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Beating Shareholder Activism at Its Own Game

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Abstract: The last book by legal scholar Lynn Stout proposes a bold plan to transform corporate governance and enhance their sustainability by creating a “Universal Fund” that would acquire a substantial share of many publicly traded corporations, but hold those shares passively. The plan would also help to redistribute wealth and income to reduce the effects of factors that are driving income inequality. This review examines how the plan might work, and where it is likely to run into problems.

Keywords: corporate governance, sustainability, institutional investors, reforming capitalism

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6. How America’s Corporations Lost Their Public Purpose, and How it Might be (Partially) Restored, by David Ciepley, <https://doi.org/10.1515/ael-2019-0088>.

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1 Introduction

The late Professor Lynn Stout was a harsh critic of shareholder rights advocates and of corporate managers and directors who are seduced by the idea that the purpose of corporations, and the goal of corporate governance, should be to maximize shareholder value.¹ But she was not critical of corporations per se, nor of capitalism itself. In fact, she regarded corporations as one of the greatest social innovations of modern times. “Corporations are among the most powerful and economically important institutions in modern society,” she proclaimed in her contribution to the OXFORD HANDBOOK OF LAW AND ECONOMICS in 2017.² The corporation, especially the board-managed corporation is a “time machine,” she asserted in another recent article.³ It promotes “intergenerational equity” and “intergenerational efficiency” by serving as a legal person with an indefinite life that can hold assets and channel investments for “the benefit of present and future generations.”⁴ Any reform of corporations or corporate governance, “should honor and amplify the full value of corporations,” which “already provide immense value in the form of new innovations, such as the development of lifesaving drugs, social media platforms, and environmentally friendly products; salaries, retirement plans, and health benefits; tax revenue; and returns on capital.”⁵

Stout believed, however, that this important institution of modern capitalism has been corrupted in recent years by the widespread promotion and popularization of the idea that corporate managers and directors should focus solely on maximizing the current value of the corporation’s shares, even when this causes the corporation to take actions that cause harm to its many stakeholders, or even to the corporation itself over time.⁶ Feisty and fearless to the end, Stout devoted her last months, even as

1 Prof. Stout’s 2012 book brings together much of her thinking on this point. See Stout, 2012a. See also Stout, 2012b (asserting that the shareholder value “myth” “can be hazardous to the health of investors, companies, and the public alike.”)

2 Stout, 2017.

3 Stout, 2015.

4 Id., at 685 (Abstract).

5 Stout, Gramitto, and Belinfanti, 2019, at 131.

6 Stout, 2012a, at 3 (“Shareholder value thinking” ... causes corporations to “sell key assets, fire loyal employees, and ruthlessly squeeze the workforce that remains; cut back on product

she was dying of lung cancer in the spring of 2018, to a grand idea to channel the amazing powers of business corporations for social good, while also redistributing income and wealth in a more egalitarian way.

In *CITIZEN CAPITALISM: HOW A UNIVERSAL FUND CAN PROVIDE INFLUENCE AND INCOME TO ALL*,⁷ Stout's final book, which she wrote with coauthors Sergio Gramitto and Tamara Belinfanti, Stout and her coauthors explain this grand plan. The book elaborates on an idea I first encountered in the late 1990s, as huge institutional investors, such as pension funds, mutual funds and endowments, were emerging as the largest and most powerful shareholders in many publicly traded corporations.⁸ That idea was that investors as a group, and especially large institutional investors, should follow the advice of finance theorists and hold the "market portfolio" – meaning a very widely distributed portfolio of stocks and bonds that mimics the performance of the market as a whole. Finance theory tells us that this is the best way for investors to reduce risk without sacrificing return.⁹ If investors actually did this, they would, presumably, have no interest in seeing corporations in their portfolio engage in negative-sum or even zero-sum competition with each other to capture wealth at the expense of other companies whose securities are also in their portfolio.¹⁰ A "universal investor" that holds the market portfolio, should only care about having the corporations they invest in engage in activities and transactions that truly create new wealth whose benefits flow broadly to the economy as a whole.¹¹

In *CITIZEN CAPITALISM*, Stout et al., take these ideas to the next level and imagine a new type of investment fund that, the authors believe, would represent the interests of all citizens, not just the relatively wealthy citizens who could afford

support, customer assistance, and research and development; delay replacing outworn, outmoded, and unsafe equipment; shower CEOs with stock options and expensive pay packages to 'incentivize' them; drain cash reserves to pay large dividends and repurchase company shares, leveraging firms until they teeter on the brink of insolvency; and lobby regulators and Congress to change the law so they can chase short-term profits speculating in credit default swaps and other high-risk financial derivatives.")

