New Thinking
On "Shareholder Primacy"

by Lynn A. Stout*

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Abstract

By the close of the twentieth century, many observers had come to believe U.S. corporate law should and does embrace a "shareholder primacy" rule that requires corporate directors always to maximize shareholder wealth. This Essay argues that such a view is mistaken.

As a positive matter, U.S. corporate law and practice does not require directors to maximize shareholder wealth but instead grants them a wide range of discretion, constrained only at the margin by market forces, to sacrifice shareholder wealth in order to benefit other constituencies. As a normative matter, several lines of theory have emerged in modern corporate scholarship that independently suggest why this may be desirable from shareholders' own perspective. The Essay reviews five of these lines of theory and explores why each gives us reason to believe that shareholder primacy rules often disadvantage shareholders.

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**NEW THINKING
ON “SHAREHOLDER PRIMACY”**

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Introduction: The Rise of Shareholder Primacy Thinking

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

The Great Debate (as it was recently characterized by two sitting Delaware corporate judges and one former Delaware judge)[2] dates back at least to the initial emergence of the public corporation as a powerful business form in the early twentieth

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[1] DISCUSS Literature too vast to survey, some examples given in notes ___ infra.

Before the emergence of the public firm the question of corporate purpose was far less salient. The reason is simple: one can safely assume that a firm with a controlling shareholder will be managed, for good or for ill, in a fashion that is agreeable to that shareholder. See infra TAN (discussing corporate purpose debate abroad in economies where most firms have controlling shareholders)

[2] ADD Chicago L. Rev. cite.

century.[3] For several decades afterwards, the two sides in the controversy seemed evenly matched. Neither the champions of shareholder primacy, nor the defenders of stakeholder interests, enjoyed the upper hand.

This changed in the 1970s with the rise of the "Chicago School" of economists. Prominent members of the School argued that economic analysis could reveal the proper goal of corporate governance quite clearly, and that goal was to make shareholders as wealthy as possible. Thus Nobel-prize winner Milton Friedman argued in the pages of the *New York Times* Sunday magazine that because shareholders "own" the corporation, the only "social responsibility of business is to increase its profits."[4] In more-academic writings, Michael Jensen and William Meckling published their influential paper on the theory of firm, describing shareholders in a corporation as principals who hire corporate officers and directors to act as their agents.[5] According to this thesis, corporate managers' only job was to maximize the wealth of the shareholders (the firm's so-called "residual

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[3] In 1932, Berle and Means published their classic book detailing the emergence and growing importance of the publicly-held firm with dispersed share ownership. Adoph A. Berle and Gardiner C. Means, The Modern Corporation and Private Property (1932). That same year Berle engaged in a spirited debate in the pages of the Harvard Law Review with Harvard Professor E. Merrick Dodd over the proper purpose of the new business entity. According to Berle, "all powers granted to a corporation or to the management of a corporation … [are] at all times exercisable only for the ratable benefit of the shareholders …" Adolph A. Berle, Corporate Powers as Powers in Trust, 45 Harv. L. Rev. 1049 (1932). Dodd disagreed, instead favoring "a view of the business corporation as an economic institution which has a social service as well as a profit-making function." E. Merrick Dodd, For Whom are Our Corporate Managers Trustees? 45 Harv. L. Rev. 1144, 1148 (1932).

[4] Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, New York Times Sunday Magazine, September 13, 1970, at 33-32 and 122-26.

[5] Michale C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and

claimants") by every means possible short of violating the law. Directors and officers who pursued any other goal only reduced social wealth by increasing "agency costs."

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

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

Ownership Structure, 3 J. Fin. Econ. 305 (1976).

My use of the past tense is not inadvertent. This essay argues that the shareholder primacy view as conventionally understood has reached its zenith, and is poised for decline. Traditional shareholder primacy thinking is being rapidly undermined by new developments in economic and corporate theory; by striking changes in business practice; and by a flood of recent empirical studies. In its classic form, the shareholder-centered model of the corporation is on the brink of failure. To survive it will be forced to evolve into a new, more complex, and far more subtle understanding of what, exactly, shareholders as a class want from corporations. In the process it will come to resemble its former rival, the stakeholder model, far more closely. Indeed, in many cases the two may merge. Although the Great Debate may not be resolved entirely, the distance between the two sides in the debate seems destined to shrink dramatically.

