case with respect to publicly held entities characterized by a separation between ownership and control. As corporations have grown in scale and complexity and shareholders have been transformed into passive investors relying on professional managers, corporate law has not evolved in ways that empower shareholders to exercise direct control over those on whom they are dependent for their financial returns.

1259, 1264 n.15 (1982) (citing Fama article); Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 Mich. L. Rev. 1155, 1177 n.58 (1982) (citing Fama article).

125. Jenson & Meckling, *supra* note 111.

126. Fischel was not the first to cite the Fama article in a law review. Professor Ronald Gilson had already done so in an article published in 1981. *See* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 836 n.67, 837 n.69, 838 n.72, 841 n.85 (1981) (citing Fama, *supra* note 124).

127. Fischel, *supra* note 124, at 918.

128. *Id.* at 917.

129. *See supra* text accompanying note 43–44.

Delaware corporate law, the most influential body of law for United States publicly held corporations, does not reflect an agency model. Directors' fiduciary duties are owed not to the shareholders alone, but rather to "the corporation and its shareholders."[130] Vague as this formulation might be, it does not express the notion of management as the agent of the shareholders as principals. In any event, the demand requirement applicable to shareholder derivative suits, the business judgment rule, and the statutory provision for exculpation of monetary liability for breach of the duty of care,[131] as a practical matter, insulates management from accountability to shareholders except, in cases involving conflict of interest or bad faith. As currently structured, the voting rights regime does not seriously threaten incumbent management because of collective action costs and rational apathy that discourage coordinated shareholder insurgency. Nor does the prospect of a hostile takeover create a strong incentive to maximize share values; Delaware common law accords target company management broad discretion to defend against hostile takeovers. The *Revlon* duty[132] to maximize current share value arises only in a narrow range of circumstances that corporate management is free to avoid if it so wishes,[133] and in practice presents virtually no threat of liability for breach.[134]

Not only is the agency idea at the heart of radical shareholder primacy absent from Delaware corporate law, the traditional model does not mandate shareholder wealth maximization. Delaware precedent to that effect is virtually nonexistent. One recent trial court opinion does speak of shareholder primacy as a statutory mandate.[135] In deciding eBay's suit against Craigslist, Chancellor Chandler states that, "Having chosen a for-profit corporate form, the Craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders."[136] Corporate policies that seek "*not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders" are invalid.[137] In other words, not only must corporate management pursue share-

130. Loft, Inc. v. Guth, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd sub nom.* Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

131. DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

132. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1994) (stating "[t]he duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit").

133. Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 46–48 (Del. 1994) (mandating "enhanced scrutiny and the directors' obligation to seek the best value reasonably available for the stockholders [arises] where there is a pending sale of control").

134. Lyman Johnson & Robert Ricca, *The Dwindling of Revlon*, 71 WASH. & LEE L. REV. 167 (2014).

135. eBay Domestic Hldgs., Inc. v. Newmark, 16 A.3d 1, 26 (Del. Ch. 2010). For a critique of this opinion, see Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule and Corporate Purpose*, 38 DEL. J. CORP. L. 405, 439–44 (2013).

136. eBay Domestic Hldgs., Inc., 16 A.3d at 34.

137. *Id.*

holder value, it must also seek to maximize the shareholders' financial interests. Apparently the court believes these assertions to be self-evidently true because it cites no statutory provision or case law in support of them. In fact, the Delaware corporation statute includes no such mandate and does not refer to corporations organized under it as "for-profit" entities. To the contrary, the statute states that "A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes."[138] Nor has a Delaware court ever endorsed shareholder wealth maximization in the stark terms used by the court in this case.[139]

