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***DE FACTO* SHAREHOLDER PRIMACY**

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For generations, scholars have debated the purpose of corporations. Should they maximize shareholder value or balance shareholder interests against the corporation's broader social and economic impact? A longstanding and fundamental premise of this debate is that, ultimately, it is up to corporations to decide. But this understanding is obsolete. Securities law robs corporations of this choice. Once corporations go public, the securities laws effectively require that they maximize share price at the expense of all other goals. This Article is the first to identify the profound impact that the securities laws have on the purpose of public firms—a phenomenon that it calls "de facto shareholder primacy."

The Article makes three primary contributions to the literature. First, it provides a rich and layered account of de facto shareholder primacy. The phenomenon is not the result of considered legislation and regulatory decision. Rather, hedge-fund activists leverage the transparency that the securities laws afford to identify, and force companies to adopt, strategies that increase share prices. Their activities cast a shadow over the public market. Because firms must maximize share prices or face costly, disruptive, and protracted battles with activist hedge funds, they preemptively focus solely on stock values. The activists' novel and opportunistic use of the securities laws has transformed the regulatory apparatus into a powerful lever of shareholder primacy. Second, this Article shows how this distortion of the regulations causes harm. The activities of activists bring the laws into conflict with principles of federalism and private ordering, which hurts entrepreneurs, investors, and equity markets. Finally, to address these concerns, the Article recommends a small change to the securities laws that would end hedge-fund activism and thereby disentangle the securities laws from corporate purpose.

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INTRODUCTION

Now more than ever, public corporations play an essential role in society.[1] They have an enormous impact on politics,[2] social issues,[3] the

[1] *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 86 (2012) ("Corporations…control more resources than many national governments."); Gabriel Rauterberg, *The Corporation's Place in Society*, 114 MICH. L. REV. 913, 913 (2016) ("The public corporation is usurping the state's role as the most important institution of wealthy capitalist societies.").

[2] *Citizens United v. Federal Election Commission* held that corporations can make unlimited political contributions. *See* 558 U.S. 310, 365 (2010). *See also* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L. REV. 923, 927 (2013) (presenting evidence that "public companies engage in substantial political spending").

[3] *See* Tom C.W. Lin, *Incorporating Social Activism,* 98 B.U. L. REV. 1535, 1535 (2018) ("Corporations … are at the forefront of some of the most contentious and important social issues of our time.").

environment,[4] and the economy.[5] Given their immense footprint, there are few questions with greater social-welfare implications than whether corporations exist solely to serve the interests of shareholders (a shareholder primacy perspective)[6] or whether they have broader responsibilities (a stakeholder perspective).[7]

Corporate-law scholars have spent at least 90 years debating these conflicting views of corporate purpose.[8] This debate swirls today,[9] but

[4] *See, e.g.,* S&P GLOBAL, S&P DOW JONES INDICES CARBON EMITTER SCORECARD 3 Ex.1 (2016) (showing that the carbon emissions of the public companies tracked in the S&P 500 Index roughly equal those of Germany, France, and the United Kingdom combined); *see generally* Sarah E. Light, *The Law of the Corporation as Environmental Law*, 71 STAN. L. REV. 137 (2019) (arguing that business law should be used as a lever of environmental law).

[5] The market capitalization of U.S. public companies is about $32 trillion. *See* THE WORLD BANK, *Market Capitalization of Listed Domestic Companies (United States)*, https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=US&view=chart (last visited Feb. 12, 2019). They employ about 30 million people, approximately 26% of the private sector workforce. *See* Steven J. Davis et al., *Volatility and the Dispersion in Business Growth Rates* 37 tbl.1 (NBER Working Paper 12354, 2016), *available at* https://www.nber.org/papers/w12354.pdf.

[6] The view derives from the canonical article, Michael C. Jensen & William H. Meckling, *Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), which casts management as agents for the firm's shareholders. *Id.* at 308-09

[7] *See* Rauterberg, *supra* note 1, at 914. Sustainability theory is one modern incarnation of stakeholder theory. *See* Lynne L. Dallas, *Is There Hope for Change? The Evolution of Conceptions of "Good" Corporate Governance*, 54 SAN. D. L. REV. 491, 554 (2017) (The "sustainability conception encourages firms to pursue long-term value and focus on the interests of their stakeholders.").

[8] Professor Adolf Berle and Professor Merrick Dodd famously debated the purpose of firms in the *Harvard Law Review* in the 1930s. *See* Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049, 1049 (1931) ("It is the thesis of this essay that all powers granted to a corporation or to the management of a corporation … are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears"); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365, 1365 (1932) (arguing that "corporations exist for the sole purpose of making profits for their stockholders"); E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?,* 45 HARV. L. REV. 1145, 1148 (1932) (arguing that the corporation has a "social service as well as a profit-making function"); *see also* A. A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 36 (1991) (tracing the history of this debate).

[9] *Compare* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory For Corporate Law*, 166 U. PA. L. REV. 579, 41-52 (2018) (presenting a model for how to make management accountable to stakeholders) *with* Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 793 (2015) (rather than encouraging firms to act in the interest of stakeholders, "if interests such as the environment, workers, and consumers are to be protected, then what is required is a revival of effective externality regulation that gives these interests more effective and timely protection").

academics, practitioners, and policymakers alike have failed to notice that securities law—the complex system of federal regulations designed to protect investors—now has a far greater impact on corporate purpose than corporate law. This Article shows that, though there is no legal mandate or intent to do so, the securities laws force public companies to conform to the shareholder primacy view of corporate purpose.[10] Public companies are compelled, in fact, to follow a narrow version of this view, which measures shareholder welfare by stock price despite broad skepticism about this metric.[11]

The mechanism for this *de facto* shareholder-primacy requirement is hedge-fund activism.[12] Hedge funds—private and largely unregulated pools of investment capital—have traditionally made money for their investors through complex trading, hedging, and derivatives strategies.[13] In recent years, though, some have adopted a much more aggressive approach. Activist hedge funds dissect the copious disclosures required of public companies. They then purchase stakes in target firms and demand that they make changes to immediately increase stock prices. Targets overwhelming cooperate. Moreover, because all firms are afraid of becoming targets, they preemptively take actions to maximize their trading value. The fear of activist intervention creates a world of *de facto* shareholder primacy, where companies are overwhelmingly incentivized to maximize stock prices at the expense of all else.[14]

Etsy's experience illustrates how the securities laws, as leveraged by activists, transform the fundamental values of corporations. The company provides a platform for artisans and small businesses to sell crafts and other (often quirky) goods to online customers.[15] As a private firm, Etsy was

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[10] *See infra* Part II.

[11] *See infra* Part II.F. As I note in Part I.C., the field of behavioral finance has led to a great deal of skepticism about the link between share price and long-term shareholder value, sometimes referred to as "fundamental value." *See generally* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); *See also* Belinfanti & Stout, *supra* note 9, at 593 n.70 ("By the close of the twentieth century…the idea that stock market prices always capture fundamental value had been largely abandoned by sophisticated commentators in the face of an enormous and growing empirical and theoretical literature demonstrating this often was not true.").

[12] *See infra* Part II.I.

[13] *See* David Finstad, *Why the Industry is Struggling—and What Investors Can Do About It*, INSTITUTIONAL INVESTOR (Oct. 21, 2018) https://www.institutionalinvestor.com/article/b1bh5sbz82rzbx/Have-Institutional-Investors-Spoiled-the-Hedge-Fund-Party (describing how hedge funds creatively combine "equities, fixed income, commodities, derivatives, and private investments").

[14] *See infra* Part II.G.

[15] *See* ETSY, https://www.etsy.com/ (last visited January 16, 2019).

idealistic and mission-driven.[16] It was a certified B Corp, a status awarded only to companies that demonstrate a commitment to stakeholders.[17] Etsy strove to be "a paragon of righteous business practices," and its "founders believed its business model—helping mostly female entrepreneurs make a living online—was inherently just."[18]

When Etsy went public in April 2015, it unwittingly sacrificed these principles. Etsy's initial public offering was a success, but its stock price slumped within a couple of years.[19] A hedge fund, Black-and-White Capital, saw in this an opportunity.[20] The fund bought a slice of Etsy and immediately pushed for changes to reverse the decline.[21] The fund forced the ouster of beloved CEO Chad Dickerson.[22] New leadership then laid off nearly 25% of Etsy's workforce[23] and let the company's B Corp certification lapse.[24] The intervention was a victory for hedge-fund investors. Etsy's stock price increased 27% in the months following the transition.[25] But the company's founding values are gone.

None of this would have happened without securities regulation. As a public company, Etsy was for the first time required to disclose its operations and finances. While Black-and-White Capital applied the decisive pressure, the transparency into Etsy's business that resulted from its compliance with the securities laws is what provided the hedge fund with the necessary insight into the company to transform it from a stakeholder-oriented firm to one driven by stock prices. Etsy's conversion shows that only one corporate purpose can survive the public markets, where hedge funds dig through securities-law disclosures for hints about how to unearth profits for their investors.

Activist hedge funds have transformed the securities laws into a powerful tool of shareholder primacy—and that has serious and unintended

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16 *See* David Gelles, *Inside the Revolution at Etsy,* N.Y. TIMES (Nov. 25, 2017), https://www.nytimes.com/2017/11/25/business/etsy-josh-silverman.html.

17 *See id.*

18 *Id.*

19 *See* Max Chafkin & Jing Cao, *The Barbarians Are at Etsy's Hand-Hewn, Responsibly Sourced Gates*, BLOOMBERG (May 18, 2017), https://www.bloomberg.com/news/features/2017-05-18/the-barbarians-are-at-etsy-s-hand-hewn-responsibly-sourced-gates.

20 *Id.*

21 *See id.*

22 Gelles, *supra* note 16.

23 *See* Caroline O'Donovan, *Some Etsy Employees Aren't Happy About The Company's More Corporate Direction*, BUZZFEED (Apr. 4, 2017), https://www.buzzfeed.com/caroline odonovan/as-etsys-new-leadership-celebrates-earnings-some-employees?utm_term=.ia WwyXdmwR#.xwp9jx6y9O.

24 Gelles, *supra* note 16.

25 John Mannes, *Etsy Lives to Fight Another Day as New Leadership Shaves Costs and Delivers an Earnings Beat,* TECHCRUNCH (Aug. 3, 2017).

consequences. It is anathema to both corporate and securities law to force companies to pursue this, or any, particular aim. Instead, corporate law leaves corporate purpose to the firms themselves.[26] Likewise, a foundational principle of securities law is noninterference with corporate operations.[27] Further still, the corporate-purpose rigidity contravenes principles of federalism and private ordering, and renders entrepreneurs less innovative, investors less diversified, and equity markets less stable.[28] The response to all this is to halt hedge-fund activism.

This Article makes three primary contributions to the literature. First, it introduces and deeply explores the concept of *de facto* shareholder primacy.[29] This brings an entirely new dimension to the corporate-purpose debate, which has so far been stuck in corporate law. Second, viewing securities regulation through the lens of *de facto* shareholder primacy provides a fresh way to analyze hedge-fund activism—the social-welfare consequences of which is one of most hotly debated topics in law and finance.[30] The new perspective reveals that the current debate fails to

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[26] *See infra* Part I.E.

[27] *See infra* notes 267-269 and accompanying text.

[28] *See infra* Part II.J.

[29] *See infra* Part II.

[30] *See* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L. J. 1870, 1871 (2017) ("Few topics are sexier … now than whether activist hedge funds are good for, a danger to, or of no real consequence to public corporations and the people who depend upon them."). As it stands, pillars of corporate and securities law stand on opposite sides of the controversy. *Compare* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1643 (2013) (arguing that hedge-fund activism provides useful management accountability), *and* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (arguing that hedge-fund activists are important "governance intermediaries"), *with* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 592-95 (2016) (arguing that hedge-fund activism raises a host of concerns and suggesting reform), *and* Leo E. Strine, Jr., *supra* note 30, at 1873-74 (arguing that the interests of activist hedge funds do not align with long-term investors and suggesting reform). One of the most influential and acerbic critics of hedge-fund activism is Martin Lipton of Wachtell, Lipton, Rosen & Katz. *See, e.g.,* Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Feb. 26, 2013, 9:22 AM), http:// blogs.law.harvard.edu/corpgov/2013/02/26/bitethe-apple-poison-the-apple-paralyze-the-company-wreck-the-economy ("[A]ctivists are aided and abetted by Harvard Law School Professor Lucian Bebchuk who leads a cohort of academics who have embraced the concept of 'shareholder democracy' and close their eyes to the real-world effect of shareholder power, harnessed to activists seeking a quick profit, on a targeted company and the company's employees and other stakeholders."). The debate is currently mired in dueling empirical studies that ultimately cannot answer the questions at the heart of the controversy. For reviews of the extensive empirical literature, see generally Yvan Allaire &

appreciate how activism interacts with the securities laws.[31] By situating the debate in its proper institutional context, this Article for the first time shows the full scope of the harms that activists cause. Third, the Article offers a simple way to eliminate activism that flows from this new, more fulsome, understanding.[32]

The proposal, which the SEC could implement without congressional involvement, is to reform one of securities regulations' many disclosure rules.[33] Currently, investors are required to report their holdings and material plans for the firm once they have acquired 5% of a target company's shares.[34] If investors were required to report acquisition and intervention plans before they buy any shares with the intent to influence corporate affairs, then activism would end. The reporting would lead to increased stock prices in anticipation of the intervention.[35] This would deprive hedge funds of the ability to buy low from unsuspecting shareholders and sell high when the market adjusts to their presence. The securities laws would recede from corporate purpose, giving firms the flexibility that is the hallmark of corporate law and, in turn, fostering innovation, adding opportunities for investors, and lending stability to markets.

