BAD AND-NOT-SO-BAD ARGUMENTS AGAINST SHAREHOLDER PRIMACY

By

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ABSTRACT

In this paper, we critically assess some recent arguments (as well as some refurbished ones) that have been made against shareholder primacy. We conclude that, given standard assumptions about the functioning of competitive markets, the principle of shareholder primacy does not violate the moral rights of other parties like contractual stakeholders.

INTRODUCTION

Shareholder primacy refers to the norm or doctrine that the directors and officers (management) of a corporation have a duty to manage the corporation in the best interests of the shareholders. This is generally held to mean that management should maximize shareholder wealth. Especially among business ethicists and progressive legal scholars, shareholder primacy has been the object of sustained criticism. Our goal in this paper is to assess some recent moral arguments against shareholder primacy.[1] We don't undertake a comprehensive review of the literature. Rather we evaluate a number of key arguments that have recently surfaced (or re-surfaced) in that literature. Thus we update the debate on shareholder primacy.

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The arguments we critically examine here fault shareholder primacy on a number of different (but sometimes overlapping) counts. The arguments against shareholder primacy are as follows: Corporations too powerful to be disciplined by market forces; therefore they should serve the public interest rather than their shareholders' interest. Corporations have been created by the state and granted various privileges by the state. Accordingly, they have a duty to subordinate the interests of shareholders to the public interest. Shareholder primacy stands for the principle that corporations are accountable only to shareholders, but the decisions of corporations affect the fortunes of a wide swathe of stakeholders or constituencies. Their success depends on teamwork between the shareholders and the corporation's stakeholders. Shareholders are absentee owners and usually too dispersed to exercise effective control over corporate management. They have forfeited their right to shareholder primacy because they are no longer active in managing the corporation. The doctrine of shareholder primacy is incoherent because shareholders don't have a homogeneous set of preferences. The doctrine, in any case, has only a tenuous basis in actual corporate law. Finally, shareholder primacy prevents shareholders and stakeholders from working cooperatively in their mutual best interests. We examine these arguments in the body of this paper.

Argument # 1: ***Corporations too powerful to be disciplined by market forces; therefore they should serve the public interest rather than their shareholders' interest.***

One endemic problem of umpiring the debate over the ethics of shareholder primacy is that the scholars on opposite sides of the argument talk past each other. Notably, they tend to rely on very different empirical assumptions. As a consequence, what passes for an ethical argument about the corporation is often really an empirical claim in disguise.[2]

One such empirical disagreement between critics and supporters of shareholder primacy lies is over the power of corporations. Business ethicists don't often squarely address the question of the corporate power, but many seem to accept without examination the view that corporations exercise considerable power. Thus James Post claims that that corporations "are not at the mercy of markets."[3] Heath believes that the "firm is often in a position to exercise significant market power over its constituency groups."[4] Another example is the literature on global CSR.[5] Much of this literature evangelizes in favor of corporations assuming much greater global responsibilities. But it (usually implicitly) rests on the empirical claim that multinational corporations "govern markets" and play a quasi-governmental role in global governance. Advocates of global CSR claim that since multinational corporations have transcended market forces they can afford to take on such responsibilities and (since their power is illegitimate) they have a duty to do so. So, even if it is not explicit, much work in business ethics appears to rest on the unspoken premise that corporations have largely succeeded in weakening or transcending competition. Not only that, but the premise does a lot of the heavy lifting in their arguments. However, the great weight of informed opinion rejects this assumption and follows the redoubtable Martin Wolf of the *Financial Times* when he states that "markets dominate companies."[6]

This debate matters for our discussion because, if corporations control markets, rather than the other way around, then it no longer makes sense to say (as we intend to) that stakeholders have consented to shareholder primacy.[7]

We side with those who believe that global and domestic markets are substantially competitive. However, for two reasons we choose not to argue the point here: First, the question

is ultimately empirical and beyond the scope of this paper. Second, we believe that the far better response to market power is for government to police it rather than for society to tolerate it but demand, in return, that corporations be run for purposes other than those of their shareholders.

Argument # 2: ***Since corporations are the beneficiaries of state privileges they have a duty to put the public interest before the interests of shareholders.***

A recurring objection to shareholder primacy rests on the claim that the state has conferred "special" privileges on corporations. In return, society has the right to demand that corporations serve more than just private interests. These privileges are said to have enabled corporations to accumulate wealth. They include (1) limited liability, (2) legal personhood, (3) perpetual life, and (4) the free transferability of interests.

To simplify our discussion, and for reasons of space, we narrow our focus to the first of those privileges, namely *limited liability*. As is well known, under limited liability the shareholders of the corporation are not liable for its debts – at least beyond the amount they have invested in the corporation.

First, it is worth repeating the obvious point that it is not only shareholders whose assets are protected by limited liability. The corporation's stakeholders like lenders and employees are also immune from personal liability for the corporation's debts (apart from those resulting from their own acts). Furthermore, the term "privilege" normally denotes a special right, advantage, or immunity granted or available only to a particular person or group of people. Since virtually anyone with a pencil and paper or a laptop and (in California) $100 for a state filing fee can form a corporation, to call limited liability a special privilege is a stretch.

