Flash Traders (Milliseconds) to Indexed Institutions (Centuries): The Challenges of an Agency Theory Approach to Governance in the Era of Diverse Investor Time Horizons

Harold Weston[*] & *Conrad Ciccotello*[**]

INTRODUCTION

One aspect of the problem in trying to align a corporate investment horizon (the time period for return on investment) to that of its shareholders is the enormous range of investor time horizons, which can range from milliseconds to centuries. Flash (high-frequency) traders hold shares for milliseconds, day traders for a few hours or days, some mutual funds and other institutional investors show a holding period limited to a few months to a year, and private equity and most mutual funds seem generally limited to three to five years. Beyond that, some actively managed mutual funds may be up to ten years, as evidenced by turnover ratios. Passively-managed index funds are oblivious to time periods, leaving that decision entirely to the index makers, which might range from a year or so for shifting indices like small cap value versus small cap growth sectors to total market indices that have few changes over ten to thirty years or longer. University endowments may have a century-length horizon.[1] Whose horizon controls? Should officers and directors be obliged to make decisions that will increase shareholder value (i.e. stock price) today or this week or this quarter or this year or this decade or this century or somehow weigh the various shareholders' diverse interests in

* Clinical Associate Professor, Georgia State University, J. Mack Robinson College of Business and College of Law (secondary appointment).

** Professor and Director of the Reiman School of Finance University of Denver, Daniels College of Business.

1. DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT, AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 2 (2000) [hereinafter SWENSEN, PIONEERING PORTFOLIO MANAGEMENT].

some weighted period pro rata to those interests? Besides, the beneficial owner of those shares is often very far removed from the actual owner,[2] as with 401(k) investors owning mutual funds through their employer-provided plans, held by trustees, recorded by institutional record keepers, managed by mutual funds managers under contract to the fund companies, with the actual securities held by custodian banks (and even then stock shares may be loaned to other investors). The chain of nominal owner to title holder to custodian to equitable owner is quite long.

A second aspect of the problem is whether ownership of shares equates to ownership of the corporation. Does a corporation actually have owners or need owners?[3] Stockholders are presumed to own the company; this is certainly so for closely-held corporations where ownership and management are co-existent,[4] but it is rather doubtful for publicly-traded corporations (also called "entrepreneurial" and "managerial").[5] Berle and Means elucidated, the widely-dispersed ownership of shares in the modern corporation creates a separation between ownership and management (control) in which "the shareholder . . . has surrendered a set of definite rights for a set of indefinite expectations."[6] Thus, shareholders have "interests" "in the form of distributions and what appraisal an open market will make of these expectations."[7] Interests are not the same as ownership. Consequently, for publicly-traded companies, a share certificate does not actually convey ownership of the corporation. Berle and Means long ago stated this, quoting from an earlier writer:

---

2. Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, 95 HARV. BUS. REV. 50, 53 (2017).

3. *E.g.*, Theresa A. Gabaldon, *Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders*, 65 MD. L. REV. 538, 538–39 (2006).

4. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 70 (1933). Berle made the distinction sharper in a later article:

> [P]roperty has now split into two distinct categories. One class may be called *active* — the farm, the little business, the collection of tangible property which the owner can himself possess, manage, and deal with. The other may be called *passive* — a set of economic expectations evidenced by a stock certificate or a bond, each representing an infinitesimal claim on massed industrial wealth and funneled income-stream. The owner of passive property is helpless to do anything with it or about it, except to sell for what the security markets will let him have.

Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1369–70 (1932) (footnotes omitted).

5. *See, e.g.*, MICHEL AGLIETTA & ANTOINE REBÉRIOUX, CORPORATE GOVERNANCE ADRIFT, A CRITIQUE OF SHAREHOLDER VALUE 35 (2005); William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives From History*, 41 STAN. L. REV. 1471, 1475–76, 1494 (1989).

6. BERLE & MEANS, *supra* note 4, at 277, 287.

7. *Id.* at 170, 286–87.

> No one is a permanent owner. The composition of the thousandfold complex which functions as lord of the undertaking is in a state of flux. . . . The claims to ownership are subdivided in such a fashion, and are so mobile, that the enterprise assumes an independent life, as if it belonged to no one . . . . [8]

Share classes that give extra weight to certain classes, such as newer technology and media companies that are still owned and managed by the founders or their scions, are a different species of corporate ownership closer to privately-held founder-led companies than the widely-dispersed shareholders of the Berle and Means modern corporation model.

A third aspect of the problem is that, despite the theories and advocacy of shareholders being owners, based on the agency model of corporate finance first developed in the 1970s, the theory is contrary to corporate law. As we explain below, those theories were based on a theoretical assumption—actually a fiction—that shareholders owned the corporation because this fit the agency theory. After all, if there is an agent (management), then there must be a principal (shareholders). Even Berle and Means relied on that fiction (and invented it) for a different reason than Michael Jensen and others later did. But long-standing corporate law, unchanged even during the agency model heydays, gives no such role to the shareholders, and the directors are not agents of the shareholders but are fiduciaries to the corporation itself, in effect making the corporation a conservatorship as far as the directors' duties to put the corporation's interest foremost.

These three aspects will be developed in this Article to urge that the question of investor time horizons should be largely irrelevant to the corporate investment decisions for publicly-traded corporations. Instead, directors should abide by their corporate-law mandated fiduciary duties to invest and manage the company in the company's own best interest. This looks more like a conservatorship of the corporation itself and less like a principal–agent relationship. The conservatorship should consider the best interests of the corporation, various classes of shareholders (common and preferred), other investors of capital (debt holders), and other stakeholders.

