

# UC Berkeley

## Law and Economics Workshop

### Title

Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy

### Permalink

<https://escholarship.org/uc/item/3pj8s2p9>

### Author

Fisch, Jill

### Publication Date

2004-12-15

## Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy

Jill E. Fisch\*

### Abstract

An extensive body of empirical research evaluates corporate law in terms of its effect on shareholder wealth and, based on this effect, makes efficiency claims designed to influence regulatory policy. Central to these claims is the premise that the principal objective of the corporation is the maximization of shareholder wealth. By defining regulatory efficiency in terms of shareholder wealth, the literature relies on the shareholder primacy norm to equate shareholder value with firm value.

This Article challenges both the positive and the normative foundations of the shareholder primacy norm. The Article demonstrates that existing legal doctrine does not require corporations to maximize shareholder wealth at the expense of other stakeholder interests. Although economic analysis offers a theoretical defense of shareholder primacy, its conclusions are based on strong and questionable assumptions about the market conditions in which the corporation operates. Finally, the Article explores and rejects the argument that shareholder primacy may be grounded in existing limits on management fiduciary duties, offering an alternative defense of those limits in terms of comparative institutional analysis.

Justifying the evaluation of corporate performance in terms of shareholder wealth is critical to empirical claims of regulatory efficiency. The presence of other stakeholders, whose interests in the firm may be not reflected in an assessment of shareholder value, raises questions about efficiency analyses that do not incorporate those interests into their assessment of firm value. Alternative conceptions of firm value suggest that empirical scholars need to offer better and explicit justifications for their reliance on shareholder wealth and, more importantly, for their argument that shareholder wealth effects should dominate regulatory policy.

---

\* Alpin J. Cameron Professor of Law, Fordham Law School. E-mail: [jfisch@law.fordham.edu](mailto:jfisch@law.fordham.edu). Copyright 2005 by Jill E. Fisch. The original draft of this paper was prepared for a Conference on Comparative Institutional Analysis at Wisconsin Law School. I am grateful for the thoughtful discussion and comments provided by the conference participants as well as for Neil Komesar's efforts in organizing and hosting the program. Helpful comments have also been provided by Lynn Stout, Iman Anabtawi, and participants in the Law & Economics Workshop at Queens University and the UCLA - Sloan Conference on the Means and Ends of Corporations.

## Introduction

Comparative institutional analysis is a fundamental component of corporate law scholarship. In the business context, a variety of institutional actors produce legal rules – state legislatures, Congress, state and federal courts, the Securities and Exchange Commission, state attorneys general, and self regulatory organizations such as the New York Stock Exchange and Nasdaq. Recognizing the relationship between institutional choice and regulatory product, policy-makers and scholars confront the ongoing question about how lawmaking authority should be allocated among different institutions, coupled with the related question about the extent to which contractual agreements produced by free market operation should be displaced by regulation.

Although a few corporate scholars have challenged the normative terms of the debate, efficiency is the dominant principle used to choose among legal rules and lawmaking institutions.<sup>1</sup> Given that most commentators would readily agree that the primary, if not the sole objective of the corporation is to make money, the identification of wealth or welfare maximization as the appropriate objective seems less controversial in corporate law than in some other areas. At the same time, this criterion supplies a ready mechanism for the evaluation and comparison of legal rules. Accordingly, in business law, an extensive body of empirical research provides information on the economic consequences of regulatory changes and compares the effects of different lawmaking structures. Scholars use statistical analysis -- event studies and other similar tools -- to measure the effect of legal rules on firm value. This research purports to offer concrete evidence to guide institutional choices such as the appropriate allocation of authority between shareholders and directors or the appropriate scope of a litigation remedy for corporate misconduct.

Despite a substantial quantity of empirical research, the basic questions of institutional choice in corporate law remain largely unresolved. Commentators continue to debate whether state regulatory competition has resulted in a race to the top, a race to the bottom, or a race to nowhere in particular. Respected scholars continue to publish articles on either side of fundamental questions such as whether anti-takeover devices increase or decrease shareholder wealth and whether shareholder litigation is socially valuable. Recent scholarship has explored in detail the prominent

---

<sup>1</sup> The Article consciously adopts the normative framework of welfare economics and efficiency analysis, excluding, for purposes of this discussion, independent considerations of equity or fairness. *See, e.g.*, Louis Kaplow & Steven Shavell, *Fairness versus Welfare*, 114 HARV. L. REV. 961, 968 (2001) (offering a definition of welfare economics and distinguishing fairness considerations).

role of Delaware as the choice for public company incorporation, but has been unable to resolve the question of whether Delaware incorporation enhances firm value and, if so, why.

This Article suggests one reason for this failure: The existing empirical literature has incompletely conceptualized the appropriate measurement of efficiency for purposes of evaluating corporate law. Corporate scholarship is premised on the shareholder primacy norm – a norm that was developed in the context of fiduciary principles. Empirical scholars appear to have extended the shareholder primacy norm to define the objectives of the corporation for purposes of efficiency analysis. Accordingly, corporate scholarship evaluates legal rules in terms of their effect on shareholder value and analyzes lawmaking institutions in terms of the quality and effectiveness of shareholder representation. In particular, the existing literature uses the shareholder primacy norm to equate firm value with shareholder value. As a result, many empirical scholars measure the efficiency of legal rules in terms of their effect on shareholder wealth.

It may be the case that shareholder wealth is an appropriate proxy for a broader conception of firm value or that shareholder wealth is the normatively appropriate basis for evaluating the efficiency of corporate law. The literature does not offer such a justification for its reliance on shareholder wealth, however. Rather, the empirical studies appear to incorporate the concept of shareholder primacy without considering the implications of this choice. Moreover, although there are powerful reasons for adhering to shareholder primacy in framing the scope of managerial fiduciary duties,<sup>2</sup> those reasons do not necessarily translate to a more general efficiency analysis in which considerations of the appropriate division of the corporate surplus should be secondary to maximization of that surplus.<sup>3</sup>

The Article addresses this analytical gap by exploring the extent to which shareholder primacy is an appropriate measure of regulatory efficiency as defined, in the corporate context, by the rules that maximize firm value. The Article begins, in Section I, by demonstrating the centrality of

---

<sup>2</sup> In particular, shareholder primacy offers management a basis for evaluating decisions within the framework of a single-valued objective function. As Michael Jensen has explained, a corporate objective function that embraces stakeholder interests is likely to result in “managerial confusion, conflict, inefficiency, and perhaps even competitive failure.” Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 8, 9 (2001).

<sup>3</sup> Compare A. Mitchell Polinsky, AN INTRODUCTION TO LAW AND ECONOMICS 7-10 (1983) (defining efficient legal rules as those that maximize aggregate social welfare).

the shareholder primacy norm to evaluations of regulatory efficiency in corporate law. The Article differentiates between shareholder wealth and firm value and argues that the focus on shareholder wealth maximization distorts the efficiency implications of the empirical literature. Section II explores the positive and normative foundations of the shareholder primacy norm in an effort to determine the extent to which it defines the objectives of the corporation. Section III examines the relationship between shareholder primacy and the scope of fiduciary duties in corporate governance. In particular, the Article explains that the shareholder primacy norm allocates rule-making authority among institutional actors and provides a mechanism for enforcement of the implicit contractual terms. This understanding, while consistent with limiting the scope of management's fiduciary duties, undercuts attempts to read such limits as a legal endorsement of shareholder primacy. Section IV considers more generally the problem of using the shareholder primacy norm as a measure of regulatory efficiency and concludes by identifying alternative approaches to valuing the firm.

The central observation of the Article is that the role of shareholder primacy as a limitation on the scope of fiduciary principles and, in turn, on the scope of judicial lawmaking access, does not imply a more general normative principle of shareholder primacy. The existing norm of shareholder primacy does not define the value of the corporation exclusively in terms of shareholder wealth. Indeed, using comparative institutional analysis to highlight the basis for the shareholder primacy norm in fiduciary duty litigation demonstrates why the norm should not be understood as framework for measuring firm value.<sup>4</sup>

Ultimately, corporate scholarship must confront the appropriate definition of firm value for purposes of efficiency analysis. Although there may be reasons to decide that the appropriate corporate objective is maximization of shareholder wealth, that case has not yet been made. Importantly, the conclusion does not simply follow from existing corporate doctrine or the shareholder primacy norm and requires independent normative justification. Alternatively, shareholder wealth may be too narrow, particularly as applied to rules that allocate rights among competing corporate constituencies. If that is the case, empirical scholars should be looking for ways

---

<sup>4</sup> The Article does not challenge the focus on shareholder wealth for the purposes of assessing firm value in the equity investment context. An equity research analyst who is evaluating a corporation in terms of its expected returns to shareholders, should obviously model firm value in terms of shareholder wealth. Rather, the premise of this Article is that conceptions of firm value are specific to and should vary with the purpose for which they are used.

to incorporate a broader conception of firm value into their research.

## **I. Efficiency in Corporate Law and the Maximization of Shareholder Wealth**

Easterbrook and Fischel posed a fundamental question almost fifteen years ago: “Is corporate law efficient or not?”<sup>5</sup> Scholars have taken various approaches in seeking to answer that question. Some scholars have used event studies to measure the effect of specific regulatory changes.<sup>6</sup> The purpose of these studies is to assess the effect of a particular legal rule on firm value. Others have compared legal regimes, most commonly, Delaware versus other states. Intra-state comparisons are useful in evaluating the debate over regulatory competition<sup>7</sup> as well as seeking to explain why most large public companies are incorporated in Delaware.<sup>8</sup> Overall, these studies seek both to analyze specific legal rules and to identify the best way to make corporate law.<sup>9</sup> Empirical research has been particularly influential in the efficiency debate yet, for the most part, empirical studies have failed to produce a convincing answer to the efficiency question.

For example, Rob Daines<sup>10</sup> and Guhan Subramanian<sup>11</sup> have both attempted to evaluate the efficiency of Delaware law relative to that of other states by looking at the correlation between Delaware incorporation and Tobin’s Q, the ratio of a firm’s stock market value to the book value of

---

<sup>5</sup> Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212 (1991).

<sup>6</sup> See ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION*, 64-70 (2002) (describing use of event studies in evaluating corporate law).

<sup>7</sup> See *infra* Part III(B) (describing debate over regulatory competition).

