

SHAREHOLDER PRIMACY AND THE NEW POLITICAL ECONOMY

William W. Bratton* and Michael L. Wachter**

Many look toward enactment of items on shareholder primacy's law reform agenda to help recovery from the financial crisis. This article negates that view, arguing that the financial crisis exposes major weakness in the claims of those who favor greater shareholder power. Our claim is that shareholder empowerment delivers management a simple and emphatic marching order: manage to maximize the market price of the stock. And that is exactly what the managers of a critical set of financial firms did in recent years. They managed to a market that focused on increasing observable earnings and, as it turned out, failed to factor in concomitant increases in risk that went largely unobserved. The fact that management bears primary responsibility for the disastrous results does not by itself effect a policy connection between increased shareholder power and regulatory reform. A policy connection instead turns on a counterfactual question: Whether increased shareholder power would have imported more effective risk management in advance of the crisis. No plausible grounds exist for making such a case.

Shareholders evaluate corporations through the stock price, registering approval in higher stock prices and disapproval in lower prices. In the years preceding the financial crisis, shareholders validated the strategies of the very financial firms that pursued high leverage, high return, and high risk strategies and penalized those that did not. It is hard to see how shareholders, having played a role in fomenting the crisis, have a positive role to play in its resolution. More broadly, a crisis elevates the public interest relative to the shareholder interest in the corporate political economy, increasing the likelihood of new regulation that narrows the corporation's zone of freedom of action. With regulation comes the responsibility to comply, a burden that falls on the managers.

* Peter P. Weidenbruch, Jr., Professor of Business Law, Georgetown University Law Center, and Research Associate, European Corporate Governance Institute.

** William B. Johnson Professor of Law and Economics, University of Pennsylvania Law School, and Co-Director, Institute for Law and Economics, University of Pennsylvania.

INTRODUCTION

Corporate legal theory takes its directions from the outside political economy. Thus did shareholder primacy rise as its focal point topic during the 1980s, a time when beliefs shifted away from a political economy in which regulation moderated competitive forces to one in which competitive forces played an increasingly unregulated role. The shift followed the stagflation of the 1970s, ascribed in turn to the preceding era's regulatory initiatives. When Reagan's election ushered in deregulation and market controls, corporate legal theory followed suit. Shareholder primacy was viewed as realizing the newly competitive economy's upside potential by shifting authority from directive managers to competitive financial markets while management authority was equated with empire-building and the dismal stock market of the 1970s.

Shareholder primacy has two aspects, the first going to the objective of the corporation and the shareholders' place as legal beneficiary, and the second going to the allocation of power within the corporation. This Article takes the first as settled in favor of the shareholders and focuses on the second aspect and the structural question it poses for corporate law: Who should decide how best to maximize long term value for the shareholders' benefit, the managers or the shareholders themselves? The question holds out a choice between the inherited legal model and a shareholder-driven model driven by informational signals from the financial markets. The shareholder side contends that the inherited model fails to provide a platform conducive to aggressive entrepreneurship, instead inviting management self-dealing and conservative decision making biased toward institutional stability. It looks to a shareholder community populated with actors in financial markets for corrective inputs. Unlike the managers, who are conflicted and risk averse, the shareholders come to the table with a pure financial incentive to maximize value.

The political economy has shifted again. The framework that gave us shareholder primacy disintegrated in the fall of 2008 when the financial system seized up forcing the government to offer bailout money in order to avoid an economic collapse. The Obama administration comes to office with a program if not a mandate to regulate the markets. A question arises for corporate legal theory: Does the political economy shift underscore or undercut shareholder primacy?

At present it looks like the new regulatory regime will include shareholder agenda items. They have great popular appeal because the public blames the managers for the failure of the financial markets to deliver the promised goods. Hence giving shareholders more power to make decisions and managers less power seems a reasonable response to current problems.

This Article states the contrary case, predicting that the new era of regulation will force shareholder primacy to give way as it becomes recognized that the perverse incentives of shareholder primacy were in part responsible for the economic problem. A shareholder-based, agency model of the corporation sends management a simple instruction: Manage to maximize the market price of the stock. And that is exactly what

some managers of critical financial firm were doing in recent years. They managed to a market that focused on increasing observable earnings and, as it turned out, failed to factor in concomitant increases in risk that went largely unobserved.

There is certainly nothing wrong with risk taking so long as the risk takers internalize not only the expected higher returns but also the expected higher systematic risk. For the financial institutions judged too big to fail and apparently for others as well, risk internalization has not proved to be the case. The rescue's net costs amount to an externalization of the risks taken and an uninvited external shock to the established political economy. If downside risk cannot be internalized under the current regulatory system, then new regulation is justified.

A negative implication follows for shareholder primacy. If managers misunderstood the quantum of risks they were taking, then shareholders with more limited access to the relevant information certainly were no better informed and accordingly had no role to play in preventing externalization. Current complaints about management irresponsibility legitimately can be restated as complaints about management to the market. At the same time, the long derided management risk aversion or willingness to accept lower return in exchange for institutional stability, all of a sudden hold out advantages. Managers are risk averse because they fear losing their jobs in bankruptcy. Whereas bankruptcy is a natural element in the "winds of creative destruction," those winds blow no good when the losses are externalized to the U.S. Treasury.

The inherited legal structure of the corporation holds out a robust framework for adjustment to the new environment. Corporate law has always performed a balancing act between management discretion and shareholder power. But the balance has always privileged the directors and their appointed managers in business policy making because they are better informed than the shareholders and thus better positioned to take responsibility for both monitoring and managing the firm and its externalities. As between directors and shareholders it is the directors who have both the best access to information and are best able to serve as the monitors of the managers, increasing the likelihood compliance with continuing and emerging regulations. As between managers and shareholders, it is the managers who have the day-to-day knowledge of the company, its history, policies, opportunities, vulnerabilities, and challenges. As the outside political economy changes, it is the managers who are likely to have the information and institutional perspective suited to anticipate points of conflict and formulate a responsive strategy. As long as they remain faithful to their trust, they are best suited to maximize the value of the corporation and thus the shareholders' residual claim.

The case outlined above must confront three responses from shareholder primacy proponents: (1) shareholder authority reduces agency costs because shareholder's incentives are correctly aligned, (2) the efficiency of stock prices ameliorates the problem of information asymmetry and reliably communicates both the value of corporate policy to the shareholders and the business preferences of the shareholder to the managers; and (3) shareholder inputs enhance corporate political legitimacy, and corporate political

legitimacy becomes an issue in a time of economic failure. This Article rebuts each piece of this trptych, dismantling its depiction of a win-win combination of shareholder power and market-sensitive management.

Part I frames the debate's economic terms. We ground our conceptual case for the inherited legal model in Eugene Fama and Michael Jensen's description of the governance of publically traded corporations. For Fama and Jensen, the inherited legal model follows from an agency cost trade off. The model divides the economic rights attached to the residual claim from the power to set corporate policy, which goes to the managers, and from the responsibility to monitor the agents who execute the policy, which goes to the board. This separation follows from a natural allocation of information and expertise. It does so for the purpose of reducing the agency costs that would result if dispersed, diversified shareholders had the power to impose policy inputs. Agency costs do result, but as an embedded and inevitable result of dispersed ownership.

Part II evaluates shareholder primacy within the trade off framework, identifying serious problems. The claim of market price robustness rests on the assertion that recent advances in the stock market's informational efficiency render fluid, unaffiliated groups of shareholders well-enough informed to make wise choices on many corporate matters. Unfortunately, the stock price has two material shortcomings when viewed as a source of day to day instructions for business policy: First, stock prices are not fully informed and, second, they can be influenced by speculative factors, such as momentum effects, unrelated to fundamental value. Serious risks of unintended negative effects follow when management decisions are directed to stock price reactions. Shareholder primacy proponents must address these risks, but have not yet done so.