I. THE HETEROGENEITY OF SHAREHOLDER TIME HORIZONS

The average investor holding period for a share of stock is 200 days,[9] but the average does not provide much help in addressing the question of

---

8. BERLE & MEANS, *supra* note 4, at 352 (quotation omitted).

9. *Quick and Dirty*, ECONOMIST (Oct. 6, 2016), https://www.economist.com/news/business/21708287-are-companies-too-short-termist-quick-and-dirty [https://perma.cc/TCF6-84NK].

aligning director duties to shareholder time horizons. The reason is that shareholder time horizons vary enormously. On the short-time side are traders who hold shares from microseconds to up to a week. That is not much of a time horizon, but, nevertheless, such rapid traders are stockholders. High frequency trading (HFT) strategies hold shares for microseconds to milliseconds or, at most, for a few hours and account for 55% of the trading volume in the U.S. markets;[10] the average holding period is eleven seconds.[11] It seems entirely logical to conclude that these traders have no interest in the underlying assets of the corporation itself. Their interest lies more in the technical issues, such as the "spread" in price between bid and ask for the shares, and the opportunity to trade so as to capture some of that spread, otherwise called "skimming."[12] As Miller and Shorter explain,

> In general, traders that employ HFT strategies are attempting to earn small amount of profit per trade. Some arbitrage strategies reportedly can earn profits close to 100% of the time. Earlier reports indicated that such strategies might make money on only 51% of the trades, but because the trades are transacted hundreds or thousands of times per day, the strategies may still be profitable.[13]

Michael Lewis in his book *Flash Boys* lists several categories of "predatory behavior" done with HFT (electronic front running, rebate arbitrate, and slow-market arbitrage).[14] A holding period of milliseconds or microseconds—with or without predatory behavior— has no regard for how the company is managed and cannot possibly align with management's investment period.

---

10. RENA S. MILLER & GARY SHORTER, CON. RESEARCH SERV., HIGH FREQUENCY TRADING: OVERVIEW OF RECENT DEVELOPMENTS 1 (2016), https://fas.org/sgp/crs/misc/R44443.pdf [https://perma.cc/KVM7-G7PZ].

11. Barry Ritholtz, *Speed Trading in a Rigged Market*, BLOOMBERG (Mar. 31, 2014), https://www.bloomberg.com/view/articles/2014-03-31/speed-trading-in-a-rigged-market [http://perma.cc/6KQT-5EYG].

12. *Id.*

13. MILLER & SHORTER, *supra* note 10, at 2.

14. MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT 172 (2014).

Day traders hold stocks for seconds to minutes.[15] Some day traders are "long-term," holding shares for one to five days.[16] Various factors are used in deciding whether to buy or sell, based on things such as moving averages, trading volume, and momentum,[17] none of which seem to have anything to do with how the company itself is being managed and cannot possibly align with the management's investment period. "You'll take no interest in a company's products or in the underlying long-term fundamentals of growing corn. You're simply dealing in a security, buying it low and selling it high[,]" wrote one author on how to day trade.[18]

Individual investors currently own about 30% of the shares in publicly-traded corporations; the balance is held by institutions, most of whom hold for the benefit of individuals (such as a mutual fund).[19] Institutional investors are defined as companies managing assets over $100 million.[20] Mutual funds (domestic equities) hold $6,414.9 billion in stock, according to the Federal Reserve.[21] Private pension funds (equities) hold $2,372.3 billion in stock.[22] All U.S.-registered investment companies owned 31% of the U.S. corporate equities in 2016,[23] of which mutual funds hold $1,776 billion in defined contribution equity assets plus some unstated equity percentage in hybrid funds whose value is $988 billion.[24] An additional $1.547 trillion is in IRA equity accounts plus some unstated percentage in hybrid accounts whose value is $831 billion.[25] Equity holdings in variable annuity mutual funds (which presumably are intended

---

15. *Day Trading: Your Dollars at Risk*, U.S. SEC. & EXCH. COMM'N (Apr. 20, 2005), https://www.sec.gov/reportspubs/investor-publications/investorpubsdaytipshtm.html [https://perma.cc/UFW3-PS6E].

16. MICHAEL SINCERE & DERON WAGNER, THE LONG-TERM DAY TRADER: SHORT-TERM STRATEGIES TO BOOST YOUR LONG-TERM PROFITS 10 (2000) (ebook).

17. *See, e.g.*, OLIVER VELEZ & GREG CAPRA, TOOLS AND TACTICS FOR THE MASTER DAY TRADER 11 (2000).

18. JACOB BERNSTEIN, THE ULTIMATE DAY TRADER: HOW TO ACHIEVE CONSISTENT DAY TRADING PROFITS IN STOCKS, FOREX AND COMMODITIES 21–22 (2009).

19. Bower & Paine, *supra* note 2; Gretchen Morgenson, *Small Investors Support Boards, But Few Vote*, N.Y. TIMES (Oct. 8, 2017), https://www.nytimes.com/2017/10/06/business/small-investors.html.

20. 17 C.F.R. § 240.13f-1 (2011).

21. *Financial Accounts Guide*, *L.122 Mutual Funds*, BOARD OF GOVERNORS OF THE FED. RES. SYS., https://www.federalreserve.gov/apps/fof/DisplayTable.aspx?t=l.122 [https://perma.cc/39YW-UVBF].

22. *Financial Accounts Guide, L.118 Private Pension Funds*, BOARD OF GOVERNORS OF THE FED. RES. SYS., https://www.federalreserve.gov/apps/fof/DisplayTable.aspx?t=l.118 [https://perma.cc/B5PS-MEC5].

23. INV. CO. INST., 2017 INVESTMENT COMPANY FACT BOOK 13 (2017), https://www.ici.org/pdf/2017_factbook.pdf [https://perma.cc/2RXJ-QU62].

24. *Id.* at 232.