7 Stout et al., 2019.

8 See, e. g. Hawley and Williams, 2000 (introducing the concept of "universal owners"); See also Davis, Lukomnik, and Pitt-Watson, 2006 (documenting the growth of assets in large pension funds, and referring to pensioners as "citizen investors").

9 See, e. g. Brealey, Myers, and Allen (2014).

10 See Davis et al. (2006), at 18 ("... corporate management styles acceptable to the conventional economy can ... do damage to the interests of citizen savers who entrust their capital to big funds. By contrast, management in a civil economy involves corporations pursuing sustainable profitability since such practices match the interests of their new capitalist owners, thus raising stock value over time and reducing a company's cost of capital.")

11 Id. See also, Hawley and Williams (2000).

to invest in it. This fund would invest broadly so that its interests would align with society as a whole, and it would have a very long-term time horizon. Stout, et al., call their imagined investment vehicle a “Universal Fund.”¹²

As envisioned by Stout et al., shares in the Universal Fund (UF) would be a right of citizenship, rather than a pure property right. Any citizen of the U.S., when she reached her 18th birthday, would be entitled to receive one share in the UF, at no out-of-pocket cost to the citizen, except the cost of registration. The share would entitle the citizen-shareholder to receive a pro-rata share of any dividends or other distributions that the fund pays out, and to vote to choose the board of directors of the fund. These rights would not be transferrable to another party. The citizen-shareholder would hold the right as long as she is alive, but she could not sell it, or will it to her children, or donate it to her university or favorite charity. When the shareholder dies, the share expires. The voting right and dividend right associated with that share dies with the shareholder. The UF, in turn, would not be allowed to trade shares of corporations that it holds in its portfolio, but must hold them indefinitely (unless the corporation buys back its own shares in a distribution, or is bought out in a takeover, in which case the UF would relinquish the shares in exchange for the cash or securities being used to repurchase the shares).¹³

2 Why a Universal Fund?

The motivation for creating the UF, as Stout, and her coauthors see it, is partly about distributing income and wealth more equitably within the U.S. Because every citizen would have the right to claim one share, the dividends that are paid out over time would go equally to all citizens. No individual could buy additional shares. Thus income rights and voting rights would be allocated on a per capita basis to U.S. citizens, not on the basis of wealth, as are shares and voting rights in ordinary investment funds. The new pattern of distribution of income created by the UF would be hardly noticeable at first, when the fund is small and the distributions it makes, which would be divided among hundreds of millions of shareholders, would be very tiny on a per share basis. Over time, however, Stout and her coauthors believe, the fund would grow (more on that point below), so that eventually it could pay out a significant amount that could begin to look like a “universal basic income” (UBI).

¹² Stout et al. (2019).

¹³ Stout et al. (2019), at 5–6. The authors assert that these rules would imply that “neither the Fund nor its citizen-shareholders have an interest in manipulating short-term share prices.”

A UBI is an idea that many progressive political activists, and even some quite conservative business people have been talking about in recent years as a public policy response to the widening of the distribution of income and wealth that has happened in the U.S. (and in other industrialized countries) in the last four decades.¹⁴ Dividends from a UF, like a UBI, could thereby help to offset the possibility that artificial intelligence will make inequality worse over time as it eliminates large swathes of middle class jobs.

But the real attraction of a UF, Stout et al. believe, is that it would, over time, dramatically transform corporate governance, and cause corporations to be managed in ways that are more consistent with the common welfare than the authors believe they are today. Lynn Stout spent a substantial proportion of her career denouncing the prescription advocated in much of contemporary corporate law scholarship that corporations should be managed solely on behalf of shareholders.¹⁵ The “shareholder primacy” view, as this prescription is called, is derived from a view of corporations as property that belongs to shareholders, and that corporate officers and directors are mere “agents” of shareholders, and must therefore act on their behalf.

