View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Digital Commons @ UM Law

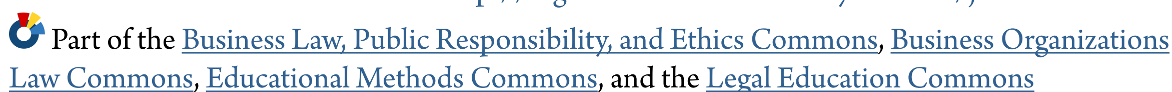
Journal of Business & Technology Law

Volume 8 | Issue 1 Article 11

# Shareholder Primacy in the Classroom After the Financial Crisis

David Millon

Follow this and additional works at: http://digitalcommons.law.umaryland.edu/jbtl


Part of the Business Law, Public Responsibility, and Ethics Commons, Business Organizations Law Commons, Educational Methods Commons, and the Legal Education Commons

Recommended Citation
David Millon, *Shareholder Primacy in the Classroom After the Financial Crisis*, 8 J. Bus. & Tech. L. 191 (2013)
Available at: http://digitalcommons.law.umaryland.edu/jbtl/vol8/iss1/11

This Articles & Essays is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Journal of Business & Technology Law by an authorized editor of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

David Millon*

# Shareholder Primacy in the Classroom After the Financial Crisis

In the wake of the financial crisis, most corporate law reform efforts have focused on the interests of shareholders. Controversial proposals include proxy access, say on pay and other reforms aimed at excessive executive compensation, elimination of staggered boards, and regulation of hedge funds.[1] Such proposals reflect the widely held assumption that the primary purpose of corporate activity — and therefore also the primary responsibility of corporate managers and the primary task for corporate law — is to maximize the shareholders' returns on their investments.[2] As a legal doctrine, this is, of course, known as the shareholder primacy principle.

The assumption that shareholder primacy is a doctrine of corporate law is pervasive. Mainstream legal academics, often law-and-economics oriented, typically take this for granted.[3] (This may be changing. Criticism of shareholder primacy from a policy perspective may be infiltrating faculties at leading law schools as concerns about short-termism draw increasing support outside the legal academy.[4])

---

© 2013 David Millon

* J.B. Stombock Professor of Law, Washington and Lee University. An earlier version of this piece appeared in *The Conglomerate Blog: Business, Law, Economics & Society* at http://www.theconglomerate.org /2011/07/corporationsba-roundtable-.html. This essay was developed after the Discussion Group on Teaching Business Law in a New Economic Environment at the Southeastern Association of Law Schools Annual Meeting on August 3, 2012.

1. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 951(a), (b)(2), 124 Stat. 1376 (2010) (requiring shareholder vote on executive compensation under some circumstances).

2. *See, e.g.,* Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. Corp. L. 975, 977–79 (2006) (defining and describing the shareholder primacy principle).

3. *See, e.g.*, Stephen M. Bainbridge, Corporation Law and Economics 419–21 (2002); Robert Charles Clark, Corporate Law 17–19, 677–81 (1986); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L. J. 439, 440–41 (2001); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23, 23 (1991).

4. For concerns discussed outside the legal academy, see John C. Bogle, *Restoring Faith in Financial Markets*, Wall St. J., Jan. 18, 2010, at A25 ("[T]he folly of short-term speculation has replaced the wisdom of long-term investing."); Dominic Barton, *Capitalism for the Long Term*, Harv. Bus. Rev., Mar. 2011, at 85 (criticizing "quarterly capitalism"); Francesco Guerrera, *Welch Denounces Corporate Obsessions*, Fin. Times (London), Mar. 13, 2009, at 1 (quoting General Electric's former CEO, Jack Welch, as describing

Shareholder primacy is also a foundational dogma at the top business schools, as Khurana explains in his excellent book on the history of business education.[5] The business press similarly takes shareholder primacy for granted,[6] and it is commonly though not universally embraced by business leaders,[7] investors, politicians, and government regulators.