Further, the court's endorsement of shareholder primacy in the Craigslist case may have very limited relevance. The facts of the case were eccentric; read narrowly, the opinion endorses the shareholder primacy idea in a highly unusual case involving a closely held corporation whose founders had explicitly chosen to eschew profit in order to pursue a social mission. Thus the opinion might be read simply to condemn corporate policies that are entirely and expressly contrary to shareholder financial interests. Such circumstances are rare to say the least. Companies pursuing social missions at the expense of shareholder value are far more likely to sacrifice some amount of profit without rejecting that objective entirely, and are likely also to justify such policies with reference to long-run shareholder financial interests, even if the claim is vague and not susceptible to proof. Under the business judgment rule, policies of this kind would not be condemned even if shareholder primacy were the law.[140] It should be noted further that even a narrow reading of the court's endorsement of shareholder primacy is quite problematic. eBay, the plaintiff minority shareholder, invested in Craigslist with full knowledge that profit-seeking (let alone profit maximization) was not that corporation's objective. This was not, in other words, a case in which those in control of a for-profit corporation chose to change direction to the prejudice of existing minority shareholders. Rather, one might argue that eBay implicitly assented to Craiglist's disavowal of shareholder primacy when it invested with knowledge of the founders' social mission.

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138. DEL. CODE ANN. tit. 8, § 101(b) (2013).

139. One trial court opinion states that "[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders." Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986). However, this case involved the contractual rights of bondholders and as such does not speak to the question of shareholder primacy. Further, the reference to the shareholders' "long-run interests" does not imply a duty to maximize current share price and is vague enough, when combined with the business judgment rule, to confer very broad discretion on management to balance a range of shareholder and nonshareholder interests in promoting the corporation's long-run sustainability.

140. Elsewhere in the Craigslist opinion, Chancellor Chandler writes, "When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value." *eBay Domestic Holdings*, 16 A.3d at 33.

The typical citation for the shareholder primacy proposition is, of course, the *Dodge v. Ford* case, a 1919 decision of the Michigan Supreme Court.[141] That decision, without citing precedent, states that "A business corporation is organized and carried on primarily for the benefit of the stockholders. The powers of directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself."[142] Despite the frequency with which the case is cited by commentators, no Delaware court has cited it as authority for the shareholder primacy principle.[143] The general statement quoted here also is not necessary to the decision of the case, which appears to be a case involving oppression of minority shareholders in a closely held corporation. This was arguably a case in which the controlling shareholder adopted a policy to forego some (but not all) profits and their distribution in favor of conflicting social objectives, to the detriment of legitimate minority shareholder expectations. The shareholder primacy idea need not be invoked to protect minority shareholders in such cases.

Further, the *Dodge v. Ford* decision may simply be wrong. There is no plausible claim that Henry Ford was using his control of the corporation to treat the plaintiff Dodge brothers unfairly. Even after adoption of Ford's new policies, the Dodge brothers were to continue to receive annual dividends of $120,000 on an initial investment of $200,000, an astonishingly rich annual return of 60 percent.[144] Further, although the corporation was earning profits far in excess of the planned distributions and might have earned even more in the short term, the corporation's management had chosen to reinvest a large share of those profits in new capital assets. This sounds on the face of it like the kind of decision that the business judgment rule ought to have protected.

Even if the *Dodge v. Ford* decision does properly stand for the shareholder primacy principle, there is no indication in the opinion that management's relation to the shareholders should be conceived of in terms of agency or that maximization is required. To the contrary, the quoted language and the result are consistent with the traditional model of shareholder primacy. Nothing suggests that management is the shareholders' agent and therefore should be subject to their control. Management is supposed to prioritize shareholder interests but it enjoys discretion as to the means to that end, largely immune from direct supervision by the shareholders. Under this view, courts would come to the shareholders' aid only in ex-

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141. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

142. *Id.* at 684.

143. *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH 27 (2012) (disputing the claim that corporate law mandates shareholder primacy).

144. *Dodge*, 170 N.W. at 683. In addition to the regular dividends of 60 percent, from 1911 through 1915 the Dodge brothers also received special dividends totaling $3.6 million.

treme cases, of which the Michigan Supreme Court seems to have thought *Dodge v. Ford* was an example.