The remainder of this Article proceeds as follows. Part I briefly overviews the shareholder primacy and stakeholder theories of corporate purpose, and shows that corporate law (with a focus on Delaware) is agnostic. Part II shows how the securities laws, because of the activities of activists, impose *de facto* shareholder primacy. It also shows that *de facto* shareholder primacy runs counter to principles of federalism and private ordering, and that these conflicts translate to real-world harms. Part III reconceptualizes the debate about hedge-fund activism around whether it is good public policy to allow hedge funds to use the securities laws to dictate corporate purpose. This new framework reveals a strong argument for curbing their influence. This Part ends with a modest proposal to end hedge-fund activism and *de facto* shareholder primacy.

François Dauphin, "Activist" Hedge Funds: Creators of Lasting Wealth? What do the Empirical Studies Really Say? (July 25, 2014), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2460920; Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185 (2009); Coffee & Palia, *supra* note 30, at 581-92.

[31] *See infra* Part III.

[32] *See infra* Part III.C.

[33] *See id.*

[34] *See* 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-l (2011); Form of Schedule 13D, 17 C.F.R. § 240.13d-101 (2014).

[35] Studies show that the gains from activism occur around when they announce their holdings and plans. *See* Coffee & Palia, *supra* note 30, at 551 & n.14.

I. THEORIES OF THE FIRM AND CORPORATE PURPOSE

The competing theories of corporate purpose are based on competing positive theories on the nature of the firm (i.e., theories about what firms are). Shareholder primacy theory is based on a "nexus-of-contracts" view[36] and stakeholder theory is generally based on an "entity" view.[37] These theories about what firms are translate into normative views about how they should act—the heart of the corporate-purpose debate.[38]

A. "Nexus of Contracts" and Shareholder Primacy

The nexus-of-contracts view is the foundation of an elegant model of firm behavior and corporate purpose. Jensen and Meckling (J&M) popularized this theory in their famous article, *The Theory of the Firm.* According to J&M, a firm "is a set of contracts among customers, suppliers, investors, managers, employees, and third-parties … with the legal fiction of the corporation serving as the central node through which all of these contractual relationships are mediated."[39] This nexus of contracts "is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals."[40]

These residual claimants are shareholders. Because they own the residual, which is a variable claim dependent on how the firm is run, J&M view management as the shareholders' agents, duty-bound to maximize their wealth.[41] To the extent they fail to wholeheartedly devote themselves to this goal, management imposes "agency costs" on shareholders.[42] The role of corporate law under this view of the firm is to police these agency costs.[43] Implicit in all of this is a theory of corporate purpose and how the law relates to it: a corporation's purpose is to serve shareholders, in particular, to

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[36] *See* Michael C. Jensen & William H. Meckling, *Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).
[37] *See* Joseph L. Bower & Lynne S. Paine, *The Error at the Heart of Corporate Leadership*, 95 HARV. BUS. REV. 50, 57–59 (2017).
[38] This section only scratches the surface of the corporate-purpose debate. For more comprehensive treatments, see Belinfanti & Stout, *supra* note 9, at 586-96; Henry Hansmann & Reinier Kraakman, *The End of History For Corporate Law,* 89 GEO. L.J. 439, 440-49 (2000–2001).
[39] Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 320 (1993).
[40] Jensen & Meckling, *supra* note 36, at 311.
[41] *Id.*
[42] STOUT, *supra* note 1, at 18–19.
[43] D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1059 (1996) ("Under the contractarian model, the purpose of the corporate governance system is the minimization of agency costs.").

maximize their wealth, and corporate law is there to police obedience to this purpose.

What makes this account—the shareholder primacy view—particularly appealing is its link to the efficient market hypothesis ("EMH"). Under EMH, stock prices reliably reflect the value of firm equity.[44] Thus, management's performance can be measured by a single, instantly accessible, figure—the firm's stock price—a second-by-second appraisal of shareholder well-being. Management is thus guided by a simple heuristic: maximize share price.[45]

J&M present their view of the firm as a positive theory, but like all positive theories, it carries normative implications. In line with J&M's view, Milton Friedman famously argued that the "social imperative of business is to increase its profits."[46] The logic behind this claim is that, since shareholders are residual claimants, and all other contractual counterparties to the firm have fixed claims, the way to maximize total value is to maximize the value of the residual.[47]

The foregoing is the orthodox law-and-economics account of the firm—it is a nexus of contracts overseen by the firm's executives, who have a duty to maximize shareholder wealth as measured by share price.[48]

Economists and legal scholars have hotly debated these ideas. As a positive matter, critics raise a number of problems with this characterization of the firm. Some of the most prominent critiques include the following: because firms can hold property, they are more than a mere contractual node;[49] because shareholders lack the requisite control, the relationship between shareholders and management is not truly one of "agency" as defined by law;[50] because shareholders have discordant interests, most notably between short- and long-term holders, the command to serve shareholders is incoherent;[51] and because others are affected by the firm's

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[44] *See* Jeff Schwartz, *Fairness, Utility and Market Risk*, 89 OR. L. REV. 175, 201-02 (2010).
[45] *See* Theresa A. Gabaldon, *The Story of Pinocchio: Now I'm a Real Boy*, 45 B.C. L. REV. 829, 848 (2004) (describing stock price as the "modern surrogate for shareholder primacy").
[46] Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits,* N.Y. TIMES MAGAZINE, Sept. 30, 1970, at 32.
[47] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 263 (1999).
[48] *See* Hansmann & Kraakman, *supra* note 38, at 447. There is also a less strident version of this theory in which management has a duty only to shareholders, but their interests stretch beyond wealth maximization to things like clean air and fair employment practices. *See* STOUT, *supra* note 1, at 90. This version turns shareholder primacy into a type of stakeholder theory, where broader shareholder values, in principle, dictate how the firm balances stakeholder interests.
[49] *See* Blair & Stout, *supra* note 47, at 268.
[50] *Id.* at 290-91.
[51] *See* Jill Fisch, *Measuring Efficiency in Corporate Law*, 31 J. CORP. L. 637, 661 (2006).

decisions, shareholders are not the only holders of variable claims.[52] To flesh out the final argument, bondholders, for instance, have interests that in many ways conflict with those of shareholders.[53] One example is that a firm might increase its debt load. This action might improve shareholder returns, but it reduces the value of outstanding bonds.[54] Thus, shareholder friendly actions can constitute wealth transfers from other stakeholders.

The positive critiques of the accuracy of J&Ms model bleed into normative ones based on both efficiency and distributional (i.e., fairness) concerns. Most importantly, if the shareholders are not the only ones impacted by management's actions, then it does not follow that corporate leadership should act solely on their behalf. In this case, the firm may generate more total value by balancing the competing claims, which would provide incentives for other stakeholders to make long-term investments in the firm's success.[55]

The distributional argument focuses on the externalities generated from a focus on shareholders.[56] For instance, under a shareholder primacy view, a firm has the incentive to pollute the waterways of local communities if it would generate shareholder value. This might be inefficient if the community's needs are weighed in the cost-benefits equation. But even if stockholders gain by more than the community loses (a net benefit calculation consistent with Kaldor-Hicks efficiency), it could reasonably be argued that this distribution of resources—from those unfortunate enough to live downstream from a polluter to those with money to invest in the offending enterprise—is unfair.[57]

B. "Entity" Theory and Stakeholder Theory

Those who reject the nexus-of-contracts view and, among other things, its implications for corporate purpose, argue that the corporate entity is more than a contracting convenience. Although there are many theories that seek to reify the firm, the one that is the best foil to the nexus-of-contracts—and in my view, has the most appeal—is sometimes referred to

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[52] Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2014 (2013).
[53] *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1928 (2013) ("it is now clear that increasing the alignment of managers and shareholders can have a significant effect on bondholders").
[54] Stout, *supra* note 52, at 2011.
[55] Blair & Stout, *supra* note 47, at 315.
[56] Belinfanti & Stout, *supra* note 9, at 592.
[57] *See* Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy*, 30 COLUM. J.L. & SOC. PROBS. 587, 605-09 (1997).

as entity theory.[58] According to this view, the firm is an artificial person and the owner of its own residual.[59] "Equity," after all, appears on the corporation's balance sheet. And the firm has discretion over what to do with it. Most tellingly, the decision whether to pay out dividends from retained earnings (a portion of firm equity) belongs to management. The shareholders lack any say over when and whether they receive distributions. Under the entity view, the firm's goal is not necessarily to maximize shareholder wealth.[60] Management may balance competing interests to the extent it deems fit—acting on behalf of the entity within legal bounds.[61]

Entity theory thus opens the door to stakeholders.[62] Who constitutes a stakeholder is the subject of debate,[63] but one commonly used (and broad) definition is that the term stakeholder encompasses "[a]ny group or individual who can affect or is affected by the achievement of the firm's objectives."[64] Under this definition, employees, consumers, suppliers, and owners are commonly listed, as well as an oblique reference to something like "broader society."[65]

These groups include those who make some investment in the firm, broadly construed.[66] Shareholders invest money. Employees invest human capital. Members of society invest through taxes, which go to fund infrastructure on which corporations depend. In addition, by granting corporations limited liability, society has made an implicit bargain with corporate shareholders.[67] While this may benefit society on the whole, everyone bears a small cost for this exchange and has thereby made an investment in these enterprises. Another way to picture stakeholders is in terms of externalities.[68] For instance, those who live in a valley downwind of

58 *See id.* at 586-87; Bower & Paine, *supra* note 37, at 60; Dodd, *supra* note 8, at 1146.
59 Stout, *supra* note 52, at 2013.
60 *See* Bower & Paine, *supra* note 37, at 60 (describing the function of corporations under entity theory as to "provide goods and services; provide employment; create opportunities for investment; drive innovation").
61 *See* Dodd, *supra* note 8, at 1159–63.
62 Not all who reject shareholder primacy, embrace entity theory. *See* Blair & Stout, *supra* note 47 at 254 (arguing for a stakeholder-oriented model from a nexus-of-contracts perspective).
63 *See* Eric W. Orts & Alan Strudler, *The Ethical and Environmental Limits of Stakeholder Theory*, 12 BUS. ETHICS Q. 215, 215 (2002).
64 EDWARD FREEMAN, STRATEGIC MANAGEMENT, A STAKEHOLDER APPROACH 46 (2010).
65 Orts & Studler, *supra* note 63.
66 *See id.*
67 *See* Stefan J. Padfield, *Corporate Social Responsibility & Concession Theory*, 6 WM. & MARY BUS. L. REV. 1, 23 (2015).
68 *See* James A. Stieb, *Assessing Freeman's Stakeholder Theory*, 87 J. BUS. ETHICS 401, 407 (2009).

a company's emissions are stakeholders because they are "affected by" the firm, namely the negative externalities of its actions.

The normative arguments for stakeholder theory are the corollary to the efficiency and distributional critiques to shareholder primacy noted above. Briefly, it is argued that it would be more efficient to balance stakeholder interests because doing so would encourage stakeholder engagement, and firms with strong stakeholder support maximize total value over the long-term.[69] Moreover, it would be fairer to balance such interests because it would avoid the concentration of wealth in shareholders to the detriment of, for example, employees and community members.[70] Consistent with these arguments, under the leading theory of business ethics, managers are encouraged to maximize a "triple bottom line"—profits, people, and planet.[71]

Like shareholder primacy, stakeholder theory has endured decades of critique. The most important revolves around accountability. Critics argue that allowing managers to balance stakeholder interests in whatever manner they please is an invitation to abuse. Accountability to everyone equates to accountability to no one. The promised efficiency and fairness gains, therefore, may be overrated or even chimerical.[72]

C. Shareholder Primacy Reimagined—Long-Term Shareholder Value and Efficient Markets

The idea that firms should pursue long-term shareholder value is a version of shareholder primacy that highlights the role of stakeholders in the

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[69] Blair & Stout, *supra* note 47, at 292; Michael C. Jensen, *Value Maximization and Stakeholder Theory*, HARV. BUS. SCH.: WORKING KNOWLEDGE (July 24, 2001) http://hbswk.hbs.edu/item/value-maximization-and-stakeholder-theory ("[I]f we tell all participants in an organization that its sole purpose is to maximize value, we would not get maximum value for the organization.").

[70] *See* Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 80-81 (1995).

[71] *See Triple Bottom Line*, THE ECONOMIST (Nov. 17, 2009), http://www.economist.com/node/14301663. ("In business ethics, the leading view is that corporate managers should balance the interests of all the constituencies affected by a firm's actions, including employees, suppliers, consumers, owners, and the broader society ('stakeholder theory').").

[72] *See* Stephen Bainbridge, *A Duty to Shareholder Value,* N.Y. TIMES (Apr. 16, 2015, 6:46 AM), https://www.nytimes.com/roomfordebate/2015/04/16/what-are-corporations-obligations-to-shareholders/a-duty-to-shareholder-value. For the stakeholder theory response, see KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES, 231-33 (2006); Dallas, *supra* note 7, 559 (arguing that decision-makers can be held accountable to multiple constituencies).

calculus.[73] Proponents of this view point out that shareholder primacy means a commitment to maximizing the fundamental value of the firm[74] (i.e., the discounted present value of the shareholders' future cash flows).[75] The way to maximize this figure likely means looking out for the long-term prospects of the firm, which includes considering the interests of stakeholders.[76] Over time, the most valuable firms are likely the ones that are good to their employees and the community.[77]

While this theory may be the most influential,[78] largely because it has been endorsed by the Delaware courts,[79] the introduction of this concept has done little to quell debate. In putting shareholders first, it fails to convincingly address the efficiency and distributional critiques levied earlier. It may not always be most efficient to prioritize shareholders in balancing competing stakeholder concerns (for instance, group welfare may be enhanced by privileging employee interests).[80] With respect to fairness, shareholders may never internalize the cost to certain non-shareholders, like

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[73] *See* Claire A. Hill & Brett H. McDonald, *Short and Long Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?* 17 (U. Minn. Research Paper No. 15-37), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699324.