Shareholder primacy states its case a historically, assuming that management agency costs have a constant salience. Part III considers this insistence on agency cost reduction from an historical perspective. We suggest that shareholder inputs had a moment of high salience during the 1980s, with their importance diminishing in subsequent years along with that of the hostile takeover. The diminution follows from a dynamic pattern of response to underlying market forces, both inside boardrooms and outside in the shareholder community. Inside, management reoriented itself and adopted key points from the shareholder agenda into corporate business plans, facilitating mergers and restructurings and stepping up cash payouts to shareholders. Outside, specialist shareholder activists in hedge funds and private equity firms undertook agency cost reduction in selected target companies, working within the inherited legal framework. Although agency costs have not been reduced to zero, any disciplinary gap stemming from barriers to hostile takeovers has been substantially ameliorated.

Part IV turns to the economic crisis and corporate legitimacy. The fact that management bears primary responsibility for the crisis does not by itself effect a policy connection between increased shareholder power and regulatory reform. A connection obtains only if increased shareholder power would have imported more effective risk management in advance of the crisis. No plausible grounds exist for making such a case. Meanwhile, a crisis elevates the public interest relative to the shareholder interest in the

corporate political economy, increasing the likelihood of new regulation that narrows the corporation's zone of freedom of action. With regulation comes the responsibility to comply, a burden that falls on the managers and the directors.

Shareholder power makes a positive political contribution to the restoration of corporate legitimacy only to the extent that shareholder inputs hold out social welfare enhancement. We argue that democratic values add nothing to the cost benefit case for shareholder primacy because any linkage between maximizing shareholder wealth and maximizing social welfare is built on a pyramid of questionable assumptions. Shareholder value maximization and social welfare maximization may be viewed as congruent only within the tight confines of corporate law and shareholder-manager relations, and only then if we assume away externalities. Once we step outside the narrow, corporate law box to consider the interests of broader public, the shareholder interest provides a very poor proxy for social welfare. Shareholders are today as in the past, largely the wealthy few.

I. FRAMING THE ISSUES: THE CORPORATE LAW INHERITANCE, SHAREHOLDER PRIMACY, AND AGENCY COSTS

The inherited legal model of the corporation privileges the decisionmaking authority of the board of directors. The board, in the classic expression, wields “original and undelegated”¹ powers that follow directly from the law’s provision of the organizational form rather than from a delegation of authority from the shareholders. Even as the shareholders elect the board, they have no right to tell it what to do. They can only proceed indirectly, removing it,² or replacing it at the next annual meeting. As a legal matter directors are not agents of the shareholders.

Shareholder primacy poses an alternative regime of shareholder choice respecting matters of business policy. Under its contrasting model of the corporation, the shareholders emerge as principals in an agency relationship.³ From this point of view, the board’s decision making power stems from a shareholder delegation. It further follows that what the shareholders delegate they should also be able to withdraw.

This Article makes a policy case to support the inherited legal result. This Part lays out the basic terms of the debate in which the Article intervenes. We begin, in Section A, by contrasting the economic framework in which we ground our case with the economic framework that undergirds the case for shareholder primacy. Section B lays out shareholder primacy’s law reform agenda. Section C references the debate between shareholder primacy’s proponents and critics to isolate what in our view is the critical issue – managing to the market.

A. The Economic Stakes: Trade Off Versus Win-Win

Shareholder primacy has historical roots in *The Modern Corporation and Private Property*⁴ of Berle and Means. They famously showed that ownership and control of public corporations had separated, charging that resultant management power needed some form of significant substantive constraint.

We base our case for the inherited legal model on Fama and Jensen’s treatment of the separation of ownership from control.⁵ Fama and Jensen took what Berle and Means described as intrinsically problematic and reframed it as a rational allocation of risk bearing and decision making functions. Expertise, access to information, and complexity

¹ See *People ex rel. Manice v. Powell*, 201 N.Y. 194, 200-01, 94 N.E. 634, 637 (1911).

² Del. Gen. Corp. L 141(k).

³ See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History of Corporate Law*, 89 *Geo. L.J.* 439, 440 (2001)(asserting that legal regimes worldwide have converged on corporate law systems characterized by “shared ownership” by investors and “delegated management” to a board).

⁴ Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (Macmillan reissue 1933).

⁵ Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J. L. & Econ.* 301 (1983), hereafter cited as Fama & Jensen, *Separation*. See also Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Costs*, 26 *J. L. & Econ.* 327 (1983), hereafter cited as Fama & Jensen, *Agency Problems*.

emerge as neutral, economic explanations for what Berle and Means described in political terms as illegitimate management empowerment.

1. The Trade Off.

Fama and Jensen substitute contract for property as the mode of analysis and ask why public corporations have survived in history. They suggest that organizational contracts must perform two functions: 1) the allocation of the residual claim, and 2) the allocation of decision rights.⁶

In Fama and Jensen's depiction, shareholders contract for the right to the net cash flows, thus taking the residual claim. Decision management and decision control, in contrast, go inside the organization subject to shareholder retention of the right to vote for the board and matters reserved for their ratification.⁷ This holds out an economic advantage: the residual risk holders "are not required to have any other role in the organization."⁸ This frees them to specialize in risk bearing, leaving others to specialize in initiation and implementing business decisions and in monitoring their effectiveness.⁹ The alternative of cutting the shareholders into business decision making could be costly: "most of the diffuse residual claimants are not qualified for roles in the decision process."¹⁰ After all, wealth and willingness to bear risk do not by themselves assure needed skills.¹¹ It follows that the delegation of decision management and control to other agents is efficient.¹²

Decision rights, thus sent inside the organization, are split between two groups. The powers of initiation and implementation go to management.¹³ Thus is management separated from residual risk bearing. The reason is agency cost reduction. Given a complex business organization with knowledge diffusion, business decision making should go to agents with relevant knowledge.¹⁴ At the same time, controls need to be imposed to protect the residual claimants from expropriation by the managers. This second aspect of agency cost reduction calls for breaking out a separate decision controller to monitor and ratify management decisions.¹⁵ The two decision functions, management and monitoring, must be separate "almost by definition."¹⁶ As a result, a board of directors that includes outsiders performs the monitoring function.¹⁷ The board retains "ultimate control" over internal agents and their decisions¹⁸ and stands in for the

⁶ Fama & Jensen, Separation, supra note __, at 302. Note that this two part division of functions precisely identifies the two contested zones in corporate law's political economy.

⁷ Id. at 313.

⁸ Fama & Jensen, Agency Problems, supra note __, at 328.

⁹ Id. at 330.

¹⁰ Fama & Jensen, Separation, supra note __, at 309.

¹¹ Id. at 312.

¹² Id. at 309.

¹³ Id. at 304.

¹⁴ Id. at 307-08.

¹⁵ Id. at 309.

¹⁶ Id. at 308.

¹⁷ Id. at 313, 315

¹⁸ Id. at 313.

classical owner-entrepreneur¹⁹ of Berle and Means. Backstopping the board as agency cost controllers are a host of public and private external monitors, the courts and regulatory agencies on the public side and the stock market and the takeover market on the private side.²⁰

What becomes of ownership in Fama and Jensen's contractual model? The model, rather than separating it from control, splits it up along with control. The classical owner-entrepreneur performs all three of the functions they identify—it sets the business policy, monitors corporate agents, and bears the residual risk. Fama and Jensen take these ownership incidents and distribute them across the organization. The shareholders emerge as owners-in-part, bearing the residual risk and, as voters, sharing in control at a step removed from business decision making and direct monitoring. It follows that management and the board share in ownership. Nothing radical is implied in this sharing of ownership functions, just a contractual adjustment of the classical model that accounts for the inherited legal model as it evolved in twentieth century corporate law.