Despite the absence of a legal mandate, the radical shareholder primacy idea is broadly embraced within the legal academy, especially among corporate law scholars at the leading law schools. For example, two scholars have recently written that:

> The shareholder value framework for analyzing corporate law and governance implies that those running a corporation should seek to maximize the value of the shareholders' claims, as measured by the stock price. This norm, which we refer to as 'shareholder value,' is adopted as a way of rendering those controlling a public company accountable to shareholders . . . . The concern is . . . that the firm will be run in the interests of its managers, rather than its owners . . . . The shareholder value norm thus responds to the 'agency problem' between managers and diversified shareholders.[145]

Professor Bebchuk, whose shareholder empowerment agenda receives widespread attention, is probably the best known of those scholars seeking to enhance managerial subservience to shareholders through law reform.[146] A number of other prominent scholars—all approaching corporate law issues from a law-and-economics perspective—also share the assumption that shareholder wealth maximization is management's primary responsibility and that the agency cost problem is the central intellectual and practical problem for corporate law.[147] Differences of opinion exist as to the need for law reform of the type that Bebchuk advocates. Some scholars incline toward the view that market forces—including product market competition, the executive employment market, compensation incentives, and even the possibility of hostile takeovers—are generally sufficient to mitigate the agency cost problem.[148]

145. John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value* 1–2 (Eur. Corp. Gvrnce. Inst., Working Paper No. 222, 2013). The authors state that the shareholder value norm "has acquired an almost axiomatic status in discussions about corporate governance." *Id.* at 2.

146. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) (documenting unsuccessful challenges to corporate management from 1996 to 2004); Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (advocating greater shareholder power to amend charter or change state of incorporation); Bebchuk, *supra* note 36 (arguing that shareholders should be able to make "rules-of-the-game decisions" affecting the state of the corporation); Bebchuk, *supra* note 32 (discussing obstacles shareholders face in using voting rights to replace directors).

147. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (examining recent dominance of a shareholder-centered ideology among government, business, and legal elites in major commercial jurisdictions); Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008); Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907 (2013).

148. *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323–25 (1986) (discussing the use of leveraged buyouts to

Not all advocates of shareholder primacy embrace the agency model. Professor Bainbridge is well known for his arguments in favor of "director primacy."[149] While Bainbridge argues that management's primary responsibility is to maximize shareholder wealth, he rejects the notion that shareholders ought to be able to exercise direct control over managerial decision making.[150] With respect to the board of director's autonomy, Bainbridge's model thus resembles what I have termed "traditional shareholder primacy." It differs, however, to the extent that it mandates shareholder wealth maximization. The traditional model includes no such mandate.

Some prominent scholars reject the shareholder primacy claim. Professor Lynn Stout has argued this position effectively, both normatively and also as a description of the current state of corporate law.[151] With Professor Margaret Blair, Stout has also maintained that management's job is to mediate among the, at times, conflicting interests of those of the corporation's various stakeholders who have invested financial or human capital in the firm.[152] With respect to shareholder primacy, Professor Einer Elhauge writes, "Corporate managers have never had an enforceable legal duty to maximize corporate profits. Rather, they have always had some legal discretion (implicit or explicit) to sacrifice corporate profits in the public interest."[153] So-called corporate law progressives or communitarians reject shareholder wealth maximization as a legal requirement and also on normative grounds.[154] Recently, two prominent economically-oriented legal scholars have argued that shareholder primacy is socially undesirable for systemically important financial firms, even if not necessarily for all corporations.[155] Nevertheless, despite these and other dissenting voices and its non-existent legal underpinnings, the agency cost problem—based implicitly on the assumption that management is the shareholders' agent—is generally seen to provide "the dominant framework of analysis for corporate law and corporate governance today."[156]

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reduce agency costs); David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 452–59 (2000) (examining use of executive stock options to combat agency costs).

149. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550–52 (2003).

150. *Id.* at 551.

151. *See* STOUT, *supra* note 143, at 7–11.

152. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250–52 (1999).

153. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interests*, 80 N.Y.U. L. REV. 733, 738 (2005).

154. *See, e.g.*, Lawrence E. Mitchell, *Trust. Contract. Process.*, *in* PROGRESSIVE CORPORATE LAW 185–219 (Lawrence E. Mitchell ed., 1995).

155. Armour & Gordon, *supra* note 145, at 2–3.

156. Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1326 (2013).

B. Business Practice

Beyond the academy, there appears to exist a widely held belief that management's job is to cater to the preferences of shareholders. For many large institutional shareholders, that generally means that management should maximize current share price. In the current environment share price movements are closely linked to a corporation's quarterly earnings performance. Corporate management finds itself under pressure to meet earnings targets and therefore typically focuses on short-term accounting results, even at the expense of long-run value. Market forces and social norms seem to be the primary drivers of shareholder expectations and management behavior. To the extent that attention is paid to the law, there may be an assumption that shareholder primacy is a legal mandate and some may embrace the agency idea at the core of radical shareholder primacy. But mistaken beliefs about the law seem to be of only secondary importance.

Institutional shareholders dominate today's stock markets. Public and private pension funds, mutual funds, insurance companies, foundations, university endowments, and bank trust departments together own on the order of three-quarters of the stock of the one thousand largest U.S. corporations.[157] For some major companies, the percentage is even higher.[158] Many of these shareholders pursue short-term investment strategies, holding shares in a broad range of companies and trading frequently in order to realize gains in share price or to unload shares whose prices have declined. The average holding period may now be as low as five months.[159] Quarterly earnings announcements have taken on special importance because a corporation's failure to meet analysts' targets can trigger large-scale sell-offs and corresponding share price decreases. Short-term accounting results thus take priority over study of underlying fundamentals and concerns about possible disjunctions between current share price and long-run value. Although some shareholders do pursue more patient investment strategies, short-termism seems increasingly to be the norm among major institutions.[160]

Short-term oriented investors assume tacitly that management acts appropriately when it prioritizes preferences for current share price maximization over other potentially competing objectives. This assumption does not seem to be based on a mistaken belief in the shareholders' legal right to command management's attention. Rather, preferences for short-term re-

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157. David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911, 913 (2013).

158. *Id.*

159. John C. Bogle, *Restoring Faith in Financial Markets*, WALL ST. J. (Jan. 18, 2010), http://online.wsj.com/news/articles/SB10001424052748703s436504574640523013840290.

160. *Id.* ("[T]he folly of short-term speculation has replaced the wisdom of long-term investing"); *see also* Dominic Barton, *Capitalism for the Long Term*, HARV. BUS. REV. 84, 87–88 (2011) (criticizing "quarterly capitalism").

sults and corresponding pressures on management to achieve them appear to arise primarily from economic and legal pressures to which many major institutional shareholders are subject.[161] Public and private pension funds confront current obligations to their retirees. For example, the California Public Employees Retirement System (CalPERS), the largest U.S. public pension fund, must make monthly payments averaging over $2,600 to over half a million people, with contingent liabilities to over a million more.[162] Thus, while pension funds must necessarily take a long view in light of anticipated retirements continuing to occur regularly far into the future, they face significant pressures to meet their legal obligations to their retirees each month. Historically, public pension funds have assumed an annual rate of return on their investment portfolios of 8 percent, but since the financial crisis this has become harder to count on.[163] This only adds to existing incentives to pursue short-term investment strategies in order to meet current obligations. Even less than previously, these shareholders do not have the luxury of waiting patiently for long-term business strategies to bear fruit.