In fact, shareholder primacy is not a legal doctrine. Beyond the anomalous case of *Dodge v. Ford*,[8] it is virtually impossible to find authority for it.[9] Even so, shareholder primacy operates as a powerful social norm that generates significant social costs. It seems clear that one of the engines driving the reckless behavior that led to the financial crisis was the desire to enhance shareholder returns even if that meant pursuit of excessively risky investment strategies.[10] More generally, it is widely recognized that many major corporations are fixated on quarterly earnings-per-share, in large part because major institutional investors base their investment strategies on a short-term perspective. (There are a number of reasons for this.[11] For example, public and private pension funds are desperate for cash to meet their own obligations to retirees, especially in an economic environment of reduced public and corporate contributions to pension plans. Similarly, mutual funds compete for investor dollars on the basis of annual and quarterly rather than longer-term performance.) Commitment to short-term shareholder value has significant negative implications for the long-term viability of large corporations, because it discourages investments in research and development,[12] marketing, customer service, and other initiatives and projects that reduce current earnings and only

"shareholder value [as] the dumbest idea in the world"). For examples of prominent academics critical of shareholder primacy, see LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

5. *See* RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS: THE SOCIAL TRANSFORMATION OF AMERICAN BUSINESS SCHOOLS AND THE UNFULFILLED PROMISE OF MANAGEMENT AS A PROFESSION (2007).

6. *See, e.g.*, Aneel Karnani, *The Case Against Corporate Social Responsibility*, WALL ST. J., Aug. 23, 2010, at R1 ("The movement for corporate social responsibility is in direct opposition . . . to the movement for better corporate governance, which demands that managers fulfill their fiduciary duty to act in the shareholders' interest.").

7. *See, e.g.*, BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 2012 at 30 (2012); Orit Gadiesh, *Say It Loud, Say It Proud — 'Shareholder Value!*,' WALL ST. J., Aug. 3, 2004, at B7 (citing a number of CEOs who identify shareholder value as a priority for their companies).

8. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 301 ("*Dodge v. Ford Motor Co.* was a highly unusual case.").

9. *See* STOUT, THE SHAREHOLDER VALUE MYTH, *supra* note 4, at ch. 2.

10. *See* Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309 (2011) (explaining how excessive risk-taking in pursuit of short-term shareholder profits led to financial crisis).

11. *See generally* David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. (forthcoming Jan. 2013).

12. Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCOUNTING REV. 305 (1998).

generate pay-offs in the long run.[13] For the same reasons, corporations are also less likely to invest in stakeholder well-being — such as employee training, improved working conditions, and cultivation of supplier and customer welfare — even though the company's long-run sustainability may actually depend on such investments.[14]

Given the widespread endorsement of the shareholder primacy idea in the academic and business arenas, it seems to me important that we law teachers do what we can to disabuse students of the assumption that corporate law requires that corporate activity prioritize shareholder interests. Many of them have heard this already and all of them are going to hear it once they get of law school if they are paying attention. One way to do this is to point out in the business organizations courses the fallacy of the view that shareholder primacy is a legal doctrine.

At Washington and Lee we divide the basic business organizations course into two parts. The first is a three-credit Close Business Arrangements (CBA) course that covers agency, partnership, corporate law in the close corporation context, and LLCs. Virtually all our students enroll in this elective course. Publicly Held Businesses (PHB) is a three-credit follow-on course that is essentially an advanced course in Delaware corporate law. In addition to full coverage of fiduciary duties and derivative actions, it is also possible to cover in greater detail than usual mergers and acquisitions, hostile takeovers, preferred stock, corporate debt, valuation, and also federal law as it relates to voting and disclosure.

The question of corporate purpose and shareholder primacy is less salient in CBA than it is in PHB. Because there is usually a strong degree of unity of ownership and control, those in charge of closely held firms are much less likely to possess the discretion or the inclination to deviate from profit maximization and, if they do, they do it with the consent of their fellow investors so there is typically no one to complain about it. Significant externalities (e.g., environmental or human rights costs) are less likely because of the generally smaller scale of closely held businesses. Even so, there are opportunities to interrogate the shareholder primacy assumption in the closely held context by introducing students to the benefit (or

13. *See* Andrew G. Haldane, Executive Director, Financial Stability, & Richard Davies, Economist Financial Stability Financial Institutions Division, Bank of England, The Short Long, Speech at the 29th Société Universitaire Européene de Recherches Financières Colloquium: New Paradigms in Money and Finance? 14 (May 2011), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech495.pdf (referring to short-termism as "a market failure . . . [that] would tend to result in investment being too low and in long-duration projects suffering disproportionately"); The Aspen Inst. Bus. & Society Program, Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management 2 (Sept. 9, 2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf ("[B]oards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation.").