25. *Id.* at 233.

also as retirement vehicles) total approximately $1,673 billion plus an unstated percentage in hybrid accounts.[26]

For individual investors, two factors seem most relevant to ascertain holding periods. One is how often individuals sell their mutual fund positions, which can reflect either their intended holding period or their tolerance of underperformance by the fund. If mutual fund investors' selling of shares is large or rapid enough, the selling could drive the portfolio manager to sell the stock holdings of the fund. This cash flow out of mutual needs to be examined in the context of the offsetting buying of shares of the fund by other individuals. More broadly, the buying and selling of mutual fund shares can occur in the context of fund investment approach, which has recently been the case with many investors selling actively managed funds and buying lower-cost index funds. Recent studies show that investors have sold $355 billion in active mutual funds and bought $337 billion in passive (index) mutual funds in 2016.[27]

A second factor to consider in determining investor holding periods is the mutual fund portfolio turnover ratio, which reflects both the fund manager's holding period and indirectly the tolerance of the fund's shareholders for underperformance. Turnover ratios for actively-managed funds range from under 10% to over 200% with growth mutual funds tending towards the higher turnover ratios and large-capitalization value funds tending towards the lower turnover ratios.[28] Turnover ratios for passive (index) funds follow the change in holdings set by the index maker, which, if the index tracks some slice of the market (e.g. small-cap value, mid-cap growth, etc.), adjusts based on representative stocks for that index, changes market capitalization of the individual stocks within that index and affects sales or mergers of individual stocks or those taken private (and thus off the exchange) or suspended or withdrawn due to bankruptcy.[29] Thus, a total stock market index has very low turnover ratio and consequently little change in holdings,[30] while a sector index (whether

26. INV. CO. INST., *supra* note 23, at 227.

27. Charles Stein, *When Bad Things Happen to Good Funds*, BLOOMBERG BUSINESSWEEK (Jan. 12, 2017), https://www.bloomberg.com/news/articles/2017-01-12/when-bad-things-happen-to-good-funds. Flows out and flows in do not necessarily prove money moved from active to passive funds. Possibly some of the active money was drawn out by older retirees to spend, while newer savers put new money into passive funds.

28. *Turnover Ratio*, MORNINGSTAR, http://www.morningstar.com/InvGlossary/turnoverratio.aspx; William F. Sharpe, *Morningstar's Performance Measures, Fund Characteristics*, https://web.stanford.edu/~wfsharpe/art/stars/stars4.htm [https://perma.cc/4LGE-KLGE].

29. *See, e.g.*, JOHN BOGLE, BOGLE ON MUTUAL FUNDS 180–85 (1994); Albert S. Neubert, *Benchmarks: Definitions and Methodologies*, *in* INDEXING FOR MAXIMUM INVESTMENT RESULTS 19–35 (Albert S. Neubert ed., 1998).

30. A low-turnover fund has tax advantages when held in a taxable account, but it does have the risk that the undistributed large capital gains might hit a recent investor in the fund if those gains are

split as value or growth, or mid-cap versus small-cap) will vary as those individual stocks grow or slide from value to growth or back to value and from small-cap to mid-cap to large cap or back down.

Mutual funds may also be segmented into investment objectives so that target date funds do have a targeted holding period as stated in the prospectus (and obviously the target date itself), though some funds view that date as a redemption date and others as a glide path to a conservative investment strategy that will last another thirty years in retirement.[31] "Retirement accounts and plans held about 37% of U.S. stocks in 2015, worth roughly $8.4 trillion."[32] The table below shows target date funds from some of the major mutual fund companies; the left column indicates what those investment horizons are based on those dates.[33]

Target Date Funds

Retirement Dates

Investment Horizon to Retirement	Investment Horizon Plus 25 years in Retirement	BLACK-ROCK	FIDELITY	T. ROWE PRICE	TIAA-CREF	VAN-GUARD
3 years	28	2020	2020	2020	2020	2020
8	33	2025	2025	2025	2025	2025

actually distributed. To the converse, the benefit of the capital gains tax rate against ordinary short-term gains tax rate is lost if the fund is held in a tax-favored retirement account, although there are still good investment reasons to hold index funds in retirement accounts. *See* BOGLE, *supra* note 29, at 217–18; CHARLES R. SCHWAB, CHARLES SCHWAB'S GUIDE TO FINANCIAL INDEPENDENCE 142–45 (1998); Lawrence R. Hudack & Duane M. Ponko, *Focus on Aftertax Returns from Nonretirement Investments in Mutual Equity Funds*, 68 CPA J. 76 (Nov. 1998).

31. *See, e.g.*, INV. CO. INST., *supra* note 23; Wojciech Krawiec, *Target Date Funds 2055 - Same Target Year, Different Glide Paths*, 35 RES. PAPERS WROCLAW U. ECON. 77, 79 (2014).

32. Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, TAX NOTES, May 16, 2016, at 923, 928.

33. *LifePath Target Date Funds,* BLACKROCK, https://www.blackrock.com/investing/financial-professionals/defined-contribution/lifepath-target-date-funds [https://perma.cc/EG8S-LZWN]; *How Fidelity Manages Freedom Funds*, FIDELITY, https://www.fidelity.com/mutual-funds/fidelity-fund-portfolios/freedom-funds-manage [https://perma.cc/9C5H-4D73]; *Target Date Funds*, T.ROWEPRICE, https://www3.troweprice.com/usis/personal-investing/mutual-funds/target-date-funds.html [https://perma.cc/C93F-W9M7]; *Performance: Mutual Funds and In-Plan Annuities*, TEACHERS INS. & ANNUITY ASS'N AMERICA, https://www.tiaa.org/public/investment-performance?defaultview=mfinstonly [https://perma.cc/G4PX-2TR8]; *Vanguard Target Retirement Funds*, VANGUARD, https://investor.vanguard.com/mutual-funds/target-retirement/#/ [https://perma.cc/H738-J3X9].