[74] *See* Cliff Asness, *Shareholder Value is Undervalued*, AQR INSIGHTS (Jan. 2015), https:// www.aqr.com/Insights/Perspectives/Shareholder-Value-Is-Undervalued#_ftn2.

[75] *See* Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation,* 39 J. CORP. L 347, 363 (2014).

[76] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991) ("maximizing profits for equity investors assists the other 'constituencies' automatically…A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profit (and jobs). Prosperity for stockholders, workers, and communities goes hand in glove with better products for consumers.").

[77] *See* Asness, *supra* note 75 (Companies maximize shareholder value by "having some combination of great products, perhaps a mission that is truly beneficial to the world, satisfied customers or clients, and a team of employees that is motivated to deliver."); Belinfanti & Stout, *supra* note 9, at 619–20 ("[E]xecutives who publicly espouse shareholder value as their ultimate objective . . . still emphasize that the best way to achieve that objective is not to focus directly on trying to 'maximize' profits or share price, but instead to pay close attention to the company's sales trends, employee morale, customer satisfaction, supply chain, and reinvestment initiatives.").

[78] *See* Stout, *supra* note 56, at 589; Jensen, *supra* note 72; Strine, *supra* note 9, at 768.

[79] *See infra* Part I.E.

[80] *See* Bower & Paine, *supra* note 37, at 58 ("Agency theory's implied decision rule—that managers should always maximize value for shareholders—oversimplifies this challenge and leads eventually to systematic underinvestment in other important relationships."); Lynn Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1198 (2002) ("[S]hareholder primacy can easily produce results that are inefficient…[T]he ideal rule of corporate governance, at least from an efficiency perspective, is to require corporate directors to maximize the sum of all the risk-adjusted returns enjoyed by all of the groups that participate in firms").

affected communities, especially if they are not local residents.[81]

Moreover, whether the long-term shareholder value view is truly an innovation depends on the validity of EMH. If stock prices are efficient, then this view is merely a restatement of the traditional law-and-economics version. Since the price would reflect its long-term prospects, any gain would reveal an increase in the long-term value of the firm.[82] Only in an inefficient market would share prices deviate from long-term value. If this is the case, then long-term value theory has significantly different implications than the original—managers should maximize long-term value rather than current stock prices.

This distinction is particularly important. It not only distinguishes strains of shareholder primacy. As further discussed in Part II, whether share prices reflect fundamental value is also essential to the debate about the consequences of hedge-fund activism.[83] There are a number of things that companies can do—and that hedge funds push—that have short-term benefits but long-term costs. Squeezing more out of current employees might increase firm value in the short term, but in the long-term they quit. The cost of hiring and training new personnel then eats into future profits. Cuts to research and development save money now, but over time a company loses its competitive edge. Companies can decrease the quality of their products to save costs. But eventually customers will switch. Professor Stout uses the imagery of fishing with dynamite.[84] It might a produce a record catch, but the long-term welfare of the fishing company is destroyed.[85]

In an efficient market, stock prices would accurately reflect the short-term/long-term tradeoff.[86] A company that starts making inferior goods would see a stock decline. If stock prices can deviate significantly from long-term value, however, then such moves could result in a stock-price bump. Despite the increase in stock prices, actions where short-term benefits are outweighed by future costs would be inconsistent with long-term value theory.

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[81] *See* GREENFIELD, *supra* note 72, at 228.

[82] *See* Jonathan R. Macey, *Market for Corporate Control*, LIBR. OF ECON. & LIBERTY, https://www.econlib.org/library/Enc/MarketforCorporateControl.html (last visited Jan. 24, 2019) ("Share prices reflect the [p]resent [v]alue of future returns to shareholders and are, therefore, a measure of the long run. Successful corporate strategies, even those that are not expected to produce positive returns for years, will generate immediate increases in share prices.") (internal citations omitted).

[83] *See infra* notes 212-224 and accompanying text.

[84] STOUT, *supra* note 1, at 51.

[85] *Id.*

[86] *See* Macey, *supra* note 82.

Research in behavioral finance suggests that, despite long-term consequences, short-term actions can increase stock prices. Prices that reflect future prospects are the result of efficient markets. Efficiency require arbitrage trading—informed buying and selling behavior that corrects mispricings. The central insight of behavioral finance is that arbitrage is inherently risky and expensive, and that stock prices deviate from fundamental value to the extent of these costs.[87] The prediction of inaccurate stock prices is backed by a mountain of empirical evidence.[88]

One particularly relevant reason why short-term moves can cause a deviation has to do with the structure of institutional investing. For the short-term and long-term to align, sophisticated institutions need to buy, sell, or short-sell stocks that are mispriced in the hopes that they will return to fundamental value in the future. Estimating the fundamental value of a security in the long-term, though, is costly and uncertain.[89] The future is inherently unknowable. And stock prices only return to fundamental value if others in the market eventually agree with a prescient analyst's assessment. But broader market awareness of a long-term mispricing may take a long time. In a competitive institutional marketplace, where money managers are judged on short-term results, analysts may lose their jobs before their bet pays off.[90]

Because of the inherent uncertainty of long-term valuation and the risk of investor flight before the market catches up, picking stocks based on fundamental value is generally a bad way to make money. That being the case, few do it. A recent study showed that 85% of analysts use metrics that are only loosely related to fundamental analysis to assess companies.[91] The use of the price-earnings ratio, for example, is common.[92] Valuation is based simply on comparing this figure to other like companies. There is no calculation of discounted cash flows. If much of the smart money is ignoring long-term valuation, then there is a significant chance that today's prices are far off from the correct value.[93]

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[87] Schwartz, *supra* note 44, at 204–21.

[88] Halliburton Co. et al. v. Erica P. John Fund, Inc., 573 U.S. 258, 291 (2014) ("'Overwhelming empirical evidence' now suggests that even when markets do incorporate public information, they often fail to do so accurately.") (quoting Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b–5 Damages: A Legal, Economic and Policy Analysis*, 47 STAN. L.REV. 7, 20–21 (1994)); Belinfanti & Stout, *supra* note 9, at 593 n.70.

[89] *See* Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYST J. 65, 65 (2005).

[90] *See* Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term*, 66 BUS. L. 1, 12 (2010).

[91] *See* Rappaport, *supra* note 89, at 65 n.8.

[92] *See id.* at 68.

[93] *See id.*

In light of the behavioral finance critique of efficient markets, the most plausible view is that share prices largely reflect short-term valuations, with some anchor to fundamental value. If the distance between short-term values and real value becomes too far off, this opens up an arbitrage opportunity despite the costs and risks. But the distance is unknown and potentially wide. This means that steps that improve the short-term prospects of a company, even if they reduce its long-term value, have the potential to increase stock prices—even over an extended period.

The challenges to market efficiency mean that long-term value theory is more than a restatement of the orthodox approach, where share price equates to value. In fact, in light of these challenges, defenders of the orthodox approach must either fall back to long-term value theory or argue that managers should still maximize stock prices even though the link to fundamental value is unknown (and unknowable). The former runs into accountability problems similar to those faced by stakeholder theory.[94] Almost any action can be framed as in the interests of long-term value, and stock prices are an unreliable lodestar.[95]

The latter view that managers should maximize stock prices regardless of their accuracy could be defended on the grounds that maximizing stock prices literally maximizes shareholder value. But this stance is normatively problematic. It amounts to an instruction to management to sacrifice the future in favor of the present if it means a higher stock price. Acting like this, however, destabilizes markets and hinders innovation.[96] It is path to nowhere. In a search of the literature, I could not find anyone who endorsed the view that short-termism regardless of future consequences was a promising corporate purpose. As I argue in Part II, however, this warped view of shareholder primacy is the one that the securities laws force on public firms.

D. An Unsettled Debate

Over time, managers have embraced disparate views of corporate purpose. In the United States, waves of shareholder primacy thinking and stakeholderism rise and fall.[97] After World War II until the 1970s, managers saw themselves as stewards for the firm and its constituents.[98] The 1980s saw the rise of shareholder primacy.[99] And these swings do not necessarily

94 *See* Belinfanti & Stout, *supra* note 9, at 585.
95 *See id.* at 598.
96 *See infra* Part II.J.
97 *See* Dallas, *supra* note 7, at 497-530; Rock, *supra* note 53, at 1912-13.
98 Dallas, *supra* note 7, at 506-07.
99 *See id.* at 508.

align with attitudes in other countries. Continental Europe, for instance, is known for a stakeholder orientation.[100] The variation means that there is no intrinsic "corporate purpose"; rather it is driven by norms and law.

What the norms or laws should be is also uncertain. From an efficiency perspective, the question is which maximizes social welfare. It might maximize welfare for management to favor long-term shareholder interests; let contractual counterparties fend for themselves; and lean on regulators to address negative externalities.[101] On the other hand, this may put too much faith in private ordering and regulatory capacity. The result might be stakeholder underinvestment and diffuse economic, social, and environmental harms. From a fairness perspective, the question is which corporate purpose leads to a more equitable distribution of resources. Again, there are two plausible outcomes. It may be better for management to have a single-minded shareholder focus and for society to handle distributional questions through tax policy or other social interventions. It could also be the case, however, that social redistribution and other programs are too blunt, and that management is better situated to decide how to equitably handle competing interests related to the business. And there would still be room for broader social redistribution to address imbalances.

Since there are no clear answers, this may be something that is best left to entrepreneurs to decide for themselves.[102] If corporate purpose is left to private ordering, each corporation could choose what to maximize and how to split the surplus it creates among its constituents. Ultimately, while there has been a long-standing and heated debate about corporate purpose, corporate law takes this final approach.

E. Corporate Law and Theories of Corporate Purpose

State corporate law governs the internal affairs of corporations.[103] It sets out the default organizational structure of firms and the fiduciary duties of management.[104] Entrepreneurs choose in which state to incorporate partly

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[100] *A New Idolatry*, THE ECONOMIST (April 22, 2010), http://www.economist.com/node/15954434#print; Dallas, *supra* note 7, at 558.

[101] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 579 (2003).; Rock, *supra*, note 53, at 1930; Strine, *supra* note 9, at 792–93.

[102] *See* EASTERBROOK & FISCHEL, *supra* note 76, at 36.

[103] *See* Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine*, 75 CALIF. L. REV. 29, 32 (1987).

[104] *See* EASTERBROOK & FISCHEL, *supra* note 76, at 15, 90-91.

based on these rules, and Delaware is far and away the most popular.[105] The default rule in Delaware requires that management adhere to the long-term value theory of shareholder primacy; it also gives shareholders legal and voting rights that theoretically allow them to police conformity. Despite this framework, however, management has a great deal of discretion to run firms as they please. Delaware corporations can easily opt out of the default structure, and other states provide additional flexibility. The result is a cafeteria-style menu of corporate-purpose options for private companies.

Delaware law clearly does not mandate a particular purpose. A company's Certificate of Incorporation can specify that the corporation takes stakeholder interests into account.[106] Whether the law imposes shareholder primacy as the default has long been debated, but the Delaware Supreme Court's decision in *eBay Domestic Holdings, Inc. v. Newmark*[107] seems to put any doubts to rest. In the case, the founders of craigslist said that they were more interested in serving the community that made use of its online marketplace than in generating shareholder value.[108] The court disapproved:

> Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders…. Thus, I cannot accept as valid … a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders.[109]

Though the language seems fairly straightforward and strict, Delaware law is not as demanding as it first appears. Delaware judges have repeatedly emphasized their commitment to "long-term shareholder value."[110] And any stakeholder-oriented action can be defended on such grounds.[111] Let us say management would like to give employees a raise. Shareholders might rightfully complain that this money comes out of their pockets, but management can respond that the added compensation is

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105 *See* Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 2003 J. L. & ECON. 383, 391 tbl.2 (57.5% of firms incorporate in Delaware; California, the next most common, claims 4.33%).
106 *See* DEL. CODE ANN. tit. 8, § 102(b)(1) (2017).
107 eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).
108 *See id.* at 8.
109 *Id.* at 34.
110 *See* Belinfanti & Stout, *supra* note 9, at 595-96.
111 *See* STOUT, *supra* note 1, at 32.

important for employee retention. Since almost any decision can be similarly justified, the command to privilege shareholders is all-but toothless.

This is particularly true given the legal standard that is applied to such challenges. The law affords extraordinary deference to management under the business judgment rule—the legal standard for adjudicating allegations of unintentional mismanagement.[112] If management provides any plausible shareholder-related defense of its actions, it will withstand scrutiny.[113] Justice Strine, the Chief Justice of the Delaware Supreme Court, concedes the point in an otherwise fiery article excoriating those who question Delaware law's commitment to shareholder primacy:

> Of course, it is true that the business judgment rule provides directors with wide discretion, and that it enables directors to justify by reference to long run stockholder interests a number of decisions that may in fact be motivated more by a concern for a charity the CEO cares about, or the community in which the corporate headquarters is located, or once in a while, even the company's ordinary workers, than long run stockholder wealth. But that does not alter the reality of what the law is…. [I]f a fiduciary *admits* that he is treating an interest other than stockholder wealth as an end in itself, rather than an instrument to stockholder wealth, he is committing a breach of fiduciary duty.[114]

The key word in that lengthy quote is that shareholder primacy only applies if management *admits* favoritism toward other stakeholders. Thus, so long as management defends its conduct through empty statements about shareholder value, its decisions are protected.[115] This leaves little of the corporate-law obligation to pursue shareholder primacy.

