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What must corporate directors do? Maximizing shareholder value versus creating value through team production

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ABSTRACT

A growing number of business and civic leaders, politicians, economists, and policy-oriented academics seem to believe that the corporate sector is suffering from something called "short-termism," a malady that seems to be holding corporations back, preventing them from investing to grow their businesses, build new businesses, or expand and train their workforces in the way we would expect them to be doing this late in an economic recovery. Although no one seems to know how to measure it or even clearly identify it, the charge of short-termism is associated with the idea that publicly-traded corporations are under so much pressure from financial markets to maximize share value that they are unable to pursue long-term strategies. The focus on short term stock price performance is believed to lead to excessive risk-taking, squeezing out of permanent employees, adoption of "just-in-time" workforces of temps and contract workers, and neglect of long-term investment.

The idea that corporations must maximize share value contrasts with an alternative theory about what corporations should do that generally prevailed throughout most of the 20th century. This theory, a variation of which has lately been revived in the so-called "team production" theory of corporate law, recognizes that creating wealth for society as a whole requires recognizing the importance of all of the participants in a corporate enterprise, and making sure that all share in the expanding pie so that they continue to collaborate to create wealth. This essay explains how the share value maximization norm came to dominate, why it is wrong, and why the team production approach provides a better basis for governing corporations for the long run.

I. INTRODUCTION

Stock market prices have climbed to new highs from the lows they hit at the bottom of the Great Recession, but U.S. corporations have not been doing well at one of the other important tasks we have historically counted on them to perform: they are not investing to grow their businesses, and are not creating enough good jobs to allow the middle class to have rising standards of living. Civic leaders, politicians, economists, and policy-oriented academics seem to believe that these failures are a symptom of something called "short-termism," defined as "an excessive focus on short-term results at the expense of long-term interests."[1] Short-termism, in turn, is regarded as a product of an excessive focus by corporate managers and directors on maximizing share value.[2]

The focus of corporate directors and managers on increasing share prices has served the shareholding class very well in recent years.[3] But there is growing evidence that this approach to managing corporations is not serving the economy as a whole nearly so well. Employment has declined in sectors that have historically been high-paying, like manufacturing, while employment has grown in sectors like retail sales, and personal services, where jobs tend to be low-paying and frequently unstable, part-time, and with few benefits.[4] The share of total output captured by workers has shrunk significantly, while the share of total income and wealth captured by the owners of capital and other persons in the top 1% of the income distribution has grown dramatically.[5] This has happened over the period in which share value maximization became the overarching goal for corporate executives.

The notion that corporations are supposed to focus exclusively on maximizing share value has become so deeply instilled in the culture of corporate boardrooms that challenging this notion is like swimming upstream against a strong current. How did this notion get so entrenched? What is the alternative? This essay reviews the legal and economic theories behind the share-value maximization norm, and then lays out a theory of corporate law that builds on the economics of "team production." The team production theory of corporate governance generates a prescription about the role that corporate boards of directors should play that harkens back to an earlier understanding of the role of boards, and is more consistent with the actual requirements of corporate law.[6] Team production theory provides an economic and legal basis for boards and managements to make the corporate sector, once again, a primary engine of widespread economic prosperity.

1 Financial Times Lexicon, The Definitive Dictionary of Economic, Financial, and Business Terms, available at http://lexicon.ft.com/Term?term=short_termism (last visited Feb. 27, 2015).

2 Dominic Barton and Mark Wiseman, Focusing Capital on the Long Term, Harvard Business Review (January, 2014) for example, observe that "The main source of the problem . . . is the continuing pressure on public companies from financial markets to maximize short-term results."

3 Since the end of 2002, when the market was just starting to recover from the dot.com bubble, the S&P 500 has increased at a compounded rate of more than 9.4% per year (as of February, 2015), a period which included the market collapse of 2008-2009. Since 1980, an investment in the S&P 500 would have grown to more than 36 times the original investment, a compounded rate of growth of more than 11% per year. Author's calculations from Aswath Domodaran, *Annual Returns on Stock, T.Bonds and T.Bills*: 1928 — Current, available at http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html.

4 See, e.g. Arne L. Kalleberg, *Good Jobs, Bad Jobs: The Rise of Polarized and Precarious Employment Systems in the United States, 1970s-2000s*, Russell Sage Foundation (2011). Frank Levy and Peter Temin discuss other institutional factors that have contributed to the uneven growth in incomes across the economy. See Frank Levy and Peter Temin, Inequality and Institutions in 20th Century America, National Bureau of Economic Research, Working Paper 13106 (May, 2007).

5 These trends are documented by Thomas Piketty, *Capital in the Twenty-first Century* (2013). See also Loukas Karabarbounis and Brent Neiman, *The Global Decline of the Labor Share*, NBER Working Paper No. 19136 (2013), available at http://www.nber.org/papers/w19136.pdf ; Emmanuel Saez, *Income Inequality: Evidence and Policy Implications*, Arrow Lecture, Stanford, January 2013, available at http://eml.berkeley.edu/~saez/lecture_saez_arrow.pdf, (last visited Feb. 28, 2015) presents data showing how income growth has skewed toward the top 1% of the income distribution since about 1980.

6 This theory was first applied to corporate law in Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Virginia Law Review, 2:247 (1999).

