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Editorial

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Why Lynn Stout Took Up the Sword Against Share Value Maximization

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As an undergraduate at Princeton University in the 1970s, the late Prof. Lynn Stout majored in economics. And as a young lawyer embarking on a career as a scholar and teacher at George Washington University, she was one of only a few women law professors in the 1980s and early 1990s to actively promote and participate in the law and economics movement.[1] But, while she appreciated the framework and the ideas that economics brings to law, Lynn also studied psychology as an undergraduate. And from that perspective, she had two big beefs with assumptions that neoclassical economics makes about the way humans process information and behave. The first was the idea that people are completely rational and logical. And the second was that they always behave in a self-interested way.[2]

1 How Financial Markets Actually Work

Lynn's early scholarship tackled economic theories about how financial markets work. She challenged the widely-accepted Efficient Capital Markets Hypothesis (ECMH), a theory that has been hugely influential in finance theory and in policy discussions about the regulation of financial markets. This theory assumes that investors in capital markets have "homogeneous expectations" – meaning that all investors have the same knowledge and expectations about the future and would therefore make the same choices in a given situation.[3] The assumption of homogeneous expectations is required for capital markets to be fully "efficient" in the sense meant by ECMH advocates. Lynn's view was that, while people may intend to be rational, they come to any activity in life (and especially to investing) with mixed experiences, prior understandings, different inclinations (such as optimism or pessimism), and different appetites for risk. As a result, investors have what she called "heterogeneous expectations," investors do not, in practice, have homogeneous expectations, and capital markets are not fully efficient.[4]

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1 Together with David Barnes, she published an early law and economics casebook, *Cases and Materials on Law and Economics*, West Group, (1992). Biographical details are available at https://www.lawschool.cornell.edu/spotlights/Remembering-Lynn-Stout.cfm.

2 Both of these assumptions have been challenged by scholars in the field of "behavioral economics" in the decades since Lynn Stout began working on these ideas. See generally Kathryn Zeiler & Joshua Teitelbaum, eds. (2019) *Research Handbook on Behavioral Law and Economics*, Edward Elgar (collecting essays by experts on various subfields of behavioral law and economics).

3 Investopedia, available at https://www.investopedia.com/terms/h/homogeneous-expectations.asp.

4 Lynn made this point in a number of articles. See, for example, Lynn A. Stout (2011) "Risk, Speculation, and OTC Derivatives: An Inaugural Essay for Convivium," *Acctg., Econ., and Law: 1 A Convivium, 1*, and other articles cited in note 9 below. See also Yuri Biondi (2011) Disagreement-Based Trading and Speculation: Implications for Financial Regulation and Economic Theory, *Acctg., Econ., and Law: 1 A Convivium, 1* (2011).

If capital markets are not fully efficient, then the price of any financial asset such as an equity security that trades on an exchange may not necessarily reflect the "true" underlying value of the security, and financial markets may be subject to excesses and bubbles and crashes.[5] To suggest that stock prices are not fully efficient, however, was at the time (and still is in some circles) heresy. Lynn's ideas were not taken seriously by many mainstream law and economics professors. In one of her first important articles on the subject, Lynn asked "Are Stock Markets Costly Casinos?"[6] This article was little noticed and rarely cited prior to the collapse of Enron, Worldcom, and the dot.com bubble more generally in 2000 and 2001.[7] Nearly all of the important citations to this work by Lynn came in or after 2001.[8] Financial market events in the last 25 years, since that article was published, have made Lynn seem increasingly prescient, and Lynn elaborated on her basic ideas about financial market in a number of subsequent articles.[9]

2 How Humans Actually Behave

The other assumption of much of the law and economics movement that Lynn objected to was the belief that humans consistently behave in self-interested ways. Even if we observe people making contributions to charity, or investing time and energy in building institutions that will mainly benefit other people at an unknown future time, economists urge us to assume that they do so because

5 Yuri Biondi and Simone Righi discuss both of these aspects of market efficiency in Biondi and Righi (2015) What Does the Financial Market Pricing Do? A Simulation Analysis with a View to Systemic Volatility, Exuberance and Vagary, *Journal of Economic Interaction and Coordination*, May.