Fama and Jensen's rebuttal of Berle and Means does not by itself determine the outcome of today's contest between shareholder primacy and the inherited legal model. But it does clear noise from the screen, facilitating a meaningful statement of the policy issue. The noise comes from the conceptual legacy of unitary ownership and the teaching that ownership makes the shareholders natural principals in agency relationship. Once the noise is filtered out, the question becomes whether the allocation of authority in public corporation makes economic sense. Fama and Jensen answer in the affirmative for the reasons just given.

2. The Win-Win.

Shareholder primacy's basic claims can be accessed through Henry Hansmann and Reinier Kraakman's identification of two touchstone points that ground a general consensus in shareholder primacy's favor: First, "ultimate control" over the corporation should rest with the shareholder class, and second, the market price of the stock should provide "the principal measure" of the shareholder interest.²¹

"Ultimate control" takes us to an agency framework²² favoring shareholder inputs. The supporting economic case focuses on agency costs and incentives. All other

¹⁹ Id. at 309.

²⁰ Id. at 313. The classical owner-entrepreneur, note Fama and Jensen, still exists in unseparated form, but in close corporations. In such small, noncomplex organizations, small numbers of actors can do both the managing and the monitoring. Since such an arrangement leaves the residual claimants without protection against opportunism, residual claim holding is restricted to the actors making the decisions. Id. at 305-06.

²¹ Hansmann & Kraakman, *supra* note __, at 440-41.

²² The phrase "ultimate control" is imprecise. The assertion in the text reflects our interpretation. The legal model already vests the franchise in the shareholders and directs the board to manage in their interests. Arguably, this amounts to an allocation of "ultimate control." Hansmann and Kraakman accordingly imply more in the way of shareholder authority. To see why, contrast, Fama and Jensen, *supra* note __, at __, who assigned "ultimate control" to the board of directors, subject to the shareholder vote. This would not suffice for Hansmann and Kraakman, for whom ultimate control at a minimum means shareholder choice

things equal, agency cost reduction enhances value, and enhanced principal control conceivably can lower agency costs.²³ So the question is whether shareholders, as principals, are well-suited to provide value-enhancing inputs, or, as Fama and Jensen asserted, not well-suited.

The suitability case begins with shareholder incentives: Their capital investment²⁴ in the residual interest lends them an undiluted, pure financial incentive to maximize the value of the firm²⁵ From an incentive point of view, they contrast favorably as against managers and independent directors, whose incentives are comprised by interests in compensation and job retention.

The question then becomes whether these pure shareholder incentives can be harnessed by the governance system despite the fact that dispersed, diversified shareholders labor under information asymmetries and lack business expertise. Hansmann and Kraakman's second proposition -- that the market price of the stock provides the "principal measure" of the shareholder interest -- holds out the means to this end. If the stock price holds out an objective and accurate measure of the purely motivated shareholder maximand, it provides the best source of instructions for governance and business policy.²⁶ From this it follows that a manager-agent with correct incentives should manage to the market price.²⁷

Thus does shareholder primacy contemplate a species of market control.²⁸ It wants the price, set by actors investing at the margin, to be the ongoing and determining shareholder input. It bids those managers who are effective agents to manage to the stock market in formulating business policy, thereby accessing the high quality instruction. With the market price as the management yardstick, value-enhancing opportunities to merge, sell, or dissolve will no longer be frustrated by the managers' desire to hold on to control; resources will no longer be squandered on excessive executive pay; and governance arrangements will import appropriate constraints and incentives.²⁹ Managing to the market price also is thought to import administrative coherence, because the yardstick provides a means with which to evaluate management performance.³⁰

on tender offers, trust-based outcomes favoring management discretion being inefficient. *Id.* at 467. Even as today's shareholder agenda goes much farther, the term "ultimate control" easily accommodates it.

²³ See Committee on Capital Markets Regulation, Interim Report 93, Nov. 30, 2006 (asserting that shareholder rights serve the "critical function of reducing agency costs," and that inadequate shareholder rights cause shares to trade at a discount to fundamental value).

²⁴ Holmstrom & Kaplan, *supra* note __, at 138.

²⁵ Hansmann & Kraakman, *supra* note __, at 449.

²⁶ Holmstrom & Kaplan, *supra* note __, at 138 (noting that the price follows from actors putting their money where their mouths are). See also George W. Dent Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 *Hou. L. R.* 1213, 1226 (2008) ("No measure is better.").

²⁷ This Article continues a line of analysis that begins in Michael L. Wachter, *Takeover Defense when Financial Markets Are (Only) Relatively Efficient*, 151 *U. Pa. L. Rev.* 787 (2003).

²⁸ See Committee on Capital Markets Regulation, *supra* note __, at 16 (asserting that strengthened shareholder rights go hand in hand with reduced regulation and litigation).

²⁹ Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 *Harv. L. Rev.* 833, 840, 850 (2005)

³⁰ Holmstrom & Kaplan, *supra* note __, at 139.

Value maximization pursued with a long-term time horizon is said to follow.³¹ Here the proponents refer to basic principles of valuation, which teach that long-term value is impounded in the present market price.³² It follows that managing to the market price is incentive compatible so far as concerns the time horizon because both short term and long term investors both have incentives to maximize long-term value.

A diagnosis of shortcomings in the inherited model follows. Managers and their monitors do not possess pure financial incentives. The model fails to confront and correct this shortcoming when it relies on the filter of an independent board of directors to channel shareholder views about maximization and stock price inputs into business policy. The absence of a means to force adherence to the market yardstick allows the independent board to fall back on a range of more amorphous, manipulable factors³³ as it monitors. Accountability suffers,³⁴ leading to inefficient regulatory responses, including shareholder litigation.³⁵ Therefore, systemic reform to facilitate shareholder intervention is appropriate because the inherited model affords management discretionary space to disregard the price directive.

Summing up, shareholder primacy seeks to reform the Fama and Jensen corporation so as to assure that shareholder inputs directly impact both business decisionmaking and monitoring. The supporting theoretical case rests two assumptions, first, that business instructions following from pure financial incentives have agency cost reductive effects, and, second, that the market price accurately communicates these instructions.

B The Law Reform Agenda.

Shareholder primacy's law reform agenda took shape in response to the takeover wars of the 1980s. State lawmakers, in particular the Delaware courts,³⁶ responded to the

³¹ Hansmann & Kraakman, supra note __, at 451.

³² Bernard Black & Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search for Hidden Value, 96 Nw. U. L. Rev. 521,522 (2002).

³³ Michael C. Jensen, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 14 J. Applied Corp. Fin. 8, 10-12 (2001).

³⁴ Committee on Capital Markets Regulation, supra note __, at 96; Dent, supra note __, at 1226.

³⁵ Committee on Capital Markets Regulation, supra note __, at 16.