Although shareholders could turn to their voting rights to police management's conformity to long-term value maximization, this avenue is also of limited practical value.[116] In theory, if shareholders think that board members are favoring other interests, they could vote them out of office. Officers would soon follow. But the prospects for such upheaval are thin, at least for private companies. Since there are no explicit disclosure

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112 *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)
113 *See* Strine, *supra* note 9, at 776–77.
114 *Id.*
115 According to Justice Strine, "My point, however, is not whether the law permits directors to engage in pretext, it is what the law allows them to do expressly and forthrightly." *Id.* at 793 n.84.
116 *See* Bainbridge, *supra* note 101, at 569.

obligations under corporate law, shareholders lack the information to take such actions.[117]

The only sources of disclosure are the duties of care and loyalty, which mandate informed shareholder consent for fundamental changes or to cure conflicts of interest, or when a director is selling to a shareholder while "possessed of special knowledge of future plans from secret resources and deliberately misleads a stockholder who is ignorant of them."[118] The Delaware code also allows shareholders to demand information under Section 220.[119] Shareholders must justify any demand by reference to a "proper purpose."[120] The bar is generally low for this request, and can be satisfied by a claim that a shareholder wishes to value her shares.[121] While this right is undoubtedly of some use, managers often resist and can hold up requests in litigation.[122] The information is also confidential and cannot be shared with other shareholders.[123] While Section 220 may provide a shareholder with information on which to base a breach of fiduciary duty claim or sell shares, it is not suitable for launching a campaign to unseat management.

In the end, because the law supports only long-term shareholder value theory, because conformity is measured by the lax business judgment rule, and because shareholders lack the information to make meaningful use of their voting rights, the legal commitment to shareholder primacy is of limited real-world import. While the law creates, or at the very least reinforces, the shareholder primacy norm, a legal obligation that can be so easily abjured is rather weak.[124]

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117 *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 867 (2003) (noting that corporate law imposes few disclosure obligations).

118 Lank v. Steiner, 224 A.2d 242, 244 (Del. 1966).

119 DEL. CODE ANN. tit. 8, § 202 (2017).

120 *Id.*

121 *See* Louisiana Mun. Police Employees Ret. Sys. v. Morgan Stanley & Co. Inc., NO. CIV.A. 5682-VCL, 2011 WL 773316, at *6 (Del. Ch. Mar. 4, 2011).

122 *See* Rolfe Winkler, *Startup Employees Invoke Obscure Law to Open Up Books*, WALL ST. J. (May 24, 2016), https://www.wsj.com/articles/startup-employees-invoke-obscure-law-to-open-up-books-1464082202.

123 Confidentiality is frequently imposed by the Delaware courts. *See, e.g.,* Disney v. Walt Disney Co., 857 A.2d 444, 448 (Del. Ch. 2004) ("[I]t is often the case that the Court of Chancery will condition its judgment in Section 220 cases on the entry of a reasonable confidentiality order 'to prevent the dissemination of confidential business information to 'curiosity seekers.'").

124 This account overlaps with a description of corporate law called "director primacy." Bainbridge, *supra* note 101, at 550. According to this view, the directors run corporations. *Id.* In that role, they are obligated to serve shareholders. *See id.* Shareholders, however, have little ability to police whether they do so. *See id* at 549. This Article, parts ways with director primacy in a number of respects. Most importantly, director primacy claims to describe the

And entrepreneurs can completely opt out if they wish. As noted, in Delaware, the Certificate of Incorporation can specify that the corporation takes stakeholder interests into account.[125] Further still, entrepreneurs can choose to form Delaware benefit corporations (an addition in August 2013).[126] Such corporations promise to balance stakeholder interests.[127] Thus, just within Delaware, there are a range of options. If founders find none of these setups appealing, they can opt to incorporate in a different state, with still other choices, including constituency statutes. Under these statutes, corporations explicitly have the right to take stakeholder interests into account.[128] Despite a longstanding and thoughtful debate about corporate purpose in Delaware law, all states, including Delaware, leave the decision to private ordering.

The result is that entrepreneurs, and the private companies they found, can largely do as they please with respect to corporate purpose. This approach makes sense in light of the uncertainty in the corporate-purpose debate.[129] But once a company goes public, everything changes. In imposing *de facto* shareholder primacy, the securities laws undermine this longstanding framework. For public companies, the flexibility and discretion afforded under corporate law disappears.

II. *De Facto* Shareholder Primacy and the Securities Laws

Despite impassioned debate about the corporate-purpose demands of Delaware law, the legal structure is ultimately deferential. Securities law is the opposite. The rules say nothing about corporate purpose, and nobody talks about it. But in practice, as a consequence of hedge-fund activism, the rules today effectively require conformity to the shareholder primacy norm. This section traces how this happened. The potential for *de facto* shareholder primacy is embedded in the structure of the securities laws, but it laid dormant until shifting securities markets gave rise to hedge-fund activism.

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governance of public corporations; this Article argues that, in this context, they are now in control.

125 *See* DEL. CODE ANN. tit. 8, § 102(b)(1) (2017).

126 *See* DEL. CODE ANN. tit. 8, § 362 (2017).

127 DEL. CODE. ANN. tit. 8, § 365(a) ("The board of directors shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation.").

128 Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 16 (1992).

129 *See infra* Part I.D.

A. The Basic Structure of Securities Regulation

The securities laws are famously arcane, but the overarching structure is straightforward. The centerpiece is disclosure, which is required of all public companies.[130] When companies go public, they register with the SEC, which involves filing a registration statement, consisting mainly of a sales document (the "prospectus") that typically stretches for hundreds of pages.[131] Once the SEC approves the registration statement, the company can sell shares to the public, and it becomes subject to periodic reporting obligations.[132] These include filing quarterly and annual reports, as well as brief disclosures when specified material events warrant.[133] The centerpiece of securities-law disclosures, both in the prospectus and later filings, are financial statements[134] and management's discussion thereof (so-called "MD&A").[135]

Public companies must also have policies and procedures in place to mitigate the risk of misstatements in these documents (so-called "internal controls").[136] The internal controls that relate to financial reporting must be audited by an independent accounting firm.[137]

Rules also touch directly on corporate governance and shareholder rights. NYSE and Nasdaq listing requirements, for instance, require that public companies have majority independent boards, and that they have wholly independent audit, compensation, and nominating committees.[138] While the listing requirements are technically part of stock market rules, they are functionally part of securities regulation.[139]

Shareholder voting is federally regulated through the proxy rules.[140] These require that public companies provide shareholders with disclosures to inform their voting with respect to board membership and any other matters upon which their consent is sought.[141] In addition, these rules dictate

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130 Schwartz, *supra* note 44, at 181.
131 *See* 17 C.F.R. § 230.404 (2011).
132 *See* 17 C.F.R. § 240.13a–13 (2008); 17 C.F.R. § 240.15d–1 (2018).
133 *See* 17 C.F.R. § 240.13a–13 (2008).
134 *See* 17 C.F.R. §§ 210.3-01–210.3-20 (2009).
135 *See* 17 C.F.R. § 229.303 (2017).
136 *See* 17 C.F.R. § 229.308 (2017); 15 U.S.C. § 7262 (2012).
137 17 C.F.R. § 210.2-01 (2005).
138 This is technically a listing standard for the New York Stock Exchange and Nasdaq, but it is federally mandated. *See* 15 U.S.C. § 78j-1 (2010).
139 *See* Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 37 (2006) ("[T]he available evidence indicates that the organized exchanges do not even act as stand-alone regulators anymore. Instead, they are better understood as conduits for the SEC . . . .").
140 *See* 17 C.F.R. § 240.14a-2 (2011).
141 *See* 15 U.S.C. § 78n (2012).

procedures that parties must follow when soliciting shareholder votes,[142] and that public companies must include shareholder proposals in the companies' proxy-solicitation materials, provided certain conditions are met.[143] Beyond all of this, public companies must now also provide shareholders with a "say-on-pay"—an advisory vote on executive compensation.[144]

Going public, however, is the exception. Firms can stay private in a number of ways, most importantly by selling shares only to financially sophisticated individuals or institutions.[145] Sophistication is almost always determined by a financial proxy—the accredited investor standard, which essentially deems parties sophisticated if they meet certain wealth or income thresholds.[146]

Regardless of whether a company is public or private, its behavior is subject to securities-fraud regulations.[147] Liability attaches to material misstatements made in connection with the purchase or sale of securities.[148] The SEC, the Justice Department, and private parties can bring suit.[149] If filings are false or misleading, a public company may be found liable for securities fraud even if the corporation or its management was not actively trading.[150] Insider trading (i.e., trading while in possession of material nonpublic information) is also a considered a form of securities fraud.[151]

The securities laws thus consist of a blanket anti-fraud prohibition that applies to all companies, and significant disclosure and operational requirements for firms that go public. The well-accepted overarching justification for securities regulation is "investor protection."[152] Though the public disclosures were designed to enable investors to make informed purchase and sale decisions, few believe that individual investors actually read them. Rather, the current theory is that information contained in the disclosures is baked into stock prices. This is because sophisticated investors read them, trade based on the information they contain, and prices adjust in reaction.[153]

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142 17 C.F.R. § 240.14a-3 (2008).
143 *See* 17 C.F.R. § 240.14a-8 (2011).
144 *See* 17 C.F.R. § 240.14a-21(2017).
145 *See, e.g.,* 17 C.F.R. § 230.506 (2013).
146 *See* 17 C.F.R. § 230.501 (2017).
147 *See* 17 C.F.R. § 240.10b-5 (2018).
148 *See id.*
149 Veronica M. Dougherty, *A [Dis]semblance of Privity; Criticizing the Contemporaneous Trader Requirement in Insider Trading*, 24 DEL. J. CORP. L. 83, 85 (1999).
150 Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1908 (2013).
151 17 C.F.R. § 240.10b5-1(a) (2018).
152 *See* Schwartz, *supra* note 44, at 181.
153 *See id.* at 181-86; Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113, 113-14 (1999).

B. Securities Law's Expansive Potential

The securities laws always contained the seeds of *de facto* shareholder primacy. While the primary aim of the securities laws may be investor protection, the primary contribution is broader—comprehensive and credible information about public companies that is available to everyone. Once in the public domain, the potential uses of the disclosures are limitless. Investors can use the information to help decide whether to purchase or sell securities, but anyone can use what they read for anything.

Central to this Article is that credible comprehensive disclosures allow shareholders to police whether managers are looking out for their interests. Most important are the financial statements. While they provide the information on earnings, growth, and risk that is essential for financial analysis of a potential investment, these same three metrics are important to shareholders. If earnings or growth appear stalled, they can put pressure on management to change how they operate. In theory, they could even wage a proxy contest if management's response is unsatisfying. This potential to use securities disclosures for monitoring corporate executives is an intrinsic part of the regulations.

Until recently, however, shareholders did not use the transparency afforded to them to intervene in firm affairs. A number of barriers stood in the way. These have all eroded, however, and while retail investors (i.e., nonprofessional individual investors) are still essentially powerless, hedge funds now leverage the securities laws to police management and promote their agenda.

C. The Shifting Equity Market Landscape

The changes to equity markets that set the stage for hedge-fund activism and *de facto* shareholder primacy took place in the last few decades. The most important shift has been from retail to institutional shareholders.[154]

Retail investors lack the time and skill to parse securities disclosures and intervene in firm affairs. And they have little incentive to do so. Even with the tools the securities laws provide, shareholders face a tremendous collective action problem. They bear all of the costs of monitoring management and effecting change, but share the benefits with other shareholders and perhaps even other stakeholders. It is, therefore, rational

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154 *See* Brian G. Cartwright, General Counsel, U.S. Sec. & Exch. Comm., The Future of Securities Regulation (Oct. 24, 2007) (transcript available at https://www.sec.gov/news/speech/2007/spch102407bgc.htm) (describing the growth in institutional ownership and its implications).

to stay out of firm governance and sell if prospects look bleak.[155] The idea that shareholders are rationally apathetic with respect to voting in public companies dominated thinking in this area for almost a century.[156] The ease of selling juxtaposed against the cost and difficulty of intervention[157] meant that securities disclosures were tools for investing rather than tools of management oversight.

The calculus, however, has changed. At the inception of the securities laws, equities were almost universally owned by retail investors.[158] While their ownership share has declined precipitously over time,[159] the paradigm shift came with the rise of mutual funds in the 1980s and 1990s.[160] These funds pool money from individuals and invest it in different types of securities, mainly stocks and bonds. Their assets now total nearly $20 trillion.[161] They, along with other institutions, now dominate the stock market, owning more than 70% of public-company shares.[162] And this figure understates the extent to which mutual funds and other institutions have come to dominate. They do almost all of the public-market trading.[163] Moreover, individuals are less likely to vote their shares in director elections: in 2017, individuals voted 29% of their shares while institutions voted 91%.[164] Thus, both trading and voting activity is heavily institutional.

Until recently, even as they amassed large holdings, institutions tended to stay out of firm affairs. The response to poor management was to sell.[165] But a series of developments has disrupted their passivity, making them a receptive audience for hedge funds seeking support for their activist campaigns.

Recent Department of Labor and SEC rule changes pushed for increased institutional involvement. In the 1980s, the DOL explicitly stated that responsible proxy voting was part of a pension-fund manager's fiduciary

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155 *See* Bainbridge, *supra* note 101, at 558.

156 *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 47-65 (rev. ed. 1967) (providing the canonical work on oversight problems in public firms caused by dispersed ownership).

157 *See* Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 623 tbl.7A (2013) (estimating the cost of a proxy contest waged by a hedge-fund activist to be $10.7 million).

158 *See* Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCOUNTING RESEARCH 391, 401 (2009).

159 *See id.* at 402 fig.1.

160 *See* Cartwright, *supra* note 154.

161 *See* INV. CO. INST., 2018 INVESTMENT COMPANY FACT BOOK 58 (58th ed. 2018).