II. HOW "MAXIMIZING SHARE VALUE" BECAME THE DOMINANT VIEW OF THE ROLE OF CORPORATE DIRECTORS

Maximizing share value was supposed to be the cure for the corporate doldrums of the 1970s. From 1969 through 1980, the S&P 500 index grew by less than 1% per year.[7] To improve profits in the 1980s and 1990s, financial investors pursued corporate takeovers and leveraged buyouts.[8] These transactions made corporate directors and managers much more vulnerable to losing their jobs, which was believed to keep pressure on them to close plants, lay off works, outsource, restructure to improve profits, and generally do a better job of managing their companies.

The corporate takeover movement was justified by finance theories that had been developed in the 1970s that said a corporation is just a legal nexus through which shareholders/investors contract with managers to manage their assets for them. Shareholders are the "principals" in a "principal-agent" relationship with managers, the theory said.[9] As agents of shareholders, managers are supposed to manage corporations for the benefit of shareholders. Two different rationales have been offered up by advocates of this "shareholder primacy" theory. The first is that shareholders are the "owners" of corporations, therefore managers and boards have duties to serve their interests.[10] This theory is problematic, however, and not consistent with corporate law because shareholders do not actually have the rights and responsibilities that go along with "ownership." They cannot take corporate assets for their own use. They are not held liable for misuse of corporate assets. And corporate law says they cannot tell boards and managers what to do.[11] The second rationale concedes that corporations cannot really be "owned" by anyone because they are just a "nexus" through which all of the participants contract with each other. Within this contractual nexus, shareholders have bargained for the right to claim what is left over after all other corporate participants are paid according to their contracts. So maximizing the profits for shareholders should have the effect of maximizing the total wealth created by the corporation.[12]

Finance theory also told us that financial markets are "efficient" in that the stock prices at any point incorporate all publicly-available information and reflect the best available estimate of the true long-term value of the corporation.[13] Thus, we can be confident that takeovers are a good thing for the economy because they nearly always cause the stock price of the target company to rise—an unequivocally good thing if all other parties are truly protected by contracts with the corporation.[14] And, since takeovers are good, directors and managers of target companies have an obligation, in the face of an unsolicited tender offer for the company, not to resist the takeover offer, but to try to get the best price they can for shareholders.[15]

Corporate law, especially the law of Delaware where more than half of all large publicly-traded corporations are chartered, has never accepted the idea that corporate directors and managers should be passive in the face of takeover

7 Author's calculations from Aswath Domodaran, as cited in note 3 above.

8 See Margaret M. Blair and Robert E. Litan, *Corporate Leverage and Leveraged Buyouts in the Eighties*, in John B. Shoven and Joel Waldfogel, eds, *Debt, Taxes & Corporate Restructuring*, Brookings (1990).

9 See Michael C. Jensen & William F. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics, 305 (1976).

10 See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 Journal of Law & Economics, 301 (1983).

11 See Blair and Stout, *Team Production Theory* (1999), cited above, at 290 — 292, for an extended discussion of these features of corporate law.

12 See Jensen & Meckling (1976). Frank H Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991) rely on this rationale for shareholder primacy.

13 See Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 Journal of Finance, 383 (May, 1970).

14 See Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 Journal of Economic Perspectives, 1, 21 (Winter, 1988).

15 Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harvard Law Review, 1161 (1981).

offers, allowing shareholders to sell their shares into the offer. In fact, Delaware courts have explicitly approved a number of defensive tactics.[16] But to true believers in shareholder primacy, the fact that boards of directors frequently put defenses into place, and resist takeovers, is taken as evidence that directors are not always good agents for shareholders, and that they need to be disciplined. In recent years, hostile takeovers have become less common, but activist financial investors who want to discipline management and influence how corporations are managed are using a variety of other tactics instead, many of which have also been resisted by corporate managers and directors.[17]

Shareholder primacy theory, and the debate about the role of takeovers and shareholder activism, have had an enormous influence on law, policy, scholarship and teaching since the 1980s. By the end of the 1980s, finance theorists and professors in business schools and law schools who embraced and promoted these ideas were teaching that changes in stock prices are the best metric for evaluating whether directors and managers are doing a good job. Thus boards of directors and managers should focus only on maximizing share value—in fact, many were told that the law requires this.[18] Policy analysts and the media also got on board with this idea. Moreover, since managers and directors might have personal goals that conflict with what is necessary to maximize share value, best practice requires that compensation packages of the top executives and board members should be strongly tied to stock price performance.[19] Managers and boards adopted these views as their mantra, and figured out how to inculcate this goal throughout their businesses by continuously monitoring stock price, and extravagantly compensating executives who oversee increases in share value.

This theory about what boards and directors are supposed to do is elegant and powerful, and came to dominate discussions about the role of corporations in our economy, and the rules by which they are governed. But it gets a few things wrong. First, there are many common situations in which maximizing share value will not result in maximizing total social value created by a corporation. Stock prices may not be good indicators of long-run, as well as short-run value being created. This will be the case if corporate management knows more about the business and prospects of the corporation than outside investors know. Maximizing share value will also not maximize social value when corporations externalize costs associated with the business onto workers, customers, or communities, or other participants in corporations who are not fully protected by their contracts. When employees make specific investments in acquiring human capital that is specialized to the particular corporation, for example, these investments will lose value if the employee loses her job. This gives managers bargaining power in relation to those employees, making it possible to cut back on employee raises and benefits while increasing dividends or stock buy-backs.

