2006

The Dividend Puzzle: Are Shareholders Entitled to the Residual?

Daniel J.H. Greenwood
Maurice A. Deane School of Law at Hofstra University

The Dividend Puzzle: Are Shares Entitled to the Residual?

Daniel J.H. Greenwood*

ABSTRACT

Everyone knows that shareholders receive dividends because they are entitled to the residual returns of a public corporation. Everyone is wrong.

Using the familiar economic model of the firm, I show that shareholders have no special claim on corporate economic returns. No one has an entitlement to rents in a capitalist system. Shareholders, the purely fungible providers of a purely fungible commodity and a sunk cost, are particularly unlikely to be able to command a share of economic profits or, indeed, any return at all.

Shareholders do win much of the corporate surplus. But this is not by market right or moral entitlement. Rather, it is the result of a (possibly temporary) ideological victory in a political battle over economic rents. Surprisingly, since corporate law often assumes a conflict between shareholders and top management, shareholder gains flow from the usefulness of the share-centered ideologies in justifying a tremendous shift of corporate wealth from employees to top managers. Burgeoning CEO salaries are part of the same phenomenon as high shareholder returns, not in opposition to it.

Taking the political nature of the corporation seriously will lead to a series of new and important questions. Are current distributions of corporate wealth justifiable, or should corporate governance treat lower-paid employees as citizens instead of subjects? Why should only one side in a political conflict have the vote, and why per dollar instead of per person? Given undemocratic internal corporate politics, are current levels of deference to corporate autonomy justifiable?

---

* Daniel J.H. Greenwood, S.J. Quinney Professor of Law, S.J. Quinney College of Law, University of Utah; J.D. Yale; A.B. Harvard. http://www.law.utah.edu/greenwood. Special thanks to Jill Fisch for convincing me to develop the point, and to Kent Greenfield, Reiner Kraakman, Daniel Medwed, Joe Singer and participants at the Faculty Workshops of Brooklyn Law School, Hofstra University School of Law, New York Law School and St. John's Law School for helpful comments; the paper is much improved as a result. I am grateful for the financial support of the S.J. Quinney College of Law Summer Research Fund and the time I spent and discussions I had

at the Tanner Humanities Center.

I. INTRODUCTION

Everyone knows that shareholders receive dividends because they are entitled to the residual returns of a public corporation. Everyone is wrong.

Corporate law scholars sharply disagree over the merits of the nexus of contract theory, which emphasizes a metaphor of the corporation as a largely contractual moment in the market;[1] corporate-finance based views emphasizing that shares and bonds are closely related and often interchangeable;[2] an older fiduciary duty based tradition, which emphasizes the obligations of managers to work for their "principals," the shareholders;[3] and institutionalist views which emphasize information problems and the bureaucratic functioning of the firm.[4] But nearly everyone agrees that the corporation exists to generate wealth for shareholders.[5] Both those who claim that shareholders "own" the

1. This view has its locus classicus in Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972) (contending that firm is a purely voluntary market phenomenon with no elements of coercion or fiat) and Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (describing the firm as a nexus of contracts and reduction of agency costs as the central issue). It currently dominates the elite law schools despite criticisms dating back decades. *See, e.g.*, KRAAKMAN ET AL, THE ANATOMY OF CORPORATE LAW (2004) (proclaiming and exemplifying hegemonic dominance of nexus of contracts theory); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989) (surveying and criticizing the approach); Arthur Allen Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451 (1974) (raising basic objections to an economic approach).

2. For introductions to the corporate finance view, see WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES (9th ed. 2004); RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE (8th ed. 2006). Corporate finance theory emphasizes that the value of a security is dependent on the risk-adjusted present value of future cash flows, regardless of whether the security is legally classified as stock, bond, or even a third-party option contract to which the corporation is not a party. Accordingly, it teaches that both managers and investors should view these various securities as largely interchangeable, despite the different legal roles they represent in the corporation. Like the nexus of contracts view, corporate finance destabilizes the traditionally privileged position of shareholders and thus undercuts the notion that corporations exist only for the benefit of shareholders. *See, e.g.*, Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) (describing use of standard finance techniques to allow separation of share voting rights from economic consequences of share ownership).

3. This tradition usually traces itself back to ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (LEGAL CLASSICS LIBRARY 1993) (1932), although modern uses of the book seem radically different from the authors' understanding. *See* Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179 (2005). Berle and Means established the key point that shareholders in the modern corporation are better understood as passive investors than as "owners" in the full legal sense. That insight underpins the Federal securities regulatory system they inspired, which is largely based on a consumer protection model with investors in the consumer role. However, in the modern debate, Berle and Means are most important for an almost opposite idea: "the separation of ownership and control." Having established that shareholders in a publicly traded corporation lack the legal and economic characteristics of ownership—control over the asset, rights to make decisions, and ability to appropriate its profits—they then continued to refer to shareholders as owners. *See*, BERLE & MEANS, *supra*, at 119. The metaphor of "equitable" ownership, as if the board of directors were trustees for shareholders, *id.* at 247, has proven to have more staying power than Berle and Means' alternative (and inconsistent) conclusion that modern corporations could no longer be viewed as private property. *Id.* at 352-59. Some modern writers in the fiduciary duty tradition, following the Dodds side of the great Berle-Dodds debate emphasize that fiduciary duties may run to more than merely shareholders. *See, e.g.*, LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY (2001). However, the more common version is symbolized by the famous dictum in *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919), "[a] business corporation is organized and carried on primarily for the profit of the stockholders." *See infra* note 16.

4. *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) (describing the corporation as a "shareholders cooperative"); OLIVER E. WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM (1985) (emphasizing transaction costs); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (describing corporate form as solution to worker's coordination problems).

5. *Dodge*, 170 N.W. at 668. *But see* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1142 (Del.

firm and those who, following the nexus of contract theory, say that "ownership" is meaningless in this context,[6] agree that shareholders are entitled to have the firm operated in their interest. Indeed, even when the shareholders are the same people as other firm participants—most corporate shareholders today are institutional investors, which often also hold bonds and may also be fiduciaries for current or past employees at the corporation, its suppliers, its customers or its competitors—courts and theorists alike often assume that the firm should grant the shareholder role primacy.[7]

Contrary to conventional wisdom, however, basic economic analysis of the modern public corporation demonstrates that shareholders have no special claim on a corporation's economic returns.[8] Economic profits are rents. No one has a pre-legal entitlement to economic rents in a capitalist system.[9] Shareholders, the purely fungible providers of a purely fungible commodity, are particularly unlikely to be able to command a share of economic profits. Indeed, since the contribution of shareholders to the firm is a sunk cost, in a competitive market, shareholders are unlikely to earn any return at all. Accordingly, market-based analyses of the firm should conclude that shareholder returns result from a market distortion.

1989) ("[W]e reject the argument that the only corporate threat posed by an all-shares, all-cash tender offer is the possibility of inadequate value."). For academic discussion, see, e.g., Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87, 87-88 (2005) (summarizing state of the debate); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (contending that share-centrism has won the debate).

6. Alchian & Demsetz, *supra* note 1, n.14. For example, note that shareholders need not be considered owners but can be thought of as investors like bondholders. More fundamentally, much of modern corporate finance is based on Miller and Modigliani's insight that, from the perspective of the firm, equity and debt are largely interchangeable, and the firm's value is largely independent of which it uses to finance itself. Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961); Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, *in* THE REVOLUTION IN CORPORATE FINANCE 129, 132-54 (Joel M. Stern and Donald H. Chew, Jr., eds., 2003). If bonds and shares are interchangeable, of course, the "ownership" rights of shareholders must be unimportant. *Cf.* David Ellerman, The Role of Capital in "Capitalist" and in Labor-Managed Firms (Dec. 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=633722 (noting that economic understanding of the firm as a production function does not imply that "capital" owns the firm in the sense of being the residual claimant). Even the standard Brealey et al. corporate finance textbook, which assumes throughout that managers ought to be maximizing shareholder return, mysteriously states that the firm "should try to minimize the present value of all taxes paid on corporate income . . . includ[ing] personal taxes paid by bondholder and shareholders," as if bondholders had precisely the same status as shareholders. BREALEY ET AL., *supra* note 2, at 473. They do not explain why tax avoidance should be a firm goal, why firms should view themselves as aliens exempt from responsibilities incumbent on all citizens, or why shareholder and bondholder taxes are different from personal taxes paid by suppliers, customers, or employees; apparently it is self-evident that the firm should consider as its own concern the personal finances of these financial investors, but not other factors of production.

7. Perhaps the most dramatic judicial proclamation of shareholder primacy is *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182-83 (Del. 1986), in which the court enjoined certain defensive measures in a hostile takeover because they favored bondholders over shareholders, without regard to whether bondholders were helped more than shareholders were hurt, even though the facts made clear that the two groups heavily overlapped and without more detailed information on actual holdings it was impossible to tell whether investors would view their bond or share holdings as more important.

8. *See infra* Part III.

9. On the concept of "rents" as used in the public choice and law and economics literature, see, for example, Mark Kelman, *On Democracy-Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement*, 74 VA. L. REV. 199, 227 (1988) (describing rent-seeking, when it is worthy of condemnation, and ambiguities in concept).

Similarly, black-letter legal doctrine makes clear that shareholders have the same legal right to dividends as waiters have to tips: an expectation that is not enforceable in court. Metaphorical claims that shareholders are "owners" suffering from a "separation of ownership and control" or "principals" suffering from "agency costs," or even "trust beneficiaries," conceal but do not overcome the legal reality. Shareholders have political voting rights in the organization, not the rights of an owner of property, a principal in an agency relationship or a beneficiary of a trust.

The implications are clear. Shareholders win some of the corporate surplus not by market right or moral entitlement, but due to a (possibly temporary) ideological victory in a political battle over economic rents. Surprisingly, since conventional wisdom portrays corporate law as a conflict between shareholders and top management, those conflicts are dwarfed by the common interest of the two groups. Shareholder returns are largely the consequence of managers finding the share-centered ideologies useful as an ideological justification for a tremendous shift of corporate wealth from employees to the CEO/shareholder alliance.

Standard metaphors of the public corporation as a trust, an agency relationship, a nexus of contracts, a piece of property or a person conceal the internal political struggles over corporate surplus and the weakness of shareholder claims to appropriate it. Taking the corporation's political nature seriously, in contrast, leads to a series of new insights and related questions. If the struggle over corporate surplus is a political struggle over economic rents, why should only one side, the shareholders, have the vote? In a democratic society, why should those votes be allocated on a per-dollar basis, instead of a per-person basis? Indeed, to the extent that shareholders are only a role, and market forces make it a limited and narrow role, is it plausible to believe that the stock market is often a reasonable proxy for the public good? Most fundamentally, why should we, the citizens of the United States, allow our major economic actors—which are also among our most important governing institutions—to treat their employees—us—as foreigners and outsiders, denied not only the vote but even a legitimate claim to the surplus they help create?

In the last several decades, virtually all corporate gains from productivity have gone to shareholders and CEOs, while ordinary employee wages have remained flat or declined.[10] This system is obviously not well designed to generate employee loyalty to the firm (or the firm productivity that follows): employees not given a fair share of the wealth they help produce are eventually likely to notice, and employees who view themselves as exploited are unlikely to cooperate fully in their exploitation. Nor is the

---

10. The problem has been noted by many commentators, both inside the large corporate sector of the economy that is my focus here and more generally. *See, e.g.*, Paul Krugman, *Feeling No Pain*, N.Y. TIMES, Mar. 6, 2006, at A21.

> Between 1979 and 2003, according to a recent research paper published by the I.R.S., the share of overall income received by the bottom eighty percent of taxpayers fell from fifty percent to barely over forty percent. The main winners from this upward redistribution of income were a tiny, wealthy elite: more than half the income share lost by the bottom eighty percent was gained by just one-fourth of 1 percent of the population, people with incomes of at least $750,000 in 2003.

Id. For a general discussion of the changes in distribution of wealth and income in the United States over the last two generations, see EDWARD N. WOLFF, TOP HEAVY: A STUDY OF THE INCREASING INEQUALITY OF WEALTH IN AMERICA (1995).

rapidly growing gap between the elite and the rest of us healthy for republican democracy: if the rich really are different from the rest of us, the common enterprise of nationhood fails. If shareholders have no special claim to corporate rents, then existing corporate governance is not only dysfunctional but simply unfair.

All is not lost, however. If the share-centered corporation is not the inevitable result of ineluctable economic law, we are free to adopt different corporate governance rules giving other participants more power, making firms both more just and more likely to succeed in their basic wealth-creation task.[11] Allocations of surplus have no efficiency implications. Thus, we need not fear a tradeoff between "efficiency" and justice: reforming the internal political processes of our corporations to make them better reflect basic democratic values should not lead to loss of wealth. On the contrary, just as democratic political systems more consistently generate wealth than dictatorial ones, expanding corporate democracy should increase the firm's productivity.

II. THE PROBLEM

In the last third of the Nineteenth Century, American law abandoned its earlier understanding that corporations, endowed with special privileges by the legislature, were inherently public in their purposes and quasi-governmental in their operations.[12] In the great divide of liberal political theory between state and citizen, public and private, corporations began to be seen as private, less a part of the state than requiring protection from it, more like citizens than their governments.[13] Indeed, by 1886, the Supreme Court was so immersed in this privatized conception that it felt no need to justify granting corporations the rights of human beings under the Fourteenth Amendment; the seminal *Santa Clara* opinion offers no reasoning whatsoever.[14]

---

11. As an aside, a realistic understanding of the corporate struggle over allocation of surplus suggests that the corporate income tax needs to be rethought. Current tax law presumes that payments to all factors of production, other than shares, are business expenses reducing profits, while all payments to shareholders are made out of profits. A more realistic system might deny deductibility to any payment to an employee that is greater than, say, five times the median wage on the theory that any payment so high is likely to contain profits. Conversely, it might grant deductibility for dividends paid to shareholders so long as they are less than some reasonable level, such as the three month T-bill rate plus a 3% risk premium, calculated on the actual amount contributed by shareholders (i.e., par value or the original public offering amount). More radically, we might abandon the inherently complex attempt to define "income" for entities and instead shift corporate taxation to a VAT or equivalent.

12. *See, e.g.*, MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860, at 111-14 (1977) (describing the transition from public to private theories of corporation); HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937, at 13-14 (1991) (describing the transition from mercantilist to classical model of corporation); Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech is not Free*, 83 IOWA L. REV. 995 (1998).

13. *Cf.* Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1075-76, 1100-02 (1980) (describing differentiation of municipal from business corporations and classification of former as public, latter as private).

14. Santa Clara County v. S. Pac. R.R., Co., 118 U.S. 394, 409 (1886). *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960, at 65-109 (1992) (describing *Santa Clara's* prefiguring of later theories of corporate personality). From *Bank of Augusta v. Earle* to *Pembina*, the Supreme Court consistently upheld differential taxes on corporations: corporations were not citizens. Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 587 (1839); Pembina Consol. Silver Mining & Milling Co. v. Pennsylvania, 125 U.S. 181, 187 (1888). From *Allgeyer* on, however, business corporations are given essentially the same rights against

Similarly, corporate purposes were reconceptualized. Corporations were no longer understood as existing to promote important public projects, but rather to promote the private interests of their particular participants—even though the largest corporations of the period, the railroads, were engaged in an enterprise of extraordinary public importance, were the beneficiaries of massive land grants and other public subsidies, and were collective enterprises of a scale previously unknown to American governments. On the new analysis, this private, self-interested endeavor would be required to serve the public good, if at all, only by means of Adam Smith's invisible hand, not by any conscious public spiritedness or deliberate consideration of the needs of the public.[15] By the turn of the twentieth century, the state generally abandoned the attempt to control corporations through corporate law, instead using external regulatory law, offering them subsidies or otherwise relieving them of the rigors of the market.

In this world of private public corporations aiming for profit, the obvious question arises: which corporate participants will be allowed to benefit from the surplus the firm generates? The most famous answer appears in *Dodge v. Ford Motor Co.*: "[A] business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed to that end. The discretion of directors . . . does not extend to a change in the end itself."[16]

But *Dodge* is an outlier.[17] Since the first of the recognizably modern general business corporation laws at the turn of the century, the basic rule instead has been that corporations choose their own ends and police them internally, with almost no judicial or other state intervention. Modern laws permit corporations to be formed "for any lawful

the government as people, generally without any discussion whatsoever of whether assimilating firms to citizens is appropriate. Allgeyer v. Louisiana, 165 U.S. 578, 589 (1897); *see* HOVENKAMP, *supra* note 12, at 47 (discussing cases and transition in legal conceptions of corporation person); Greenwood, *supra* note 12 (arguing that rights given to corporations often diminish the rights of their participants); Daniel J.H. Greenwood, *First Amendment Imperialism*, 1999 UTAH L. REV. 659 (discussing expansion of speech rights, asserted by corporations, into doctrinal territory of *Lochner*-like assertion of "natural" markets); Carl J. Mayer, *Personalizing the Impersonal: Corporations and the Bill of Rights*, 41 HASTINGS L.J. 577 (1990) (describing cases granting corporations constitutional rights).

15. Adam Smith himself, of course, wrote that corporations would never serve the public good; however, he was working within the older, public, paradigm of corporations. ADAM SMITH, INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (R.H. Campbell & A.S. Skinner eds., Oxford University Press 1976) (Corporations "very seldom succeed[] without an exclusive privilege; and frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it."). Early 19th century Americans frequently shared this distrust of the large corporation. *See, e.g.*, HOVENKAMP, *supra* note 12, at 23 (describing Jeffersonian hostility to corporations); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE UNITED STATES 30-45 (1970) (describing suspicions of Gouge (1833) and others regarding corporations, echoing Smith almost verbatim).

16. Dodge v. Ford Motor Co., 170 N.W. 668, 685 (Mich. 1919) (ordering board of directors to declare a dividend despite their own views and views of majority shareholder). Although *Dodge* is perhaps the most extreme judicial statement of the privatized view of the corporation as existing solely for the benefit of its shareholders, the general attitude was, and remains, common. *See also* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 5, 9 (1932) (describing the rise of the modern "quasi-public" corporation, but perceiving this as a problem because corporations were no longer subject to "the old assumption that the quest for profits will spur the owner of industrial property to its effective use").

17. *See, e.g.*, Blair & Stout, *supra* note 4, at 301 (describing *Dodge* as "highly unusual").

purpose."[18] Moreover, governance of the firm virtually is the exclusive province of the board; judicial supervision is limited by the extreme deference to board decision-making embodied in the business judgment rule.[19] Thus, in contrast to *Dodge*'s external command, the usual rule stresses the firm's autonomy. The board of directors of a corporation has extraordinary flexibility in determining how to apply any surplus the firm may earn.

A. Economic and Accounting Profit Contrasted

To discuss shareholder returns, it is first necessary to clarify terms. Profit is an ambiguous term. Common accounting understandings confuse two separate issues: whether the firm is earning a return, on the one hand, and which firm participants are receiving the return, on the other.

A successful firm is one that creates a surplus, by which I mean that it *could* sell its product for more than it *must* pay its various inputs. In the standard jargon, this surplus is the "residual" or "economic profit." A firm that is able to produce a product or service which can be sold for more than the market value of the various inputs is a firm that is successfully creating value—what it produces is worth more than what it consumes.[20]

Economic profit, so defined, is quite different from the more familiar accounting or legal profit bookkeeping concepts. Accounting profit is equal to the sum of properly declared dividends plus so-called retained earnings (referring, roughly speaking, to funds the corporation holds but has not allocated to any corporate participant).[21] On the other side of the ledger, all payments made to corporate participants, other than dividends, reduce accounting profit. Thus, any amount the firm pays its employees, any amount the firm does not obtain from its customers, and any amount the firm pays its investors in the form of interest, each reduce accounting profits. Dividends, in contrast, are treated as if they were not costs at all.