162 JAMES R. COPLAND & MARGARET M. O'KEEFE, PROXY MONITOR 2017: SEASON IN REVIEW (Fall 2017), http://www.proxymonitor.org/Forms/pmr_15.aspx.

163 Zingales, *supra* note 158, at 392.

164 COPLAND & O'KEEFE, *supra* note 162.

165 Coffee & Palia, *supra* note 30, at 553.

obligations.[166] In 2003, the SEC changed its rules to "require advisers to adopt and implement policies and procedures for voting proxies in the best interest of clients, to describe the procedures to clients, and to tell clients how they may obtain information about how the adviser has actually voted their proxies."[167]

The changes caused institutions to start paying attention to proxy voting. They also fueled the rise of proxy advisory firms, which allow for partial outsourcing of oversight responsibilities and an associated cost savings.[168] Through the use of proxy advisory services, mutual funds can participate in corporate governance, and meet their legal obligations, without a significant financial drain.[169]

There have also been major shifts within the mutual-fund industry. Index fund investing has boomed in recent years.[170] Unlike active fund managers, index funds cannot sell whenever they please. Because they are required to track a particular index, the only way to improve returns is to take an active role.[171]

The industry has also become more concentrated. On average, 45% of an S&P 500 company's stock is held by its 10 largest institutional investors.[172] Taken together, three mutual-fund complexes—Vanguard, State Street, and BlackRock—are the largest shareholder in 90% of S&P 500 firms.[173]

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166 The statement first came in an interpretive letter. *See* Letter from U.S. Dep't of Labor to Mr. Helmuth Fandl, Chairman of the Retirement Bd. of Avon Products, Inc., at 3 (Feb. 23, 1988), *reprinted in* Pens. Rpt. (BNA) Vol. 15, No. 9 at 391 (Feb 29, 1988). The obligation is now codified as 29 C.F.R. § 2509.08-2 (2011).

167 U.S. Sec. & Exch. Comm., Proxy Voting by Investment Advisors; Final Rule, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003).

168 *See* Coffee & Palia, *supra* note 30, at 557.

169 *See id.* at 557–59; *see also See* James Copeland et al., *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* 2 (Stan. U. Grad. Sch. Bus. Research Paper No. 18-27, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174 (providing an overview of the proxy advisory industry).

170 *See* Trevor Hunnicutt, *Index Funds to Surpass Active Fund Assets in U.S. by 2024: Moody's*, REUTERS (Feb. 2, 2017), https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN; Ryan Vlastelia, *Passive Investing, a Winner in 2016, Shows No Signs of Stopping*, MARKETWATCH (Dec. 31, 2016), https://www.marketwatch.com/story/passive-funds-arent-afraid-to-throw-their-weight-around-as-activists-2017-05-01.

171 *See* Fisch et al., *Passive Investors* 3 (European Corp. Governance Inst. Working Paper No. 414/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069.

172 David Benoit & Kristen Grind, *Activist Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015), https://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910.

173 *See* Jan Fichtner et al., *These Three Firms Own Corporate America*, CONVERSATION (May 10, 2017), http://theconversation.com/these-three-firms-own-corporate-america-77072.

These mutual-fund complexes are not activists. But hedge-fund activism would be impossible without their concentrated ownership and engagement.[174] An activist's threat is only credible if there is widespread shareholder support. It would be extraordinarily costly and likely fruitless to lobby millions of uninformed retail investors, but it is cheap and productive to make the case to a limited group of sophisticated institutions that have a legal obligation to listen.

Institutions also aided activists through their involvement in the shareholder proposal process. They backed, and in some cases pushed for, changes that have shifted power to shareholders. Shareholder proposals tend to cluster into three categories: corporate governance reforms that increase shareholder power, executive compensation, and social policy.[175] While shareholder proposals can be made by shareholders with only minimal holdings[176]—and in fact are commonly made by individuals (so-called "gadflies")[177]—it is institutional support that gives them teeth. Their votes ultimately determine what gets implemented. While proposals with little support have little influence, those with majority support frequently become company policy.[178]

The institutional vote has tended to back shareholder-empowering proposals and those that address executive compensation, while rejecting proposals with a social aim.[179] The support for shareholder-friendly proposals has led to a spate of corporate governance changes, such as proxy access, declassified boards, simple majority voting, and separation of the CEO and Chairman-of-the-Board positions.[180] Without getting into detail, these changes loosen management's control over boards and foster shareholder involvement in director nomination and selection. Although this was not what institutions had in mind in lending their support, the shift in the balance of power toward shareholders eased the path for activism, a hallmark of which is confrontation with incumbent boards.

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174 Strine, *supra* note 30, at 34 ("Without the support of … mainstream funds, the activist hedge fund leader would not have the clout to extract favorable concessions in a settlement, much less to prevail in a contested proxy fight").

175 *See* COPELAND & O'KEEFE, *supra* note 162.

176 *See* 17 C.F.R 240.14a-8 (1998) (requiring holdings of $1,000 in market value or $2,000).

177 *See* COPLAND & O'KEEFE, *supra* note 162.

178 *See* Luc Renneboog & Peter G. Szilagyi, *The Role of Shareholder Proposals in Corporate Governance*, 17 J. CORP FIN. 167, 167 (2011).

179 John Roe, *Shareholder Proposals: Evidence of Private Ordering Supplanting Public Policy?*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (June 19, 2017), https://corpgov.law.harvard.edu/2017/06/19/shareholder-proposals-evidence-of-private-ordering-supplanting-public-policy/.

180 COPLAND & O'KEEFE, *supra* note 162.

Finally, as the barriers to activism declined, the hedge-fund industry has also matured. In the 1980s and 1990s hedge funds prospered with novel arbitrage strategies.[181] But the low-hanging fruit has been picked and the fund marketplace has become crowded.[182] With more pliable boards and concentrated ownership, active engagement with companies became a newly promising way to make money for their investors.

D. The Strategy of Hedge-Fund Activists

Against this backdrop, activist hedge funds have proliferated. Their strategy is straightforward. The funds first research companies and select their target.[183] They then purchase a portion of the company's stock, typically around six to eight percent.[184] Funds also join together in so-called "wolf packs." In this case, a group of funds invest in a target before the lead fund's intervention is publicly disclosed.[185] Next, hedge funds pressure management for change and lobby institutional investors to support their position.[186] If management does not immediately concede, the fund publicly criticizes firm leadership, and if that does not work, they wage a proxy contest to gain board seats and push their agenda.[187]

Institutional investors frequently support activist campaigns. While they do not always go along, proxy advisory firms and mutual funds have shown themselves often to be receptive to the activists' proposals.[188] There

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181 *See* David Finstad, *Have Institutional Investors Spoiled the Hedge Fund Party*, INSTITUTIONAL INVESTOR (Oct. 21, 2018), https://www.institutionalinvestor.com/article/b1bh5sbz82rzbx/Have-Institutional-Investors-Spoiled-the-Hedge-Fund-Party.

182 *See id.*

183 *See* Damien J. Park, *Activist Investors and Target Identification*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (JUNE 23, 3016), https://corpgov.law.harvard.edu/2016/06/23/activist-investors-and-target-identification/; *How to Outsmart Activist Investors*, HARV. BUS. REV. (May 2014), https://hbr.org/2014/05/how-to-outsmart-activist-investors.

184 *See* Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 4-5, 15 (2013) (finding a median ownership interest of 6.3%); C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 300 (2016) (finding median ownership of 8.3%).

185 Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Jan. 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors/.

186 Allaire & Dauphin, *Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence*, *supra* note 30, at 17.

187 *Id.*

188 Allaire & Dauphin, *supra* note 30, at 42 (describing "strong support" from institutional investors); Coffee & Palia, *supra* note 30, at 568 ("Although [proxy adviser] recommendations do not invariably favor the insurgents, they do support the insurgents

is also anecdotal evidence that mutual funds nudge activists towards certain engagements.[189]

Activist interventions fall into roughly four categories. The first involves challenges to the governance of the target firm. They might seek to change the structure of corporate governance or the makeup of management.[190] For example, funds might push to increase board independence or remove the CEO.[191] The second involves demands to distribute corporate cash to shareholders. Along these lines, funds will commonly demand dividend payments or stock buy-backs (even if companies must borrow to raise the necessary funds).[192] Third, activists call for corporate reorganizations. They argue that the target should be sold[193] or that it should spin-off a division or substantial assets.[194] Finally, activists look for ways to reduce costs.[195] They might advocate cuts to executive compensation,[196] research and development, or staff.[197] Hedge funds have also pushed for ways to reduce the targets' taxes, including inversions.[198]

Companies initially resist,[199] but they frequently concede to activist demands. In about 75% of cases they enact the activist's agenda in whole or in part.[200] Usually companies accede as part of a privately negotiated settlement in which hedge funds also receive board seats.[201] If companies are

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much of the time"); Strine, *supra* note 30, at 1898 (describing mutual-fund support of activists).

189 *See* Strine, *supra* note 30, at 1898 & n.98; Che Odom, *Long-Term Investors Increasingly Hiding Behind Activists*, BLOOMBERG BNA (March 16, 2016), https://www.bna.com/longterm-investors-increasingly-n57982068614/.

190 Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1742 (2008).

191 *Id.*

192 *Id.*

193 *Id.*

194 *Id.*

195 Allaire & Dauphin, *supra* note 30, 16.

196 Brav et al., *supra* note 190, at 1742 (showing that almost 5% of activists target executive compensation).

197 Allair & Dauphin, *supra* note 30, at 22-24 (showing significant declines in the number of employees and the amount spent on R&D); Roger L. Martin, *Activist Hedge Funds Aren't Good for Companies or Investors, So Why Do They Exist*, HARV. BUS. REV. (Aug. 20, 2018), https://hbr.org/2018/08/activist-hedge-funds-arent-good-for-companies-or-investors-so-why-do-they-exist.

198 Strine, *supra* note 30, at 789–90.

199 Brav et al., *supra* note 190, at 1746 ("[T]arget companies choose to…resist [hedge fund intervention] 41.3% of the time.").

200 *See* Allaire & Dauphin, *supra* note 30, at 18 (finding 75.7% of hedge funds partially or completely achieved their stated goals).

201 *See* Kai Haakon & Liekefett, *The Hypocrisy of Hedge Fund Activists*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (June 4, 2018), https://corpgov.law.harvard.edu/ 2018/06/04/the-hypocrisy-of-hedge-fund-activists/.

unwilling to settle, and a proxy contest ensues, hedge funds win 60% of the time.[202]

E. *De Facto* Shareholder Primacy

Activist interventions, and the larger shadow they cast, are forcing firms to adopt the myopic view of shareholder primacy, where shareholder welfare is judged by share price regardless of its link to fundamental value.[203] The changes to board governance that hedge funds advance build on previous efforts by institutions and others to reduce managements' influence over boards. Hedge funds present these more sympathetic boards with proposals to increase stock prices.

Increasing stock prices is, and always is, their goal.[204] They pursue it regardless of the impact on stakeholders and long-term shareholders. Which is no surprise. It is, after all, what their own investors demand. Even though hedge funds have no interest in corporate purpose per se, because their actions focus solely on immediate stock-price gains irrespective of other interests, their actions, when viewed in such terms, compel companies to pursue a version of shareholder primacy that ignores long-term consequences.

Activists' record in generating stock-price gains is mixed. On the whole, hedge-fund activists cause stock-price improvements.[205] But not all interventions are equally profitable. Sale of the target reliably generates strong returns, but other interventions are less fruitful.[206] Some generate gains; others losses.[207] Overall, such interventions perform slightly worse than a random sample of firms.[208] Just as in stock picking, there are better and worse activist investors.[209]

Those interventions that do generate above-market gains must do so from wealth transfers from stakeholders and long-term shareholders,

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[202] April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188 (2009).
[203] *See supra* notes 94-96 and accompanying text.
[204] *See* Strine, *supra* note 30, at 1892 ("[A]ctivist hedge funds identify companies and take an equity position in them only when they have identified a way to change the corporation's operations in a manner that the hedge fund believes will cause its stock price to rise.").
[205] *See* Coffee & Palia, *supra* note 30, at 583 ("Most studies have found that target firms of activist hedge funds earn on average positive abnormal returns in the event window.").
[206] *See* Allaire & Dauphin, *supra* note 30, at 34, 42; Strine, *supra* note 30, at 1944.
[207] *See* Coffee & Palia, *supra* note 30, at 584-85.
[208] *See* Allaire & Dauphin, *supra* note 30, at 33 (finding the mean total shareholder return for firms with activists involved was 12.42% while a random sample of firms produced a mean total shareholder return of 13.92%).
[209] *See* Krishnan, et al., *supra* note 184, at 296.

from increasing the intrinsic value of the firm, or from some combination of the above. Although an exact allocation is impossible, wealth transfers appear to play the dominant role.

All of the substantive changes discussed above move value from stakeholders to shareholders. Selling the target immediately boosts its stock price.[210] But it does so, at least partly, at the expense of employees. Although explanations for this bump vary, these transactions almost always lead to layoffs as redundancies are eliminated.[211] When money is returned to shareholders through stock buybacks and dividends, it hurts bondholders and lenders because it decreases their capital cushion. Cuts to research and development hurt consumers, who are deprived of innovative products. Tax inversions and tax evasions (even if lawful) shift the burden of funding the government to other taxpayers and reduce government resources.

There are rare cases where the changes are neutral, or may even inure to stakeholders' benefit. As noted above, occasionally interventions lead to cuts in executive compensation.[212] The savings makes money available to the rest of the company. This does not hurt stakeholders, and it could, at least in theory, lead to greater employee compensation. Generally speaking, though, while stakeholders may sometimes benefit accidentally from activism, their interests are not considered. As result, they usually end up on the wrong side of the equation.