Second, limited liability is *voluntary*. It is a default rule, meaning that the parties are free to contract around it: Shareholders can waive its protection, and stakeholders are free to condition their doing business with the corporation on shareholders forgoing its protection. For example, stakeholders can (and often do) withhold their business from corporations that do not compensate them (say, by means of a higher interest rate or better price or a debt covenant) for any additional risk they run of not getting paid.[8] Also, if a company wants to raise capital on more favorable terms, then a wealthy shareholder may offer a personal guarantee to achieve that.

Third, because limited liability is a default rule, the fact that it is almost invariably accepted by the corporation's stakeholders is evidence that it enriches all of the stakeholders. Corporations with limited liability evidently find it possible to offer better terms to contractors. If corporations find it easier, say, to raise capital, that makes for a more productive corporation and a stable employer, supplier and customer.

Fourth, if the firm's stakeholders benefit from limited liability, it follows that if it did not exist, the stakeholders would invent it. As Easterbrook & Fischel have pointed out, the obvious mechanism for doing so is contract.[9] Thus, the stakeholders (all of whom, by assumption, are contractual) and the shareholders might simply insert into each contract language limiting recovery to the assets of the corporation.

To conclude, the benefits of limited liability don't flow exclusively to shareholders. They reduce the contracting costs of all of the stakeholders by providing a standard contract provision that the stakeholders would have chosen. The fact that limited liability is the default rule enables the stakeholders to economize on the transaction costs of re-inventing it. Default rules, because they are negotiable, don't confer any privilege, except (conceivably) when the transaction costs associated with renegotiating the rule are prohibitively high so that the parties are effectively

locked into it. That does not seem to be the case here. (As we saw, in the absence of limited liability, the same result might be obtained by contract). If we are right, and stakeholders have acquiesced in limited liability (because it makes possible higher wages and better terms), it is not properly called a privilege (always assuming, as we do in this paper) that neither shareholders nor stakeholders enjoy significant market power.

Argument # 3: *Shareholder primacy unfairly favors shareholders over other stakeholders*.

Shareholder primacy means that, in case of conflict, the shareholders' interests prevail over the interests of stakeholders. The intuitive appeal of the case against shareholder primacy stems from the apparent unfairness of this arrangement. It seems unbalanced inasmuch as it bars managers from considering the interests of anyone except shareholders, despite the fact that all stakeholders contribute (if in different ways and degrees) to the corporation's success. As Keay puts it, "[t]he shareholders are only one group amongst many who are affected by the corporation's actions, so why should they benefit in priority to others?"[10]Thus Donaldson & Preston argue that shareholder primacy violates the principle that the "interests of all stakeholders are of intrinsic value."[11] And Cragg says, "everyone ought to count."[12] Donaldson describes shareholder primacy as a "special privilege of shareholders."[13] To put it another way, the charge against the shareholder primacy principle is that it fails to respect the equal moral worth of all the firm's stakeholders.

This argument against shareholder primacy raises two questions: (1) Is it true that shareholders are favored over other stakeholders? (2) If shareholders are treated differently, is the different treatment morally justifiable? In answer to the first question, whether shareholders are favored over other stakeholders, it is not at all obvious that that is the case. True, they are generally the beneficiaries of management's fiduciary duties, but in other respects they are disadvantaged. The most striking difference is familiar to every first-year business student. It is that in the event of the failure of the corporation, shareholders are paid last, "after debt investors, employees and other investors with (relatively) 'fixed' claims." [14] Unlike other stakeholders, shareholders don't have (relatively) fixed claims on the corporation. As a consequence, their interests are not as easily protected by contract.

In the standard law & economics account, it is precisely because the shareholders stand to gain (or lose) the most from the management of the corporation that the duties of managers run to shareholders rather than another stakeholder. The differences don't end there. Stakeholders generally enjoy more extensive statutory protections than shareholders, and shareholders notoriously pay taxes twice on the same income.

With respect to (2), is the different treatment morally justifiable, partiality is not *per se* unethical, and so we cannot conclude that different treatment is necessarily unfair treatment. Treating people differently is not unfair. Aristotle said that treating unlike alike is a violation of justice. So everything turns on whether there exist morally relevant differences between the parties that justify the different treatment. The preceding discussion pointed to some of the ways in which shareholders are unfavorably situated vis-à-vis the corporation that might justify the shareholder primacy principle. In light of these differences, the relationship between shareholders does not seem so one-sided. The differences also suggest a plausible explanation for why fully rational stakeholders would acquiesce in this allocation of rights and duties within the corporation.