6 Lynn A. Stout (1995) "Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation," 81 *Va. L. Rev*. 3, 611–712.

7 A notable exception was Donald Langevoort (1996) "Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers," 84 *Cal L. Rev*. 627 (citing Lynn Stout's work on market failure and securities regulation, and exploring the question of why investors readily pay for and accept investment advice from stock brokers who have obvious conflicts of interest).

8 Google Scholar reports that Stout's Costly Casinos article had been cited 285 times as of May 20, 2020.

9 See, e.g., Lynn A. Stout (1988) "The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation," 87 *Mich. L. Rev*., 3 (Dec., 613–709); Lynn A. Stout (2011) "Risk, Speculation, and OTC Derivatives: An Inaugural Essay for Convivium," *Acctg., Econ., and Law: 1 A Convivium, 1* ; Lynn A. Stout (2009–2011) "Regulate OTC Derivatives by Deregulating Them," 32 *Regulation*, 31; Lynn A. Stout (2011) "Derivatives and the Legal Origin of the 2008 Credit Crisis," 1 *Harv. Bus. L. Rev*. 1.

it serves some need of their own, such as for fame, or recognition, or appreciation.[10] From her formal training in psychology, her reading on the subject, and, really, just from her own observations about people, Lynn believed that people often behave in "other-regarding" ways, and that models that assume otherwise will not correctly predict or reflect observed behavior. But she also understood that people do not engage in other-regarding behavior in a random way – they tend to do so when prompted by social signals that tell them they should cooperate rather than compete, or that they are expected to help the team succeed rather than simply seek glory for themselves. If, in practice, people are often "pro-social," it is important to understand what triggers this behavior, and what circumstances sometimes suppress cooperative behavior, which Lynn believed to be an inherently natural, if not universal human trait.

Lynn was working on the implications for corporate law of heterogeneous expectations and pro-social behavior when I met her in the late 1990s. One of the implications is that if we tell corporate managers that they are only supposed to do things that will make share prices go up (and especially if we incentivize them to focus only on the market value of shares), they will be more likely to cut costs by squeezing wages and benefits for workers, slashing investments in R&D, and operating with minimal staffing and inventory, and will consequently have few resources to fall back on in bad times.[11] They are also likely to pay excessive dividends and buy back the corporation's shares to get money out the door to shareholders as quickly as possible.[12] Even otherwise highly thoughtful and moral

10 See, e.g., Robert Simons (2015) "Self-Interest: The Economist's Straitjacket," *Harv. Bus. School Working Paper* 16-045. (Examining troubling implications of widespread adoption of this assumption in studies of organizations).

11 Firms in which top managers are focused solely on share value will likely also tend to shortchange investments in reducing pollution. Yuri Biondi advocates an accounting device that he believes could mitigate the damaging effect of excessive attention to share value, which is to recognize potential environmental liabilities in the financial accounts of firms. See Yuri Biondi. (2014), "Better Accounting for Corporate Shareholding and Environmental Protection," *11 European Company Law, 2,* April.

12 William Lazonick has been one of the leading voices arguing that excessive stock buybacks have had a negative impact on corporate performance See, e.g., William Lazonick Mustafa Erdem Sakinc and Matt Hopkins (2020) "Why Stock Buybacks Are Dangerous for the Economy, *Harvard Business Review*, January 7, available at https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy. But see also, Jesse M. Fried and Charles C. Y. Wang (2018), "Are Buybacks Really Shortchanging Investment?" Harvard Business Review, March-April, available at https://hbr.org/2018/03/are-buybacks-really-shortchanging-investment (arguing that, when new issues of equity are taken into account, stock buybacks and dividends are not excessive, and do not limit investment).

leaders will cut corners in this way, rather than making long-term investments, if that drives up share prices.[13]

At the time, I was working on the role of human capital in the wealth-creating activities of corporations.[14] Lynn and I were both aware of "theory of the firm" literature in economics that hypothesized that people organize themselves into "firms" to carry out productive activity when it is more efficient for a boss to tell employees what to do, rather than letting individual crafts persons, purchasing agents, administrators, and marketing specialists enter into separate complex contracts with each other.[15] I was skeptical about this theory, and began talking with Lynn about the idea that employees of corporations often work in teams, and that much of the creative outcomes happen in the interactions among team members, rather than in the control exercised by the senior officers. That idea dovetailed nicely with the work she was doing on prosocial behavior. We speculated that, where team production is important, a hierarchical chain of command in such situations often serves to identify and construct promising teams, choose and reward winning teams, and resolve disputes, rather than closely supervising every activity of the team members.[16]