Long-term shareholders might similarly suffer. If stock-prices were efficient, this would be impossible. Rather, the moves would have to benefit long-term holders; otherwise the stock price would remain steady or decline. For example, layoffs would only lead to stock-price gains if the firm had too many employees, not if the cuts were to muscle rather than fat. Along these lines, proponents of hedge-fund activism rely on market efficiency to argue that activism benefits all shareholders.[213] According to this logic, if returning money to shareholders through buybacks or dividends increases the value of target firms, it must mean management was holding too much capital; companies that were told to cut staff and reduce R&D must have been overspending in those areas; gains from M&A must come from synergy.

As discussed above, however, appeals to EMH are uncompelling.[214] There is good reason to believe stock prices largely reflect a short-term valuation rather than an intrinsic value that accounts for cash flows stretching to infinity. Further, the claims that activists increase the intrinsic

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[210] Strine, *supra* note 30, at 1944.
[211] *See id.* at 1945.
[212] *See supra* note 196 and accompanying text.
[213] *See* Paul Singer, *Efficient Markets Need Guys Like Me*, WALL. ST. J. (Oct 19, 2017), https://www.wsj.com/articles/efficient-markets-need-guys-like-me-1508454427.
[214] *See supra* notes 82-94 and accompanying text.

value of target firms strains credulity. Most importantly, activists typically target strong performers.[215] They tend to be profitable and have steady cash flows.[216] It seems odd that strong performers would have across-the-board blind spots for the areas that hedge funds target—areas that happen to deliver quick stock-price boosts. Rather, what looks to be happening is that activists have identified a set of easily implementable ways to increase stock prices given the short-term nature of stock valuations, and then search for companies where the changes would generate the greatest return. Their approach is formulaic, not bespoke.[217]

Activists are not examining companies for ways to improve intrinsic value. If this were the case, then interventions would be *sui generous*. Hedge funds, for example, always look to cut (rather than increase) staff and R&D. If the funds were focused on intrinsic value, there should be campaigns that argue for more staff and more R&D. Also, how do hedge-fund managers know how much companies should be spending in these areas? They are financial professionals, not experts in target businesses.[218] More likely, they are looking to make cuts to firm workforces and R&D to quickly boost net earnings—a change with an immediate stock-price impact.[219]

Similarly, if activists were long-term oriented, we would see interventions that aim to improve long-term operational performance. They might recommend heavy investments in research and development and in generating a loyal workforce. They might push companies to build communities ties or to cut prices to develop consumer loyalty. They might even push for a shift in strategy. But this is not what hedge funds propose.[220]

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[215] *See* Brav et al., , *supra* note 190, at 1753 ("[T]arget firms tend to be low growth firms, but are significantly more profitable."); Coffee & Palia, *supra* note 30, at 582 ("In general, we observe that target firms are often more profitable than the control sample, suggesting that these targets are not poorly performing firms as some advocates for hedge fund activism suggest.").

[216] *See* Brav et al., *supra* note 190, at 1753; Dennis Berman, *A Radical Idea for Activist Investors: What If the Goal Were More Investment With an Eye on the Long Term?*, WALL ST. J. (January 27, 2015), https://www.wsj.com/articles/a-radical-idea-for-activist-investors-1422370260 ("The vast majority [of hedge funds] are making similar demands of their targets, delivered with what now feels like a dull percussion: Raise the dividend, buy back shares, cut these costs, spin off that division, sell the company."); Coffee & Palia, *supra* note 30, at 582; Strine, *supra* note30, at 1891.

[217] *See* Strine, *supra* note 30, at 1899, 1939-40.

[218] *See* Coffee & Palia, *supra* note 30, at 592 ("In particular, there is reason to doubt that activist hedge funds bring much specialized organizational knowledge or expertise to their engagements with target firms.").

[219] *See* Rappaport, *supra* note 89, at 65.

[220] *See* Allair & Dauphin, *supra* note 30, at 42 (Hedge fund "recipes are shop-worn and predictable, and (almost) never include any growth initiatives"); Berman, *supra* note 216 ("Consider the database kept by FactSet, which has tracked 3,774 activist campaigns since 2005, and has placed each in one of five categories. There is no such category for

Their proposals have no relationship to long-term value, only to inputs in short-term financial models.[221]

The nature of activist interventions actually reinforces the inefficiency narrative. If stock prices reflect short-term valuations, then moves that would increase the long-term value of the firm would not be captured in current stock prices. They could even lead to stock-price declines. That hedge funds are opting for a short-term agenda suggests that they lack faith that the market rewards true value creation.

And their short-term agenda may actually hurt long-term investors. If stock prices reflect short-term valuations, it is possible for hedge funds to increase stock prices while decreasing long-term value, in the process transferring wealth from long-term shareholders. It is easy to see how this might be the case. Giving money back to shareholders might increase stock prices because of the wealth transfer from creditors. But it might hurt long-term holders because it leaves the company less resilient to shocks. Cuts to R&D increase short-term profits, but make the firm less competitive in the long-term.[222] Layoffs may also hurt. Net earnings may improve. Remaining employees may even work harder for a time for fear of losing their jobs. But then they leave. And recruitment and training is expensive. If stock prices mainly reflect expectations for the near future, then the long-term consequences would be underpriced. The price change would be driven primarily by the goosed financial statements, even if they are bound to regress in the future.

In sum, it is clear that activists engineer gains in stock prices. It is also clear that there are wealth transfers from stakeholders. The degree to which stock price gains come from the wealth transfers themselves (and the improved financial statements that result) or from increases to the intrinsic value of target firms is inextricably linked with the question of market efficiency. If markets are efficient, the interventions must be creating real value; if they are inefficient, then the stock-price gains reflect increases in short-term values potentially at the expense of long-term shareholders. Much evidence suggests that stock prices are inefficient.[223] The nature of hedge-fund interventions also suggest that they are leveraging inefficiency to

'advocating more long-term investment,' says FactSet vice president John Laide. 'It's an extremely rare demand, so we don't code for it.'").

[221] *See* Berman, *supra* note 216.

[222] A recent study assessing growth among the 500 largest companies in the world found that investors realize outsized rewards when their companies invest aggressively in R&D and lose value when R&D spending is low. *See* Neera Tanden, *How to Foster Long-Term Innovation Investment*. CTR. FOR AM. PROGRESS (June 30, 2015), https://www.americanprogress.org/issues/economy/reports/2015/06/30/116294/how-to-foster-long-term-innovation-investment/.

[223] *See supra* notes 86-93 and accompanying text.

create stock price moves rather than lasting value. Therefore, while the effect on long-term shareholders cannot be known with absolute certainty, it is highly likely that they do not benefit from activism, and are in fact harmed by it.[224]

Regardless, hedge funds aim for purely stock-price gains. There is no reason to think they care about stakeholders, and, other than blind appeals to efficient markets, there is no case that hedge-fund-driven financial engineering maximizes long-term value—the form of shareholder primacy embraced by commentators and Delaware law.

F. The Market Shadow of Hedge-Fund Activism

It is not only targets that act in line with the activists' agenda. The idea of *de facto* shareholder primacy is that all firms, not only those that have come under attack, are forced to adopt the hedge-fund ethos. No public companies are immune from activism. Activists target hundreds of companies a year.[225] They target firms big and small.[226] Apple,[227] Microsoft,[228] and Procter & Gamble[229] have all been engaged by activists. And these funds have a lot of resources. At last count, they have $130 billion in assets under management.[230]

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224 Some argue that institutional support shows that hedge-fund activism is beneficial to long-term shareholders. *See* Charles Nathan, *Seven Deadly Fallacies of Activist Investing's Critics*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 29, 2016), http://corpgov.law.harvard.edu/2016/06/29/criticism-of-activist-investing. But actively managed funds dictate the voting at large mutual-fund complexes. These funds share the hedge fund's short-term agenda. *See* Strine, *supra* note 30, at 1923.

225 *See* WALL ST. J, *WSJ-FactSet Activism Scorecard (Historical Data)*, http://graphics.wsj.com/activism-scorecard/ (last visited Feb. 18, 2019).

226 Coffee & Palia, *supra* note 30, at 554 ("Historically, hedge fund activism focused on smaller cap companies because it was too costly to assemble a sizeable stake in a larger cap company. But this has changed. In 2013, for the first time, almost one third of activist campaigns focused on companies with a market capitalization of over $2 billion.").

227 *See* John Carney, *Welcome to the Golden Age of Activist Investors*, CNBC (Aug. 14, 2013), https://www.cnbc.com/id/100963166; William Lazonick et al., *Opinion, Carl Ichan's $2 Billion Apple Stake Was a Prime Example of Investment Inequality*, MARKETWATCH (June 7, 2016), https://www.marketwatch.com/story/carl-icahns-2-billion-apple-stake-was-a-prime-example-of-investment-inequality-2016-06-07.

228 Carney, *supra* note 227.

229 Lauren Debter, *P&G Targeted by Billionaire Nelson Peltz in Biggest Proxy Fight in History*, FORBES (JUL. 17, 2017), https://www.forbes.com/sites/laurengensler/2017/07/17/procter-gamble-proxy-fight-nelson-peltz-trian-fund-management/#1935b4634162.

230 Vipal Monga et al., *As Activism Rises, U.S. Firms Spend More on Buybacks Than Factories*, WALL ST. J. (May 26, 2015), https://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805.

Since every firm is a potential target, and since activist interventions are so disruptive,[231] management has a significant incentive to take actions to deflect their attention. The best way to do this is to preemptively adopt measures activists would push, and more generally, to work to maximize current share prices.[232] And this is what corporations are doing. It is increasingly common for companies to engage in hedge-fund favorites like stock buybacks,[233] M&A transactions,[234] and spinoffs[235] even without an activists' prodding. They are also spending less on R&D.[236] Capital investment is at "historic lows."[237] The credible threat of activism is fundamentally reshaping the agenda of public companies.

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[231] The median cost of a proxy fight in 2017 was $750,000. Mike Coronato, *2017 Proxy Fights; High Cost, Love Volume*, FACTSET (Nov. 6, 2017), https://insight.factset.com/2017-proxy-fights-high-cost-low-volume. The proxy fight at Proctor & Gamble, the most expensive in history, cost $60 million. *Id.* Companies frequently complain about the diversion of time and resources related to activist engagements. *See, e.g.,* Sheelah Kolhatkar, *Paul Singer*, *Doomsday Investor*, NEW YORKER (Aug. 27, 2018) ("Gradually, Bush diverted his attention from running Athena to focus on repelling, or appeasing, the hedge fund."); Amie Tsang, *Sina Doubles Down to Ward Off Activists After Proxy Fights*, N.Y. TIMES DEALBOOK (Nov. 7, 2017), https://www.nytimes.com/2017/11/07/business/dealbook/sina-proxy-activists.html.

[232] *See* Coffee & Palia, *supra* note 30, at 580 (discussing pressure on firms to "take preemptive steps to cut research expenditures"); Peter Cohan, *The Activist Imperative: How CEOs Can Preempt Shareholder Activists*, FORBES (Feb. 20, 2015), https://www.forbes.com/sites/peter cohan/2015/02/20/the-activist-imperative-how-ceos-can-preempt-shareholder-activists/ #7280c0f6204a; Kolhatkar, *supra* note 231 ("Bush had repeatedly been told that the best defense against an activist hedge fund was to get Athena's stock price up").

[233] Vipal Monga et al., *As Activism Rises, U.S. Firms Spend More on Buybacks Than Factories*, WALL ST. J. (May 26, 2015), https://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805; Michael Wursthorn, *Stock Buybacks Are Booming, But Share Prices Aren't Budging*, WALL ST. J. (Jul. 8, 2018), https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801.

[234] Emily Liner, *What's Behind the All-Time High in M&A*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Mar. 16, 2016), https://corpgov.law.harvard.edu/2016/ 03/16/whats-behind-the-all-time-high-in-ma/.

[235] Antonella Ciancio, *M&A Boom Fuels Spin-Offs*, GLOBAL FIN. (Feb. 7, 2018), https://www.gfmag.com/magazine/february-2018/bull-market-adds-fuel-spin-offs; Steven Davidoff Solomon, *Remaking Dow and DuPont for the Activist Shareholders*, N.Y. TIMES DEALBOOK (Dec. 15, 2015), https://www.nytimes.com/2015/12/16/business/deal book/remaking-dow-and-dupont-for-the-activist-shareholders.html?_r=0.

[236] Anne Marie Knott, *The Trillion-Dollar R&D Fix*, HARV. BUS. REV. (May 2012), https://hbr.org/2012/05/the-trillion-dollar-rd-fix; Alana Semuels, *Can American Companies Survive America's Most Aggressive Investors*, ATLANTIC (Nov. 18, 2016), https://www.theatlantic.com/business/archive/2016/11/activist-investors/506330/.

[237] Dominic Barton, *Finally, Evidence That Managing for the Long Term Pays Off*, HARV. BUS. REV. (updated Feb. 9, 2017), https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off.

This is not to say that the forces of *de facto* shareholder primacy operate equally on all companies. Firms may have traits that give them more space to pursue long-term value or stakeholder goals. For instance, firms with broader retail investor ownership, and less of an institutional base, are harder for activists to target.[238] Since hedge funds tend to engage stronger companies,[239] weaker companies, somewhat paradoxically, also have some slack. Finally, firms may give public shareholders, including institutional investors, diluted voting rights or none at all.[240] The unequal voting rights reduce the power of activists, or in the latter case, disempowers them. Although this mode of disempowerment has gained headlines, only ten percent of companies reduce public shareholder voting rights,[241] and so far, only one company—Snap—has disenfranchised them completely.[242] More generally, there is a transaction cost boundary on activist activities. Certain corporate practices might not affect share price enough, or in a certain enough way, to be worth a fight.[243]

The limits to *de facto* shareholder primacy trace the limits of investor protection. As noted earlier, nobody believes that retail investors actually read the disclosures that securities law demands. Instead, the theory is that transparency protects investors indirectly, because everyone trades at a price informed by sophisticated trading.[244] The strength of this protection varies with the degree of institutional interest. Less institutional involvement weakens both *de facto* shareholder primacy and investor protection. Their heavy presence, however, means that both are powerful forces in the securities markets.