³⁶ The question went to the terms of fiduciary review. It took a decade and four famous cases before the Delaware courts delivered a definitive answer respecting the scope of the fiduciary duty. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2D 946 (Del. 1985)(applying proportionality scrutiny to management defensive tactics); *Moran v. Household Int'l, Inc.* 500 A.2d 1346 (Del. 1985)(sustaining the poison pill as a structural matter and applying *Unocal* scrutiny); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990)(sustaining the "just say no" defense of the business plan); *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995)(ruling that refusal to redeem a poison pill survives review if neither "preclusive" nor "coercive" and falls within a "range of reasonableness"). When the answer finally came, trust trumped agency, with hostile offerors being forced to resort to the shareholder franchise in the from of a proxy fight for board control in order to put to the shareholders the choice between the offer price and management's claim that its business plan held out greater value on a long term basis. That is, the board was left with the power to block offers to protect the business plan; remitting the zone of protected shareholder choice not to the market for shares but to the exercise of the franchise. See Ronald J. Gilson &

outbreak of hostile activity by restating and reinforcing the inherited model's allocation of authority to management. Shareholder primacy coalesced as a protest against that outcome. It was a context ideally suited to the shareholder case. Recall that Fama and Jensen defended the inherited model on the assumption that a vigorous control market operated as a check on subpar managers.³⁷ Now courts and legislatures had impaired that market's operation. Moreover, the takeover context minimized the importance of the shareholders' debilities respecting information and expertise. Primacy for shareholder business instructions was being claimed only with respect to the narrow set of issues presented by a contested control transaction. In the information enriched environment created by the disclosure requirements of a contested battle for control, shareholders were deemed informed enough rationally to choose between the value of two or more competing corporate strategies. A clear cut valuation issue was joined because, by definition, at least of one of the strategies was defined in terms of an offer on the table at a premium to the market price.³⁸

Furthermore, shareholders were seen as having been on the right side of the era's valuation questions. The capital markets emerged from the 1980s with a much enhanced reputation as drivers of productivity. The era's corporate restructurings were deemed to have been a productive success. It followed that capital markets had a comparative advantage over appointed managers in effecting structural reforms necessitated by deregulation and technological change.³⁹ Firms tend to be expert in existing technologies, products and processes. Markets, it is argued, have the advantage when it comes to recognizing the implications of new technologies, products and processes. Thus do markets not only move capital to higher valuing users, the new users put the capital to more productive projects.⁴⁰

Shareholder primacy accordingly emerged from the takeover era as corporate law's theory of choice. Its list of agenda items continued to grow during the period of institutional adjustment that followed. The shareholders, dissatisfied with the legal outcome and led by now-dominant institutions, lost their passivity. "Governance" became a zone of ongoing engagement between managers, institutional shareholders, and a new class of professional intermediaries. Independent boards of directors assumed greater institutional salience.⁴¹ Even so shareholder empowerment remained elusive.⁴²

Alan Schwartz, *Sales and Elections as Methods for transferring Corporate Control*, 2 *Theoretical Inquiries in L.* 783, 788 (2001). More particularly, an offeror facing a board refusal to redeem a poison pill had only a slim chance of successfully making a case for breach of fiduciary duty. Its recourse lay instead in a subsequent proxy fight for board control.

³⁷ See *supra* text accompanying note ____.

³⁸ The Delaware courts disagreed even so, channeling the contested control transaction into the even richer information environment of the proxy contest. *Cite to Time Warner*

³⁹ Holmstrom & Kaplan, *supra* note ___, at 122. We note that while Holmstrom and Kaplan expect the 1980s experience of market advantage to persist over time, they also acknowledge the possibility of changed conditions under which market price guidance could lose its productive quality. *Id.* at 139.

⁴⁰ *Id.* Cf. Bebchuk, *supra* note ___, at 451 (noting that shareholder input will favor aggressive development of new product markets and abandonment of inefficient investments).

⁴¹ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 *Stan L. Rev.* 1465, 1511 (2007).

The implication for shareholder primacy was clear. Its agenda, which started out with takeover related issues,⁴³ needed to be expanded. If the shareholders could not surmount collective action problems themselves, then law reform directed to lowering the costs and expanding the payoffs of shareholder intervention made sense. Today, shareholder primacy's law reform agenda serves these dual purposes.

Proposals on the agenda fall into two categories. The first, narrower category accepts the inherited legal model and focuses on process reforms designed to expand the range of shareholder choices in the election process and facilitate shareholder contests. The second type would give the shareholders the option to legislate their way out of the inherited model to an agency model holding out direct control of business policy. Cost concerns are pervasive in both categories. Some reforms are designed to enhance the impact of existing low cost activist strategies like "just vote no" campaigns. All of the rest include outright subsidies to intervening shareholders.

The list of improvements proposed for the present election system is lengthy. The first items are designed to facilitate rejection of selected candidates and protest voting. These include majority (as opposed to plurality) voting and confidential voting, both of which already have been adopted voluntarily by many corporations.⁴⁴ The reformers want shareholders to have the option of a "no" vote (as opposed to the present "withhold vote" expression of negativity) and a right to replace all incumbents every two or three

⁴²The post takeover era had begun with a vision of direct institutional investor control through aggressive use of the shareholder franchise. It was hoped that institutional holdings had reached a level of concentration that would render collective action barriers surmountable. Black, Shareholder Passivity. But collective action barriers, far from yielding, emerged in the new environment much reinforced. The free rider problem continued to discourage investment managers from incurring the costs of governance challenges – gains that must be shared with competitors who do not share the costs do not advance investment manager careers. Rock, Geo. L. J. At the same time, many fund advisors sell services to managers, importing an independent business reason to stay cooperative. See, e.g., Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735, 1750-54 (2006)(describing the incentive problems of financial institutions). Finally, mutual fund investors can redeem at any time, inhibiting investment in large, illiquid blockholder positions that would carry boardroom influence.

Shareholder primacy proponents investigated alternative routes, none of which proved satisfactory. For example, it was suggested that institutional investors could organize on a subscription basis and fund correctly incentivized candidates for board seats. Gilson & Kraakman But no such movement to self help by spontaneous order occurred. As a still further alternative, it was suggested that blockholding along European or Asian lines could ameliorate agency costs here. See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 223-24 (1994) Gilson & Kraakman, MVIC. But, it turned out that the incentives that supported blockholding abroad could not be replicated domestically. Path dependencies within the system retarded its adaptability. At the same time, blockholding in other countries followed from their different political environments, in particular their stronger social democratic systems. See Lucian A. Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership & Governance, 52 Stan. L. Rev. 127 (1999); Mark J. Roe, Chaos and Evolution in Law & Economics, 109 Harv. L. Rev. 641 (1996). See also, Bratton & McCahery, Colum Transnat'l (looking to systemic integrity to account for the absence of convergence).

⁴³ Shareholders can be counted on to vote against antitakeover amendments and in favor of poison pills. See Marcel Kahan & Edward I. Rock, How I Learned to Stop Worrying and Love the Pill: Adoptive Responses to Takeover Law, 69 U. Chi. L. Rev. 871, 898 (2002).

⁴⁴ Cite

years.⁴⁵ Other provisions hold out more in the way of power shifting. They would clear a way for shareholder nomination of board candidates, not only by opening access to the proxy statement but by providing for reimbursement of solicitation expenses.⁴⁶ Whether such reforms would merely “facilitate” or outright “encourage” shareholder candidacies would have to be worked out in details respecting qualification hurdles.

The second legislative category is more radical. The shareholders already have the power to amend the by laws under state codes.⁴⁷ But, even cabined in a tight zone of process-based subject matter,⁴⁸ the power has been unexercised because shareholders lack subsidized access to the proxy statement to put a by law amendment to a shareholders’ meeting and state law power to trump contrary board-adopted by laws. The reformers would grant both.⁴⁹

At the same time, there are definite limits on what can be accomplished through by law amendment. By laws are limited to process matters and cannot surmount the reservation to the board of the power to manage the business, a reservation read broadly by the Delaware courts.⁵⁰ Only a charter amendment can delimit the board’s powers, and state corporate codes accord the board agenda control over charter amendments.⁵¹ The agency reformers accordingly would open the door to shareholder initiated charter amendments and accord power to initiate a change of jurisdiction of incorporation, with expense reimbursement.⁵² They contemplate that once the door is opened, shareholders can allocate to themselves the power to force a sale or liquidation of the firm,⁵³ or to force large dividend (and the leveraged financing thereof) or subsidiary spin off.⁵⁴ Present proposals respecting business policy stop at this point. But we note an implicit

⁴⁵ Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 699-702 (2007).