The accounting view is not a realistic picture of the corporation's economic success from a social perspective. When a firm needs capital to create its product, the price of that capital is a cost just like all other costs. If it earns an accounting profit insufficient to allow it to pay dividends sufficient to attract the capital it needs, it fails just as surely as if

---

18. REV. MODEL BUS. CORP. ACT § 3.01(a) (1984) (stating "[e]very corporation incorporated under this Act has the purpose of engaging in any lawful business. . . .") [hereinafter RMBCA]; *cf.* DEL. CODE ANN. tit. 8, § 102 (2006) (voiding prior doctrine regarding limited corporate purposes).

19. Current Delaware law enshrines the principle of directorial supremacy in § 141(a)'s proclamation that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2006). The business judgment rule, best understood as a form of judicial deference analogous to judicial deference to agency and legislative decisions, similarly ensures that directors are the primary corporate decision-makers. *See* Daniel J.H. Greenwood, *Beyond the Counter-Majoritarian Difficulty: Judicial Decision-Making in a Polynomic World*, 53 RUTGERS L. REV. 781 (2001) (discussing judicial deference in these and other contexts).

20. *See infra* note 43.

21. Retained earnings do not, however, represent a fund available for payments to shareholders, despite older misunderstandings to that effect. On the one hand, the corporation may choose or market pressures may constrain it to distribute retained earnings to other corporate constituencies in the form of increased payments to other inputs or decreased prices to customers. On the other hand, dividends may be paid out of other sources, including future earnings, economic profit, borrowing, or sales of assets. Indeed, retained earnings do not represent a fund at all. They are not, for example, a synonym for cash on hand or liquid investments.

it is unable to pay market wages or market price for raw materials. Conversely, if a firm is able to sell its product for more than the costs of its inputs, it is successful, even if it pays out that surplus in some form other than dividends.

Economic profit classifies normal (market) returns as a cost to any input, including capital, regardless of legal label or accounting treatment. Similarly, economic profit classifies as profit any payment to any input in excess of the market price necessary to acquire that input, regardless of accounting treatment. Thus, on the economic view, what counts is not the firm's actual payments for inputs but the market cost for those inputs (including the cost of acquiring capital); not the price it actually does receive but the price it could obtain; not what it does with its surplus but the size of the surplus in the first place. On this view, any part of dividends or interest that is necessary to obtain capital on the market is a cost. Any payment above that necessary cost is part of the firm's economic profits (which has been distributed to bondholders or shareholders respectively).

In short, economic profit is a theoretical measure of the surplus available to the corporation to be distributed among its various participants, inputs, patrons or customers, while accounting or legal profit is a formal measure of the funds distributed to shareholders in the form of dividends or classified by the firm as retained earnings. The distinction should be familiar. Before check-the-box taxation, it would have been surprising to see a successful closely held corporation report an accounting profit; publicly traded corporations often manipulate accounting conventions to the opposite effect.[22]

In a theoretical fully-competitive market, of course, prices are driven down to costs. It follows that, as I have defined it, economic profit is a disequilibrium producer's surplus: an imbalance in the market in which price is (or could be, at the seller's option) higher than cost.

When economic profit exists, typically it will be difficult to calculate, because surpluses exist only when markets are less than perfectly competitive, and if a market is imperfect, the market price of inputs and products may be imprecise as well.[23]

22. *See, e.g.*, Kamin v. Am. Express, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976) (upholding accounting treatment that management believed would improve stock market perceptions of profit, despite consequence of higher income tax obligation). Since the development of the LLC and "check the box" pass-through taxation, closely-held firms generally can elect not to pay entity-level tax without manipulating accounting profit labels. However, manipulating labels remains important for other reasons. Leveraged buyouts, for example, which pay out surplus in the form of interest, were highly effective in convincing employees to accept a smaller share of corporate surplus: employees who might have protested had the company insisted it needed employee give-backs in order to increase its profits were willing to pitch in to stave off bankruptcy, even when the cash flows were identical transfers of a slice of the corporate pie from employees to capital. Similarly, CEOs of publicly traded companies discovered that stock-option grants allowed them to transfer corporate surplus to themselves with minimum publicity and, until recent reforms, no impact on reported profits.

23. In competitive markets, each input will be priced at (or marginally above) its value in its next most profitable use, and the product should be priced at (or marginally below) the cost of production of the next lowest cost producer. At that level, the firm will have as large a supply of inputs and be able to sell as much of its product as it wishes. A firm earning an economic profit is one that can pay those prices and sell at that price and have something left over; it is more efficient than its competitors. As other firms learn, they should compete away that advantage. However, in less competitive markets, firms may be able to earn economic rents—i.e., sell their product for more than economic costs—for extended periods of time. This Article is concerned with the distribution of those rents or surpluses. In a fully competitive market at equilibrium, there are no surpluses; if

Nonetheless, the concept is essential. Economic profit is the pie that is available for distribution, the fund which can be struggled over, regardless of where it ends up.

B. Who Owns the Economic Profit?

It is fundamental to the very notion of corporate existence that any economic profit or surplus belongs in the first instance to the corporation itself, and not to any of its various participants.[24] Accordingly, it is the corporation's board or its delegates, operating as the decision-makers for the institution itself, who decide what to do with this economic surplus and how to classify it for legal purposes.[25]

Rather than declare a dividend, the board and executives[26] may decide to reinvest economic profits—that is, to increase the firm's contractual obligations, thereby distributing the former period's profit to the next period's corporate contractual participants. They may pay it to employees in the form of higher salaries or increased managerial benefits. They may distribute it to creditors by paying debt before it is legally due or in the form of interest on new debt. They may distribute it to customers by reducing sales prices or to suppliers by increasing purchase prices. They may decide to simply retain it in the corporate bank account or other financial investments. Or they may decide to distribute it to shareholders, by means of a dividend, dissolution of the firm or a stock buyback.

If the board chooses to retain the economic surplus in the corporation's name beyond the end of an accounting period or distributes it to shareholders, the economic surplus will become profit in the accounting and legal sense. But nothing forces a board to do that. If it prefers not to have accounting profit, it can simply increase its contractual obligations during the period in which the surplus is earned.[27] In this case, no profit will

---

any factor of production (including capital) succeeds in demanding more than competitors pay, the firm will be driven out of business.

24. DEL. CODE ANN. tit. 8, § 122 (2006) (granting corporation, inter alia, powers of permanent succession, ownership, contracting, etc.). Individual shareholders have no right to dissolve a corporation or otherwise force the corporation to distribute any of its assets to the shareholder. *See, e.g.*, *id.* § 275 (dissolution of corporation is by resolution of the board followed by vote of shareholders). In contrast, in a partnership, any partner has the right at any time to demand his or her pro rata share of the partnership assets (including, of course, any surplus from prior periods). *See, e.g.*, UNIF. P'SHIP ACT § 31 (1997) [hereinafter U.P.A.] (granting every partner the right to dissolve the partnership even in contravention of partnership agreement); *id.* § 38 (granting every partner on dissolution rights to pro rata share of partnership assets, except that wrongfully dissolving partners are not entitled to share in value of goodwill).

25. DEL CODE ANN. tit. 8, § 141 (2006) (business and affairs of every corporation managed by or under direction of its board); *id.* § 170 (board may declare and pay dividends, subject to certain restrictions); RMBCA § 8.01(b) ("all corporate powers shall be exercised by or under the authority of its board"); *id.* § 6.40(a) (stating that board may authorize distributions to the shareholders, subject to certain restrictions).

26. Hereafter, I will generally refer just to the board—with the understanding that in practice most relevant decisions will be made in the first instance by executives and many may never even be submitted to the board for ratification. For current purposes, the specific allocation of power between board and executives seems unimportant.

27. Precisely the same problem arises in the corporate income tax context. The income tax is levied on profit, defined as revenues less expenses allowable as deductions. Corporations, therefore, may be tempted to reduce their taxable profits (and therefore taxes) by classifying as "expenses" payments greater than those required by the market. Most obviously, a shareholder CEO will minimize taxes by paying economic profit to herself in her CEO role as salary, rather than in her shareholder role as dividends. *See, e.g.*, I.R.C. § 162(a)(1)

ever appear on the corporation's books. Instead, prices will be lower or input costs will be higher than necessary.[28]

Legal restrictions on this board discretion are few. Shareholders have a legal right to the surplus only after the board of directors declares a dividend.[29] The duty of care requires the board to give due consideration before deciding to act (or not act).[30] The duty of loyalty prevents the board from giving away corporate assets without receiving an appropriate quid pro quo.[31] Within these broad constraints, boards are free to do what seems right in their eyes.

Even where the duties of care or loyalty might seem to restrict board discretion, however, the business judgment rule severely limits judicial review of board decisions. In effect, courts police only insider deals, in which a dominant shareholder or other insider receives corporate assets on terms not available to others.[32] Even then, courts mainly look for secret deals, routinely declining to second-guess the decisions of informed

(2000) (allowing corporate deduction for "reasonable" executive compensation, even when the executive is also a (or the sole) shareholder). In contrast, payments to a partner of a partnership are ordinarily classified as profit, even if the partner contributed time to the partnership. *See* U.P.A. § 18.

28. For several years, the standard corporate finance text explicitly asserted that "retained earnings are additional capital invested by shareholders, and represent, in effect, a compulsory issue of shares." RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 324 (4th ed. 1991); RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 364 (5th ed. 1996). Obviously this is not true in any literal sense. Retained earnings result when sales proceeds and other income exceed costs and other expenses; not shareholder contributions or share issuance. Instead, Brealey & Myers mean it metaphorically: as they explain, "a firm which retains $1 million could have paid the cash out as dividends and then sold new common shares to raise the same amount of additional capital." *Id.* To be sure, a firm could have done that. But money is fungible, and firms can obtain it from many sources. Generally, corporate law allows dividends to be paid out of "surplus," which may be any portion so designated of the net assets of the corporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 154. In effect, so long as the firm remains solvent, it may pay out any funds it has as dividends. For example, a firm with retained earnings could borrow money and immediately pay it out as dividends, or it could reduce employee pay (or, more easily, fail to increase employee pay to match increases in productivity) and pay that cash out as dividends. On the Brealey & Myers logic—that any money which could have been paid out as dividends should be treated as if it were a shareholder capital contribution—shareholders should be deemed to have contributed these amounts as well! In Brealey & Myers's world, the shareholders magically create all value in the firm, regardless of the contributions of others. Of course, a less shareholder-sympathetic view could use the same logic to reach the opposite conclusion. Thus, the firm could also have paid out its retained earnings or any other available cash as salary, bonuses to suppliers, discounts to customers, or made any other legal use of it, and then borrowed or sold shares to raise the same amount of capital. So, we could just as well say that retained earnings were contributed by employees and represent a compulsory reduction of salary. This shareholder claim to corporate funds is no more than Sophistic spin.

29. *See supra* notes 25-26; *cf.* RMBCA § 6.40(f) (declaring dividends treated as an unsecured debt to the shareholders at parity with other unsecured debt).

30. Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985); RMBCA § 8.30 (setting out duty of directors to act in good faith and in a manner the director reasonably believes to be in the best interest of the corporation).

31. RMBCA § 8.31 (lifting director's protection against suit for breach of duty of loyalty on, inter alia, showing of lack of objectivity due to a conflict of interest); *id.* § 8.60 (setting out requirements for actions challenging director's conflicting interest transactions); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995) (setting out a procedural test for determining possible breaches of duty of loyalty); *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1201-06 (Del. Ch. 1995) (similar).

32. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (defending business judgment rule on ground that judicial abstention promotes risk taking by managers).

independent directors.[33] Thus, no American court has yet set any limit to the amount a public corporation's fully informed board may publicly pay its CEO, even in the absence of any evidence that the board had any basis to think the CEO's services could not have been obtained for less.[34] As long as the board does not appear to be unduly influenced by the CEO, modern courts do not intervene, even if the firm appears to be giving the bulk of its economic profits to the CEO—just as courts during the unionized age did not intervene when companies appeared to be acting primarily in the interests of unionized employees and mid-level managers, or when companies have adopted as their primary goal promoting their product or even a particular way of doing business.[35]

In short, the board has legal discretion to treat the economic profits—the residual—in virtually any way it pleases.

C. Who Should Get the Residual?

Nonetheless, commentators and courts routinely ask what the board *should* do with the corporation's profits. And the answer has seemed obvious to many: profits are rightfully for the shareholders.[36]

But economic profits are rents, and as a general rule, no one has a moral entitlement to rents. When cooperation creates a surplus in a market economy, normally we assume that the parties are free to bargain for any division of it. If shareholders can win some of the surplus, all power to them. But if they cannot, they have nothing to complain about. As we shall see, however, it is virtually inconceivable that shareholders would be able to win a share of the rents in a competitive market. Shareholder returns, therefore, must be the result of a non-competitive process that cannot be legitimated by market claims.

---

33. *See, e.g.*, KRAAKMAN ET AL., *supra* note 1, at 114-18 (describing the largely procedural approach of fiduciary duty law). Even the leading case finding liability follows this procedural approach of never suggesting a limit on the right of a fully informed board to operate the corporation in the interests of any party it chooses. *See Van Gorkum*, 488 A.2d at 893 (finding uninformed board liable). The RMBCA permits a conflicting interest transaction to stand if it is either approved by a majority of informed, unconflicted directors or shareholders, or it is entirely fair to the corporation. RMBCA § 8.61-.62.

34. Brehm v. Eisner, 746 A.2d 244, 263 n.56 (Del. 2000) (noting that there is a point at which executive compensation becomes actionable waste, but according "great deference" to board judgment because the "size and structure of executive compensation are inherently matters of judgment"); *In re* Walt Disney Co. Derivative Litig., No. CIV.A.15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005) (similar proposition).

35. Corporations have been managed with different primary goals in different periods. *See, e.g.*, BERLE & MEANS, *supra* note 3, at 67 (discussing instances in which corporations were managed on behalf of the "control" rather than passive shareholders); JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE 175, 181, 186, 207, 222 (4th ed. 1985) (1967) (contending that major corporations were, at that time, managed on behalf of the institution's own autonomy—and thus its employees, growth and stability—with little concern for consumers or shareholders). Courts have also declined to intervene when managers have described their goals as furthering the interests of the product or even particular ways of doing business, rather than any human party. *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1144 n.4 (Del. 1989) (stating that outside directors sought to run corporation in order best to protect "Time Culture"); Cheff v. Mathes, 199 A.2d 548 (Del. 1964) (appearing to approve company's dedication to a particular sales method).

36. Even Lynn Stout, who has questioned most aspects of the shareholder-primacy model in the course of de-essentializing the fictional shareholder, continues to assume that ultimately the goal of every corporation should be to make money for shareholders. *See, e.g.*, Lynn A. Stout, *Bad and Not-So-Bad Arguments For Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002). For a recent survey of the remarkable consensus in favor of the shareholder-centric model of the corporation, see Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 39-41 (2004).

Shareholders are not entitled to profits by law. They are not entitled to them by economic right. Are they entitled to them at all?

III. THE MARKET MODEL: THE DIVIDEND MYSTERY

In standard nexus of contract and most other economically oriented models,[37] shareholders are viewed as a factor of production like all other factors of production in the firm.[38] Firms need capital (among other things) in order to produce their product, and they purchase or rent that capital in the capital markets.[39] Roughly speaking, they purchase capital by selling stock; they rent it by issuing debt.

---

37. Modern economically oriented models of the corporation come in a wide variety of forms. Classic models took the firm as a "black box," treating it as if it were a single producer without investigating its internal dynamics. Coase argued that this obfuscated the issue of why firms exist in the first place, which he contended could only be due to an efficiency advantage resulting from eliminating the market's pricing mechanism internally. Firms, thus, should exist where the market generates poor results and administration ("fiat" in his terms) can generate better ones. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* R.H. COASE, THE FIRM, THE MARKET AND THE LAW 33-57 (1988), *and in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 18-33 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

Theorists have since developed Coase's insight in several different directions. Institutional economics focuses on the internal dynamics of the firm. Williamson's transaction cost economics focuses particularly on the microeconomics of contract failure that might lead to firms. *See generally* OLIVER WILLIAMSON, THE NATURE OF THE FIRM (1991); WILLIAMSON, *supra* note 4. Hansmann has used a similar approach to explore corporate governance and, importantly for this Article's analysis, distribution of ownership rights in the firm. *See generally* HANSMANN, *supra* note 4. More recently, Blair & Stout have emphasized the role of the corporation as a "mediating hierarchy" in resolving such problems of team production, and Stout has begun to consider the implications of abandoning the fiction that shareholders have a single and uniform interest. Blair & Stout, *supra* note 4; Lynn Stout & Margaret Blair, *Specific Investment: Explaining Anomalies in* Corporate Law, 31 J. CORP. L. 719 (2006); *see also* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996) (arguing that the fiction of a unified shareholder interest serves as an ideological justification for lack of corporate democracy). Others, such as Alchian & Demsetz, *supra* note 1, and Jensen & Meckling, *supra* note 1, and their followers, have gone in the opposite direction, treating the firm itself as no more than a moment in the market, a nexus of contracts understandable without any need to refer to the institution itself. This approach was early-on critiqued for its mystification by Arthur Leff and Bill Bratton, *supra* note 1, but nevertheless its market reductionism proved quite popular, reaching its quintessence in books by Roberta Romano and Easterbrook & Fischel. *See generally*, FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). Recent market-based theories have sought to apply the insights of sophisticated behavioral finance theorists such as Andrei Shleifer to model the behavior of shareholders, thought of primarily as participants in a finance market rather than "owners" of a company. Communitarians, including Larry Mitchell, have emphasized the importance of trust and its social bases, often assumed and therefore neglected in older economic models. *See, e.g.*, Lawrence Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591 (2001). Mark Roe has usefully emphasized that efficiency considerations always exist within a particular political framework, so that market evolution may lead to different results in different contexts. *See generally* MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

38. HANSMANN, *supra* note 4, at 12-16 (treating firm as a capital cooperative). This Article may be seen as a claim that the market problems identified by Williamson and Hansmann as reasons for the firm structure we see—principally, lock-in, asymmetric information and marginal/average cost difference problems—have *not*, in fact, been solved by the existing legal structures.

39. *See, e.g.*, BREALEY ET AL., *supra* note 2, at 445 (describing the full interchangeability of debt and equity financing under Miller and Modigliani's proposition 1, and partial interchangeability under competing theories).

Treating the stockholders as a factor of production that has sold capital to the firm has the heuristic advantage of emphasizing that, from the firm's perspective, the capital market is a market like all others, in which an array of commodities is for sale or rent at a variety of market-determined prices. Here, as in any competitive commodity market, a purchaser (i.e., the firm) has no reason to pay anything more than the competitive price, and that should equal its marginal cost of production. Thus, we can state the puzzle:

> Shareholders are perfectly fungible providers of the most perfectly fungible of commodities (cash and some risk-bearing services), in our most competitive of markets. A priori, then, one would expect that they would receive no more than the market price for their product, which should equal its marginal cost of production.

If so, it is surprising to find that shareholders expect to share in any excess returns the firm may obtain. Rather, one would expect that any disequilibrium or monopoly firm profits would be retained by the firm itself or go to a firm participant with disequilibrium or monopoly power. Public shareholders—because they are fully fungible providers of a fully fungible commodity in a highly competitive market—are the *least* likely firm participants to have that kind of power.

Bond holders and bank lenders are in fact paid precisely in this manner: they receive a fee that is closely related to the general cost of producing money (i.e., general interest rates), adjusted to reflect the expected risk of the particular firm. They do not expect to participate in extraordinary firm earnings, except perhaps to the extent that such earnings reduce risk for which the creditors have already been compensated. But equity is harder to understand.