Financial innovation also creates situations in which maximizing share value does not maximize total social value. When a corporation issues hybrid securities that have some features that are like debt, and some features that are like equity, or when a corporation issues stock "options" in addition to regular debt and equity, or when investors engage in other financial transactions, the result may just shift risk among security-holders. Financial innovation may thus make it possible to make shareholders better off at the expense of other security holders. In the years leading up to the financial crisis of 2008-2009, for example, many financial institutions bought extremely risky portfolios of

16 See Unocal Corp. v. Mesa Petroleum Co.493 A.2d 946 (Del. 1985)(approving use of selective self-tender in the context of a coercive two-tier offer); and Moran v. Household International, 500 A.2d 1346 (Del. 1985) (approving preemptive use of poison pill).

17 See Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 Vanderbilt Law Review, 299 (2008).

18 See, e.g., Roberta Romano, *Corporate Law and Corporate Governance*, 5 Industrial and Corporate Change, 2: 277 (1996); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 Washington and Lee Law Review, 1423 (1993).

19 See Michael C. Jensen and Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, 22 Journal of Applied Corporate Finance, 1: 64 (Winter, 2010).

mortgages, and then offset that risk by buying "credit default swaps," which moved the risk to other institutions that sold the swaps. These risks were not reflected in the balance sheets and income statements of the institutions that took on the risks. While they had high payoffs for shareholders of the issuing institutions when they did not crash, they imposed significant risks on other corporate participants such as creditors and ultimately the taxpayers who bailed out the failed financial institutions.

The assumptions and prescriptions of shareholder primacy also get the law wrong. As I will show in detail in Part IV below, corporate law has never required boards of directors to maximize share value as a general duty. Statutory law in Delaware and in states that follow the Model Business Corporation Act (MBCA) require only that corporate officers and directors act "in good faith," and in a manner the director reasonably believes to be in the "best interests of the corporation" (notably not "the shareholders")[20] The law regards the corporation as distinct from its shareholders. Pronouncements about the duties of directors that come out of court decisions consistently say that directors owe fiduciary duties to the corporation. In certain situations, courts have said that directors also owe fiduciary duties to shareholders, but there are only two contexts in which courts have interpreted that to mean maximization of share price: (1) when the corporation is about to undergo a substantial transaction such as a merger or leveraged buyout in which holders of common shares are going to be eliminated.[21] In that case, courts have said directors and managers have a duty to shareholders to try to get the best price they can get for the shares; and (2) when a controlling shareholder engages in actions and transactions that prevent a minority shareholder from sharing in the benefits of his investment in the stock of the corporation.[22] In such a situation, the court will likely remind the board and management that the shareholder invested to earn a return, so it is not fair to manage the corporation in a manner that deprives the minority shareholder of capturing any returns on his investments.[23] In all other contexts, courts will defer to the "business judgment" of managers and directors about what is in the best interest of the corporation, as long as directors act in good faith, and there is no evidence of fraud, illegality, or conflict of interest. This doctrine is called the "business judgment rule."[24]

III. THE TEAM PRODUCTION PROBLEM

Economists have long puzzled over the following question: if markets do such a good job of allocating resources and encouraging production of goods and services that customers want, why is it that business people typically organize themselves into "firms" or productive organizations which are governed by hierarchical decision-making rather than by markets? It seems clear that the answer must have something to do with the scale and complexity of the enterprise. An early theory about this question developed the concept of "team production," in which the goods being produced require inputs from a number of different input providers, the inputs and/or outputs of each provider are difficult to measure and contract over, and the output is "nonseparable," meaning that we cannot tell by examining the output which input provider is responsible for which portion of the output.[25] The difficulty this creates

20 MBCA §8.30(a).

21 See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

22 See, e.g., eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010) (discussed below).

23 As the court said in eBay v. Newmark, "Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders." eBay v. Newmark, at 34.

24 See Aronson v. Lewis, 473 A2d 805 (Del. 1984).

25 Armen A. Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, American Economic Review, 62: 777 (1972) at 779.

is that any decision rule about how to allocate the economic gains from production will encourage team members to shirk their duties, and/or to dissipate the gains by squabbling over how the gains are to be divided up.[26]

In such situations, which are likely ubiquitous in business, some theorists have argued that it is helpful if one of the members of the productive team serves as a "monitor."[27] The job of the monitor is to choose (hire and fire) the team members and observe them in action to try to make sure that they do not shirk. The monitor can agree to compensate each team member at her "opportunity cost," which is what she could have earned in any alternative employment. The monitor, then, captures all of the economic surpluses from team production, which gives the monitor an incentive to work hard. This model provides a possible explanation for organizing production in small, entrepreneurial firms, but its emphasis on the role of an individual monitor suggests that the model may not explain large corporations with many managers and many investors.