3 A New Theory of Firm

Around this time, two University of Chicago economists, Raghurum Rajan and Luigi Zingales, were circulating a draft of an article eventually published as "Power in the

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13 See, e.g., John R. Graham, Campbell R. Harvey, Shiva Rajgopal (2004) The Economic Implications of Corporate Financial Reporting, NBER Working Paper 10550 (survey finding that many corporate executives would rather take actions that will have a negative long-term effect on the company's earnings than report lower earnings).

14 See, e.g., Margaret M. Blair (1995) *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, Brookings Institution, and Margaret M. Blair & Mark J. Roe, eds. (2001), *Employees and Corporate Governance*, Brookings Institution.

15 Among the seminal papers in this literature are Ronald H. Coase (1937) "The Nature of the Firm," *Economica*, New Series, Vol IV, 386-405; Oliver Williamson (1981) "The Economics of Organization: The Transaction Cost Approach," 87 *Am. Jour, of Soc.*, 3, 548–577; Oliver Williamson (2002)"The Theory of the Firm as Governance Structure: From Choice to Contract," 16 *Jour. Econ. Persp.*, 3, 171–195; Armen A. Alchian and Harold Demsetz (1972) "Production, Information Costs, and Economic Organization," 62 *Am. Econ. Rev.*, 5, 777–795; Michael C. Jensen and William H. Meckling (1976) "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," 3 *Jour. Fin. Econ.*, 305–360; and Oliver Hart and John Moore (1990) "Property Rights and the Nature of the Firm," 98, *Jour. Pol. Econ.* 6 (Dec.) 1119–1158.

16 See Margaret M. Blair & Lynn A. Stout (1998–1999), "Team Production in Business Organizations: An Introduction 24 J. Corp. L. 743 (explaining the concept of team production methods and their implications for economic theories of the firm).

Theory of the Firm,”[17] which argues, among other things, that ownership of the assets in a firm does not always give the owners incentives to make optimal use of those assets. This counterintuitive result happens because property rights can have perverse effects on owners by discouraging them from investing in firm-specific skills, ideas, and resources that will make the firm and its employees as productive as it can be. This is because owners can capture potential value simply by selling the owned asset. But, knowing the firm can be sold out from under them, other participants in the firm, such as employees, will resist investing in firm-specific knowledge and skills since they would lose their firm-specific investments in case of the firm sale. The negative incentives for employees can more than offset the positive impact of property rights on owners, limiting the potential productivity of the enterprise.

A solution that helps to solve this problem is for the decision-rights in corporations to go to parties who are not necessarily the owners – that is, to separate ownership from control. Rajan and Zingales claimed that the perverse incentives associated with ownership help to explain why we often see third-party ownership of assets in firms. Lynn and I both realized, however, that this model explains something even more relevant and important about a particular class of firms – publicly traded corporations. This is that shareholders, often referred to as “owners” of publicly traded corporations, have almost no decision-rights, while boards of directors, members of which may or may not own any stock, have all decision rights over corporations – one of the most fundamental and universal features of corporate law.

Lynn and I also appreciated right away that this was a new “theory of the firm,” which emphasizes the lateral interactions and firm-specific investments among employees as sources of value, rather than top-down control, and de-emphasizes the “agency cost” problem between directors and shareholders that so dominates corporate law scholarship.[18] In widely-held corporations, boards of directors are not, strictly speaking, “agents” of shareholders. Corporate law makes them more like trustees who owe fiduciary duties to the corporation and its shareholders. And dispersed shareholders aren’t really even “owners” in any traditional sense of that word. Hierarchical decision-making topped by a board of directors isn’t (at least not entirely) about controlling managers and other employees, but is about separating the decision-making function from the investment and risk-taking functions. The separation of ownership and control is a feature, not a bug.

This “team production theory” resonated with my prior work on the sources of value and productivity that are tied to the human capital of employees. Lynn

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17 Raghurum Rajan and Luigi Zingales (1998), “Power in a Theory of the Firm,” 113 *QJE*, 2, May, 387–432.