A. Full Competitive Equilibrium

First, some background. Under standard economic models, a firm selling a commodity product in a fully competitive equilibrium market must sell its product at a price equal to the marginal cost of production of the lowest-cost firm. If it sets its price any higher, customers will purchase from a competitor and it will fail. This is normally expressed in standard black box models by stating that a firm in fully competitive markets earns no economic profit.

At equilibrium there can be no internal distribution issues within the firm. Each factor of production must be paid no more than its lowest cost on the market. If any factor of production were to successfully demand more than its replacement cost, it would, parasite-like, kill its host. The firm would have higher costs of production than its competitors and be unable to compete.

Capital is no different than labor or raw materials in this model. It must be paid the lowest possible amount necessary to generate the minimum capital required to run the company—that is, capital may be paid no more than its cost of production in a competitive market. If it is paid more than that, the firm's costs will be higher than its competitors and it will be unable to price its product competitively, leading to failure.

Actually, shareholders should expect even less. In competitive markets, prices normally adjust to marginal cost. Equity capital usually will be a sunk cost with a marginal cost of zero.[40] Shareholders, then, should expect no return at all at competitive equilibrium. Consider the following.

B. The Sunk Costs Problem Generally

It is a commonplace of economic theory that when marginal costs are lower than average costs with respect to real factors of production, prices will reflect only the marginal costs.[41] When this occurs, the firm will be operating at a long-term loss, and the result should be market failure. Either the product will not be produced, a monopoly will avoid market pricing, or allocation by market prices will be replaced by a non-market process such as administrative allocation inside a firm.[42] This is said to be the problem that drove the American railroads out of business (and continues to be a regular problem in high fixed cost businesses such as telecoms and airlines).[43] It once motivated J. P. Morgan's attempts to end "ruinous price wars" by consolidation.[44] Later, it underpinned New Deal "natural monopoly" theories. And Coase famously contended that avoiding it is the major reason firms exist.[45]

1. Market Pricing at Marginal, Not Average, Cost

To see the problem, imagine a simplified firm using capital, labor and raw material inputs to produce widgets. Assume that a single employee operating a single widget-making machine can produce one-hundred widgets from one unit of proto-widget raw material. The cost of producing one-hundred widgets, then, consists of variable costs of one unit of proto-widget and one day of labor, plus the fixed costs associated with the machine (roughly, the cost of the machine divided by the number of widgets it can be expected to make over its useful life).

Ex ante, of course, no one would invest in the machine unless they expected to be able to charge a price for widgets sufficiently above the variable costs to cover the costs of the machine (and some extra for the effort). Thus, internal accounting will always include a cost for the machine itself, typically in the form of amortization of fixed costs, and firms normally will calculate their per-widget costs on an average basis.

But ex post, after the machines are in place, the calculation changes. If the firm has a machine sitting idle, the cost of producing an extra batch of widgets is determined only by the variable costs. The machine adds nothing to the firm's cost of producing these hundred widgets, nor does leaving it idle save anything. In other words, the marginal cost of producing an additional hundred widgets is simply one unit of proto-widget and one day of labor. A firm faced with the choice of leaving the factory idle or dropping prices to

---

40. *See, e.g.*, WILLIAMSON, *supra* note 4, at 33, 53, 263 (1985) (emphasizing the importance of relative asset specificity in creating contracting problems and possible institutional resolutions).

41. *See, e.g.*, Ronald Coase, *The Marginal Cost Controversy*, 13 ECONOMICA 169 (New Series, 1946) (discussing the relationship between marginal and average costs).

42. Coase, *supra* note 37.

43. *See, e.g.*, ALFRED D. CHANDLER, JR., SCALE & SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 56-58 (1990) (describing sunk cost problem as central to the economic history of larger American corporations); JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 55-78 (2003) (describing history of corporate form).

44. MICKLETHWAIT & WOOLDRIDGE, *supra* note 43, at 62 (describing J.P. Morgan).

45. Coase, *supra* note 37 (criticizing New Deal understandings of monopoly).

increase demand will find that it will make more money (or lose less) if it drops prices to just above marginal (variable) cost and keeps producing. Moreover, closing down, like death, often results in quick deterioration. By staying in operation, the firm preserves employee networks and loyalty while keeping the equipment from rusting away from neglect.

But if one firm drops its prices to just above its marginal costs, in a competitive market all firms will be forced to match. With prices at marginal cost, producing firms will not be charging customers for the cost of the (old) machines and (anticipating similar problems in the next period) will not invest in new ones.

2. General Solutions

Often we solve this problem by tax-financed subsidies (as in agriculture, highways and single family mortgages), legally imposed monopoly rights or similar barriers to entry (as in much of the utility and hospital industries, or in pharmaceuticals, software and other industries dependent on the legal monopolies of patent or copyright) or state-administered price fixing (trucking, agriculture, many forms of insurance, etc.). Absent governmental intervention, market failure can take several forms. One possibility is that the various firms will drive each other out of business or that entrepreneurs, foreseeing the problem ex ante, will never invest in the first place. The product simply will not be produced, despite technical feasibility, willing buyers and potentially willing sellers. The best example of this in the United States may be passenger rail service.

Alternatively, the market may solve the sunk cost problem by eliminating competition through monopoly or at least partially price-fixed oligopoly. This was J.P. Morgan's solution to "ruinous price wars": to reorganize industries into a limited number of players which could then raise prices sufficiently to cover fixed costs (and then some).[46] In other industries, monopolistic pricing power may stem from cascades, such as the one that allows Microsoft to price Windows well above its marginal cost (which is roughly zero).[47] Many industries with significant sunk costs settle into oligopoly—the common phenomenon of two or three major producers seen in areas dominated by the old trusts (breakfast cereals, sugar, steel, oil), services (banking, Bar reviews) or new commodities (computer hardware and software, electronics) helps to avoid fully competitive pricing that would be below average cost.[48]

However, monopoly profits attract competitors, so if costs of entry are relatively low or price-fixing agreements are difficult to enforce, new entrants (or old competitors

46. MICKLETHWAIT & WOOLDRIDGE, *supra* note 43.

47. A cascade occurs when consumers derive value from using the same product as others, independent of the merits of the underlying choice. It matters far more, for example, that we choose the *same* side of the road, instant message service, keyboard, or computer operating system than that we make the *right* choice. Brian Arthur, *Positive Feedbacks in the Economy*, SCI. AM., Feb. 1990, at 92. Indeed, even where there is no obvious advantage to standardization, it still often remains more important to go to the same movies, listen to the same music, wear the same clothes, or join the same club as our peers than it is to find the best of those products. *See, e.g.*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 892 (1980) (describing this phenomenon in the context of country clubs). When a cascade occurs, the producer of the favored product may be able to charge monopoly prices despite the existence of competitors. Even if the competing product has similar technical specifications, without the customer base, it cannot provide true substitutability.

48. *See generally* CHANDLER, *supra* note 43.

tempted to cheat in order to increase volume) will constantly threaten comfortably high pricing. The result may be an industry without an equilibrium, gyrating madly between excess monopoly profits and competitive bankruptcy as firms enter and depart, with prices rarely matching either marginal or average costs. Think of our semi-deregulated airlines, California's electric markets or farmers selling commodity agricultural produce before the New Deal price support system.

Finally, some industries may be able to eliminate the sunk cost problem by eliminating sunk costs. The more an industry uses flexible, readily re-allocable physical capital, the less it needs to worry about the difference between marginal and average costs. Companies using generic machine tools controlled by ordinary computers do not face the same issues as old-fashioned rust-belt dedicated factories. If the equipment can be resold, marginal cost includes the opportunity costs of not selling it, thus bringing marginal cost closer to average cost.

Similarly, even where the equipment itself remains highly specific, competitive industries may develop around it. Doctors, for example, avoid the sunk cost problem because their expensive non-redeployable equipment is owned by hospitals (which, in turn, often have local monopolies). Lawyers need not form monopolistic firms because much of the physical capital they need is either socialized (courts) or outsourced and oligopolistic (Westlaw and Lexis).[49]

C. Financial Capital as a Sunk Cost

The fixed capital problem is generally discussed in terms of real assets—widget machines, airplanes, railroad tracks, CT-scanners, law libraries, fiber optics lines or electric plants. But it applies to purely financial assets as well. Securities and similar liquid assets held in the corporation's name are easily redeployed, so rational managers should price them at their opportunity cost (i.e., the most profitable available alternative use), which is therefore their effective marginal cost.

In contrast, the equity contributed by stockholders to a public firm is a sunk cost. Stockholders have no legally enforceable right to a dividend. Thus, there is no legal cost to using funds shareholders contributed to the firm in the past. Conversely, there is little opportunity cost: the corporation cannot profit from not using past public offering proceeds either. Thus, unless stockholders have some extra-legal ability to demand payment, the firm's marginal cost of continuing to use the assets stockholders have invested is nil. If shareholder claims have no marginal cost, they should command no return in a competitive market. Any firm that increased its prices to create a fund from which to pay shareholders would have to charge more than its marginal costs and therefore, in a competitive market, more than its competitors. That would put it out of business.

Accordingly, no part of a corporation's earnings in a competitive market at equilibrium is attributable to shareholders' contribution. On the contrary, all positive earnings must be attributed to different inputs that do have positive marginal costs. At competitive equilibrium the corporation will not only fail to earn economic profits (by definition), it will fail to earn legal profits representing a normal return to equity capital.

49. HANSMANN, *supra* note 4, at 96.

Since this claim is so counter-intuitive—after all, shareholders do pay good money in the expectation of future returns—let us take the argument more slowly.

1. Shareholders Have No Legal/Contractual Right to Distributions

First, shareholders have no legally enforceable right to a dividend or other distribution from the firm. As a matter of formal law, this is clear. Shareholders have no right to any interim payments for the continued use of their capital and firms have no legal obligation ever to declare a dividend or any other distribution, even if there is a surplus available to do so. The decision to declare a dividend rests in the exclusive discretion of the board.[50]

Perhaps even more fundamentally, shareholders have no legal right to their money back. Quite unlike standard partnership law, which provides that each partner has the unalienable right to withdraw his capital at any time,[51] corporate law gives shareholders no opportunity to regain their capital except by decision of the firm's directors. To be sure, shareholders generally have the right to sell their shares to someone else, but this transaction does not withdraw funds from the firm.[52] The corporation continues to hold the capital paid by the initial stock purchaser regardless of what happens in the secondary market.[53] The only way for shareholders to get a return of the capital they have contributed is for the firm to decide—by vote of its board of directors—to repurchase its shares or declare a liquidating dividend.[54] Shareholders, that is, may have political power to vote for directors or lobby them, but they have no legal entitlement to any particular result.

Early corporate law seems to have assumed that firms would be created for a specific project (such as a particular trading voyage) and last for a limited period, after which they would wind up, distributing the original contributions and any accumulated profits (or losses) to the shareholders.[55] Dividends were thought of as interim payments

---

50. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2006) (determining that business and affairs of every corporation shall be managed by or under the direction of the board of directors); *id.* § 170(a) (granting directors sole power to declare dividends).

51. *See, e.g.*, U.P.A. § 31 (permitting any individual partner to dissolve partnership at any time, in accordance with or in breach of the partnership agreement); *id.* § 38 (granting each partner at any time the right to either a winding up and distribution of the surplus or to payment of the "value of his interest in the partnership").

52. *See, e.g.*, RMBCA § 6.27(a) (authorizing corporation to impose restrictions on transferability of shares).

53. Thus, the U.S. Supreme Court's suggestion in *Bellotti* that a shareholder unhappy with managerial actions (in that case, political contributions) can withdraw at any time is based on a misunderstanding of corporate law. First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 794 n.34 (1978).

54. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160 (authorizing corporation to purchase and redeem its own stock); *id.* § 170 (allowing board to declare dividend); *id.* § 244 (allowing board to reduce capital); RMBCA § 12.02 (requiring board resolution followed by shareholder vote for certain dispositions of substantial assets); *id.* § 14.02 (providing that dissolution requires board resolution followed by shareholder vote). The fact that shareholders have no claim on funds that remain inside the firm underlies the standard corporate finance theorem that the value of public shares is no more than the present value of the expected future dividends. *See, e.g.*, BREALEY ET AL., *supra* note 2, at 64.

55. The expectation prior to the mid-nineteenth century was that business firms (generally not incorporated) would exist only for a short period to complete a specified task, such as a single shipping trip. After each trip, the firm would be wound up and the profits distributed to investor/owners even if the

against this final settling up.

In sharp contrast, modern corporate law assumes the firm will last indefinitely and does not provide for winding up after a particular project or a given amount of time.[56] If a firm declares a dividend or similar distribution, or decides to wind up, the shareholders generally have a right to a pro rata share of the dividend or the residual on winding up after other claimants are paid.[57] But this right exists only after the firm's board—not the shareholders—has declared the dividend or decided to wind up. There is no equivalent to the right of individual partners to cause dissolution. Indeed, shareholders lack even a collective right to dissolve or to order the board to do so.[58]

Moreover, distributions to shareholders are always subject to the prior claims of parties with contractual claims on the corporation.[59] But contracts do not just appear as an act of God. The board has exclusive authority to cause the corporation to enter into contracts or to authorize its agents, the employees, to do so. That means that not only may the board refuse to declare dividends from legal profits, it may even decide that the firm will never have unencumbered funds from which shareholder distributions could legally be made.[60] In short, as far as the text of modern business corporation laws is concerned, a corporation could exist indefinitely without ever making any payment at all with respect to its shares. Of course, that a firm is *permitted* to fail to declare a dividend

---

expectation was that the same individuals would participate in the next ship. Even firms without obvious end-points were normally organized with limited life spans: recall, for example, the Jacksonian controversy over the rechartering of the Second Bank of the United States. *See, e.g.*, HURST, *supra* note 15, at 25 (stating that most early charters set "sharp limits on corporate life"). Similarly, until near the end of the nineteenth century, business corporations were ordinarily restricted to a single, narrowly defined purpose. *E.g.*, *id.* at 44. Partnership law retains this presumption in its provisions for dissolution of the partnership and requirement of unanimous consent for any fundamental change in the business. *See, e.g.*, U.P.A. § 18(h) (requiring unanimous consent for changes to partnership agreement); *id.* § 18(g) (requiring unanimous consent of existing partners for any person to become a partner); *id.* § 31 (permitting any partner to dissolve partnership at any time, in accordance with, or in breach of the partnership agreement); *id.* § 38 (granting each partner at any time the right to either a winding up and distribution of the surplus, or to payment of the "value of his interest in the partnership").

56. Modern corporate law allows corporations to be organized for any or every lawful purpose, and to change purpose without shareholder consent, see, e.g., DEL. CODE ANN. tit. 8, § 102(3) (voiding prior doctrine regarding limited purposes of corporations), permits a corporation to exist indefinitely, see, e.g., *id.* § 122(1) (providing for perpetual succession), and places power of dissolution in the corporation itself. *See, e.g.*, *id.* § 122(7) (granting corporation power to wind itself up).

57. *See, e.g.*, *id.* § 151 (providing that classes of stock shall have the rights, preferences, etc., specified in the articles or applicable board resolution).

58. *See, e.g.*, Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1191 (Del. Ch. 1998) (upholding pleading that "dead hand" poison pill is invalid because, unlike pill upheld in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), it would "interfere with the board's power to protect fully the corporation's (and its shareholders') interests"); Grimes v. Donald, No. CIV.A.13358, 1995 WL 54441, at *7 (Del. Ch. Jan. 11, 1995), *aff'd*, 673 A.2d 1207 (Del. 1996) (prohibiting board from entering into arrangements that would substantially restrict board's ability to manage the corporation); Abercrombie v. Davies, 123 A.2d 893, 899 (Del. Ch. 1956) (similar); McQuade v. Stoneham, 263 N.Y. 323, 328-29 (N.Y. 1936) (declaring void contract that attempted to bar directors from exercising their business judgment).

59. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170 (limiting corporation's ability to declare dividends in order to protect contracting parties).

60. *See, e.g.*, *id.* § 141(a) (determining that business and affairs of every corporation shall be managed by or under the direction of the board of directors); *id.* § 170 (dividends may be declared only out of surplus or net profits).

does not mean that it *will* do so. To reach that conclusion requires one more step.

2. In Competitive Markets, Corporations Cannot Charge for Their Use of Shareholder Funds

From the corporation's perspective, if shareholders have no right to withdraw their capital and no right to demand payment for its continued use, the corporation has no variable costs associated with continuing to use the capital provided by shareholders. Once a firm has sold shares to the public, the funds paid for the shares belong to the firm and it can use them freely with no further payment. In other words, the marginal cost of continuing to use assets contributed by shareholders is zero.[61] In competitive product markets, as discussed above, price tends to drop to marginal cost.

Since dividends are not a legal cost, they will not be treated as an economic cost. Rather, so far as the firm is concerned, they are simply a gift; voluntary transfers made out of profits, not costs incurred to earn profits. The market will prevent firms from paying them as effectively as it would prevent making any other charitable gift or paying any legally externalizable cost out of firm funds.[62] Firms that increase prices to fund voluntary payments for shareholders will be outcompeted by firms that do not.

Thus, in a competitive market equilibrium, publicly traded firms with capital contributed by shareholders should run economic losses (because economic profits treat normal returns to capital as a corporate expense necessary to produce the product, and they will have no returns to equity capital). Similarly, absent manipulation, they will have no accounting or legal profits. Use of shareholder capital has no marginal cost, and competitive markets will drive prices down to marginal cost.

Were shareholders unexpectedly able to demand payment of a dividend, in a competitive market the net result would only be to drive the firm out of business. By hypothesis, there is no surplus from which to pay the dividend. In order to pay one, then, the firm must either offer below-market wages to some other input or charge above-market price for its product. Neither behavior is sustainable. In a competitive market a firm that paid dividends would be a high cost producer and would fail.

D. The Unsustainable Public Equity Market

If this were a correct description of the actual workings of our markets, stable and competitive capital markets would be unusual and difficult to maintain. Ex post, firms would find themselves unable to charge customers for the use of shareholder capital

61. Hansmann's description of the business corporation as a capital cooperative is, therefore, incomplete with respect to public corporations. In Hansmann's model, a business corporation:

> pays the members a fixed interest rate on their loans, set low enough so that there is a reasonable likelihood that the firm will have net earnings after paying this interest and all other expenses. The firm's net earnings are then distributed pro rata among its members according to the amount they have lent, with the distributions taking place currently, as dividends, or upon liquidation.

HANSMANN, *supra* note 4, at 14. In the public corporation as we know it, shareholders do not have a right to demand either dividend or liquidation. Thus, they are not "owners" or "members" in Hansmann's sense unless they have market or political, rather than legal or contractual, power to enforce the hypothetical deal that Hansmann postulates.

62. *Compare* MITCHELL, *supra* note 3 (describing corporations as "externalizing machines").

unless they could escape competitive product pricing. Ex ante, in competitive product markets, shareholders should expect to earn no return. Prospective shareholders should foresee this problem and refuse to invest unless they expect monopoly pricing.[63]

The net result should be a failure of the public equity capital market. Investors should be willing to lend to public companies, since bondholders and other lenders are entitled to a legally enforceable rate of return. But knowing that equity, having no legal entitlement to a payment, will not receive any return in competitive product markets, they should simply decline to provide equity capital.

Even in less competitive product markets, shareholders should expect no return. Firms at competitive disequilibrium may generate economic surplus. In the long run, standard economic theory predicts that competition will force its distribution to consumers in the form of lower prices. In shorter terms, firms may be able to retain some of the surplus. But nothing in the competitive account suggests that firms will give the surplus (or even normal returns) to shareholders. Rationally maximizing firms will not give free gifts when free riding is an option.