The next important development in team production theory was the idea that the employer has "power" over other team members because the employer owns and controls the specialized assets that the team members need to use for their productivity to be as high as possible.[28] This has been called the property rights theory of the firm. But what if numerous team members need to make specialized investments in human capital for optimal productivity? Which team member should be the "owner"? Oliver Hart and various co-authors argued that the ownable assets should be owned by the team member whose specific human capital investments are most important for the productivity of the venture. The owner would then have appropriate incentives to invest in her human capital, and if the other team members do not, well, their investment was less important by assumption. Hart's model provided an important insight into the role played by property rights, which, he said, help to fill in the gaps in incomplete contracts by giving the owner of assets used in a joint enterprise the right to make decisions about the use of the assets that have not been otherwise specified in the contract. This theory of firms was combined with the idea that shareholders are "owners" and corporate managers their "agents" to support the dominant shareholder primacy theory of corporate law and corporate governance. This model, however, again provides a rationale for individual proprietorships—with a single owner by definition—but not for corporations because it doesn't explain joint ownership by multiple investors or governance by non-owning boards of directors.

Moreover, subsequent theorists have shown that property rights can be a source of problems in a team production enterprise. In a 1998 article, Raghuram Rajan and Luigi Zingales noted that there are likely to be situations in which the owner of assets used in team production can extract a larger share of the gains from production by selling the assets rather than by making her own specialized human capital investments in the business. Knowing this, the other team members may be reluctant to make the specialized human capital investments they need to make.[29] Thus, the "owner" can have perverse incentives. Rajan and Zingales hypothesized that the optimal structure for some team production enterprises might be for a complete outsider to the team to be the party that would have the right to hire and fire the teams, buy and sell assets, and allocate the surplus generated by the enterprise to the team members.[30] But, to avoid the perverse incentives that ownership can generate, that outsider must not have the authority to take those assets for himself.

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26 See Bengt Holmstrom, *Moral Hazard in Teams*, 13 Bell Journal of Economics, 324 (1982).

27 This was the solution proposed by Alchian and Demsetz in their article, cited in note 25 above.

28 See Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Columbia Law review, 1757 (1989); and Oliver Hart and John Moore, *Property Rights and the Nature of the Firm*, 98 Journal of Political Economy, 6: 1119 (1990).

29 See Raghuram Rajan and Luigi Zingales, *Power in the Theory of the Firm*, 113 Quarterly Journal of Economics, 387 (1998) at 408.

30 Ibid.,at 422.

In a 1999 paper, Blair and Stout applied this idea to corporations, pointing out that the story provides a rationale for many of the legal arrangements provided by corporate law.[31] When a corporation is formed, a new legal entity is created that has rights to buy, sell, and own property and enter into contracts. That legal entity owns the property used in production, as well as the output from productive activity, at least until a decision is made to pay out some of the wealth created to the team members in the form of wages, or purchases of inputs, or interest or dividends. The relevant decisions about such payouts cannot be made by the owner—the corporation itself—because it is a non-sentient being. Instead, corporate law provides that those decisions are made by, or under the direction of, a board of directors.[32] Boards of directors may be neither members of the productive team, nor the owners of the corporation's assets. Individual board members do not have authority to act on their own, but can only act as a board. They also have fiduciary duties to the corporation that prevent them from self-dealing. Thus they are perfectly situated to serve as the outside decision-makers whose role was hypothesized in the Rajan and Zingales model. Seeing boards of directors in this light helps to explain and justify features of corporate law that are problematic under a principal-agent theory of the role of corporations.

Part IV reviews five key characteristics that distinguish corporations (and similar legal entities) from individual proprietorships and partnerships to show that these characteristics are more consistent with a "team production" theory of corporations, than they are with "principal-agent" theory. In part V, I show how case law also supports a team production theory. In the final part, I explore how the team production conception of corporations can help to counteract some of the pressures corporate managers and directors sometimes experience to focus on maximizing short-term share value.

IV. WHY THE CORPORATE FORM HELPS SOLVE THE TEAM PRODUCTION PROBLEM

Corporations are remarkable organizational forms that became widely popular for businesses beginning in the 19th century. Prior to the middle of the 19th century, nearly all business activity was carried out by individual proprietorships and partnerships. Corporations are different from individual proprietorships and partnerships in that they can involve numerous investors, managers, and employees, all of whom are legally separate from the corporation. These participants can come and go in the enterprise without affecting who legally owns the assets or who is legally responsible for the liabilities of the business.

Five features, created by the law when a corporation is formed, distinguish corporations from other organizational forms: 1) Legal personality or separate entity status; 2) Limited liability for investors; 3) Transferable shares; 4) Management by or under a board of directors; and 5) Indefinite existence.

1) *Legal personality*. Legal personality may be the single most important characteristic of the corporate form. It cannot be achieved using contracts alone, and the other characteristics follow logically from the legal separateness of the corporate entity. The fact that corporations are created by actions of a state, and cannot be replicated by private contract, does not fit the theory that corporations are just nexuses of contracts. In fact, many advocates of nexus of contracts theory understand this, and thus deny that corporations should be regarded as separate "persons,"

31 Blair and Stout, *Team Production* (1999).

32 MBCA §8.01(b) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors." This is subject to an exception for very closely held corporations that operate under a shareholders' agreement.)

stressing that corporations cannot have goals, duties, or interests apart from the aggregate interests of the people who make up the firm, especially the interests of shareholders.[33]

Separate entity status is a legal fact, however, and it serves a number of important functions. It facilitates contracting among the various participants in the corporation by allowing them each to contract with the corporation itself, rather than having to create separate contracts with each of the other participants. It also helps to define and clarify which pools of assets are dedicated to the business and can be used to satisfy creditors of the business. Creditors of the business cannot seize personal assets of the participants to satisfy corporate debts, and individual participants may not pledge corporate assets to secure personal loans.[34]