18 It was more than two decades ago when Lynn and I were working on this problem, but it is still true that the problem of agency costs still dominates corporate law scholarship.

and I rejected shareholder value maximization as the only goal of corporations because it can undermine these sources of value. For instance, it encourages corporations to try to minimize the amount of capital they have invested, so they buy back their own shares from the market rather than retaining cash flow to support R&D or other new investments. It also discourages firms from investing in their employees, or in alternative suppliers, or in building reputational capital or financial reserves, which can help them be more resilient in the face of economic challenges.[19]

Our "team production theory of corporate law"[20] also resonated with Lynn's work on other-regarding behavior because it recognizes that, as fiduciary representatives, directors must be expected to put the interest of the corporation ahead of their own personal interest – indeed, corporate law holds that directors have fiduciary duties that *require* them to do exactly this. Lynn and I firmly believed that directors and managers generally will be trustworthy, if social signals encourage them to make other-regarding choices. But they may switch to being self-interested if the social signals they receive tell them they must only focus on maximizing share value, they are rewarded for doing so, and that the game they are playing is a competition, not a cooperation game.[21] We reject the idea that boards and managers should focus solely on maximizing share value for a number of reasons, including that it sends precisely the wrong social signals, signals that say that corporate behavior is all about getting as much money as possible. This is especially the case if boards and managers are rewarded handsomely if the stock price goes up, and penalized for making hard decisions to do the "right thing" for employees, suppliers, and communities, such as, for example, fulfilling contractual obligations and providing "catastrophe pay" as long as possible for employees furloughed in a pandemic!

4 Recurring Themes

These themes – that financial markets are not always efficient,[22] that people often behave in other-regarding ways if the social signals they observe suggest they

19 See Blair (1995), *Ownership and Control*, Chapter 6, "Whose Interests Should Corporations Serve," 202–234; Blair & Roe (2002), *Employees & Corporate Governance*, Chapter 2, "Firm-Specific Human Capital and Theories of the Firm," 58–90; and Lynn A. Stout & Tamara Belinfanti (2018) "Contested Visions: The Value of Systems Theory for Corporate Law," 166 *U. Penn. L Rev.*, 3 (Feb.).
20 Margaret M. Blair & Lynn A. Stout (1999), "A team production theory of corporate law," 85 *Virginia Law Review*, 247–328.
21 Margaret M. Blair & Lynn A. Stout (2000–2001) "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law," 149 *U. Penn. L. Rev.* 1735–1810.
22 See Lynn A. Stout (1995).

should do so,[23] and that setting the maximization of share value as the primary goal for corporations often has pernicious results[24] – are developed in numerous articles, essays, and in three books that Lynn wrote during her prolific years as a scholar. They are also touched upon, and explored in the seven essays in this symposium.

Don Langevoort's essay recounts the way that Lynn "immersed" herself "in the study of human behavior and the evolution of cooperation,"[25] to "support the prediction that given sufficient autonomy to act responsibly, with the right social cues – most people will do so."[26] Summarizing Lynn's challenge to shareholder primacy, Langevoort says Lynn believed that by "expecting selfishness, we normalize it and make it more likely. What has to go, then, is the legitimizing of Wall Street beliefs."[27] Langevoort examines what he sees as the three broad positions of scholars, practitioners, and corporate managers and directors: shareholder primacy versus managerialism versus stakeholder primacy. He notes that, politically, the rejection of shareholder primacy might not lead to better outcomes for stakeholders if managerialists can make themselves appear to be aligning themselves with stakeholderists, but practice stakeholderism only so long as it strengthens their power and autonomy from shareholders.

5 The Many Issues with Shareholder Primacy

Thomas Clarke offers a full-throated endorsement of Lynn's rejection of shareholder primacy.[28] He writes his piece as a critique of Milton Friedman's and Friedrich Hayek's "narrow view of freedom and democracy as dependent on individuals, corporations and markets," a view which he says provided the "philosophical underpinning for the hegemony of agency theory and the consequent impulsion towards the maximization of shareholder value" in corporate governance, a development he believes has been "profoundly damaging to corporations."[29]

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23 See Blair & Stout, (2000–2001); and Lynn A. Stout (2011), *Cultivating Conscience: How Good Laws Make Good People*, Princeton University Press.