IV. NO EXIT: FIDUCIARY DUTY LAW'S FAILURE

Shareholders do not have a right to sue for dividends or return of their capital, but they have an equitable right to sue for breach of fiduciary duty, which might appear sufficient to make companies treat them *as if* they had a right to ongoing payments.

A. Fiduciary Duty: The Interests of the Corporation

Some cases—notably *Dodge*[64] and *Revlon*[65]—purport to find an enforceable right to returns on shares in the general fiduciary duty of care, which requires managers to manage the firm in the interests of the corporation.[66] On its face, a duty to manage the

63. Alternatively, if investors are assumed to be rational, the existence of a public market for a company's stock should be prima facie evidence that it has monopoly pricing power. This, of course, is not the current state of anti-trust law.

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

65. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (holding that once directors decide that the sale of the company is inevitable, their sole duty is to maximize the price to be received by shares, disregarding other corporate participants, even in the factual situation presented, where many shareholders were likely to have interests in corporation in other roles). Later cases have made crystal clear that, absent a decision to sell the company, the board has no duty to maximize returns to shares in any identifiable time frame. *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). Corporate finance theory suggests that time frame is irrelevant for shareholders (since share prices should reflect the present risk and time discounted value of all future returns). However, from an enforcement perspective, returns that may come at any time at all are the same as returns that may never come. Thus, directors have no enforceable duty to maximize share returns at all. For further discussion, see *infra*, Parts IV.B and IV.C.

66. For the fiduciary duties of directors, see, e.g., RMBCA § 8.30(a) (stating that each member of the board of directors shall act "in a manner he reasonably believes to be in the best interests of the corporation"). In Delaware, these duties are separated into two duties. First is the duty of loyalty, namely the director's obligation to act "in the good faith belief that her actions are in the corporation's best interest." Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003); *see also*, *In re* Walt Disney Co. Derivative Litig., No. CIV.A.15452, 2004 WL 2050138, at n.49 (Del. Ch. Sept. 10, 2004) (holding that the "duty of loyalty . . . imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that [a director] absolutely refrain from any conduct that would harm the corporation"). Second is the duty of care,

firm in the corporation's best interests does not seem to offer much support for the shareholder position. Standard doctrinal language either does not mention shareholders at all, as in the "interests of the corporation" formula used by the RMBCA and many Delaware cases, or mentions them in a context that makes clear that shareholder interests and firm interests are different and potentially in opposition, as in the alternative "interests of the corporation and its shareholders" formula.[67]

Shareholder distributions facially fail these tests, if taken seriously. As we have seen, dividends are a gratuitous expression of appreciation for past services already rendered—that is, a gift. In the absence of a quid pro quo, gifts to shareholders are no more in the corporation's interests than any other form of charity. At most, perhaps dividends can be understood as a sort of vague good-will advertising meant to entice future purchasers of future equity issues by creating a reputation for generosity.[68] However, this reputational gambit should not work. It will fail to convince rational potential shareholders, due to the final period problem. Successful companies rarely need or want to issue additional equity to the public markets; instead, they generally finance expansion with retained earnings.[69] In other words, as soon as the company is capable of being generous to its shareholders, it loses the incentive to do so. Accordingly, rational shareholders would assume that successful companies will no longer care about future shareholders and, therefore, will have no reputational reason to continue to pay dividends to current ones once they are successful. But, if current dividends cannot deceive rational shareholders into believing that the firm will provide future dividends after it no longer needs shareholders, then the reputational justification of current dividends fails as well. The result is that rational, self-interested corporations should decline to issue any dividends at all.

In standard corporate finance influenced understandings, it is the job of the corporate treasurer to find funding for the firm at the cheapest possible price, whether by issuing stocks, bonds or other securities, bank loans or internal sources. Similarly, the nexus of contract approach portrays shareholders as factors of production in a more or less normal arms-length relationship with the corporation. On this view, a duty to act in the "interests of the corporation" makes the gratuitous transfer of corporate funds to shareholders more, not less, problematic.

The only way to generate a duty to distribute corporate returns to shareholders from the directors' duty to act in the best interests of the corporation is to conflate shareholders and corporation. Were corporate interests just shorthand for shareholder interests, or if

namely the requirement that "in making business decisions, directors must consider all material information reasonably available." Brehm v. Eisner, 746 A.2d 244, 259, 264 (Del. 2000) (also noting that Delaware duty of care is purely procedural); *see also* DEL. CODE ANN. tit. 8, § 145 (2001) (permitting indemnification of directors and others who act in "good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation").

67. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360-61 (Del. 1993) ("[D]irectors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders.").

68. *See* A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145 (1953) (upholding charity contributions, inter alia, as a sort of advertising).

69. *See, e.g.*, BREALEY & MYERS, 5th ed., *supra* note 28, at 366-67, tbl. 14-3 (showing that from 1981-1994, 60-90% of corporate investment was financed internally and most of the remainder was financed by debt rather than equity. Indeed, in most of these years, net stock issues were negative.).

corporations had no existence separate from their shareholders, giving corporate money to shareholders could be seen as just moving money from one pocket to another. The fact that courts often use the "corporation and its shareholders" formula as interchangeable with the "best interests of the corporation" formula offers some support for the notion that shareholder and corporate interests are the same.[70]

Unfortunately, viewing the corporation as the same as its shareholders makes a mess of the law. Separate existence is the fundamental point of incorporating. The key characteristics of the corporation—legal personality, permanent existence, limited liability, entity-level taxation, and centralized management—all flow from its separateness. The corporate veil separating shareholders from corporation means that neither is responsible for the debts of the other, neither is the agent of the other, and neither can contract for the other. It prevents individual shareholders from holding up the firm by threatening to withdraw capital at inopportune times or to veto new business opportunities.[71] Moreover, separation is necessary to convert real, complicated human shareholders into fictional investors, thus allowing business managers to focus on a few simple goals instead of all the problems of collective existence.[72] In short, the rule that a corporation is not its shareholders is what makes a corporation a firm instead of an evanescent moment in the market on the one hand or a full, self-governing political community on the other.

Viewing the corporation as the same as its shareholders also contradicts the leading theories of the firm. Nexus of contract theories tend to disparage the view of lawyers and sociologists that the corporation has an independent existence, instead reducing it metaphorically to a mere fictional point in a web of contracts. However, even this vanishing corporation does not collapse into its shareholders. Like the corporate finance approach from which they descend, nexus of contracts theories assume that debt and equity are largely interchangeable claims on firm cash flows, not fundamentally different roles in a quasi-sovereign polity. But that means equity has no more claim to the firm surplus than anyone else. In a capitalist system, there are no pre-legal rights to economic rents.

The duty of care and duty of loyalty are duties to the corporation, not to its shareholders. If fiduciary duties to the corporation require paying dividends, it will be to the same extent that they require paying wages or fuel bills—firms must pay their factors of production their market value in order to attract and retain them. But the surplus created by the corporation belongs to the corporation. Giving away corporate assets obviously is not in the interest of the corporation in any normal sense; it is hard to see how it could be mandated by such duties. In fact, if there were anyone with standing to bring the lawsuit, the easier claim would be the opposite one—that paying dividends is waste, defined in Delaware as "an exchange that is so one-sided that no business person

70. For example, in *Cede & Co.*, 634 A.2d at 361, the court uses the "corporation and its shareholders" formula to gloss a quotation that uses the "best interests of the corporation" formula without any suggestion that the two phrases might have different meanings.

71. Lynn Stout and Margaret Blair recently have reemphasized the importance of potential conflicts of interest among shareholders. Lynn Stout & Margaret Blair, *Specific Investment and Corporate Law*, 7 EUROPEAN BUS. ORG. L. REV. (forthcoming 2006); Lynn Stout & Margaret Blair, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 431 (2001).

72. *See* Greenwood, *supra* note 37.

of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[73]

B. The Autonomous Corporation: The Business Judgment Rule

Moreover, even if the law could be read to include a fiduciary duty to run the corporation on behalf of its shareholders, it is hard to see how a court could force a board to create shareholder returns without taking over the business.[74] For a firm to survive, it must create new contractual obligations, and each new obligation immediately reduces the scope of potential shareholder claims at the same time as it opens the possibility for future growth and profits. The essence of sound business judgment is deciding how much to reinvest and where, which inputs to hire for the next period, and distinguishing between surplus available for shareholders and funds that must be retained for business needs. There can be no mechanical or objective answer to distinguishing costs from surplus that a neutral court could impose on interested parties.

Perhaps as a result, substantive fiduciary duty doctrine is of no use at all in solving the sunk cost of equity problem. Not only do courts decline to force boards to *maximize* share returns, as a rule they do not even attempt to require boards to provide shareholders with *any* returns whatsoever (at least outside of the narrow "*Revlon* Mode" that begins when the board determines to sell the company).

Moreover, even if fiduciary duty doctrine were substantively helpful in avoiding the equity sunk cost trap, it would be procedurally inadequate. Modern corporate law provides that a corporation is managed by its board of directors.[75] In order to prevent shareholders from shifting the locus of decision-making to courts, courts must defer to board decisions.[76] The business judgment rule restates this fundamental principle of corporate politics: So long as the board has exercised its business judgment in good faith, acting in the manner it determines to be in the best interests of the corporation, courts will not intervene on behalf of shareholders.[77]

Courts, especially since the *Carolene Products* footnote 4, have largely defined their

---

73. *In re* Walt Disney Co. Derivative Litig., No. CIV.A.15452, 2005 WL 2056651, at *111 (Del. Ch. Aug. 9, 2005) (quoting Brehm v. Eisner, 746 A.2d 244, 263 (2000)).

74. *See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (defending the business judgment rule on ground that "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions").

75. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").

76. *See, e.g.*, *Joy*, 692 F.2d at 885-86 (stating that "courts need not bend over backwards to give special protection to shareholders . . . ").

77. *See, e.g.*, Gagliardi v. TriFoods Int'l, 683 A.2d 1049, 1052-53 n.4 (Del. Ch. 1996). *Gagliardi* stated that:

> to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary *acting in a good faith pursuit of corporate purposes*, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect . . . . [The business judgment rule] in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.

Id.

competence in procedural terms.[78] Corporate law is no exception. The business judgment rule reflects the judicial view that the primary fora for addressing controversies regarding corporate management are the boardroom, the managerial hierarchy, and the stock markets, and that courts should generally respect the outcome of struggles among those power structures, just as they defer to the decisions of the political branches of government.[79] The business judgment rule, then, is best understood as a rule of institutional competence, analogous to agency-deference rules in public law.

In effect, the business judgment rule assures that courts normally will not review breach of duty claims. As a result, boards and managers are free to favor non-shareholder constituencies (other than, perhaps, directors themselves) in distributing any surplus that does exist.[80]

1. The Business Judgment Rule's Division of Labor

Corporate decision-making structure, as created by state corporate law in combination with the Federal regulatory scheme and ordinary practice, reflects a generally sensible division of labor between managers, shareholders, directors and courts. Managers are experts in running companies. Under ordinary principles of agency law, they act for the company in all routine matters, make its decisions in the first instance, and so on. Shareholders, particularly the institutional shareholders that dominate our public stock markets, are specialists in pricing, buying and selling shares. The law ordinarily grants them full autonomy in deciding whether to hold, buy or sell individual shares.

The board of directors formally serves as the principal of the corporation, making decisions where the firm itself, rather than its agents or constituents, must act directly. However, directors are part-timers with only a limited ability to participate meaningfully in corporate governance. In practice, their main responsibility is hiring and firing top management. They also have a key role when managerial and shareholder competencies conflict or overlap, specifically when either managers or shareholders wish to sell the company or engage in certain related radical transformations, such as merger, sale of all assets, dissolution or reincorporation. At least since the judicial approval of the poison pill and its statutory equivalents, the combined state/federal regime has provided that virtually all such transactions require the directors' approval, usually followed (except in the case of a tender offer) by ratification by a majority of the shares.

Courts and the law generally allow each of the experts near complete autonomy in their respective areas of expertise, restricting their interference to policing process and

---

78. United States v. Carolene Prods. Co., 304 U.S. 144 152 n.4 (1938) (affirming New Deal rejection of substantive due process and leaving most constitutional issues to the electoral process and legislative-executive branches, but providing for more significant judicial review where issues of the integrity of those processes are raised).

79. *See, e.g.*, *Aronson*, 473 A.2d at 812 ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)."); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("The [business judgment] rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.").

80. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 259 n.64 (Del. 2000) (noting that "directors' business 'decisions will not be disturbed if they can be attributed to any rational business purpose'") (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

overreaching rather than substantive error.[81] As a result, the main policing of managers and shareholders is by the peer review mechanisms of market pricing, bureaucratic promotion, and directorial supervision, rather than by courts. Shareholders hold or do not, and managers manage, with little judicial supervision.

2. Judicial Deference: Time, Rational Basis Inquiry and the Business Judgment Rule

Procedural deference means that shareholders cannot look to courts to grant them a right to corporate surplus when they fail to appropriate it without judicial intervention. To see the degree of the Delaware courts' deference to managerial and board decisions, consider the centrally important decision in *Paramount v. Time,*[82] in which the issue was the relative authority of board and shareholders in connection with decisions regarding the sale or merger of the company.

Time upheld a decision of Time's board to restructure a planned merger in order to eliminate a shareholder vote and preclude an alternative transaction that, by all indications, would have been vastly more attractive to shareholders. From the standard perspective of a fictional shareholder—a theoretical undiversified Time shareholder with no interests or values at stake other than maximizing the present value of its Time stockholdings—the decision is so difficult to understand that one is forced to assume that the court was not taking that perspective at all. The sums offered by Time's suitor Paramount were so large that Wall Street's professional money managers overwhelmingly viewed them as greater than any reasonable estimate of returns to holding Time stock. Were the goal of the court to protect undiversified shareholders, this would have been a paradigmatic case for restricting managerial overreaching and allowing shareholders to follow the norms of the market—to sell for an unexpectedly and perhaps unreasonably high price.[83]

---

81. *See, e.g.*, *In re* Caremark, 698 A.2d 959, 967 (Del. Ch. 1996) (emphasizing that the business judgment rule protects directors "so long as the court determines that the *process* employed was *either* rational or employed in a *good faith* effort to advance corporate interests" and that "compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss") (first and second emphases added). Although *Aronson* described the business judgment rule in seemingly substantive terms as a "gross negligence" standard, even that case both justifies and tests this rule by procedural considerations. *Aronson*, 473 A.2d at 805. Absent the autonomy considerations discussed in the text, exempting directors from the ordinary negligence rules that apply to all other decision-makers would raise serious problems of equal protection: in republics, unlike aristocracies, great responsibility does not automatically produce great privilege.

82. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

83. In this instance, the stock market's prospective assessment seems to have been on the mark. Time's subsequent history of spectacular executive compensation and its spectacularly unsuccessful merger with AOL are hardly unimpeachable advertisements for the inevitable triumph of managerial capitalism.

However, the interests of stock investors as a whole may well be better met if merger decisions are made by both corporate managers and financial specialists. To be sure, in any particular cash-out merger, shareholders are exiting and thus unconcerned with the successor institution's success. Moreover, narrowly profit-maximizing shareholders would be perfectly happy to sell out to an irrational buyer (for example, one overpaying due to winner's curse) or a rent-seeking buyer (for example, one intent on creating private value by monopoly power) knowing that the buyer likely would destroy the firm or create social costs in excess of private benefits. However, most shares are held by diversified portfolios, and portfolios have interests that extend beyond the particular stock being sold. Most clearly, often the buyer will be publicly traded, so that institutional investors will be on both sides of the transaction and have no interest in value-destroying deals.

Instead, the Delaware courts chose to reaffirm the central principle of directorial supremacy. Directors are primarily responsible for setting the corporate agenda and that, as Delaware has repeatedly pointed out, includes setting the time frame in which the corporation will meet its goals. But *Time* stands for a stronger position than mere judicial reluctance to attempt to parse the difference between long and short term. Under Delaware law, the directors control more than merely the timing and means the corporation will use to achieve its ends. The directors set the corporate ends themselves.

Time defended its decision to eliminate a planned shareholder vote on the ground that it sought to preserve "Time Culture," an ill-defined concept that seemed to center around "the separation of church and state," as Time referred to its policy of separating editorial from advertising staff. Time made no claim that "Time Culture" was necessary or even helpful to maximizing shareholder returns. Indeed, although the court reports the company's paeans to the contribution of "Time Culture" to a superior quality product, it does not purport to determine whether that claim was plausible—it makes no judgment of the quality of *Time*, *People* or *Sports Illustrated*, let alone of the links between "separation of church and state" and the ultimate product.

Nor did Time claim that it was committed to "Time Culture" in all circumstances. "Time Culture" was not written into the corporation's by-laws, let alone its articles of incorporation, and the firm offered no assurances that it would continue to be the policy of the successor corporation. Preservation of "Time Culture" was simply the current board's current stated policy. The Time case, then, stands for the principle that the board is entitled to determine both means and end, both how to pursue the corporation's interests and even what those interests are.

Thus, business judgment review looks much like "rational basis" equal protection review. Post-*Lochner*, courts largely accepted that legal reasoning's power is limited. Legal reasoning can help determine the relationship between a given end and the means to reach it, and can even help clarify the conflicts between differing moral and political principles. But in the end, not legal logic but democratic politics of persuasion must set our ultimate goals and resolve the inevitable conflicts among the infinite aspirations of finite people. In the basic *Carolene Products* footnote 4 allocation of authority between courts and legislature, the court conceded that the goals and interests of society are for the legislature to determine. The post-*Lochner* courts recognized that the legitimate judicial role is in setting procedures and mediating disputes within given moral/legal frameworks, not in imposing controversial economic or political theories on the body politic.

Similarly, in corporate law courts largely permit boards to determine, within extremely broad boundaries, what the corporate interests are. Just as the Constitution "does not enact Mr. Herbert Spencer's Social Statics,"[84] so too the Delaware Corporations Code does not enact Mr. Milton Friedman's narrow profit maximization or Mr. Alfred Dunlap's short-term shareholder orientation. Corporate law, like

---

Less obviously, portfolios have an interest in maintaining the integrity of the process, since the price of future mergers will reflect participants' estimates of the likelihood of post-merger success and those estimates, in turn, are likely to be affected by past history. Pressing too hard for the maximum sales price in particular instances may endanger the long-run game. Shareholders, however, should recognize that generally shareholders will free ride rather than defend these long-term interests. That, in turn, should lead shareholders, acting only in their own self-interest, to support disempowering shareholders in favor of less short-sighted decision-makers.

84. Lochner v. New York, 198 U.S. 45, 75 (1905) (Holmes, J., dissenting).

constitutional law, simply is not rich enough to provide a ready-made legal answer to the issue of how or why to run a corporation.

But if the board can determine what its ends are, virtually any decision it makes will be defensible. Just as classical rational basis review nearly always discovered some legitimate legislative purpose to which even the oddest legislative act could be rationally related, so too business judgment review will nearly always discover that board actions rationally promote some permissible end.

3. The Poverty of Wealth Maximization: Multiple Ends Under the Business Judgment Rule

It may not be obvious that the business judgment rule is this broad. Occasional courts have suggested that corporate boards have only one legitimate goal: to maximize profit for the benefit of shareholders.[85] Similarly, litigants often defend actions that on their face appear to favor non-shareholder corporate constituencies as in the long-term interests of shareholders. Often, of course, they are. However, sometimes the claim seems a polite evasion. So long as the favored constituency is not the decision-makers themselves, courts rarely blink at even implausible theories of long-term shareholder interests.[86]

Willingness to allow boards to choose goals other than shareholder value maximization is the only rational explanation of the "just say no" cases. In *Unitrin*,[87] for example, the Delaware Supreme Court upheld a board's defensive tactics against an offer that was highly attractive to shareholders on the purported ground that they had to be protected from "substantive coercion." But there was no coercion other than the high price itself. The shareholders faced a choice between the offer and management's assurances that future profits would justify a higher price still. That decision is precisely the kind of calculation shareholders are in the business of making. If shareholders cannot be trusted to make that calculation, it is hard to see why they should be trusted at all.[88]

---

85. In addition to *Dodge* and *Revlon*, see, e.g., *Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971) (barring shareholder from exercising legal right on ground that he was not acting within shareholder role to further proper corporate goal).

