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Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy

Jill E. Fisch
University of Pennsylvania Carey Law School

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Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy

Jill E. Fisch*

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ABSTRACT

The shareholder primacy norm defines the objective of the corporation as maximization of shareholder wealth. Law and economics scholars have incorporated the shareholder primacy norm into their empirical analyses of regulatory efficiency. An increasingly influential body of scholarship uses empirical methodology to evaluate legal rules that allocate power within the corporation. By embracing the shareholder primacy

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* Alpin J. Cameron Professor of Law, Fordham Law School. E-mail: jfisch@law.fordham.edu. Prepared for the symposium on *Robert Clark's Corporate Law: Twenty Years of Change* held on September 8 and 9, 2005, at the University of Iowa College of Law. An initial draft of this paper was presented at the Conference on Comparative Institutional Analysis at the University of Wisconsin Law School, and I am particularly grateful for the thoughtful discussion and comments provided by participants at that conference as well as for Neil Komesar's efforts in organizing and hosting the program. Many helpful comments have also been provided by Melvin Eisenberg, Lynn Stout, Iman Anabtawi, Mark Weinstein, Brett McDonnell, participants in the Clark Symposium, the Berkeley Law & Economics Workshop, the Law & Economics Workshop at Queens University, the UCLA-Sloan Conference on the Means and Ends of Corporations, and the Columbia-UCLA Conference on Shareholder Democracy: Its Promises and Perils.

norm, empirical scholars offer normative assessments about regulatory choices based on the effect of legal rules on measures of shareholder value such as stock price, net profits, and Tobin's Q.

This Article challenges the foundations of using the shareholder primacy norm to judge corporate law. As this Article explains, existing legal doctrine and economic theory provide only limited support for shareholder primacy. Similarly, shareholder primacy cannot be justified as a necessary consequence of existing limits on the enforcement of management fiduciary duties. This Article demonstrates that, rather than defining the corporation's objectives, the limited scope of a fiduciary duty claim provides a mechanism for institutional specialization in responding to the needs of different corporate stakeholders. Comparative institutional analysis suggests that the courts are uniquely positioned to protect the interests of shareholders in the context of inter-stakeholder conflicts. Implementation of this role through rules that grant shareholders a unique degree of judicial access does not privilege the interests of shareholders in the evaluation of firm value.

The presence of other stakeholders, whose interests in the firm may not be reflected in an assessment of shareholder value, offers reasons to question the conclusions of existing empirical research. In addition, the measures of shareholder value typically employed by empirical scholars—particularly short-term stock price—are problematic as indicators of firm value and may reinforce inappropriate managerial decisions. This Article maintains that empirical scholars need to offer better and explicit justifications for their reliance on shareholder wealth and, more importantly, for their argument that shareholder wealth effects should dominate regulatory policy.

I. INTRODUCTION

In many ways, Robert Clark's 1986 analysis of the shareholder primacy norm could have been written today.[1] Chapter 16 of Clark's treatise, *Corporate Law*, describes five clusters of views concerning the proper role and objectives of the corporation.[2] Citing strengths and weaknesses of each approach, Clark warns of the peril of attempting to choose among them.[3]

Twenty years have passed since the publication of *Corporate Law*. Nonetheless, the debate over the shareholder primacy norm continues. At one end of the spectrum are those commentators who argue that a corporation's sole goal should be the maximization of shareholder wealth; at the other are those who argue that the corporation should be managed in the interests of a broad range of stakeholders.[4]

Much has changed, however, in the past 20 years. Since Clark published his treatise

1. ROBERT CLARK, CORPORATE LAW 675-703 (1986).

2. *Id.* at 677.

3. *Id.* at 702.

4. Steve Bainbridge describes shareholder primacy as encompassing "two distinct principles: 1) the shareholder wealth maximization norm . . . and 2) the principle of ultimate shareholder control." Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003). A third and related principle is that shareholder primacy defines the beneficiaries of judicially enforceable fiduciary duties by management. In his analysis of director primacy, Bainbridge focuses on the second principle—the extent of manager versus shareholder control. *Id.* at 574. In contrast, this Article focuses on the first and third principles and, particularly in Part III, on the relationship between the two.

in 1986, an entire chapter of corporate law concerning the rights and powers of managements, shareholders, and other stakeholders in the context of control contests has been written and refined. Corporations have experimented with new methods of management compensation, including the dramatic rise in executive stock options.[5] Institutional investors have become increasingly important—and increasingly active—equity holders. These changes, and many others, have affected the allocation of power among corporate constituencies and, in turn, given new importance to evaluating the effects of this allocation of power upon firm value and social welfare.

An explosion of empirical analysis of corporate law—also an important development since 1986—has responded to this demand.[6] An increasing number of scholars in law, economics, finance, and related fields are using event studies, regression analysis, and other statistical tools to evaluate the effect of corporate law on firm value. The normative framework for this work is efficiency analysis.[7] The studies seek to identify as efficient those legal rules that maximize firm value and, on the basis of this efficiency analysis, to offer concrete evidence to guide lawmakers with respect to regulatory choices such as the allocation of authority between shareholders and directors, or the scope of a litigation remedy for corporate misconduct.

Empirical scholars have embraced the shareholder primacy norm. Although the studies frequently fail to define firm value explicitly, they incorporate the concept of shareholder primacy by evaluating legal rules in terms of their effect on measures of shareholder value such as stock price and Tobin's Q. Consequently, the resulting efficiency analysis evaluates regulatory efficiency in terms of shareholder wealth.

Shareholder wealth may be an appropriate proxy for a broader conception of firm value. Alternatively, shareholder wealth may simply be the normatively appropriate basis for evaluating the efficiency of corporate law. However, most existing empirical studies do not justify their reliance on shareholder wealth in these terms. Indeed, most studies do not expressly consider the implications of using shareholder wealth as a measure of firm value, despite the fact that they purport to be conducting a general efficiency analysis in which the primary goal should be maximizing the size of the corporate surplus, while

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5. *See, e.g.*, Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 ACCENTURE J. APPLIED CORP. FIN. 21, 23 (2003) (describing the rise in median equity-based compensation of executives at S&P 500 companies from 0% in 1984 to 66% in 2001).

6. *See, e.g.*, Randall S. Thomas, *The Increasing Role of Empirical Research in Corporate Law Scholarship*, 92 GEO. L.J. 981, 982-83 (2004) (reviewing MARK ROE, POLITICAL DETERMINATES OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003)) (identifying the "explosion" in new corporate law empirical scholarship).

7. The Article consciously adopts the normative framework of welfare economics and efficiency analysis, excluding, for purposes of this discussion, independent considerations of equity or fairness. *See, e.g.*, Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 968 (2001) (offering a definition of welfare economics and distinguishing fairness considerations). Within this framework, the applicable standard is Kaldor-Hicks efficiency. *See* Robert Cooter & Thomas Ulen, LAW AND ECONOMICS 43-44 (3d ed. 2000) (explaining Kaldor-Hicks efficiency). Economists commonly argue that distributional concerns can be addressed through tax and transfer policies, although this claim has been criticized both generally and with respect to corporate law. *See* Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1254-55 (2004) (questioning the goal of Kaldor-Hicks efficiency in corporate law); *see also* Chris W. Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003 (2001) (advocating equity-informed legal rules).

considerations of the appropriate division of the corporate surplus should be secondary.[8]

Clark recognized the problems inherent in various attempts to specify the corporate objective, concluding that an effort to choose among the different conceptions was likely to be "inconsequential or misguided."[9] Despite Clark's rational skepticism, current scholars have overwhelmingly embraced the shareholder primacy norm. This Article explores the justifications for this choice, focusing in particular on the implications of incorporating the shareholder primacy norm into empirical research.

This Article begins, in Part II, by demonstrating the centrality of the shareholder primacy norm to the evaluation of regulatory efficiency in corporate law. This Article focuses on the premise of most empirical research—that firm value is equivalent to shareholder wealth—and argues that scholars have failed to justify this premise. Part III explores the extent to which reliance on shareholder primacy can be justified in terms of existing law, practice, or economic theory. Part IV considers the specific subject of fiduciary duties and argues that, while there are compelling reasons to favor shareholder primacy as a limit on the scope of legally enforceable fiduciary duties, the scope of fiduciary duties does not offer a basis for defining the corporate objective exclusively in terms of shareholder wealth. Part V identifies possible concerns in premising efficiency analysis on the shareholder primacy norm. In particular, Part V observes that measures of shareholder wealth are poorly suited to capture certain issues of particular importance to corporate regulation, such as transfers of wealth between corporate stakeholders, externalities, and the appropriate level of risk-taking.

Ultimately, corporate scholarship must confront the appropriate definition of firm value for purposes of efficiency analysis. Although the appropriate corporate objective may be the maximization of shareholder wealth, scholars have not yet made the case. Consequently, empirical analyses of shareholder wealth may not support the efficiency conclusions offered by their authors, particularly when the subjects of the analyses are legal rules that allocate rights among competing corporate constituencies, rules that impose externalities on other corporations, or rules that affect the overall level of risk borne by the corporation's stakeholders. If this is the case, the challenge for future empirical scholars is to develop methods by which to incorporate a broader conception of firm value into their research.

II. EFFICIENCY IN CORPORATE LAW AND THE MAXIMIZATION OF SHAREHOLDER WEALTH

Easterbrook and Fischel posed a fundamental question almost 15 years ago: "Is corporate law efficient or not?"[10] As Randall Thomas has observed, corporate legal scholarship has, in recent years, increasingly sought to answer that question through empirical research.[11] Some scholars have used event studies to measure the effect of specific regulatory changes.[12] The purpose of these studies is to assess the effect of a

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8. *Cf.* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7-11 (3d ed. 2003) (defining efficient legal rules as those that maximize aggregate social welfare).

9. CLARK, *supra* note 1, at 702.

10. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 212 (1991).

11. Thomas, *supra* note 6, at 982.

12. *See* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES

particular legal rule or component of corporate structure on firm value.[13] Thus, for example, Michael Bradley and Cindy Schipani examined the effect on stock prices of new legislation permitting corporations to limit or eliminate director liability for violations of the duty of care. They concluded that, because adoption of director exculpation statutes resulted in lower stock prices, the statutes inefficiently lowered firm value.[14] Similarly, Jonathan Karpoff and Paul Malatesta studied the adoption of second generation antitakeover statutes, finding a small negative effect on stock prices.[15]

Other studies analyze firm-specific differences to compare the effect of variations in firm structure. Bernard Black and Sanjai Bhagat studied the impact of board independence on firm performance.[16] Gompers, Ishii, and Metrick constructed a corporate governance index to measure the aggregate effect of a variety of governance mechanisms—including many takeover defenses—on firm value.[17] Roberta Romano analyzed the effect of confidential voting and determined that it does not affect firm performance.[18]

Still others have compared legal regimes, most commonly Delaware versus other states. Interstate comparisons are useful in evaluating the debate over regulatory competition as well as seeking to explain why most large public companies are incorporated in Delaware.[19] For example, Rob Daines and Guhan Subramanian have both attempted to evaluate the efficiency of Delaware law, relative to that of other states, by looking at the correlation between Delaware incorporation and firm value.[20] The influence of these studies is substantial: the *Wall Street Journal* prominently reported

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REGULATION 64-70 (2002) (describing the use of event studies in evaluating corporate law).

13. Most commonly, studies seek to evaluate the effect of a legal rule on firm value, using stock price or Tobin's Q as a measure of firm value. Tobin's Q is the ratio of a firm's stock market value to the book value of its assets. *See* Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1785 (2002) (defining Tobin's Q). In theory, there should be a strong correlation between stock price and long-run returns to stockholders. *See* EASTERBROOK & FISCHEL, *supra* note 10, at 18-20 (exploring the extent to which stock price reflects a firm's current and future value). *But see* Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 HOUS. L. REV. 399, 416 n.64 (1998) (reporting study results finding a correlation of only .4859 between cumulative returns and return on equity). Alternatively, some studies seek to examine performance, a flow-type variable, rather than focusing on a static variable such as value. The finance literature has considered extensively the extent to which performance is correlated with value, as well as the most appropriate measure of performance. *See id.* (reporting a study finding a correlation of only 0.2386 between shareholder returns and pre-tax profits); *see also infra* Part V (discussing methods of evaluating firm performance).

14. Michael Bradley & Cindy A. Schipani, *The Economic Importance of the Business Judgment Rule: An Empirical Analysis of the Trans Union Decision and Subsequent Delaware Legislation*, *in* THE BATTLE FOR CORPORATE CONTROL 105 (Arnold W. Sametz ed., 1991) (finding that the passage of section 102(b)(7) of the Delaware General Corporation Law actually lowered the value of Delaware corporations).

15. Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989).

16. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002).

17. Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

18. Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 J. LEGAL STUD. 465, 502-06 (2003).

19. *See* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000) (explaining the debate over regulatory competition and efforts to explain Delaware's dominance as the site of incorporation for large public companies).

20. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Guhan Subramanian, *The Disappearing Delaware Effect*, 46 J.L. ECON. & ORG. 32 (2004).

Daines's finding that Delaware firms were worth 5% more than firms incorporated elsewhere.[21]

Overall, these studies seek both to analyze specific legal rules and to identify the best way to make corporate law.[22] Empirical studies have been widely cited in the debate over regulatory competition, primarily to support Judge Winter's claim that market competition constrains management and produces efficient regulation—a so-called race "to the top."[23] Empirical research has been influential in debates over regulatory policy. Surprisingly, however, this empirical research has failed to provide convincing answers to many of the efficiency questions to which it has been directed.