Many mutual funds also face significant incentives to insist on corporate pursuit of short-term investment strategies.[164] Mutual fund fees are typically a function of total assets under management, meaning that fund owners increase their compensation through successful competition for investor dollars. Investors typically respond to short-term, year-to-year fund performance in making decisions about where to invest their money, and may also withdraw their money in cases of poor performance. Fund managers face the prospect of reduced compensation or even termination if they do not achieve acceptable results and therefore adjust their trading strategies accordingly. For example, managers who are behind their year-end targets at six months are likely to trade aggressively during the second half of the year, chasing riskier short-term returns.[165]

Large shareholders seeking short-term returns can put pressure on corporate management to achieve acceptable results in a number of ways. Large-scale sell-offs in response to disappointing quarterly earnings reports can result in sharp share price declines, which in turn can lead to a CEO's termination[166] or decreased compensation.[167] More activist investors may

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161. *See* Millon, *supra* note 157, at 914–18 (providing a full discussion of this phenomenon).

162. CALIFORNIA PUBLIC EMPLOYEE'S RETIREMENT SYTEM, *Facts at a Glance*, 1, 6 (updated Nov. 30, 2013) http://www.calpers.ca.gov/eipdocs/about/facts/facts-at-a-glance.pdf.

163. Mary Williams Walsh, *Public Pension Funds are Adding Risk to Raise Returns*, N.Y. TIMES (Mar. 8, 2010), http://www.nytimes.com/2010/03/09/business/09pension.html?pagewanted=all&_r=0.

164. *See* Millon, *supra* note 157, at 934–36.

165. Keith C. Brown, W. V. Harlow & Laura T. Starks, *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85, 103–04 (1996).

166. Dirk Jenter & Katharina Lewellen, *Performance-Induced CEO Turnover* 2–5 (Feb. 2010) (working paper).

choose to put pressure on boards to remove senior executives who fail to produce acceptable quarterly results.[168] Others may attempt to use voting rights or shareholder proposals.[169]

In addition to direct or indirect pressure from shareholders, corporate management is also subject to other incentives that have the effect of encouraging them to behave as if they were the agents of the shareholders. Widely used equity-based compensation arrangements address the agency cost problem by aligning the interests of management with those of the shareholders.[170] A strong record of quarterly performance can also create reputational pay-offs.[171] More generally, a widely held social norm may encourage corporate management to think of itself as the agent of the shareholders.[172] Leading business schools teach what amounts to radical shareholder primacy's agency model of the relation between management and shareholders.[173] The business press typically views this question in a similar vein.[174]

To a large extent, business practice and discourse embrace the radical shareholder primacy idea that management is the agent of the shareholders, and is thus charged with doing their bidding. This is apparent in the behavior of many shareholders, including some very powerful ones, and also in the approach commonly taken by the management of many major corporations. I do not claim that the emergence of radical shareholder primacy in the legal academy at the University of Chicago in the later 1970s, spreading from there to the rest of the leading law schools, was the kernel from which developments in the business world sprouted. The story is far more complex than that. Radical shareholder primacy in the law schools is probably part of a larger ideological, economic, and socio-political phenomenon that now shapes and legitimates business practice in powerful ways. That complex but hugely important story has yet to be told.

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167. Steven R. Matsunaga & Chul W. Park, *The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus*, 76 ACCT. REV. 313, 330–31 (2001).

168. Barton, *supra* note 160, at 87.

169. Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, 13 J. APPLIED FIN. 4, 10 (2003).

170. *See* Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 680 (2011).

171. John R. Graham, Campbell R. Harvey & Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 28 (2005).

172. *See, e.g.*, STOUT, *supra* note 143, at 113 (referring to "the business world's own intellectual embrace of shareholder value ideology").

173. *See* KHURANA, *supra* note 116, at 317–26.

174. *See, e.g.*, Aneel Karnani, *The Case Against Corporate Social Responsibility*, WALL ST. J. (Aug. 23, 2010), http://online.wsj.com/news/articles/SB100014240527487033380045752301126 64504890.