24 See Blair & Stout (1999); and Lynn A. Stout (2012) *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, Berrett-Koehler.

25 Donald Langevoort, "Lynn Stout, Pro-Sociality, and the Campaign for Corporate Enlightenment," in this issue, p. 4.

26 Id.

27 Id.

28 Thomas Clarke, "The Contest on Corporate Purpose: Why Lynn Stout Was Right and Milton Friedman Was Wrong," in this issue.

29 Id., at p. __.

Clarke's essay rails against alleged corporate sins of environmental accidents, and neglect of safety measures and other forms of cost-savings that harm employees and communities, tying these to executive compensation packages stuffed with stock options that give executives incentives to neglect long term investments and fudge short-term earnings reports. Massive share buybacks and associated failures to invest for the long term are other perverse effects of the drive to maximize stock value, Clarke says. Clarke reviews what Lynn Stout had to say about all of these problems and then observes that, in just two years since Lynn's death, there are signs that the primacy of shareholders in corporate management and law may actually be giving way to a new recognition that corporations must have a social purpose. Exhibit one for this proposition, he says, is The Business Roundtable's announcement in August of 2019 that 181 of its members had signed a new *Statement on the Purpose of a Corporation* which rejects shareholder primacy and adopts the rhetoric of social purpose.[30] Clarke then reports on a number of prominent CEOs and management scholars who have praised this new development, and expresses his hope that "the stark beliefs of Milton Friedman have finally been cast aside."[31]

6 Model Specifications

In his contribution to the symposium, David Ciepley also focuses on the evils of shareholder primacy and the drive to maximize share value. He approaches this thesis "from the perspective of history," in which, he asserts "the American corporation has lost its way."[32] Modern business corporations, Ciepley tells us, evolved from entities born in the 16th and 17th centuries to "bridge [the] gap between public need and private risk."[33] They were created by means of a charter, granted by the king, or parliament, or other central governing authority, which was the mechanism used to ensure that the corporation fulfilled the public need.[34] What the investors got in exchange for fulfilling the public need was that the state created a "juridical person" to be the central contracting party, and to hold the assets and be legally responsible for the debts of the enterprise.

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30 Id., p, ___, quoting Business Roundtable (2019) Statement on the Purpose of a Corporation, Washington DC.
31 Id., p, ____.
32 David Ciepley, "How America's Corporations Lost Their Public Purpose, and How It Might Be (Partially) Restored," in this symposium.
33 Id., at p. 5.
34 Id., at p. 6.

Over time, this understanding of corporations has changed. The "reigning wisdom" of the last 40 years has been "that the business corporation is a private contractual association … to be run in the interest of its shareholders alone," Ciepley says.[35] He traces the legal and political changes in the U.S. since the late 19th century that produced this evolution in the understanding of, and expectations about the social purpose of corporations. By the 1980s, it became accepted that this purpose was solely to enrich shareholders, and the result has been what Ciepley calls "vampire management," characterized by massive payouts to shareholders and corresponding reductions in investment, or, as he puts it, "cannibalism, with stockholders consuming the corporate body."[36] For a variety of reasons, Ciepley doesn't believe that it would be possible to restore the public purpose requirement for modern corporations in the U.S. Instead, he proposes that the shares of corporations should be held by, and corporations should be controlled by, non-profit foundations, as is common in Denmark.[37] This would require a change in the tax code in the U.S., he says, but Ciepley believes this is more feasible politically than the change to corporate law that would be required to undo shareholder primacy.

7 Externalization Machine

Jean-Philippe Robé calls our attention to the distinction between a corporation, and a "firm," and the role that accounting conventions play in what he calls the "Shareholder Value Mess."[38] The corporation, he says, is the legal entity, and accounting conventions only record transactions between this entity and the various parties it contracts with. His concept of a "firm," however, encompasses all of the parties who engage with or are affected by the organization which carries out some economic enterprise.[39] The "firm" may include individuals with no formal role in the corporation, and one or more corporations as legal structures for

35 Id., at p. 10.

36 Id., at p. 14.

37 Id., at p. 24. See also Henry Hansmann, and Steen Thomsen (2013). "Managerial Distance and Virtual Ownership: The Governance of Industrial Foundations," ECGI Finance Working Paper No, 372, Yale Law & Economics Research Paper No. 467, available at SSRN: https://ssrn.om/abstract=2246116; and Colin Mayer (2015), "Reinventing the Corporation," Sir John Case's Foundation Lecture, British Academy, London. See also Colin Mayer (2013), *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in it*, London: Ox.U. Press.