Separate entity status is inconsistent with the idea that shareholders are owners of the corporation's assets. But the fact that the corporation is a separate entity is one of the key reasons why it helps solve team production problems. Separate entity status makes it possible for team members to dedicate assets to the business, while making it clear that none of the team members have property rights over those assets. This helps to prevent team members from opportunistically pulling assets out of the corporation, or selling or threatening to sell the assets to get an advantage in bargaining with the other participants in the corporation. In fact, no team member has the unilateral right to take assets out of the corporation or expropriate them for personal use.[35]

2) *Limited liability*. Limited liability for investors follows almost automatically from separate entity status. It means that neither the shareholders nor other participants can be held personally liable for debts incurred by the business. Shareholders, creditors, employees, and suppliers can all lose what they have invested in a corporation if the business fails. But if such a loss occurs, none of them can go after the personal assets of any of the others to make themselves whole. The position of shareholders is, in this sense, similar to the position of other participants. Limited liability does not fit well with a description of shareholders as the "owners" of corporations, but it makes sense if we understand the corporation as a separate legal entity that owns assets needed to support team production.

3) *Transferable shares*. Transferability of shares refers to the right that corporate shareholders generally have to sell or transfer their equity shares to other parties. The contribution of shareholders is normally just money, and does not include specialized knowledge or other unique assets. This, combined with the fact that shareholders have limited liability, means that shareholders in a corporation are interchangeable. The equity claims in a corporation can be carved up into fungible pieces that can be parsed in various ways and traded among investors without having any direct impact on the operation of the corporation. If a shareholder wants to get out of a particular investment, the corporation does not have to buy out that shareholder—instead, the shareholder can sell her shares to another investor. This enables the corporation to lock-in the capital that has been invested, without locking-in any particular investors. [36]

33 This argument is nearly always used in support of the idea that corporations do not have social responsibilities beyond maximizing share value. See, e.g., Jensen and Meckling, *Theory of the Firm*, 1976, cited above.

34 See Henry Hansmann and Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale Law Journal, 3:387 (2000); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA Law Review, 2:387 (2003).

35 Ibid.

36 See Margaret M. Blair, *Locking in Capital*, cited above; and Margaret M. Blair, *Corporate Law and the Team Production Problem*, *Research Handbook on the Economics of Corporate Law*, Claire A. Hill and Brett H. McDonnell, eds., Edward Elgar (2012) at 40.

The ability to lock-in the capital makes it possible for a corporation to invest in assets and build businesses that have a very long-term horizon,[37] which is why the earliest uses of the corporate form for business activities were for investments such as infrastructure projects (bridges, canals, etc.) that required committed capital. Because investors can come and go without affecting the investments or strategies of a corporation, the shareholders of a corporation at any point in time may have no long-term connection to the firm. Different shareholders may have different investment goals, but any attempt to aggregate the goals of shareholders would be in constant flux as the ownership of the shares fluctuates. Thus this feature of corporations is inconsistent with the notion of shareholders as the "owners" or "principals" in a principal-agent relationship with corporate managers. Multiple goals and frequent turnover among shareholders fits more easily with a team production analysis which assumes that various team members will have multiple, sometimes competing goals that must be negotiated and balanced on an ongoing basis.

Because investors can come and go without affecting the investments or strategies of a corporation, the shareholders of a corporation at any point in time may have no long-term connection to the firm.

If the equity shares of a corporation are traded in an efficient market, the separation between shareholders and the corporation is nearly complete. Shares are bought and sold, sometimes repeatedly within a given day or hour, without having any necessary impact on what is happening inside the corporation, and the rapidly shrinking holding periods for shares make it clear that many individual shareholders are not in it for the long run.

Advocates of shareholder primacy counter that all shareholders are served when the stock price is high, and that the active trading of shares moves share prices quickly to reflect the market's best estimate of the short and long-term implications of any news about the corporation. But as noted below, this may not be true among investors who hold shares as part of a hedging strategy.

4) *Management under a Board of Directors.* The requirement that a corporation be managed by or under a board of directors is another characteristic that is unique to the corporate form. Other organizational forms can choose to use board-like governance structures, but only corporations are required by statute to have a board of directors.[38] Advocates of shareholder primacy argue that governance is delegated to boards because boards can specialize in management, while shareholders specialize in risk-taking.[39] This structure is nonetheless consistent with shareholder primacy, they argue, because directors are required by law to be faithful agents of shareholders.[40] But this assertion is contradicted by legal descriptions of directors and their duties. First, corporate directors are not "agents" of shareholders—shareholders may not dictate to directors what they are to do.[41] Legally, directors are more like trustees for the corporation as a whole.[42] Directors acting as a body, but not individually, are authorized to exercise

37 Late in the 20th century, other organizational forms were authorized that can take on some of these characteristics. The corporate form is no longer the only form that can have all of these characteristics, but it is the oldest and most well-established such form.

38 The only exception to the requirement that corporations have a board is for so-called "close corporations," which have strict limits on the number of shareholders, under MBCA §7.32 or Delaware General Corporate Law §350.

39 See, e.g., Stephen M. Bainbridge, *Why a Board — Group Decisionmaking in Corporate Governance*, 55 Vanderbilt Law Review, 1: 1 (2002).