<sup>8</sup> See Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000) (explaining debate over regulatory competition and efforts to explain Delaware’s dominance as the site of incorporation for large public companies).

<sup>9</sup> See, e.g., Lucian A. Bebchuk & Alma Cohen, *Firms’ Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003) (suggesting that, because Delaware faces very limited competition for out-of-state corporations, existing market pressure may be insufficient to produce efficient legal rules; cf. Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003) (identifying the role of potential federal override as a constraint on state corporate law)).

<sup>10</sup> Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

<sup>11</sup> Guhan Subramanian, *The Disappearing Delaware Effect*, 46 J.L. ECON. & ORG. \_\_ (2004)

its assets.<sup>12</sup> Daines' research found that incorporation in Delaware was associated with a higher Tobin's Q for most years between 1981 and 1996 – indeed, in 1996 Delaware firms were worth an average of 5% more than non-Delaware firms.<sup>13</sup> Daines' results led him to conclude that incorporation in Delaware led to higher firm value, results that, along with other empirical work,<sup>14</sup> are widely cited to support the claim that regulatory competition is an efficient structure for producing corporate law and produces a race to the top.

Subramanian's subsequent research, extending the Daines' study, disputed its conclusions.<sup>15</sup> Subramanian, again looking to Tobin's Q, found first that the Delaware effect was driven by small firms, and second that it disappeared during the period from 1997 to 2002.<sup>16</sup> Subramanian therefore concluded that Daines had failed to provide convincing empirical support for the race to the top theory. Relatedly, Roberta Romano has reported that a number of event studies have found positive stock price affects associated with reincorporation in Delaware, but that the several studies attempting use performance based measures to evaluate the effect of incorporation have found “no significant difference in accounting performance.”<sup>17</sup>

Empirical studies of corporate governance reforms such as independent boards or board committees similarly have produced conflicting results.<sup>18</sup> Thus, for example, the recent large-sample, long-horizon study of the impact of board independence conducted by Sanjai Bhagat and Bernard

---

<sup>12</sup> See, e.g., Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1785 (2002) (defining Tobin's Q).

<sup>13</sup> Daines, *supra* note 10.

<sup>14</sup> E.g., Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES IN L. 1, 113 (2001), at <http://www.bepress.com/til/default/vol2/iss2/art1>, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 273 (1985), Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: “Unhealthy Competition” versus Federal Regulation*, 53 J. BUS. 59 (1980).

<sup>15</sup> Subramanian, *supra* note 11.

<sup>16</sup> *Id.*

<sup>17</sup> Romano, *supra* note 6 at 72-73.

<sup>18</sup> See Jill Fisch & Caroline Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 559-63 (2003) (summarizing empirical studies).

Black failed to find any correlation between board independence and financial performance.<sup>19</sup> In contrast, Laura Lin has cited research indicating a positive relationship between director independence and firm performance.<sup>20</sup>

In designing empirical studies of corporate law, scholars have largely equated firm value with shareholder value.<sup>21</sup> As Subramanian states, commentators share common assumptions that the social welfare goal under analysis is maximization of shareholder wealth.<sup>22</sup> Accordingly, the empirical studies evaluate regulation in terms of its impact on a shareholder-based component of corporate value such as net income or profits, stock price, or Tobin's Q.<sup>23</sup> Thus, in seeking to assess the efficiency of Delaware incorporation, both Daines and Subramanian looked to the effect on Tobin's Q. Similarly, a study by Gompers, Ishii and Metrick uses the statistical relationship between their governance index and Tobin's Q to demonstrate the inefficiency of firm takeover defenses.<sup>24</sup> Event studies use the effect on stock price to assess the effect of regulatory change. For example, Michael Bradley and Cindy Schipiani concluded that director exculpation statutes inefficiently lowered firm

---

<sup>19</sup> Sanjai Bhagat & Bernard S. Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 IOWA J. CORP. L. 231 (2002).

<sup>20</sup> Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 922 (1996).

<sup>21</sup> See, e.g., Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113 (1987) (describing "the maximization of equity share prices [as] the core goal of corporation law"); but see Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1485 (1992) (observing that, because "a given corporate law issue ... implicates not only the interests of shareholders, but also those of third parties . . . these [third party] interests must be taken into account in arriving at the socially optimal rule.).

<sup>22</sup> Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1798 (2002).

<sup>23</sup> Standard market efficiency analysis suggests that, in general, there should be no meaningful difference between measuring corporate performance in terms of a performance-based variable such as profitability or a shareholder return variable such as stock price, because, in an efficient market, stock price should reflect an issuer's profitability.

<sup>24</sup> Paul Gompers *et al.*, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).



value by looking at the effect that their adoption had on stock prices.<sup>25</sup> In seeking to assess the relationship between board independence and “corporate performance,” Bernard Black and Sanjai Bhagat looked at a range of accounting variables.<sup>26</sup> Regardless of the precise variable selected, in each of these examples, the authors are evaluating the efficiency of legal rules based on their effect on shareholder wealth. The design of the studies is premised on the conclusion that efficient rules are correlated with higher returns to shareholders.

Although, as Subramanian states, empirical scholars have largely equated firm value with shareholder value, the two concepts are not identical. Corporations produce value not simply for shareholders, but also for a variety of non-shareholder groups, including management, employees, creditors, customers, suppliers, and community residents. A corporation provides value to its creditors in the form of interest payments on its debt. It provides value to management and other employees through the provision of jobs resulting in compensation, fringe benefits and, in some cases, the development of specialized skills or marketable reputations. A corporation provides value to its customers and its suppliers through voluntary surplus-producing market transactions. Corporations may also provide value to the communities in which they are located, through the property taxes that they pay, the services they provide, even the charitable activities in which they engage. Accordingly, it is useful to distinguish, in terminology, between the concept of shareholder value and that of firm value. Firm value, for purposes of this Article, includes not just shareholder wealth but also the value provided by the corporation to non-shareholder stakeholders.

Moreover, firm value is likely to differ from shareholder value, regardless of the method by which each is measured. The value that a corporation produces and distributes to its stakeholders in the form of salaries, interest payments, charitable contributions and so forth, is subtracted from the corporation’s pre-tax revenues. Thus, this stakeholder value is not incorporated into the calculation of corporate profits. Similarly, because it is distributed to non-shareholder stakeholders, it does not

---

<sup>25</sup> Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Michael Bradley & Cindy A. Schipani, *The Economic Importance of the Business Judgment Rule: An Empirical Investigation of the Trans Union Decision and Subsequent Delaware Legislation*, in THE BATTLE FOR CORPORATE CONTROL 105 (Arnold N. Sametz ed., 1991) (finding that the passage of § 102(b)(7) actually lowered the value of Delaware corporations).

<sup>26</sup> Bhagat & Black, *supra* note 19 at 241-42. Bhagat and Black also looked at stock price performance but recognized some of the limitations of this approach. *See id.* at 242.

affect shareholder returns. Because empirical studies measure efficiency in terms of shareholder wealth, they therefore exclude the effect of regulatory changes on non-shareholder constituencies within the corporation.

What explains the focus on shareholder wealth in empirical analyses of the efficiency of corporate law? There are several possible explanations. First, data on shareholder wealth, particularly changes in market capitalization, are easy to obtain. Although empirical research could probably incorporate a reasonable measure of creditor value, based on something like the market value of publicly traded corporate debt, neither the legal nor the financial literature has developed standardized measures of employee value, customer value, and so forth.<sup>27</sup> Second, researchers may believe shareholder wealth is a reasonably good proxy for firm value. Even if shareholder wealth does not incorporate aggregate firm value, if regulatory changes are likely to have a similar affect on all corporate constituencies – that is, if shareholder wealth is closely correlated with firm value – any error resulting from the use of shareholder wealth is likely to be small. Third, because corporate and securities law focus on the role and rights of investors, scholars may believe that the effect of changes in corporate law on non-shareholder constituencies is relatively minor and may be disregarded for purposes of their analysis.

The problem with these explanations is that conflicts of interest among various corporate stakeholders is the, or at least a, central focus of corporate law. Reinier Kraakman and his co-authors highlight this point in their recent book, *The Anatomy of Corporate Law*.<sup>28</sup> Kraakman, *et al.*, describe as a core function of corporate law “constraining value-reducing forms of opportunism among the constituencies of the corporate enterprise.”<sup>29</sup> They explain that the conflicts of interest within the corporation – between shareholders and management, between controlling and minority shareholders, and between shareholders and other stakeholders – create agency problems, and the role of corporate

---

<sup>27</sup> Cutting edge research attempting to create and incorporate a formal measure of employee value into firm value is currently being done by Jeffrey Gordon. Jeffrey N. Gordon, *The Contestable Claims of Shareholder Wealth Maximization: Evidence from the Airline Industry* (working paper, Nov. 25, 2002).

<sup>28</sup> Kraakman, *et al.*, *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (2004).

<sup>29</sup> *Id.* at 2.

law is to minimize these agency problems.<sup>30</sup> This characterization of corporate law suggests a fundamental problem in using shareholder wealth to measure the efficiency of corporate law. Situations involving a conflict of interest between corporate stakeholders are precisely those in which an increase in value to one stakeholder group may result from costs imposed on another stakeholder group rather than net increases in the size of the corporate pie. Shareholder wealth – a single constituency’s value – is not an appropriate measure of the efficiency of rules that allocate rights among constituencies.

Whether or not one agrees with Kraakman, *et al.*’s characterization of agency issues as the central focus of corporate law, it is clear that such agency issues are the focus of many empirical studies of corporate law. Takeover regulation is perhaps the most obvious example of legal rules that allocate firm value among shareholders, employees, and other corporate constituencies. Indeed, some commentators have explicitly defended antitakeover regulation as necessary to respond to the appropriation of value by shareholders from other corporate stakeholders.<sup>31</sup> If shareholder gains from takeovers come as the result of losses imposed on employees or creditors, an empirical study that seeks to evaluate the efficiency of an antitakeover regulation by looking at its effect on stock price is clearly incomplete. Instead, efficiency would require the study to determine the net effect of the regulation on a broader measure of firm value. Similarly, because Rob Daines posits that the shareholder wealth effect of Delaware incorporation may be due to its takeover rules, his finding that Delaware incorporation enhances shareholder value does not prove that Delaware enhances firm value.