Contemporary Challenges to Shareholder Primacy

The high-water mark for traditional shareholder primacy thinking can perhaps be set early in the year 2000, when Professors Reinier Kraakman and Henry Hansmann—leading corporate scholars from Harvard and Yale law school, respectively—circulated a manuscript entitled "The End of History for Corporate Law."[6] Echoing the title of Frances Fukayama's book about the overwhelming triumph of capitalist democracy over

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

communism,[7] Hansmann and Kraakman argued that shareholder primacy thinking similarly had triumphed over other theories of corporate purpose. "[A]cademic, business, and governmental elites," they wrote, shared a consensus "that ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; …and the market value of the publicly traded corporation's shares is the principal measure of the shareholders' interests."[8] What's more, this "standard shareholder-oriented model" not only dominated U.S. discussions of corporate purpose, but conversations abroad. According to Hansmann and Kraakman, "the triumph of the shareholder-oriented model of the corporation is now assured" not only in the U.S., but in the rest of the civilized world as well.[9]

Hansmann and Kraakman certainly were correct in observing as a descriptive matter that shareholder primacy thinking dominated discussions of corporate law in early 2000. There were several ironic aspects, however, to their prediction that this state of affairs was likely to be permanent. For one thing, it was only a few months later that Enron's collapse provided a dramatic object lesson in the perils of management obsession with share price. But there were several more-subtle ironies as well.

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[7] Frances Fukayama, The End of History ADD CITE.

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

[9] Hansmann and Kraakman, The End of History, supra note __ at 468.

First, even as shareholder primacy thinking gained traction among academics and policymakers in the 1980s and 1990s, it became increasingly clear that U.S. law did not and does not actually follow the "standard" model. (Hansmann and Kraakman implicitly recognized this when they suggested that shareholder primacy thinking would lead to the "reform" of corporate law.)[10] I have discussed this reality of corporate law in detail elsewhere,[11] as have many others,[12] so I will not offer more than an brief survey here. The point is obvious enough. *Corporations are run by boards of directors, not by shareholders*. The U.S. system of corporate governance is more accurately described as "director primacy" than "shareholder primacy."[13] This does not mean that corporate law does not grant shareholders certain rights. Indeed, they have three--the right to vote, the right to sue, and the right to sell their shares. But these rights are of remarkably little value to shareholders seeking to force managers of a public company to act as their "agents" and serve only their interests.

Consider first shareholders' voting rights. As a matter of law these are severely limited in scope, principally to the right to elect and remove directors.[14] Shareholders

[10] Hansmann and Kraakman, The End of History, supra note __ at 439, ___.

[11] ADD CITES.

[12] ADD CITES, especially Jacobs, Strine at 1202 ("Delaware case law generally follows the entity model.").

[13] ADD CITES.

[14] ADD CITE.

have no right to select the company's CEO; they cannot require the company to pay them a single penny in dividends; they cannot vote to change or preserve the company's line of business; they cannot stop directors from squandering revenues on employee raises, charitable contributions, or executive jets; and they cannot vote to sell the company's assets or the company itself (although they may in limited circumstances vote to veto a sale or merger proposed by the board).[15] The rules of voting procedure further limit exercise of the shareholder franchise. Delaware law, for example, gives only directors authority to call a special shareholders' meeting,[16] and shareholders who wait for the regularly-scheduled annual meeting to try to elect or remove directors must pay to solicit proxies.[17] Finally and perhaps most significantly, in a public firm with widely-dispersed shareownership, shareholder activism is a public good, and shareholders' own "rational apathy" raises an often-insurmountable obstacle to collective action.[18] As Robert Clark has put it, a cynic could easily conclude that shareholder voting in a public company is "a mere ceremony designed to give a veneer of legitimacy to managerial power."[19]

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[15] DISCUSS how boards can avoid by retaining some assets or using triangular mergers..

[16] ADD CITE.

[17] ADD CITE.

[18] ADD CITE.

[19] Clark, Corporate Law 95 (1986).

What about shareholders' right to sue corporate officers and directors for breach of fiduciary duty if they fail to maximize shareholder wealth? Here, too, shareholders' "rights" turn out to be illusory. The fiduciary duty of loyalty precludes officers and directors from using their corporate positions to line their own pockets. They remain free, however, to pursue other, nonshareholder-related goals under the comforting mantle of the business judgment rule. As I have pointed out in writings with Margaret Blair, courts consistently permit directors "to use corporate funds for charitable purposes; to reject business strategies that would increase profits at the expense of the local community; to avoid risky undertakings that would benefit shareholders' at creditors' expense; and to fend off a hostile takeover at a premium price in order to protect employees or the community."[20] Contrary to the shareholder primacy thesis, shareholders cannot recover against directors or officers for breach of fiduciary duty simply because those directors and officers favor stakeholders' interests over the shareholders' own.