86. *See, e.g.*, Chesapeake Corp. v. Shore, 771 A.2d 293, 325-26 n.66 (Del. 2000) (attempting to make sense of *Unitrin*'s holding that directors may 'protect' shareholders from an offer to sell the company for a high price); A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953) (upholding charitable contribution on implausible ground that it is really self-interested); Kamin v. Am. Express, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976) (upholding, as in interests of shareholders, directors' intentional decision to pay unnecessary taxes in order to make true financial condition of company less apparent to shareholders); Blair & Stout, *supra* note 4.

87. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

88. Here is how Vice-Chancellor Strine, struggling to understand the decision within a shareholder centered paradigm, describes it:

> On the other, the same electorate must be protected from substantive coercion because it (the target board thinks) is unable to digest management's position on the long-term value of the company, compare that position to the view advocated by the tender offeror, and make an intelligent (if not risk-free) judgment about whether to support the election of a board that will permit them to sell their shares of stock.

Chesapeake Corp., 771 A.2d at 326. The Vice-Chancellor's attempt to take seriously the notion that shareholders may only be "protected" leads him to conclude that the Supreme Court's jurisprudence is nearly incoherent. As he quite correctly points out, if the problem is lack of information, the solution should be more

In short, the Delaware court was either radically foolish or somewhat disingenuous. Permission is granted to "protect" shareholders, but in fact the permission is broader—to define when and whether shareholders will determine the overall goal of the firm. The easiest way to understand *Unitrin* is simply that the board, not outsiders, decides when or whether shareholder return will be the goal of the firm. As we have seen, even when boards have dared to explicitly admit that they are not acting in shareholder interests, as in *Time*, the Delaware courts have not seen that as a problem.[89] Instead, the law is that the court must defer both to the board's determination that a threat exists, as well its decision respond in a particular manner. Additionally, such a threat may be to the corporation's goals, and not solely to shareholder returns.[90]

C. The Red Queen's Jam: The Impossibility of Timing

Fiduciary duty's inability to guarantee shareholders a return is not an artifact of particular holdings or doctrinal language. If the courts were determined to create an enforceable fiduciary duty to operate corporations only in shareholder interests, they could, for example, reject *Time,* build up *Dodge* and *Revlon*, strengthen the lip service they pay to the shareholder-centered goal by demanding evidence of it, or even revert to a *Lochner*-esque confidence in the power of legal categories to govern complex societies. It would not suffice. The problem is fundamental.

Since Miller and Modigliani's work half a century ago, finance theory has taught that time frames are irrelevant from the perspective of a diversified investor.[91] The price of a share of stock should be equal to the market's estimate of the current risk-adjusted, time-discounted value of all future returns to that share (i.e., future dividends plus the final period payment).[92] Because the share price capitalizes all predicted gains—whether near or distant in expected date—investors should be perfectly happy with a firm that reinvests internally with an eye to future profit rather than paying out current dividends.

---

information, not allowing the board to preclude shareholder decision making. *Id.* at 328.

89. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1140 (Del. 1989). Mark Roe's summary of the law is thus incomplete. Roe states, correctly, that under the business judgment rule, courts police self-dealing by directors and managers, but not incompetence or mismanagement. *See generally* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2002). But he fails to note that courts do not even view intentional failure to act in shareholder interests as mismanagement. In the absence of self-dealing, U.S. law-in-the-courts delegates to the board decisions of balancing shareholder interests against other firm values nearly as much as in more openly balancing regimes such as the Netherlands. KRAAKMAN ET AL., *supra* note 1. Despite its absence from the law in the books, the shareholder-centered norm is key to understanding corporate law as it stands today. *See, e.g.*, Greenwood, *supra* note 37; Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773. Its normative power, however, stems from non-legal norms, such as the metaphoric rhetoric of "ownership," "agency," or "shareholder democracy," rather than the shareholders-*über-alles* mandates of *Revlon* and *Dodge*. These norms are reinforced by the non-trivial market pressures. The more competitive product or supplier markets are, the less distinction there will between maximizing shareholder value and merely surviving (at competitive equilibrium, of course, the firm must run as fast as it can just to stay in one place—survival requires maximization). Even when product markets are more forgiving, capital markets, even after the decline of the market for corporate control, amply reward actions they perceive to be in the interests of shareholders.

90. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *see also Unitrin*, 651 A.2d at 1388-89.

91. See *supra* note 6.

92. *See, e.g.*, BREALEY ET AL., *supra* note 2, at 64; KLEIN & COFFEE, *supra* note 2.

Indeed, since internal reinvestment avoids a layer of income taxes, they may even prefer the firm to defer dividends.

As a result, in a moderately efficient capital market, stock market investors should be entirely indifferent between long and short term profits or varying dividend policies, regardless of their own personal cash needs or time preferences. Should the company generate cash later than they need it, they can sell shares, thereby realizing the current discounted value of the future cash. Conversely, should the company generate cash at a time when the investor does not need it, the investor can simply reinvest. Accordingly, courts seeking to require corporate managers to operate the company in the interests of shareholders rationally should respond by focusing entirely on rate of profit, not its timing.

Inside the corporation, however, timing is everything. First movers have potential for disequilibrium profits or to create cascade effects and lasting market domination. Conversely, a product that takes too long to develop or that appears before its time is a product that is likely to fail. Receivables collectible next quarter may be of limited use if payables must be met this quarter; as Long Term Capital Management demonstrated, being right (and solvent) in the long run is not enough. [93] No legal principle can tell a judge when a company should focus on the next quarter and when it should focus on the next decade.

Thus, were courts to attempt to require firms to profit maximize in some particular time frame, they would destroy one of the key advantages of the business corporation. In modern business corporations, shareholders do not have a right to their capital back at a specified time or on demand. Instead, equity serves as permanent financing for the firm, independent of market fluctuations. This predictability is key to long-term planning and illiquid investments that would otherwise be impractical.[94]

Economic projects do not come in neatly packaged units with fixed end points and many are illiquid for long periods of their expected life. Often, a project could be destroyed if investors were permitted to withdraw mid-stream: a half-built factory, a drug in development or a computer program that doesn't yet work may have little value to outsiders suffering from information asymmetries. Similarly, the secondary market for used factors of production is often problematic: buyers who have difficulty telling whether a machine or building has been well maintained should not be willing to pay full value for it.[95] If the company is required to pay off an individual investor at a time when it is illiquid, it may be forced to raise additional money on unfavorable terms, sell off assets at fire-sale prices or compromise with the departing investor.

Ex ante, foreseeing such problems, investors might be unwilling to invest if the enterprise's success were dependent on other investors choosing not to withdraw. Thus, individual investor rights to withdraw, either at will (as in a partnership) or at fixed times (as in many investment pools) can preclude illiquid investing. But illiquid investing—

93. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG TERM CAPITAL MANAGEMENT (2000).

94. One should not over-exaggerate the necessity of equity investors, however. Other highly successful market economies function with less developed stock markets than ours, finding alternative—often bank-based—sources of long-term capital.

95. *See generally* George Akerlof, *The Market for Lemons*, 84 Q.J. ECON. 488 (1970) (discussing the uncertainty of quality and the incentives to sell poor-quality goods).

disequilibrium, non-commodity investing—is likely to be the most dynamic and profitable investing in the economy.

For each of these reasons, then, courts must allow firms to determine both the time frame of their investments and the timing of payments to shareholder investors.

Unfortunately, as every procrastinator knows, something that is always better done tomorrow—like paying dividends in a Miller and Modigliani world—is something that need never happen today.[96] The result is the promise of fiduciary duty to make shareholders into residual beneficiaries fails. The freedom to determine the time frame in which to maximize shareholder returns is the freedom never to return anything at all to shareholders.[97] As a practical matter, a corporation's board can evade any requirement that it act in the shareholders' interests by simply declaring that it wishes to use retained earnings for corporate purposes, such as expansion or other plans to improve long-term profits.[98] Instead, the corporation may invest for a long term that, like the Red Queen's jam, never arrives: "Two pence a week and jam every other day. . . . The rule is, jam to-morrow and jam yesterday—but never jam *to-day*."[99]

---

96. *Cf.* Manuel Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329 (describing procrastination problems).

97. Moreover, in the real world, the possibility of market inefficiency is omnipresent. Wall Street, after all, could not exist if the market price were always correct—there would be no reason to research and little cause to trade. For this reason, "the directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan." Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1376 (Del. 1995). Thus, not only may a board determine to pursue long-term rather than short-term value, but it may also decide that the market's assessment of its plans is simply incorrect. These are not odd doctrinal positions. They are necessary. A corporation exists, as Coase pointed out, because it has some advantage over the market. Coase, *supra* note 37. If corporations were forced to follow the whims and will of momentary market fluctuations, they would lose that advantage and with it their reason to exist.

98. Louis Lowenstein has made a similar point in connection with Hecla Mining, where, he contends, all the profits from a highly successful mine were reinvested in the mine until the ore ran out—with no payments having been made to the shareholders. LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE 125 (1991) (describing repeated instances in which managers did not pass on economic profits to shareholders, but instead used them to expand, diversify, etc). Lowenstein presents his examples as instances of managers wasting shareholder money. Courts, he contends, simply do not (I would contend, could not) police boards that use all economic returns to continue the business as long as possible, thus ensuring that employees, suppliers and customers—but not shareholders—obtain the benefit of the firm's activities. But Lowenstein's condemnation *assumes* that the funds, which legally belong to the corporation, "actually" belong to shareholders. Taking corporate ownership seriously, the issue is, rather, whether corporate managers made proper use of the funds from the inevitably contested perspective of the corporation.

In some cases, it is hard to imagine any perspective from which managers acted successfully—running a great department store into the ground does not seem to be in any one's interest. However, in other cases, what looks like waste from the perspective of shares may not have been waste at all from the perspective of other corporate participants. Hecla, for example, as Lowenstein describes it, owned a highly profitable but non-renewable wasting asset. It chose to fully exploit the mine, taking all economic profits and reinvesting them into the mine. While the shareholders received nothing, employees and silver consumers (if not the environment) did quite a bit better than they might have under an alternative management plan. Contrary to Lowenstein, who sees the managers' decisions as a simple self-interested breach of their professional duties, one could view the managers' decision to continue mining as long as possible without paying shareholders as perfectly rational if managers were seeking to maximize the profits (or longevity) of the corporation, or the mine itself—thought of as an institution with a value of its own—or if they were seeking to maximize employees' continued employment or silver consumers' low-cost silver.

99. LEWIS CARROLL, THROUGH THE LOOKING GLASS AND WHAT ALICE FOUND THERE 53 (The Tempest

Investing for the future, taken to its logical extreme, means never giving anything at all to shareholders.

D. The Impossibility of Fiduciary Liability: Post-Lochnerism in Corporate Law

It is conventional at this point to condemn courts for failing to enforce the shareholder primacy norm. But the courts have not failed. Rather, they have appropriately remained within their institutional constraints in declining an invitation to impose a norm nowhere found in the applicable law and, in any event, unenforceable at any reasonable price. Even if courts were prepared to force every corporation to adopt a uniform rule of profit maximization notwithstanding the arguments of the previous sections, the realities of the business world would require extreme deference.

We have no professional consensus on how profit is to be maximized. Many people believe that profit, like happiness, is best pursued indirectly. The business schools and business press regularly debate whether, even if one wishes to pursue profit, it is not better done by placing some other goal foremost—customer satisfaction, a great product or quality service. Reflecting this debate, the statutes typically are completely silent on the subject of profit maximization.

Indeed, more broadly, the problem of enforcing fiduciary duty inheres in the basic notions of the liberal state itself.[100] In our post-*Lochner* world, it is hard to imagine courts consistently being anything but deferential to corporate boards. Normally, courts decline to make value judgments or enter into political conflicts unless they have an authoritative norm to which to defer.[101] In ordinary politics, when interests conflict, decisions about whose interests to favor are for the legislature. Similarly, when values conflict, courts seek an authoritative determination of the conflict outside their own decision-making process: judges routinely view themselves as compelled by norms that some other institution has created.

Corporate law is no different. Courts will impose norms only if they are certain that the norm was imposed on the courts by an external authority. In corporate law, however, the courts lack either a social consensus or a legislative mandate for imposing a limited range of purposes on corporations. As noted above, the statutes do not merely allow corporations to determine how best to pursue profit, including indirectly. They explicitly authorize forming corporations for any legal purpose at all. The statutes reflect the social reality: we have no consensus on a single, normative purpose for the corporation. Shareholder primacy may be hegemonic today, but, every decade or two, we see a flurry of arguments that corporations in a democracy might actually have purposes or responsibilities beyond making their shareholders rich.[102] Corporations themselves, even

---

Co. 1986) (1871).

100. See generally on the problem of values in pluralist societies, ROBERTO UNGER, KNOWLEDGE AND POLITICS (1976); MICHAEL SANDEL, DEMOCRACY'S DISCONTENTS (1996).

101. On patterns of judicial deference, see Greenwood, *supra* note 19.

102. *See, e.g.*, MARJORIE KELLY, THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY (2001); MITCHELL, *supra* note 3; RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87 (2005); Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Responsibility*, 112 HARV. L. REV. 1197 (1999).

the most profit-oriented, assiduously advertise their other virtues and purposes to the general public, offering at least the hypocrite's tribute of vice to virtue in acknowledging that profit is not, after all, the ultimate end of life.

To be sure, some writers have long claimed that something in the nature of the corporation or markets or capitalism itself mandates that corporations be run solely in the interests of shares and that the interests of shares can be understood as a matter of logic without deference to the views of the human shareholders themselves.[103] Courts that have accepted that claim—notably, the *Dodge* and *Revlon* courts—feel more free to coerce boards to act in the manner they deem in the interests of these imaginary shareholders.[104] But in the post-*Lochner* world, property is usually viewed as a creation of the state without a set of inherent rules that can be divined by judges without regard to the statute book.

As we have seen, the statute book simply does not resolve conflicts between shares and other corporate constituencies. Instead, it creates internal corporate politics. Under our legislation, the corporate board makes value judgments for the firm. It is the ultimate decision-maker not only of the technical issue of how to maximize, but also of the political issue of what or whether to maximize. Courts following the post-*Lochner* paradigm are likely to be inclined to defer to legislative judgments about the extent of property rights and the proper realm of political regulation of our mixed economy. The same world-view will lead them to respect the legislative decision that governing the corporation is for its board, within only the broadest of limits.

Fundamentally, in a liberal society, the interests of articulate adults generally are contested and contestable, and therefore it is usually accepted that they cannot be set out in the abstract without regard to the views of the interested parties themselves. Shareholders are a diverse group—roughly half the American electorate, many foreigners, and institutions representing those individuals in varying roles, as well as institutional interests not readily reducible to the interests of their constituents.[105] For courts to impose a single purpose on corporations, they would have to accept a clearly false claim that all these people and organizations have a single interest—maximizing the return on their stock investments at any cost to other human, social, aesthetic, political or ecological values. This flies in the face of ordinary liberal assumptions that people have

---

103. For further discussion, see Greenwood, *supra* note 37.

104. Such courts also see no need to defer to the actual views of shareholders, which—if they differ from the hypothetical interests defined by theorists—are merely evidence of inauthenticity or false consciousness. One clear example is *State ex rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971), in which the court decided that a shareholder who sought to urge the corporation to serve his real interests—by declining to participate in war production on political rather than profit grounds—was not a "real" shareholder. But the view that corporations exist only to pursue profit, regardless of the views of shareholders or other corporate participants, is quite widespread and has influenced many areas of corporate law. *See* Greenwood, *supra* note 37.

105. University endowment funds, for example, represent a set of interests peculiarly difficult to reduce to any individual's. *See* Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3 (1990) (suggesting various interests endowments may serve); Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1787 n.115 (1990) (suggesting that universities have some characteristics of professor cooperatives). Most faculty members and administrators are likely to find the professor's co-op view at odds with daily experience. Generally, professors do not vote for the board of trustees, and faculty governance ends precisely when the board, or its delegates—the administration—disagrees.

many ends, and many and conflicting goals, which they, not judges or economists, ought to resolve or mediate. Courts accepting the idea that a limited government ought not impose specified ends on its citizenry should be reluctant to impose the share-return maximization goal on corporations or their boards. Rather, it will seem natural to protect the autonomy of internal corporate decision-making mechanisms by deferentially applying the business judgment rule.

In short, corporate law imposes no legal obligation to pay shareholders. While the fiduciary duties of care and loyalty, particularly if seen through the lens of *Dodge*, might seem to impose an equitable obligation to work for shareholders, nearly all observers agree that when combined with the business judgment rule, they provide little restraint on managers. The most common explanation is Judge Winter's: courts defer to boards in order to ensure that managers continue to take risks—that is, courts are deferring to professional board decisions regarding the means the corporation chooses to employ to reach its agreed-upon end.[106] I have argued that deference is even broader—it extends to the board's choice of ends as well, as most clearly illustrated in *Time*. However, regardless of the motivation for judicial deference, the practical result is clear: in the absence of self-dealing, courts do not police management discretion.[107]

V. BEYOND THE SIMPLE ECONOMIC MODELS: LIFTING ASSUMPTIONS

As we have seen, our legal rules should generate no dividends for shareholders in competitive markets. Given the complete absence of any legal duty to make distributions to shareholders and the near absence of any fiduciary or equitable duty to do so, shareholders are sunk costs and payments to them are in effect gifts. Competitive product markets bar producers from paying more than marginal costs and leave no funds available for shareholders. Since this is predictable, potential shareholders should decline to invest and the equity market should collapse into a market for lemons. But equity financing of publicly traded companies actually exists. Accordingly, we need an explanation of how the model differs from the real world.

A. Competitive Market Solutions—Converting Fixed Costs to Variable Costs

One way to avoid the sunk cost problem would be to convert fixed costs into variable costs. To see how this works, return to the physical asset example. If the widget company rents its widget machines on a daily basis, its calculation of when to run them and when not changes. Now it will decide to operate the machine on any given day only if the price it expects to receive for the widgets will cover not only the cost of raw materials and labor, but also the rental of the machine. If prices drop below that, the firm

106. *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982); *cf. In re* The Walt Disney Co. Derivative Litig., No. CIV.A.15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005) (explaining that it would not be in the interest of shareholders for the law to create incentives for overly cautious corporate decisions).

107. *See, e.g.*, ROE, *supra* note 89, at 172 (stating "one does not exaggerate much by saying that American corporate law has produced only one major instance in which non-conflicted managers were held liable for mismanagement: *Smith v. Van Gorkum*"); Edward Rock, *Preaching to Managers*, 17 J. CORP. L. 605, 609 (1992) ("[Lowenstein's] horror stories [of companies not managed in the interests of their shares] clearly show the limited extent to which either market or institutional or legal mechanisms constrain management discretion.").

will simply close down. For this firm, marginal price (at least on time spans of more than one day) is now equal to average price. If the entire industry were organized in this fashion, the fixed cost problem would be solved and the market would find a competitive equilibrium in which supply, demand, marginal cost, and average cost all converge.

For financial capital, the equivalent solution is to substitute debt for equity.[108] If investors fear that they will not be paid for selling their capital to the firm, they can rent it. The equivalent to the daily rental of machinery is short-term or callable loans. If the firm is financed with daily renewable loans, each day the firm must decide whether to continue to pay for funds or close down; accordingly, fees for use of capital are variable costs and will be included in its price. Interest payments, then, are a variable cost.