The inability of shareholder value to serve as a good proxy for measuring the effect of rules that allocate rights among corporate constituencies requires a rethinking of the objectives of empirical research. It is, of course, possible for empirical scholars simply to frame their conclusions narrowly in terms of shareholder wealth. Indeed, a few scholars have done so. One example is the work by Rob Daines and Michael Klausner analyzing the effect of anti-takeover protection in IPO charter

---

<sup>30</sup> *Id.* at 2-3. See also David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1528-29 (explaining and evaluating Kraakman’s characterization).

<sup>31</sup> See, e.g., Kenneth B. Davis, Jr., *Epilogue: The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 517 (defending takeover regulation to protect interests of workers).

provisions.<sup>32</sup> Although their paper title poses the question in terms of “firm value,” Daines and Klausner make clear in the body of the paper that the focus of their analysis is shareholder wealth. Importantly, the authors explicitly recognize the distinction between maximization of shareholder wealth and efficiency by identifying the possibility that anti-takeover provisions may protect management private benefits at the expense of shareholders.<sup>33</sup>

There is considerable value to legal research that examines the impact of regulatory change on shareholder value. Empirical studies should, however, be clear about the scope of any efficiency claims based on such analysis. Alternatively, empirical scholars might argue that shareholder wealth is the appropriate benchmark for evaluating regulatory efficiency in the corporate context. That case has not yet been made, but in the following section, this Article considers the extent to which such an argument can be premised on the shareholder primacy norm in corporate law. A third option is for empirical scholars to incorporate a broader conception of firm value in their empirical research. That option is addressed in the final section of this Article.

## **II. The Shareholder Primacy Norm**

### **A. Origins of the Norm**

Shareholder primacy, the obligation of corporate decision-makers to focus on shareholder interests, is a dominant principle in corporate law.<sup>34</sup> As the court explained in the textbook staple *Dodge v. Ford Motor Corp.*: “A business corporation is organized and carried on primarily for the profit of the stockholders.”<sup>35</sup> Although some scholars, most notably progressive scholars, have questioned whether the norm is either descriptively accurate or normatively appropriate, the vast majority of commentators accept the premise that the primary objective of the corporation is to

---

<sup>32</sup> Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, working paper, [http://papers.ssrn.com/paper.taf?abstract\\_id=187348](http://papers.ssrn.com/paper.taf?abstract_id=187348).

<sup>33</sup> *See id.* at 27-29 (characterizing efficiency in terms of the sum of share value and private benefits to management).

<sup>34</sup> As Steve Bainbridge has observed, shareholder primacy actually encompasses “two distinct principles: 1) the shareholder wealth maximization norm . . . and 2) the principle of ultimate shareholder control. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW.U. L. REV. 547, 573 (2003). In his analysis of director primacy, Bainbridge focuses on the second principle and does not discard the principle of shareholder wealth maximization. *Id.* at 574. In contrast, this Article focuses on the first principle.

<sup>35</sup> 204 Mich. 459, 170 N.W. 668 (Mich. 1919).

maximize shareholder wealth.

The origins of the shareholder primacy norm can be found in the classic debate between Merrick Dodd and Adolf Berle in the 1930s, at the time that the U.S. corporation was expanding from an organizational form used primarily for public work – building and operating railroads, ferry services, bridges and the like – to the foundational form for private business enterprise. Berle and Dodd were actually debating two related questions – how properly to characterize the developing structure of corporate law and, relatedly, how corporate law should develop in the future. Thus Berle, who espoused the conception of shareholder primacy in the debate, argued that corporate law was essentially a variant of trust law, in which corporate managers owed fiduciary duties to manage the corporation in the interests of the shareholder-beneficiaries.<sup>36</sup> Berle’s claim was primarily descriptive: “all powers granted to a corporation or to the management of a corporation . . . are . . . exercisable only for the ratable benefit of all shareholders as their interest appears.”<sup>37</sup> Berle’s argument was essentially premised on the conception of shareholders as owners of the corporation. Managers’ obligations to shareholders stem from their role as trustees or agents.

Dodd responded with the essentially normative and largely aspirational argument, that managers “should concern themselves with the interests of employees, consumers, and the general public as well as of the stockholders. . . .”<sup>38</sup> Dodd’s argument sought to distance corporate or business law from private law, claiming that public opinion was moving the law toward a view in which the business corporation has “a social service as well as a profit-making function.”<sup>39</sup> At least for a period of time, corporate law came to adopt Dodd’s position, granting managers wide discretion to manage the corporation in the general interests of society.<sup>40</sup>

---

<sup>36</sup> Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 1074 (1931).

<sup>37</sup> *Id.* at 1049.

<sup>38</sup> Merrick Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932).

<sup>39</sup> *Id.* at 1148.

<sup>40</sup> See Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 444 n.6 (2001) (describing Berle’s subsequent statements on the issue). See also Adolf Berle, Foreword, *THE CORPORATION IN MODERN SOCIETY* xii (E. Mason ed. 1959) (conceding that corporate law had developed to be consistent with Dodd’s position but maintaining his misgivings about whether this was the “‘right’ disposition.”).

A variety of commentators have based their defense of shareholder primacy on the legal status of shareholders as owners of the corporation.<sup>41</sup> More recently, however, this defense has lost favor. Indeed, Lynn Stout has characterized it as “the worst, of the standard arguments for shareholder primacy.”<sup>42</sup> Among other problems, the defense is weakened by the substantial legal and practical differences between shareholders and traditional property owners.<sup>43</sup> From a legal perspective, shareholders own stock, which gives them claims to certain control and financial rights within the corporation but not direct control over or even access to the firm’s underlying assets. Other stakeholders, including creditors, options holders and managers have claims to different control and financial rights. From a practical perspective, shareholders also do not resemble traditional owners. They are a fluid and fluctuating group of investors. Many are short term participants in the corporate enterprise. Others hold stock as part of a diversified investment strategy in which they simply seek to obtain the market rate of return. Large numbers of shareholders do not vote, do not read corporate disclosure statements, and do not maintain an ongoing interest in developments concerning their portfolio companies. As a result, it seems inappropriate to privilege their claims by relying on a property rights conception of legal ownership.

In the 1930s debates, Berle identified a key drawback to Dodd’s public law conception of managerial responsibilities. Increasing management discretion in favor of other constituencies – so-called stakeholder capitalism – would weaken management’s fiduciary obligations to shareholders. This would have the effect, in Berle’s view, of making managerial power, “for all practical purposes absolute.”<sup>44</sup> Berle’s analysis provides an alternative normative foundation for shareholder primacy: as a basis for constraining management discretion and, ultimately, management self-dealing.

---

<sup>41</sup> See Adolf A. Berle & Gardiner Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 9 (1932) (referring to shareholders as “owners” and noting that corporate governance must focus on the problems caused by the separation of ownership and control); David Millon, *Redefining Corporate Law*, 24 *IND. L. REV.* 223, 229-30 (1991) (explaining idea that shareholders hold corporations as property).

<sup>42</sup> Lynn A. Stout, *Bad and Not-so-bad Arguments for Shareholder Primacy*, 75 *S. CAL. L. REV.* 1189, 1190 (2002).

<sup>43</sup> See, e.g., Margaret M. Blair, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 4-5 (1995) (describing as misleading the characterization of shareholders as owners).

<sup>44</sup> Adolf A. Berle, *For Whom Corporate Managers are Trustees: A Note*, 45 *HARV. L. REV.* 1365, 1367 (1932).

Similarly modern scholars have defended shareholder capitalism against arguments in favor of stakeholder interests by arguing that legal recognition of such interests is unmanageable. First, imposing upon management fiduciary obligations to multiple stakeholders creates irreconcilable conflicts in the frequent situations in which the interests of those stakeholders conflict. Second, legal endorsement of stakeholder interests has the practical effect of vesting management with a largely irreviewable degree of decision-making discretion that is likely to increase agency costs. The shareholder primacy norm, in contrast, provides an objective standard by which to evaluate operational decisions.

The imposition of trustee-like fiduciary duties, as Berle described, also offers a vehicle for enforcement of the shareholder primacy norm. Shareholders can address deviations from shareholder primacy through derivative litigation against errant corporate decision-makers. Today, the shareholder derivative suit enforces the use of fiduciary principles as a constraint on management decision-making, both to insure that management acts in furtherance of shareholder interests rather than its own and to limit management discretion to favor the interests of other corporate constituencies over the interests of shareholders.

Concededly, shareholder capitalism only supplies a loose set of constraints on managerial discretion because there are a range of interests represented within the shareholder class. Shareholders may differ in the temporal scope of their investment, the extent of their diversification and their willingness to bear risk. Conflicts of interest between different shareholder groups limit the functionality of shareholder primacy as a decision-making constraint. Nonetheless, shareholder primacy offers a more focused objective than consideration of the interests of all corporate stakeholders.

## **B. Shareholder Primacy and Existing Law**

Despite widespread academic endorsement of the shareholder primacy norm, it is unclear that existing law actually requires officers and directors to make operational decisions in an effort to maximize shareholder wealth. In other words, although shareholder primacy has considerable rhetorical power, the shareholder primacy norm does not actually require operational decisions to be made with the sole objective of shareholder wealth maximization. Even the Delaware statute, which is generally described as favoring the interests of shareholders more than the law of other states, does not explicitly require that a corporation be managed exclusively or even primarily in the interests of

its shareholders. Indeed, although the Delaware statute explicitly provides that the directors (and not the shareholders) have the authority to run the corporation, it is silent both with respect to the standard by which board decisions are to be evaluated and with respect to the stakeholders whose interests may legitimately be taken into account.

Delaware case law is similarly ambiguous. Although shareholder primacy advocates point to the language of cases like *Dodge v. Ford*, there is a surprising absence of modern precedent explicitly requiring management to maximize shareholder value. A recent case, albeit in the context of an LLC rather than a corporation, is illustrative. In *Blackmore Partners, LP v. Link Energy, LLC*,<sup>45</sup> the board approved a distribution of 100% of the company's assets to creditors. Plaintiff's complaint alleged that this distribution exceeded the value of the creditors' claims and destroyed all value for equity holders. The allegations, if true, describe the most extreme example of a decision that privileges the interests of creditors over those of equity holders. The board's actions were flatly inconsistent with an obligation to maximize shareholder value. Notably, however, although the Chancery court denied the defendant's motion to dismiss, the court's opinion did not state that the directors' decision could be invalidated for a failure to adhere to shareholder primacy. Instead the court inferred that the directors were likely to have acted out of disloyalty or in bad faith, stating that where directors take action against a class of security holders, they may be required to justify their actions.<sup>46</sup>

Concededly the *Revlon* decision requires the directors, in the context of a cash sale of the company, to obtain the highest possible selling price.<sup>47</sup> But the *Revlon* decision is limited to the corporate control context and, even within that context, applies to an extremely limited set of cases. More generally, the Delaware cases make clear that shareholders do not have the power either to make operational decisions or to impose their vision of the corporate good upon a board that disagrees with that assessment.