In addition, as Heath, Boatright and Hansmann have described, shareholder primacy is not the universal rule.[15] In cooperatives, the rule is employee or customer or supplier primacy. In mutual insurance companies the rule is policy holder primacy. [16] In some sectors of the economy, these non-shareholder models predominate (law firms, etc.). Evidently, if *stakeholder* primacy is the rule in some other sectors of the economy, it is not the law that blocks stakeholder primacy in the corporation, but the choices of the parties. (Heath says that, if anything, cooperatives are more favored by tax and other laws than are shareholder corporations [17]). In conclusion, it is not clear that shareholder primacy does more than balance the other disabilities of shareholders in the corporation's governance. In any case, if we are right in assuming that the arrangement has been freely agreed to by the stakeholders, then that is all the justification it needs.

Argument # 4: ***As state creations corporations have a duty to serve the public interest.***

It is sometimes said that corporations owe their existence to the state and, as creatures of the state, they have a duty to put the public interest ahead of the shareholders' interests. Recent examples include: Corporations are "are totally dependent on society for their existence… [and so have a duty] to "adapt to changing public perceptions of the public good."[18] Corporations are "socially constructed so society's interests should take precedence over 8 shareholders' interests".[19] "[S]ociety has the right to make whatever changes it wants to the corporation."[20]

Our first inquiry is what part the state has played in bringing the corporation into existence. That role is limited if not actually trivial. The state has not invented a product or service, it has not exposed itself to any financial risk -- it has simply registered the birth of the corporation. As Ribstein has said, "a corporation is a piece of paper in a Secretary of State's office."[21] Incorporation simply requires that a business file paperwork with the Secretary of State and pay a filing fee. The state may verify that the proposed name of the corporation is available. Otherwise its role is basically limited to record-keeping. This minuscule expenditure of effort hardly seems to justify this breathtaking assertion of power over the corporation. The state state-creation theory is also implausible because it proves too much. No one claims that the newborns are creatures of the state's Registrar of Vital Records because their births are recorded there.

Of course, there is a sense in which the critics are right. Incorporation is a legal act. Therefore, as a matter of raw power, the state may be able attach conditions to the incorporation – though very onerous conditions may be subject to challenge under the "takings" clause of the Constitution. Historically, it is true, before general incorporation, states often attached conditions to incorporation. But from a moral, as well as a constitutional standpoint, such a practice raises a fundamental question concerning the proper limits of state power. If corporations are truly voluntary associations, and if their purpose and means are lawful, then the case for granting the state the right to determine whether corporations may exist or not, and *a fortiori* to dictate their actions, say, outside of a public emergency, is questionable. In conclusion, the fact that state incorporation is a necessary condition for the existence of the corporation cannot morally ground its backdoor socialization.

Argument # 5: ***Shareholders have forfeited their right to primacy because they are no longer active in managing the corporation.***

Shareholders, of course, play a passive role in the management of the corporation. Some scholars have seized on shareholders' passivity to argue that they have forfeited their right to primacy. Robert Solomon maintains that the separation of owners from managers reduces moral obligations to the shareholders.[22] And, more recently, James Post and his associates have made the same claim: "[C]orporations need not manage themselves primarily for the benefit of individuals who are in this passive and often indirect ownership role."[23]

One obvious problem with this argument is that it offers no account of how or why the passivity of shareholders should excuse managers from keeping their promises or allow managers to expropriate shareholders. To bring the argument down to earth, imagine the case of a teacher who saves for her retirement and invests her savings in an S&P 500 Index fund. She does not take an active part in managing the corporations she has invested in. Does that justify management of the corporations she has indirectly invested in (or her fund managers?) diverting her savings to some cause that they (sincerely) deem to be worthy? By analogy, the duties of a trustee to a minor beneficiary are not weakened because of the minor's passive role in managing the trust's assets. Bainbridge is surely correct when he points out that "[s]eparating ownership from control does not divest the owner of his rights." [24]

Most statements of this view treat it as self-evident. The puzzle is that the theory that passivity attenuates shareholders' claims on the corporation has a distinguished pedigree. One of its earliest formulations appears to be Dodd's in his famous debate with Adolph Berle in 1932.[25] Dodd wrote about the weakness of the claims of "absentee owners who in many cases have not even seen the property from which they derive their profits." [26] Subsequently, Berle & Means embraced the argument in their influential study of *The Modern Corporation and Private Property*.[27] For example, in that work, they wrote that, "by surrendering control and responsibility over the active property, [shareholders] have surrendered the right that the corporation be operated in their sole interest. . . . They have placed the community in a position to demand that the modern corporation should serve not alone the owners or the control but all society."[28]

Berle and Means' lead has been followed by other scholars in the 1950s and 1960s. Edward Mason called shareholders "functionless *rentiers*,"[29] In 1956, John Kenneth Galbraith described shareholders as "vestigial."[30] The contemporary statements quoted at the beginning of this section echo these claims almost verbatim.