13	38	2030	2030	2030	2030	2030
18	43	2035	2035	2035	2035	2035
23	48	2040	2040	2040	2040	2040
28	53	2045	2045	2045	2045	2045
33	58	2050	2050	2050	2050	2050
38	63	2055	2055	2055	2055	2055
43	68	2060	2060	2060	2060	2060

Individuals may have entirely different reasons for investment holding periods than firms or mutual funds. In financial planning, investors may invest for particular purposes, such as saving for a down payment for a house, for college tuition for children, for retirement, for asset allocation and rebalancing, and for other major purchases. Thus, the same investor may have multiple horizons ranging from five to thirty-five years. The many households that invest have an even wider variety of goals, time horizons, and risk tolerances. The Investment Company Institute's 2017 *Fact Book* notes:

> [H]ouseholds often use mutual funds to save for the long term, such as for college or retirement. . . . many long-term fund shareholders seek the advice of financial advisers, who may provide a steadying influence during market downturns. These factors are amplified by the fact that assets in mutual funds are spread across 94 million investors and fund investors have a wide variety of individual characteristics (such as age or appetite for risk) and goals (such as saving for purchase of a home, for education, or for retirement).[34]

Pension funds (and annuity providers) have both immediate payment demands for current retirees and long-term investment obligations for all current employees whose retirement date will range from one year to thirty-five years or longer. Similar time horizons might be expected in non-traditional corporate forms, such as employee-owned companies where stockowners are the current employees and probably some retirees. Some companies are mutual, meaning the customers and policyholders are also the shareholders. This is common with insurance companies (e.g., Northwestern Mutual, State Farm, New York Life, USAA, Massachusetts

34. INV. CO. INST., *supra* note 23, at 33.

Mutual) and other companies like REI and Vanguard.[35] The time horizon (if there is one) for employee-owned companies and mutual companies would seem to be as long as the customer or policyholder is a member and the employee is an owner; but (like target-date funds), this is an endless rolling period as new customers/policyholders/employees enlist, so the company's real time horizon is, as New York Life's webpage says, "for generations to come."[36] It further states:

> Mutuality means we are collectively and entirely owned by our clients, not outside investors. And since we don't have to continually appease the bulls and bears of Wall Street, our exclusive focus—every decision we make—is in the best interests of our policy owners.
>
> Being able to look beyond short-term profits to invest for the longterm produces results that speak for themselves. We've amassed a cash reserve in excess of $22 billion. And we have unfailingly met our financial obligations for over 170 years.
>
> And, we expect, for generations to come.
>
> The fact is, mutuality is at the core of everything we do. It's what enables us to stand by our principles of humanity and integrity every single day. To strive for greatness, but never at the expense of goodness. To keep our promises, and do what's right.
>
> Mutuality also enables our clients to be active participants in the life of our company. Those who purchase participating policies have the power to elect members of our board of directors. And, of course, those policy owners have also enjoyed the benefit of annual dividends, which in 2016 totaled $1.7 billion.[37]

Institutional investors have other considerations. Institutional investors, because of the size of their holdings, may find liquidity is less

---

35. *See, e.g.*, GEORGE E. REJDA & MICHAEL J. MCNAMARA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 88–90 (12th ed. 2014); *Why Ownership Matters*, VANGUARD, https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters/ [https://perma.cc/J8VN-9MQ8]; *About REI*, REI, https://www.rei.com/about-rei.html [https://perma.cc/Y2BA-DRQE] (REI is a co-op).

36. *Mutuality Matters*, N.Y. LIFE, https://www.newyorklife.com/about/our-strength/mutuality-matters/ [https://perma.cc/3JZP-G2BQ].

37. *Id.* (footnotes omitted).

of an option due in part to moving the market price merely by exiting a position.[38]

University endowments will usually have very long time horizons plus a need for distributions for current operations.[39] Total endowments were $515 billion in 2016, which included all assets, not just equities.[40] David Swensen, the portfolio manager of the Yale endowment, puts the horizon at "centuries,"[41] stating "most educational institutions aspire to exist in perpetuity. . . . The perpetual nature of colleges and universities makes endowment management one of the investment world's most fascinating endeavors."[42]

Sovereign wealth funds have similar long-term horizons, described as "inter-generational" horizons, holding more than $6 trillion in assets;[43] Norway's fund says "the fund's investments are about the future and belong to our future generations."[44]

While investors have many different holding periods, one study found that an investment holding period for stocks is fifteen years to reliably beat the risk-free rate of return 95% of the time and even longer when investing in large capitalization stock;[45] another study put that holding period at nineteen years.[46] If investors collectively were to have an investment time horizon, these studies would direct that the period be nearly two decades. For retirement portfolios that may begin at a new worker's age of twenty-five, individual investors and their investment

---

38. John Coffee has explored the agency problems inherent in these institutional investor arrangements. John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1317–18, 1328–29 (1991).

39. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT, *supra* note 1, at 8–10, 14–15.

40. *2016 NACUBO-Commonfund Study of Endowments*, NAT'L ASS'N COLL. & UNIV. BUS. OFFICERS, http://www.nacubo.org/Research/NACUBO-Commonfund_Study_of_Endowments.html [https://perma.cc/4WFD-SBLL].

41. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT, *supra* note 1, at 2.

42. *Id.* at 25.

43. *See* TAMARA GOMES, THE IMPACT OF SOVEREIGN WEALTH FUNDS ON INTERNATIONAL FINANCIAL STABILITY 8 (Dec. 2008), http://www.bankofcanada.ca/wp-content/uploads/2010/01/dp08-14.pdf [https://perma.cc/L29D-LC65]; Nuno Fernandes, *The Impact of Sovereign Wealth Funds on Corporate Value and Performance*, 26 J. APPLIED CORP. FIN. 76, 83 (2014). The divergence of sovereign wealth fund time horizons to that of other investors is also noted in Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote And The False Promise Of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 489–91 (2008).

44. *Responsibility*, NORGES BANK INV. MGMT, https://www.nbim.no/en/responsibility/ [https://perma.cc/B4E7-FKKH]. Sovereign wealth funds may create other divergent interests with the corporate entity, which is a point not relevant here. *See, e.g.*, Paul Rose, *Sovereigns as Shareholders*, 87 N.C.L. REV. 83, 93–95 (2008).