In the operational context, the business judgment rule affords management ample discretion to

---

<sup>45</sup> 864 A.2d 80 (Del. Ch. 2004).

<sup>46</sup> *Id.*, 2004 Del. Ch. LEXIS 164, \*17, quoting *Orban v. Field*, 1993 Del. Ch. LEXIS 277, \*9 (Del. Ch. Dec. 30, 1993).

<sup>47</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).



consider the interests of other stakeholders.<sup>48</sup> Delaware courts have described the business judgment rule as imposing an obligation to act “in the best interests of the company,”<sup>49</sup> not the best interests of the shareholders. Even in the takeover context, so long as the company has not entered the *Revlon* mode, Delaware law permits directors to consider the interests of “creditors, customers, employees, and perhaps even the community generally.”<sup>50</sup> As the court explained in *Paramount Communications Inc. v. Time Inc.*: “[A] board of directors . . . is not under any per se duty to maximize shareholder value.”<sup>51</sup> Rather, Delaware appears to endorse the right, if not the obligation of directors to manage the corporation as a legal and economic entity.<sup>52</sup>

Moreover, it is important to distinguish two concepts in Delaware case law. The Delaware courts have explicitly rejected the argument that management has a *fiduciary obligation* to other stakeholders at the expense of shareholders, at least so long as the corporation is not operating in the vicinity of insolvency. Fiduciary obligations are enforceable through derivative litigation to protect shareholder interests. The limitation to shareholders of the power judicially to enforce fiduciary duties does not, however, mandate shareholder primacy, a point that will be considered further in Part III below.<sup>53</sup> Similarly, the cases that reject stakeholder claims for breach of fiduciary duty do not contain anything *preventing* management from favoring stakeholder interests; they simply provide

---

<sup>48</sup> See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 307 (1999) (terming these “mixed motive situations” in that the board may be benefitting other stakeholders at the expense of shareholders and arguing that courts generally uphold such operational decisions under deferential business judgment rule analysis).

<sup>49</sup> *Aronson v. Lewis*, 473, A.2d 805, 812 (Del. 1984).

<sup>50</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

<sup>51</sup> 571 A.2d 1140, 1150 (Del. 1989).

<sup>52</sup> See, e.g., William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992). It is important to note that this conception cannot readily be explained as simply a “long term” obligation to maximize shareholder value. Modern finance theory suggests that current stock price should reflect the long term benefits to shareholders of considering the interests of other corporate stakeholders. See Blair & Stout, *supra* note 48 at 304 (rejecting shareholder’s long run interests as explanation for consideration of non-shareholder stakeholders).

<sup>53</sup> Indeed, as Margaret Blair and Lynn Stout have observed, the law provides that the recovery in a derivative suit that successfully establishes a breach of management’s fiduciary duty **to shareholders** is payable, **not** to those shareholders, but to the corporation itself, where its benefits “accrue to all the corporation’s stakeholders.” Blair & Stout, *supra* note 48, at 294-95.

that management's failure to favor such interests is not judicially remediable.

Shareholders do, of course, have the power to exercise control rights under Delaware law, most significantly, the right to elect the board of directors and to vote on certain other corporate transactions.<sup>54</sup> Arguably management accountability to shareholders, through these control rights, should result in management decisions that maximize shareholder value.<sup>55</sup> Nonetheless, these control rights are limited and largely indirect. Shareholders cannot control specific business decisions; their decision-making power is limited to vetoing certain types of extraordinary corporate decisions such as mergers and dissolutions. Similarly, while shareholders nominally have the right to elect directors, their limited power over the nominating process and the corporate proxy machinery prevent shareholders from using their voting rights to demand shareholder primacy from directors.<sup>56</sup>

States other than Delaware have endorsed broader conceptions of firm value for the purposes of managerial decision-making. The majority of states have adopted corporate constituency statutes that explicitly authorize directors to consider the interests of non-shareholder stakeholders.<sup>57</sup> Although these statutes were adopted in response to hostile tender offers and several are limited to the change of control context, the vast majority apply to all corporate decisions. In many cases, the statutes explicitly provide that directors will not be required to regard the effects of a corporate decision on any particular group – including shareholders – as a dominant factor.<sup>58</sup> As former SEC Commissioner Al Sommer has observed, the salient point of these statutes is that they define the best

---

<sup>54</sup> Blair and Stout argue that shareholders enjoy voting rights “as partial compensation for their unique vulnerabilities” which lack of involvement in the corporation’s day-to-day activities, limited access to information about firm operations, and collective action problems. *Id.* at 313-14.

<sup>55</sup> One can also argue that vesting control rights in other corporate stakeholders would be inferior because stakeholders who are not residual claimants would not make decisions that maximize firm value. It is worth noting that, although preferred shareholders are not residual claimants, they often exercise some level of control rights. In addition, Delaware permits corporations to allow creditors to exercise voting rights to creditors in addition to, and even in place of stockholders. Del. Gen. Corp. L. § 221.

<sup>56</sup> See *e.g.*, *id.* at 310-12 (describing limited shareholder ability to use their voting rights effectively); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003) (identifying limitations in meaningful shareholder access and proposing remedies).

<sup>57</sup> See Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1801 (2002) (identifying thirty-one states that have adopted corporate constituency statutes).

<sup>58</sup> See Ind. Code 23-1-35-1.

interests of the corporation in terms of the interests of both shareholders and non-shareholder stakeholders, thereby omitting any requirement that decisions favoring non-shareholder stakeholders be justified in terms of a nexus to shareholder value.<sup>59</sup>

It is true that the statutes – other than that of Connecticut – do not require directors to favor other stakeholders, nor do they impose fiduciary obligations on directors in favor of non-shareholder constituencies.<sup>60</sup> Nonetheless, the plain language of the statutes is inconsistent with the shareholder primacy norm. In some cases, statutory provisions extend even further. For example, the New York Business Corporation Law authorizes corporations to make charitable donations “irrespective of corporate benefit.”<sup>61</sup> There is also ample case law rejecting an affirmative obligation on the part of directors to sacrifice the interests of other constituencies in order to maximize shareholder wealth. As the court explained in *GAF v. Union Carbide Corp.*,<sup>62</sup> the board must balance investors interests, on the one hand, and “the legitimate concerns and interests of employees and management . . . on the other.”<sup>63</sup>

Commentators have suggested that, in practice, the shareholder primacy norm is even less influential than might be inferred from statutory and judicial rhetoric. Lynn Stout has argued that the business world itself seems to favor director primacy over shareholder primacy, demonstrating that both law and practice condone a variety of standard practices – options repricings, retroactive increases in employee retirement benefits, and corporate charitable contributions – in which

---

<sup>59</sup> A. A. Sommer Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 42 (1991).

<sup>60</sup> The Connecticut constituency statute, affirmatively requires directors, in the context of evaluating certain corporate transactions including mergers and other business combinations, to consider the interests of non-shareholder constituencies. *See* Conn. Gen. Stat. § 33-756 (“a director . . . shall consider, in determining what he reasonably believes to be in the best interests of the corporation . . . the interests of the corporation’s employees, customers, creditors and suppliers, and . . . community and societal considerations . . .”) (emphasis added).

<sup>61</sup> N.Y. B.C.L. § 202(a)(12). Similarly, the Delaware Supreme Court, in *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991), held that the appropriate standard to be applied in reviewing a corporate charitable donation was whether the donation constituted waste.

<sup>62</sup> 624 F. Supp. 1016, 1018 (S.D.N.Y. 1985).

<sup>63</sup> *Id.* at 1019-20.

shareholder interests are subordinated to those of other stakeholders.<sup>64</sup> Daines and Klausner have even found cases in which corporations in states that lacked statutory non-shareholder constituency provisions, such as Delaware, adopted such provisions in their charters.<sup>65</sup> Thus, there are reasons to question the validity of the shareholder primacy norm both as a matter of legal obligation and existing corporate practice.

### **C. Contract Principles as a Normative Foundation for Shareholder Primacy**

Many law and economics scholars defend shareholder primacy not by reference to some legal or theoretical conception of shareholder status but from a contractual perspective. If the corporation is a private enterprise in which the interests of its stakeholders are defined by their contractual agreements, the efficiency of legal rules should be measured by the extent to which they maximize the achievement of the parties' contractually specified objectives. Contractarian scholars describe the corporation as a hypothetical contract in which shareholders provide capital and other stakeholders provide other inputs, such as labor.<sup>66</sup> The standard economic literature distinguishes between the contractual rights of shareholders and other corporate stakeholders in two ways. First, non-shareholder stakeholders receive a fixed claim, while shareholders have a residual claim - they receive the surplus. Second, the fixed claimants have priority over shareholders – the right to have their claims paid, in full, and shareholders receive what is left over after the fixed claimants are paid.

It is interesting that shareholder primacy has not been formalized into an explicit contractual term, either through legislation or in the corporation's charter. Nonetheless, there are reasons that shareholder primacy makes sense as an implied element of the contract. First, and foremost, a contractual right to receive surplus is of little value if managers have no obligation to generate a surplus and are free to pay out all revenues to other corporate stakeholders. Second, shareholder primacy is a partial substitute for the priority that other stakeholders enjoy. In particular, shareholder primacy adds to the upside potential of the residual claim, which compensates shareholders for

---

<sup>64</sup> See Stout, *supra* note 42, at 1202-03.

<sup>65</sup> See Daines & Klausner, *supra* note 32, at 17 (describing adoption of explicit nonshareholder constituency provisions or control share acquisition provisions by 16 of 66 IPO firms in sample).

<sup>66</sup> See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (describing the corporation as “a complex set of explicit and implicit contracts”).

bearing greater risk than fixed claimants. Third, shareholders are passive investors. Through their control, other stakeholders, particularly management, can protect their priority interests directly. Fourth, shareholder primacy serves as a gap-filler. A contract that fully specified management's decision-making obligations with respect to shareholders would be impossibly complex and arguably too inflexible to respond to developments in the business world.