To make sense of these arguments, it is necessary to view them against the background of the evolution of the corporation in the 1930s, and continuing as late as the 1950s. At the time, many progressive scholars became convinced that the economy was destined to be dominated by a handful of ever-larger corporations run by an unaccountable managerial class. This development was driven by the separation of ownership and control as a result of the dispersion of shareholdings. This development led economists like Galbraith to predict the convergence of the Soviet and U.S. economies. If we are right, Berle's real concern was with the new corporate behemoths that had transcended competition. His critique of the illegitimacy of shareholder primacy was rooted in his fear of the emergence of an unaccountable managerial class. Seen against that background, the idea that shareholders are "functionless" is perfectly reasonable.

However, Berle's predictions about the economy have not panned out. The economy is not dominated by a monopolistic or oligopolistic combines that exercise market power over their respective industries. We rely primarily on competition to police corporations, not on appeals to their sense of ethics or social responsibility. Shareholders aren't the beneficiaries of monopolistic

power but rather are exposed to genuine risks. Therefore, critics of the corporation have failed to offer any compelling case for why shareholders' passivity justifies their expropriation.

Argument # 6: ***Shareholder primacy has been eroded by developments in the law (1)***

Some other recent critiques of shareholder primacy are rooted in developments in the law. One argument against shareholder primacy is that it is virtually impossible to enforce. It is said to have been "eviscerated" by a legal doctrine known as the business judgment rule.[31] Under the business judgment rule, so long as managers make decisions that are plausibly related to the "best interests of the corporation" and are not completely irrational, American courts don't hold them liable for violating their duty of care.[32] The rationale for this hands-off policy has been described by Bernard Black as follows:

> First, courts are bad at second-guessing in hindsight decisions that turned out poorly. Second, an investment in a business can turn out badly, for a whole host of reasons. Bad management decisions are only one of these reasons. They are a risk that shareholders knowingly assume. Third, some risky decisions will work out wonderfully, while others will work out terribly. If the directors risk being found personally liable for bad outcomes, they will be reluctant to take risks, and we will get fewer really good decisions also. We may not get better decisions on average, just more cautious decisions. [33]

One of the practical results of the business judgment rule is that it is very difficult for shareholders to use the courts to enforce managers' fiduciary duties. Courts are reluctant to interfere with management's decisions except in extreme cases. As a consequence, according to Marens & Wicks, "[v]irtually any act that does not financially threaten the survival of the business could be construed as in the long-term best interest of the shareholder."[34] So long as managers utter the magic words "best interests of the corporation," they are likely to get a free pass from the courts.

Doubtless it is true that, as a practical matter, one result of the rule is to give management virtually unreviewable discretion to manage the corporation. But that is a practical result of the rule, not the rule's intent. So it is surprising that some scholars use the business judgment rule to argue that stakeholder theory is "well within the boundaries of the law." [35] These scholars openly urge managers to use the rule to conceal their true motives to implement stakeholder-friendly policies. We think that is ethically questionable. At best it risks encouraging managers to dissemble; at worst it appears to condone fraud. The rule evolved to reduce transaction cost. It has never been intended a backdoor way of expropriating shareholders.

Similar arguments are made by other scholars. Some follow Blair & Stout's lead in claiming that "[c]ase law … often explicitly authorizes directors to sacrifice shareholders' interests to protect corporate constituencies."[36] However, nothing has really happened in the meantime to change David Millon's conclusion in his review of Blair & Stout's "Team Production Theory of the Firm" that "[f]ew cases…offer only doubtful support."[37]

However, even supposing that that the law did explicitly expropriate shareholders, that would still fail to provide a moral basis for such an action. It would amount to confiscation, and managers would be acting unethically if they took advantage of it, even to serve other worthy interests. That is not to argue that governments may not change property rights. But it is to hold

with Charles Fried that such changes should be gradual or prospective. "[Even [property] rights which are conventional … are conventional *rights*. A sharp change in definition [of property rights] amounts to confiscation. It is a dishonest procedure, which succeeds only by preying on the confidence of individuals…"[38]

Argument # 7: *Shareholder primacy has been eroded by developments in the law (2)*

As we saw, courts have been reluctant to second-guess management's business judgment so long as management's decisions are plausibly related to *the best interests of the corporation*. Some critics of shareholder primacy have seized on this formula – "the best interests of the corporation" – to try to drive a wedge between shareholders and the corporation. Blair & Stout say that "American law views the corporation as an entity with interests of its own, and not just a proxy for shareholders' interests."[39] But, if the corporation is not the shareholders, who is the corporation? Blair & Stout claim that case law generally interprets the "best interest of the company" to include non-shareholder interests, including those of employees, creditors, and the community."[40]

There are reasons to think that this claim is bad law. For example, in a recent decision in *eBay v. Newmark* (2010), the Chancellor held that "[d]irectors for a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization--at least not consistently with the directors' fiduciary duty under Delaware law."[41]

But, even if this were a correct reading of the law, would this expropriation by stealth be morally defensible? Using our yardstick, the test is whether the parties agreed to the use of corporate assets for purposes other than the best interests of shareholders.