40 Ibid.

41 See Robert C. Clark, *Agency Costs versus Fiduciary Duties, in Principals and Agents: The Structure of Business*, John W. Pratt and Richard J. Zeckhauser, eds. (1985) at 56.

42 Ibid.

"all corporate powers."[43] The board may hire corporate officers who are agents of the corporation under the law. But the board itself is not subject to the oversight and direction of shareholders or of any of the other participants in the corporation. And second, as mentioned above, there is no statutory requirement that boards of directors must maximize share value. Instead, the statutes (and case law) say that directors must act in good faith and in the belief that their actions are in the best interests of the corporation.[44] As discussed more fully below, courts deciding corporate law cases sometimes also say that fiduciary duties are owed to the corporation and the shareholders. This legal description is completely consistent with a team production theory, which hypothesizes that all of the members of a team yield ultimate decision-making authority to the board so that they can more easily overcome mutual shirking and rent-seeking problems.

5) *Indefinite existence*. The default rule when a corporation is formed is that the corporation exists until it is formally dissolved. Corporations, in theory, can thus continue in existence for hundreds of years.[45] The earliest corporate charters were issued to churches, monasteries, and townships to make it possible for them to hold property indefinitely, and administer that property for some quasi-public purpose, even as the natural persons who administered the property came and went. By contrast, both individual proprietorships and traditional general partnerships cease to exist if the proprietor or a partner dies, or withdraws for some other reasons. Partnerships and hybrid organizational forms such as LLCs (Limited Liability Corporations) can now be formed with indefinite existence, but generally these forms exist for a specified limited time, or to carry out some specific venture or enterprise.

In a corporate enterprise of any magnitude, inputs are required from managers, workers, investors, the developers and owners of intellectual property, suppliers, and customers. All are encouraged to participate without a complete guarantee of what they will get out of the venture. But all have some assurance that the assets contributed to the corporation cannot be unilaterally claimed and stripped out by any one "team member," because none of the team members holds title to the assets. Instead, the corporation owns the assets. And only the board of directors is authorized to make decisions about the use or distribution of those assets.

Indefinite existence facilitates the accumulation of assets in a firm that are dedicated to the team enterprise. Once shareholders have paid capital into a corporation to purchase shares, neither shareholders, nor heirs of shareholders, nor creditors of the shareholders, can compel the corporation to buy back the shares or even to pay dividends. The capital is "locked in" until the board of directors decides to pay it out. These rules are problematic from the perspective of a principal-agent theory with shareholders as principals. Shareholders cannot get their money back out of the corporation when they want, and cannot tell managers and directors what to do with corporate assets. But these rules are easy to explain under a team production model because they

43 MBCA §8.01(b).

44 MBCA §8.30(b); Delaware General Corporation Law has no statutory statement of the fiduciary duties of boards of directors, but case law confirms that fiduciary duties are the underpinning of the "business judgment rule," which is "an acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

45 Hudson's Bay Co., a Canadian corporation that now owns several major department store chains, has been in existence since 1670. See http://www3.hbc.com/hbc/about-us/.

protect all of the parties who make specific investments in the firm, and whose return on investment depends on the overall success of the venture.

These five characteristics are all problematic from a principal-agent point of view. But the team production theory makes sense out of these arrangements. In a corporate enterprise of any magnitude, inputs are required from managers, workers, investors, the developers and owners of intellectual property, suppliers, and customers. All are encouraged to participate without a complete guarantee of what they will get out of the venture. But all have some assurance that the assets contributed to the corporation cannot be unilaterally claimed and stripped out by any one "team member," because none of the team members holds title to the assets. Instead, the corporation owns the assets. And only the board of directors is authorized to make decisions about the use or distribution of those assets. This theory provides a rationale for the role of directors that is consistent with the role that boards of directors historically understood themselves to play—that is, to balance competing interests to make sure that the whole organization stays productive.[46]

This is also how boards of directors typically described their jobs prior to the 1990s.[47] As stated in a 1981 Business Roundtable publication, "carefully weighing the impacts of decisions and balancing different constituent interests—in the context of both near-term and long-term effect—must be an integral part of the corporation's decision-making and management process."[48] And this is an explicit function today of boards of directors in venture capital financed firms, where there are generally seven or eight directors, with two representing the founding entrepreneurs and two or three representing the venture capital investors. The remaining three are often wise elders from the industry, whose job is to cast deciding votes, and to reassure both parties that they will not be taken advantage of by the other party.[49]

V. BUT WHAT ABOUT CASE LAW?

We have already noted above that there is nothing in statutory law of corporations that requires that boards of directors must try to maximize the value of a corporation's equity shares. Corporations may be formed for "any lawful business."[50] And statutes provide only that directors should act in the best interest of the corporation.[51] As for "case law" (the product of judicial decisions handed down when courts resolve disputes), there has long been a discrepancy between the language the courts use, and the circumstances in which courts actually find directors liable for breach of fiduciary duties.

Advocates of shareholder primacy often point to a 1919 decision of the Michigan Supreme Court in a case called *Dodge v. Ford* for the proposition that directors must maximize share value, and may not use corporate resources for other purposes, such as better wages and benefits for employees.[52] In that case, two brothers, John Francis Dodge and Horace Elgin Dodge, owned 10% of the outstanding shares of Ford Motor Co. The largest shareholder

46 See Margaret M. Blair, *Boards of Directors as Mediating Hierarchs,* 38 Seattle University Law Review, 2: 297 (2015); and Henry Hansmann and Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, 123 Yale Law Journal, 100 (2014).