Finally, shareholders cannot withdraw their investment from the corporation without substantial sacrifice. Managers, employees, creditors and suppliers provide input to the corporation on an ongoing basis. Thus market forces constrain the corporation's ability to exploit these stakeholders in addition to explicit contract terms. In contrast, a shareholder provides permanent capital to the corporation. Although shareholders can exit the corporation if their interests are not adequately protected, they can do so only by selling their shares to another investor, and the market price for those shares will reflect the risk of shareholder exploitation.<sup>67</sup> As a result, they will bear the costs of misdeeds or self-dealing by other stakeholders even if they exit.

This effect is demonstrated in cases in which states of have adopted extreme antitakeover legislation. Several states have adopted antitakeover statutes that are widely viewed as unduly interfering with the market for corporate control, including Ohio, Massachusetts and Pennsylvania.<sup>68</sup> Commentators widely agree that these statutes harm shareholders by 1) reducing the ability of the takeover market to discipline management decision-making; and 2) making a takeover, with its likely premium for shareholders, less probable. These effects are borne out by empirical work, which shows a negative impact on stock price. The stock price of affected firms drops because the market anticipates the effect of these harms on the future value of the stock. Significantly, however, existing shareholders in these firms are the group that suffers the harm from the legislation, and shareholders cannot avoid the harm through exit because, once the legislation is adopted or even proposed, the price of existing shares falls to reflect the anticipated harm.

Ultimately, the contractual defense is largely positive rather than normative. The terms on which shareholders contribute capital to the corporation provide management with a high level of

---

<sup>67</sup> See, e.g., A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. (2004) (arguing that market will cause price of minority shares in controlled corporation to reflect the risk of self-dealing by the controlling shareholder).

<sup>68</sup> See Bebchuk *et al.*, *supra* note 12, at 1804-5.

operational discretion and with the freedom to consider the interests of multiple stakeholders. The terms of the contract do not, explicitly or implicitly, require managers to favor shareholders at the expense of other constituencies – the strong case of shareholder primacy. Shareholders would not contribute to the enterprise, however, if operational decisions were not constrained by the requirement that they be expected to provide some value to shareholders. As with the business judgment rule, this constraint is of limited scope. A contractual obligation to generate value for shareholders does not dictate how management should choose among business alternatives that couple different levels of risk-adjusted pay-off for different corporate stakeholders, so long as the alternative is expected to provide some positive value for shareholders. Thus, a contract analysis would prevent a corporation from diverting all shareholder return to labor, but would not prevent managers from raising employee salaries above market levels if the raise could be defended, in part, as increasing employee productivity, thereby enhancing long term shareholder value.

Moreover, it is important to distinguish the contractual argument that the corporate constituencies have agreed to shareholder primacy from the economic argument that shareholder primacy maximizes aggregate firm value. The economic theory behind shareholder primacy is based on the status of shareholders as residual claimants. Because residual claimants receive the surplus after fixed claims are paid, by definition, it is simply a truism to contend that maximizing the surplus is the equivalent of maximizing aggregate firm value.

Standard economic theory argues, because of this truism, residual claimants will have the appropriate incentives to maximize aggregate firm value, and that operational decisions should therefore be made based on their interests. Recent commentary has questioned this claim.<sup>69</sup> A number of commentators have observed that the residual claimants in a corporation may prefer excessive levels of risk taking, particularly when their expected return is small in the absence of that risk.<sup>70</sup> Because residual claimants may, in essence, gamble with value that would otherwise be paid

---

<sup>69</sup> See, e.g., Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH L. REV. 214, 221 (1999) (arguing that “the shareholder value maximization norm, if strictly applied, would require firm managers to make socially inefficient choices”); Stout, *supra* note 42, at 1197-98 (demonstrating how shareholder primacy can lead to inefficient outcome).

<sup>70</sup> Smith, *supra* note 69, at 221-224 (offering example of inefficiently risky investment and then extending the analysis beyond the “vicinity of insolvency”). Smith has also argued that the interests of a modern diversified investor are more appropriate than those of a hypothetical long term shareholder in defining the firm’s objectives.

to fixed claimants, their interests may directly conflict with the interests of other corporate stakeholders.<sup>71</sup> As Jeffrey Gordon has observed, even for financially sound corporations, the relationship of shareholder value to firm value is a function of the strength of the various markets in which the corporation participates, including the capital market, the labor market and the product market.<sup>72</sup>

Even if a firm can maximize aggregate value by making decisions based on the interests of the residual claimants, residual claimants are simply, by definition, those claimants who receive the firm surplus. It is not clear that shareholders should be viewed as the exclusive residual claimants in a corporation.<sup>73</sup> Even under existing law, other stakeholders arguably have an interest in the corporate surplus in addition to their fixed claims. As Lynn Stout argues, non-shareholder stakeholders are accurately described as residual claimants in the sense that they enjoy extra-contractual benefits when the corporation does well, and suffer, along with shareholders, when the corporation does poorly.<sup>74</sup> The corporation's contracts can explicitly allocate part of the residual claim to other stakeholders. Creditors can receive a share of firm profits rather than simply a fixed rate of interest. Managers and employees can receive performance-based compensation rather than fixed salaries.<sup>75</sup> Customers can

---

Robert Monks takes a similar view in his conception of a "Global Investor" for whom no societal effect is an externality. Robert A.G. Monks, *THE NEW GLOBAL INVESTORS: HOW SHAREOWNERS CAN UNLOCK SUSTAINABLE PROSPERITY WORLDWIDE* 105 (Oxford: Capstone, 2001)

<sup>71</sup> See Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 *STAN. L. REV.* 73, 77 (1995) (explaining why equity holders have an incentive to shift assets to risky investments and how this shift constitutes a transfer of wealth from the fixed to the residual claimants).

<sup>72</sup> See Gordon, *supra* note 27.

<sup>73</sup> Nor, perhaps, is it fully accurate to describe shareholders as residual claimants. Although shareholders have a theoretical claim on the firm's surplus, they have no actual entitlement either to the distribution of surplus or to control the allocation of surplus between themselves and contractual claimants, outside the context of bankruptcy. See Stout, *supra* note 42 at 1193-94 (stating that "as a legal matter, the shareholders of public corporations are entitled to receive nothing from the firm unless and until the board of directors decides that they should receive it").

<sup>74</sup> Stout, *supra* note 42, at 1194.

<sup>75</sup> Indeed, one might argue that the shift toward greater performance-based compensation for management has converted managers into residual claimants, resulting in a form of managerial capitalism. Performance based compensation has, of course, been justified on the basis that it reduces agency costs and properly incentivizes management to maximize firm productivity. See, e.g., Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 *U. CHI. L. REV.* 871, 898 (2002) (describing

receive a share of firm surplus through price cuts or rebates. Indeed, Henry Hu has argued that out of the money call option holders, who have little more than a bet on the firm's future stock price, are in fact the ultimate residual claimants.<sup>76</sup> Although complete contracts that are perfectly priced by efficient markets would concededly have the effect of fixing these interests, scholars have identified widespread market deficiencies suggesting that the interests of non-shareholder constituencies are imperfectly addressed by contract.<sup>77</sup>

What this means, is that, while maximizing the return to the residual claimants is economically equivalent to maximizing firm value, it is not necessarily the case either that shareholders are the exclusive residual claimants in the firm or that maximizing shareholder wealth is the same as maximizing firm value. Relying on shareholder wealth as the basis of an efficiency claim requires further justification.

### **III. The Shareholder Primacy Norm and Fiduciary Duties**

The rhetorical dominance of the shareholder primacy norm has arisen, in part, in response to challenges to the scope of corporate fiduciary duties, as described in section A below. Some commentators have argued that fiduciary principles should be extended to increase managerial accountability to non-shareholder stakeholders and, indeed, corporate constituency statutes have been defended on this basis although, as a practical matter, they do not impose additional fiduciary obligations on managers. Thus, within the context of fiduciary duty law, an ongoing debate pits advocates of shareholder primacy, who favor limiting the scope of fiduciary protection to

---

the evolution of the poison pill together with shifts in executive compensation during period after pill was developed); *cf.* Hansmann & Kraakman, *supra* note 40 (arguing that managerial capitalism has been correlated with reduced productivity).

<sup>76</sup> Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991). Hu's claim might be stronger with respect to warrant holders than for option holders. *But see* *In re New Valley Corp. Derivative Litig.*, 2004 Del. Ch. LEXIS 107, \*18-19 (Del. Ch. 2004) (rejecting argument that warrant holder had comparable legal interest to a stockholder).

<sup>77</sup> *See, e.g.*, Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PA. L. REV. 1349, 1354 (1988) (explaining how, in internal labor markets, "a bilateral monopoly replaces the textbook model of competitive supply and demand [and] asymmetric information and strategic behavior allow for inefficient outcomes"); *but see* Daniel R. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. CHI. L. REV. 1061, 1065-68 (1984) (identifying and rejecting reasons why labor markets might be less efficient than capital markets).



shareholders, against a stakeholder movement that advocates more expansive fiduciary protection. It seems like a small step to move from the argument that fiduciary protection should be limited to shareholders to a broader conception of the shareholder primacy norm as defining the corporation's objectives.

The Article does not challenge the limitation of fiduciary principles to protect shareholder interests. Although a variety of arguments have been made on both sides of the debate, this Article identifies a new argument that further supports the limited scope of fiduciary principles – institutional specialization. The role of the shareholder primacy norm as an interpretive principle in allocating lawmaking authority among competing institutions is developed in section B below. Importantly, however, the analysis highlights the distinction between shareholder primacy as a limitation on the scope of fiduciary duty and the normative defense of shareholder primacy as the exclusive measure of firm value. The distinction demonstrates why limiting the scope of fiduciary duties does not provide a normative basis for privileging the narrow conception of shareholder wealth over a broader conception of firm value for purposes of efficiency analysis.

#### **A. The Scope of Fiduciary Duties**

Although, as discussed above, the shareholder primacy norm operates as a limited constraint on managerial discretion, there is one area of corporate law in which it is of key importance: defining the scope of managerial fiduciary duties. Although corporate statutes do not explicitly require officers and directors to make operational decisions that favor shareholders over other stakeholders, only shareholders are protected by fiduciary duties. Fiduciary duties in corporate law operate as a type of supra-contractual constraint on managerial decision-making. Fiduciary duties – in particular, the duty of care and the duty of loyalty – limit managerial discretion. More importantly, fiduciary duties specifically empower shareholders, and not other stakeholders, to enlist judicial lawmaking to address problems of intra-stakeholder conflicts.