38 Jean-Philippe Robé, The Shareholder Value Mess (And How to Clean it Up), (2019) in this symposium.

39 Id., in this volume, p. 2.

holding assets. Proper accounting for costs and benefits of a firm would include externalities, such as the cost of carbon emitted in the process of carrying out the economic activity, even if the corporation is not required to pay for those costs. If the firm doesn't pay for using up some of "nature's CO_2 absorption capacity" the implicit cost is imposed on the community of interests that make up the firm, or completely externalized onto parties who have no other connection to the firm at all. Robé argues that accounting should be done at the level of the firm, rather than at the corporate level. This would incorporate any benefits and costs of a corporation's activities that devolve onto affected parties who are not part of the corporation.

"Nature's CO_2 absorption capacity is a form of capital we share," Robé says to illustrate his point, but "no one is in a position to present a bill for its use … [therefore] … the use of this capital is not properly accounted for."[40] Accounting rules, however, are designed for corporations, not for firms, he says. This results in a distinction being made between the value of some economic activity on the income statements and balance sheets of a corporation, and the total social value of the activity, net of associated costs. "A corporation can be treated as creating 'shareholder value' while emitting massive quantities of CO_2"[41] which may render the *net* effect of the enterprise much smaller, or even negative, even while the corporation records positive profits. "Proponents of shareholder value maximization contribute to the existence of corporate governance systems which systematically convert externalities … into profits. And there is no one to adopt the bylaws to prevent this from happening."[42]

Robé proposes that corporations should be required to adopt an approach to accounting which he calls "sustainability accounting." This would require corporations to calculate the annual cost of constructing a "CO_2 well" that would absorb all of the CO_2 emitted by the corporation in the process of carrying out its economic activities, and subtract this cost from the net earnings of the corporation as determined by standard approaches to accounting. In this way, net corporate earnings would become an indicator of whether the corporation is "sustainable."

8 Compounding Effects of Financialization

Yuri Biondi also explores how standard approaches to financial accounting produce misleading inferences about the actual value being created, or destroyed, by

40 Id., in this volume, p. 4.

41 Id., in this volume, p. 4.

42 Id., at 10–11.

corporate activity. The "ownership view on corporate affairs,"[43] Biondi says, treats corporations as if they have a single entrepreneur proprietor who holds shares that give her control rights. Consistent with shareholder primacy, the focus of standard accounting is on the value of the entrepreneur's shares. But accounting rules often provide no insight into the complex ways that assets and risk flow from one set of claimants to another within a complex "enterprise entity."

Biondi argues that three legal-economic innovations have dramatically "decoupled" the ownership of shares of stock from any exercise of control over the enterprise, rendering shareholder value maximization increasingly irrelevant to any question about total value being created. These innovations are, first, "the corporate legal form" itself, which "facilitated a fundamental disconnection between shareholding investors and the legal entity whose issued shares are held by those investors."[44] The second is the "organizing [of] corporate affairs through a web of contractual arrangements" in which the contracts may not "show [their] purpose and meaning except in connection with all the other contracts."[45] Corporate groups, with cross-shareholding and the use of subsidiaries enable moving assets around to avoid regulation or taxes, for example. The third category of innovation is "financial innovation [which] has enabled use of financial instruments that disentangle and recombine that set, hybridizing traditional equity and debt positions," while "derivative contracts, share lending and share sale-and-repurchase (repo) agreements have fundamentally disintegrated the legal equity position."[46]

A dramatic illustration of how "financialization" has scrambled the lines of accountability in corporations was exposed during the 2008–2009 financial crisis. In the months and years leading up to the crisis, many banks and other financial institutions were making profligate use of "special purpose entities" (SPEs) for the securitization of mortgage loans and other debt instruments. The financial institution would package up a collection of financial claims and put them into a separate corporate entity[47] whose stock was not only controlled by the parent bank, but the entity was dependent on the parent bank for management, and as a result of guarantees and liquidity lines and other contractual arrangements. The special entity would then issue and sell debt securities, using the debt instruments it received from the parent corporation as collateral. The effect of this maneuver is