Finally, a shareholder's right to sell her shares sometimes can protect an individual investor who wants to express her unhappiness with a board by "voting with her feet." But disappointed shareholders cannot sell *en mass* without driving down share price, making selling a Pyrrhic solution. An important exception to this rule arises when

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[20] Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 303 (1999).

shareholders as a group have the opportunity to sell to a single buyer who, because he does not face collective action problems, can depose the incumbent board more readily. During the 1970s and early 1980s, as the Chicago economists' arguments began to gain steam and changes in the banking industry made hostile takeover bids more feasible, it appeared that just such a lively "market for corporate control" might develop. A series of legal developments, however, soon brought hostile takeovers to an effective halt.[21] The list is legion, but prominent examples include the passage by almost every state of some form of antitakeover statute;[22] the invention of the "poison pill" defense by *uber*-lawyer Marty Lipton and the subsequent approval of the pill by the Delaware courts;[23] and the effective reversal of the Delaware Supreme Court's 1986 *Revlon* ruling (which seemed to require boards facing a hostile offer to maximize shareholder wealth) by subsequent opinions issued only a few years later.[24] Thus, by the mid-1990s, U.S. corporate law insulated incumbent directors from the pressures of the market for control even more effectively than it had in 1970, when Milton Friedman trumpeted shareholder primacy in the pages of the *New York Times*.

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[21] DISCUSS replacement by friendly bids. CITE Rock et al, How I Learned to Stop Worrying and Love the Pill, cross cite to discussion of executive options infra.

[22] DISCUSS other constituency statutes and Delaware section 203.

[23] CITE.

[24] CITE.

The irony does not stop there. Even as corporate law was evolving further away from shareholder primacy, changes in corporate practice were accelerating and accentuating this shift.[25] To understand this point it is important to understand that U.S. corporate law is enabling, meaning that corporate promoters can to a great extent choose the rules that apply to their firms. They can do this in at least two ways. First, they can select a state of incorporation. (Under the "internal affairs" doctrine, corporations are governed by the rules of the state in which the promoter chooses to incorporate). Second, they can add customized provisions to the corporate charter that enhance or dilute either directors' or shareholders' power.

For the past two decades, promoters have been taking advantage of the enabling nature of U.S. corporate law to select governance rules that insulate boards and more from shareholder influence. Recent studies have found, for example, that states that offer directors strong protection against hostile takeovers are more successful in attracting new incorporations and in retaining existing firms than states whose laws are more "shareholder friendly."[26] The trend away from shareholder primacy is even more obvious when we look at charter provisions. Over the course of the 1990s, the percentage of corporations "going public" with a staggered board (a charter structure that

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[25] DISCUSS talking state corporate not federal law; 1992 changes, but also reversal of SEC's position in Cracker Barrel. CITE Roe article on federal intervention.

[26] See Stout, Bad and Not So Bad at note 53 (citing studies).

greatly enhances director power and, when combined with a poison pill, makes takeover nigh impossible)[27] rose steadily, from about one-third in the early 1990s to over 80 percent in 1999.[28] These days, many firms go even further and adopt dual-class voting structures that disenfranchise public shareholders entirely. (Google's IPO offers a recent high-profile example).[29] In contrast, charter provisions that make it easier for shareholders to force directors to do their bidding "are so rare as to be almost nonexistent."[30]

Such empirical findings set the stage for the third irony associated with Hansmann's and Kraakman's declaration that "there is no longer any serious competitor to the view that corporate law should … strive to increase … shareholder value."[31] Even

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[27] See studies cited in Stout, Antitakeover Defenses, at note 23.

[28] See Coates, cited in Stout, Antitakeover Defenses, note 23.

[29] See Stout and Anabtawi, Sometimes Democracy Isn't Desirable, Wall St. J. (ADD CITE).

[30] Coates at 1397 (referring specifically to provisions that restrict directors' ability to employ poison pills).