⁴⁶ *Id.* at 696-700 (noting that threshold requirements would be needed).

⁴⁷ Del. Gen. Corp. L. 107.

⁴⁸ See *supra* text accompanying note ____.

⁴⁹ Bebchuk, *supra* note ___, at 707-11. In 2007 the SEC advanced two proposals which seemed to point in opposite directions. The first “allow[ed] shareholders holding 5% or more of a company’s shares to propose bylaw amendments that establish procedures for enabling shareholder nominees to be included in a company’s proxy statement.” See Fairfax, at 77. In the second, the commissioners voted to “forbid shareholders from putting forth proposals related to board elections or nominations.” *Id.* Each decision lead to a different result for proxy access: one would grant shareholders access to the ballot while the other would deny it altogether.. In December of 2007, the Commission decided to support the second proposal, which effectively denied shareholders access to the ballot. See *Shareholder Proposals Relating to the Election of Directors*, 72 Fed. Reg. 70,450. While this decision seemed to signal the end of the debate, there is still some question as to how long it will stand. Shortly after its December decision, SEC Chairman Christopher Cox committed to reexamine this issue once the vacant seat on the commission was filled (this is currently the case). *SEC nixes proxy access, with revisit seen in '08*, December 3, 2007, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20071203/REG/712030314/1004/TOC>. SEC Commissioners continue to cite the importance of action on shareholder proxy access in speeches. See Commissioner Elisse B. Walter, “*Restoring Investor Trust through Corporate Governance*” — *Remarks Before the Practicing Law Institute*, Feb. 18, 2009, available at: <http://www.sec.gov/news/speech/2009/spch021809ebw.htm>

⁵⁰ See *supra* note ____.

⁵¹ See *supra* notes ____ and accompanying text.

⁵² Bebchuk, *supra* note ___, at 865-70.

⁵³ *Id.* at 895-96.

⁵⁴ *Id.* at 900-08.

open end. Once any door to reversal board business judgment is opened, there will be no principled basis for containing shareholder mandates respecting business policy.

“Say on pay” initiatives similarly would allow the shareholders to cross the line to control of business policy, but in ratification mode and on a mandated annual basis. Here the idea is to put the top executives’ total compensation package to the shareholders for an up-down vote.⁵⁵

Summing up, the reform agenda reflects the view that history has denuded the inherited model of plausibility. By hypothesis, it remained defensible only so long as collective action problems rendered shareholder exercise of discretionary powers infeasible. But, as we have seen, concentrated institutional shareholdings have not by themselves removed this barrier. Accordingly, if the legal firm is to be reconstituted along agency lines,⁵⁶ the shareholder collective action must first be solved by changing the terms of shareholding itself, through a system of subsidies for activists. That accomplished, shareholder primacy would accord the shareholders the power to opt out of the inherited model firm by firm.

C. Questions and Answers

Others already have raised questions about the shareholder agenda. They point out that the pure financial incentives posited by agency model proponents will not obtain in all cases, whether the shareholders in view are activist interveners or passive voters, and even assuming subsidization. Some investors, particularly pension funds, labor unions, and social investors, have separate governance agendas unrelated to market price maximization or have different views as to the corporate policy that best maximizes shareholder value.⁵⁷ Others will seek inside access in order to wrest private benefits from the firm.⁵⁸ Still others will have incentives skewed by hedged positions.⁵⁹

The shareholder response to these questions relies on virtues of democratic process. Any activist motivated by selective incentives will need to persuade a majority of the body as a whole, a group that will not be inclined to approve items on value-destroying private agendas.⁶⁰ Self-dealing transactions effected by shareholders who

⁵⁵ Precatory shareholder proposals to this end have appeared in increasing numbers in each of the last the last three proxy seasons. The class of 2008 included 90 companies. The average vote in favor was 43.1 percent. Six proposals garnered majority votes. See Anne Moore Odell, *Executive Pay Weights Heavily with Shareholders*, socialfunds.com, available at <http://www.socialfunds.com/news/article.cgi/2516.html>. A House bill providing for a non binding shareholder vote passed in 2007; H.R. 1257, 110th Cong., Apr. 20, 2007. The Senate companion remains tied up in committee. S. 1181, introduced Apr. 20, 2007.

⁵⁶ Cf. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 608 (1990) (noting that shareholder voice is an idea that has never been tried rather than an idea that has failed).

⁵⁷ Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 588-90 (2006).

⁵⁸ *Id.* at 577, 586-88. See also *id.*, at 594-96, presenting a hypothetical case where private benefit seeking causes voting shareholders to reject a project with a positive net present value.

⁵⁹ *Id.* at 591-92.

⁶⁰ See, e.g., Bebchuk, *supra* note ____.

succeed in acquiring inside influence present a separate problem, a problem dealt with by the same fiduciary rules that presently constrain directors and officers.⁶¹

In our view, this response suffices. Selective incentives and self-dealing will remain a problem whatever the prevailing model. Fiduciary law imports effective constraints for many of the problems that would arise due to shareholder empowerment under an agency regime. Other problems will have to be dealt with case by case, just as occurs under the present system.

A second line of questions addresses the residuum of collective action problems that will persist even given subsidies to activists. For example, modern portfolio investors are fully diversified and own a market capitalization weighted index of all the stocks in the market. They remain rationally apathetic, lacking specialized information about individual companies and having no time to vote deliberatively on the enormous number of propositions put to them in the proxy statements of their portfolio companies. Although some may follow recommendations from market intermediaries, others will simply vote with management, particularly if satisfied with the stock's performance. Nor is it clear that credible shareholders will emerge to take leadership roles.

One can only lead the horse to the water: Changing the legal model to facilitate shareholder intervention does not assure that shareholders will find it cost effective to intervene or deliberate carefully in the wake of intervention.⁶² The proponents acknowledge this point.⁶³ They have two answers. First, the subset of institutions that seek to outperform the indexes will have an incentive to vote deliberatively on activist proposals. Second, and more importantly, the threat of intervention by itself will influence management conduct; managers will focus on the stock price in order to avoid triggering destabilizing and disempowering shareholder action.⁶⁴

We think the two answers are cogent. But they give rise to questions in turn. As to the first answer, deliberative voting on the part of a significant subset of institutions does not solve the problem of asymmetric information. We will show in Part II that this informational imbalance is unavoidable given public trading and a dispersed group of shareholders. How then can business policy be determined at a shareholders' meeting? Shareholder proponents admit a problem and make two points in an attempt to minimize its impact. First, they argue that information asymmetries respecting business policy matter little as regards process and structure amendments, such as removal of a staggered board or a poison pill.⁶⁵ Second, in the context of a shareholder challenge to a previous specified decision, they argue that management will get the opportunity to state its more particular informational case during the course of the ensuing trial by proxy context.⁶⁶

⁶¹ Cite.

⁶² Anabtawi, *supra* note __, at 569-71.

⁶³ See, e.g., Bebchuk Kahan Cal. 1991.

⁶⁴ Bebchuk, *supra* note __, at 878.

⁶⁵ Bebchuk, *supra* note __, at 881.