45. Bin Li et al., *Stock Returns and Holding Periods*, 2 JASSA- FINSIA J. APPLIED FIN. 43, 44 (2012).

46. Shen Pu, *How Long Is a Long-Term Investment?*, 90 ECON. REV. 1, 12 (2005).

managers actually will have such a period, particularly if using index funds, but otherwise it is doubtful that anyone would actually wait fifteen to nineteen years to see how a particular stock investment turns out.

Even if we could ascertain *an* investor's time horizon, there are too many investors to say what *all* investors' time horizons are. "In practice, of course, shareholders are often not a homogeneous block with a collective interest. . . ."[47] As one author noted:

> A single shareholder, or multiple shareholders with homogeneous preferences, would in theory be able to specify a single objective for running the firm. Shareholders with private interests, however, might prefer the firm to pursue those interests at the expense of the interests they have in common with other shareholders. . . .
>
> Thus, when shareholders have divergent private interests, it is no longer accurate to think of shareholder action as a collective good. That conception depends on there being a uniform maximand for all shareholders.[48]

Thus, shareholders have short-term and long-term interests, hedged and unhedged positions, diversified and undiversified interests, inside versus outside shareholders, social and economic interests (if public pensions) and labor interests (if labor union pension funds). These concerns are not limited only to these investors[49] and liquidity versus capital appreciation preferences. Variations on the basic stock security have their own target horizons, as with options, warrants, conversions (e.g. convertible bonds), stock redemption and repurchase dates, and covered puts and calls. Another set of targets lie within executive incentive compensation plans with their different stock options that have largely and miserably failed to fix the agency problem by turning managers into active shareholders-in-control but, instead, created another opportunistic means for managerial enrichment and extraction of surplus.[50] There are even

47. *The Business of Business*, ECONOMIST (Mar. 21, 2015), https://www.economist.com/news/business/21646742-old-debate-about-what-companies-are-has-been-revived-business-business; *see also* Hayden & Bodie, *supra* note 43.

48. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 575 (2006).

49. *Id.* at 579–91.

50. *See, e.g.*, Claire A. Hill & Brett H. McDonnell, *The Agency Cost Paradigm: The Good, the Bad, and the Ugly*, 38 SEATTLE U. L. REV. 561, 566; Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE. U. L. REV.

"phantom" shareholders who are credited with stock under incentive compensation plans but do not actually own shares.[51] Diversified stockholders have multiple investments and may prefer single-minded emphasis on shareholder wealth maximization (whatever that really is), while non-diversified investors are (or are like) the founding entrepreneurs whose interests may be closer to bondholders and employees.[52]

> [A] diversified investor will prefer that management of any individual company pursue the highest risk-adjusted return even at the risk of the ruin of the company. In contrast, an undiversified investor—one with all of his or her eggs in one basket — will care very much whether that one company survives. In short, an undiversified stockholder is risk-averse.[53]

Stephen Bainbridge expands on this divergence in interest:

> Shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, for example, which in turn is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders who disagree about the merits of allowing management to invest the firm's free cash flow in new projects.[54]

Perhaps only private equity investors give a clear holding period demand in their stated three- to five-year investment horizons (5.5 is the average length),[55] but this type of rigid investment philosophy effectively caters to a particular type of investor. It begs the question of how to address

---

1169, 1176 (2016); Ric Marshall, *Out of Whack: U.S. CEO Pay and Long-term Investment Returns*, MSCI RES. INSIGHT, https://www.msci.com/ceo-pay [https://perma.cc/MBS6-N3DA].

51. D. Kyle Sampson, Comment, *The Fiduciary Duties of Corporate Directors to "Phantom" Stockholders*, 62 U. CHI. L. REV. 1275, 1277–78 (1995).

52. Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 435–36 (1998).

53. *Id.* at 442 (footnote omitted).

54. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 623 (2006).

55. Amy Or, *Average Private Equity Holding Times Drops to 5.5 Years*, WALL ST. J. (June 10, 2015), https://blogs.wsj.com/privateequity/2015/06/10/average-private-equity-hold-times-drop-to-5-5-years/.

the duties the board owes the firm when the shareholder base has diverse horizons, as in the case in publicly-traded corporations.

A further way to classify the different types of investors is by how they invest. Many investors have little interest in the company *qua* company. They care not for the fundamentals. These investors follow the pattern of stock prices with the view that they can determine trends that will allow them to profit. The technical stock trader (also called a "chartist") looks at moving averages and trading volume and trends of the market as a whole. Malkiel says, "A true chartist doesn't even care to know what business or industry a company is in, as long as he can study its stock chart."[56] Under Modern Portfolio Theory, the advantage of eliminating company specific risks results in focus on individual security selection.[57] Eugene Fama wrote:

> [P]ortfolio theory tells us that the optimal portfolio for any investor is likely to be diversified across the securities of many firms. Since he holds the securities of many firms precisely to avoid having his wealth depend too much on any one firm, an individual security holder generally has no special interest in personally overseeing the detailed activities of any firm.[58]

With limited interest in particular companies and greater interest in portfolio asset allocation and diversification, we should expect that this category of investors, however long-term their horizon, to have little interest in seeing themselves as owners of the corporation.

Investor focus on company-specific fundamental analysis varies widely. Some investors focus their analysis within certain sectors of the market, based on factors such as market capitalization, style, or industry (sector). Examples would be small cap value, mid-cap growth, utility or airline or biotechnology companies, etc., with the result that whichever companies fall into that sectors are the ones the investor examines and

---

56. BURTON MALKIEL, A RANDOM WALK DOWN WALL STREET 118 (1996).

57. BOGLE, *supra* note 29, at 235–36; MALKIEL, *supra* note 56, at 203–05; DAVID SWENSEN, UNCONVENTIONAL SUCCESS, A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 21 (2005) [hereinafter SWENSEN, UNCONVENTIONAL SUCCESS] ("Security selection plays a minor role in investment returns, because investors tend to hold broadly diversified portfolios that correlate reasonably strongly with the overall market."); SWENSEN, PIONEERING PORTFOLIO MANAGEMENT, *supra* note 1, at 55–58; Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291 (1980).