[31] At this point I feel I must offer an apology to Professors Hansmann and Kraakman. I have omitted from this quote two fundamental, and indeed arguably capitulating, qualifications that appear in the original, which reads "there is no longer any serious competitor to the view that corporate law should *principally* strive to increase *long-term* shareholder value." Hansmann & Kraakman, supra at 439 (emphasis added).

I have left out the qualifiers "principally" and "long-term" because the more one tries to rely on them, the more they undermine and indeed destroy Hansmann & Kraakman's main thesis as they express it elsewhere: that managers should be directly accountable "only" (not merely "principally") to shareholders' interests, and that the "market value of the publicly traded corporations shares"—meaning, presumably, today's market value, not yesterday's or tomorrow's—"is the principal measure of its shareholders' interests." Id. at 440-41.

I want to emphasize Hansmann's and Kraakman's unqualified expression of the shareholder primacy thesis here because I think it better represents the dominant form of shareholder primacy thinking today,

as Hansmann and Kraakman were observing in their 2000 draft that the "standard" model had achieved the status of received truth, corporate theorists were busily exploring new and alternative theories of corporate structure and shareholder interest that undermined it.

To use the terminology employed by Thomas Kuhn in *The Structure of Scientific Revolutions,* by early 2000 the shareholder primacy model had indeed become the "standard," or dominant, paradigm of the corporation. But it failed to explain at least two important empirical anomalies. First, the default rules of U.S. corporate law stubbornly refused to treat shareholders as "owners," "principals," or "residual claimants." Unlike owners, shareholders lacked the power to control how the corporation used its assets and outputs. Unlike principals, shareholders lacked the ability to command the board. And unlike residual claimants, shareholders were not guaranteed to receive even a penny of the corporation's profits--assuming the company had "profits" in the first place. (Although the point may be obvious, it is perhaps worth reminding readers that profit is an accounting concept that depends on expenses as well as revenues, with the result that the amount of profit earned by a company ultimately is determined by its board).

The second anomaly that could not be easily explained by the standard model was that corporate promoters bringing new firms to market were increasingly taking advantage of the enabling nature of U.S. law to weaken shareholders' already-weak

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and so offers the best foil for my arguments. I agree, however, with their highly-qualified version, as the balance of this Essay attests.

position in the firm even further. This observation was especially puzzling because it suggested that *shareholders themselves* did not object to director primacy. After all, prospective investors who are thinking of buying shares in an IPO can easily determine the company's state of incorporation and the nature of its charter. If they are troubled by governance structures that dilute shareholder rights, they should discount their willingness to pay accordingly. Corporate promoters cannot pull the wool over shareholders' eyes at the IPO stage. If they structure the firm in a fashion that harms investors, it is the promoters themselves who should pay the price, because they have devalued the very shares they are trying to sell.

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

There is reason to hope the pace in corporate theory be more brisk. Even as Hansmann and Kraakman were announcing the triumph of the shareholder wealth maximization paradigm in 2000, scholars were at work exploring not just one, but several, alternative theoretical models of corporate purpose that could explain director primacy. Indeed, in today's literature one can identify at least five recently-developed lines of thought that challenge the traditional shareholder primacy paradigm while simultaneously offering to explain the twin anomalies of director primacy in the default rules of U.S. law, and promoter preference for even greater director primacy at the IPO stage.

The balance of this Essay is devoted to exploring those five emerging theories of director primacy. Given space constraints I cannot do them justice, and I urge interested readers to consult the primary sources that develop these arguments in detail. But even a cursory glimpse at economic and corporate law scholarship at the turn of the millennium offers a number of important observations.

Some Preliminary Lessons from the New Thinking

First, shareholder primacy is no longer the only intellectually respectable game in town. Indeed, shareholder primacy theory suffers from a potentially fatal weakness. As Stephen Bainbridge has pointed out, the chief criterion for any model of the corporation must be the model's ability to predict the separation of ownership and control that is the

hallmark of the public firm.[32] The "standard shareholder-oriented model" described by Hansmann and Kraakman fails this basic criterion.[33] In contrast, each of the five theories discussed below can explain the twin anomalies of substantial director primacy under the default rules of corporate law, and promoter preference for enhancing director primacy in firms going public.