Commentators generally cite agency or trust law as the source of managerial fiduciary duties. The scope and significance of these duties is a matter of some debate – indeed, recent studies suggest that, absent self-dealing transactions, the liability exposure of directors for a breach of fiduciary duty

claim is virtually nonexistent.<sup>78</sup> Nonetheless, it is a fundamental principle of corporate law that, absent extraordinary circumstances,<sup>79</sup> non-shareholder stakeholders are not protected by fiduciary principles. Only shareholders can bring a lawsuit to address a director or officer breach of fiduciary duty.

Moreover, because fiduciary principles are, by definition, extra-contractual gap-fillers, their interpretation and application triggers a broad judicial inquiry into fairness, procedural protection, and the appropriate balance of power among corporate constituencies. Judicial case law on fiduciary duties is an important component of corporate law. Yet, only shareholders can trigger this type of judicial lawmaking. Other stakeholders can only call upon the courts to enforce explicit contractual or legal claims. The absence of fiduciary protection operates as a gatekeeping mechanism that reserves judicial lawmaking for shareholders and directs other stakeholders to other lawmaking institutions such as the legislatures and the markets.

## **B. Institutional Specialization and Fiduciary Principles**

The central focus of corporate law is agency problems created by conflicts of interest.<sup>80</sup> Conflicts between shareholders and managers have dominated the analysis.<sup>81</sup> The paradigm-shifting contribution of Berle and Means was the recognition that the separation of ownership and control in the public corporation, and the resulting corporate structure of strong managers and weak dispersed shareholders created an agency problem that had to be addressed by corporate law.<sup>82</sup> As a result, comparative institutional analysis in corporate law has typically pitted the role of shareholders in the

---

<sup>78</sup> See Bernard S. Black, Brian R. Cheffins, & Michael D. Klausner, Outside Director Liability, 2 (November 2003), <http://ssrn.com/abstract=382422> (finding that “[o]utside directors of U.S. public companies face a tiny risk of actual liability for good faith (non-self-interested) conduct, no matter how careless or reckless they are.”).

<sup>79</sup> Creditors are protected with fiduciary duties when the corporation is in the “zone of insolvency.” See, e.g., *Credit Lyonnais Bank v. Pathe Communications*, No. 12150, 1991 LEXIS 215 (Del. Ch. Dec. 30, 1991) (recognizing this protection).

<sup>80</sup> Kraakman, *et al.*, *supra* note 28.

<sup>81</sup> *But see id.* (identifying three sets of agency problems: those created by conflicts between shareholders and management, between controlling and minority shareholders, and between shareholders and other stakeholders).

<sup>82</sup> Adolf A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

institutional process against the role of management.<sup>83</sup>

In the classic Cary-Winter debate over regulatory competition, for example, former SEC commissioner William Cary argued that the dominance of Delaware as a corporate domicile – and thus the source of state corporate law for more than half of all publicly traded U.S. corporations – reflected the appeal of Delaware’s law to corporate management.<sup>84</sup> Cary attributed this appeal to the laxity of Delaware law – its failure to provide shareholders with optimal protection from management malfeasance and self-dealing – and thus termed the federalist system in which incorporating businesses can choose the state law that will govern their internal affairs a “race for the bottom.”<sup>85</sup> Ultimately, the race to the bottom sacrificed shareholder interests in favor of management.<sup>86</sup> Other commentators have identified the ability of management to lobby state legislatures and obtain favorable regulatory changes, such as the adoption of state antitakeover statutes. Thus, particularly if corporate law is concerned about the agency problem between shareholders and management, the lawmaking structure creates a particular risk that management will dominate the process and obtain rules that allow it to exploit the shareholders.

The standard public choice considerations also affect comparative institutional analysis in corporate law.<sup>87</sup> Public company stock in the United States is owned, directly or indirectly, by

---

<sup>83</sup> See Fisch, *supra* note 8, at 1065-66.

<sup>84</sup> William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

<sup>85</sup> *Id.* at 705.

<sup>86</sup> Cary’s conclusions were challenged, most famously, by Judge Ralph Winter, who argued that various market constraints discipline management and prevent a race to the bottom. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Regulatory competition, in Judge Winter’s view, instead produces a “race to the top.” *Id.* Judge Winter subsequently conceded the race to the top might, in fact, merely be a “leisurely walk.” Ralph K. Winter, *The “Race for the Top” Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1529 (1989).

<sup>87</sup> The terminology and methodology of comparative institutional analysis has been developed most extensively by Neil Komesar. See, e.g., Neil Komesar, *IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY* (1994). Komesar argues that a choice among lawmaking institutions such as Congress, the courts, and the market, requires a careful examination of the particular characteristics of each institution coupled with an assessment of that institution’s ability, relative to other institutions, to achieve a particular policy objective. *Id.* Komesar has exposed, most famously, the weaknesses in a critique based on single institutional analysis. *Id.*

dispersed small shareholders.<sup>88</sup> Small stakes and collective action problems limit the effectiveness of investors, particularly in a forum such as a legislature in which the reputation and experience of repeat players is a major factor in their effectiveness. Cost considerations, agency problems and their own political vulnerability limit the ability of even institutional investors with comparatively larger stakes to overcome these problems. Additionally, because much corporate law is enacted at the state level, shareholders lack even the minimum political power that they might otherwise be able to exert through the voting process. Although Delaware supplies corporate law to more than half of all publicly traded companies, few investors have the power to vote on the election of Delaware legislators.

In contrast, managers have substantial firm-specific stakes that make political activity rational. Corporations, pay substantial yearly franchise taxes to Delaware – revenue that Delaware risks losing if its corporate law fails to remain attractive to corporate management.<sup>89</sup> Corporations also provide substantial revenue to key interest groups in the creation of corporate law, such as Delaware corporate lawyers, through the consumption of legal services. In addition, managers may exploit their firm’s political capital for their personal benefit.

Arguably the disparity in access between managers and shareholders is even greater with respect to federal law. Roberta Romano has argued, for example, that Congress is even more likely than state legislatures to respond to interest group pressure.<sup>90</sup> Romano reasons that the “national political dynamic . . . favors managers” and that shareholders are likely to face greater collective action problems than managers in lobbying Congress.<sup>91</sup> In particular, Romano notes that, in addition to possessing higher stakes, managers can use corporate funds to pay their lobbying expenditures.<sup>92</sup>

---

<sup>88</sup> Even the growth in institutional shareholder does not change this, as most institutions such as pension and mutual funds are simply vehicles through which small investors hold stock indirectly.

<sup>89</sup> See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888 n.8 (1990) (stating that, in 1990, franchise taxes accounted for approximately 20% of Delaware’s general revenues).

<sup>90</sup> Roberta Romano, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

<sup>91</sup> *Id.* at 76.

<sup>92</sup> *Id.*

Other commentators have identified limitations in the SEC's ability to address deficiencies in state law through its rule-making authority.<sup>93</sup> Although an analysis of the SEC's institutional competence is beyond the scope of this Article, institutional characteristics such as expertise, the potential for industry capture, the extent of agency independence versus susceptibility to political influence, and the explicit and implicitly delegated scope of rule-making authority are all relevant to this issue. Because interest groups such as managers, corporate lawyers and securities analysts are small in size and have concentrated stakes, they are able to dominate the regulatory agenda and obtain legislation that favors their interests over those of dispersed investors.<sup>94</sup> Romano identifies the Williams Act and mandatory disclosure as examples of this type of regulation.<sup>95</sup> Consequently, public choice analysis suggests that corporate legislation, state or federal, is unlikely to serve the interests of investors relative to managers.

Similarly, to the extent that corporate law is addressed to intra-stakeholder conflicts, shareholders are likely disadvantaged in the legislative process relative to other stakeholders. Labor, suppliers and other businesses, customers, and community members all have the ability to participate in the political process. Other corporate stakeholders may have particular advantages in political participation relative to shareholders. Their interests may be aligned along a range of political issues. They may be repeat players. They may have greater stakes. Union lobbying and use of political action committees has enabled labor to develop a powerful political presence. The Teamsters, for example, is one of the most powerful interest groups in Washington politics. Corporate creditors and suppliers have the concentrated stakes and traditional resources of business interests.<sup>96</sup> Consumers

---

<sup>93</sup> See, e.g., J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 321 (2004) (describing as "unsuccessful" the SEC's efforts to compensate for deficiencies in state laws concerning corporate governance).

<sup>94</sup> Indeed, this dynamic may be responsible for the SEC's repeated decisions to abandon its efforts to provide direct shareholder nomination of directors. See Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 62-67 (describing SEC's consideration and abandonment of direct nomination proposals). It will be interesting to see whether current proposal suffers a similar fate. See Fisch & Gentile, *supra* note 18 at 578-80 (describing current SEC proposal to allow shareholder nomination of directors).

<sup>95</sup> *Id.*

<sup>96</sup> Note, for example, the range of explicit statutory protections for the interests of creditors, such as restrictions on dividend payments and personal liability of directors for approving an illegal dividend.

have increasingly been able to exert political pressure through organizations such as AARP and through the potential voting power that they command.

Some commentators such as Romano and Easterbrook and Fischel rely on this analysis to favor a market dominated approach in which investors have the option of using the pressure of the capital markets to pressure issuers to modify statutory default rules. There are reasons to believe, however, that the market based contractual approach is also better suited to serving the interests of non-shareholder stakeholders than to protecting shareholder interests. Contractual modifications can be used to adjust risk, priority, or fixed claims. Thus employees might respond to a rule that reduced employee perks by demanding higher cash compensation. Bondholders might respond to adjustments to the takeover market by demanding the right to approve changes in control or providing that such changes trigger a put option. Fixed claims also simplify a stakeholder's monitoring by reducing the task to determining adherence to the contract terms. The limited duration of many stakeholder interests enables participants to adjust the contractual terms to reflect interim legal or market changes at the time of new investments. At the same time, most stakeholders can exit, either continuously or periodically, at relatively low cost.<sup>97</sup> The value of the stakeholder's investment is only affected to a limited extent by its withdrawal from the corporation.