Critics of shareholder primacy sometimes make the telling observation that nothing in the law or corporate charter specifically obligates management to try to maximize shareholder return. Assuming that the law deliberately leaves this point vague and corporate charters do not specifically provide for shareholder primacy, what other evidence can help us establish what the fiduciary duties of managers entail? One way of triangulating the question is to examine the *exceptions* to the shareholder primacy rule. So-called constituency statutes that grant management latitude to consider the interests of stakeholders are sometimes cited as evidence of a trend in the law away from shareholder primacy. But a more reasonable interpretation would seem to be that constituency statutes *vindicate* shareholder primacy. After all, they would be superfluous if the law already authorized management to favor stakeholders over shareholders. Presumably, the same point applies to benefit corporation legislation.[42] Such legislation would be redundant if corporations already enjoyed the power to consider non-financial interests when making decisions.

The takeaway from this is that the legal baseline for the parties' normative expectations is shareholder primacy. If these constituency statutes and benefit corporation laws are exceptions to the rule, then the rule in question is shareholder primacy. Indeed, the sustained attacks from the academy on shareholder wealth maximization and shareholder primacy would be pointless these doctrines were not entrenched in corporate theory and practice.

Another way of determining whether the interests of the corporation are distinct from those of the shareholders is by means of a thought experiment. Since corporations are created by incorporation, when investors originally bought the corporation's stock what did the investors and management think they were agreeing to? Was it (a) that management would use the

investors' funds in the best interests of the shareholders? Or (b) that management would use the funds for public good or to benefit stakeholders? Or (c) something in-between? We think the thought experiment yields an answer closer to (a) than the other values. And since subsequent shareholders step into the shoes of their predecessors, they have purchased the same rights that were agreed to at incorporation.

One piece of evidence in support of this answer comes from Stout herself. She concedes that, "even though law does not dictate shareholder primacy, as a practical matter today's public companies pay far more attention to shareholder value than American companies did two or three decades ago." [43] That is to say that, even if there is dissent in the academy, actual market participants appear to share the perception that management's duties are to serve the interests of the shareholders. Even among academic ethicists, there is some support for this view. Heath says, "shareholders [have] some sort of agreement, which involve[s] assigning priority to the interests of shareholders over other constituency groups…"[44] Or, to quote Heath again, "something like shareholder primacy is implicit in all these transactions, and is certainly the expectation that most parties bring to the table…."[45]

One of the most devastating critiques of shareholder primacy is that it is not spelled out in the corporate charter. If it is so important, why not? We can only offer conjectures. One is that shareholders believe that managers are adequately policed by the markets for corporate control and managers so that they are minimally tempted to stray from shareholder wealth maximization. Another is that shareholders believe that, given the treacherous political and other currents management has to navigate, it is in the shareholders' own interests not to tie management's hands.

We conclude that the attempt to drive a wedge between the corporation and its shareholders fails as a matter of law, but it also fails *as a matter of ethics* because its effect would be to confiscate the property of shareholders.

Argument # 8: *Shareholder primacy is incoherent*

Recently Lynn Stout has attacked shareholder primacy on the grounds that it is incoherent.[46] She says that the idea that managers can maximize shareholder value "rests on an impossible abstraction of the shareholder as a Platonic entity that cares only about the market price of a single corporation's equity." [47] So long as shareholders are heterogeneous (i.e., they want different things from their investments), managers obviously cannot simultaneously maximize all their interests.

However, we suggest that it is beside the point whether shareholders have different values or interests. The only thing that counts morally is what management implicitly or expressly promised shareholders when the corporation went public. (Easterbrook & Fischel say that "entrepreneurs make promises in the articles of incorporation and the securities they issue when they go public."[48]) Nothing else counts morally or, we suggest, legally unless the promises have been amended by the appropriate procedures. (In the previous section we examined reasons for concluding that shareholder wealth maximization is what management has promised). Stout's mistake is to assume that shareholder primacy requires that management continuously adapt corporate policy to the shifting preferences of the shareholders. That would result in incoherent policies, but it would also violate the parties' original understanding.

In any case, even if shareholders are heterogeneous, much less follows from this point than Stout appears to think. Take, for example, Stout's comparison of two hypothetical

shareholders of Apple – one long-term and the other short-term.[49] She says that their different investing time horizons mean that they want Apple to adopt different policies. The short term shareholder wants Apple to reduce its expenditures on customer support and product quality, but the long-term shareholder does not. Stout says that the short term shareholder "knows that such actions will damage employee and customer loyalty, but she expects to have sold her Apple shares and moved on to her next investment long before these long-run harms are reflected in [Apple's] stock price." [50]

On closer inspection, however, it is plain that there is no conflict between the two hypothetical shareholders. Consider what happens if the short term shareholder gets her wish. Either Apple's decision will be announced, in which case the short term investor won't be able to sell her Apple shares in time. Or the decision will be implemented by stealth, in which case the short term investor will be unable to judge if the run-up in Apple's share price is the result of reduced spending on customer support or of other factors, and so she won't know when to time her sale of Apple shares. In short, the short-term shareholder won't be able to profit from Apple's change of policy *unless she has insider knowledge*.