58. Fama, *supra* note 57, at 291.

holds.[59] Some mutual funds specialize in fulfilling these sectors; the firm Dimensional Fund Advisors specializes in this portfolio sector slicing and is a favorite of financial planners.[60] Even within sectors, the investor, be it an individual or a fund, can be largely passive and not follow individual company issues. For example, exchange-traded funds (ETF) provide a portfolio of stocks, typically an index, which can be traded as a portfolio[61] and can focus on narrow market sectors, even commodities and currencies.[62] ETFs can be traded throughout the day,[63] which can create the need for the ETF to buy and sell the underlying stock holdings.

Given the heterogeneity of investors at any one point in time, we contend that trying to ascertain an investor's time horizon for his/her/its investments is infeasible standing alone, infeasible for reconciling diverse time horizons and not workable for directors in determining the corporate investment horizon to correspond with the investors' time horizons. Corporate directors, therefore, would be in the irreconcilable position of appeasing the demands of multiple investors demanding returns across multiple conflicting periods.

The corporation conceivably can be immortal, so its own investment decisions can conceivably be similarly long-term,[64] although evolving businesses, markets and technologies will require adjustments, not static investment decisions. Having a very long corporate investment horizon would match only a subset of investors, such as university endowments, foundations, and sovereign wealth funds.

The heterogeneity is also a moving problem with rolling periods because individual investor time horizons are subject to change. Every year shareholders make new stock purchases, stock sales, related mutual fund purchases, and mutual fund redemptions for different reasons. As a result, the investor who originally had a ten-year horizon now has a nine-year horizon; meanwhile, new investors have a ten-year horizon. Only if we look at some demographic shift in an aging population that will redeem

---

59. JOHN A. HASLEM, MUTUAL FUNDS, 206–09 (2003); Bruce D. Westervelt, *Adding Value Through Equity Style Management*, *in* INDEXING FOR MAXIMUM INVESTMENT RESULTS 237–42 (Albert S. Neubert ed., 1998).

60. Robert Barker, *So You Think Stock Picking Is a Fool's Game*, BUSINESS WEEK, Nov. 18, 2002, at 144; Ian Salisbury, *The New Faces of Stock Picking*, TIME (Jan. 13, 2014), http://time.com/money/2795053/beat-the-market-without-picking-stocks/ [https://perma.cc/EZ5N-CX36]; Charles Stein, *Charming Investors by Playing Hard to Get*, BUSINESSWEEK, Jan. 26, 2015, at 41.

61. GARY L. GASTINEAU, THE EXCHANGE-TRADED FUNDS MANUAL 110 (2002).

62. DAVID J. ABNER, THE ETF HANDBOOK 162 (2d ed. 2016); FRANCIS GROVES, EXCHANGE TRADED FUNDS: A CONCISE GUIDE TO EFTS 71–87 (2011).

63. GROVES, *supra* note 62, at 69; *see also* GASTINEAU, *supra* note 61, at 80.

64. Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 773–74 (2012); Lynn A. Stout, *The Corporation As Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE. U. L. REV. 685, 694–95 (2015).

more than it invests, might we see some time horizon buoy on the waves of investment flows.

II. OTHER DOUBTS ABOUT MATCHING INVESTOR TIME HORIZON'S TO THE COMPANY'S

For the question posed at this symposium, it might be sufficient to stop here with the problem of the heterogeneity of investor time horizon providing no definitive direction to the management of the firm. But there are other reasons why we ought not to look at investor time horizons to guide the company's investment horizon. Those reasons are (1) in the modern corporation of diversified ownership, common stock investors do not actually own the company, although they get to vote on directors and management proposals (and some of the shareholder's own tendered proposals); (2) agency theory itself relies on the fiction of shareholder ownership of the company to support the theory; (3) agency theory, as supplanted by the more lofty theory of contractualism, dispenses with even the fictive assumption that shareholders own the corporation. These points follow.

A. Ownership of Stock Shares Is Not Ownership of The Company

There is no legal basis for the contention that shareholders own the corporation, which is often made under the agency model of corporate finance (discussed below). Corporate law states the contrary. "Shareholders just own shares—that is, bundles of entitlements such as the right to receive dividends and to vote on certain issues."[65]

Corporations come into existence upon the filing and approval of the articles of incorporation, not when shares are sold.

> Under the Revised Model Business Corporation Act and state corporation statutes with comparable provisions, unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed. In comparison, under the old Model Business Corporation Act upon the issuance of the certificate of incorporation, the corporate existence begins.[66]

Various corporate statutes support this assertion. California law provides that "corporate existence begins upon the filing of the articles and

65. *The Business of Business*, *supra* note 47.

66. MOD. BUS. CORP. ACT § 166. *See generally* 1A FLETCHER CYC. CORP. § 166.

continues perpetually, unless otherwise expressly provided by law or in the articles."[67] Delaware law provides:

> Upon the filing with the Secretary of State of the certificate of incorporation, executed and acknowledged in accordance with § 103 of this title, the incorporator or incorporators who signed the certificate, and such incorporator's or incorporators' successors and assigns, shall, from the date of such filing, be and constitute a body corporate, by the name set forth in the certificate, subject to § 103(d) of this title and subject to dissolution or other termination of its existence as provided in this chapter.[68]

Georgia law provides:

> (a) Unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed. (b) The Secretary of State's filing of the articles of incorporation is conclusive proof that the incorporators satisfied all conditions precedent to incorporation except in a proceeding by the state to cancel or revoke the incorporation or involuntarily dissolve the corporation.[69]

Maryland law provides, "When the Department accepts articles of incorporation for record, the proposed corporation becomes a body corporate under the name and subject to the purposes, conditions, and provisions stated in the articles."[70] Similarly, New York law provides:

> Upon the filing of the certificate of incorporation by the department of state, the corporate existence shall begin, and such certificate shall be conclusive evidence that all conditions precedent have been fulfilled and that the corporation has been formed under this chapter, except in an action or special proceeding brought by the attorney-general.[71]

---

67. CAL. CORP. CODE § 200 (West 2014).
68. DEL. CODE ANN. tit. 8, § 106 (West 2017).
69. GA. CODE ANN. § 14-2-203 (West 2017).
70. MD. CODE ANN. CORPS. & ASS'NS § 2-102 (West 2017).
71. N.Y. BUS. CORP. LAW § 403 (McKinney 2017).