⁶⁶ Bebchuk, *supra* note __, at 893.

These answers are insufficient. Informational enhancement generated in the course of a proxy contest by no means positions shareholders to make business policy. Nor is it enough to cite the expected proposals' focus on process and structure. This point gets us to our questions respecting the second answer above, which correctly projects that even threatened intervention influences management conduct. Process and structure initiatives, once promulgated, would serve the primary purpose of enhancing the threat. They hold out sticks pointed at boardrooms on a going concern basis to assure that managers and directors formulate and execute business plans to satisfy shareholder interests and forestall actual use of the stick. Returning to shareholder primacy's theoretical assumptions, that means managing to the market price. So doing makes sense only if the market price provides a reliable basis for formulating business policy, a proposition we will address in Part II.

II. SHAREHOLDER PRIMACY'S AGENCY COST: MANAGING TO THE MARKET

A. Information Asymmetry

1. The Governance Trade Off.
2. Idiosyncratic Volatility
3. Summary.

B. Market Mispricing

C. Managing to the Market under Asymmetric Information and Market Mispricing

1. Underpricing, Investment Policy, and Earnings Management.
2. Overpricing, Investment Policy, and Earnings Management.
3. Summary.

D. Implications

III. THE SHAREHOLDER AGENDA AND THE INHERITED LEGAL MODEL

A. The Market for Corporate Control and Corporate Governance

B. New Blockholders: Hedge Funds and Private Equity

C. Cash Payouts

D. Summary

IV. SHAREHOLDERS, MANAGERS, MARKETS, AND GOVERNANCE IN A CHANGING POLITICAL ECONOMY

Two years ago, the shareholder primacy agenda figured prominently in a well-publicized law reform agenda presented by the Committee on Capital Markets Regulation, a private group concerned with the competitiveness of U.S. capital markets. Enhanced shareholder rights, said the Committee's Report, provide accountability and accountability means lower agency costs and higher market prices, and accordingly, a more competitive equity marketplace.⁶⁷ Strong shareholder rights also invite more dependence on shareholder discipline, and less on regulation and litigation.⁶⁸

The financial collapse of 2008 materially changes the environment in which we evaluate the shareholder agenda. Where the Committee invoked market discipline, today's questions go to the terms of new regulatory initiatives motivated by market failure. The shareholder agenda nonetheless gains political traction because it promises more management accountability. To illustrate this mode of reaction, we note the comments of former SEC Chair Arthur Levitt on the meltdown in the financial sector,⁶⁹ still in its early phase when he wrote in the summer of 2008. For Levitt, the subprime collapse, the Bear Stearns implosion, and revelations of poor risk management at large financials had "injected a large degree of mistrust into the markets." Managers and boards should have raised the alarm. Enhanced shareholder voice, while "not a panacea . . . would go a long way in helping to restore trust."⁷⁰

Certainly the managers who now have to rely on government largesse to keep their companies operating bear primary responsibility for the precipitating decisions. In the eyes of many, their shareholders emerge as the primary bearers of losses incurred and thus invite characterization as victims. The prevailing picture of management culpability already has imparted political traction to the "say on pay" initiative.⁷¹ The sense of an urgent need for reform could lend forward motion to other items on shareholder primacy's reform agenda.

This Part offers an alternative analysis, making three points. First, the simple ascription of primary responsibility to management does not suffice to support a positive policy connection between increased shareholder power and regulatory reform in the financial sector. Any policy connection instead turns on a counterfactual question:

⁶⁷ Committee on Capital Markets Regulation, *supra* note __, at 16. The Committee's Report focused on shareholder ratification of poison pills adopted by a staggered board, majority voting for boards of directors, shareholder access to nominate directors, executive pay, and contractual alternatives to litigation. *Id.* at 16-18.

⁶⁸ *Id.*

⁶⁹ Arthur Levitt, Jr., How to Boost Shareholder Democracy, *Wall St. J.*, July 1, 2008 at A17.

⁷⁰ *Id.*

⁷¹ See Maria Bartiromo, Barney Frank on Detroit, Housing, and Executive Pay, *Bus. Wk.*, Dec. 22, 2008, at 17 (predicting passage); American Recovery and Reinvestment Act of 2009, __ Stat. __, §§ 7000-7002 (limiting incentive payments to the CEO and 20 next highest paid executives of large TARP recipients other than restricted stock not to exceed one-half of the executive's salary (other than payments required under earlier contracts), and prohibiting golden parachutes and defined "luxury" expenditures, and mandating "say on pay" votes);

Whether increased shareholder power would have imported more effective risk management in advance of the crisis. In our view, no plausible grounds exist for making such a case. In fact, we argue that a more plausible answer to the question is that a legal model including mandatory shareholder inputs would only have exacerbated the problem. There is no evidence that the shareholders were trying to reign in the managers prior to the market break. Instead, bank stocks increased so much in price as to become a larger component of the overall market (as measured by the weight of financial stocks in the S&P 500).

Second, crisis elevates the public interest and triggers regulation that narrows the corporation's zone of freedom of action. In such times, as between directors and shareholders, power flows the managers' way. With regulation comes the responsibility to comply, a burden that falls on the directors. The more intense the regulatory shock, the more irrelevant the shareholders become. For authority, we draw on Berle and Means, writing in anticipation of new regulation during the economic crisis of the early 1930s.

Third, depending on the depth and duration of this crisis, shareholder primacy's conceptual underpinnings could come up for fundamental review on the merits. The pure financial incentives that advantage shareholder inputs in expansive, deregulatory times register equivocally in the face of public demands for control of market risk taking. In a time of increasing regulation, shareholder inputs improve the alignment of corporate business decisions with the external political environment only to the extent that they mirror the preferences of the public as a whole. Past commentators have made this claim for the shareholder voice, attributing to it democratizing properties. We refute this claim by reference to data on shareholder income levels. As an economic matter, shareholders do not proxy for the public.

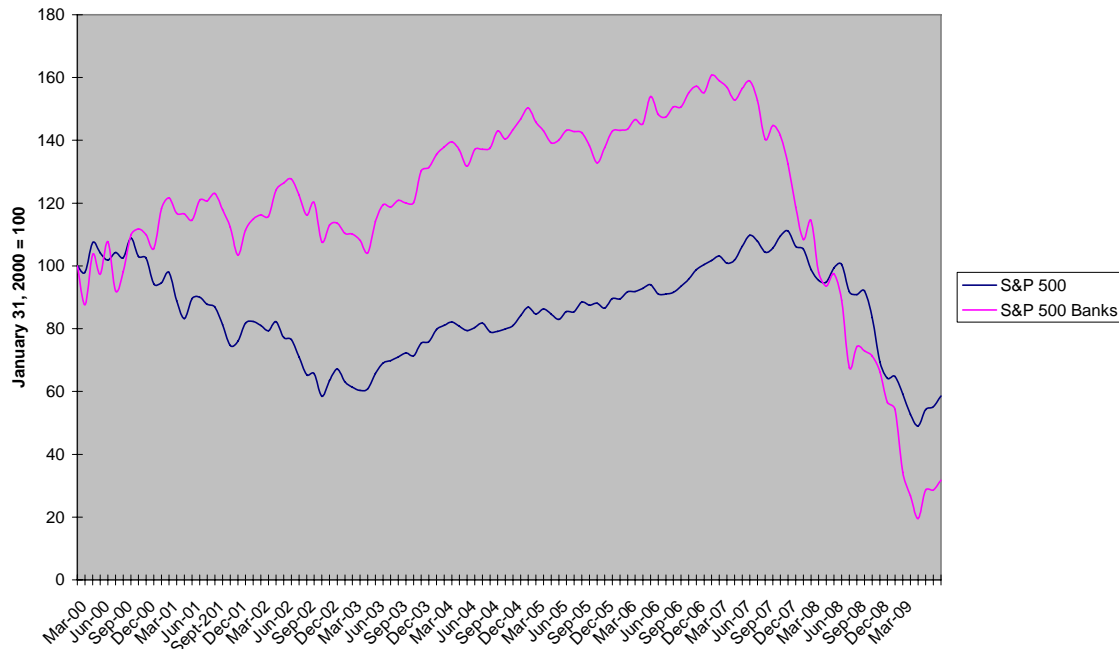
Section A reviews the financial crisis through the lens of shareholder value, highlighting a place for managing to the market in the chain of causation. Section B assesses shareholder primacy's place in the present political economic context. Section C considers and rejects the notion that advancing shareholder interests enhances social welfare.