For example, Guhan Subramanian's study of Delaware incorporation, extending and subsequent to the Daines study, found insufficient evidence that Delaware incorporation was correlated with higher firm value.[24] Subramanian found first that the "Delaware effect" was driven by small firms, and second that it disappeared during the period from 1997 to 2002.[25] Subramanian therefore concluded that Daines had failed to provide convincing empirical support for the race-to-the-top theory. Relatedly, Roberta Romano has reported that a number of event studies have found positive stock price effects associated with reincorporation in Delaware, but that the several studies attempting to use performance-based measures to evaluate the effect of incorporation have found "no significant difference in accounting performance."[26]

Similarly, empirical studies of corporate governance reforms, such as independent boards or board committees, have produced conflicting results.[27] Thus, for example, the recent large sample, long-horizon study of the impact of board independence conducted by Sanjai Bhagat and Bernard Black failed to find any correlation between board independence and firm value or financial performance.[28] In contrast, Laura Lin has cited research indicating a positive relationship between director independence and firm performance.[29]

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21. Steven Lipin, *Deals & Deal Makers: Firms Incorporated in Delaware Are Valued More by Investors*, WALL ST. J., Feb. 28, 2000, at C21.

22. *See, e.g.*, Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003) (suggesting that, because Delaware faces very limited competition for out-of-state corporations, existing market pressure may be insufficient to produce efficient legal rules); *cf.* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (identifying the role of potential federal override as a constraint on state corporate law).

23. Ralph K. Winter, Jr., *The Development of the Law of Corporate Governance*, 9 DEL J. CORP. L. 524, 528 (1984).

24. Subramanian, *supra* note 20, at 57.

25. *Id.*

26. ROMANO, *supra* note 12, at 72-73.

27. *See* Jill Fisch & Caroline Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 559-63 (2003) (summarizing empirical studies).

28. Sanjai Bhagat & Bernard S. Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002). Bhagat and Black used a variety of variables to measure firm value and performance, including Tobin's Q, return on assets, ratio of sales to assets, and market-adjusted stock price. *Id.* at 242. They also tested their results with other accounting measures such as sales per employee and cash flow. *Id.*

29. Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 922 (1996).

The absence of more definitive results from empirical research may be due to methodological weaknesses. Commentators have offered many criticisms of the design and methodology of corporate empirical research.[30] Critics have noted, for example, that event studies and other studies that use stock price may depend on unrealistically strong assumptions about the efficiency of the markets. Some scholars have identified weaknesses in the assumptions underlying the predicted stock market response to the studied event.[31] Event studies depend critically upon identifying the appropriate event; researchers have argued that, in some cases, studies are not focusing on the correct event. The financial literature is replete with debates over the most appropriate tools for measuring firm performance. Economists have also identified flaws in the use of Tobin's Q, particularly with respect to the method used to measure the replacement cost of firm assets.[32]

To date, however, scholars have not focused on one core aspect of corporate empirical research: its equation of firm value with shareholder value.[33] As Subramanian states, commentators share common assumptions that the social welfare goal under analysis is maximization of shareholder wealth.[34] The empirical studies uniformly evaluate corporate law in terms of its impact on a shareholder-based component of corporate value. Whether the variable used is net profits, stock price, or Tobin's Q, in each case, the authors are determining efficiency by reference to shareholder wealth. The design of the studies is premised on the conclusion that efficient corporate rules are those rules that maximize returns to shareholders.

Within a framework of welfare economics in which the goal is societal wealth maximization, firm value is conceptually distinct from shareholder value.[35] Corporations provide value to a variety of nonshareholder groups, including managers, employees, creditors, customers, and suppliers. A corporation provides value to its creditors in the form of interest on and repayment of its debt. It provides value to managers and other employees through jobs that yield compensation, fringe benefits, perquisites, and, in some cases, the development of specialized skills or marketable reputations. A corporation provides value to its customers and its suppliers through voluntary surplus-producing market transactions.[36]

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30. For an overview of methodological weaknesses common to empirical research conducted by legal scholars, see Lee Epstein & Gary King, *Exchange: Empirical Research and the Goals of Legal Scholarship*, 69 U. CHI. L. REV. 1 (2002).

31. *See, e.g.*, Charles J. Goetz, Comment, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven*, 71 CORNELL L. REV. 344, 346-47 (1986) (questioning study's prediction about the predicted stock market response to announcements about derivative litigation).

32. *See, e.g.*, Wilbur Lewellen & S.G. Badrinath, *On the Measurement of Tobin's Q.*, 44 J. FIN. ECON. 77 (1997) (finding flawed methodology in common computations of Tobin's Q and proposing an alternative approach).

33. *See, e.g.*, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113 (1987) (describing "the maximization of equity share prices as the core goal of corporation law").

34. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1798 (2002).

35. S*ee* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1485 (1992) (observing that, because "a given corporate law issue . . . implicates not only the interests of shareholders, but also those of third parties . . . these [third party] interests must be taken into account in arriving at the socially optimal rule).

36. Corporations may also provide value to the communities in which they are located, through the

Firm value will, by its nature, exceed shareholder value because most or all of the value provided to nonshareholder stakeholders, in the form of salaries, interest payments, and so forth, is explicitly excluded from shareholder-oriented concepts of firm value such as corporate profit. Similarly, because it is distributed to nonshareholder stakeholders, this excess does not affect shareholder returns and ultimately will not be reflected in stock price. Empirical studies that measure efficiency in terms of shareholder wealth therefore exclude the effect of regulatory changes on nonshareholder constituencies within the corporation.

Why do empirical analyses of the efficiency of corporate law focus on shareholder wealth? There are several possible explanations. First, data on shareholder wealth, particularly changes in market capitalization, are easy to obtain. Although empirical research could probably incorporate a reasonable measure of creditor value, based on something like the market value of publicly traded corporate debt,[37] neither the legal nor the financial literature has developed standardized measures of employee value, customer value, and so forth.[38] Second, researchers may believe shareholder wealth is a reasonably good proxy for firm value. Even if shareholder wealth does not reflect aggregate firm value, if regulatory changes are likely to have a similar effect on all corporate constituencies—that is, if shareholder wealth is closely correlated with firm value—any error resulting from the use of shareholder wealth is likely to be small. Third, because corporate and securities law focus on the role and rights of investors, scholars may believe that the effect of changes in corporate law on nonshareholder constituencies may legitimately be disregarded for purposes of their analysis.[39]

If researchers have focused on shareholder wealth because of the relative ease of data collection, the consequence may be merely that some of their conclusions are somewhat narrower than claimed. Empirical scholars can frame their conclusions explicitly in terms of shareholder wealth rather than overall firm value or societal efficiency, and indeed, a few scholars have done so. One example is the work by Rob Daines and Michael Klausner analyzing the effect of antitakeover protection in IPO

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property taxes that they pay, the services they provide, even the charitable activities in which they engage. The range of stakeholders and scope of interests that should be taken into account in assessing firm value is a matter of some debate.

37. *See, e.g.*, Mark Klock et al., *Tobin's* q *and Measurement Error: Caveat Investigator*, 43 J. ECON. & BUS. 241, 245 (1991) (identifying a method of constructing imputed value for privately placed debt to refine a Tobin's Q calculation).

38. Disclosure laws, which are oriented in terms of shareholder wealth, could be modified to increase the transparency of other components of firm value. *See* Marleen O'Connor, *Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge-Based Economy*, 1 U. PA. J. LAB. & EMP. L. 527 (1998) (advocating the revision of accounting procedures to increase disclosure of human resource values); *see also* Jeffrey N. Gordon, The Contestable Claims of Shareholder Wealth Maximization: Evidence from the Airline Industry (Nov. 25, 2002) (unpublished paper) (developing a market-based measure of the value of labor).

39. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441-42 (2001) (arguing that shareholder value is the normatively appropriate focus of corporate law and that the interests of other corporate stakeholders are better addressed through other bodies of law such as labor law, consumer law, and so forth); Adam Winkler, *Corporate Law or the Law of Business: Stakeholders and Corporate Governance at the End of History*, 67 CONTEMP. PROBS. 109, 132 (2004) (detailing extensive stakeholder protection through the broader law of business but terming the distinction between corporate law and other business law "artificial").

charter provisions.[40] Although their paper title poses the question in terms of "firm value," Daines and Klausner make clear in the body of the paper that the focus of their analysis is shareholder wealth. Importantly, the authors explicitly recognize the distinction between maximization of shareholder wealth and efficiency, identifying the possibility that antitakeover provisions may protect management private benefits at the expense of shareholders.[41]

Legal research that examines the impact of regulatory change on shareholder value is valuable. Relatedly, such research can be defended on normative grounds as focused upon the core subject of corporate law. Clark argued, for example, that corporate law and securities regulation "are simply defined to deal only with the relationships between shareholders and managers."[42] Empirical studies should, however, be clear about the scope of any efficiency claims based on such analysis. Alternatively, researchers who seek broader efficiency implications may need to counteract the lamplight effect and expand their data collection.

As to the argument that shareholder wealth serves as a legitimate proxy for firm value, this claim is at least partially true. On many issues, the interests of multiple corporate stakeholders are aligned.[43] Indeed, as Clark recognized, there is also considerable overlap between firm interests and societal interests. Clark described the monist viewpoint as the claim that, in the long run, there is an identity between public and corporate interests.[44] Charles Wilson put it in somewhat different terms: "What was good for our country was good for General Motors, and vice versa."[45]

Surprisingly, little research demonstrates a correlation between doing well and doing good, that is, a correlation between corporate performance and decisions that favor the interests of nonshareholder stakeholders or the public at large.[46] Despite the existence of an extensive literature arguing for increased corporate social responsibility, there is scant evidence that corporate decisions favoring the interests of workers, customers, or the community actually increase the size of the pie, as opposed to reflecting transfers of

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40. Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001).

41. *See id.* at 110-12 (characterizing efficiency in terms of the sum of share value and private benefits to management).

42. CLARK, *supra* note 1, at 30.

43. In addition, shareholders may also be creditors, customers, and employees, leading them to care about the effects of corporate conduct on nonshareholder constituencies. *See, e.g.*, Roger H. Gordon, *Do Publicly Traded Corporations Act in the Public Interest?*, 3 ADVANCES ECON. ANALYSIS & POL'Y 1 (2003) (describing how shareholder interests may extend beyond share price).

44. CLARK, *supra* note 1, at 681.

45. *Nomination of Charles Wilson for Secretary of Defense Before the S. Armed Servs. Comm.*, 83d Cong., 1st Sess., 26 (1953).

46. *See, e.g.*, STEPHEN J. GARONE, THE LINK BETWEEN CORPORATE CITIZENSHIP AND FINANCIAL PERFORMANCE (1999) (finding inconclusive evidence demonstrating that good corporate citizenship improves financial performance); WALKER INFO., INC., MEASURING THE BUSINESS VALUE OF CORPORATE PHILANTHROPY 6 (2000), *available at* http://www.cof.org/files/Documents/Corporate_Grantmaking/Measurement/Measuring_the_Business_Value_of_Corp_Phil-Executive_Summary.pdf (summarizing the literature and finding that "[e]mpirical research on the relationship between corporate citizenship and corporate financial performance has yet to prove a conclusive link").

wealth from one group of stakeholders to another.[47] To the extent that researchers are relying on shareholder wealth as a proxy for firm or societal value, empirical evidence documenting the relationship would be helpful.

Even if the interests of corporate stakeholders are, in many cases, aligned, sometimes they are not. In at least a subset of corporate decisions, there is a true conflict between the interests of different stakeholders, and a decision that benefits one class of stakeholders will harm another. Moreover, many of the corporate rules upon which empirical research is focused are addressed to these types of intra-capital structure battles. Takeover regulation, the scope of director and officer liability, board structure, and executive compensation all have the potential to affect wealth transfers between stakeholders. The decision to evaluate these rules exclusively in terms of shareholder wealth requires normative justification for favoring shareholder interests, at the expense of other stakeholders.

The implicit assumption then, in existing empirical research, is that the shareholder primacy norm permits or requires empirical scholars to define efficiency in corporate law exclusively in terms of shareholder wealth. Is such a claim justified? Answering this question requires a more careful analysis of the basis for the shareholder primacy norm and the extent to which it constrains corporate decision-making, an analysis to which this Article turns in the next part.

III. THE SHAREHOLDER PRIMACY NORM

A. Origins of the Norm

1. The Berle-Dodd Debate

Shareholder primacy, the obligation of corporate decision-makers to focus on shareholder interests, is a dominant principle in corporate law.[48] The American Law Institute's Principles of Corporate Governance state "a corporation . . . should have as its objective the conduct of business activities with a view to enhancing corporate profit and

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47. *See* Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350, 353 (2004) (reviewing extensive literature attempting to link stakeholder management with performance and concluding that empirical results fail to support such a relationship); *see also* Mark S. Klock et al., *Does Corporate Governance Matter to Bondholders?*, 40 J. FIN. & QUANT. ANAL. 693 (2005) (concluding that antitakeover provisions, although not beneficial to shareholders, are valued by creditors); Olubunmi Faleye et al., When Labor Has a Voice in Corporate Governance (2004) (unpublished paper), *available at* http://papers.ssrn.com/abstract=498962 (finding that favoring labor interests is inconsistent with shareholder value maximization); Henrik Cronqvist et al., Do Entrenched Managers Pay Their Workers More? (Dec. 2, 2005) (unpublished paper), *available at* http://ssrn.com/abstract=845844 (finding that, as a result of agency problems, entrenched managers pay higher wages, benefiting workers at the expense of shareholders). *But see* Wayne F. Cascio, *Downsizing: What Do We Know? What Have We Learned?*, 7 ACAD. MGMT. EXEC. 95 (1993) (finding that, contrary to management claims, corporate downsizing was associated with lower long term stock performance).