Also, Pennsylvania law states, "Upon the filing of the articles of incorporation in the Department of State or upon the effective date specified in the articles of incorporation, whichever is later, the corporate existence shall begin."[72] Finally, Washington law provides that "[u]nless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed."[73]

Corporations need capital, which is raised by selling shares.[74] "It is not a prerequisite to corporate existence that there be shares of stock issued or outstanding. The corporation comes into existence when its articles of incorporation are filed with the Secretary of State," said the court in *Brodsky v. Seaboard Realty Co.*[75] "That certificates of stock were not issued does not detract from this conclusion, for the incorporators became stockholders and were entitled to have issued to them the certificates for the number of shares which they had subscribed for," said the court in *J.W. Williams Co. v. Leong Sue Ah Quin*;[76] other cases interpreting statutes to this point are *Hammond v. Strauss*[77] and *Hawes v. Anglo-Saxon Petroleum Co.*[78] In fact, a corporation could buy back all its outstanding shares, as treasury stock, without delimiting or denigrating the existence of the corporation, although a few states limit repurchases to surplus capital.[79]

The assertion that stock shares constitute ownership of the modern corporation is tenuous because the rights of the shareholders are limited to the right to vote, the right to inspect the books and records, the right to hold directors accountable for misconduct,[80] the right to preempt (if granted by statute or by the articles of incorporation),[81] and the right to any residual value after all creditors and preferred stockholders are paid.[82] This puts us back to Berle and Means' shareholders who have *indefinite*

72. 15 PA. STAT. AND CONS. STAT. ANN. § 1309 (West 2017).

73. WASH. REV. CODE ANN. § 23B.02.030 (West 2017).

74. *See generally* 1 FLETCHER CORP. FORMS § 6:24 (5th ed.).

75. 206 Cal. App. 2d 504, 515–16 (1962).

76. 44 Cal. App. 296, 298 (1919).

77. *See generally* 53 Md. 1 (1880).

78. *See generally* 101 Mass. 385 (1869).

79. 11 FLETCHER CYC. CORP. § 2847 (discussing the history of treasury shares and the early prohibitions on buybacks to as "a violation of its charter and a diversion of its funds to an authorized purpose," and to avoid "impairment of its capital needed for the protection of creditors."); *see also id.* §§ 2848–49, 5148, 2845; MODEL BUS. CORP. ACT § 6.31 (2010) (AM. BAR ASS'N).

80. *See generally* 1 FLETCHER CORP. FORMS § 6:43 (5th ed.); David J. Berger, *One Practitioner's Random Thoughts on Shareholders' Rights in the Modern Corporation*, *in* 1 THE ACCOUNTABLE CORPORATION 121–28 (Marc J. Epstein & Kirk O. Hanson eds., 2006); George D. Hornstein, *Rights of Stockholders in the New York Courts*, 56 YALE L.J. 942 (1947).

81. 1 FLETCHER CORP. FORMS § 6:44 (5th ed.).

82. Hornstein, *supra* note 80, at 955.

expectations and *interests* "in the form of distributions and what appraisal an open market will make of these expectations,"[83] where "appraisal" means tradable nature in liquid stock markets.[84]

What is the origin of the belief that common shareholders own the corporation and therefore the corporation should be run in their interest? The assertion of ownership by the shareholders and their right to financial information was noted before the "[c]rash" by William Ripley in an important article preceding Berle and Means' work.[85] Another pre-Berle book, *Business Ownership Organization*, describes stockholders as the owners of capital: "stocks . . . represent an ownership interest or contributions of capital to remain permanently in the business," as against bondholders who expect to receive their loans plus interest,[86] (although the author is not consistent, later describing the ownership of shares as representing an ownership interest[87] and then later as an equitable interest[88]). As Ripley and Benjamin Graham noted in their practice of "shareholder activism," management disregarded the stockholders' assertion of interest in the company, often brushing off investor inquiries with the admonition to sell the stock if they did not like how the company was run.[89]

"By tradition, a corporation 'belongs' to its shareholders," wrote Berle and Means, but this meant the directors would then act as "trustees

---

83. BERLE & MEANS, *supra* note 4, at 277, 286–287. The appraisal idea was later developed as a theory of locked-in capital, whereby shareholders could not redeem their shares back to the corporation absent some repurchase agreement, but, instead, sold to other investors, making those shares "liquid" in an open market. *See* Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253 (2005) (exploring implications of equity capital lock-in); *see also* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

84. AGLIETTA & REBÉRIOUX, *supra* note 5, at 35 (contending that this liquidity "provides [shareholders] with a capacity for exit and diversification without equal, in any case much higher than that of the employees").

85. William Z. Ripley, *Stop, Look, Listen! The Shareholder's Right to Adequate information*, ATLANTIC (Sept. 1926), https://www.theatlantic.com/magazine/archive/1926/09/stop-look-listen-the-shareholders-right-to-adequate-information/376225/ [https://perma.cc/BRM3-E7WJ].

86. ARCHIBALD H. STOCKDER, BUSINESS OWNERSHIP ORGANIZATION 14 (1922).

87. *Id.* at 86.

