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On the Demise of Shareholder Primacy (Or, Murder on the James Trains Express)

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ON THE DEMISE OF SHAREHOLDER PRIMACY (OR, MURDER ON THE JAMES TRAINS EXPRESS)

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The hypothetical introduced by Vice Chancellor Leo Strine's Essay[1] exposes an important arena of corporate governance where adherence to the traditional norm of "shareholder primacy" is particularly troublesome. In fact, it is hard to find an analogous domain of corporate governance law that is as jarringly discontinuous as that found in the factual circumstances suggested by Strine's hypothetical. Explicitly, the legal scrutiny accorded to managers who resist a hostile acquisition depends critically on whether a court invokes the *Revlon* doctrine or the *Unocal* doctrine as the appropriate governing standard. Under the former (and its progeny),[2] shareholder primacy arguments carry great (and nearly exclusive) weight: corporate directors must be able to demonstrate that its resistance is reasonably calculated to maximize short-term shareholder value. Under the latter doctrine,[3] however, immediate shareholder interests are just one of a panoply of considerations that directors may use to justify resistance to a hostile bid. Moreover, the factual distinctions that separate a *Revlon* case from a *Unocal* case can be surprisingly modest and nuanced.[4]

Of course, a simple description of this legal discontinuity dramatically undersells the aims of the James Trains hypothetical. Indeed, the hypothetical itself spawns deeper questions about whether shareholder

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1. Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change in Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169, 1177–85 (2002).

2. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182–83 (Del. 1986).

3. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

4. *See, e.g.*, McMullin v. Beran, 765 A.2d. 910 (Del. 2000) (holding that a majority shareholder who instigates an acquisition of the entire corporation by a third party must comply with *Revlon* duties).

primacy arguments are normatively justified with principles transcending the historical path dependence of judicial precedent. Even when a company has committed to a course of action that would ordinarily invoke *Revlon*, why *should* shareholder interests trump those of corporate founders, employees, debtholders, communities, or other interested constituencies? This is a difficult question to answer, and it is routinely debated within the pages of countless law reviews, conference proceedings, and legal briefs every year.[5]

Like Strine, I have little interest in opining on the final result of this hypothetical if the dispute were litigated in the Delaware courts (though I earnestly hope that my former students would be part of the litigation teams billing hours on the issue). I have a few perspectives on the hypothetical, however, that diverge (albeit slightly) from Strine's and that might be offered for general consumption.

As an initial matter, it is unclear whether one's ultimate position in the James Trains hypothetical sheds much light on the (significantly) larger issue of the purpose of the corporation. Indeed, although takeover law garners a fair amount of popular and academic attention, relatively few publicly traded firms (and no privately held firms) ever travel this quadrant of the corporate jurisprudential universe. To be sure, noteworthy takeovers occur every year, but one need not presume from this fact that either takeovers are likely in the short- to medium-term lifespan of most firms, or that the specter of an acquisition constitutes a defining characteristic of a firm's identity.

Perhaps a better way to glean what's at stake is to inquire into whether the issues presented by takeover law are in some way emblematic of all corporate law. Here, one's conclusions are likely to be decidedly milder. Indeed, the areas of corporate law likely to govern affairs within a firm year-in and year-out view shareholder primacy arguments with markedly less solicitude. Marketing decisions, compensation packages, product line reforms, investment options, workforce adjustments, supply decisions, and the like are rarely (if ever) matters in which shareholders may have much of a say. Indeed, state statutes,[6] federal regulations, and the infamous "business judgment rule" (inter alia) all conspire to ensure that the judgment of corporate boards can be challenged by dissenting shareholders

5. A Westlaw search, for example, reveals there to be well over 200 law review articles discussing the term "shareholder primacy" within recent years.

6. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001) (requiring affairs of a corporation to be managed by a board of directors).

only in the most extreme cases. And, while shareholders who disagree with their boards can attempt to use the proxy system or the market for corporate control as a means to displace directors, such devices are extremely costly to invoke. In many respects then, it appears that much of corporate law has already rejected shareholder primacy arguments in favor of allowing managers greater freedom of action.

Notwithstanding the fact that much of corporate law explicitly parts company with shareholder primacy as a *positive* matter, the James Trains hypothetical may still introduce important questions about whether this state of affairs is *normatively* justified. One distinction Strine draws in posing this broader question is that between the "property" (or "residual claimants") view of the firm and the "entity" view of the firm.[7] Consistent with other commentators, Strine at times characterizes these two views as constituting the "economic" versus "communitarian" accounts of the corporation. Under this characterization, a rejection of the primacy norm would in some way be tantamount to a rejection of the economic account of the corporation.

This distinction, while common in corporate literature, seems a bit exaggerated to me. In recent years, even among more economic-minded thinkers, the property account of the corporation has fallen into a state of considerable disrepair, for a number of reasons. Perhaps most noteworthy, it no longer seems factually accurate to depict shareholders as the sole "residual claimants" of a corporation, standing last in line to collect at the corporate till should the firm go bankrupt. The formal lines separating the various constituents of a corporation have become progressively blurred in recent years. This has been true for some time with creditors, who frequently own hybrid claims on a company that are easily convertible into stock. Even more recently, however, other constituencies have gotten in on the game. As a prime example, consider employees: an increasing number of them hold stakes in their firms, which makes them increasingly resemble shareholders. By one estimate, over ten million employees own significant stock options (one of the volatile sorts of stock ownership), up from only one million in 1992, and a majority of these workers are employed not by technology firms, but by nonhigh-tech businesses.[8] Moreover, in a recent survey of 247 companies, some seventy-four percent report that they routinely grant options to nonmanagement employees at least every other year as part of ongoing incentive pay programs.[9] The value of these annual