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

I have argued elsewhere, that there are reasons to believe courts may also offer a superior alternative to both the legislature and the market for the production of legal rules that protect

---

<sup>97</sup> A stakeholder's ability to exit is limited by the extent to which it has made firm-specific investments that are incompletely protected by formal contract. The presence of such investments must be considered a component of firm value in that they are valuable only if the firm continues operations.

shareholder interests.<sup>98</sup> Courts are insulated from the financial and political pressure associated with the legislative process.<sup>99</sup> Moreover, the transparency of written opinions provides a level of accountability.<sup>100</sup>

In addition, shareholders have far greater access to the courts than to the legislatures. The representative lawsuit, such as the shareholder derivative suit or securities class action, enables the small investor to obtain access to judicial lawmaking and allows the aggregation of small investor interests into substantial stakes while, at the same time, overcoming coordination and collective action problems, although concededly there are substantial administrative costs imposed through the collection of legal fees.<sup>101</sup> In addition to the shareholder interests in a particular company, shareholders generally enjoy the deterrent effect of litigation on future self-dealing and other misconduct by corporate officers and directors.

Experience supports the conclusion that judicial lawmaking is more responsive to shareholder interests than the lawmaking of other institutions. Many of the most pro-shareholder corporate law rules have been adopted through judge-made lawmaking – the auction requirement of *Revlon*, *Unocal*'s requirement of heightened judicial review of management decision-making in the takeover context, and the various expansive interpretations of the private right of action for federal securities fraud. Notably, where legislatures have responded to these rules, they have cut back on shareholder protection. Examples of these cutbacks include congressional adoption of the Private Securities Litigation Reform Act of 1995<sup>102</sup> which cut back on the imposition of fiduciary principles through federal securities fraud litigation, the Ohio legislature's rejection of the *Unocal* standard of fiduciary principles in the takeover context,<sup>103</sup> and the adoption of other constituency statutes by a variety of states to dilute the shareholder primacy norm.

---

<sup>98</sup> See Fisch, *supra* note 8.

<sup>99</sup> *Id.* at 1092-93.

<sup>100</sup> *Id.* at 1095.

<sup>101</sup> *Id.* at 1090-91.

<sup>102</sup> Private Securities Litigation Reform Act of 1995, Pub. L. No.104-67, 109 Stat. 737 (1995).

<sup>103</sup> See Ohio Rev. Code § 1701.59(C) (rejecting *Unocal* and codifying existing common law).

These institutional advantages are consistent with the role of the shareholder primacy norm in defining the scope of fiduciary duties. Shareholder primacy has the effect of granting shareholders, but not other stakeholder groups, access to judicial lawmaking. The justification for granting courts a specialized role in protecting shareholder interests vis a vis those of other corporate stakeholders, is one of institutional competence. The markets and the political process generally function well with respect to other corporate stakeholders. Because the interests of managers, employees, creditors, customers and suppliers, are adequately protected through other institutions, there is little need for judicial intervention. Shareholders, however, are relatively disabled from using these institutions effectively. As a result, shareholder primacy affords shareholders access to an alternative institutional actor: the courts. Fiduciary duty cases provide a mechanism through which shareholders can trigger a lawmaking process that protects their distinctive interests. Moreover, unlike the markets and the legislatures, the institutional structure of the courts is particularly well suited to provide shareholders with meaningful access and voice.<sup>104</sup>

This analysis explains why fiduciary principles – and thus judicial access– are limited to shareholders. Importantly the reason shareholders are protected with fiduciary duties is not because theirs are the only interests that count within the corporation. The interests of managers, customers, and employees count, but those interests are protected through mechanisms other than fiduciary duty litigation. As a result, contrary to the claims of progressive scholars, the legitimacy of other stakeholder claims does not justify the extension of fiduciary principles to protect non-shareholder interests. Rather the scope of existing fiduciary principles can be understood, and defended, as a mechanism for institutional specialization — allowing the different institutions to serve the interests of different corporate participants.

#### **IV. The Relationship Between Shareholder Value and Firm Value**

##### **A. Shareholder Primacy and Regulatory Efficiency**

---

<sup>104</sup> Significantly, the market can protect the interests of future shareholders far more effectively than the interests of existing shareholders. On the conflict between the interests of current and future investors, see Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors* (working paper dated 6/7/04). As a result, legal doctrines such as the contemporaneous ownership requirement and the standing requirement in securities fraud litigation constrain judicial access by such future shareholders in favor of market remedies.



The importance of goal specification is a key component of efficiency analysis.<sup>105</sup> As Susan Freiwald observes, “[s]eemingly minor variations in goals lead to major differences in the analysis.”<sup>106</sup> It is, however, frequently overlooked. There is also a risk that scholars will invent their goal in order to fit their project without independently considering the extent to which their goal is defensible.<sup>107</sup> This Article argues that existing empirical research in corporate law is premised on the theory that the goal of corporate law is maximization of shareholder wealth. Accordingly, the studies equate firm value with shareholder wealth and characterize regulations that maximize shareholder wealth as efficient.

I have argued in the preceding sections that the normative case for defining firm value exclusively in terms of shareholder wealth cannot be made simply on the basis of existing legal doctrine, contractual analysis or the scope of fiduciary duty law. Is there an alternative justification for analyzing regulatory efficiency in terms of shareholder welfare? A complete answer to this question is beyond the scope of this Article.<sup>108</sup> A partial answer, is that the appropriate definition of efficiency in empirical analysis, depends on the purposes of the analysis. Regulatory provisions have explicit and implicit objectives, and the goal of efficiency analysis should be to evaluate the extent to which a provision is serving its intended goals.

---

<sup>105</sup> See, e.g., Neil Komesar, *Basic Instincts: Participation, Economics and Institutional Choice*, working paper at 15-16 (2004) (criticizing both economic and philosophic analysis for failure adequately to define goals upon which analysis is based).

<sup>106</sup> Susan Freiwald, *What A Comparative Institutional Analysis of Online Surveillance Reveals*, working paper at 25 (2004) (describing importance of goal specification in comparative institutional analysis).

<sup>107</sup> See Komesar, *supra* note 105 at 16-17 (warning of risk that scholars will invent new goals without sufficient analysis or justification).

<sup>108</sup> One answer might be that, given the difficulty of valuing non-shareholder interests and the challenges of multi-attribute decision-making, shareholder wealth is an acceptable, albeit second-best proxy for firm value. See Richard S. Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHI.-KENT L. REV. 3, 5 (1998) (explaining that it may be desirable to allow imperfect decision-makers to take approaches that would not be ideal if those decision-makers were first-best perfect). Alternatively, reliance on the shareholder wealth proxy may encourage policy-makers and corporate decision-makers to focus excessively on short term price effects at the expense of long term value. See Jensen, *supra* note 2 at 16-17 (identifying this risk and proposing alternative approach of “enlightened stakeholder theory”). To the extent that the stock market bubble of the late 1990s was fueled by corporate risk-taking justified in terms of maximizing shareholder wealth, the bursting of that bubble suggests that the dislocation costs of such risk taking may be substantial even if the risks can, in theory, be addressed through diversification.

Corporate scholars disagree on the appropriate characterization of the objectives of corporate law – corporate law itself, as opposed to the objectives of the corporation. Some scholars, such as Lucian Bebchuk, argue that the efficiency of corporate law must be analyzed by reference to the interests of all corporate constituencies. Because “a given corporate law issue ... implicates not only the interests of shareholders, but also those of third parties . . . these [third party] interests must be taken into account in arriving at the socially optimal rule.”<sup>109</sup> Others such as Henry Hansmann and Reinier Kraakman, have argued that shareholder value is the normatively appropriate focus of corporate law, and that the interests of other corporate stakeholders are better addressed through other bodies of law such as labor law, consumer law, and so forth.<sup>110</sup>

The larger debate need not be resolved here. At least some corporate law is addressed to agency issues among corporate stakeholders – allocating wealth, power or decision-making among various corporate constituencies. These rules may have an impact on overall firm value, but they may also effect transfers of value between corporate stakeholders. As a result, empirical research that seeks to evaluate these rules in terms of efficiency cannot use shareholder wealth as a proxy for firm value, and must consider the effect of the rules on all affected constituencies. When a legal rule is addressed, at least in part, to a division of the corporate pie, its effects cannot be assessed by looking to only to the shareholders’ piece of the pie.

An alternative justification for looking beyond shareholder value can be based on Jensen and Meckling’s characterization of the corporation as a nexus of contracts.<sup>111</sup> Jensen and Meckling recognize that these contracts include non-shareholder constituencies, the “owners of labor, material, and capital inputs.”<sup>112</sup> Yet measuring a firm’s equity capitalization reflects only the value of its contracts with shareholders. Valuation of other types of contracts may pose a challenge, but recognition that these contracts constitute a component of firm value supports an effort to develop a

---

<sup>109</sup> Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1485 (1992).

<sup>110</sup> Hansmann & Kraakman, *supra* note 40.

<sup>111</sup> Michael Jensen, & W. H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>112</sup> *Id.*

broader conception of firm value for purposes of efficiency analysis. The following section offers some preliminary thoughts on this enterprise.

### **B. Alternative Conceptions of Firm Value**

Are there alternatives to shareholder wealth as a measure of firm value? Within the legal literature, a handful of scholars have identified mechanisms for incorporating components of firm value beyond shareholder wealth. First, as Thomas Smith suggests, empirical research could readily broaden the concept of shareholder wealth to a measure of investor value by including the market value of a firm's debt.<sup>113</sup> An assessment of the effects of regulatory change on investment value would reflect impact on both shareholders and creditors. Similarly Michael Jensen defines firm value as "the sum of the values of *all* financial claims on the firm – debt, warrants, and preferred stock, as well as equity."<sup>114</sup> Second, Jeffrey Gordon is doing cutting edge work attempting to develop and apply a methodology for measuring employee value that can be incorporated into firm value.<sup>115</sup> Third, some scholars have identified the private benefits obtained by managers or controlling stockholders as an independent component of firm value.<sup>116</sup>

These methods may be imperfect. In particular, traditional financial measures of firm value may be poorly suited for measuring the value to other stakeholders, such as customers, suppliers, and community members. As Ramesh Rao has observed, business contracts with these stakeholders are often illiquid and lack both hedging options and market valuations.<sup>117</sup> George Constantinides identifies particular elements of the risk associated with an employee's investment in a firm – the risk of job loss is uninsurable, persistent and counter-cyclical.<sup>118</sup> As a result, job stability, in addition to

---

<sup>113</sup> Smith, *supra* note 69.