Second, each of these five models explains these anomalies by suggesting why investors purchasing stock in a public company might *prefer* that company to be governed by a board of directors largely insulated from shareholders' command and control—not just despite, but in some cases because, this makes it more difficult for shareholders to stop the board from pursuing strategies that benefit stakeholders at the expense of share price. In other words, each of the theories suggests that shareholders, like the mythic hero Ulysses, benefit from "tying their own hands." In the process they offer insights into such notions as the claim that a business strategy that decreases share price nevertheless benefits shareholders "in the long run," or the idea that action that harms shareholders nevertheless helps "the firm." They also illustrate how conventional shareholder primacy thinking rests on a flawed, narrow, cartoonish, and ultimately unrealistic notion of shareholder "interest."

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[32] See Stephen M. Bainbridge, The Board of Directors as a Nexus of Contracts, 88 Iowa L. Rev. 1, 3 (2002).

[33] See Lynn A. Stout, The Shareholder as Ulysses, ADD CITE.

Third, while these theories suggest how director primacy rules benefit investors as a whole, they also suggest how director primacy rules can harm certain shareholders at certain times. Thus the theories predict--in accord with what we actually observe--that even while investors are happy to purchase shares in director-run public companies ex ante, at the IPO stage, certain shareholder groups are equally happy to protest, and even try to overturn, director primacy rules ex post.[34] Such protests and "reform proposals" do not serve the interest of investors as a class. They may, however, serve the interests of particular subgroups of investors in particular situations.

A fourth and related point is that U.S. regulators and policymakers should not reflexively respond to every business crisis or scandal *de jour* by trying to "reform" corporate law to give shareholders greater power. As I write, for example, the Chair of the Securities Exchange Commission is promoting a proposed "proxy access" rule that would enhance certain large shareholders' ability to use the proxy process to remove incumbent directors. The assumption seems to be that anything that gives shareholders greater leverage necessarily serves investors' interests. The new scholarship severs this supposed linkage. While the proxy access rule might attract political support by promising an immediate windfall to certain types of shareholders, there is every reason to suspect it may ultimately work against the interests of the "investing class" as a whole.[35]

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[34] CITE Klausner.

[35] CITE Stout and Anabtawi.

Fifth, this analysis cautions even more strongly against attempts to export the "standard shareholder-oriented model" abroad. During the 1970s, many experts argued that U.S. corporations could learn from the example of highly-successful, stakeholder-friendly German and Japanese firms. With the decline of the Japanese and German economies and the bubble-fueled ascendancy of the U.S. stock market during the 1990s, however, the advice tended to flow the other way. Corporate governance experts trumpeted the success of the "U.S. model" and counseled other countries to follow our lead by moving their corporate law rules closer to shareholder primacy. A few nations actually heeded this advice, sometimes with disastrous results.[36] The new literature suggests at least two reasons why governance experts who tout the "U.S. model" abroad may, in fact, be exporting damaged goods. First, as already noted, the "standard shareholder-oriented model" does not actually describe U.S. law. Second, this may not be accident: U.S. law may not follow the "standard" model because it does not in fact serve investors' interests. Accordingly, we may do other nations a grave disservice by urging them to adopt rules that give shareholders greater power.

Finally, by suggesting how director primacy ultimately serves investors better than the "standard" model of governance, the five theories of director primacy examined below may go a long way toward resolving the Great Debate. As will be seen, each of

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

the five theories suggests a different reason why shareholders benefit from ceding control over the firm to a board of directors. But they also suggest different, and increasingly broad, reasons why shareholders might not only want to grant boards the sort of authority that permits them to serve other stakeholders at shareholders' expense, but *actually prefer that boards in fact do this*. Because the five theories provide different accounts of exactly what range of stakeholder interests shareholders would like directors to consider—creditors? employees? society as a whole?--the area of dispute that remains in the Great Debate will depend to some extent on exactly how many, and which, theories of director primacy one subscribes to. But to the observer who finds merit in all five—and, as I shall argue, all five have merit—the Great Debate, if not entirely resolved, is at least greatly diminished in scope and importance.

Five Theories of Director Primacy

[To readers: due to time constraints, the five theories are presented below only in summary form. If you are unfamiliar them or would like to delve more deeply, I have tried to include citations to original and secondary sources that can give greater guidance.]