Moreover, borrowing need not be short-term to solve the investor sunk cost problem. Debtors have a legal right to be paid interest at regular intervals. Since the firm must meet its interest obligations in order to continue to operate, it will treat interest as a variable cost even though it does not vary with production, and it will not be tempted to ignore the cost of debt in calculating its marginal costs. But the problem is more complicated.

1. Preconditions to the Rental Solution

First, the debt solution can only work under limited circumstances. If other firms continue to finance using equity, they will have lower variable costs and be able to drive a purely debt-financed firm out of business (before driving each other out of business as well). Even if all firms adopt debt, firms will be tempted to defect—to switch to lower marginal-cost ownership and below average-cost prices in the hope of achieving economies of scale or creating a monopoly. Thus, even debt financing may not lead to a stable equilibrium with prices at or above average cost. Instead, so long as public equity financing is available, competitive pressures should drive companies, first, to issue equity, and second, to lower prices to marginal costs with the result that they will earn no fund from which to pay shareholders anything.

For the debt solution to work, the market must have some characteristic preventing competitors from switching to equity financing. For example, if rapid technological change means that capital equipment has a very short life-span, fixed costs basically disappear, and lenders should be able to assume that debtor firms will not be competed into bankruptcy.

The simplest solution is for the public equity market to fail. For example, if investors are confident that the relevant product market is competitive, they might conclude that no firm will be able to charge prices in excess of marginal cost, and therefore no firm will earn a fund from which to pay dividends. If dividends will not be paid, then equity is valueless. Equity's despair is the precondition to debt's success. Without a public equities market offering zero marginal-cost financing, firms and investors could solve their sunk cost problem by using debt to keep marginal costs aligned with average costs. This scenario may bear some resemblance to the financing of the American railroads or of the post-war Japanese and German economies: in each case, the public capital markets provided largely debt, not equity.

---

108. Rental of equipment and debt financed purchase are close economic substitutes, as tax and finance lawyers are well aware.

2. Is it Turtles All the Way Down?

Second, it may seem that shifting to rental, even if successful, simply pushes the sunk cost problem back one level. If railroads all rented their rails, they might not be tempted to push prices to a level below average cost. However, the owners of the rails would. Each rail owner would prefer to rent at any price above its marginal cost for renting—essentially zero—rather than let the rails sit unused. Thus, rail owners will replicate the original problem. As William James is alleged to have said, "It's turtles all the way down."[109] The market should collapse or gyrate from boom to bust, because, ex ante, foreseeing the sunk cost problem, no one would enter the rail business in the first place without seeing some escape from competitive pricing.

Here, however, financial capital does not work the same way as real capital assets. The sunk costs problem appears when the marginal cost (not including sunk costs) of using an existing physical asset is lower than the average cost. Equity capital replicates that problem because once an investor purchases stock from a company, the company has the right to use those funds with no legally mandated further payments to the investor. But financial capital in general does not replicate the sunk cost problem.

The cost of using a highly fungible asset—and money is the most fungible of all assets—includes Coasian opportunity costs: the profits that could be made by using it in an alternative investment. Investors can sell or rent their cash to many different businesses, not all of which will be afflicted with the sunk cost problem. Accordingly, lenders, who can readily shift their funds to other uses, will not be susceptible to the sunk cost problems of renters of railroad tracks, who are stuck with tracks that have no ready alternative use. If railroads wish to borrow, they will have to pay the going rate for finance capital, and if loans are short term, they will have to pay it on a current basis with no difference between ex ante and ex post calculations.

So far, then, we come to this odd conclusion. Firms selling their product in competitive markets should treat equity capital as a sunk cost and not include it in prices, which will be set at marginal cost. Whether or not the stock is "entitled" to the residual, it has no reasonable expectation of actually receiving any payment at all—not only no residual, but not even the ordinary cost of capital. Since this ex post defection is entirely predictable ex ante, rational investors would expect to receive no compensation for their purchase of equity in such firms and would not purchase it. In short, the public equity market should not exist (except in monopoly sectors).

On the other hand, if finance capital is supplied in the form of debt, firms will be forced to include its cost in their prices and therefore (assuming other firms do the same), to recover its costs from consumers. The result should be that firms in competitive markets are entirely debt financed. Once again, the model suggests the original puzzle: why does equity financing exist at all?

---

109. John R. Ross, Constraints on Variables in Syntax iv (Sept. 1967) (unpublished Ph.D. dissertation, Massachusetts Institute of Technology), *available at* https://dspace.mit.edu/bitstream/1721.1/15166/1/14704247.pdf (an earlier version of this sentiment appears in 2 JOHN LOCKE, AN ESSAY CONCERNING HUMAN UNDERSTANDING, ch. XXIII § 2 (1690)); *cf.* Clifford Geertz, *Thick Description: Towards an Interpretive Theory of Culture*, *in* THE INTERPRETATION OF CULTURES 29 (1973). James's published version of the story uses rocks rather than turtles. WILLIAM JAMES, THE WILL TO BELIEVE AND OTHER ESSAYS IN POPULAR PHILOSOPHY 104 (1956).

B. Escaping the Equity Capital Sunk Cost Trap Through Leveraged Buyouts

For a moment in the 1980s, prominent theorists declared the public corporation dead, for reasons that partly fit this analysis.[110] The world, Jensen said, belonged to management-led leveraged buy-outs (LBOs).[111] In these transactions, equity is replaced by debt. Firms borrowed money in order to buy back their stock, resulting in a firm financed mainly with debt. The small amount of equity left generally was held in large part by managers who had contributed little or no actual capital to the firm.

As a result of replacing equity with debt, interest payments would rise, and the firm's legal profit would drop sharply. Reduced profit might seem bad, but the relevant players thought otherwise. The basic notion was that the new interest payments were simply a reclassification of the old dividend payments—a different name for the same return to capital.

Re-labeling profits as interest had a series of advantages, not all of them explicitly set out by Jensen. For our purposes, the most important is that debt capital is rented, not contributed; it is an ongoing, not a sunk, cost. Since bondholders have a legal right to returns, the marginal cost of debt is not zero, but rather the contractually mandated interest rate (discounted by the firm's ability to renegotiate contracts in bankruptcy). Accordingly, capital can expect to earn a normal return and the sunk cost trap problem is solved.

Moreover, if the firm is able to generate surplus, changing dividends into interest changes the frame in which conflict over corporate surplus takes place. A corporation that creates surplus must allocate it in some fashion between consumers, capital, labor and other factors of production. The change from equity to debt capitalization does not change this fundamental reality, but it radically shifts the appearance of the conflict. When a successful firm is financed by equity capital, its surplus is labeled profits. The firm appears rich. It then decides whether to allocate its wealth to shareholders (in the form of dividends) or employees (in the form of pay increases) or other corporate constituents. The direct conflict is transparent and obvious: every penny that goes to dividends is a penny that does not go to employee profit sharing or consumer rebates. Employees can be expected to be highly resentful if they do not share in the surplus; it is hard to frame a morally acceptable reason why the success of the team should go only to one part of the players.

In contrast, the leveraged firm transforms wealth into poverty, profits into loss and voluntary gifts to capital into unavoidable necessity. When the surplus is created, the debt capital already has a claim on it. In a debt-financed firm, the allocation of surplus is done ex ante, before the surplus is created; at the time when debt is issued, contracts are negotiated and prices are set. The direct conflict between capital, consumers, and labor over the surplus is likely to be less salient at this point. Indeed, it may be entirely invisible. The only way for an observer to determine where the surplus is going, or even whether there is a surplus, is to create a second set of accounting records for the firm in which the actual contractual prices are replaced with hypothetical market prices reflecting

---

110. *See, e.g.*, Michael C. Jensen, *The Eclipse of the Public Corporation*, 5 HARV. BUS. REV. 61 (1989) (explaining that "[t]he publicly held corporation . . . has outlived its usefulness in many sectors of the economy and is being eclipsed").

111. *Id.*

the minimum the firm could have paid to obtain the resources it needs. Any such calculation is likely to be highly controversial. How can we ever know what different bargaining might have achieved?

Consider the most extreme example, where the firm seeks to allocate the entire surplus to capital. With conventional financing, this requires simultaneously pressing hard on labor, keeping prices high, and paying obviously high dividends out of highly visible profits. Since the equity market is quite competitive, high dividends will result in high stock prices. Consumers, then, see price gouging, while employees see harsh bargaining on wages, high accounting profits, large dividends, and increasing stock prices. Surely this is a recipe for labor unrest and political reaction. Relatively few people like being squeezed to make the rich richer, recent election returns notwithstanding.[112]

The highly leveraged firm, however, looks quite different. To allocate all surplus to capital, this firm issues debt with large interest obligations—obligations that can only be met if the firm is quite successful. There is no easy way for employees or other observers to distinguish between the part of the promised interest payments that is a necessary market payment to obtain capital and the part that is a promise to distribute future surplus, if any, to capital. Now, even if the firm is generating the same economic surplus as before, it will no longer show accounting profits. Instead, given ordinary variation in business success, the firm will frequently generate accounting losses. Ex post, employees will see a firm in crisis, insolvency a real possibility, low or no dividends, and (if the stock remains publicly traded) highly variable stockmarket performance. Even if the underlying economic reality continues to be that the firm creates a disequilibrium surplus, employees are likely to see demanding pay increases from this firm as greedy and even counterproductive—it is in no one's interest to force your employer into bankruptcy.

By the simple expedient of setting high interest rates, the firm creates a crisis in which it can call on employees to make extra sacrifice for the team, rather than making the less attractive claim that employees ought to accept less so that investors can profit more.[113] Employees who might be disinclined to accept a smaller share of the corporate pie in order to increase shareholder profits are likely to be far less obdurate in the face of demands that they sacrifice to prevent "default" and "bankruptcy" that will result if interest is not paid. Contributing your share towards collective survival feels good—quite different from being squeezed to make higher profits for investors. At the same time, eliminating legal "profit" eliminates corporate income tax obligations. Thus, reclassifying capital investors from equity (shareholders) to debt (bondholders) reduces the sunk cost problem and simultaneously allows transfer to capital investors of rents that formerly

112. In a capitalist market, shortages create disequilibrium profits, which induce producers to produce more and return the market to equilibrium. Economists, therefore, frown on attempts to suppress price increases that result from shortages. However, when the producers are corporations, nothing in the logic of capitalism requires that the corporation turn its excess profits over to shareholders. On the contrary, ideally it would reinvest them in expanding production, thus eliminating the underlying shortage. Moreover, if the corporation turns its excess profits over to employees (in the form of higher wages) or to the citizenry generally (in the form of excess profit taxes), the incentive for other producers to enter the market in order to seize some of the excess remains just as strong. Only if, counterfactually, we imagine that public shareholders are making investment decisions would it be important that some of the disequilibrium rents flow through to them.

113. *See* Daniel J.H. Greenwood, *Team Spirit: Doing Bad Things in the Cause of Good*, *in* THE RANGES OF EVIL: MULTIDISCIPLINARY STUDIES IN HUMAN WICKEDNESS 5-15 (William Andrew Myers ed. 2006); Blair & Stout, *supra* note 4.

went to employees and the citizenry generally (as taxes or price cuts).

Moreover, if managers hold substantial stakes in whatever equity is left, the LBO may solve another part of the returns-to-equity puzzle. Dividends remain discretionary, and continue to be a cost that a firm in competitive equilibrium cannot sustain. But if the firm is able to earn economic profits—that is, to charge a price above its marginal costs—now there is some reason to think that those disequilibrium rents will go to shareholders. When managers are shareholders, they may find that by helping shareholders they are helping themselves.[114]

Finally, bankruptcy law, unlike general corporate law, creates an enforceable fiduciary obligation to run the company on behalf of creditors. If the firm does end up in court-supervised reorganization, the courts are likely to assist the firm in further transfers from labor to capital. While no firm is ever entitled to breach an employee contract in order to pay a dividend, bankruptcy courts routinely relieve firms of their obligations to pay employees in order to pay interest. Indeed, not only will bankruptcy courts allow firms to reject their contractual obligations to pay for future labor, they will allow them to renege on pension and related promises to pay for labor that employees have already performed. It would be inconceivable for a firm to publicly state that it was reneging on pension promises because it wished to make high dividends higher. But it is routine to do the same thing to fulfill economically equivalent interest obligations—even if the obligations were assumed knowing they likely could not be met without defaulting on promises to employees.

The LBO, then, is one possible solution to the sunk cost trap. It transforms equity into debt, changing capital from zero-marginal cost to a high marginal cost, from no legal right to payment to high priority, from weak moral claims to strong ones. The net result should be an increased part of the corporate pie going to capital. Had the LBO taken over the world, we would be able to say confidently that equity capital suffers from a serious sunk cost problem precisely analogous to that of the railroads. However, we do see companies that are able to sell equity, so there must be other ways out of the sunk cost pricing trap.

C. Market Irrationality

Another possibility is that stock investors are not rational. Perhaps, Charlie Brown-like, they continually expect that this time will be different and are doomed to

114. If managers are not the only shareholders, however, we still need some explanation why managers would choose to share firm rents with other shareholders rather than simply increasing their salaries to absorb the excess. Of course, managers *have* increased their pay to astonishing levels. However, I think it clear that the LBO movement recognized a genuine political truth—while money may be fungible, salary and dividends are quite different. High pay is inherently more offensive than high returns to capital. High salary at a certain point invites questioning about whether anyone's efforts could be worth that much more than the rest of us. In contrast, returns to capital do not imply anything about the moral qualities or hard work of the recipient relative to others. Consequently, there is something necessarily unseemly about someone receiving pay hundreds of times higher than fellow workers, but there is nothing odd about an owner receiving profits. When Michael Milken chose to tie his salary to the profits of the company he built, he became the highest paid employee in the country and a national scandal. In contrast, when Ross Perot or Bill Gates chose relatively small salaries accompanied by ownership interests, they not only appropriated more of their firms' wealth, they also became heroes.

disappointment. For example, investors may routinely expect companies to overcome the fixed cost problem through monopoly power. A certain number of companies will, of course, achieve pricing power for some period of time, leading to spectacular economic profits. Cognitive errors, such as the greater salience of success over failure or dramatic over routine results, might lead investors to miscalculate the actual odds of success.[115]

The possibility that the equity market exists only because of irrationality should not be dismissed outright. Even devotees of rational market theories acknowledge that certain aspects of market pricing seem irrational. Perhaps the best known problem is the initial public offering of closed-end funds.

1. The IPO Puzzle

Closed-end mutual funds consisting of a package of publicly traded stock routinely trade in the secondary market at a *discount* to the value of the underlying assets taken separately (net asset value).[116] In contrast, initial public offerings of such funds are always sold at a *premium* to the net asset value, because that premium is how the promoters are paid. It would seem to be somewhat irrational to pay a premium for a package that one could construct for oneself for minimal cost, and entirely irrational to pay that premium knowing that odds are high that the package itself will soon be available at a discount. Why pay a mark-up today when you know the product will be on sale next week? Often the market is rational and no new closed-end funds are issued. But closed-end funds exist, which must mean that, sometimes, irrational investors are available to purchase them in IPOs.

Investing in the initial public offering of an ordinary corporation is almost as hard to understand. To be sure, ordinary corporations are less transparent, so it is harder to tell that IPO investors are routinely overpaying. Still, there are several bases for thinking the closed-end mutual fund story is generalizable. First, strong statistical evidence suggests that IPOs, as a group, lose money for their initial investors, especially over the medium term. That is, if you have determined that you wish to own stock of a company that is going public, you are generally better off waiting until after the IPO and the initial price pop that promoters attempt to create have passed.

This statistical result is theoretically sensible. The decision to offer stock to the public is made by insiders in the company who normally are, or represent, both incumbent management and the pre-IPO shareholders. It is hard to understand why those insiders would choose to sell their control and/or stock unless they thought they were getting a good price.[117] But a good price for the insiders is a bad price for IPO purchasers. Accordingly, an investor buying stock in an IPO is, in effect, betting that the insiders are wrong. This, in turn, seems to suggest that the investor has concluded that the insiders are either incompetent or uninformed relative to the investor. In either case, it is surely irrational to give them money to invest.

---

115. *See generally* Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, *in* CHOICES, VALUES 1 (Daniel Kahneman & Amos Tversky eds., 2000).

116. *See* Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 897-901 (1988).

117. Even if insiders needed cash, if they were confident that the company and/or stock price was likely to rise, they would borrow rather than sell equity.

Alternatively, the investor may have concluded that whether or not the IPO is priced correctly, other outside investors will be willing to overpay even more. Oddly, this might even be correct—leading to a situation in which even rational investors may be willing to sell their capital to the company (by purchasing stock) at prices that cannot be rationally defended. I'd happily buy your worthless paper for $5 if I'm quite confident that someone else will quickly buy it from me for $10.[118]

2. A Sucker a Minute Keeps the Market Healthy, Wealthy and Wise

Accordingly, one depressing explanation for why the stock market exists might be straight P.T. Barnum: a sucker is born every minute. On this view, the sunk cost model correctly describes the analysis of rational investors in a market of rational investors. But if there are enough irrational investors who do not understand that they have no reasonable expectation of the company paying for the money they give it, the market can continue. Rational investors will buy in the expectation of selling to irrational investors, who will expect, baselessly, to share in economic profits the company is unlikely ever to make. Occasional firms will defy the odds, thus confirming the irrational investors in their biased preconceptions. More often, the stock will be merrily sold back and forth in the secondary market without any rational basis until, in the end, some sucker ends up holding it when it becomes apparent to all that it is worthless.

But all this is unsatisfying. Many publicly traded companies do appear to earn economic profits and do pay dividends. Retrospective investigations of stock prices generally can rationally justify them using expectations of future dividends that, even if often overly optimistic, do not seem to be wildly different from the actual event. Even if the financial markets as we know them are heavily dependent on irrationality, it seems hard to believe that irrationality is the whole explanation.

D. The Power of the "Market for Corporate Control"

Rather than a legal *right* to the surplus, perhaps shareholders just have the raw *power* to take it. The shareholders' relationship to the corporation is basically political. They are not owners, contracting parties, trust beneficiaries or principals, despite the widespread popularity of such metaphors among ideological defenders of the investor role.[119] Owners, of course, do not have to offer justifications for why they should be

---

118. On rational arbitrage creating even more irrational pricing, see, for example, ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 44-68 (2000).

119. For preliminary discussions of the metaphors of corporate law, see Daniel J.H. Greenwood, *Markets & Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005); *supra* Part I; Greenwood, *Enronitis*, *supra* note 89; *supra* Parts IV.A, IV.B.3; Daniel J.H. Greenwood, *Introduction to the Metaphors of Corporate Law*, 4 SEATTLE J. SOC. JUST. 273 (2005). The claim that public shareholders are "owners" of the corporation, even though they lack the normal attributes of ownership, is deeply embedded in business culture. Brealey, for example, states that "a corporation is owned by its common shareholders." BREALEY ET AL., *supra* note 2, at 366. They explain this claim by stating that in a corporation with no debt and a single shareholder who is also the CEO, the shareholder would have "complete cash-flow" and "complete control" rights. The former is clearly incorrect if the corporation has other contracting parties, such as employees or suppliers. In any event, close shareholders have the ability to defeat the separate existence of the corporation that public shareholders lack. Brealey deals with this problem by the bare assertion that the shareholders of a public corporation have the same "ultimate" rights as a single shareholder. *Id.* at 368. This claim appears to ignore the

entitled to take any surplus associated with their property. Owners just take it as an aspect of their general rights to control the property. If someone prevents them from doing so, they can invoke the judicial process and police to deliver it to them. Shareholders, unlike owners, have no legal right to control the corporation and specifically no right to demand that the corporation turn over corporate property—whether surplus or not—to them. Similarly, shareholders lack enforceable contractual rights; lack the legal protections of trust beneficiaries; and, quite unlike principals in an agency relationship, they have no right to direct or terminate directors, and directors are not bound by their actions.