43 Yuri, Biondi, "Ownership (Lost) and Corporate Control: An Enterprise Entity Perspective," in this volume, (abstract).

44 Id., at 3.

45 Id., at 4.

46 Id. At 4.

47 Technically, these separate entities were sometimes corporations, but they could also be LLCs. The distinction is not important for Biondi's point.

that assets that had been available to pay general creditors of the bank were now (in theory) only available to creditors of the SPE. The transaction also took the assets off the balance sheet of the parent company, which (in theory) had no liability if the securities issued by the SPE defaulted.[48] After this restructuring, the debt instruments issued by the SPE were often more highly-rated by the bond rating agencies than the general debt of the bank. General bank creditors, such as depositors, meanwhile, had fewer assets backing up their investments, and to the extent that depositors in banks are protected by federal deposit insurance, the new risk was implicitly being borne by taxpayers. In other words, the corporate form was used to carve up existing assets and move risk around, rather than to create any new value. "This instrumental use of corporate form may shift risk toward creditors and undermine the entity capacity to cope with social and environmental responsibilities and liabilities over time and circumstances," Biondi says.[49]

The disconnect between individual shareholding and management and control is further exacerbated by "delegated management and share-holding and trading" that happens when investors put their savings into retirement accounts or mutual funds.[50]

Biondi believes that corporations cannot be made accountable to all of their constituencies until accounting systems track the entire web of contracts, regardless of where the boundaries of specific corporations are set. He advocates "a comprehensive accounting system – based upon economic substance (rather than legal form) – [that] may make enterprise groups accountable for their ongoing activities to stakeholders (including shareholders), human community and nature."[51]

Sanford Jacoby, a historian of labor and business, examines one era in the long and fraught relationship between corporations and labor.[52] During the first decade of the 21st century labor union pension funds began making use of the voting rights associated with corporate stock held in the funds to challenge executive pay. In the

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48 I say "in theory" because, as the financial system teetered toward collapse from the excessive leverage it was operating with in 2008, the largest financial institutions, under pressure from regulators, accepted responsibility for debts of their own SPEs, even though the contracts and charters that created them expressly denied responsibility by the parent corporation for debts of the SPEs. See, e.g., Margaret M. Blair (2010–2011), Financial Innovation, Leverage, Bubbles and the Distribution of Income, 30 *Rev. Bank. & Fin. Law* 225–312.

49 Biondi (2020), at 10.

50 Id, at 9.

51 Id., at 2.

52 See Sanford M, Jacoby (2020) "Executive Pay and Labor's Shares: Unions and Corporate Governance from Enron to Dodd-Frank," in this volume.

1990s, shareholder activists, including public employee plans, and union pension plans, had pushed corporations to tie CEO pay to stock performance (which, ostensibly, they did by paying CEOs in stock options), but they did not focus on the scale of CEO pay. In the years since, CEO pay has soared, while pay for ordinary workers has flat-lined, and no longer tracks productivity.[53] CEO pay has gone from about 30 times the compensation of ordinary workers, on average, to hundreds of times the pay of ordinary workers. [54]

Labor unions are prohibited by law from negotiating over executive compensation,[55] but unions have two other levers of power that they can use to challenge excessive CEO pay – political influence, and the voting power of union-sponsored pension plans in elections of directors, and in say-on-pay voting. Beginning in the 2000s, unions began trying to use both levers to challenge excessive executive compensation. As various scandals unfolded, beginning with collapse of the dot.com companies in 2000, continuing through earnings manipulations at Enron, and Worldcom in 2001-2002, and on to Lehman Brothers, Merrill Lynch, AIG, and Fannie Mae and Freddie Mac in 2008, union pension plans began to take issue not only with the mode of compensation but with the sheer size of payouts to top executives.