47 See Statement on Corporate Responsibility, Business Roundtable, October (1981).

48 Ibid.

49 See Elizabeth Pollman, T*eam Production Theory and Private Company Boards*, 38 Seattle University Law Review, 619 (2015); and Brian Broughman, *The Role of Independent Directors in Startup Firms*, Utah Law Review, 2010:461 (2010).

50 MBCA § 3.01(a).

51 MBCA §8.30(a).

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

was Henry Ford, who controlled the board with 58% of the shares.[53] Ford (the company) was making huge profits at the time, and had accumulated a $60 million capital surplus. Nonetheless, Henry Ford announced that the company would discontinue paying special dividends because he planned to reduce the price of Model T's, and reinvest the surpluses by building a new factory and employing many more workers to meet the increased demand. The Dodge brothers wanted the company to pay large dividends instead, so that they could use the money to invest in their own competing automobile company. They could not simply sell their shares to get their cash out, because there was no active market in Ford shares at the time. So they took Henry Ford to court, asking the court to compel payment of dividends. The court notably did not decide that Ford must drop its expansion plans or withhold raises for its employees, but did decide that Ford would have to pay about $19 million—less than one third of its surpluses at the time—to shareholders as dividends. In explaining that result, the court said:

> "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. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes..."

This decision was unusual because, ordinarily, courts follow a doctrine (mentioned above) called the "business judgment rule," by which the court refuses to second-guess the business judgment of the board, unless a plaintiff can show that board members had engaged in fraud, or illegal behavior, or had a significant conflict of interest.[54] The context of *Dodge v. Ford* represents one exception to this rule, a situation called "shareholder oppression," which occurs when a controlling shareholder in a closely-held corporation uses the corporation to benefit her own personal agenda, and refuses to pay dividends or provide other benefits to minority shareholders. In such cases, courts occasionally step in to require some action of a corporation so that the oppressed minority shareholder can either get out of her investment, or receive some share in the financial benefit that the controlling shareholder is getting. Corporate law scholar D. Gordon Smith has reviewed case law going back to the early 19th century and concluded that the most important context in which Delaware courts have adopted shareholder primacy language has been cases in which majority shareholders were depriving minority shareholders of the full benefit of their shares, cases that now go under the rubric of "minority oppression."[55]

The other context in which courts have explicitly exhorted directors and managers to "maximize share value" has been in hostile takeover contests, once it becomes inevitable that the corporation is either going to be sold, or is going to engage in some transaction in which existing shareholders will be bought out, and/or the existing board will no longer control the corporation.[56] In such a situation, courts have said that existing shareholders will not be able to benefit from any alternative long-term plans the corporation might have because the shareholders are being eliminated, and/or because the board is being eliminated and will not be in a position to carry out its long term plan. In that situation, Delaware courts have said the duty of directors "changes," from "the preservation of [the company] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit".[57] The idea that the duty must "change" to become a mandate to maximize share value confirms the general rule, which is that,

53 Ibid.

54 Schlensky v. Wrigley 237 N.E.2d 776 (Illinois App. Ct., 1968).

55 D. Gordon Smith, *The Shareholder Primacy Norm*, 23 Journal of Corporation Law,277 (1997-1998).

56 See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173 (Del. 1986); Paramount Communications, Inc. v. QVC Network, Inc. 637 A.2d 34 (Del., 1994).

57 Revlon v. Macandrews & Forbes, at 182.

absent fraud, illegality, or conflict of interest, the court will defer to the judgment of the board about what is best for the corporation in the long run.

Until very recently, judges in Delaware cases have generally used cautious language about the duties of directors outside of these two contexts, and generally tried to avoid framing cases as if there could be a direct conflict between maximizing share value and doing what is in the long run best interest of the corporation.[58] In recent years, however, some of the Delaware judges have used more pointed language, seeming to endorse the share value maximizing norm more directly. In a widely-cited case involving craigslist,[59] the classified ads website, for example, the Delaware Chancery Court observed that "there is nothing inappropriate about an organization seeking to aid local, national, and global communities by providing a website for online classifieds," but once the craigslist founders organized the firm "as a for-profit Delaware corporation" and accepted investment capital from eBay, "the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders." Although this case has been characterized as pitting shareholder value against the interests of communities, this was actually a classic case of shareholder oppression—craigslist directors Newmark and Buckmaster were the controlling shareholders in craigslist, and were managing the company in a way that completely deprived investor eBay of any benefit from its investment.

> In another case, decided in 2013, the Chancery Court said
>
> "the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants . . . .it is the duty of directors to pursue the best interests of the corporation and its common shareholders, if that can be done faithfully with its contractual promises."[60]

This case involved a small corporation in which venture capital investors all held preferred stock rather than common stock, and served on the board of directors. The venture capitalists who served on the board decided that the company should be sold, so that they could get out of their investment. So they instructed the CEO and other corporate managers to find a buyer. A deal was worked out with a buyer that provided enough cash to pay the CEO and other senior managers their promised bonuses, plus buy out all of the preferred shares at face value plus accrued dividends, but not enough to provide any payment to the common shareholders. A common shareholder sued the board, charging that the board breached its fiduciary duties because the board had an obligation to seek the best deal it could get for common shareholders. So here again, while the language sounds like shareholder primacy, the context was a situation in which the controlling investors (in this case, preferred shareholders rather than common shareholders) caused the corporation to pursue a plan that deprived the minority common shareholders of any benefit.