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[238] *See* Simi Kedia et al., Institutional Investors and Hedge Fund Activism 4 (unpublished manuscript) (Sept. 2017), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=AFA2018&paper_id=342 (finding institutional ownership increases likelihood of being targeted by activists).

[239] *See* notes 215-216 and accompanying text.

[240] *See* COUNCIL OF INST.'L INV., *Dual-Class Stock*, https://www.cii.org/dualclass_stock (last visited, Feb. 15, 2019).

[241] *Id.*

[242] *Id.*

[243] The transaction-cost boundary may explain why, for instance, an increasing number of firms are adopting so-called ESG reporting (ESG stands for "Environmental, Social, and Governance") even in the era of hedge-fund activism. *See* IRCC INSTITUTE, STATE OF SUSTAINABILITY AND INTEGRATED REPORTING 2018 3 (2018) (finding that 78% of S&P 500 companies issue a sustainability report in some form). These might help stakeholders, even at the expense of shareholders, but the harm to the stock price may not be large enough to warrant reprisal. It is also possible that these are actually good for shareholder value, because consumers like to purchase from companies that appear to care about the environment. Finally, the impact of ESG reports may be negligible or indeterminant. *See generally* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, GEO. L. J. (forthcoming 2019) (critiquing the current state of sustainability reporting and suggesting reform).

[244] *See supra* note 50 and accompanying text.

G. Why *De Facto* Shareholder Primacy is Different

Hedge-fund activism is not the only thing pushing executives to maximize stock prices. But the pressure hedge funds exert is unique. When confronted by activists, boards and executives face the credible threat of removal if they fail to abide.[245] In other cases, leadership has far greater discretion about how much value to put on share price.

As noted above, many institutional investors have a short-term focus.[246] Mutual funds are measured each quarter, and active managers might sell if a company fails to deliver anticipated returns.[247] Enough sales might trigger a stock-price drop, which might cause the board to fire the CEO. Alternatively, if the board does nothing, a competitor or private equity firm might launch a hostile takeover. Like hedge-fund activism, fear of termination or fear of acquisition should incentivize share-price maximization.

The comparison to activism, however, is superficial. Boards might or might not choose to fire their CEO for an underperforming stock price. The decision is up to the directors, which they are free to make in conformity with the company's chosen corporate purpose. A board might very well decide that current stock prices do not reflect the true value of the CEO or the company, in which case they might choose a wait-and-see approach. The board retains discretion over its corporate purpose, and its decision on whether to retain the CEO is a function of that choice.

If the stock price sinks too low, this raises the possibility of a hostile acquisition. In this case, the board and the CEO could be replaced. These are not the threat they seem, however. Boards can defeat hostile takeovers with poison pills.[248] While fewer and fewer companies have poison pill plans in place, companies can choose to implement them as soon as they come under attack.[249] These plans make a hostile acquisition nearly impossible, and

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245 *See supra* note 202 and accompanying text.

246 *See supra* notes 91-92 and accompanying text.

247 *See* Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 296-297, 304; Rappaport, *supra* note 89, at 66 & n.2.

248 *See* Macey, *supra* note 139, at 31-32 (describing poison pills).

249 Jessica Hall, *Poison Pills Drop to Lowest Level in 20 Years*, REUTERS (Mar. 30, 2010), https://www.reuters.com/article/us-dealtalk-poisonpills/poison-pills-drop-to-lowest-level-in-20-years-idUSTRE62T5D320100330. Because activists purchase relatively small stakes in private firms, and assemble in "wolf packs," poison pills are ineffective against them. *See* Coffee & Palia, *supra* note 30, at 604-05; Gardner Davis, *Sotheby's Poison Pill Battle Reshapes World of Shareholder Activism*, A.B.A. (Sept. 19, 2018), https://www.americanbar.org/groups/business_law/publications/blt/2014/06/keeping_current_davis/.

under Delaware law, boards have wide discretion around them.[250] The deference that courts afford not only undermines this mechanism for tying management to stock price; it is also another indication of the corporate-purpose flexibility corporate law provides.

Commentators have also argued that executive compensation pushes executives to maximize stock prices.[251] This is because they are paid with equity, either in the form of stock grants or stock options. Indeed, these compensation schemes were introduced to focus management's attention on stock prices.[252] Executive compensation plans, however, often do not reward immediate gains. Options and stock grants vest over time.[253] More importantly, as above, executive compensation is different because it is set by the board. The board chooses whether it wants to incentivize its officers in this way, whether doing so aligns with their corporate purpose. A compensation scheme that emphasizes share prices is by choice rather than *de facto* fiat through the threat of activism.

Finally, the existence of activism itself is proof that these mechanisms do not fully align corporate activities and shareholder primacy. The existence of the arbitrage opportunities that draws in activists show that companies are not currently doing all that they can to maximize share prices.

H. Hedge-Fund Activism as Mechanism of *De Facto* Shareholder Primacy

Hedge-fund activism is discussed and debated as if it was as a stand-alone phenomenon. But the institutional context is crucially important for a full understanding of how it should be viewed and whether it should be constrained. What has been so far ignored in the debate is that the securities laws are necessary for activism and that activists are mechanisms of shareholder primacy in the same way that sophisticated institutional investors are mechanisms of investor protection.

If not for the trustworthy comprehensive disclosures public companies are forced to make available to everyone, activist hedge funds would lack the information to make policy proposals in the first place. The corporate financial statements contained in the mandated disclosures are the building blocks of financial analysis, and without access to them, hedge funds would have no basis on which to intervene.[254] The transparency

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[250] *See* Macey, *supra* note 139, at 35-36; *see also* Zingales, *supra* note 158, at 399 ("State anti-takeover statutes and poison pills have made hostile takeovers all but impossible.").
[251] *See* Rock, *supra* note 53, at 1911.
[252] *See id.* at 1917.
[253] Coffee & Palia, *supra* note 30, at 593-94.
[254] Park, *supra* note 183 (surveying the metrics activists use).

provided by the securities laws are the ground on which hedge-fund activism is built.

The crucial role of the securities laws is apparent when the public markets are contrasted to the private ones. In the private markets, there is no disclosure requirement. And companies do not share information with the public.[255] Rather, they share it only in privately negotiated transactions with investors they would welcome as shareholders.[256] As a result, hedge-fund activism is nonexistent. Entrepreneurs choose a corporate purpose that suits them, and investors that find it agreeable become shareholders.[257]

It is only when companies go public, and are required to make their finances available to everyone, that they are forced to adopt shareholder primacy. Activism is the mechanism through which the securities laws translate to a *de facto* corporate purpose mandate. This theory—that hedge-fund activists are mechanisms of *de facto* shareholder primacy—has the same structure as the predominate theory about how the securities laws protect investors. Each is about how the securities laws, through institutional intermediation, impact the securities market. The conventional story is that institutions read disclosures to inform their trading, which protects investors as their diligence translates into prices.[258] In *de facto* shareholder primacy, institutions, namely activist hedge funds, also rely on the securities disclosures. But they use it to identify suitable targets for intervention. The market pressure translates to homogeneity of corporate purpose.

Viewing hedge-fund activists as regulatory intermediaries is useful for three reasons. First, it highlights the crucial role that the securities laws play in dictating corporate purpose, something that has gone unrecognized. As noted above, while corporate law theoretically embraces shareholder primacy, it does not do so in practice, because, most of all, the business judgment rule is so deferential.[259] In contrast, the securities laws are theoretically about investor protection. In practice, however, the securities laws have become the primary regulatory apparatus driving shareholder primacy. Despite the enormous amount of attention that corporate purpose

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[255] *See* PITCHBOOK, VENTURE'S LIQUIDITY RELEASE VALVE 3 (2017) (noting the "opacity and scarcity of information" in the private market).
[256] *See id.* at 3-5.
[257] *See* EASTERBROOK & FISCHEL, *supra* note 76, at 17. Liquidity is also important for *de facto* shareholder primacy. Activists need to be able to purchase and resell shares easily and without interference from the target. The securities laws kill liquidity in the private market and provide the informational richness that it requires in the public market. *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 550-563 (2012) (discussing private-market liquidity and the hurdles the securities laws pose).
[258] *See infra* notes 152-153 and accompanying text.
[259] *See infra* notes 112-114 and accompanying text.

has received from corporate law scholars, it is actually securities law that now demands it.

More broadly, their relationship to corporate purpose shows that the securities laws are much more closely connected to corporate law than previously understood. The aspects of the securities laws that dictate corporate governance, like those requiring that public companies have majority independent boards and fully independent audit and compensation committees, have been recognized as pushing into corporate law's territory. These rules are sometimes even referred to as federal corporate law.[260] What scholars have failed to recognize is that all of securities law impacts corporate governance. Although corporate leadership is inherently better informed, securities-law disclosures close much of the information gap between shareholders and management that exists under corporate law.[261] The securities laws thus empower public shareholders at the expense of insiders. Collective action problems meant that this power long went unused, but the institutionalization of the securities markets have caused these to greatly erode.[262] Today, securities law fundamentally alters the nature of public firms—complementing, and as I argue further below, supplanting key aspects of corporate law.

Finally, recognizing the role of securities law reframes the debate about hedge-fund activism. As I flesh out in Part III, it transforms the debate into one over the proper scope of the securities laws rather than over whether market actors engaged in an innovative new practice should be constrained. Similarly, because their activities are what transform the securities laws into a *de facto* shareholder primacy regime, a critique of *de facto* shareholder primacy is also a critique of hedge-fund activism. The debate about activism today focuses almost solely on implications for shareholder welfare at target firms. Linking hedge-fund activism to the securities laws and to the advent of *de facto* shareholder primacy provides a much broader perspective on the implications of their activities.

I. Critique of *De Facto* Shareholder Primacy

De facto shareholder primacy forces public companies to maximize share price regardless of the preferences of the board, management, or the principles on which the corporation was founded. This outcome contravenes core tenets of corporate and securities law and the federalist

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260 *See* Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake*, 34 DEL. J. CORP. L. 57, 91 (2009).
261 *See supra* Part II.B.
262 *See supra* Part II.C.

principles that divides them. In doing so, it hurts entrepreneurs and investors, and weakens securities markets.

De facto shareholder primacy unravels the structure of corporate law. Corporate law is enabling. It sets default rules, but leaves the outline of the corporate structure—including corporate purpose—to private ordering.[263] When they incorporate, founders can choose whatever lawful purpose they wish.[264] If, as is commonly the case, a company incorporates in Delaware, but leaves corporate purpose unspecified, then Delaware law nominally requires that management maximize long-term shareholder value. The legal standard for judging compliance is so deferential, however, that, in practice, management has broad discretion to run the firm as it pleases. The securities laws eviscerate this flexibility.

Moreover, under corporate law, boards run corporations. Shareholders have little power. The legal structure situates shareholders as passive owners with little say over the firm's business or purpose.[265] The securities laws reverse this power structure. Boards are at the mercy of shareholders, and the most influential have rallied behind the activist agenda.

Worse still, corporate law is implicitly about public corporations. The legal structure it sets up is meant to function when there is a separation between management and shareholders—the hallmark of public companies.[266] Securities law thus eviscerates core features of corporate law—its enabling stance toward corporate purpose and its insulation of the board—in the exact area where it is targeted.

Securities law, and the transparency it affords, was never supposed to upend corporate law. The laws aim to foster informed financial transactions, not impact firm operations.[267] The famous securities-law aphorism, "sunlight…is the best disinfectant," suggests that the requirement to disclose should lead to more ethical behavior.[268] And this was likely part of the motivation for the securities laws, but disclosure is not meant to alter the fundamentals of corporate operations or purpose.[269] In response to the

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263 *See supra* Part I.E.
264 DEL. CODE ANN. tit. 8, § 102(b)(1) (2017).
265 *See supra* Part I.E.
266 *See* Bainbridge, *supra* note 101, at 568.
267 *See* Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation* 81 WASH. U. L. Q. 417, 418 (2003).
268 LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).
269 *See* S. Rep. No. 73-792, at 10 (1934) ("The principal objection directed against the provisions for corporate reporting [in the securities laws] is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The committee has no such intention, and feels that the bill furnishes no justification for such an interpretation.").

rules, firms are expected to disclose material aspects of their businesses, not change what they do or why they do it. That the securities laws bring *de facto* shareholder primacy thus contravenes foundational aspects not only of corporate law, but also of securities law.

Principles of federalism go by the wayside as well. By federally imposing a corporate purpose, the securities laws deprive the states of their longstanding jurisdiction over the matter.[270] Stepping past that boundary is particularly problematic when it comes to corporate purpose.

Generally speaking, federalist principles dictate that federal law should govern when uniformity is desired.[271] In general, federal securities regulation makes sense because it is a nightmare for companies to comply with 50 different state securities law regimes.[272] If, however, it would be better to allow states to serve as "laboratories of experimentation," then the matter should be left to the states to allow for competition and innovation.[273]

Corporate purpose fits squarely in the latter category. This is an area where there is currently a great deal of innovation. The widespread adoption of benefit corporation statutes is one example. The first was in Maryland in 2010,[274] and the form of doing business is now available in 34 states.[275] There also does not appear to be any harm to leaving this to state courts and legislatures. Sometimes, for example, uniformity is desired because there is a concern with a race to the bottom.[276] But that is not an issue here. The boundaries of corporate purpose are perfect for the state level trial-and-error process of legal development.