3 Why shareholder primacy is wrong

The idea that shareholders are the “owners” of corporations is the simplest statement of the rationale for shareholder primacy, although it is fatally flawed because, in fact, shareholders own claims against the corporation they are invested in, but do not have any direct property rights in the assets of the corporation. A somewhat more sophisticated version of the rationale for shareholder primacy is that shareholders are the residual claimants in corporations, and therefore, maximizing value for shareholders has the effect of maximizing the size of the social surplus created by the corporation. This too is a problematic rationale because, as finance students and practitioners understand, shareholders are often not the only residual claimant on the wealth of a corporation.¹⁶ Even when shareholders are residual claimants,

¹⁴ Entrepreneur and philanthropist Andrew Yang, who is one of the many candidates seeking the nomination of the Democratic party for the 2020 elections, has made a UBI the central policy proposal of his campaign. See <https://www.yang2020.com/what-is-ubi/>. Yang claims on this website that Richard Nixon and Milton Friedman each advocated for a UBI.

¹⁵ See cites in notes 1–4 above, as well as numerous other articles by Lynn Stout listed in the faculty publications page at Cornell University Law School, available at https://works.bepress.com/lynn_stout/.

¹⁶ Stout, 2012a, discusses these arguments at length in Chapters 2 and 3.

they can easily trade away this claim (even while continuing to own the stock) by buying or selling derivative securities.¹⁷

In work that Prof. Stout and I did together two decades ago, we articulated an alternative theory of corporate law that does not imply that the duties of directors and managers should be to maximize share value at all times. Our theory stresses that corporate law provides a unique arrangement for governing “team production.”¹⁸ This arrangement is governance by boards of directors.¹⁹ Granting all decision rights to the board of directors facilitates the resolution of disputes that arise within the firm about the allocation of responsibilities, rights, distributions, and liability, thereby keeping these disputes out of the courts.²⁰ This theory about the key function of corporate law implies that an important job of corporate directors is to make sure that all of the participants in the corporate enterprise are satisfied enough with what they receive from the corporation that they stay in the enterprise and keep it productive. A mandate to maximize share value (which corporate law generally does not require²¹) would upset the balancing act that boards must engage in to play this mediating role effectively.

In the twenty years since we proposed our team production theory, Prof. Stout became a major academic voice challenging the dominance of shareholder primacy in corporate law. Her arguments drilled down on three points: First, the law does not require shareholder primacy.²² Second, shareholder primacy is a bad idea because (a) it fails to take into account the value that other participants

¹⁷ See also, Blair, 1995, Chapter 6, for a full discussion of these issues.

¹⁸ Blair and Stout, 1999.

¹⁹ Corporations have long been the only organizational form that are required by law to be governed by boards of directors, although recent changes in corporate law now make it possible for a corporation with only a few shareholders, and that otherwise meets the qualifications for being a “close corporation,” may now operate without a board of directors. See, e. g. Blair, 2015. Other organizational forms are permitted to delegate decision-making to boards of directors, although that would not necessarily relieve the members of the organizations of liability for actions of the organization.

²⁰ *Id.*

²¹ There is no statutory mandate that corporate boards maximize the value of the corporation’s shares. In certain very narrow circumstances, such as when a corporation is about to be sold or broken up, directors may have a duty to try to get the highest value they can for the corporation’s common shareholders. See *Revlon, Inc. v. MacAndrew & Forbes Holdings*, 506 A. 2d 173, Del. Sup. Ct., 1986 (holding that at the point at which the board of Revlon Inc. recognized that “the company was for sale,” the duty of the board “changed” to “the maximization of the company’s value at a sale for the stockholders’ benefit.”). Prior to that point, courts will defer to the “business judgment” of the directors if the directors are not conflicted and acted with care.

²² See, e. g. Stout, 2012, Chapter 2, *How Shareholder Primacy Gets Corporate Law Wrong*.

in the firm contribute,²³ (b) shareholders can extract value for themselves at the expense of other participants;²⁴ and (c) focusing solely on share value leads to short-termism.²⁵ And third, allowing activist shareholders to have too much influence harms other shareholders who may have longer time horizons, or prefer that corporations be managed in more socially responsible and beneficial ways.²⁶

4 How a Universal Fund could end short-termism, and increase equity

In *CITIZEN CAPITALISM*, Stout and her co-authors directly address this last point. The authors argue that if their UF were a substantial shareholder in a corporation, it would use its voting power in that corporation to urge the corporate management to pursue socially responsible investment and management strategies that would create more total social wealth over the long term.²⁷