14. *See* David Millon, *Two Models of Corporate Social Responsibility,* 46 Wake Forest L. Rev. 523 (2011) (discussing importance of investment in stakeholder well-being for long-run corporate sustainability).

"B") corporation alternative.[15] It may also be useful to bring up constituency statutes[16] and reforms like Oregon's 2007 revision to its corporate statute authorizing corporations to include in their articles of incorporation a provision allowing or requiring management consideration of environmental and social values.[17] Even if most small businesses are likely to focus on profit as the predominant objective, it would be good for students to understand that this is not a legal mandate.

The shareholder primacy question is primarily a problem for publicly held corporations. I address it on day one in my PHB course and come back to it periodically throughout the semester. I do not spend a lot of time with the political or moral question of whether large corporations have an obligation to temper profit maximization with pursuit of conflicting objectives. Such discussions at this stage in the course tend to be uninformed and to devolve fairly quickly into little more than expressions of previously held political preferences. I do, though, want the students to see that the size and the scope of the operations of our largest corporations necessarily mean that there are substantial and potentially negative effects on the wider society in which they operate. I think the students also need to know that there is significant support abroad for the idea that large businesses have social responsibilities, even if that idea seems more marginal in this country. So I start the course by explaining the shareholder primacy conception of corporate purpose and management responsibility (*Dodge v. Ford* is a useful illustration of what can be at stake) and then contrast that conception with the idea of corporate social responsibility (CSR) as a competing alternative that is taken seriously in many quarters around the world.[18] I make no effort to resolve what is essentially a controversy over social policy or moral obligation, but I do want students to know that important choices about those questions are embedded in a commitment to shareholder primacy.

While I do not try to convert students to my way of thinking about CSR, I do think it is very important that they understand that corporate law — this is supposed to a course about law, after all — is ambivalent on the question of shareholder primacy, generally agnostic, at best conflicted, and at times even hostile. (My colleague Christopher Bruner's articles on this subject are important.[19]) There are several opportunities to point this out. For example, state statutes

15. *See, e.g.*, Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?,* 46 WAKE FOREST L. REV. 591 (2011).

16. *See generally* David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991).

17. OR. REV. STAT. § 60.047 (2007).

18. *See* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 101 (2008) (noting the competing theories in corporate law scholarship).

19. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1421 (2008)

authorize corporate philanthropy.[20] Federal Rule 14a-8 allows shareholders to communicate with each other about the social, political, or ethical implications of what their firms are doing.[21] The business judgment rule insulates from shareholder scrutiny management policies aimed at promoting nonshareholder interests as long as those policies can with at least minimal plausibility be said to further the long-term interests of the corporate entity.[22] Corporations confronted by hostile takeovers can take effects on nonshareholders into account in formulating defensive responses (except in the narrowly-defined and readily avoidable *Revlon* situation[23]). At the same time, even if the law does not require it, it does allow corporate management to disregard nonshareholder interests and pursue short-term profit maximization if it chooses to do so, as long as the corporation honors contracts and complies with applicable regulations.

So corporate law ends up being irrelevant to the crucial question of corporate purpose and management's responsibility, leaving them largely within the discretion of management itself. The students therefore need to understand that non-legal values and incentives — including political commitment, social norms, compensation arrangements, pressure from institutional shareholders, to name a few — can lead corporate management to prioritize current share price maximization over long-term strategic investment and cultivation of the well-being of key nonshareholder constituencies. Even if this approach does not produce another financial crisis, it has important implications for the future of our society. As corporate law teachers, our powers are limited but we can at least do our best to avoid perpetuating facile assumptions about shareholder primacy.

---

20. Del. Code Ann. tit. 8, § 122(9) (West 2012).

21. *See* 17 C.F.R. § 240.14a-8(a) (2011) ("shareholder proposal rule" allowing shareholders to communicate with each other by including proposals in management's proxy solicitation materials under certain circumstances).

22. Model Bus. Corp. Act §§ 8.30–.31 (2002); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (clarifying that "the business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors").

23. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (stating that a corporation's 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").