48. *See, e.g.*, John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1326 (1992) (stating that "the fundamental goal of corporate law is so theoretically and historically obvious that it need not be explicated: the goal is to maximize corporate—and thus shareholder—welfare").

shareholder gain."[49] Although some scholars, most notably progressive scholars, have questioned whether the norm is either descriptively accurate or normatively appropriate, the vast majority of commentators accept the premise that the primary objective of the corporation is to maximize shareholder wealth.[50]

The origins of the shareholder primacy norm can be found in the classic debate between Merrick Dodd and Adolf Berle in the 1930s, which took place at the time when the U.S. corporation was expanding from an organizational form used primarily for public work—building and operating railroads, ferry services, bridges, and the like—to the foundational form for private business enterprise. Berle and Dodd were actually debating two questions—how properly to characterize the developing structure of corporate law and, relatedly, how corporate law should develop in the future. Thus Berle, who espoused the conception of shareholder primacy in the debate, argued that corporate law was essentially a variant of trust law, in which corporate managers owed fiduciary duties to manage the corporation in the interests of the shareholder-beneficiaries.[51] Berle's claim was primarily descriptive: "[A]ll powers granted to a corporation or to the management of a corporation . . . are . . . exercisable only for the ratable benefit of all shareholders as their interest appears."[52] Berle's argument was premised on the conception of shareholders as owners of the corporation. Managers' obligations to shareholders stem from their role as trustees or agents for these owners. Berle's rationale for drawing upon the law of trusts was to constrain management discretion, which he viewed as leading to self-dealing, by interposing fidelity to shareholders as a requirement for legitimacy.

Dodd responded with the essentially normative and largely aspirational argument that expanded the trust conception of corporate managers by extending their obligations to a wider set of beneficiaries. Dodd argued that managers "should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders."[53] Dodd sought to distance corporate or business law from private law, claiming that public opinion was moving the law toward a view in which the business corporation has "a social service as well as a profit-making function."[54]

Berle's response to this argument was pragmatic.[55] As he explained, increasing managerial discretion reduced managerial accountability. Moreover, managers could not feasibly be held accountable to employees, creditors, or the general public, as Dodd had proposed. Consequently, Berle stated: "When the fiduciary obligation of the corporate management and 'control' to stockholders is weakened or eliminated, the management and 'control' become for all practical purposes absolute."[56]

The Berle-Dodd debate was, in reality, less of a debate than commentators typically

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49. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §2.01(a) (1994).

50. *But see* William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights,* 50 WASH. & LEE L. REV. 1449, 1456 (1993) (noting that under the ALI principles "maximization language is eschewed in favor of an equivocal directive to 'enhance'").

51. Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1074 (1931).

52. *Id.* at 1049.

53. Merrick Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932).

54. *Id.* at 1148.

55. Adolf Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

56. *Id.* at 1367.

suggest. In 1942, Dodd acknowledged various legal and practical obstacles to treating corporate managers as trustees for workers and consumers and conceded that it was misleading to characterize the relationship between managers and nonshareholder constituencies in terms of a trust.[57] In turn, Berle subsequently conceded that, at least as a descriptive matter, corporate law came to adopt Dodd's position, granting managers wide discretion to manage the corporation in the general interests of society.[58] In other words, both Berle and Dodd distinguished the legal obligations of managers to shareholders from their obligations to other stakeholders but, at the same time, acknowledged the legitimacy of other stakeholder interests.

2. Shareholders as Owners

Berle's trusteeship argument was based, at its core, on the legal status of shareholders as owners of the corporation. This view led Berle famously to characterize the public corporation in terms of the separation of ownership and control.[59] The characterization of shareholders as owners persists in case law and scholarship.[60] For example, the Delaware Supreme Court explained:

> One of the fundamental tenets of Delaware corporate law provides for a separation of control and ownership. The board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.[61]

Similarly, Chancellor Allen has recognized the "traditional model of the nature of the corporation that sees shareholders as 'owners.'"[62] The model of shareholders as owners or principals leads to the argument that the corporation should be managed in their interests. Thus Milton Friedman argued that corporate executives did not have the authority to sacrifice maximization of profits in favor of social responsibility because the executives were merely employees of the owners of the business, the shareholders.[63]

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57. E. Merrick Dodd, Book Review, 9 U. CHI. L. REV. 538, 547 (1942) (reviewing MARSHALL E. DIMOCK & HAROLD K. HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS (1940)).

58. *See* Henry Hansmann & Reinier Kraakman, *supra* note 39, at 444 n.6 (describing Berle's subsequent statements on the issue); *see also* Adolf A. Berle, Jr., *Foreword*, *in* THE CORPORATION IN MODERN SOCIETY xii, ix-xv (Edward S. Mason ed., 1959) (conceding that corporate law had developed to be consistent with Dodd's position but maintaining his misgivings about whether this was the "'right' disposition").

59. *See* ADOLF A. BERLE JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 9 (1932) (referring to shareholders as "owners" and noting that corporate governance must focus on the problems caused by the separation of ownership and control).

60. *See, e.g.*, Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825-26 (1999) (identifying various reasons why shareholders should be characterized as owners of the corporation). Prominent economists have also characterized shareholders as owners, by virtue of their status as residual claimants and suppliers of physical capital. *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 695 (1986); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1765-66 (1989); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1119-20 (1990).

61. Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998).

62. Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1124 (Del. Ch. 1990).

63. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32.

Deeming shareholders to be the owners of the corporation has led to the characterization of the shareholder's interest in terms of property rights.[64] Describing the corporation as shareholder property is a powerful rhetorical device, because property rights convey a sense of absolutism. Thomas Grey explains, "To own property is to have exclusive control of something—to be able to use it as one wishes, to sell it, give it away, leave it idle, or destroy it."[65] Indeed, at least one scholar has argued that corporate constituency statutes, which authorize managers to consider nonshareholder interests, may constitute unconstitutional takings by virtue of the fact that they diminish the shareholders' property interests in the corporation.[66]

The characterization of shareholders as legal owners has been widely criticized.[67] Lynn Stout calls it "the worst[] of the standard arguments for shareholder primacy."[68] Critics argue that there are substantial legal and practical differences between shareholders and traditional property owners.[69] From a legal perspective, shareholders own stock, which gives them claims to certain control and financial rights within the corporation but not direct control over or even access to the firm's underlying assets. Other stakeholders, including creditors, options holders, and managers have claims to different control and financial rights. Corporate managers, unlike traditional agents, are not directly controlled by their principals in that the source of their power is largely statutory. From a practical perspective, shareholders also do not resemble traditional owners. They are a fluid and fluctuating group of investors, many of whom hold only short-term interests, and perhaps most importantly, they do not exercise the control associated with traditional property rights. Berle and Means themselves argued that shareholders "by surrendering control and responsibility over the active property . . . surrender[] the right that the corporation should be operated in their sole interest, . . . [and] release[] the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights."[70]

It is not clear, however, that these arguments effectively defeat the ownership characterization. Property scholars have largely rejected the absolutist view of property rights, recognizing that such rights can be divisible, shared, and contingent.[71] Melvin Eisenberg observes that "life interests, remainder interests, and easements are property rights, not contractual rights, even though they lack some of the standard incidents of

64. David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 230-31 (1991) (explaining the idea that shareholders hold corporations as property).

65. Thomas C. Grey**,** *The Disintegration of Property, in* NOMOS XXII, at 69 (J. Roland Pennock & John W. Chapman eds., 1980).

66. Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1, 2-3 (1998).

67. Contractarians reject the view of shareholders as owners, characterizing their claims as merely contractual. Eisenberg, *supra* note 60, at 825. Communitarians similarly reject shareholders as owners of the corporation. *Id.*

68. Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190 (2002).

69. *See, e.g.*, MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 4-5 (1995) (describing as misleading the characterization of shareholders as owners).

70. BERLE & MEANS, *supra* note 59, at 355-56.

71. *See, e.g.*, A.M. Honoré, *Ownership*, *in* OXFORD ESSAYS IN JURISPRUDENCE 107 (A.G. Guest ed., 1961) (describing the concept of split ownership).

ownership."[72] Moreover, the fact that shareholders may be characterized as owners does not resolve the question of whether other corporate stakeholders can also claim an ownership interest in the corporation. Indeed, property law frequently concerns conflicts in which holders of differing interests in the same asset seek to control or use the asset in ways that interfere with the each other's legally protected interests.[73] As Joseph Singer explains, "In these cases, title and ownership are not helpful ways to conceptualize the dispute."[74]

Moreover, the scope of property rights does not flow automatically from an ownership interest but is a function of underlying political and economic forces. The possession of a property interest in an asset does not resolve one's rights to use or control the asset. As Joan Williams explains, "labeling something as property does not predetermine what rights an owner does or does not have in it."[75] Thus, despite its appeal, the characterization of a corporation as property doesn't tell us which stakeholders may be deemed to possess an ownership interest; nor does it tell us the legal rights associated with that interest. While ownership rights may be a consequence of shareholder primacy, they do not justify shareholder primacy.

Ultimately, the Berle-Dodd debate and the rhetoric of shareholder ownership offer insights into the historical foundations of the shareholder primacy norm, but neither provides a convincing justification for defining the corporate objective exclusively in terms of shareholder wealth. A potential alternative is existing law. In the next section, this Article explores the extent to which existing law requires managers to focus exclusively on shareholder wealth.

B. Shareholder Primacy and Existing Law

Commentators widely recognize that shareholder primacy functions more as a norm than an enforceable legal rule.[76] Although corporate law mandates managerial fidelity to shareholder interests both through shareholder election rights and through fiduciary principles, existing law does not actually require officers and directors to make operational decisions with the sole objective of shareholder wealth maximization.

The high point of shareholder primacy as a legal mandate was the Michigan Supreme Court's 1919 decision in *Dodge v. Ford Motor Co.*,[77] in which the court struck down Henry Ford's plan to use surplus earnings to reduce car prices rather than distribute those earnings to shareholders. The court explained: "A business corporation is organized and carried on primarily for the profit of the stockholders."[78] The modern counterpart of

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72. Eisenberg, *supra* note 60, at 825.

73. Joseph William Singer, *No Right to Exclude: Public Accommodations and Private Property*, 90 NW. U. L. REV. 1283, 1455-56 (1996) (describing how "many disputes about property involve conflicts among title holders").

74. *Id.* at 1456.

75. Joan Williams, *The Rhetoric of Property*, 83 IOWA L. REV. 277, 297 (1998).

76. *See* Edward B. Rock & Michael L. Wachter, *Norms & Corporate Law Symposium: Introduction*, 149 U. PA. L. REV. 1607, 1611 (2001) (introducing a symposium exploring "the complex relationship between legal and nonlegal enforceability, between 'law' and 'norms'"); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 n.1 (1998) (describing the use of the term "shareholder primacy norm").

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

78. *Id.* at 684.

Dodge v. Ford is the Delaware Supreme Court's *Revlon* decision.[79] In *Revlon*, the court held that "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder."[80] Rather, the directors were required, in that context, to maximize shareholder value.

Importantly, however, even in these cases, the directors' duty to maximize shareholder wealth is limited. Although *Dodge v. Ford* is frequently cited, no modern court has struck down an operational decision on the ground that it favors stakeholder interests over shareholder interests. Indeed, some commentators argue that *Dodge*'s holding is limited to the close corporation context, and rather than defining appropriate corporate objectives, the case should be understood as a precursor to the modern doctrine of shareholder oppression.[81] The *Revlon* decision is limited to the corporate control context and, even within that context, applies to an extremely small set of cases. The court in *Revlon* explicitly noted that the inevitability of a cash sale changed the role of the directors "from defenders of the corporate bastion to auctioneers."[82]

Perhaps more significantly, the *Revlon* court explained that when the board decided to put the company up for sale, its duty "*changed* from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[83] In other words, even in the takeover context, so long as the company has not entered the *Revlon* mode, Delaware law permits directors to consider the interests of "creditors, customers, employees, and perhaps even the community generally."[84] As the Delaware Supreme Court explained subsequent to the *Revlon* decision in *Paramount v. Time*, "[A] board of directors . . . is not under any per se duty to maximize shareholder value."[85] Indeed, the Delaware courts have gone so far as to conclude that a board may take actions that affirmatively disadvantage shareholders if the board can justify those actions.[86]

Had Oracle and PeopleSoft not resolved their recent takeover dispute, the Delaware courts might have had occasion to consider the question of whether an issuer can protect stakeholder interests at the expense of the shareholders. After Oracle made its takeover bid, PeopleSoft began including "customer assurance" provisions in its contracts that entitled customers to substantial damages if a buyer acquired PeopleSoft and stopped servicing the customers.[87] The provisions had the effect of making a takeover more

79. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

80. *Id.* at 182.