<sup>114</sup> Jensen, *supra* note 2 at 8 (emphasis in original).

<sup>115</sup> Gordon, *supra* note 27.

<sup>116</sup> See, e.g., Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (identifying private benefits of control that may be enjoyed by controlling stockholders or managers).

<sup>117</sup> Ramesh K.S. Rao, *The Value of the Firm as a Nexus of Heterogeneous Contracts*, 3 (November 15, 2004) <http://ssrn.com/abstract=624101>.

<sup>118</sup> George Constantinides, *Rational Asset Prices*, 57 J. FIN. 1567, 1575-76 (2002).

compensation, may represent an important component of a firm's value to employees.

Nonetheless, the approaches outlined above address, at least to some degree, the concern that shareholder wealth does not include the value produced for non-shareholder constituencies. An additional problem identified by the business literature is that shareholder-based measures of firm value often do not adequately reflect risk. As one commentator observes, "a low-risk investment that produces a low return which is in excess of cost of capital does more for shareholders than a high-risk investment that produces a high return that is below the investment's cost of capital."<sup>119</sup> Because two comparable firms can have different costs of capital, one firm's economic profit, which is the ratio of its return minus its cost of capital to its total capital, may differ substantially from another's even if they produce comparable returns to shareholders. Similarly true shareholder value should be measured in terms of the excess return over the firm's cost of capital.<sup>120</sup>

A consequence of this deficiency is that defining the corporate objective as shareholder primacy, measured by criteria such as stock price or net income, may lead managers to make excessively risky investments.<sup>121</sup> The reason is that these metrics of firm productivity focus on absolute returns without reflecting the firm's true cost of capital. In essence, they artificially treat equity capital as free. As a result, managers may select inefficient investment projects that, provide a lower return than the firm's cost of equity capital.

Scholars and consultants have developed a variety of measures that are designed to evaluate firm productivity in terms of whether the return exceeds the firm's cost of capital.<sup>122</sup> One of the best known is EVA or economic value added.<sup>123</sup> Developed by New York based Stern Stewart, EVA is

---

<sup>119</sup> Leonard S. Hyman, *Investing in the "Plain Vanilla" Utility*, 24 ENERGY L.J. 1 n.1 (2003).

<sup>120</sup> See, e.g., Pablo Fernandez, A Definition of Shareholder Value Creation, working paper, (April 27, 2001), <http://ssrn.com/abstract=268129> (defining shareholder value as a return that exceeds the required return to equity or cost of capital).

<sup>121</sup> At the same time, these criteria do not capture the role of corporate risk management in increasing shareholder value. See, e.g., Sohnke M. Bartram, *Corporate Risk Management as a Lever for Shareholder Value Creation*, 9 FINANCIAL MARKETS, INSTITUTIONS AND INSTRUMENTS \_\_ (2000) (defending corporate risk management as a means of increasing shareholder value).

<sup>122</sup> A firm's cost of capital is computed as a weighted average of the firm's costs of equity and debt.

<sup>123</sup> See Cyrus A. Ramezani, Luc A. Soenen, & Alan Jung, Growth, Corporate Profitability, and Shareholder Value Creation, 6 (March 21, 2001) <http://ssrn.com/abstract=304880> (computing EVA as NOPAT (net

the net operating profit after taxes minus a charge for the firm's cost of capital, a charge that reflects the opportunity cost of all capital, equity and debt, invested in the firm.<sup>124</sup> Stern Stewart describes EVA as "an estimate of true 'economic' profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk."<sup>125</sup> Peter Drucker explains the significance of EVA as follows:

EVA is based on something we have known for a long time: what we call profits, the money left to service equity, is usually not profit at all. Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources. Until then it does not create wealth; it destroys it.<sup>126</sup>

EVA is not the only alternative measure of firm productivity.<sup>127</sup> The business school literature has identified a variety of productivity measures,<sup>128</sup> and there is an ongoing debate over which measure is most appropriate.<sup>129</sup> It is unnecessary, for purposes of this Article, to identify the relative advantages and disadvantages of the various methods. Common to all these methods is the recognition that, whether the goal is measuring firm value or identifying criteria to assist managerial decision-making, there are shortcomings to using net income or stock price. Commentators explicitly

---

operating profit after taxes) - WACC (weighted average cost of capital) \* capital).

<sup>124</sup> About EVA, Stern Stewart Website, <http://www.sternstewart.com/evaabout/whatis.php>.

<sup>125</sup> *Id.*

<sup>126</sup> Peter Drucker, *The Information Executives Truly Need*, HARV. BUS. REV. 54 (Jan.-Feb. 1995).

<sup>127</sup> The chief competitor to EVA is CFROI, an inflation-adjusted measure of cash flow return on investment, developed by HOLT Value Associates. Randy Myers, *Metric Wars*, CFO, Oct. 1996. A variant on CFROI is total business return or TBR, promoted by the Boston Consulting Group. *Id.*

<sup>128</sup> Other measures include return on assets (ROA), market value added (MVA), and shareholder value added (SVA). See, e.g., John Yozzo, *et al.*, *Return on Assets: So Useful . . . and So Misused*, 2001 ABA Jnl. LEXIS 204, \*2-4 (defining ROA as the product of total asset turnover and operating margin, and distinguishing ROA, which is the return to all a firm's suppliers of capital, from net income, which "belongs entirely to the firm's shareholders"); *Value Analytix, Strengths and Weaknesses*, [http://www.valueanalytix.com/articles/comparison\\_of\\_methodologies.html](http://www.valueanalytix.com/articles/comparison_of_methodologies.html) (describing basis of calculating SVA, EVA and CFROI and describing strengths and weaknesses of each methodology).

<sup>129</sup> See, e.g., Randy Myers, *Measure for Measure*, CFO MAGAZINE, Nov. 1, 1997 (describing controversy over which performance metric is most useful); Alix Nyberg & Bill Birchard, *On Further Reflection*, CFO Magazine, Mar. 1, 2001, [www.cfo.com/printable/article.cfm/2991941?f=options](http://www.cfo.com/printable/article.cfm/2991941?f=options) (questioning whether EVA and other value metrics are useful measures of firm performance).

defend these methods because they “measure performance from a corporate finance perspective rather than shareholder wealth creation.”<sup>130</sup> Moreover, studies have found substantial differences in assessments of firm performance, based on the choice of methodology.<sup>131</sup>

The innovation in and controversy over performance metrics in the business world suggests that measuring firm performance is complex.<sup>132</sup> The implication of this research is that legal academics should worry about focusing exclusively on shareholder wealth and, in particular, on relatively simplistic measures of that wealth, in assessing firm value.

## Conclusion

The shareholder primacy norm is commonly understood as the normative claim that a corporation should be managed in order to maximize shareholder wealth. From this claim, it follows that the efficiency of corporate law can be assessed by empirically measuring the effect of regulation on shareholder wealth. This reasoning provides the basis for the efficiency claims of empirical studies of corporate law.

This Article challenges the foundations of the shareholder primacy norm. Both existing legal doctrine and economic theory provide only limited support for shareholder primacy. The Article

---

<sup>130</sup> See Ramezani, *et al.*, *supra* note 123, at 7 (applying this characterization to EVA and MVA).

<sup>131</sup> See, e.g., Pablo Fernandez, *EVA and Cash value Added do Not Measure Shareholder Value Creation*, SSRN working paper, <http://ssrn.com/abstract=270799> (May 23, 2001) (finding lack of correlation when measuring firm value, over a 10 year period, among MVA, EVA, NOPAT and WACC); Ramezani, *et al.*, *supra* note 123 (identifying differences in performance measures and finding that earnings and sales growth are not correlated with shareholder value creation).

<sup>132</sup> A complete analysis of this complexity is beyond the scope of this Article. An example is illustrative, however. A Darden School case study of the relative performance of FedEx and UPS during the period 1985 to 1995 finds that FedEx’s financial performance during that time period was much worse than that of UPS. Robert F. Bruner & Derick Bulkley, *The Battle for Value: Federal Express Corporation vs. United Parcel Service of America, Inc.*, UVA-F-1115, Darden School Case Study (July 1997). In particular, the study observes that “Between 1985 and 1994 FedEx destroyed \$1.36 billion in economic value while UPS created \$2.08 billion.” *Id.* Based on these findings, the study questions the rationality of the stock market valuation of FedEx. On the other hand, the cumulative return of FedEx since its inception in 1978 has been over 9000%. FedEx Investment Calculator, <http://fdx.client.shareholder.com/calculator.cfm> (showing that an investment of \$1000 in FedEx stock on April 12, 1978 was worth \$91,638.67 as of Oct. 27, 2004). Moreover from 1999 to 2004, a comparable investment in the common stock of each company would have produced a cumulative return of 107.65% for FedEx and 15.37% for UPS. FedEx Investment Calculator, <http://fdx.client.shareholder.com/calculator.cfm> (calculating return for an investment of \$1000 from Nov. 10, 1999 to Oct. 27, 2004); UPS Investment Calculator, <http://www.shareholder.com/ups/calculator.cfm> (calculating return for an investment of \$1000 from Nov. 10, 1999 to Oct. 27, 2004).

further rejects the argument that shareholder primacy may be grounded in existing limits on management fiduciary duties. Rather, the Article identifies and defends the shareholder primacy norm as an interpretive principle for judicial lawmaking in the context of applying fiduciary principles, based on principles of comparative institutional analysis. Understood in this way, however, the shareholder primacy norm cannot readily be extended to support a normative defense of shareholder wealth as the exclusive measure of firm value.

Identifying the shareholder primacy norm as tool for allocating judicial lawmaking authority suggests that the case has not yet been made for reliance on shareholder wealth as the benchmark of regulatory efficiency. Although a more complete analysis of firm value may demonstrate that strongly efficient credit, labor and product markets, for example, make shareholder value a reasonable proxy for firm value, scholars need to provide this type of explicit justification for their reliance on shareholder wealth. Similarly, in light of the fact that regulatory constraints often address allocational issues among corporate stakeholders, economic scholars need to provide a better justification for the argument that shareholder wealth effects should dominate regulatory policy.