CITIZEN CAPITALISM also develops an extensive argument that a Universal Fund that pays dividends to all citizens who apply to become investors could help to redistribute income in ways that are socially beneficial. This part of the book engages an emerging political debate about whether a UBI might be a desirable way to address growing inequities in the distribution of wealth and income in the U.S. Prior advocates of a UBI usually imagine that payments that would be distributed would be paid for through some form of taxation. But Stout and her co-authors distinguish their proposed UF from other UBI proposals by noting that the UF would be funded through voluntary contributions by wealthy individuals and corporations.²⁸ This claim, that a fund large enough to provide meaningful distributions of income to all U.S. citizens could be funded by voluntary contributions, is one that I believe will strike many readers as doubtful. But I regard the book as articulating a thought experiment: What would happen if large shares of the equity in a broad swathe of corporations were held on behalf of the citizens of the U.S. who would each have a claim to an equal share of any distributions from

²³ See, generally, Blair and Stout (1999); see also, Stout, 2002, at 1195–1199.

²⁴ See Blair and Stout, 2001 (discussing implications of options and other derivatives on how risk is allocated in corporations). See also, Stout, 2001–2002, at 1192.

²⁵ Stout, 2012b, at 1–2.

²⁶ See, e. g. Stout, 2012a, at 8–10, and 63–73.

²⁷ See Stout et al., 2019, at 75–83.

²⁸ See Stout et al., 2019, at 61–73.

those corporations? Stout and her coauthors believe it would have the effect of easing the pressure to maximize share value at all costs on corporations, and encourage them to create new wealth in a sustainable way over the long term.

Why would wealthy individuals donate their wealth to such a fund? On this point, the authors are a bit vague. They make the intriguing point, however, that, one way or another, over the 55 years from 2007 to 2061, an estimated \$58 trillion of wealth will be transferred from current owners to the next generation of owners, or to charity, with some experts on philanthropy speculating that nearly half of that value will go to charities.²⁹ This estimate comes from a private sector organization that attempts to model charitable giving in the future as a function of (among other things) wealth holdings and life expectancies of wealthy people, growth rates, and estate tax rates.³⁰ The forecasts of wealth transfers include all categories of wealth, such as real estate, art and other tangible assets, and debt securities, not just equity securities, and depend on many assumptions such as how rapidly the value of such assets grows over time. But the \$58 trillion is in the middle of the various forecasts reported in this study, and relies on only a 2 % growth rate in the value of assets.

Of the \$58 trillion in wealth transfer, an estimated \$27 trillion is expected to go to some form of charity.³¹ Stout and her coauthors seem to believe that if wealthy people are willing to give away upwards of \$27 trillion of their wealth to charities and other nonprofits such as universities and foundations, perhaps they would be willing to give a significant share of that \$27 trillion to a UF, although they do not offer much evidence that private individuals would be willing to give away this much of their wealth to individuals or entities over which they would have very little influence or control.

Nonetheless, to pursue this thought experiment, suppose that sufficient wealth in the form of corporate equity were contributed to a UF between now and 2061 so that the fund would have a portfolio value of \$13 trillion by 2061, half of the \$27 trillion Havens and Schervish estimate might go to charities? And suppose the fund then pays out an average of 5 % of its value each year as dividends to its citizen shareholders.³² That suggests that, by the 2060s, the fund might generate a distribution of \$650 billion every year. Dividing that among,

²⁹ *Id.*, at 61, citing Havens and Schervish, 2014, at 5.

³⁰ Havens and Schervish, 2014.

³¹ *Id.*, at 5.

³² This is a somewhat aggressive distribution rate, but the average rate of return on the S&P 500 since the early 1950s has been about 8 % (see <https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp>), while the average payout rate of university endowments in 2017 was 4.4 % (See College and University Endowments: Overview and Tax

say, 350 million citizens³³ would result in \$1,857 per year per citizen shareholder, or about \$155 per month.³⁴

5 Transformation in corporate governance

In any case, regardless of whether you think it is plausible, or even desirable, that wealthy people would give away their wealth over the next few decades in large enough quantities to be able to fund a significant redistribution of income, Stout and her coauthors believe that an even greater benefit of a UF would be the transformation it could produce in corporate governance. It is this benefit that links the Universal Fund idea to so much of Prof. Stout's prior intellectual contributions. The Citizen Capitalism idea began, the authors tell us in the Preface, as an effort to answer the question "Is there a way to address the flaws in our corporate governance system in a manner that helps address a number of ... economic, social, and environmental threats."³⁵ The book, they claim, "offers a simple plan for harnessing the power of corporations to save ourselves and our future."³⁶

The key to how the UF would change corporate governance is that the Fund would not be allowed to sell securities that it buys or receives from donors, but "must hold them indefinitely."³⁷ The authors believe that broad diversification of holdings, which the UF would achieve over time, and a very long-term orientation, would cause the fund to support only corporate actions that lead to the broadest and longest-term benefits to society as a whole. Mechanically, the way this would work, the authors say, is that voting rights in the corporate

Policy Options, EveryCRSReport.com, available at <https://www.everycrsreport.com/reports/R44293.html>).