1. Market Inefficiency and Director Primacy

[The "standard" model described by Kraakman and Hansmann presumes stock price is a fairly accurate measure of shareholder wealth; in other words, it presumes the stock market is "fundamental value efficient." Since the Crash of 1987, however, finance theorists have developed a number of ideas and produced a number of empirical studies that challenge the theoretical and empirical validity of efficient market theory, including heterogeneous expectations asset pricing models; an emerging literature on the limits of arbitrage; and the behavioral finance literature.[37] If, as the "New Finance" suggests, stock prices can depart dramatically from rational estimates of fundamental value, the possibility arises that business strategies that raise share price in the short term can harm firm value and shareholder wealth over the long term. The result is a conflict of interest between short-term investors (e.g., hedge funds and mutual funds) and investors who expect to hold shares for longer periods.

One possible solution to the conflict is for both groups to cede control to a board of directors that has the authority to pursue business strategies that preserve long term value even if they don't produce immediate gains in share price (e.g., investing in research and development or in employee or community relations). This idea supports arguments raised over the years by a variety of governance experts--including Kihlstrom

[37] For a survey see Lynn A. Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance 28 J. Corp. L. 635 (2003).

& Wachter, Lipton, Stout, and, ironically, Kraakman--[38] who have suggested that director authority can sometimes benefit shareholders by protecting long-term value even while short-term share price languishes.]

2. Capital "Lock In" and Director Primacy

[Corporations have traditionally been defined as entities with the standard attributes of limited shareholder liability, centralized management, perpetual life, and freely transferable shares. In recent years, however, a variety of scholars, including Harold Demsetz, Margaret Blair, and, again ironically, Hansmann and Kraakman,[39] have argued that corporate entities are also marked by a fifth essential attribute: capital "lock in." This phrase captures the notion that equity investors in a corporation, unlike investors in a partnership or proprietorship, lack the ability to unilaterally withdraw their capital from the firm.

Capital lock-in protects equity investors from the risk their fellow investors will want, or need, to withdraw their equity investment, triggering a dissolution or "fire sale" of the firm. This encourages corporate investment in long-term projects that require large

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[38] See, e.g., Richard E. Kihlstrom & Michael L. Wachter, Corporate Policy and the Coherence of Delaware Takeover Law, 152 U. Pa. L. Rev. 523 (2003); Reinier Kraakman, Taking Discounts Seriously, 88 Colum. L. Rev. 891 (1988); Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979); Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 Yale L. J. 1235 (1990).

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

amounts of firm-specific assets (e.g., a railroad, manufacturing plant, or brand name) that cannot be easily liquidated or sold without harming their value. It may also encourage creditors to lend the firm, by similarly protecting their interest the firm from shareholder demands for a return of capital.

For a variety of reasons, explicit contracts often cannot lock in capital effectively. Incorporation offers an alternative means of achieving lock in, because the corporate entity becomes the legal "owner" of the firm's specific assets and control of the firm rests in the hands of a board. Thus lock in supports the claim that director primacy can serve investor interests ex ante even as it weakens investor control ex post, by reassuring both creditors and other equity investors they can safely invest in or lend to the firm.[40] In the process, it provides normative support for board decisions that benefit creditors by protecting the firm's specific assets from shareholder attempts to withdraw capital.]

3. Team Production Theory and Director Primacy

[Like lock-in theory, team production theory[41] focuses on the economic importance of firm specific investment. Team production theory recognizes, however, that equity investors are not the only group whose resources can be converted into firm specific assets. Employees, for example, may make specific investments by putting in

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[40] See Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999) ADD CITES.

[41] See, e.g., Lynn A. Stout, Other-Regarding Preferences and Social Norms, downloadable at SSRN.com ADD CITE.

time and effort far beyond the minimum their contracts require, or by developing knowledge, skills, and relationships of greater value to the firm than any other potential employer. Customers may invest time and effort becoming familiar with the firm's products. Local communities may build roads, schools, and other specialized infrastructure to support the firm's manufacturing plant or headquarters.

It is often in shareholders' ex ante interest to encourage such specific stakeholder investments. However, once the investments have been made, shareholders also often stand to profit from opportunistic strategies that threaten to destroy their value, e.g., from firing loyal employees or closing a manufacturing plant originally built with tax breaks. Formal contracts often can provide only limited and inadequate protection against such shareholder opportunism. As an alternative, shareholders might reassure stakeholder investors and encourage their specific investment by ceding control to a board that cannot personally profit (as shareholders can) from business strategies that enhance shareholder wealth by destroying the value of other stakeholders' specific investments. Again, the team production approach supports director primacy as a governance structure that serves shareholders' ex ante interests by giving boards ex post power to favor other constituencies.]