Instead, the shareholders are electors. Shares have the right to vote for the directors who do have legal rights of control over the firm. Unlike shareholders, the board of directors is entitled to control over the corporation's property (although only for appropriate purposes: the directors are not owners either).

Perhaps the political rights of shares create indirect control sufficient to ensure that shareholders will receive the surplus. This in turn would suggest that we should see them as simple rent-seekers in the mode of standard public choice models, using their power in the (corporate) political process to obtain benefits (by corporate administrative decree) that they could not win under standard competitive market conditions. Clearly, the shares sometimes do have the ability to force the corporation to distribute its assets to them.

1. Corporations with a Single Shareholder: Quasi-ownership, Political Control

Consider the simplest case, a corporation with only a single shareholder. A single shareholder has almost the standard bundle of ownership rights with respect to the corporation. Corporate law insists that the corporation remain separate from the shareholder. Still, so long as the shareholder works within the formal procedures of corporate law, it is largely free to determine whether assets remain in the firm or exit it and to whom.[120] While the law places the directors in formal control of the firm, with the associated fiduciary duties of independent judgment, loyalty and care, a sole shareholder controls their tenure and can readily replace any director whose independent judgment fails to match that of the shareholders'. Moreover, only shareholders have standing to enforce the fiduciary duties, so those duties do not limit a sole shareholder. Accordingly, the sole shareholder has indirect but effective control of the decision-making apparatus of the firm. In the medium run, the shareholder's will determines what will happen, not board judgments about shareholder interests or legal doctrines of due care, loyalty or corporate purpose. With a single shareholder, the corporation's separate existence becomes a legal fiction and the shareholder, formally merely an elector, is almost a real owner.

Here, if the firm has market power to create a producer's surplus, the surplus is (almost) the shareholder's. It will go to other firm participants only if the shareholder

---

realities of fiduciary law and board autonomy.

120. Corporate law limits are not entirely procedural. The Fraudulent Conveyance Acts and dividend restrictions will limit the ability of single shareholders of corporations near insolvency to remove corporate assets. *See, e.g.*, RMBCA § 6.40(c) (restricting dividends when corporation is insolvent). However, corporate law is so flexible that a single shareholder can effectively plan around these restrictions in most instances. *See generally* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996) (detailing methods of rendering firms judgment proof while continuing business as usual).

decides to give it to them. We do not need any account of the "right" of the shareholder or the "purpose" of the firm to reach this result. As a matter of law, that surplus belongs to the firm, and the shareholder decides what the firm will do with it. Presumably, self-interested shareholders will take it for themselves.[121]

Of course, political right is not market power. If other firm participants have sufficient market power, they are likely to demand and receive part or all of the returns to cooperation reflected in a producer's surplus. If other firms imitate the efficiencies of this one, the surplus will go to consumers, as prices are bid down to costs. If other producers do not appear, but factors in this firm are able to make themselves expensive to replace—skilled employees, for example—those factors will charge the firm more, and the surplus will go to them. It is a question of relative market power whether the gains created by cooperation will become firm residual available for the shareholder.

The shareholder's political control, in short, gives it power over the residual, not the surplus. But that entitlement is somewhat tautologous. The residual is simply whatever is left in the corporation at the end of a struggle with everyone else over the surplus to cooperation. If the entire surplus goes to some other corporate participant, the shareholder may be disappointed, but has no cause to complain of unfairness or illegitimacy. In a capitalist system, no one has a right to rents—only a right to struggle with other rent seekers over them until, hopefully, competition eliminates them entirely.

2. Closely Held Corporations

Even when a single shareholder (or a small group of shareholders legally permitted to coordinate) controls only a majority of the shares, that control is enough to give the shareholder significant power. When a single shareholder controls a majority of the stock and its associated votes, the distinction between shareholder role and director role becomes less important. At that point, the shareholder has the legal right to elect the board of directors and therefore can control their decisions within the broad constraints of the business judgment rule.

To be sure, such a majority shareholder still does not have all the rights of ownership. Courts continue to insist that directors exercise independent judgment and, in particular, that they not unduly favor the interests of the majority shareholder over the (imagined) interests of other shares. But, in practice, judicial supervision may be limited enough that the power of a controlling shareholder is close to that of a sole shareholder, particularly in conflicts with non-shareholders.

3. Public Corporations: The Right to Go Private

Shareholders in a public corporation have one important source of power that we have not discussed: the ability to sell to a single shareholder who will take the company private. More precisely, the entire stock market has this power because it is the entire stock market that determines stock price.[122] If the investment community decides that a company is not being run in the interests of shareholders (or sufficiently in their interest),

---

121. In order to avoid corporate income tax, generally sole shareholders will pay themselves in some other, deductible, role.

122. For a fuller discussion, see Greenwood, *supra* note 37.

potential purchasers will lower the amount they are willing to pay for its stock, and potential sellers will only be able to sell at a reduced price. The stock price drops.

Critically, this price drop is not an action of the existing shareholders, but of the market as a whole. If the stock price drops enough, competitors or investors will see a profit opportunity: if they can purchase all the stock, they will be able to use the quasi-ownership rights of a single shareholder to change the distribution of the company's economic profits.

a. The Brief Heyday of Stock Market Control

For a brief moment in the 1980s, this was the end of the story. Once an opportunity was spotted, someone seized it, and the company was forced to change. The stock market always won.[123] When a tempting target presented itself—often a conglomerate or heavily unionized company that obviously was generating surplus and distributing it to constituents other than the shareholders—junk bond-financed financial operators or strategic investors smelling a bargain would launch a tender offer, sometimes in combination with a proxy contest, to replace the incumbent board. Often, the tender price could be dramatically higher than the current market price of publicly traded stock, precisely because the offeror's valuation would reflect the greater power of a single shareholder while the public price reflected the reality that public shareholders have no power to force managers to distribute surplus to shareholders.[124]

If the offer price was higher than the market's estimate of the value of the company's public stock under existing policies, the stock price usually rose immediately to match, as pessimistic or backwards-looking shareholders sold to professional arbitrageurs whose profits depended on a quick sale of the company. The new shareholders, in turn, would quickly sell into a tender offer, and control of the company would move to a single shareholder. Sometimes, particularly in the early 1980s, potential buyers could make success even more likely by structuring the offer to provide a prisoner's dilemma, in which shareholders would be tempted to race to tender even at unattractive prices lest others tender first and leave them holding an even less attractive package. In any event, after a successful tender offer, the buyer then ended up with all the stock, and could appropriate the firm's surplus as a quasi-owner of a closely held corporation.

In the world of the ever-present hostile takeover threat, the stock market had real power. Managers quickly learned that running the company as the stock market preferred was their only choice; anything else threatened removal through hostile tender offers. Managers who remained loyal to their subordinates in middle management and the blue collar ranks quickly became an endangered species.

The pain of managerial disempowerment was lessened once it became clear that the stock market was happy to see managers take unprecedentedly large shares of the corporate surplus for themselves, so long as they did it in a way that appeared to tie their interests to those of shareholders. Managers, thus, faced a strange choice. They could

---

123. The literature on the active market for corporate control of the 1980s is enormous. A good starting point might be John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

124. *See, e.g.*, Kraakman, *supra* note 116.

maintain their old loyalties and ways of operation and risk being displaced by someone who would violate the implicit agreements and norms of the prior era.[125] Alternatively, they could do the betrayals themselves and assuage their guilt with a large chunk of the wealth transferred from other corporate participants.

In the middle 1980s, defensive advisors often had to pull their clients into this brave new world kicking and screaming. For many, when loyalty and professional ethics conflicted with economic self-interest, the choice was not clear. By the 1990s, the culture of America's board rooms had changed to the point where this Faustian bargain no longer seemed clearly immoral. The new generation of CEOs celebrated market norms of self-interest, gave themselves enough stock or options to become shareholders on a level not seen since the company founders of the Gilded Age, and made profit and high stock price key corporate goals. The stock market applauded. From the market's perspective, it was better to pay CEOs than run of the mill employees. It seemed impossible that one CEO, even if overpaid beyond imagination, could take as much of the corporate surplus as the entire workforce.[126] Similarly, shareholding managers, the market correctly understood, would be far more likely to see returns to shares as a key corporate purpose. Moreover, as CEOs moved out of the professional classes into the ranks of the super-rich, they could be expected to find the share-centered view of the world increasingly consonant with their daily lives: the new plutocrats have more in common with the rentier class than the subordinates with whom they work every day. Unsurprisingly, however, even as the new CEOs accepted the profits of their new alliance with the stock market, they proved no more loyal to shareholders than they had to their co-workers.

b. Return to Normalcy: The Poison Pill and the New Politics of Corporate Control

The stock market's power was quickly quashed. It turned out that a robust take-over market had few supporters outside of the corporate-law academy. By the early 1990s, the courts and legislatures had assiduously approved new rules that shifted power back to corporate boards. Most important, the poison pill and its statutory equivalents effectively bar the stock market from transferring control to a single shareholder without the consent of the board.[127] Virtually every publicly traded corporation has taken advantage of these developments to eliminate the anomalous right of shareholder initiative that made the hostile takeover possible. Today, the shareholders have no more legal power to sell the

---

125. *See* Coffee, *supra* note 123 (discussing how the stock market regulated actions of managers).

126. Whereas median salaries and productivity rose in lockstep from the Depression through the early 1980s, after the shareholder revolution the two became unstuck. In the last several decades essentially all productivity gains have gone only to the top 10% of income earners, and the vast bulk has gone to the very top of that group. *See, e.g.*, Ian Dew-Becker & Robert Gordon, *Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income*, *in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 67-127 (William C. Brainard & George L. Perry, eds. 2006) (median income was virtually unchanged 1996-2001, while the share of the top .1% increased by almost 300%; income growth rates over 35 years were 0.3% per year at the median and 3.4% at the top 0.1%).

127. A poison pill drastically dilutes the holdings of any offeror who proceeds without board permission. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (describing and upholding pill). Parallel statutory provisions bar "interested shareholders" from merging with the company for prohibitively long periods if they acquire controlling positions without prior board consent. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (2006) (barring interested shareholders from merging for three years absent prior board consent or supermajority share approval at a shareholder's meeting).

company to a single shareholder than they have to act for the corporation in any other way. To buy a publicly traded corporation and take it private, you must obtain board approval. Moreover, the courts, as we saw in the *Time* case, are reluctant to force boards to endorse particular transactions, so, in the end, the question is whether the market can persuade the board to see things its way.

Interestingly, boards continue to approve uninvited takeover attempts. Rarely, however, is it fair to say that boards are forced to do so. Shareholders simply lack the power to force boards to do their bidding. Since only shares vote in the corporation, shareholders have a certain advantage in political struggles to dominate the board. But the power of the vote is limited, since incumbent boards normally select the candidates in elections that, in turn, normally are uncontested. Even when elections are contested, the incumbents have enormous advantages, including the right to use corporate resources to defend their positions. Corporate elections more often look like elections in Saddam Hussein's Iraq, with dissidence apparently absent, than like the hard-fought conflicts of real democracy or the sharply divided "Red-Blue" contests of the rest of American society.[128]

Moreover, shareholders have no right to instruct the board. They must, instead, elect directors who independently conclude that the company should be sold. But shareholders have no right to replace board members except at the end of their term and at a shareholders meeting.[129] Generally, shareholders, even an overwhelming majority, have no right to call a special meeting, and regularly scheduled meetings occur only once a year.[130] Moreover, many firms have staggered boards, where each director has a three year term and only one-third of the board is elected each year.[131] As a result, as a matter of raw power, even a board with no shareholder support can usually hang on for quite a while.

Potential buyers, in contrast, usually cannot keep their offers open indefinitely. Financial buyers (planning not to run the company but simply to buy it at a price reflecting the current shareholder-unfriendly policies, change those policies to give more of the surplus to shareholders, and then return the company to the public markets at a higher valuation or sell it to a strategic investor) operate in the financial markets and are therefore painfully aware of the time value of money. Whether financial buyers are operating on borrowed money and therefore running up interest costs, or with equity and therefore suffering opportunity costs as their funds remain un-invested, they typically cannot simply hang around waiting for directors to be replaced. Strategic buyers are no

128. I have discussed the reasons for this near unanimity and its implications for the metaphor of "corporate democracy" in Greenwood, *supra* note 37. For further discussion of the mechanisms of political democracy in corporate and non-corporate contexts, see Greenwood, *supra* note 19 (discussing the varieties of political decision-making); Daniel J.H. Greenwood, *Akhnai*, 1997 UTAH L. REV. 309 (discussing paradoxes of majority rule).

129. DEL. CODE ANN. tit. 8, § 141(b) (2006) (providing that directors serve until successor is qualified); § 141(k) (providing that majority of share votes may remove a director, except that corporations may, by adopting classified board or cumulative voting, prevent removal of director without cause before the end of his term); § 211 (b) (providing that election of board of directors is at the annual shareholders meeting).

130. DEL. CODE ANN. tit. 8, § 211(d) (authorizing directors to call special meeting and allowing corporation to bar shareholders from doing so). Delaware law permits corporations to bar shareholders from electing directors by written consent in lieu of a meeting. *Id.* § 211(b).

131. DEL. CODE ANN. tit. 8, § 141(b), (d) (authorizing staggered board).

more likely to wait extended periods. They have businesses to run. In consolidating industries, alternative deals may disappear; businesses feel pressure to either get the deal done or move on to another one. Defensive strategists know, therefore, that a board that is willing to fight with all the tools available to it generally can delay a potential transaction until it dies.

The market for corporate control, in short, is no longer an adequate explanation for why shareholders should receive any of the corporate surplus. With the demise of tender offers that can be consummated without board approval, the stock market lacks a legal means to impose its will on directors and managers. Under current law and practice, shareholders have no legal right to sell to a single shareholder. The potential buyer must follow the stringent requirements of the federal regulatory scheme in order to make a tender offer. Incumbent managers and directors, should they oppose the plan, are entitled to use company resources to resist it in every legal fashion. Most importantly, if the company has a poison pill in place, as most do, a potential buyer usually will find the transaction financially impossible unless the board allows it to go forward by voting to redeem the pill.

4. The Limits of Power

In the end, both the political and the market power of public shareholders are quite limited. Any given shareholder is purely fungible, readily replaceable by another money source. Even collectively, the entire stock market has only the power to drive the stock price down. Low stock prices may be unattractive to managers in their personal capacity if they hold stock or stock options themselves. High stock prices, in contrast, provide the company a ready currency with which to purchase other companies, which may be attractive to managers both as professionals and as status or power-seeking individuals. But these carrots and sticks have their limits; directors or managers with values or goals other than stock price maximization should be able to resist them.

Most politics is by informal persuasion, in the shadow of the power of the electorate, donors, masses, violence, organization, guns or wealth. In public corporations, shares have votes, but shareholders lack the other sources of political power. They are anonymous, transient, unorganized and fungible. As we have seen, generally they cannot call on the power of the state or the market to support them.

Beyond the thin shadow of their limited power, the shareholders lack full mechanisms of informal persuasion. They have only the weakest of connections with the actual sociological entity of the firm. The human beings who act for the firm—the employees—have actual relationships with each other, but not with shareholders. In most cases, directors are likely to respond to each other and especially to top management—the people they actually talk to on a daily basis. The power of real, human, shareholders (or, more often, human representatives of institutional shareholders) to influence this conversation is relatively limited.

E. Cynics and Ideologues: Self-Interested Managers and The Metaphors of Corporate Law

Why then do companies pay dividends to their shareholders, buy back their stock, or otherwise distribute any of their economic profits to shareholders? As we have seen, neither economics, legal rights nor raw power provides the answer. Public shareholders are not owners who can simply take surplus and depend on the power of the state to stand behind them if anyone tries to stop them, nor do they have market power or political power sufficient to force the company to give the surplus to them.

1. Atavistic Irrationality

Only a few explanations are left. Perhaps the boards are irrationally unaware of their power. The hostile takeovers of the 1980s were a traumatic experience; perhaps boards are still afraid of a repeat even though the law no longer allows it. This would be surprising, however, since boards are typically well advised and the power of the defensive tactics is no secret.

2. Tag-along Behind Powerful Managers

More likely, boards are responding to the very real power of top management, and top management has concluded that paying dividends and otherwise acting to keep stock prices high is in its own interest (as opposed to the corporation's). Cynically, simplistic, unprofessional, and uninteresting as this explanation is, it must be a major part of the truth. The great revolution of the 1980s ended with top managers holding a major part of the stock of our major public corporations. Since then, we have discovered the obvious—that managers who are invited to pursue their own self-interest will do so, and that self-interest will often drive them in directions that are not in the interests of shareholders or any other corporate participant.[132] Still, when a manager holds millions of dollars of stock or stock options, he is likely to find the claims of stock to a share of the corporate pie more persuasive, and the claims of ordinary employees (now so much poorer as to be in almost a different world) less so.

The great secret of the great manager/shareholder conflict at the heart of corporate law is that, conflicts notwithstanding, managers and shareholders have united to shift the corporate surplus from all the other corporate participants. Only then do the arguments over the spoil begin. The basic protection shareholders have today is the principle that all shares must be treated equally when a dividend is declared and the assumption that stockholding managers will, in the end, want to issue dividends, both to extract larger sums from the corporation than they feel they can award themselves in salary and to maintain the value of their own stock or options.[133] That said, when managers determine that their interests are no longer aligned with the other shareholders, there is not a lot the outside shareholders can do about it.[134]

To the extent, then, that shareholder returns depend on power, the power in question is managerial power. As long as managers do not discover a way to compensate

132. *See, e.g.*, Greenwood, *Enronitis*, *supra* note 89, at 800-01 (discussing reasons why managers might defect from their fundamental alliance with shareholders).

133. In an earlier era, shareholders would have relied principally on the sense of integrity and professionalism of managers, combined with normative expectations regarding appropriate dividend policy. However, the general acceptance of Miller & Modigliani's irrelevance hypothesis destabilized expectations regarding appropriate dividends. Concurrently, two decades of "incentivizing" have taught managers that they are expected to act as rational maximizers rather than selfless agents. *See, e.g.*, Greenwood, *supra* note 113.

134. *Id.*

themselves without compensating shareholders as well, shareholders will continue to receive returns.