Rather than allow for experimentation, the securities laws have unintentionally created corporate-purpose clones. This result weakens securities markets, and harms both entrepreneurs and investors. Securities markets are diminished when firms have the same corporate purpose. In particular, if a firm focuses only on stock price, it might lead to riskier behavior, which jeopardizes its long-term prospects. Stock buybacks, for

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[270] *See* Buxbaum, *supra* note 103, at 32.

[271] *See* Cooley v. Board of Wardens, 53 U.S. (12 How.) 299, 318-19 (1851) (need for uniformity is central test for federal preemption).

[272] *See* Rutheford B. Campbell, Jr., 104 KY. L.J. 325, 327 (2015-16).

[273] The classic statement comes from Justice Brandeis. *See* New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

[274] *First Benefit Corporation Goes Public–Laureate Education*, CORP. SOC. RESP. NEWSWIRE (Feb. 13, 2017), http://www.csrwire.com/press_releases/39700-First-Benefit-Corporation-Goes-Public-Laureate-Education.

[275] BENEFIT CORP., *State by State Status of Legislation*, http://benefitcorp.net/policymakers/state-by-state-status (last visited Feb. 5, 2019).

[276] *See* Edward J. Janger, *Predicting When the Uniform Law Process Will Fail*, 83 IOWA L. REV. 569, 579 (1998).

example, reduce a firm's capital cushion, making it more susceptible to shocks. The securities laws provide an overwhelming incentive to take this risk. *De facto* shareholder primacy deprives the market of diversity of corporate purpose, diversity that would provide a cushion if firms devoted to share-price maximization stumble. The market—and the economy—is therefore less resilient.

The rigidity is also bad for entrepreneurs. Unless they have the clout and hutzpah to issue low-vote or no-vote shares to the public, founders who wish to maximize stakeholder value or long-term shareholder value cannot go public without sacrificing this purpose. There is no reason for regulation to cut entrepreneurs off from this means of capital raising and deprive them of the other benefits of going public. Indeed, there is much debate about why the public markets have become less attractive. Many blame the monetary costs of being a public company.[277] But perhaps this fundamental change that happens when a company goes public is a bigger factor.[278]

Retail investors are the final victims. They may wish to back companies that have a stakeholder focus or care about long-term value. These firms exist in the private market.[279] But private firms may only sell stock to institutions and accredited investors.[280] Retail investors can only invest in public firms, but these must adhere to *de facto* shareholder primacy. This is particularly problematic for the many mutual-fund investors who put money in these instruments to fund their retirement. *De facto* shareholder primacy might lead to a short-term boost in their returns, but the long-term is uncertain. They may even give aspiring retirees a false sense of security. Although it is counterintuitive, the shift in power to shareholders is likely bad for many shareholders.

The only sure beneficiaries of the returns bump that results when firms take actions to boost stock prices are the hedge funds that lobby for them. While their wealth is part of the social-welfare equation, the range of negative consequences suggests that reform is appropriate.

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[277] *See* Schwartz, *supra* note 257, at 544-48 (discussing the argument that costs have caused the decline in IPOs).

[278] *Cf.* Jamie Dimon & Warren E. Buffett, *Short-Termism Is Harming the Economy*, WALL STREET J. (June 6, 2018), https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801 ("Short-term-oriented capital markets have discouraged companies with a longer term view from going public at all, depriving the economy of innovation and opportunity.").

[279] There are thousands of private B. Corps, including companies like Patagonia and Warby Parker. *See* Chafkin & Cao, *supra* note 19.

[280] *See supra* Part II.A.

III. A New Lens For Hedge-Fund Activism

This paper has shown that the securities laws underpin hedge-fund activism and therefore also underpin *de facto* shareholder primacy. Recognizing the role of the securities laws is important to the debate on activism because it shifts the perspective of the regulatory analysis and allows for a more fulsome consideration of its societal costs.

A. The Cost-Benefit Framework

The critical policy question is whether activist hedge funds should be constrained. The way to approach this question is through cost-benefit analysis. This is the core analytical framework for judging the probity of regulatory intervention, and it is required of the SEC.[281] If hedge-fund activism is viewed as a free-market innovation, then regulators would have to show that the costs of activism outweigh its benefits before undertaking regulatory efforts.

The notion that hedge-fund activism is an independent phenomenon is implicit in the current debate about activism,[282] as is its corollary, that a showing of net harm is a precondition to regulation.[283] This Article shows that these premises are incorrect. Rather, hedge-fund activism is a product of the securities laws. Since the securities laws should not support activities of questionable social value, activism itself must withstand cost-benefit scrutiny. The burden is on the hedge-fund industry, not regulators.[284]

Another way to see this is to imagine that regulators foresaw the potential for the securities laws to be used to support activism, and considered whether it would be good public policy for them to be used in that way. The regulatory analysis would assess whether the benefits of activism outweigh the costs. If not, the securities laws would be drafted to avoid supporting it. That the securities laws only came to support the activity

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281 *See* Jeff Schwartz & Alexandrea Nelson, *Cost-Benefit Analysis and the Conflict Minerals Rule*, 68 ADMIN L. REV. 287, 295-96 (2016) (discussing the required use of cost-benefit analysis in SEC rulemaking).

282 *See, e.g.,* Gilson & Gordon, *supra* note 30, at 896-97 (framing hedge-fund activism as arising in response to an arbitrage opportunity in corporate governance).

283 *See, e.g.,* Bebchuk, *supra* note 30, at 1667 (criticizing opponents of activism for lack of empirical evidence of long-term consequence).

284 In areas like this, where there are competing theoretical claims and contested empirics, which side bears the burden in regulatory analysis can be decisive. *See* Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1003 (2003) (discussing the precautionary principle, which "imposes a burden of proof on those who create potential risks").

well into their existence, and as a result mainly of market innovations, should not alter the policy analysis. This is a common problem in economic regulation. Rules are static; markets are dynamic. As markets change, regulations must be reassessed so that they continue to provide a net benefit to society. Here, if the securities laws are supporting an activity that cannot be shown to improve social welfare, they should be changed.

B. The Social-Welfare Calculus

There is no compelling case that hedge-fund activism is good for society. The real-world harms to entrepreneurs, investors, and the economy that stem from *de facto* shareholder primacy can be viewed as the costs of activism.[285] These must be weighed against the benefit—the amount of wealth that activists create.[286]

This figure is not equivalent to the increase in stock prices at target firms and in firms that take similar actions as a way to ward off the activist threat. Three discounts need to be applied to account for the possibility that much, if not all, of the stock-price bump results from wealth transfers.[287]

First, as noted above, much of the wealth creation owes to transfers from stakeholders. This is true regardless of whether stock prices reflect short- or long-term valuations. Laying off an employee, for instance, is a wealth transfer from that employee to shareholders. All else being equal, stock prices will rise to reflect this reallocation. The only real economic gain, however, is the extent to which the money that was being spent on wages for this employee is now better spent. Wealth transfers only create value when it means capital flows to a more efficient use.[288]

Second, much of the gains from activism comes from M&A transactions where the target firm is sold.[289] Typically in such transactions, the increase in stock price at the target is offset by a decrease at the acquiring firm.[290] Thus, wealth just changes hands from shareholders of the acquiring firm to shareholders of the target.

Finally, the stock-price increase might reverse over time. If prices reflect only short-term valuations, then there is a good chance that the rise

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[285] *See infra* Part II.J.

[286] This Article uses the total surplus approach to cost-benefits analysis, which seeks to measure the welfare impact on society rather than certain parties. *See* Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 103 (2015).

[287] *See* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation*, 124 YALE L. J. 882, 933 (discussing how "canonical economic theory" treats transfers).

[288] *See id.*

[289] *See* Allaire & Dauphin, *supra* note 30, at 34, 42

[290] *See* Strine, *supra* note 30, at 1945-46.

reflects a transfer from long-term shareholders. As discussed above, the nature of the hedge-fund interventions suggests that the changes they push, like cuts to R&D, fall into this category.[291] While it is impossible to know just how much of the increase in stock prices owe to transfers from stakeholders, acquiring-firm shareholders, and long-term shareholders, there is good reason to believe that they represent the bulk of the pop.[292]

Whatever is left represents true value—an increase to shareholder wealth after subtracting out transfers. This amount can be compared to the manifold problems—from stymied entrepreneurs and investors to unstable markets—that *de facto* shareholder primacy creates. While it is beyond the scope of this Article—if feasible at all—to put hard numbers to this weighing,[293] a qualitative balancing suggests that the benefits of activism do not outweigh the widespread and significant costs. This suggests reform.

C. Reforms to Eliminate Hedge-Fund Activism

This Article has shown that the securities laws unintentionally force companies to adopt share-price maximization as their corporate purpose and that this *de facto* shareholder primacy requirement is probably bad for social welfare. The policy implication is, therefore, that reforms should be implemented to free companies from this weight. The way to do that is to restrain hedge-fund activism. There is a way to end the practice that builds on the existing structure of the securities laws.

Currently, investors are required to report their holdings and material plans for the firm once they have acquired 5% of a target company's shares.[294] If this rule were changed to require reporting before any acquisition with the intent to intervene in firm affairs, it would remove the profits from activism. Because much of the stock-price bump from activism occurs when the intervention is disclosed,[295] the activist gains would evaporate. Deprived of the vast majority of their profits, there would be no incentive to intervene. This is a simple change that could come directly from the SEC.[296]

The biggest counterargument to this proposal is that it goes too far. It eliminates all of hedge-fund activism even though there is the potential

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[291] *See supra* notes 221-222 and accompanying text.
[292] *See supra* Part II.F.
[293] *See* Coates, *supra* note 288, at 1011 ("Detailed case studies of six rules reveal that precise, reliable, quantified CBA remains unfeasible.").
[294] *See* 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-l (2011); Form of Schedule 13D, 17 C.F.R. § 240.13d-101 (2014).
[295] *See* Coffee & Palia, *supra* note 30, at 551 & n.14.
[296] *See* James D. Cox & Benjamin J.C. Baucom, 90 TEX. L. REV. 1811, 1818 (2012) (discussing the SEC's rulemaking authority).

that some provide long-term benefits to shareholders. As noted above, however, it is unlikely that this is a large loss. It is quite difficult and risky to make money from long-term bets,[297] and the evidence strongly suggests that activists are looking for a quick boost.[298]

A related argument is that ridding the market of hedge-fund activists would provide management with too much slack.[299] As a result, they would be able to prioritize their own interests rather than that of the firm. This argument is also unconvincing. First, it presumes that stock prices are an accurate way to police slack. If management is looking to maximize stakeholder interests, then stock price is only a partial metric. If management is looking to maximize long-term value, then stock price is a deeply noisy metric. Management may be looking out for long-term interests, which might not be reflected in stock prices, or might even be punished.[300] Second, even if stock price is an accurate measure of management performance, corporate leadership has ample incentive already to focus on it. As noted above, executives are commonly compensated with equity;[301] they also face pressure from institutional investors worried about short-term performance.[302] Finally, if there is truly a concern that management is not responsive enough to share price, then this is an issue for corporate law. That is where the balance between management and shareholders has always been struck.[303] The overriding influence of securities law—an instrument of investor protection—is an accident.

A final argument is that hedge-fund activism should be left to private ordering. First, institutional investors might stop supporting them. Second, companies can adopt dual-class share structures to choke off the activists' influence. Despite promising rhetoric, the hope that institutional investors will turn away is fanciful so long as they chase short-term returns.[304] And dual class shares go too far.[305] Placing a regulatory constraint on activism leaves in place every other form of shareholder engagement, while dual-class shares eviscerates them all.

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[297] *See supra* notes 89-90 and accompanying text.
[298] *See supra* notes 215-221 and accompanying text.
[299] *See* Bebchuk, *supra* note 30, at 1679.
[300] *See supra* notes 86-94 and accompanying text.
[301] *See supra* notes 251-253 and accompanying text.
[302] *See supra* notes 246-247 and accompanying text.
[303] *See* Strine, *supra* note 90, at 9.
[304] *See* Strine, *supra* note 9, at 786-88.
[305] *See* Robert J. Jackson Jr., Commissioner, U.S. Sec. and Exchange Comm'n, Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018), transcript available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

If hedge-fund activism were curbed through the recommended disclosures, then there would be no mechanism for *de facto* shareholder primacy. Although firms might still choose to focus their efforts on share-price maximization, it would not automatically follow from going public. Firms would have the ability to change and adapt, and to incorporate and be more receptive to, a broader range of interests. The benefits of this restored flexibility would flow through to securities markets, securities-market participants, and to the economy.

IV. Conclusion

This Article introduces the concept of corporate purpose to securities law. In doing so, it shows that the legal regime unintentionally compels firms to maximize share price regardless of the implications for long-term shareholders, let alone stakeholders. This world of *de facto* shareholder primacy hurts investors, entrepreneurs, and the overall economy.

Hedge-fund activism is the mechanism of *de facto* shareholder primacy. Based on the insights they glean from the required disclosures, hedge funds demand share-price maximizing actions of target management. Fear of proxy contests drives targets to consent; fear of activist intervention leads all firms to act like they are already targets.

The way to disentangle the securities laws from corporate purpose is to curb hedge-fund activism. The way to curb hedge-fund activism is to require that funds announce their planned acquisitions and interventions before purchasing target securities. Demanding that hedge funds disclose so early would eliminate the profit potential from engagement, thus ending the practice. An end to hedge-fund activism, and the concomitant end to *de facto* shareholder primacy, would give firms the freedom to pursue other corporate purposes. Given the crucial role of corporations in society, this flexibility would have far-reaching benefits.