A. Financial Risk and Shareholder Inputs

Figure II tracks the performance of the subset of bank stocks included in the S&P 500 index against that of the S&P 500 from January 2000 to March 2009. Prior to the autumn of 2007, the banks handsomely outperform the market as whole, albeit in a rough correlation with its ups and downs. They then undergo a precipitous fall that presages and outstrips that of the market as whole, which begins a year later. Of course, keep in mind that the S&P 500 line has a 20 percent financial sector weight by 2008. Hence, the S&P 500, excluding finance, neither rose as much as the line indicates, nor did it fall as much. Economic recessions and stock market declines are not equally weighted across the sectors of the economy. The upturn in stocks after the dot.com bust and then the

recent decline were heavily weighted by shareholders first falling in love and second, falling out of love, with the dominant firms in the financial sector.

Figure II: S&P 500/S&P 500 Banks, 2000-2009



The market favored the banks during the good years because they were profitable, enjoying wide spreads between returns on lending and the cost of capital. Their problem, which became more and more apparent in 2007, was that high yield loans into the subprime mortgage sector were much riskier than had been appreciated: Securitization⁷² had turned loans to marginal or poor credits into AAA paper on the assumption that the price of the real estate securing the loans would continue to rise.⁷³ Although Figure II depicts the banks' stock prices more in the mold of a highly favored sector than in the mold of an asset price bubble, the real estate securing many of the loans in the banks' portfolios did experience the peak and burst of a price bubble during the period in question.⁷⁴

The stock market failed to appreciate the risks held out by the sector. In our view, the lack of appreciation can be traced to the information asymmetry problem described in Part II. As we there noted, markets can easily fail to measure the risk factors incorporated into discount rates. What was unusual here was the magnitude of the underestimation.

⁷² See Stephen Schwarcz, *The Alchemy of Asset Securitization*, 1 *Stan. J.L. Bus. & Fin.* 133 (1994).

⁷³ See, e.g., Floyd Norris, *Market Shock: AAA Rating may Be Junk*, *N.Y. Times*, July 20, 2007, at C1.

⁷⁴ See, e.g., Andrey D. Pavlov & Susan M. Wachter, *Subprime Lending and House Price Volatility*, *U of Penn. Inst for Law & Econ Research Paper No. 08-33*, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316891. (establishing a theoretical and empirical link between recent use of aggressive mortgage lending instruments, such as interest only, negative amortization or subprime, mortgages and the underlying house price volatility).

Exactly how this occurred is beyond the scope of this paper, but a brief example may be useful. Banks historically have been low beta stocks. Operating with less leverage than recently has been the case, their profitability turned on the spread between borrowing and lending rates. Since one does not generate enormous returns on this spread, the banks were hardly high flying firms. Furthermore, by historically matching the duration of their assets with their liabilities, they contained their risk, and hence their returns.

This all changed as some banks became more involved in buying and selling securitized assets and began to operate with more leverage. This change in corporate policy meant a move to greater expected return and greater risk. In the stable economic environment of the last several years, those banks generated much higher profits with little volatility.

The stock market accordingly fell in love with certain financial institutions since they combined unexpectedly high returns and apparently constant low risk. Higher stock prices resulted. For a management dedicated to maximizing shareholder value, the instruction manual was clear: Get with the program by getting into securitized markets and doing so with more leverage. Any bank whose managers failed to implement the new math of high returns and low beta got stuck with a low stock price. Given increasing industry concentration, such a bank made for an attractive merger target.

As long as the economy was expanding the strategies worked well. But when the economy slowed the higher risk of the bank's business strategy became observable. High returns went along with higher risk after all and the realization caused stock prices to fall. But just how much risk was embedded in the business strategy? Was it enough to make the banks insolvent if the recession was steep? In 2007, investors and regulators both suddenly needed to know the risk embedded in the balance sheets of financial companies.⁷⁵

Now let us turn back the clock to 2005 to hypothesize a newly appointed CEO at a large bank pursuing the new high leverage policy. How would this actor evaluate the policy, in particular the bank's structured investment vehicle (SIV)?⁷⁶ The stock market was sending a strong signal that the shareholders loved the new approach. This is the mechanism through which managing to the market sends perverse message to directors and managers. If the CEO is shareholder sensitive, he or she views the SIV as a terrific

⁷⁵ See, e.g. Michael Tsang & Rachel Layne, Nobody Says Mark to Market Doesn't Matter as GE Falls (Update2), Bloomberg, March 10, 2009 available at: <http://www.bloomberg.com/apps/news?pid=20601109&sid=aanSIg9Vo6hA&refer=home> (explaining the connection between GE's limited employment of mark to market accounting and the steep fall of its stock price).

⁷⁶ The SIV is an off balance sheet entity that invests in securitized subprime mortgages, financing its portfolio with a mix of short term commercial paper and intermediate term notes. See Joseph R. Mason, Structuring for Leverage: CPDOs., SIVs, and ARSs, at 9-13, working paper, November 2008, available at: <http://ssrn.com/abstract=1288051>.

strategy. The CEO might even have gotten to that position by pushing this levered strategy as the bank's COO or CFO. If that is the case, then the bank's fortunes are set.

However, suppose the new CEO comes from outside of the bank and subscribes to the old adage that borrowing short to invest long is a risky thing to do. More specifically, our new CEO perceives risks held out by the mismatched maturities between the assets and liabilities, which in turn imply balance sheet risk for bank due to the SIV's dependence on continued financing in the commercial paper market. In the CEO's analysis, all depends on the future of the subprime mortgage market, a new, highly risky sector with no downside track record, expanding in the midst of a price bubble. The new CEO accordingly decides that borrowing short to invest long is too risky in this case and orders the SIV dismantled, selling off the securitized mortgages at a slight loss and incurring other transaction costs.

Does the CEO's insightful move improve the stock price? Certainly, the bank is forced to lower its earnings forecast substantially, but it can presumably adequately explain the development as a return to a lower risk corporate strategy that it believes will pay off when the economy cools and the returns on the SIV turn negative. But why presume that the market will be informed by the new CEO. Instead, the new corporate policy is unlikely to be rewarded precisely because the stock market believes the existing corporate strategy is the correct one – hence the rising stock price. More likely, the bank's stock price drops substantially and the managers' stock options are underwater.

Now return to the question asked at the beginning of this Part: Whether increased shareholder power might somehow have moderated the bank's risky business practices. The answer is no for the reasons briefly outlined above. Managers and shareholders shared the high returns and so their interests, broadly speaking, were aligned in favor the strategies responsible.⁷⁷ Because stock prices proved insensitive to the risks undertaken, they failed to provide an objective, critical reference point for monitoring purposes. To the contrary, stock prices confirmed the strategies until well past the point of no return.