The bottom line is Stout has failed to show that it makes any practical difference if you are a long or short-term investor.

Argument # 9: *Shareholder primacy doctrine impedes the board's ability to make credible commitments to stakeholders*

Probably the most sophisticated and original argument for expropriating shareholders is that it is *in the shareholders' own best interest*. In their much-cited article on "Team Production", Blair & Stout argue that corporations are more productive if they can induce stakeholders to make specific investments.[51] Examples are employees who learn to operate a particular process that is unique to her employer; or a vendor who locates a warehouse near the corporation in order better to service it. However, transaction cost economics teaches that such investments are vulnerable to hold up by the corporation because they have no value (other than scrap value) outside the relationship with the firm. Once a stakeholder has made a firm-specific investment, if the corporation refuses to share the resulting rents with the stakeholder, the stakeholder cannot terminate the transaction without forfeiting his investment. In the words of Asher et al., the firm may "renege on promises [to stakeholders] embedded in previous implicit contracts."[52] Knowing this, the stakeholder will not make the firm-specific investment in the first place, and the opportunity for mutual gains will be lost.

This problem would not arise if the corporation could credibly commit not to expropriate the stakeholder's firm-specific investment. But protestations of good faith by management will be treated with skepticism by the stakeholder because the stakeholder knows that at some subsequent time the corporation may be tempted to renege on its commitments. (This is known to economists as the "time inconsistency" problem). Stout refers to "the conflict between shareholders' initial interest in making commitments to stakeholders and each other, and their subsequent interest in breaking those commitments later."[53]

Blair & Stout's' proposed solution to the problem of credible commitment is for shareholders to relinquish shareholder primacy. Once management is no longer exclusively beholden to shareholders, it can function as an impartial arbiter (or "mediating hierarch") between the different constituencies that comprise the firm. Its independence will allow it to make the credible commitments that are necessary for stakeholders to be willing to make specific

investments. In this way, by giving up their monopoly of the fiduciary duties of management, shareholders benefit (along with the stakeholders) from the corporation's greater productivity.

Blair and Stout's theory has attracted considerable scholarly commentary. (For an excellent critique see Ian Lee[54]). One problem with the team production theory of the firm is that it is not necessary for the stakeholders to pick up the tab for their investments in firm specific assets; the corporation has the option of paying for them. (Alternatively the parties can share or balance specific investments, along the lines of Oliver Williamson's exchange of hostages). Another problem is that it is not clear what the incentives are for Blair & Stout's board to perform its duties conscientiously since it is independent of both shareholders and stakeholders.

However, we suggest that the most serious defect of the team production theory is that it "solves" a non-existent problem. There is no time inconsistency problem, so long as the corporation is a going concern. A time inconsistency problem arises when a player's best plan for some future period will not be optimal when that future period arrives. But in the case of a "going" corporation that future period never arrives. That is because the corporation always needs to provide its current stakeholders with the assurance necessary to induce them to make firm-specific investments, so it dare not risk its credibility by reneging on its past promises. Stakeholders know this, so they can safely make specific investments in the corporation.

Nor is the risk of hold up a problem if the corporation is on the edge of going out of business. True, in such a case, shareholders might try to lighten the ship by jettisoning any unnecessary weight – like promises of higher wages to employees who are no longer paying their way. But the firm's opportunism makes little practical difference to stakeholders who have made firm-specific investments. Either the corporation keeps its promises to the stakeholders and goes out of business. Or it reneges on those promises and (as a result) stays afloat. The outcome is the same irrespective of whether the stakeholders have been held up or not.

The only situation where hold up is a theoretical possibility is where the corporation is viable (if barely) but is generating no return to shareholders. In these conditions, shareholders may be tempted to gamble. They might, for example, invest in a high-return project with a higher risk. From the standpoint of the shareholders this is a one-way bet because if it pays off the shareholders will capture the gain while if it fails the stakeholders will absorb the loss (say because the corporation may go out of business). As a consequence, stakeholders bear the entire risk of the project. Because of this risk, there is legal precedent for the proposition that, when the firm is in the vicinity of insolvency, management's fiduciary duties shift to creditors and bondholders (whose interests are similar to those of employees).

In conclusion, this argument fails to show that shareholder primacy should be replaced by an independent board. In most cases, the board (as the agent of the shareholders) is fully able to credibly commit to stakeholders that it won't hold up their firm-specific investments. In the rare exceptions, say in an "end game," stakeholders are out of luck irrespective of whether they are held up or not, so the board's credibility is irrelevant.

CONCLUSION

We conclude that the principle of shareholder primacy is morally robust. Given certain assumptions (like reasonably competitive markets), the principle is consistent with the rights of other parties like stakeholders.