³³ Remember that we are talking about some future point in time, beyond 2061.

³⁴ This leads me to observe that a wealth tax of 1.14 % per year on the entire \$57 trillion worth of *inherited* wealth (as distinguished from earned wealth), with the proceeds distributed across the population on a per capita basis, could achieve the same thing. But, of course, under our current tax rules, if the wealth is donated to charities, it would be protected from being taxed, so the remaining inherited wealth would have to be taxed at about twice that rate to achieve a similar redistribution. By comparison, presidential candidate Elizabeth Warren's wealth tax proposal is to tax the wealth of families that have more than \$50 million worth of assets at 2 % of assets in excess of \$50 million, and an additional 1 % of assets in excess of \$1 billion. See Irwin, 2019.

³⁵ Stout et al., 2019, at xi.

³⁶ Id., at xii.

³⁷ Id., at 5.

shares held by the UF would pass through to the citizen shareholders that hold shares in the UF.³⁸ In order to exercise these voting rights, the authors say, UF shareholders would have “the opportunity to use Fund-approved ‘proxy advisory services’ that would be paid for by the Fund.”³⁹ The Fund-approved advisory services would, in turn, be selected to provide voting recommendations based not on what would maximize share value in the short run, but on the corporate actions that would produce the greatest social wealth over the long term.⁴⁰ The problem with this part of the Citizen Capitalism proposal, it seems to me, is that each UF shareholder would have such a tiny influence on corporate decisions that he would have virtually no incentive to bother with shareholder voting at all. UF shareholders would, rationally, leave the problem of voting shares of portfolio companies to the board and management of the UF. Unless the UF is committed to being completely passive, this places a substantial amount of influence over the U.S. economy, and maybe over the entire global economy, in the hands of a very tiny group of people elected by the citizens of the U.S. To prevent the board of the UF from being corrupted by this power, the UF would have to be committed to being a passive investor.

So the effect would be that corporations whose shares are held by the UF would have a significant block of completely passive shares. If that block were large enough relative to the total number of shares in the portfolio companies that are outstanding, the shares held in the UF could have the effect of shielding its portfolio corporations from influence by activist shareholders, and muting pressures on corporate managers to focus exclusively on maximizing share value.

38 It is not clear from the book how the UF would allocate these voting rights. Suppose the UF had, say, 100 million citizen shareholders, each by assumption holding only one UF share, but the UF, in turn, held only 1 million voting shares of a given company in its portfolio. Would each UF shareholder receive 1/100th of a vote in the portfolio company? If so, how would such a fractional share be voted?

39 Stout et al., 2019, at 6.

40 At the time that Stout and her co-authors were writing this book, no such shareholder advisory services existed. The two largest shareholder advisory services, Institutional Shareholder Services (ISS) and Glass Lewis, are both committed to making recommendations based on reducing “agency costs” by empowering shareholders, and increasing share value. But in a closely-related idea that Stout worked on during her last years, she organized and raised initial funding for a non-profit entity called the Ethical Shareholder Initiative (ESI) whose purpose is to develop and provide guidelines for shareholder voting recommendations based on advancing socially responsible policies, rather than share value maximizing strategies. In the interest of full disclosure on this point, Lynn asked me before she died, and I agreed, to serve on the board of directors of ESI after she died to help determine the feasibility of such a project.

Given the intellectual energy that Lynn Stout devoted in her career to challenging shareholder primacy, it seems likely to me that, from Lynn's perspective, this is a feature, not a bug. The hope of neutralizing what she saw as the pernicious consequences of shareholder activism in corporations today may have been the most compelling feature of Citizen Capitalism as she saw it.

Reading CITIZEN CAPITALISM reminded me of the boundless energy, imagination, and optimism that Lynn Stout possessed. She could frame complex problems in simple terms to bring them to lay audiences. And she could fearlessly offer bold ideas to address those problems. Sadly, she was compelled to leave it to the rest of us to work out many of the details in her vision. While much of her work will live on, her lively contributions to public and academic debates about corporate law and corporate governance will be missed by all of us who think and write on these topics.

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