81. Smith, *supra* note 76, at 322-23; Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 256-57 (1999).

82. *Revlon*, 506 A.2d at 182.

83. *Id.* (emphasis added).

84. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

85. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989).

86. *See* Orban v. Field, No.12820, 1993 Del. Ch. LEXIS 277, at *27 (Dec. 30, 1993) (recognizing the general principle that "if directors take action directed against a class of securities they should be required to justify it"); *see also* Blackmore Partners, LP v. Link Energy, LLC, 864 A.2d 80, 86 (Del. Ch. 2004) (concluding that directors who approved a distribution of 100% of a solvent company's assets to creditors, wiping out all value for the equity holders, may be required to justify their actions).

87. *See, e.g.*, David Marcus, *Delaware to See Oracle-PeopleSoft Dispute*, THE DEAL, Oct. 4, 2004, http://www.law.com/jsp/article.jsp?id=1096473931503 (describing PeopleSoft's use of a "customer assurance

difficult—thus hurting shareholders—at the expense of PeopleSoft customers.

In the operational context, the Delaware statute, which is generally described as favoring the interests of shareholders more than the law of other states, does not explicitly require that a corporation be managed exclusively or even primarily in the interests of its shareholders. The Delaware statute provides that the directors, and not the shareholders, have the authority to run the corporation and is silent both with respect to the standard by which board decisions are to be evaluated, and with respect to the stakeholders whose interests may legitimately be taken into account.[88] Delaware appears to endorse the right if not the obligation of directors to manage the corporation as a legal and economic entity.[89]

The discretion afforded by the open-ended Delaware statute is increased by the application of the business judgment rule. The business judgment rule provides a corporation's officers and directors with broad discretion to consider the interests of other stakeholders.[90] Significantly, the Delaware courts have described the business judgment rule as imposing an obligation to act "in the best interests of the company,"[91] not the best interests of the shareholders. The scope of protection for board decisions is further enhanced to the degree that the charter exculpates the directors for breaches of the duty of care.[92] The combined effect of the business judgment rule and director exculpation provisions is to limit most fiduciary duty claims to breaches of the duty of loyalty, that is, manager self-dealing. Moreover, the courts have made clear that the shareholders do not have the power either to make operational decisions or to impose their vision of the corporate good upon a board that disagrees with that assessment.

Shareholders do, of course, have the power to exercise control rights under Delaware law, most significantly, to elect the board of directors and to vote on certain other corporate transactions.[93] Arguably, management accountability to shareholders, through these control rights, should result in management decisions that maximize shareholder value. Importantly, however, these control rights are not exclusive to

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plan").

88. *See* DEL. CODE ANN. tit. 8, § 141(a) (2005) (providing that the corporation's business and affairs "shall be managed by or under the direction of a board of directors").

89. *See, e.g.*, William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 276 (1992). It is important to note that this conception cannot readily be explained as simply a "long-term" obligation to maximize shareholder value. Modern finance theory suggests that current stock price should reflect the long-term benefits to shareholders of considering the interests of other corporate stakeholders. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 304 (1999) (rejecting shareholder long-run interest as an explanation for consideration of nonshareholder stakeholders).

90. *See* Blair & Stout, *supra* note 89, at 306 (terming these "mixed motive situations" in that the board may be benefiting other stakeholders at the expense of shareholders and arguing that courts generally uphold such operational decisions under deferential business judgment rule analysis); Bratton, *supra* note 50, at 1457 (stating that the business judgment rule grants management "considerable latitude to derogate from the shareholder primacy norm as it makes decisions respecting investment, financing, and operations").

91. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

92. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (authorizing such exculpation).

93. Blair and Stout argue that shareholders enjoy voting rights "as partial compensation for . . . [their] unique vulnerabilities," which include lack of involvement in the corporation's day-to-day activities, limited access to information about firm operations, and collective action problems. Blair & Stout, *supra* note 89, at 314.

common shareholders.[94] Preferred shareholders exercise control rights, and Delaware law explicitly permits corporations to grant rights to creditors in addition to or even in place of shareholder voting rights.[95]

Additionally, shareholder control rights are limited and largely indirect. Shareholders cannot initiate transactions or make operational decisions; their power is limited to vetoing certain types of extraordinary corporate decisions such as mergers and dissolutions. Similarly, while shareholders nominally have the right to elect directors, their limited power over the nominating process and the corporate proxy machinery prevent shareholders from using their voting rights to demand shareholder primacy from directors.[96]

In considering the protection of nonshareholder constituencies under Delaware law, it is important to distinguish between two related concepts: the permissible objectives for management decision-making and the enforcement of fiduciary duties. The Delaware courts have explicitly rejected the argument that management has a *fiduciary obligation* to other stakeholders at the expense of shareholders,[97] at least as long as the corporation is not operating in the vicinity of insolvency. Consequently, stakeholders cannot initiate litigation to require that management consider their interests. The fact that only shareholders can judicially enforce fiduciary duties does not mean, however, that directors must make decisions solely in the interests of shareholders, a point that will be considered further in Part IV below.[98] Similarly, the cases that reject stakeholder claims for breach of fiduciary duty do not forbid management from favoring stakeholder interests; they simply provide that management's failure to favor such interests is not judicially remediable.

Although the shareholder primacy norm is used to describe corporate objectives nationally, not just in Delaware, states other than Delaware have endorsed broader conceptions of firm value for the purposes of managerial decision-making.[99] The majority of states have adopted corporate constituency statutes that explicitly authorize

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94. *But see* Eliasen v. Itel Corp., 82 F.3d 731, 735 (7th Cir. 1996) (stating that "a corporate structure in which the bondholders . . . have all the voting rights, and the shareholders . . . have no voting rights, is anomalous").

95. DEL. CODE ANN. tit. 8, § 221.

96. *See, e.g.*, Blair & Stout, *supra* note 89, at 310-12 (describing limited shareholder ability to use their voting rights effectively); Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003) (identifying limitations in meaningful shareholder access and proposing remedies).

97. *See, e.g.*, Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988) (holding that a corporate bond does "not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties").

98. Indeed, as Margaret Blair and Lynn Stout have observed, the law provides that the recovery in a derivative suit that successfully establishes a breach of management's fiduciary duty to shareholders is payable, not to those shareholders, but to the corporation itself, where its benefits "accrue to all the corporation's stakeholders." Blair & Stout, *supra* note 89, at 295.

99. Indeed, if one extends the analysis globally, the corporate laws of other countries expressly reject the shareholder primacy norm. *See, e.g.*, Peer C. Fiss & Edward J. Zajac, *The Diffusion of Ideas over Contested Terrain: The (Non)Adoption of a Shareholder Value Orientation Among German Firms*, 49 ADMIN. SCI. Q. 501, 503 (2004) ("[T]he original German corporate law of 1937, which stated that the company was to be managed for the good of the enterprise and its employees (*Gefolgschaft*), the common wealth of the citizens (*Volk*) and the State (*Reich*)."); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2072-75 (2001) (explaining the role of shareholder primacy in France and Germany).

directors to consider the interests of nonshareholder stakeholders.[100] Although these statutes were adopted in response to hostile tender offers and several are limited to the change of control context, the vast majority apply to all operational decisions. In many cases, the statutes explicitly provide that directors will not be required to regard the effects of a corporate decision on any particular group—including shareholders—as a dominant factor.[101] As former SEC Commissioner Al Sommer has observed, the salient point of these statutes is that they define the best interests of the corporation in terms of the interests of both shareholders and nonshareholder stakeholders, thereby omitting any requirement that decisions favoring nonshareholder stakeholders be justified in terms of a nexus to shareholder value.[102]

It is true that the statutes—other than that of Connecticut—do not require directors to favor other stakeholders, nor do they impose fiduciary obligations on directors in favor of nonshareholder constituencies.[103] Nonetheless, the plain language of the statutes is inconsistent with the shareholder primacy norm. In some cases, statutory provisions extend even further. For example, the New York Business Corporation Law authorizes corporations to make charitable donations "irrespective of corporate benefit."[104] There is also ample case law rejecting an affirmative obligation on the part of directors to sacrifice the interests of other constituencies in order to maximize shareholder wealth. As the court explained in *GAF v. Union Carbide Corp.*,[105] the board must balance investors' interests, on the one hand, and "the legitimate concerns and interests of employees and management . . . on the other."[106] The point is not that constituency statutes prohibit managers from maximizing shareholder value, but simply that they do not require it.

C. Shareholder Primacy and Business Practice

Terming shareholder primacy a "norm" implies that, as a practical matter, directors seek to maximize shareholder wealth even if they do not face a legally enforceable obligation to do so. Indeed, there are widespread claims that the shareholder primacy model dominates the MBA curriculum and that the shareholder primacy norm is an accurate description of business practice. Recent interview research conducted by the Aspen Institute Business and Society Program, for example, found that the norm of shareholder wealth maximization was implicit in most business school courses, and so

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100. *See* Subramanian, *supra* note 34, at 1801 (identifying 31 states that have adopted corporate constituency statutes).

101. *See* IND. CODE § 23-1-35-1 (2005).

102. A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 42 (1991).

103. The Connecticut constituency statute affirmatively requires directors, in the context of evaluating certain corporate transactions, including mergers and other business combinations, to consider the interests of nonshareholder constituencies. *See* CONN. GEN. STAT. § 33-756(d) (2004) (stating that "a director . . . *shall consider*, in determining what he reasonably believes to be in the best interests of the corporation . . . the interests of the corporation's employees, customers, creditors and suppliers, and . . . community and societal considerations") (emphasis added).

104. N.Y. BUS. CORP. LAW § 202(a)(12) (Gould 2006). Similarly, the Delaware Supreme Court, in *Kahn v. Sullivan*, 594 A.2d 48, 63 (Del. 1991), held that the appropriate standard to be applied in reviewing a corporate charitable donation was whether the donation constituted waste.

105. GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985).

106. *Id.* at 1019-20.

powerful that it did not need to be defended.[107]

Other scholars have questioned the claim that the shareholder primacy norm dominates business practice, however. After compiling website and survey data from both U.S. and foreign firms, Petra Joerg, Claudio Loderer, Lukas Roth, and Urs Waelchli found a surprising unwillingness of managers even to identify shareholder wealth maximization as a priority.[108] Because talk is cheap, the authors concluded that this finding reflects "a lack of commitment to the goal of shareholder-value maximization."[109] Similarly, Lisa Fairfax has found that corporations are increasingly embracing stakeholder rhetoric[110] and that a similar trend is occurring in business school curricula.[111]

Stephen Bainbridge has argued that the business world itself seems to favor director primacy over shareholder primacy.[112] Lynn Stout has identified a variety of standard business practices—options repricings, retroactive increases in employee retirement benefits, and corporate charitable contributions—in which shareholder interests are subordinated to those of other stakeholders.[113] Daines and Klausner have even found cases in which corporations in states that lacked statutory nonshareholder constituency provisions, such as Delaware, adopted such provisions in their charters.[114]

Performance-based compensation arguably creates the greatest incentive for corporate decision-makers to focus on shareholder wealth maximization. The dramatic growth since the early 1990s of performance-based compensation, particularly stock options, would seem to provide circumstantial evidence that shareholder wealth maximization has become increasingly important to management. Yet a careful analysis of executive compensation demonstrates that, although stock options appear designed to increase the correlation between shareholder wealth and executive pay, in reality pay has largely been decoupled from firm performance. As Lucian Bebchuk and Jesse Fried explain, equity-based compensation plans that, in principle, were designed to align management incentives, "have enabled executives to reap substantial rewards even when their performance was merely passable or even poor."[115]

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107. Mary D. Gentile, The Aspen Inst. Bus. & Soc'y Program, Corporate Governance and Accountability: What Do We Know and What Do We Teach Future Business Leaders?, Address at the European Academy of Business in Society's Third Annual Colloquium 3-4 (Sept. 27, 2004), *available at* http://www.caseplace.org/references/references_show.htm?doc_id=306381.

108. Petra Joerg et al., *The Purpose of the Corporation: Shareholder-Value Maximization?* 23 (European Corp. Governance Inst. Fin., Working Paper No. 95/2005, 2006), *available at* http://ssrn.com/abstract=690044.

109. *Id.* at 24.

110. Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 781-84 (2006).

111. *Id.* at 782.

112. Bainbridge, *supra* note 4.

113. Stout, *supra* note 68, at 1202-03.

114. *See* Daines & Klausner, *supra* note 40, at 97 (describing the adoption of explicit nonshareholder constituency provisions or control share acquisition provisions by 14 of 52 IPO firms in their sample).

115. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 7 (2004). Moreover, there is evidence that strong performance incentives can increase earnings management. *See* Marcia Millon Cornett et al., Earnings Management, Corporate Governance, and True Financial Performance 17-18 (2006) (unpublished paper), *available at* http://ssrn.com/abstract=886142 (finding that options based compensation increases earnings management and that adjustments for likely earnings management may eliminate positive correlation between option

Admittedly, managers frequently defend controversial business decisions in terms of shareholder value. It is unclear, however, whether those statements are more than rhetoric. Moreover, management public statements are directed to investors, who are obviously highly concerned about shareholder primacy. Regardless of management priorities, managers are likely to espouse investor concerns in investor-oriented public statements.