The starting point for our critique of some recent arguments against shareholder primacy has been the observation that the corporation is, in Easterbrook & Fischel's phrase, a "voluntary

adventure." [55] That is to say, the great majority of corporate stakeholders have become stakeholders by virtue of their voluntarily contracting with the corporation. (There are exceptions. One important class of such stakeholders is "involuntary creditors." They deserve a separate treatment).

We conclude that, by the act of doing business with the corporation, non-shareholders have acquiesced in the principle of shareholder primacy. Stakeholders are free to withhold their business from the corporation or to condition it on their receiving the same rights as shareholders or even some role in the governance of the corporation. But they have not done so. That is so (we believe the evidence suggests) because stakeholders believe that they have got the best package of terms available. They understand that, to obtain the same governance rights as shareholders, they will have to make concessions with respect to other terms of their contract with the corporation. For example, if the stakeholders are employees, they might have to accept lower wages. That may make the transaction unfavorable, so they may rationally acquiesce in shareholder primacy.

It may be objected that the freedom of the stakeholders is illusory. Every corporation practices shareholder primacy. Stakeholders cannot realistically threaten not to do business with corporations. That objection overlooks two key points. First, if stakeholders genuinely value a role in corporate governance, and are willing to grant offsetting concessions in return for it (say, in the form of lower wages or increased effort), then alert entrepreneurs won't wait for offers. They will take the initiative in offering such concessions because that will provide them with a competitive edge. Second, once such trades get rolling, other corporations will be forced to follow suit on pain of being left at a competitive disadvantage.

For this reason, we suggest that it is not implausible to talk of the institutions of our economy having been *chosen* by stakeholders. Shareholder primacy is one of those institutions. If stakeholders are generally unwilling to outbid shareholders for it, we assume that is because they prefer the package they get without it.

We also conclude that, if the parties are left free to bargain over the allocation of rights and duties in the corporation, it can be expected that those rights and duties will gravitate to where they are most productive, because the most productive form of organization will generate the greatest surplus. The greatest surplus, in turn, will finance more attractive packages for all stakeholders. If this analysis is correct, external pressure to dismantle or dilute shareholder primacy would reduce the welfare, not only of shareholders, but stakeholders (broadly conceived) as well. The same criticism may apply to other policies that tie the hands of the stakeholders instead of allowing them to work out their relationships among themselves.

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[1] There is a voluminous literature. See, especially, Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy* 75 Southern Calif. Law R. 1189, 1193 (2002); Stout, THE SHAREHOLDER VALUE MYTH (2012a); Stout, THE PROBLEM OF CORPORATE PURPOSE (2012b); Joel Bakan, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER (2004); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N. Y. U. L. REV. 733 (2005); Joseph Heath, "*Business Ethics without Stakeholders*," 16 BUS. ETHICS Q., 533 (2006); Joseph Heath, *Business Ethics and the 'End of History' in Corporate Law*, 102 J. BUS. ETHICS, 5 (2011); Andrew R. Keay, *Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?* 7 ECFR, 369 (2010). Citation is to draft at http://ssrn.com/abstract=1498065. Ian B. Lee, *Efficiency and Ethics in the Debate about Shareholder Primacy*, 31 DEL. J. CORP. L, 533 (2006): James Post, Lee Preston & Sybille Sachs, REDEFINING THE CORPORATION: STAKEHOLDER MANAGEMENT AND ORGANIZATIONAL WEALTH (2002).

[2] Ian Maitland, *The Morality of the Corporation: An Empirical or Normative Disagreement?* 4 BUS. ETHICS Q., 445 (1994).

[3] Post *supra* note i; Florian Wettstein, MULTINATIONAL CORPORATIONS AND GLOBAL JUSTICE: HUMAN RIGHTS OBLIGATIONS OF A QUASI-GOVERNMENTAL INSTITUTION (2009); Andreas G. Scherer & Guido Palazzo. *Globalization and Corporate Social Responsibility*. In A. Crane, A. McWilliams, D. Matten, J. Moon, D. Siegel (eds.), THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY at 413-431 (unrevised draft). (2008).

[4] Joseph Heath (2011) *supra*, note 1 at 18.

[5] Florian Wettstein and Andreas Scherer & Guido Palazzo, all *supra*, note 3.

[6] Martin Wolf, WHY GLOBALIATION WORKS (2004)
[7] Here, we limit our analysis to *contractual* stakeholders. We omit so-called "involuntary creditors." This class of stakeholders deserves separate treatment.

[8] Andrew Keay reports that contracts drafted by corporate creditors "frequently restrict the implementation of shareholder primacy," *supra*, note 1 at 3.

[9] Daniel H. Easterbrook and Daniel R. Fischel. THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) at 41.
[10] Keay *supra* note 1 at 48 citing D. Wood, *Whom should business serve?* 14 AUSTL. J. CORP. L. 1, 13 (2002).

[11] Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACADEMY OF MANAGEMENT REV., 65, 67 (1995).
[12] Thomas Donaldson, *The Stakeholder Revolution and the Clarkson Principles*, 12 BUS. ETHICS Q. 107, 108 (2002).