There is nothing new about this phenomenon. Buoyant markets have a way of bringing forth classes of investment or investment strategies that with the benefit of hindsight appear overpriced or in some cases can be characterized as market bubbles. In the 1920s the investment was common stocks bought on margin. In the early 1970s it was the Nifty Fifty growth stocks. Later in that decade it was companies that owned commodities whose prices were thought forever to be rising due to diminishing supplies. In the late 1990s it was the new economy stocks. Whether expectations were simply too high or the stock prices went into a bubble feedback loop is unimportant to our conclusion. It is the market participants' expectations – that is, the corporation's shareholders – that cause the bubble or to the exuberant expectations. Having caused the high stock prices by buying into the strategy, the shareholders are poorly equipped to solve it.

⁷⁷ For a formal model of this, see John H. Doyd & Hendrik Hakenes, *Looting and Gambling in Banking Crises*, at 19, working paper 2008, available at:

It is accordingly difficult to agree with Arthur Levitt that increasing shareholder power by itself enhances trust. The high risk-high return strategies undertaken in the financial sector were undertaken to enhance return on equity and raise stock prices.⁷⁸ The executives who undertook them were compensated with stock options and restricted stock in addition to cash bonuses, and so had incentives roughly in alignment with those of their shareholders.⁷⁹

The inference does arise that equity-based compensation incorporating long-term holding constraints should dominate cash bonuses in incentive compensation schemes at financial companies. We note that a compensation package thus designed would enter a wedge into the manager-shareholder incentive alignment, for market liquidity leaves the shareholders free to cash out at will.

B. The New Policy Context

Financial collapse reorients policy agendas. Is the shareholder primacy agenda helped or hurt by these developments? As noted above, there is still a clientele who believes that market exuberance can be fixed by giving shareholders more say. But there is an alternative story that goes in the opposite direction. To tell it, we turn to Berle and Means.

As we noted in Part I, the Berle and Means separation of ownership and control survives as shareholder primacy's conceptual ancestor. For its originators, writing in 1932, the implications were different. In a time of depression, they wrote, empowered managers must attend to the claims of the community, once "put forward with clarity and force."⁸⁰ Management for the "sole benefit of inactive and irresponsible security owners"⁸¹ no longer was acceptable and the "doctrine of strict property rights" would have to yield. Even as they subscribed to the notion that the legal corporation amounted to a trust for the shareholder's benefit,⁸² they did not, given a crisis, ask the managers to pay closer attention to the shareholders' interests.

What Berle and Means envisioned in 1932 was not corporate socialism but a new regulatory state with which managers of necessity had to cooperate. They wrote at a moment of transition. We may be similarly situated today. New relational patterns are emerging. Actors in the government are beginning to see the government as having some ownership claims of the banks funded by the TARP. As such they deem it appropriate

⁷⁸ See, e.g., William D. Cohan, A Tsunami of Excuses, N.Y. Times, Mar. 12 2009, at A23.

⁷⁹ The mix between stock options, restricted stock, and cash bonus varies from company to company and executive to executive with each company. Compare Citigroup Inc. Schedule 14A, filed March 14, 2006 at 39-52, available at:

http://idea.sec.gov/Archives/edgar/data/831001/000119312506053761/ddef14a.htm#toc42986_25, with Bank of America Corporation, Schedule 14A, filed March 20, 2006, at 22-26, available at:

http://idea.sec.gov/Archives/edgar/data/70858/000119312506058636/ddef14a.htm#toc36503_26. Citibank shows a heavier weighting to cash bonuses, Bank of America relied more on stock options.

⁸⁰ Berle & Means, *supra* note __, at [310,312].

⁸¹ *Id.* at [311].

⁸² See *supra* text accompanying note __.

for the government to generate instructions respecting business operations and for bank managers to respond by redirecting operations in directions indicated by public policy.⁸³

If the pattern persists, negative implications follow for shareholder primacy. Managers will still be charged with maximizing corporate profit, but will have to do so in new framework determined and constrained by whatever new regulations are instituted.⁸⁴ For example, we may see a tension between the pure, risk neutral financial incentives that shareholders bring to the corporate governance table and a new risk adverse regulatory atmosphere.⁸⁵

Stepped up regulatory demands bring the managers, not the shareholders, to the forefront. Berle saw this quite clearly in a speech he (and his wife Beatrice) wrote for Franklin Roosevelt during the 1932 presidential campaign: in the regulatory environment, said Berle, “the day of the manager has come.”⁸⁶ New regulations do more than constrain the corporation’s freedom of action in the public interest. They impose new responsibilities, responsibilities that the managers must assume.

In today’s context, we expect the particular managers who must rise to the occasion will be not only the operating officers mentioned by Berle but also the independent directors serving on committees responsible for monitoring compliance with government regulations. There is nothing new in this, rather it is an extension of the current system. Since the emergence of the monitoring board as the fulcrum of the governance system, faithful corporate directors have always responded to regulation by monitoring their appointed senior executives. Their job becomes more complex, but the directive remains intelligible – they maximize the value of the corporation given the specific constraints of the policies.

The new monitoring requirements may be even more complex than those imposed in the past. Under SOX regulations, triggered by corporate fraud, boards simply extended their existing oversight mechanisms to cover internal compliance systems. In the current crisis, the underlying problem is somewhat different, involving the amount of

⁸³ For example, in February 2009, the government asked banks to suspend foreclosures pending the appearance of a homeowner relief package, and Citigroup and JPMorgan Chase promptly acceded. See *Some Banks Will Put Off Foreclosures Until March*, N.Y. Times, Feb. 14, 2009, at 5.

⁸⁴ For an overview of the incentive problems attending state ownership, see Andrei Schleifer, *State Versus Private Ownership*, NBER Working Paper No. 6665, July 1998, available at: <http://www.nber.org/papers/w6665>.

⁸⁵ For a preview, see Ben S. Bernanke, *Financial Reform to Address Systemic Risk*, Speech at the Council of Foreign Relations, Washington, D.C., Mar. 10, 2009, available at: <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>. Bernanke projects that capital requirements at banks and financials will be tightened and restructured, that risk taking at large financials will be closely monitored going forward, and that supervisory authority will be enhanced, constraining the expansion of new markets. All of this would lower shareholder returns.

⁸⁶ The speech, entitled “The New Individualism” and delivered by Roosevelt on September 23, 1932 to the Commonwealth Club of San Francisco. The text can be found at the American Rhetoric Online Speech Bank, available at <http://www.americanrhetoric.com/speeches/fdrcommonwealth.htm>. The speech called for management cooperation with government planning. The chaotic marketplace would be disciplined by “an economic constitutional order.” For a fuller account, see Bratton & Wachter, *supra* note ___, at ___.

systematic risk accepted by financial corporations. Although companies have long had risk management policies and those policies have been reviewed by audit committees, rules that regulate leverage or the amount of risk in the investment portfolio could be very complex and materially increase the board's oversight burden.

The details of whatever regulatory reform will emerge are not yet known. Perhaps the momentum behind shareholder empowerment and the loss of confidence in managers and directors is too far along to be stopped at this point. That said reliance on markets now is being revisited due to the externalities⁸⁷ resulting from the status of certain financial institutions judged as too big to fail.⁸⁸

C. Shareholders and Social Welfare

CONCLUSION

⁸⁷ Bernanke, *supra* note __ (describing the perverse effects and calling for tighter controls).

⁸⁸ See, e.g., Daniel K. Tarullo, Rules, Discretion, and Authority in International Financial Reform, *J. Int'l Econ. L.* 613 (2001)(discussing the sovereign debt crises of the 1990s).