D. Economic Arguments for Shareholder Primacy

Law and economics scholars offer a twofold normative defense of shareholder primacy. First, they argue that, from a contractual perspective, shareholder primacy is simply the objective to which the corporation's constituencies have agreed. Second, they argue that shareholder primacy leads to economic efficiency.

Contractarian scholars describe the corporation as a hypothetical contract in which shareholders provide capital and other stakeholders provide other inputs, such as labor.[116] Under a contractarian approach, the parties to the corporate contract are understood to have agreed that the corporation is to be run so as to maximize shareholder wealth. If the corporation is a private enterprise, the efficiency of corporate law should be measured by the extent to which it maximizes the achievement of the parties' contractually specified objectives.

The standard economic literature identifies two key differences between the rights of shareholders and those of other corporate stakeholders. First, nonshareholder stakeholders receive a fixed claim, while shareholders have a residual claim—they receive the surplus. Second, the fixed claimants have priority over shareholders—the right to have their claims paid in full—and shareholders receive what is left over after the fixed claimants are paid.

Although shareholder primacy has not been formalized into an explicit contractual term—either through legislation or in the corporate charter—these differences provide justifications for viewing shareholder primacy as an implied term of the contract. First, and foremost, a contractual right to receive surplus is of little value if managers have no obligation to generate a surplus and are free to pay out all revenues to other corporate stakeholders. Second, shareholder primacy is a partial substitute for the priority that other stakeholders enjoy. In particular, shareholder primacy adds to the upside potential of the residual claim, which compensates shareholders for bearing greater risk than fixed claimants. Third, shareholders are passive investors. Through their control, other stakeholders, particularly management, can protect their priority interests directly. Fourth, shareholder primacy serves as a gap-filler. A contract that fully specified management's decision-making obligations with respect to shareholders would be impossibly complex and arguably too inflexible to respond to developments in the business world.

Finally, shareholders cannot withdraw their investment from the corporation without substantial sacrifice. Managers, employees, creditors, and suppliers provide input to the corporation on an ongoing basis. Thus market forces, in addition to contract terms,

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compensation and performance).

116. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (describing the corporation as "a complex set of explicit and implicit contracts").

constrain the corporation's ability to exploit these stakeholders. In contrast, a shareholder provides permanent capital to the corporation. Although shareholders can exit the corporation if their interests are not adequately protected, they can do so only by selling their shares to another investor, and the market price for those shares will reflect the risk of shareholder exploitation.[117] As a result, they will bear the costs of misdeeds or self-dealing by other stakeholders even if they exit.

This effect is demonstrated in cases in which states have adopted extreme antitakeover legislation. Several states have adopted antitakeover statutes that are widely viewed as unduly interfering with the market for corporate control, including Ohio, Massachusetts, and Pennsylvania.[118] Commentators widely agree that these statutes harm shareholders by (1) reducing the ability of the takeover market to discipline management decision-making and (2) making a takeover, with its likely premium for shareholders, less probable. These effects are supported by empirical work that shows a negative impact on stock price. The stock price of affected firms drops because the market anticipates the effect of these harms on the future value of the stock. Significantly, however, existing shareholders in these firms are the group that suffers the harm from the legislation. Shareholders cannot avoid the harm through exit because, once the legislation is adopted or even proposed, the price of existing shares falls to reflect the anticipated harm.

The extent of shareholder primacy supported by the contractual analysis is somewhat limited. It can be argued that shareholders have bargained for a risk-adjusted market rate of return on their investment, and that the terms of the corporate contract are silent as to the appropriate allocation of any surplus. Contract theory suggests that shareholders would not contribute capital unless operational decisions included a shareholder value objective, but, in practice, shareholders are more likely to be concerned with the level of return on their investment than their claim, relative to other stakeholders, to the firm's surplus. A firm with high fixed costs may allocate its entire surplus to shareholders and still pay those shareholders a lower return than a competitor that gives greater weight to stakeholder interests. In addition, as indicated above, the implicit contract provides management with considerable discretion to choose among business strategies.

It is important to distinguish the contractual argument from the normative argument that shareholder primacy leads to economic efficiency. As Jeff Gordon explains:

> Seen from an economic perspective, the goal of a system of corporate governance is to maximize the economic value of the firm, as measured by the total of economic returns for all possible residual claimants. For instance, the goal is to maximize the sum of the returns for shareholders, debt claimants, and workers. The ultimate defense of the assignment in the Anglo-American system of exclusive governance rights to the stockholders rests on the empirically contestable fact that this is how to maximize the size of the economic pie.[119]

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117. *See, e.g.*, A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. 83 (2004) (arguing that the market will cause the price of minority shares in a controlled corporation to reflect the risk of self-dealing by the controlling shareholder).

118. *See* Bebchuk et al., *supra* note 13, at 1804-05 (listing states that have adopted "extreme takeover statutes").

119. Jeffrey N. Gordon, *Deutche Telekom, German Corporate Governance, and the Transition Costs of*

At its core, the economic argument is based on a truism. If stockholders are the residual claimants, by definition they receive the surplus that remains after all fixed claims are paid. Maximizing this surplus means maximizing total firm value, assuming that other stakeholder values remain unchanged. Consequently, maximizing firm value is the equivalent of maximizing shareholder value. Law and economics scholars argue that this approach gives residual claimants the appropriate incentives to maximize firm value. This theory, in turn, leads to the argument for vesting control rights in shareholders.

Three components of this analysis deserve further scrutiny. First, is it true that shareholders are the exclusive residual claimants in the firm? Second, is it possible to maximize the value of the firm to the residual claimants without affecting the value of other stakeholder interests? Third, does maximizing firm value lead to economic efficiency?

As Amir Licht observes, the assumption that the interests of all fixed claimants, that is, all nonshareholder constituencies, are fixed and well-defined, is unrealistic. Rather, "the corporate enterprise comprises several constituencies whose interests are both interdependent and indeterminate."[120] Residual claimants are simply, by definition, those who receive a share of the firm's surplus. Shareholders are not the only stakeholders with a claim to the firm's surplus.[121] Indeed, nonshareholder stakeholders frequently have an explicit contractual claim on a portion of the surplus. Creditors can receive a share of profits instead of a fixed rate of interest. Managers and employees can receive performance-based compensation rather than fixed salaries.[122] Customers can receive a share of firm surplus through price cuts or rebates. Lynn Stout has argued that even absent an explicit contractual claim to the firm's surplus, nonshareholder stakeholders are accurately described as residual claimants in the sense that they enjoy extra-contractual benefits when the corporation does well, and suffer, along with shareholders, when the corporation does poorly.[123]

At the same time, options, warrants, and other derivative securities enable investors to restructure the scope of the residual claim. Thomas Smith has argued that out of the money call option holders, who have little more than a bet on the firm's future stock

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Capitalism, 1998 COLUM. BUS. L. REV. 185, 197 (1998).

120. Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 652 (2004).

121. Nor, perhaps, is it fully accurate to describe shareholders as residual claimants. Although shareholders have a theoretical claim on the firm's surplus, they have no actual entitlement either to the distribution of surplus or to control the allocation of surplus between themselves and contractual claimants, outside the context of bankruptcy. *See* Stout, *supra* note 68, at 1193-94 ("[A]s a legal matter, shareholders of a public corporation are entitled to receive nothing from the firm unless and until the board of directors decides that they should receive it.").

122. Indeed, one might argue that the shift toward greater performance-based compensation for management has converted managers into residual claimants, resulting in a form of managerial capitalism. Performance-based compensation has, of course, been justified on the basis that it reduces agency costs and properly incentivizes management to maximize firm productivity. *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 898 (2002) (describing the evolution of the poison pill together with shifts in executive compensation during the period after the pill was developed); *cf.* Hansmann & Kraakman, *supra* note 39 (arguing that managerial capitalism has been correlated with reduced productivity).

123. Stout, *supra* note 68, at 1194.

price, are in fact the ultimate residual claimants.[124] In contrast, hedging enables a shareholder to reduce or eliminate the scope of the residual interest while maintaining shareholder status. Frank Partnoy describes a variety of financial innovations that have led to the mutability of the residual claim, complicating the case for defining corporate objectives in terms of the interests of the residual claimants.[125]

Additionally, the scope of protection afforded to stakeholder interests depends on the quality of contractual protection. As Jeffrey Gordon has observed, the relationship of shareholder value to firm value is a function of the strength of the various markets in which the corporation participates, including the capital market, the labor market, and the product market.[126] Jensen and Meckling recognized that the nexus of contracts theory of the corporation includes all the "owners of labor, material and capital inputs."[127] The failure of the shareholder primacy model to explicitly address stakeholder interests is premised on the assumption that stakeholders are protected by contract. This assumption proves problematic to the extent that stakeholder contracts are deficient. Indeed, scholars have identified extensive evidence that stakeholder contracts are neither complete nor perfectly priced.[128] Ramesh Rao notes, for example, that contracts with nonshareholder stakeholders are often illiquid and lack both hedging options and market valuations.[129] George Constantinides identifies particular elements of the risk associated with an employee's investment in a firm—the risk of job loss is uninsurable, persistent, and counter-cyclical.[130] To the extent that stakeholder contracts are imperfect or incomplete, stakeholders may retain a residual interest as well as a fixed claim.

If the interests of fixed claimants are not fully protected by contract, increasing shareholder value may not increase the size of the corporate pie. Although shareholders can benefit from increasing productivity, they can also benefit by transferring value from fixed claimants to themselves. Perhaps the most obvious type of transfer is increasing the level of risk. Residual claimants may prefer excessive levels of risk in a corporation, particularly when their expected return is small in the absence of that risk.[131] Because

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124. Smith, *supra* note 81, at 260-61; *see also* Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. REV. 141, 150 (2002) (stating "the most residual claims are equivalent to barely in-the-money call options"). Smith's claim might be stronger with respect to warrant holders than for option holders. *But see In re* New Valley Corp. Derivative Litig., No. 17649-NC, 2004 Del. Ch. LEXIS 107, at *18-19 (June 28, 2004) (rejecting the argument that the warrant holder had a comparable legal interest to a stockholder).

125. Frank Partnoy, *Financial Innovation and Corporate Law*, 31 J. CORP. L. 799 (2006).

126. *See* Gordon, *supra* note 38.

127. Michael Jensen & W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

128. *See, e.g.*, Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PA. L. REV. 1349, 1354 (1988) (explaining how, in internal labor markets, "a bilateral monopoly replaces the textbook model of competitive supply and demand . . . [and] . . . asymmetric information and strategic behavior allow for inefficient outcomes"). *But see* Daniel R. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. CHI. L. REV. 1061, 1065-68 (1984) (identifying and rejecting reasons why labor markets might be less efficient than capital markets).

129. Ramesh K.S. Rao, The Value of the Firm as a Nexus of Heterogeneous Contracts 3 (Feb. 1, 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=624101.

130. George Constantinides, *Rational Asset Prices*, 57 J. FIN. 1567, 1575-76 (2002).

131. Thomas A. Smith, *supra* note 81, at 221-24 (offering an example of inefficiently risky investment and

residual claimants are, in essence, gambling with value that would otherwise be paid to fixed claimants, their interests conflict with those of other corporate stakeholders.[132] Even when a corporation is financially sound, increasing the level of risk to further the interests of shareholders may harm other stakeholders. Greater risk may reduce the creditworthiness of the firm and hence the value of its debt, or reduce job security, thereby reducing the value of the firm to its workers.

If nonshareholders can be residual claimants or corporate decisions can transfer value between stakeholders, then maximizing shareholder value is not the equivalent of maximizing firm value. Careful economic scholars have made this point explicitly. Michael Jensen, for example, observes that management is continually forced to make tradeoffs among different corporate constituencies.[133] Jensen explicitly argues that firm value should be defined to include "the sum of the values of all financial claims on the firm—debt, warrants, and preferred stock, as well as equity."[134] He then argues that tradeoffs between other constituencies must be addressed by assessing their effect on long-term firm value, with no stakeholder obtaining "full satisfaction."[135]

The relationship between firm value and social welfare raises another efficiency question. Jensen explains that "200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy attempt to maximize their own total firm value."[136] Others have questioned this claim, however, identifying a variety of conditions under which maximizing firm welfare need not be efficient.[137] A particular concern is that individual firm decisions may create negative externalities.[138] Although the markets in which a firm operates may impose a certain level of discipline, the extent of that discipline depends, again, on the quality of the markets. For example, Mark Roe demonstrates that maximizing firm value will be socially wasteful in the absence of sufficiently competitive product markets because monopoly firms will sacrifice consumer surplus.[139] Scholars have debated, and will continue to debate, the extent to which corporate laws, as opposed to other forms of regulation, should resolve problems such as externalities and monopoly.[140] Nonetheless,

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then extending the analysis beyond the "vicinity of insolvency"). Smith has also argued that the interests of a modern diversified investor are more appropriate than those of a hypothetical long-term shareholder in defining the firm's objectives. Robert Monks takes a similar view in his conception of a "Global Investor" for whom no societal effect is an externality. ROBERT A.G. MONKS, THE NEW GLOBAL INVESTORS: HOW SHAREOWNERS CAN UNLOCK SUSTAINABLE PROSPERITY WORLDWIDE 105 (2001).

132. *See* Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 77 (1995) (explaining why equity holders have an incentive to shift assets to risky investments and how this shift constitutes a transfer of wealth from the fixed to the residual claimants).

133. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 8, 16 (2001).

134. *Id.* at 8.

135. *Id.* at 16.