[13] *Id*.

[14] Easterbrook & Fischel *supra* note 9 at 1.

[15] Heath (2011) *supra*, note I and John R. Boatright, *What's Wrong – and What's Right – with Stakeholder Management*, 21 J. OF PRIVATE ENTERPRISE, 106 (2006); also Henry Hansmann, THE OWNERSHIP OF ENTERPRISE (1996).
[16] Boatright , *id.*
[17] Heath (2011) *supra*, note 1.

[18] Norman E. Bowie, BUSINESS ETHICS: A KANTIAN PERSPECTIVE (1999) at 94.
[19] Post *supra*, note 1 at 13.

[20] Amitai Etzioni, "*A Communitarian Note on Stakeholder Theory*," 8 BUS. ETHICS Q.679, 680 (1998).
[21] Ribstein, Larry, *Is a Corporation a Person?* http://busmovie.typepad.com/id (2004).

[22] Robert C. Solomon, ETHICS AND EXCELLENCE: COOPERATION AND INTEGRITY IN BUSINESS (1992) at 178.

[23] Post *supra*, note 1 at 15.

[24] Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*," 50 WASH. & LEE L. REV., 1423, 1426 (1993).

[25] Edwin M. Dodd, *For Whom Are Corporate Managers Trustees?* 45 Harvard Law Review, 1145 (1932). Adolph Berle, A. & Gardiner Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed.) (New York: Macmillan). (1933)
[26] Dodd *id*.

[27] Berle & Means, *supra,* note 25.

[28] *Id*. at 355-6.

[29] Edward S. Mason, THE CORPORATION IN MODERN SOCIETY at 2-6 and 14-15 (1959).

[30] John Kenneth Galbraith, AMERICAN CAPITALISM (1956).

[31] Margaret M. Blair & Lynn Stout, *A team production theory of corporate law*, 85 Univ. of Va. Law Review, 247 (1999); Richard Marens & Andrew Wicks, *Getting Real: Stakeholder Theory, Managerial Practice, and the General Irrelevance of Fiduciary Duties Owed to Shareholders*, 9 BUS. ETHICS Q, 273, 287 (1999).
[32] Bernard Black, THE PRINCIPAL FIDUCIARY DUTIES OF BOARDS OF DIRECTORS (2001); Margaret M. Blair, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY at 58 (1995).
[33] Bernard Black *supra* note 32.

[34] Marens & Wicks *supra,* note 31at 281.

[35] *Id*. at 288.

[36] Blair & Stout *supra,* note 31at 303.

[37] David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. LAW REV., 1001, 1015 (2000).
[38] Charles R. Fried , CONTRACT AS PROMISE (1981).
[39] Blair & Stout *supra,* note xxxi at 300-1; see also Keay, *supra* note 1 at 14.

[40] Blair & Stout *id*.

[41] *eBay Domestic Holdings, Inc. v. Newmark*, C.A. No. 3705-CC (Del. Ch. Sept. 9, 2010).

[42] Lynn Stout (2012a) *supra,* note 1 at 98.

[43] Stout (2012a) *supra,* note 1.

[44] Joseph Heath (2006) *supra*, note 1 at 9.

[45] Heath (2011) *supra,* note 1 at 10.

[46] Stout (2012b) *supra,* note 1 at 10. See also Eric Orts, *The Complexity and Legitimacy of Corporate Law* 50 WASH. & LEE L. REV, 1565, 1591 (1993); and Keay *supra* note 1 at 44.

[47] Stout *id*.

[48] Easterbrook & Fischel *supra*, note 9 at 6; see also Kenneth Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 BUS. ETHICS Q. 53, 63 (1991).

[49] See Stout (2012b) *supra,* note i at 9. Here is the heart of Stout's hypothetical case: "Suppose, for example, Anne and Betty each own shares in Apple Corporation. Anne is an asocial hedge fund manager who seeks only to "buy low and sell high," who takes positions in only two or three companies at a time, and who churns her investment

portfolio two or three times annually. Betty is a prosocial, diversified, buy-and-hold investor saving toward her retirement, who works as an elementary school teacher in California…. Anne … wants Apple to reduce its expenditures on customer support and product quality. In the long run, this will likely hurt employee and customer loyalty and Apple sales, but Anne expects to have sold her Apple shares and moved on to her next investment long before these long-run harms are reflected in Betty's stock price."

[50] *Id*.

[51] Blair & Stout *supra*, note i. See also Keay, *supra* note 1 at 11.

[52] Cheryl C. Asher, James M. Mahoney & Joseph T. Mahoney, *Towards a Property Rights Foundation for a Stakeholder Theory of the Firm*, 9 J. MANAG GOV, 5, 15 (2005).
[53] Stout (2012a) *supra*, note 1 at 74.

[54] See Ian B. Lee (2006) *supra*, note 1.

[55] Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).