Jacoby tells the story of how union pension funds found their voice on this issue. After the mass collapse of banks and financial institutions in 2008, including the failure of a number of major financial institutions such as Country Wide Financial and Merrill Lynch, it became known that executives of these institutions had taken out hundreds of millions of dollars in compensation in 2006 and 2007. This enabled the issue of excessive CEO pay to get sufficient political traction so that a provision was enshrined in the Dodd–Frank Act passed in 2010,[56] that required publicly traded corporations to submit their compensation plans for their executives to periodic votes of shareholders. These votes are advisory only, however, and CEO pay has continued to rise. Meanwhile, the effort to rein in CEO pay had the partial effect of increasing shareholder power and, therefore, shareholder primacy. Moreover, Jacoby notes that, even while union pension plans were working to exercise some influence on executive compensation, they were taking no action to try to limit the size of payouts to shareholders, which are orders of magnitude greater than payouts for executives.[57]

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53 Id., at 7.

54 Id., at p. 35–36.

55 Id., at p. 8.

56 Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L 111–203 (2010).

57 Jacoby (2020), at 38.

9 A Final Challenge to Shareholder Primacy Advocates

For my own contribution to this symposium, I review and discuss what may be Lynn Stout's most ambitious new idea.[58] Even as she knew she was dying, Lynn poured her expansive imagination into an effort to try to rethink in a big way the role that shareholders play in publicly traded corporations. In *Citizen Capitalism: How a Universal Fund Can Provide Influence and Income to All*,[59] Lynn, together with coauthors Sergio Gramitto, and Tamara Belinfanti, propose a private-sector initiative to help redistribute income, while providing corporations with long-term, patient, investment capital.

The authors propose that wealthy individuals who want to leave a valuable social legacy contribute money and equity shares of corporations to what they call a "Universal Fund," (UF) which would be like a mutual fund in which only U.S. citizens could hold shares. All U.S. citizens would be eligible to register to receive one, and only one, share in the UF when they turn 18. Shares would be like birthrights, rather than property, in that they could not be sold or given away or (presumably) borrowed against, and they would expire when the person dies. These shares would give shareholders the right to receive a pro rata share of any distributions made by the fund, as long as the shareholder is alive.

The UF would be required to hold the shares indefinitely, providing long-term and very patient capital for the corporations in its portfolio. It could not sell the shares it holds, unless a corporation repurchases its own shares, or is acquired by another company, so that its shares are extinguished. But in such a case, the UF would invest the proceeds of any such sale of shares back into other equity shares – perhaps the shares of the acquiring company. The UF would grant its shareholders the right to designate how voting rights associated with shares held by the UF would be voted.

Citizen Capitalism, the authors argue, addresses two major problems with capitalism as practiced in the U.S. today. The first is the ever widening gap in income and wealth in the U.S. This issue would be addressed over time, as distributions to all the citizen-shareholders would, the book argues, eventually grow to be large enough that they would act like a "universal basic income," providing a baseline of income and wealth that would be every citizen's birthright. The second is the concern that shareholder primacy, in a context of extremely liquid and

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58 See Margaret M. Blair, "Beating Shareholder Activism at Its Own Game," this volume.

59 Lynn A. Stout, Sergio Gramitto, and Tamara Belinfanti, (2019), *Citizen Capitalism: How a Universal Fund Can Provide Influence, and Income to All*, Berrett-Koehler.

volatile financial markets, places constant pressure on corporate leaders to focus on generating and distributing cash to shareholding investors and executive managers, even at the expense of long-term growth and prosperity. The authors believe that this problem would be ameliorated as the UF grows in size an influence on the corporations in its portfolio.

I'm sure that if Lynn were alive today, she would be the first to acknowledge that the idea sketched out in *Citizen Capitalism* is a thought experiment rather than a fully-developed and well-specified policy proposal. One question that comes up immediately is whether it is even remotely possible that a significant share of the owners of the $35 trillion worth of corporate equity traded on U.S. stock markets would give enough of that wealth away to fund a UF. The authors note that, over the next four or five decades, most of that wealth will be transferred, in one way or another, to the next generation. If, indeed, investors are as "other-regarding" as Lynn believed most people are, perhaps it is not too crazy to imagine that would use their wealth to help redistribute wealth and income in the U.S. by endowing a Universal Fund.

10 In Memoriam

Lynn Stout's energy, piercing intellect, and iconoclastic ideas drove her work especially in challenging efficient market theory, and assumptions of hyper-rationality and self-interestedness of economic agents. These ideas came together in her intellectual attacks on the norm of shareholder primacy. She will be missed for many years.

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