136. *Id.* at 11.

137. *See, e.g.*, Thomas A. Smith, *supra* note 81, at 221 (arguing that "the shareholder value maximization norm, if strictly applied, would require firm managers to make socially inefficient choices"); Stout, *supra* note 68, at 1197-98 (demonstrating how shareholder primacy can lead to inefficient outcomes).

138. *See, e.g.*, Gordon, *supra* note 38 (describing potential externality effect of firm-specific decisions).

139. Roe, *supra* note 22, at 2071.

140. *See, e.g.*, Jensen, *supra* note 133, at 17 (arguing that monopoly and externality problems should be

to the extent that these problems exist, they temper the strength of the efficiency argument.

One can defend shareholder primacy as an efficient decisional guide. A major drawback to stakeholder theory is that it lacks a specific maximand to guide managerial discretion.[141] To the extent that the interests of different stakeholders conflict, the stakeholder model offers no principled basis for choosing among them.[142] In contrast, shareholder primacy is said to offer management a way to evaluate decisions within the framework of a single-valued objective function. As Michael Jensen has explained, a corporate objective function that embraces stakeholder interests will likely result in "managerial confusion, conflict, inefficiency, and perhaps even competitive failure."[143]

Here too, however, superiority of the shareholder primacy norm is overstated, primarily because shareholders are not a homogenous group.[144] Within the shareholder class, the investors vary considerably among such dimensions as the time frame over which they invest, the extent to which they trade versus passively holding the corporation's stock, their degree of diversification, the extent to which they hold non-equity interests in the issuer, any option or other hedging positions that they hold, and so forth. Scholarly commentary has recognized that the interests of short and long-term shareholders may differ and that, consequently, they may prefer different management decisions. Indeed, managers have criticized institutional investors for unduly emphasizing short-term corporate performance. Scholars have also noted the conflicting interests of current and future shareholders.[145] Options and other financial derivatives further blur these lines, as they allow investors to refine the time period of their investment and the scope of risk reflected in that investment.[146]

The economic argument in response is that shareholder primacy is not defined by reference to specific shareholders, but reflects the theoretical interests of a hypothetical long-term equity holder. The problem, for both managers and scholars, is that absent perfect market efficiency, short-term performance and value indicators, such as profitability and stock price, may not accurately reflect the long-term value of operational decisions.[147] Thus, if the notion of shareholder primacy is refined in this way, shareholder primacy becomes less useful, both as a decisional rule and as a tool of

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resolved by the government in its rule-setting function).

141. *See* Sundaram & Inkpen, *supra* note 47, at 354 (criticizing stakeholder theory for the idea "that managers should juggle multiple goals in a complex hierarchy").

142. *See* Jensen, *supra* note 133, at 13 ("Obviously any decision criterion—and the objective function is at the core of any decision criterion—must specify how to make the tradeoffs between these demands.").

143. *Id.* at 9.

144. Sundarum and Inkpen highlight the problem of heterogenous interests with respect to stakeholders, but do not acknowledge that the same problem applies to shareholders. *See* Sundaram & Inkpen, *supra* note 47, at 353 (criticizing stakeholder advocates for ignoring the differences within stakeholder groups such as employees).

145. *See, e.g.*, Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005).

146. *See* Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1286-87 (1991) (arguing that financial innovation has made the shareholder primacy norm "intolerably ambiguous").

147. *See, e.g.*, Michael L. Wachter, *Takeover Defense When Financial Markets Are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787, 798-800 (2003) (explaining reasons why stock price may diverge from firm's intrinsic value).

empirical analysis. The consequences of this result will be explored in Part V below.

IV. THE SHAREHOLDER PRIMACY NORM AND FIDUCIARY DUTIES

A. The Scope of Fiduciary Duties

Although, as described in Part III, the shareholder primacy norm has limited effect as a legal constraint on operational decisions, it nonetheless occupies a key role in defining the scope of judicially enforceable fiduciary duties. Despite the protection of the business judgment rule, corporate law limits management discretion through the imposition of fiduciary duties: the duty of care and the duty of loyalty.

Fiduciary duties operate as supra-contractual constraints on management decision-making by triggering open-ended judicial review. Cases on fiduciary duties are an important source of law dealing with fairness, procedural protection, and the appropriate balance of power among corporate constituencies.[148] Courts have generally described fiduciary duties as running to the corporation and/or its shareholders. Nonetheless, the right to trigger this judicial intervention rests exclusively with the shareholders. It is a fundamental principle of corporate law that, absent extraordinary circumstances,[149] fiduciary principles do not protect nonshareholder stakeholders. Only shareholders can bring a lawsuit to address a director or officer breach of fiduciary duty.

The argument that corporate law endorses shareholder primacy flows readily from the legal limits on enforcement of fiduciary duties. By vesting shareholders with the exclusive right to enforce these constraints on management, corporate law appears to define the corporate objective exclusively in terms of shareholder welfare. This definition has led stakeholder theorists or "progressive" corporate law scholars to criticize the exclusion of other stakeholders from the protection of judicially enforceable fiduciary duties, and to seek an obligation of management to consider stakeholder interests in cases in which those interests conflict with those of the shareholders. Toward this end, stakeholder theorists advocate the extension of fiduciary protection to nonshareholder stakeholders.[150] In practice, this extension means expanded litigation rights.

Debate over the appropriate scope of fiduciary duties continues to flourish, and a summary of the arguments is beyond the scope of this Article. Despite its claim that the shareholder primacy norm reflects too narrow a conception of firm value, this Article

148. Importantly, the role of courts in articulating these rules is likely the most significant output of fiduciary duty litigation, in that corporate decision-makers rarely face liability for a breach of fiduciary duty. *See* Bernard S. Black et al., *Outside Director Liability* (*Before Enron and WorldCom*) (Stanford Law and Econ. Olin Working Paper No. 250, 2003), *available at* http://ssrn.com/abstract=382422 ("[O]utside directors of U.S. public companies face a tiny risk of actual liability for good faith (non-self-interested) conduct, no matter how careless or reckless they are.").

149. Creditors are protected with fiduciary duties when the corporation is in the "zone of insolvency." *See, e.g.*, Credit Lyonnais Bank v. Pathe Commc'ns, No. 12150, 1991 LEXIS 215 (Del. Ch. Dec. 30, 1991) (recognizing this protection).

150. *See, e.g.*, Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992) (arguing in favor of a fiduciary duty to bondholders); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991) (advocating a fiduciary duty to displaced workers in the context of plant closings).

does not challenge—and indeed endorses—the limitation of fiduciary protection to shareholders. Rather, it questions the inference about the appropriate measure of firm value that shareholder theorists draw from the scope of fiduciary duty. In the following subsection, this Article identifies a new argument supporting the limited scope of fiduciary duties—institutional specialization. This Article argues that the scope of fiduciary duties is not a statement that shareholder interests should be privileged above those of other corporate constituencies; shareholder interests are not the only interests that count. Rather, fiduciary duties are a mechanism for allocating protection of constituency interests through institutional specialization.

B. Institutional Specialization and Fiduciary Principles

Corporate law devotes its primary focus to the agency problems created by conflicts of interest—conflicts between shareholders and managers, between controlling and minority shareholders, and between shareholders and other stakeholders.[151] As Reinier Kraakman and his co-authors explain, a core function of corporate law involves minimizing "value-reducing forms of opportunism among the constituencies of the corporate enterprise."[152] Conflicts between shareholders and managers have dominated the analysis. This is largely due to the paradigm-shifting work of Berle and Means in identifying the agency problem of strong managers and weak dispersed shareholders resulting from the separation of ownership and control in the public corporation.[153] Stakeholder analysis highlights a second conflict—between the interests of shareholders and other stakeholders.

In corporate law, academic commentary has analyzed the relative merits of different institutional mechanisms for addressing these conflicts. Most famously, in the classic Cary-Winter debate over regulatory competition, former SEC commissioner William Cary argued that the dominance of Delaware as a corporate domicile—and thus the source of state corporate law for more than half of all publicly traded U.S. corporations—reflected the appeal of Delaware's law to corporate management.[154] Finding that management power over the choice of domicile had resulted in a lax statute that failed to provide shareholders with optimal protection from management malfeasance and self-dealing,[155] Cary called for the adoption of federal minimum standards of corporate responsibility.[156] Cary's conclusions were challenged by Judge Ralph Winter.[157] Winter argued that various market constraints, including the capital markets, disciplined managers and prevented them from exploiting shareholders through inefficiently lax corporate law.[158]

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151. REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 2 (2004).

152. *Id.*

153. BERLE & MEANS, *supra* note 59.

154. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 670 (1974).

155. Cary therefore termed regulatory competition a "race to the bottom." *Id.* at 705.

156. *Id.* at 701.

157. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

158. Instead, Winter argued, market discipline caused regulatory competition to produce a "race to the top."

The appropriate allocation of corporate regulation among different lawmaking institutions depends on an assessment of comparative institutional competence. As Neil Komesar demonstrated, comparative institutional analysis should consider the strengths and weaknesses of competing institutional regulators relative to each other.[159] Komesar argued that a choice among lawmaking institutions, such as Congress, the courts, and the market, requires a careful examination of the particular characteristics of each institution coupled with an assessment of that institution's ability, relative to other institutions, to achieve a particular policy objective. Factors that affect relative institutional competence include the susceptibility of an institution to interest group pressure that may result in minoritarian bias, the contrasting risk of majoritarian bias, transaction costs and other factors that may impact the ability of those affected to participate in institutional debate, and the complexity of the issues involved.

Because of the range of institutional players, comparative institutional analysis is particularly applicable to corporate law. One study that applies the methodology, although not the terminology, is Roberta Romano's book, *The Genius of American Corporate Law*.[160] Romano identifies a variety of institutional factors that make Delaware institutionally superior, as a provider of corporate law, both to other states and to the federal government. These factors include Delaware's small size, its dependence on franchise taxes, its specialized court system, and the role of its corporate bar. Romano argues, for example, that Delaware's dependence on franchise taxes causes it to be responsive to the need for legal reform because of the significant cost of losing charter business to other states. Both Delaware's specialized courts and its unique corporate bar, which plays a substantial role in revising corporate legislation, enable Delaware to address the complexity of corporate law, and reduce the transaction costs of regulatory change.

Romano's work can be extended in two directions. First, it is worthwhile to look more carefully at the institutions within Delaware and other states and to consider the relative competence of courts, legislatures, and the market in supplying corporate law. Second, these institutions can be evaluated based on their ability to protect particular corporate constituencies. Comparative institutional analysis demonstrates that courts are uniquely positioned to protect the interests of corporate shareholders. This insight, in turn, explains the exclusion of nonshareholder constituencies from access to judicial lawmaking as a mechanism for institutional specialization.

Fiduciary duties provide shareholders with access to the courts to challenge management decisions. Why do shareholders need recourse to the judicial system to address the management-shareholder conflict? A key reason is the limited power of shareholders, relative to management, with respect to legislative lawmaking. Public company stock in the United States is owned, directly or indirectly, by dispersed small shareholders.[161] Small stakes and collective action problems limit the effectiveness of

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Id. Judge Winter subsequently conceded the race to the top might, in fact, merely be a "leisurely walk." Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1530 (1989).

159. *See generally* NEIL KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994).

160. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

161. Even the growth in institutional shareholders does not change this, as most institutions such as pension and mutual funds are simply vehicles through which small investors hold stock indirectly.

investors to access the legislative process. Cost considerations, agency problems, and their own political vulnerability limit the ability of even institutional investors with comparatively larger stakes to overcome these problems. Additionally, because much corporate law is enacted at the state level, shareholders lack even the minimum political power that they might otherwise be able to exert through the voting process. Although Delaware supplies corporate law to more than half of all publicly traded companies, few investors have the power to vote on the election of Delaware legislators.[162]

In contrast, corporate managers have significant advantages. Because lobbying, testifying before Congress, and other forms of participation in the political process are part of managers' operational responsibilities, managers function as repeat players and are able to draw upon their experience and reputations in the legislative process.[163] Managers have substantial firm-specific stakes that make political activity cost-effective in contrast to diversified investors. Managers also control the powerful financial resources of businesses, causing their interests to be of greater concern to politicians. Corporations pay substantial yearly franchise taxes to Delaware—revenue that Delaware risks losing if its corporate law fails to remain attractive to corporate management.[164] Through the consumption of legal services, corporations provide substantial revenue to key interest groups, such as Delaware corporate lawyers. Managers may exploit their firm's political capital for their personal benefit. In particular, Romano notes that, in addition to possessing higher stakes, managers can use corporate funds to pay their lobbying expenditures.[165]

Although the SEC appears to view its function as one of investor protection, similar factors limit the SEC's ability to address deficiencies in state law through its rule-making authority.[166] An analysis of the SEC's institutional competence is beyond the scope of this Article, but institutional characteristics such as expertise, the potential for industry capture, the extent of agency independence versus susceptibility to political influence, and the explicitly and implicitly delegated scope of rule-making authority are all relevant to this issue. Because interest groups such as managers, corporate lawyers, and securities analysts are small in size and have concentrated stakes, they are able to dominate the regulatory agenda and obtain legislation that favors their interests over those of dispersed investors.[167] Romano identifies the Williams Act and mandatory disclosure as examples

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162. In addition, as Romano observes, the "national political dynamic . . . favors managers" and shareholders are likely to face greater collective action problems than managers in lobbying Congress. ROMANO, *supra* note 160, at 76.