7. Strine, *supra* note 1, at 1170–71.

8. Margaret A. Jacobs, *The Legal Option*, WALL ST. J., Apr. 12, 2001, at R9.

9. *Id.*

option grants range on average from $511,804 for chief executives to $22,708 for salaried nontechnical employees to $7,982 for hourly employees.[10]

In addition, however, when viewed from a contractual perspective (which is how most economists tend to view things), the property/residual claimant account of the firm can be downright inconsistent. Under a pure contractarian view, a corporation is little more than a "nexus" or collection of contracts. As such, the parties to this universe of contracts are (and should be) expected to try to maximize their joint gains instead of only the gains of a single party to the contract. This makes a great deal of sense: if a governance system gives shareholders a minor advantage at the cost of visiting large disadvantages on other constituencies (such as employees, bondholders, and the like), all parties would be better off if the disadvantaged constituencies "purchased" the advantage away from the shareholders, compensating them through cash transfers, ex post settlements, or other concessions. Consequently, if a court's principal charge were to implement the terms of a contract that the parties would have reached through Coasean bargaining, then an "efficient" corporate law would necessarily balance the interests of shareholders with those of others. It would be at least mildly surprising to find that such balancing always favors shareholders.[11]

If most economists have also parted company with the pure property view of the firm, then one wonders who might be left to champion its merits. (To be perfectly candid, this population has been decreasing rapidly of late, and the shareholder primacy argument has increasingly become a straw person among academics.) Nonetheless, there may well be a practical rationale for retaining some deference for shareholder primacy. Indeed, shadows of these practical considerations are already evident in an ongoing scholarly discourse. For example, very few advocates of a multiconstituency view of the firm also advocate allowing nonshareholder constituencies to have the same rights that shareholders have in bringing derivative actions in right of the corporation against the boards of directors. The reason for stopping short of such a position, one would guess, is that such a state of affairs would give rise to an exponential rate of growth in the filing of lawsuits (both legitimate and unfounded). Such administrative

10. *Id.*

11. *See, e.g.*, Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277, 281 (1998) (formalizing this argument and noting that divergences from it would be due predominantly to capital constraints on the paying party).

costs can make the litigation game unworthy of the candle, thereby justifying a limitation on nonshareholders' rights to sue.

Interestingly, practical considerations like these also expose why there may, ultimately, be a good reason for retaining shareholder primacy (at least in certain situations) as a sensible allocation of corporate responsibility. Indeed, the underlying reason that multiple constituents' interests can be thwarted stems from a difficulty inherent in monitoring managerial actions (or contracting over them) in public corporations. Striving for balance among constituents' interests can help to ensure that managers do not play favorites with one constituency over another, at a potential efficiency loss.[12]

There is, however, another type of monitoring dilemma that should be of at least as much concern to all nonmanagerial constituencies in a corporation: that directors will line their own pockets by diverting benefits that would otherwise augment overall firm value. If managers are awarded broad protection from legal scrutiny for such acts of self-dealing, it is likely that most (if not all) other constituencies stand to lose. And it is in such instances that shareholder primacy may play an important (and even critical) role. For even if shareholders do not perfectly reflect the interests of every constituency in the firm, they likely share some core common interests (such as deterring managerial self-dealing). As such, one might think twice about affording corporate fiduciaries a more potent defense against shareholder litigation, permitting them to argue that some other constituency's welfare gain justifies an action that (allegedly coincidentally) enriches managers as well.[13]

In a world where such defenses are available, we would have to rely almost exclusively on other, extra-legal forms of managerial restraint—such as markets for reputation or "norms" of selfless comportment—to protect company interests from an "intervening hierarch" that remains relatively immune from legal challenges.[14] While such extra-legal forces are certainly important, it is unclear whether they can completely carry the deterrent load in a world of cutthroat competition, manipulative accounting,

12. For a recent take on whether such favoritism is necessarily bad in a strategic setting, see Stephen Choi & Eric Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 326–44 (2002).

13. Or, as Frank Easterbrook and Dan Fischel put it their seminal book on corporate law, "[A] manager told to serve two masters . . . has been freed of both and is answerable to neither" FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991).

14. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250–51 (1999) (advocating such a system of extra-legal constraints).

and imperfect monitoring.[15] Ironically, these misgivings become particularly salient as nonshareholder constituencies increasingly assume positions alongside shareholders as "joint" residual claimants of the firm. Indeed, with greater commonality of interest, shareholders can be expected to pursue agendas that are even more closely aligned with the goals of other constituencies.

A few years ago, I participated in a roundtable conference with a few other corporate law professors, and we were attempting to summarize contemporary corporate law in a nutshell. The most succinct and accurate sound bite that surfaced was the following: "Don't jerk around any constituency too badly, and you'll be ok."[16] Many, of course, resisted this definition, fearing that if word got out, our respective deans would require us to start teaching other courses that had somewhat more substance and content.

But when push comes to shove, the above sound bite may well be exactly what modern corporate law has come to reflect. Of course, this trajectory may be entirely appropriate—for corporations are by definition multifaceted creations; their pressure points are many, and their structure necessarily complex. But if that is the direction that corporate law is heading, we should not be excessively cavalier about the challenges that a multi-constituency legal account of the firm imposes, only a few of which I have pointed out above. For if we are, the constituency that stands to lose the most will be ourselves.

15. Indeed, it is worth noting that virtually none of the past year's prominent corporate and securities scandals (such as Worldcom, Enron, Tyco, and Imclone, to name a few) involved allegations that managers favored shareholders over other constituencies. Rather, their common thread appears to be managerial self-dealing of some variety or another.

16. Though I cannot recall precisely who originated this statement, I believe that it was Henry Hansmann.