Neither of these cases went up to the Delaware Supreme Court, so we don't know for sure whether that court would use similar language. But neither of these cases actually raised the issue that Cassandras of short-termism are concerned about, such as a corporation forgoing an attractive investment opportunity in order to meet a quarterly

58 See, e.g., William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 Cardozo Law Review 261 (1992) (noting that Delaware courts long finessed the issue of whether spending corporate resources to benefit some constituency other than shareholders was a breach of duty to shareholders by accepting the argument that taking care of other stakeholders would be good for shareholders in the "long run.")

59 eBay Domestic Holding, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010).

60 In re Trados, Inc., Shareholder Litigation, 73 A.32 17 (Del. Ch. 2013).

earnings forecast. Instead, the fundamental issue was that controlling shareholders were depriving minority shareholders of the opportunity to participate at all in the wealth being created by the corporation—the same circumstances as in Dodge v. Ford.

Leo E. Strine Jr., a prominent and outspoken Delaware judge who was named Chief Justice of the Delaware Supreme Court in early 2014, has also taken issue in recent years with scholars and others who argue that the law does not require share value maximization, and that the law should be supportive of corporate managers who manage corporations in the interest of other stakeholders, or of society at large.[61] Strine asserts that the "business judgment rule" is conditional on directors using their authority to make profits for shareholders. "Fundamental to the rule," he says "is that the fiduciary be motivated by a desire to increase the value of the corporation for the benefit of the stockholders."[62]

Despite these exhortations, it remains clear from the decisions courts issue that managers and directors will be granted enormous deference to make and to carry out long term plans for corporations, even when those plans are not consistent with what some or all shareholders believe the corporation should do.[63] "Directors are not thermometers, existing to register the ever-changing sentiments of stockholders," Justice Strine wrote in a 2008 decision when he was Vice Chancellor. "Directors may take good faith actions they believe will benefit stockholders, even if they realize that stockholders do not agree with them."[64] Because it may not be clear whether a given action will benefit shareholders or not, in application, the rule is that as long as directors and managers are not engaging in fraud or illegal behavior, or benefiting themselves at the expense of the corporation, and they can make a plausible argument that the decisions at issue are rationally related to making the corporation more productive and profitable over the long run, courts will not second-guess their decisions.

VI. ACTING IN THE BEST INTEREST OF THE CORPORATION

Advocates of shareholder primacy are, thus, not wrong that corporate managers and directors must be attentive to shareholder value in their corporate decision-making. But directors are not required by law to engage in reckless or dangerous behavior, to cheat their customers, manipulate their accounting, exploit their workers, or reincorporate overseas to dodge taxes in hopes of improving share price. Corporate managers and directors are free to do what corporate leaders in the past generally said they did, and what the team production theory of corporate governance affirms they should do: draw on the best resources they can to carry out the corporation's vision for what it wants to achieve, then reward the team members, balancing and trading off various interests as necessary to keep the team functioning together, and as productive as it can be.

In carrying out that vision, corporate law clearly permits, and even supports corporate executives who make decisions that benefit other stakeholders, as long as there is a reasonable argument that the decisions will be good for the corporation in the long run. On February 19, 2015, for example, Wal-Mart made what many regarded as a remarkable announcement: It would immediately institute a policy of paying a minimum of $9 per hour to its workers, and would

61 See, e.g., Leo E. Strine Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 Wake Forest Law Review (2012); see also Leo E. Strine Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 Business Law, 1 (2010), at 10-11.

62 Strine, *Continuing Struggle*, at 147 — 148. Strine's larger point is that scholars and advocates should not count on corporate managers and directors to act in the best interest of society at large. Instead, the government must regulate business activities to prevent corporations from externalizing the negative effects of their reckless behavior on the rest of us.

63 See Paramount Communications, Inc. v. Time, Inc., 571 A2d 1140 (Del., 1990).

64 In re Lear Corporation Shareholder Litigation, Con. C.A. No. 2728-VCS, at 28.

increase that to $10 per hour in early 2016. Wal-Mart's stock price fell 2.5 % almost instantly on the announcement,[65] and was down 4% by the end of the day. Wal-Mart CEO Doug McMillan told reporters that the raises would boost morale among workers and improve the service provided to Wal-Mart customers.[66] If we believe that share prices efficiently reflect the long-term as well as short-term effect of such changes, the reaction of the market suggests that shareholders doubt they will benefit from this action. Neither Delaware courts, however, nor a court in any other state, would ever find Wal-Mart executives in breach of their fiduciary duties to shareholders for taking this action.

The problem of short-termism is not in our law. It is in the unfortunate lesson that our business schools and law schools have taught that fetishizes share value, in the share-price worshipping culture that has come to permeate boardrooms, and in the seductive compensation packages that tie management pay to share prices.

65 Paul Ziobro and Michael Calia, "Wal-Mart Plans to Boost Pay of U.S. Workers," *Wall Street Journal*, Feb. 19, 2015,

66 "Wal-Mart CEO: Pay Hike Will Boost Morale," CNBC, Feb. 19, 2015.

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