163. *See generally* Jill E. Fisch, *How Do Corporations Play Politics?: The FedEx Story*, 58 VAND. L. REV. 1495 (2005) (describing the role of political activity in business operations).

164. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888 n.8 (1990) (stating that, in 1990, franchise taxes accounted for approximately 20% of Delaware's general revenues).

165. ROMANO, *supra* note 160, at 76.

166. *See, e.g.*, J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 321 (2004) (describing as "unsuccessful" the SEC's efforts to compensate for deficiencies in state laws concerning corporate governance).

167. Indeed, this dynamic may be responsible for the SEC's repeated decisions to abandon its efforts to provide direct shareholder nomination of directors. *See* Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 62-67 (describing the SEC's consideration and abandonment of direct nomination proposals); *see also* Fisch & Gentile, *supra* note 27, at 578-80 (describing a more recent SEC proposal to allow shareholder nomination of directors).

of this type of regulation.[168] Another recent example is the SEC's proposal that shareholders be granted access to the issuer's proxy statement to nominate candidates for the board of directors.[169] Despite widespread shareholder support, the measure was ultimately blocked through a combination of direct management opposition and political pressure.[170] In short, public choice analysis suggests that corporate legislation, state or federal, is unlikely to serve the interests of investors relative to managers.

Similarly, to the extent that corporate law is addressed to intra-stakeholder conflicts, shareholders are likely disadvantaged in the legislative process relative to other stakeholders. Labor, suppliers, customers, and community members all have the ability to participate in the political process. Other corporate stakeholders may have particular advantages in political participation relative to shareholders. Their interests may be aligned along a range of political issues. They may be repeat players. They may have greater stakes. Union lobbying and the use of political action committees have enabled labor to develop a powerful political presence. The Teamsters, for example, is one of the most powerful interest groups in Washington politics.[171] Corporate creditors and suppliers have the concentrated stakes and traditional resources of business interests.[172] Consumers have increasingly been able to exert political pressure through organizations such as the AARP and through the potential voting power that they command.

Some commentators such as Romano and Easterbrook and Fischel rely on this analysis to favor a market dominated approach in which investors have the option of using the pressure of the capital markets to pressure issuers to modify statutory default rules. There are reasons to believe, however, that the market based contractual approach is better suited to serving the interests of nonshareholder stakeholders than to protecting shareholder interests. Contractual modifications can be used to adjust risk, priority, or fixed claims. Thus, employees might respond to a rule that reduced employee perks by demanding higher cash compensation. Bondholders might respond to adjustments to the takeover market by demanding the right to approve changes in control or providing that such changes trigger a put option. Fixed claims also simplify a stakeholder's monitoring by reducing the task to determining adherence to the contract terms. The limited duration of many stakeholder interests enables participants to adjust the contractual terms to reflect interim legal or market changes at the time of new investments. At the same time, most stakeholders can exit, either continuously or periodically, at relatively low cost.[173]

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168. ROMANO, *supra* note 160, at 78.

169. Security Holder Director Nominations, Exchange Act Release No. 48-626, 2003 SEC LEXIS 2431 (Oct. 14, 2003).

170. *See, e.g.*, Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, at C2 (describing the shareholder access proposal as "dead" as the result of pressure from the Bush administration and corporate executives).

171. *See, e.g.*, Fisch, *supra* note 163, at 1522 (describing the political influence exerted by the Teamsters in opposition to trucking deregulation).

172. Corporation statutes offer a variety of explicit protections for creditor interests such as restrictions on dividend payments and personal liability of directors for approving an illegal dividend. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170 (2005) (requiring that corporations have existing surplus or net profits to pay dividends); *id.* § 174 (imposing liability on directors for unlawful payment of dividends).

173. A stakeholder's ability to exit is limited by the extent to which it has made firm-specific investments that are incompletely protected by formal contract. The presence of such investments must be considered a component of firm value in that they are valuable only if the firm continues operations.

The value of the stakeholder's investment is only affected to a limited extent by its withdrawal from the corporation.

In contrast, the ability to use contract terms to adjust a residual stake is inherently limited. By definition, shareholders receive what is left over after the fixed claims of other stakeholders have been satisfied. If their legal rights are reduced relative to those of other stakeholders, they will get less, but they cannot compensate for this by putting themselves ahead or getting a bigger piece up front. Similarly, the value of exit to shareholders is overstated. Although shareholders can exit an underperforming corporation, in the absence of a fraudulent cover-up, the price at which they can exit will reflect the corporation's poor performance. Relative to an employee, who loses only the value of firm-specific sunk costs, the shareholder loses more.

As I have argued elsewhere, there are reasons to believe that courts offer a superior alternative to both the legislature and the market for the production of legal rules that protect shareholder interests.[174] Courts are insulated from the financial and political pressures associated with the legislative process.[175] Open-ended legal standards provide judges with the flexibility to adjust their analysis to case-specific issues and enable them to respond to innovations in business practice. The incremental approach of common law adjudication permits courts to assess the practical consequences of corporate developments such as poison pills, golden parachutes, and termination fees and to respond accordingly. Moreover, the transparency of written opinions provides a level of accountability.[176]

In addition, shareholders have far better access to the courts than to the legislatures. Representative lawsuits, such as shareholder derivative suits and securities class actions, enable the small investor to obtain access to judicial lawmaking and allow the aggregation of small investor interests into substantial stakes while, at the same time, overcoming coordination and collective action problems.[177] Litigation maximizes participation by shareholders in corporate lawmaking.[178] Specialized plaintiffs' firms address concerns about complexity in corporate law and, through their expertise, enable shareholders to enjoy the advantages of repeat players in the litigation process. In addition to their issuer-specific interests, shareholders benefit from the deterrent effect of litigation on self-dealing and other misconduct by corporate officers and directors.

Experience supports the conclusion that judicial lawmaking is more responsive to shareholder interests than the lawmaking of other institutions. Many of the most pro-shareholder corporate law rules have been adopted through judge-made lawmaking—the auction requirement of *Revlon*, *Unocal*'s requirement of heightened judicial review of management decision-making in the takeover context, and the various expansive interpretations of the private right of action for federal securities fraud. Notably, where legislatures have responded to these rules, they have cut back on shareholder protection.

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174. *See* Fisch, *supra* note 19, at 1088-96.

175. *Id.* at 1092-93.

176. *Id.* at 1095.

177. *Id.* at 1090-91. Concededly, the collection of legal fees imposes substantial administrative costs on representative shareholder litigation.

178. *See* Neil Komesar, Basic Instincts: Participation, Economics and Institutional Choice (July 8, 2004) (unpublished manuscript), *available at* http://www.law.wjsc.edu/ils/CIA-conference-papers.htm (highlighting the importance of participation in evaluating institutional competence).

Examples of these cutbacks include congressional adoption of the Private Securities Litigation Reform Act of 1995,[179] which cut back on the imposition of fiduciary principles through federal securities fraud litigation, the Ohio legislature's rejection of the *Unocal* standard of fiduciary principles in the takeover context,[180] and the adoption of other constituency statutes by a variety of states to dilute the shareholder primacy norm.

These institutional advantages explain the role of the shareholder primacy norm in defining the scope of fiduciary duties. Shareholder primacy has the effect of granting shareholders, but not other stakeholder groups, access to judicial lawmaking. The justification for granting courts a specialized role in protecting shareholder interests vis-a-vis those of other corporate stakeholders, is one of institutional competence. The markets and the political process generally function well with respect to other corporate stakeholders. Because the interests of managers, employees, creditors, customers, and suppliers, are adequately protected through other institutions, there is little need for judicial intervention. Shareholders, however, are relatively disabled from using these institutions effectively. As a result, shareholder primacy affords shareholders access to an alternative institutional actor: the courts. Fiduciary duty cases provide a mechanism through which shareholders can trigger a lawmaking process that protects their distinctive interests. Moreover, unlike the markets and the legislatures, the institutional structure of the courts is particularly well suited to provide shareholders with meaningful access and voice.[181]

This analysis explains why fiduciary principles—and thus, judicial access—are limited to shareholders. The reason shareholders are protected with fiduciary duties is not because theirs are the only interests that count within the corporation. The interests of managers, customers, and employees count, but those interests are protected effectively through mechanisms other than fiduciary duty litigation. Indeed, at the point when creditor interests are in the most jeopardy—when the corporation is in the zone of insolvency—the courts have extended fiduciary protection to them.[182] As a result, contrary to the claims of progressive scholars, the legitimacy of other stakeholder claims does not justify the extension of fiduciary principles to protect nonshareholder interests. Rather, the scope of existing fiduciary principles can be understood, and defended, as a mechanism for institutional specialization—allowing the different institutions to serve the interests of different corporate participants.

V. EFFICIENCY ANALYSIS AND SHAREHOLDER VALUE

Robert Clark suggested in 1986 that it would be misguided to attempt to choose

179. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

180. *See* OHIO REV. CODE ANN. § 1701.59(C) (LexisNexis 2006) (rejecting *Unocal* and codifying the existing common law).

181. Significantly, the market can protect the interests of future shareholders far more effectively than the interests of existing shareholders. On the conflict between the interests of current and future investors, see Schwarcz, *supra* note 145. As a result, legal doctrines such as the contemporaneous ownership requirement and the standing requirement in securities fraud litigation constrain judicial access by such future shareholders in favor of market remedies.

182. *See, e.g.*, *In re* STN Enters., 779 F.2d 901, 904 (2d Cir. 1985); Brandt v. Hicks, Muse & Co., 208 B.R. 288 (Bankr. D. Mass. 1997). The creditor fiduciary duty cases, by precluding shareholders of a distressed corporation from gambling with creditor funds, are inconsistent with a strong version of shareholder primacy.

among the differing conceptions of corporate purpose, recognizing that each conception has both strengths and weaknesses.[183] The emergence of empirical scholarship as a dominating force in corporate law imparts new pressure upon any effort to remain agnostic about the choice of corporate objectives. Efficiency analysis depends critically upon goal specification.[184] As Susan Freiwald observes, "[s]eemingly minor variations in goals lead to major differences in the analysis."[185] Although Clark may have been able to defer the question of whether corporations should attempt to maximize shareholder value, firm value, societal value, or something else, for scholars seeking to evaluate and defend regulatory policies, articulating and defending the choice of maximand is obligatory.

Researchers may argue that, given the difficulty of measuring nonshareholder interests, shareholder wealth is an acceptable, albeit second best, proxy for firm value.[186] As indicated above, this approach is particularly problematic in that corporate law, at least in part, is addressed to agency issues among stakeholders—allocating wealth, power, decision-making, or other rights among various corporate constituencies. These rules may have an overall effect on firm value—or they may not—but they also have distributional consequences. When a rule affects the division of the corporate pie, its effects cannot be assessed by measuring the size of a single slice. Although Coasian analysis suggests that the participants in the corporate contract should, in theory, allocate legal rights to maximize the overall size of the pie because the resulting efficiency gains can benefit all constituencies, there are reasons to suspect that transaction costs may impede such an allocation.

Several scholars have identified broader conceptions of firm value that could be incorporated into empirical research. Thomas Smith has suggested broadening the concept of shareholder value to investor value by including the market value of a firm's debt in empirical measures of firm value.[187] This broadening would enable an empirical study to assess the effects of regulatory change on both shareholders and creditors. Similarly Michael Jensen has suggested a definition of firm value that includes "the sum of the values of *all* financial claims on the firm—debt, warrants, and preferred stock, as well as equity."[188] Although calculating this value is more complex than calculating a firm's market capitalization—the full extent of financial claims may include instruments that are not publicly traded—this type of calculation is not unlike evaluations done for purposes of credit analysis.[189] Extending the conception of firm value to include human capital, Jeffrey Gordon is doing cutting edge work attempting to develop and apply a methodology for measuring employee value that can be incorporated into firm value.[190]

183. CLARK, *supra* note 1, at 702.

184. *See, e.g.*, Komesar, *supra* note 178, at 15-16 (criticizing both economic and philosophic analysis for failing adequately to define goals upon which their analysis is based).

185. Susan Freiwald, What A Comparative Institutional Analysis of Online Surveillance Reveals (Sept. 10, 2004) (unpublished manuscript), *available at* http://www.law.wisc.edu/ils/CIA-Conference-Papers.htm (describing importance of goal specification in comparative institutional analysis).

186. *See* Richard S. Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHI.-KENT L. REV. 3, 5 (1998) (explaining that it may be desirable to allow imperfect decision-makers to take approaches that would not be ideal if those decision-makers were first best perfect).

187. Smith, *supra* note 81.

188. Jensen, *supra* note 133, at 8.

189. *See also* Klock et al., *supra* note 37 (suggesting a method for valuing privately placed debt).

190. Gordon, *supra* note 38.

Finally, some scholars have identified the private benefits obtained by managers or controlling stockholders as an independent component of firm value.[191] Attempts to quantify these benefits are crucial for efficiency analyses in areas such as takeover regulation or the recent Italian corporate governance reforms.