Shareholders, then, are not entitled to the residual. They do not have the legal right to take it. They do not create it. They do not have market power to demand it. They just have had the good fortune to receive part of it as a side-effect of managerial self-enrichment. Presumably, this is a short-term game. Sooner or later top managers, now extraordinarily wealthy as well as positionally powerful, will figure out a more efficient way to distribute corporate surplus to themselves without leaving so much of it for purely fungible providers of a sunk cost.[135]

3. The Power of Words

The last explanation is ideology. If directors are persuaded that shareholders ought to be treated as if they were owners, trust beneficiaries, principals or contractual insurers with an inexplicably favorable deal, they may conclude that shareholders' claim to the surplus is just and right. The metaphors of ownership, agency, trust, contract and property rights are pervasive in corporate law discourse and management training alike.[136] These metaphors not only hide the market reality that equity capital would have difficulty commanding any return at all in anything resembling a free, competitive market, but are themselves a major source of shareholder power. Ironically, the central pillar of the shareholder value maximization principle is its demand that directors act not as self-interested, amoral, rational maximizers but according to the normative demands of . . . the maximizers themselves.

a. The Problem of Managers as Fiduciaries

The rule is clear that directors and CEOs are fiduciaries, not owners. They run the company, but they must do so as professionals, in the interests of their client, not for their own benefit. In this respect, they are like elected officials and civil servants, who also run

135. As one would expect, we have seen a number of instances in which CEOs have paid themselves vast sums while the shareholders received little. These include assorted scandals—Enron, Tyco, WorldCom, Sunbeam, Adelphia, the New York Stock Exchange—as well as other less well publicized instances. *See, e.g.*, *CEO Compensation*, FORBES.COM, Apr. 20, 2006, http://www.forbes.com/2006/04/17/06ceo_ceo-compensation_land.html (the link "Worst Performing CEOs" lists examples of CEOs who received payments of millions of dollars while their stock trailed the market). One recent study models CEO compensation as a function of stock prices. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?* (MIT Dep't of Econ., Working Paper No. 06-13, 2006), *available at* http://ssrn.com/abstract=901826. If that is correct, we should regularly see additional examples of blatant CEO seizure of the surplus. Stock prices reflect (at best) expectations about future distributions of corporate surplus, while CEO salaries are largely current. Accordingly, every time the stock market, for whatever reason, is overly optimistic, CEOs paid relative to market valuation will have an opportunity to appropriate an extraordinary share of the company surplus. As companies correct for the accounting fiction that stock options are free to firms and their shareholders, we are likely to see more instances where it becomes retrospectively clear that in fact the entire corporate surplus went to the CEO and accounting profits suggesting shareholder returns were illusory. *See, e.g.*, *Now for Plan B: Expensing Share Options*, THE ECONOMIST, Mar. 15, 2003, at 62 (reporting that proposed change would reduce reported profits at tech companies by 70%); *The Right Option*, THE ECONOMIST, Apr. 10, 2004, at 63 (reporting that accounting for stock options would have reduced 2002 S&P 500 profits by 19% and Apple would have reported a loss instead of profit).

136. *See supra* note 119.

large institutions for the benefit of the general public without "owning" them. More importantly, they are like all other employees in our system. Ordinary agency law gives employees no ownership rights in the products they create or the positions they hold, while demanding that they set aside their own interests in order to promote the interests of their employer.[137] A director or CEO who operates the company in his own private interest is as clearly corrupt as a governmental official who diverts public assets to become privately wealthy or a professional who misuses client trust for personal gain.

But the client of the directors and the CEO is the firm itself, and that creates room for creative ambiguity. If it is clear that the board may not enrich itself at the corporation's expense,[138] it is far less clear what it means to work for "the corporation." Thus, directors and CEOs alike need a theory to explain what they are supposed to be doing when they act for the corporation. Moreover, as long as CEOs accept that they do not own the corporation, they need to justify distributing corporate assets to themselves. For the last generation, the easiest justification has been that high CEO salaries are good for the shareholders because they align incentives.

Occasionally, CEOs, trapped in the metaphor of a corporation as a thing with an owner, have concluded that the shareholders' lack of ownership means that the CEO is the owner. The same authority of the board to operate the company under the protection of the business judgment rule with minimal input from shareholders that proves that shareholders do not own the company, means that CEOs, who typically do have significant power over the board, have most of the legal rights of control and use that ordinarily are associated with ownership. CEOs who succumb to this illusion, however, are likely to end badly. CEOs are no more owners of the firms they run than mayors are owners of their cities, or presidents of the country.

The same culture that celebrates highly paid CEOs is delighted to take down corrupt ones. Even the imperial CEO must remember that he is merely an officer of the corporation, not its owner; million dollar salaries are fine, but using corporate funds to pay for personal shower curtains is not. Smart CEOs, then, remain in their role as agents of the firm, not its principal. Acknowledging that their power comes from office rather than ownership, they must find a way to justify their actions as in the interests of the firm.

b. The Benefits of Share-centeredness to CEOs

CEOs have found that rhetorically reducing the corporation and its interests to the shares and their interests justifies corporate decisions to squeeze (lesser) employees, on

137. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 387 (setting out duty of loyalty).

138. The duty of loyalty clearly bars corporate fiduciaries from promoting their own interests at the expense of the corporation's. Corporate law's duty of loyalty is, however, quite a bit weaker than the equivalent duties in trust law or governmental civil service norms: nepotism, conflicts of interest, and even what Boss Tweed defended as "clean graft" are typically permitted in the corporate sector, at least with adequate disclosure and approval by disinterested parties. Bayer v. Beran, 49 N.Y.S.2d 2, 10 (N.Y. Sup. Ct. 1944) (allowing corporation to hire CEO's spouse so long as the transaction was fair to the corporation); DEL. CODE ANN. tit. 8 § 144 (2006) (regulating ratification of interested transactions). This rule is often defended as an appropriate response to information problems (insiders may be willing to provide better terms than could be had in arms length transactions and apparently corrupt transactions may have benefits that are not obvious to outsiders). Still, the information problems are identical in the public sector and, indeed, seem more likely to be correlated to scale than business form, so this explanation is not altogether satisfactory.

the ground that increasing profit at the expense of wages is in the interest of the shares, at the same time as it justifies granting a large part of the surplus to top management, on the grounds that top managers, unlike other employees, must be enticed rather than coerced into doing their best, and that high, stock-based, pay will tie their interests to those of the shares.

Moreover, the rhetoric of share-centeredness conceals one of the key problems with the increasing pay of CEOs. Most companies require a degree of employee loyalty to survive and prosper. Employee loyalty, in turn, is best encouraged by appealing to team spirit—convincing the employees that the company's interest is their interest. But the rapidly increasing income and status gaps between CEOs, as team captains, and their employees, as team players, is obviously destructive of *esprit de corps*. No one likes to be a sucker, and when one player gets all the prizes, the others are likely to begin to feel that the game is fixed. A certain degree of egalitarianism is essential to create the sense that "we are all in this together" that is, in turn, nearly always the most effective way to induce employees to work. For these reasons, any credible organizational theory will have difficulty justifying vast gaps between leaders and led as a sound way to run an organization. The opposite is more nearly the case: ordinary understandings celebrate generals who are in the thick of the troops, not emperors who rule from distant palaces. If CEOs are seen as chief executives of quasi-governmental organizations dedicated to creating a public service (in the form of useful products or decent jobs), or even if they are merely leading an organization with its own will-to-live, the pay and perquisites of recent decades will seem dysfunctional and disturbing. Dictators, not democratic leaders, use their positions to enrich themselves.

Firms are bureaucracies, and any bureaucracy is limited by its ability to process information up and down the hierarchy. Vast social gaps between the decision-makers at the top and the actors at the bottom predictably lead to bad decisions and poor implementation. This is why we expect democratic armies to outperform aristocratic ones and egalitarian capitalist economies to outperform dictatorial ones of the left or the right. No doubt, alternative stories can be told—perhaps there are leaders who are so smart and so charismatic that they can successfully lead without communication from those below them—but their proponents fight an uphill battle. Astronomical CEO salaries, prima facie, will look like dereliction of duty if the core of the CEOs duty is to rally the troops or listen to them (and the relevant troops are the employees).

Share-centered understandings of the corporation—by defining the corporate team as its shareholders, labeling the employees outsiders, and suggesting (at least implicitly) that the only tools available to induce employee work are market pay and the threat of firing, conceal this common-sense understanding of internal corporate dynamics. If the central problem of corporate leadership is not overcoming the bureaucratic problems of communication but rather assuring that CEOs have common interests with shareholders, high CEO pay can appear as a solution instead of a central part of the problem. CEOs, thus, have a tremendous incentive to accept and promote the share-centered metaphors: in the share-centered corporation, they are doing their duty by making themselves into the new American aristocracy.[139] The rest of us, however, must worry that by turning our CEOs into rational maximizers, we are threatening the basis of our economic success.

139. *See supra* note 119.

4. Where Shareholder Returns Come From

The short answer to the puzzle of shareholder returns, then, is this: shareholders receive returns because directors and CEOs believe they are entitled to them. That belief is not based on any compelling economic, moral or legal argument. However, CEOs who wish to justify seizing a significant part of the corporate surplus for themselves find the share-centered metaphors of the corporation more comfortable than the alternatives, and CEOs, unlike shareholders, have actual economic and political power in the corporation. Outside the chief executive's office, the share-centered metaphors also have some appeal: they offer an explanation of a world that would otherwise seem unfair, exploitative, anti-democratic and dysfunctional. If corporations exist for the sake of their shareholders, then perhaps their employees, customers and neighbors have no legitimate complaint when they are treated as no more than means to an end not their own. And if you are being treated that way, it may be more appealing to have an explanation than simply a simmering sense of injustice.

VI. THE SIGNIFICANCE

Shareholders are not entitled to the residual by law or nature. Indeed, the shareholder theory of value—that all extra value belongs to the shareholders—is little more than a mirror-imaged imitation of Adam Smith and Karl Marx's labor theory of value, which postulated that all the returns to enterprise were created by labor and, as a matter of natural law, belong to laborers.[140] As a matter of economics, the shareholder theory of value is even more wrong than the labor theory of value. Labor alone, without capital, leads to poverty. Capital alone, without labor, is simply barren. Modern economies require both, as well as elaborate mechanisms for governing them.

A. The Struggle for Surplus is Political

Instead, the struggle for the corporate surplus—the residual—is a political struggle over economic rents to which no party has any special claim precisely because it would not exist but for the contribution of all the claimants. From an economic perspective, the shareholders, as fully fungible providers of a fully fungible commodity, have less claim than most. From a political perspective, the power of the shareholder claim depends on the power of the shareholder role, which, as we have seen, is more limited than a casual student of the corporate governance literature might imagine.

The key weapons the shares have are two. First, an ideological claim to entitlement, founded in the metaphors of ownership, contract, and agency. A full explication of the rhetorical force of these metaphors is beyond the scope of this essay.[141] However, it should now be clear that their force is indeed simply rhetorical. As a matter of law, neither property, contract, nor agency entitle shareholders to the residual; indeed, if the shares had the rights associated with those rules, they would have no need of ideological claims in order to seize what would be their own. It is precisely because public shareholders are not owners of the corporation, not entitled to the residual by contract,

---

140. *See, e.g.*, KARL MARX, THEORIES OF SURPLUS VALUE 107-16 (Int'l Pubs. 1952) (1863).

141. *See supra* note 119.

and not the principals of the corporation that defenders of shareholder entitlements feel the need to so strenuously insist that they are. As a matter of extra-legal moral claim, the claim that shareholders ought to be treated as if they were owners or principals or as if they had contracted for rights they have not obtained in the market, is simply a demand for redistribution to the rich.

Second, in recent decades top management has found the rhetoric, and sometimes the reality, of share-centeredness useful for its own purposes. Managers, nearly everyone agrees, are fiduciaries for the corporation with no independent claim to ownership or entitlement. So long as this remains the law and the social understandings, CEOs must justify their actions as on behalf of the corporation, not themselves. The share-centered views of the corporation conveniently rationalize high CEO pay and perquisites—if CEOs are major shareholders, they are more likely to think like shareholders than like employees. Moreover, by viewing the stock market rather than the bureaucracy as central to corporate life, the share-centered metaphors distract attention from the ineffectiveness of our modern CEO aristocrats and their failure to create decent jobs at decent wages.

B. Making Political Sense of the Corporation's Struggles

If the shareholders' claim to the residual is an ideological demand for rents in a fundamentally political struggle for power within the corporation, it follows that citizens are free to debate the merits of their claim. We are free to intervene to help or hinder the stock market's attempts to remake the world in its image, without fearing that we are fighting an ineluctable rule of capitalism. Indeed, we are free even to intervene to help employees—or any other corporate participant—to win more of the corporate surplus. The corporate world will survive and thrive if CEO pay shifts a decimal point, if shareholders earn returns of 8% rather than 18%, or if employees routinely take virtually all the gains of increased productivity instead of, as has been the pattern of the last several decades, virtually none. Efficiency never requires that one particular party win the surplus from cooperation.

As Coase pointed out long ago, the primary explanation for the corporate dominance of our economy is that the bureaucratic business form is able to out-produce markets.[142] Corporations create value that would not exist absent the enterprise itself. The legal rule that corporate surplus belongs to the corporation reflects the underlying reality that it is a product of the corporation itself—that is, it is a result of the cooperative enterprise of all the various corporate stakeholders. Corporate surplus is the gains from the enterprise, not from any one or another of its participants.

Any realistic view of corporate law must begin, then, with the reality of the corporation. Like most collective wholes, social or otherwise, corporations are more than simply the sum of their parts. Just as dividing an individual human into her component organs, cells or chemicals would provide only a partial view of the complete person, dividing a corporation into its parts hides something crucial.

The corporate entity is a self-governing, partially autonomous, semi-sovereign organization. Its internal decision-making is affected by market pressures, but is no more the unmediated deterministic result of market conditions than any other political decision.

142. Coase, *supra* note 37.

Rather than being the simple result of free contracting in a spot market, the internal processes of corporations are complex mixtures of bureaucracy, contract, and agency, under the supervision of a board answerable to its nominal subordinate the CEO, to its electors (the shareholders voting according to the plutocratic principle of one-dollar-one-vote), to the stock market as a whole through its determination of stock price, and to the legal fiction of an undiversified shareholder with no other interest in the corporation or the societies in which it functions.[143]

Looking at the firm in this way, the next steps in the debate are obvious. If corporations are semi-autonomous, semi-sovereigns with many state-like characteristics, they are remarkably unsatisfactory quasi-states in a democratic world. Most of their constituents have no vote at all. The one role that does, shareholders, has its votes allocated per dollar instead of per person. The power of the leader is near dictatorial; if CEOs do not have the power of torture or the gulag, they do retain the right of summary expulsion from the community. We have no adequate countervailing structures inside the organization to balance foolish or corrupt leaders—there is no internal corporate equivalent to cabinet government, ombudsmen, separation of powers or even the rule of law and judicial review.

Poor corporate organization is not as disastrous as dictatorial political government because unusually badly-run corporations are more restrained by the market. In the medium run, unusually inefficient or corrupt organizations are killed by market competition. Still, when an Enron or a Drexel Burnham is destroyed for corruption, or a major airline, old-line steel corporation, or major automobile company collapses out of incompetence or excessive rigidity, many innocent people suffer, losing jobs, pensions, and communities. This disruption, of course, is not nearly as bad as the warfare typically necessary to overthrow seriously dysfunctional governments, but nonetheless it creates a significant amount of unnecessary human suffering. Darwinian selection is almost as cruel and coarse a tool for regulating human societies as in nature—if we have the option of intelligent design to make functional organizations, we ought to use it.

Market competition, however, comes with no more guarantees than does Darwinian evolution. Extinction and death are always possibilities even for interesting or useful organisms, organizations, or, frighteningly, systems. Indeed, even success can lead to disaster. Sometimes biological evolution creates organisms that exploit their environment so efficiently that they destroy it—think of cancers or virulent viruses.[144] Our current corporate law and financial markets are efficiently replacing businesses that viewed employees and jobs as central to their mission with self-interested kleptocrats. We need to worry that our newly "incentivized" CEOs may yet kill the democratic goose that lays our golden eggs.

---

143. On the legal fiction of a shareholder, see Greenwood, *supra* note 37; on the varieties of decision-making procedures in a democratic polity, see Greenwood, *supra* note 19, at 789-90.

144. I am using the viral metaphor loosely, as an image of potential economic problems rather than literal extinction. *But see* JARED DIAMOND, COLLAPSE: HOW SOCIETIES CHOOSE TO FAIL OR SUCCEED (2005) (describing human societies that efficiently exploited their environment until they destroyed their own underpinnings); ELIZABETH KOLBERT, FIELD NOTES FROM A CATASTROPHE: MAN, NATURE AND GLOBAL WARMING (2006) (suggesting that current economic processes threaten global survival); MITCHELL, *supra* note 3 (describing corporations as "externalizing machines").

C. Beyond Determinism: Market Pros and Cons

The theories of economic determinism failed in the communist regimes. They fare no better in the capitalist ones. The role of shareholders in the public corporation is open for debate.

The stock market has proven immensely useful in offering start-up funding for certain kinds of organization. Perhaps it sometimes also provides an insurance function for established firms, helping less diversified corporate participants to weather the inevitable fluctuations of life under capitalism. The market effectively assimilates certain types of public information and usefully signals the consensus (although if the market consensus were an adequate basis for running companies, managers would be unable to charge anything for their services).

On the other hand, the stock market is unable to reflect the full range of human values important to a democratic society. It values only what is priced; whatever cannot be bought is of no interest to it. The capital markets are time and risk indifferent, since they can discount the future to the present and diversification eliminates particular commitments; people, however, are always deeply situated and can exist only in particular places, at particular times, and with particular projects. The market, therefore, will always press us in the direction of the radical revolutions and creative destructions of capitalist markets, even when all of us might be inclined to be a little more conservative. Diversified portfolios have no strong interest in the sorts of competition that are essential for capitalist functioning; a shareholder that holds both CostCo and Walmart, Chevron and windmills, American factories and Chinese ones, polluters and pollution control suppliers, or guns and butter rationally should not care which business model prevails. Similarly, ordinary competition between different firms in the same industry will appear as no more than an unfortunate way to divert corporate profits to consumers (who, unfortunately, are not publicly traded).

Not least, markets redistribute wealth upwards, but never downwards. Voluntary trade can happen only when both sides find them worthwhile and the diminishing marginal utility of money assures that the rich will always require more of an inducement than the poor. Thus, giving governance of our most powerful institutions to the stock market guarantees that they will be forces for inegalitarianism. It is not accidental that the increased power of the stock market in our public corporations since the 1980s coincided with the enormous expansion of the pay gap between top executives and ordinary employees. Inequality, in turn, is deeply troubling both from democratic and economic perspectives. Inside the corporation, greater inequality necessarily leads to decreased solidarity; employees who think they are being taken by the company are more likely to take from it.[145] Outside the firm, relative equality is a prerequisite both to democratic

145. *See, e.g.*, EMILE DURKHEIM, SUICIDE 381 (George Simpson ed., John A. Spaulding & George Simpson trans., Free Press 1951) (on the importance of solidarity); E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE 81, 187, 200-01, 238 (1988) (marshaling evidence that perceived procedural fairness results in increased compliance, acceptance of legitimacy of outcome, and loyalty to institution, regardless of merits of decision); Alchian & Demsetz, *supra* note 1, at 790 (describing team spirit or loyalty as useful because it reduces shirking). Similarly, perceived justice is essential if those the institution wishes to reprimand are to see and react to sanctions as punishment (to be internalized) rather than oppression (to be resisted). *See, e.g.*, Daniel J.H. Greenwood, *Restorative Justice & The Jewish Question*, 2003 UTAH L. REV. 533, 552 n.59 (2003) (describing the significance of the punishment/oppression distinction).

republican government and to avoiding Keynsian demand-deficit depressions.

VII. CONCLUSION

The issue of how much power to give to the stock market, how much to give to democratic processes, and how much to leave to unguided professionals is the key political question of the corporation. The distribution of the surplus is part of the issue, but perhaps less important than more fundamental issues of how we want our public corporations to operate, towards which goals, and with what relationship to the people who make them up. So far, the defense of the share-centered corporation has proceeded mainly by invoking rhetorical claims to a supremacy that simply does not exist. But metaphors of ownership or agency are no substitute for social analysis—the question is not whether shareholders "are" owners of the corporation, but whether giving them so much power in the corporate-governance structure is good for society as a whole.

The alliance of convenience between CEOs and the stock-market has proven only partially productive, and the metaphors of share-centeredness have not helped us to understand the world we live in. The academic task is, first, to fully elucidate the false metaphors, and second, to shift the debate's imagery to metaphors that illuminate instead of concealing. The political task is to find a model which produces wealth for all, not just a small elite; which promotes decent work places and productive careers, not just consumers' playgrounds; which respects our ecosphere, not just a narrow vision of the econosphere.

***