Conclusion

The agency model of the relation between management and shareholders enjoys broad currency among corporate executives and major shareholders. I term this view radical shareholder primacy because it makes an extreme claim about management's responsibility and shareholders' rights. This model is also widely—though not universally—embraced by legal academics. As an academic theory, radical shareholder primacy's agency theory—and preoccupation with the so-called agency cost problem—is a recent innovation, tracing its origins only to the later 1970s at the University of Chicago Law School.

Radical shareholder primacy's conception of corporate governance contrasts with an older, long-established model that I term traditional shareholder primacy. It should be kept in mind that referring to this model as "shareholder primacy" is misleading because that phrase does not appear in the law reviews until 1989, in articles published contemporaneously by me and my friend and Washington and Lee colleague Lyman Johnson, gaining widespread currency thereafter. It is also misleading to the extent that it suggests that shareholders have meaningful powers of control over management. To the contrary, the hallmark of traditional shareholder primacy is the nearly complete absence of such powers. This lack of accountability has been a central feature of corporate law and practice since the later nineteenth century, when the emergence of a separation between ownership and control led to the legal and theoretical reconceptualization of management's relation to the shareholders. The term shareholder primacy in the traditional sense is also potentially misleading to the extent that it might be taken to imply a duty to maximize shareholders' financial returns. The traditional model did not include such an injunction. As far as shareholder primacy within the traditional model is concerned, the most that could be said was that shareholders could claim a special place among the corporation's various constituencies by virtue of their voting rights, rights of inspection, and right to bring derivative lawsuits to enforce corporate claims. By the turn of the twentieth century these were little more than vestiges of an earlier age when shareholders actually did control the business. There was a general expectation that business corporations should earn profits—they could hardly survive if they didn't—but there was no actual legal mandate even as to that. In any event, corporate law accorded management broad discretion as to how to pursue that objective and effectively conferred on it the freedom to temper profit seeking with competing values. This it might choose to do in order to enhance the corporation's long-term economic prospects, but it was also free to do so in order to act as a "good citizen."

All this amounts to shareholder primacy in only a very modest sense of the term. However accurate it might have been in the earlier nineteenth century in an age of closely held firms, an agency characterization of man-

agement's relation to the shareholders has been completely inaccurate as a descriptive matter since the turn of the twentieth century and was still so in the later 1970s when corporate law academics first began to insist on it. Against this backdrop, the emergence of the agency claim and its widespread embrace as an assumed legal requirement are nothing short of astonishing.

Understanding the distinction between the radical and traditional models of shareholder primacy is important because it sheds light on the otherwise puzzling fact that corporate law academics disagree on the truly fundamental question of whether shareholder primacy is the foundational principle of corporate law in the United States. Those who say no are implicitly rejecting the agency characterization and they are right, but they are wrong to insist that shareholder primacy has no place in traditional thinking about corporate law. It does, but only in a very modest sense. If agency theory were laid to rest, there would be no harm in accepting that fact and perhaps resistance to it would dissipate. Meanwhile, the opposing camp is wrong to insist on the agency idea but correct to the extent that corporate law has always accorded shareholders a privileged governance position in relation to other stakeholders, even as it has done little to facilitate actual shareholder control. In other words, academics arguing about shareholder primacy are actually talking about two different things, lacking a clear sense of the distinction between them.

Appreciation of the two meanings of shareholder primacy—and the recent origins and non-existent legal basis for the radical version—is also important for another reason. Once it is understood that the agency model is aspirational rather than grounded in corporate law, a more serious conversation about corporate purpose and the desirable balance of power between management and shareholders can occur. Perhaps the severe social costs of excessive commitment to short-term share price maximization—one lesson of the recent financial crisis—will be sufficient to counter calls for increased shareholder power and managerial accountability.