Modifications to statutory disclosure requirements could assist this effort. Existing disclosure requirements are oriented in terms of shareholder value. Standard financial statement disclosure focuses on indications of shareholder wealth such as net profits and omits many components of value provided to other sources of capital such as creditors and labor. Financial reporting requirements could also be modified explicitly to require the disclosure of other elements of firm value such as charitable donations.[192]

In addition, the shareholder-based measures of firm value used by empirical scholars distort efficiency assessments because they do not generally reflect risk.[193] A consequence is that evaluating shareholder primacy based on a measure such as stock price or Tobin's Q, may unduly emphasize risk-taking and disregard the effect of risk management on shareholder value.[194] As one commentator observes, a low-risk investment that produces a low return that is in excess of the investment's cost of capital does more for shareholders than a high-risk investment that produces a high return that is below the cost of capital.[195]

This observation is particularly important with respect to the extent that stock price reflects returns to shareholders. In theory, stock price should reflect risk-adjusted shareholder returns. Because two comparable firms can have different costs of capital, one firm's economic profit—the ratio of its return less its cost of capital to its total capital—may differ substantially from another's even if they produce comparable returns to shareholders. True shareholder value should be measured in terms of the excess return over the firm's cost of capital.[196]

The business world has developed a variety of tools to measure whether a firm's return on capital exceeds its cost of capital.[197] One of the best known tools for evaluating firm productivity is economic value added (EVA).[198] Developed by New York-based

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191. *See, e.g.*, Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 147-49 (1999) (noting the private benefits of control that may be enjoyed by controlling stockholders or managers).

192. *See* Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 769 n.120 (2000) (describing proposed legislation that would have required disclosure of corporate charitable contributions).

193. *See, e.g.*, Wachter, *supra* note 147, at 802 (explaining that "abnormal returns are defined on a risk-adjusted basis").

194. *See, e.g.*, Sohnke M. Bartram, *Corporate Risk Management as a Lever for Shareholder Value Creation*, 9 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 279 (2000) (defending corporate risk management as a means of increasing shareholder value).

195. Leonard S. Hyman, *Investing in the "Plain Vanilla" Utility*, 24 ENERGY L.J. 1, n.1 (2003).

196. *See, e.g.*, Pablo Fernandez, A Definition of Shareholder Value Creation (Apr. 27, 2001) (unpublished manuscript), *available at* http://ssrn.com/abstract=268129 (defining shareholder value as a return that exceeds the required return to equity or cost of capital).

197. A firm's cost of capital is computed as a weighted average of its costs of equity and debt.

198. *See* Cyrus A. Ramezani et al., Growth, Corporate Profitability, and Shareholder Value Creation 6 (Mar. 21, 2001) (unpublished manuscript), *available at* http://ssrn.com/abstract=304880 (computing EVA as NOPAT (net operating profit after taxes) minus WACC (weighted average cost of capital) multiplied by capital).

Stern Stewart, EVA is the net operating profit after taxes less a charge for the firm's cost of capital, a charge that reflects the opportunity cost of all capital, equity and debt invested in the firm.[199] Stern Stewart describes EVA as "an estimate of true 'economic' profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk."[200] Peter Drucker explains the significance of EVA as follows:

> EVA is based on something we have known for a long time: what we call profits, the money left to service equity, is usually not profit at all. Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources. Until then it does not create wealth; it destroys it.[201]

EVA is not the only alternative measure of firm productivity.[202] The business school and finance literature consider numerous alternatives[203] and there is an ongoing debate over which measure is most appropriate.[204] Common to all these methods is the recognition that, whether the goal is measuring firm value or identifying criteria to assist managerial decision-making, there are shortcomings to using net income or stock price. Commentators explicitly defend the alternative methods because they "measure performance from a corporate finance perspective rather than shareholder wealth creation."[205] Significantly, studies have found substantial differences in assessments of firm performance, based on the choice of methodology.[206]

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199. About EVA, Stern Stewart & Co. Homepage, http://www.sternstewart.com/evaabout/whatis.php (last visited May 4, 2006).

200. *Id.*

201. Peter Drucker, *The Information Executives Truly Need*, HARV. BUS. REV., Jan.-Feb. 1995, at 59.

202. The chief competitor to EVA is CFROI, an inflation-adjusted measure of cash flow return on investment, developed by HOLT Value Associates. Randy Myers, *Metric Wars*, CFO MAGAZINE, Oct. 1, 1996, at 41. A variant on CFROI is total business return (TBR), promoted by the Boston Consulting Group. *Id.*

203. Other business school measures include return on assets (ROA), market value added (MVA), and shareholder value added (SVA). *See, e.g.*, John Yozzo et al., *Return on Assets: So Useful . . . and So Misused*, 2001 ABA JNL. LEXIS 204, *2-4 (defining ROA as the product of total asset turnover and operating margin, and distinguishing ROA, which is the return to all of a firm's suppliers of capital, from net income, which "belongs entirely to the firm's shareholders"); Value Analytix, Strengths and Weaknesses, http://www.valueanalytix.com/articles/strengths_and_weaknesses.html (last visited May 4, 2006) (describing the basis of calculating SVA, EVA, and CFROI and describing the strengths and weaknesses of each methodology). The finance literature uses additional measures. *See, e.g.*, Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance 11 (Dec. 7, 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=586423 (employing six different performance criteria "spread out across three categories: operating performance, valuation and shareholder payout").

204. *See, e.g.*, Randy Myers, *Measure for Measure*, CFO MAG., Nov. 1, 1997, *available at* http://www.cfo.com/printable/article.cfm/2990607?f=options (describing the controversy over which performance metric is most useful); Alix Nyberg & Bill Birchard, *On Further Reflection*, CFO MAG., Mar. 1, 2001, *available at* www.cfo.com/printable/article.cfm/2991941?f=options (questioning whether EVA and other value metrics are useful measures of firm performance).

205. *See* Ramezani et al., *supra* note 198, at 7 (applying this characterization to EVA and MVA).

206. *See, e.g.*, Brown & Caylor, *supra* note 203, at 45 tbl.5 (finding differing results depending on the choice of performance measure such that a firm may have good performance using one measure and poor performance using another measure); Pablo Fernandez, EVA and Cash Value Added Do Not Measure Shareholder Value Creation (May 23, 2001) (unpublished manuscript, on file with author) (finding a lack of

The innovation in and controversy over performance metrics in the business world suggest that measuring firm value and firm performance is complex.[207] One of the reasons that the business world has been driven to search for better measures of productivity is the recognition that stock price is a poor measure of firm value. Even in a market that is relatively informationally efficient, it is unlikely that market prices reflect fundamental value.[208] Noise may also reduce the informativeness of stock price reactions to regulation. As Fischer Black has explained, an efficient market is "one in which price is within a factor of [two] of value, i.e., the price is more than half of value and less than twice value."[209] The noise results, in part, from limits on the market's ability to quantify the effect of regulations on future firm performance.

In addition, as Michael Jensen has observed, the market can overvalue stocks.[210] The problem of overvalued equity highlights the potential operational damage that can result from focusing on shareholder primacy. Jensen argues that when stock price exceeds the firm's fundamental value, managers will be pressured to make value-destroying decisions—manipulating reported accounting figures or engaging in high risk negative net present value projects—in an effort to maintain the inflated price.[211] Such actions appear justified in terms of the shareholder primacy norm. As Jensen puts it, how can managers argue to their board (or their shareholders) that "they must manage the price of their stock down?"[212]

Bill Bratton refers to these types of decisions as the "dark side of shareholder

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correlation when measuring firm value, over a 10-year period, among MVA, EVA, NOPAT, and WACC); Ramezani et al., *supra* note 198 (identifying differences in performance measures and finding that earnings and sales growth are not correlated with shareholder value creation).

207. A complete analysis of this complexity is beyond the scope of this Article. An example is illustrative, however. A Darden School case study of the relative performance of FedEx and UPS during the period 1985 to 1995 finds that FedEx's financial performance during that time period was much worse than that of UPS. Robert F. Bruner & Derick Bulkley, The Battle for Value: Federal Express Corporation vs. United Parcel Service of America, Inc., UVA_F_1115, Darden School Case Study (July 1997), *available at* http://ssrn.com/abstract=299291. In particular, the study observes that "[b]etween 1985 and 1994 FedEx destroyed $1.36 billion in economic value while UPS created $2.08 billion." *Id.* Based on these findings, the study questions the rationality of the stock market valuation of FedEx. On the other hand, the cumulative return of FedEx since its inception in 1978 has been over 9000%. FedEx Investment Calculator, http://fdx.client.shareholder.com/calculator.cfm (last visited May 4, 2006) (showing that an investment of $1000 in FedEx stock on April 12, 1978 was worth $91,638.67 as of Oct. 27, 2004). From 1999 to 2004, a comparable investment in the common stock of each company would have produced a cumulative return of 107.65% for FedEx and 15.37% for UPS. *Id.* (calculating the return for an investment of $1000 from Nov. 10, 1999 to Oct. 27, 2004); UPS Investment Calculator, http://www.shareholder.com/ups/calculator.cfm (last visited May 4, 2006) (calculating the return for an investment of $1000 from Nov. 10, 1999 to Oct. 27, 2004).

208. *See* Jill E. Fisch, *Picking A Winner*, 20 J. CORP. L. 451, 464 (1995) (explaining the difference between informational efficiency and fundamental value efficiency); Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986) (describing evidence indicating the absence of fundamental value efficiency).

209. Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986). Black concedes that the factor of two is "arbitrary," but explains that it is "reasonable . . . in the light of sources of uncertainty about value and the strength of the forces tending to cause price to return to value." *Id.*

210. Michael C. Jensen, *The Agency Costs of Overvalued Equity and the Current State of Corporate Finance*, 10 EUR. FIN. MGMT. 549 (2004).

211. *Id.* at 555.

212. *Id.* at 562.

value."[213] Bratton identifies as one reason for Enron's spectacular collapse its obsession with meeting the short-term performance demands of its institutional investors. As Enron stated in its annual report, "it was a company 'laser-focused on earnings per share.'"[214] The implication of Bratton's analysis is that shareholder primacy, aggressively pursued, can be inconsistent with maximizing firm value and can, instead, lead to a "cultural pathology."[215] Importantly, to the extent that managers take on excessive risk or manipulate their reported numbers in an effort to increase or maintain inflated stock prices, these decisions impose an overall cost to the market that investors cannot eliminate through diversification.

Empirical studies based on the shareholder primacy norm reinforce managerial decisions to focus exclusively on measures of shareholder value such as stock price and net profits. By endorsing regulatory and operational decisions that maximize stock price without regard to the effect of those decisions on risk, sustainability, or other corporate stakeholders, the studies risk legitimizing undesirable management behavior. Stock options, phantom stock, and other equity-based forms of management compensation increase the risk, as illustrated by the dramatic pay-offs that Enron executives were able to generate by maintaining Enron's stock price for just a few years.

In sum, focusing exclusively on shareholder wealth, and, in particular, on relatively simplistic measures of that wealth, in assessing firm value is wrong. It is wrong because shareholder wealth does not include the interests of other stakeholders. It is wrong because shareholder wealth is ephemeral and not accurately measured through short-term stock prices. And it is wrong because the focus on shareholder wealth encourages operational decisions that may ultimately destroy firm value. As Richard Roll has observed, "stock price increases do not necessarily imply increases in the economic value of the total firm."[216]

VI. CONCLUSION

Law and economics scholars have embraced the shareholder primacy norm and incorporated it into their empirical analyses of corporate law. As a result, studies designed to evaluate the effect of legal rules that allocate power among corporate stakeholders analyze those rules in terms of their effect on shareholder wealth. The result is an increasingly influential body of scholarship that offers normative assessments of regulatory policy based on measures of shareholder value such as stock price, net profits, and Tobin's Q.

This Article challenges the incorporation of the shareholder primacy norm into empirical analysis. Shareholder value is neither the equivalent of firm value nor a reasonable proxy for firm value, particularly when applied to the agency context upon which corporate law is focused. Existing legal doctrine and economic theory do not justify evaluating regulatory policy exclusively in terms of shareholder interests. Nor can existing limits on the enforcement of management fiduciary duties be used as a basis for

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213. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

214. *Id.* at 1284 (citing ENRON, 2000 ANNUAL REPORT 2 (2001)).

215. *Id.* at 1357.

216. Richard Roll, *Empirical Evidence on Takeover Activity and Shareholder Wealth*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 241, 248 (John C. Coffee, Jr. et al. eds., 1988).

limiting the corporation's objectives to maximizing shareholder interests. Instead, as this Article has demonstrated, fiduciary principles are properly understood as a mechanism for institutional specialization in the context of inter-stakeholder conflicts. Rules that grant shareholders a unique degree of judicial access do not privilege the interests of shareholders in the evaluation of firm value.

The measures of shareholder value typically employed by empirical scholars pose additional problems. In addition to omitting the interests of other stakeholders, measures of shareholder value such as stock price, net profits, and Tobin's Q may be distorted by market deficiencies and inefficiencies, risk, and noise. Furthermore, academic endorsement of such measures—and short-term stock price in particular—as benchmarks of efficiency may reinforce inappropriate managerial decisions. The extensive business and financial research aimed at developing better measures of firm value and performance should give pause to legal academics.

This Article does not make the normative claim that corporations should be operated in the interests of nonshareholder stakeholders or society at large; nor does it support expanding the scope of fiduciary duties to protect nonshareholders. Robert Clark's warning about the difficulty of defining the corporate objective continues to ring true. This Article simply advocates caution in the use of shareholder primacy in empirical research. Although future scholarship may demonstrate that shareholder value can appropriately be used as a proxy for firm value, as yet, scholars have not made that case.