4. Director Primacy and the Universal Shareholder

[The standard shareholder primacy model assumes that shareholder wealth is best maximized by strategies that maximize the price of the company's own shares. Very

often, however, directors and executives can increase the share price of Firm A by pursing strategies that impose costs on Firm B (thus Oracle pursues monopolistic acquisitions that will allow it to charge its customers, mostly corporations, higher prices). Alternatively, they can raise Firm A's share price by harming the value of Firm A's bonds (consider Enron's decision to load up on risky energy derivatives).

Such decisions increase the wealth of the nondiversified shareholders of Firm A. But they may reduce the aggregate wealth of the "Universal Shareholder" – the highly diversified pension or mutual fund that owns stocks and bonds in many different firms. Also, Universal Shareholders are often fiduciaries for individual beneficiaries who are themselves customers and employees of firms, and who are also biological organisms that depend on their environment. One can thus question whether the Universal Shareholder serves its beneficiaries well by supporting business strategies that raise share price by harming employees or customers, or by creating an unhealthful environment.

Proponents of the Universal Shareholder idea—most notably, investor activist Bob Monks[42] and professors James Hawley and Andrew Williams[43] —have tended to focus on the idea that the best way to get corporations to serve the interests of the Universal Shareholder rather than the canonical undiversified shareholder is to increase the political power of diversified pension funds and mutual funds. Director primacy

[42] Robert A.G. Monks, The New Global Investors (2001).

[43] James P. Hawley and Andrew T. Williams, The Rise of Fiduciary Capitalism (2000)

offers an alternative governance means toward this end, however. This is because directors have no innate interest in favoring the interests of the undiversified shareholder over the interests of the Universal Shareholder. As a result, directors who are free to pursue corporate goals other than maximizing share price are also free to pursue strategies that ultimately benefit the Universal Shareholder by benefiting creditors, other firms, employees, customers, and the environment.]

5. Director Primacy and the Concept of the Social Shareholder

[The Universal Shareholder's concerns are confined to those of its beneficiaries, the individuals who are wealthy enough to have investments in pension and mutual funds. What of employees and customers who are too poor to have such investments? What of environmental concerns above and beyond those that affect the health and wealth of the moneyed "investing class?"

Conventional director primacy presumes that investors, Universal or not, care only about themselves. There is a substantial body of evidence from the social sciences, however, including extensive evidence from experiments with human subjects, that documents that most people are more altruistic and "other-regarding."[44] Other-regarding shareholders might prefer to sacrifice at least some corporate profits in order to benefit (at least avoid harming) employees, consumers, society, or the environment. Direct

[44] ADD CITES See, e.g., Lynn A. Stout, Other-Regarding Preferences and Social Norms, downloadable at SSRN.com ADD CITE.

evidence for this can be found in the significant and growing investor interest for "social" investment funds.[45]

Einer Elhauge has employed the idea of the "social investor" as an interesting platform for yet another theory of director primacy.[46] This theory recognizes that, just as shareholders face obstacles bringing firms to heel to serve their economic interests, they face obstacles making firms serve their altruistic desires. For a host of reasons—including lack of access, lack of time, lack of information, and their own rational apathy—shareholders often find it difficult to determine whether and to what extent the corporations they invest in are reaping profits from socially harmful behavior. Directors stand in a much better position to make such judgments. Also, anonymous shareholders are largely insulated from shaming or other "social sanctions" that follow corporate misbehavior, where directors are not. The end result is that corporations run by directors who enjoy a range of authority to sacrifice profits in the public interest may end up serving investors' interests—including investors' altruistic interests--better than corporations run according to the "standard model" would.]

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[45] ADD CITE Cynthia William, Social Disclosure, __ Harv. L. Rev. __ (2000).

[46] ADD CITE Einer Elhauge, Sacrificing Corporate Profits in the Public Interest (Draft of August 17, 2004).

Conclusion

Until recently, it has been commonplace to conceptualize the Great Debate in corporate law as a duel between those think that directors ought to run corporations only in the interests of shareholders, and those who think boards ought to consider the interests of others in society as well. The first group has been associated with economic theory, and the second with a political agenda.

By the turn of the millennium, shareholder primacy thinking shows signs of becoming more subtle. Scholars increasingly argue that, for a variety of economic reasons, shareholders themselves might prefer more stakeholder-friendly director primacy rules. Such arguments offer to explain a number of otherwise-puzzling empirical realities of corporate law and practice. They also offer to close the distance between the two sides of the Great Debate.