88. *Id.* at 451.

89. *See* BENJAMIN GRAHAM, THE MEMOIRS OF THE DEAN OF WALL STREET 203 (1996); *see also id.* at 199–216. Graham was one of the first to seek out undervalued companies and try to improve them through shareholder activism, as related in his account of trying to get the management the Northern Pipeline Company to issue a larger dividend starting in 1925. Armour and Cheffins more recently studied the period and concluded that "offensive shareholder activism" was rare during this period, in part due to the same reasons that Graham and Ripley found but led Graham to his success—the lack of available information. John H. Armour & Brian R. Cheffins, *Origins of "Offensive" Shareholder Activism in the United States*, *in* ORIGINS OF SHAREHOLDER ADVOCACY 253–76 (Johnathan GS Koppel ed., 2001).

for the sole benefit of inactive and irresponsible security owners."[90] William Allen explains the "tradition" was based on 19th century corporate law and practice, where "corporate shareholders during this period did not enjoy the protection of limited liability to the same degree as they modernly do," with the corporation existing as "essentially the stockholders in a special form" for whom the "directors were seen as agents of the stockholders."[91] Wells explains this period:

> Only unanimous shareholder consent could change a corporation's purpose, which points to a second distinctive feature of nineteenth century corporation law: not only did it constrain the corporation's activities, but it also gave meaningful control to shareholders. The Board's power over the corporation was, in theory, limited to managing its day-to-day affairs.[92]

Other research shows there has long been a question about what ownership of shares meant as to ownership of the corporation. Epstein explains that the notion of shareholders owning parts of the corporation and having the right to vote arose from the New York Stock Exchange's requirements and promotions (starting in the 1940s) that attempted to equate stock ownership with "the political metaphor of corporate democracy."[93] Initially, the goals were to restore public confidence in the stock market and thus, draw out the public's savings in government bonds, and then later, (as the then president of the American Stock Exchange testified to Congress) to forestall government regulation by showing that investors were overseeing the corporations.[94] Colleen Dunlavy similarly, and with greater detail, develops the history of shareholder voting rights, noting that in the 19th century the concern was horizontal imbalance among shareholders to plutocratic control, which was addressed by statutes mandating one-share one-vote, to the post-war 20th century statutory changes to deal with the vertical imbalance between shareholders

90. BERLE & MEANS, *supra* note 4, at 354.

91. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 266 (1992).

92. Harwell Wells, *The Modernization of Corporation Law, 1920-1940*, 11 U. PENN. J. BUS. L. 573, 582 (2009).

93. EDWARD J. EPSTEIN, WHO OWNS THE CORPORATION?: MANAGEMENT VS. SHAREHOLDERS 7–8 (1986).

94. *Id.* at 8–10.

and management.[95] Harwell Wells points out that prior to the post-war period, the vast majority of securities were bonds and preferred shares because people viewed common stock as speculative.[96] Hayden and Bodie assert a similar view:

> Shareholder primacy could simply be viewed as a democratic legitimacy argument: the corporation has to keep shareholder interests at the forefront because shareholders are the voting polity. But this puts the cart before the horse: after all, who made the shareholders the voting polity? The choice of this group as the enfranchised citizenry is what needs justifying. A variant of this justification is that shareholders are the corporation's "owners" and thus are entitled to the ownership rights of profits and control. However, the ownership justification is also doomed by its circularity: who made the shareholders the "owners"? As corporate law commentators have convincingly pointed out, shareholders simply purchase a set of rights from the corporation. The right to vote is made part of the stock ownership "bundle," but a stock could be constructed (and has at times been constructed) without the right to elect directors. Even shareholders with the right to vote do not possess many of the rights that traditionally accrue to property owners--the right to exclude, for example, or the right of possession. Labeling shareholders "owners" is no more of a justification for the vote than is labeling them "voters."[97]

Epstein calls shareholders "nominal owners,"[98] which is probably more accurate than cases that refer to shareholders as equitable or "beneficial owners,"[99] these latter terms being considerably ambiguous unless used to identify beneficial owners of shares held in street name or

---

95. Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1359–65 (2006).

96. Wells, *supra* note 92, at 586–87.

97. Hayden & Bodie, *supra* note 43, at 473; *cf.* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–94 (2007) (arguing that the shareholder vote accomplishes little due to structural impediments in governance and voting).

98. EPSTEIN, *supra* note 93, at 13.

99. *See* Med. Comm. for Human Rights v. SEC, 432 F2d. 659, 681 (3rd Cir. 1970), *vacated on other grounds* 404 U.S. 403 (1972).

trust,[100] in a close corporation,[101] preferred shareholders,[102] owners trying to sue to recover debts of the inactive or dissolved corporation,[103] or derivative suits,[104] as the cases in the footnote illustrate. And when looking at individual retirement investors through their employer-provided 401(k) and 403(b), accounts, "nominal owners" and "beneficial owners" look like accurate terms to describe the employee putting money into the employer-provided plans, which are overseen by the employers as fiduciaries (with many under ERISA), with separate third-party record keepers and administrators, multiple fund companies, mutual fund managers and sub-managers, trustees for the retirees, stock custodians and transfer agents. Thus, the terms "nominal" or "beneficial owner," as terms, make more sense for the employee-investor through multiple layers of administrators and intermediaries.

Julian Velasco contends the "tradition" of ownership should be right—that shareholders own the corporation—but admits there is no law that actually supports this tradition.[105]

---

100. *See, e.g.*, Sadler v. NCR Corp., 928 F.2d 48, 50 (2d Cir. 1991); Phillips v. United Corp., No. 40-497, 1947 U.S. Dist. LEXIS 3123 (S.D.N.Y. July 30, 1947); Bird v. Wilmington Soc. of Fine Arts, 43 A.2d 476 (Del. 1945); In re Digex S'holders Litig., No. 18336-NC, 2002 Del. Ch. LEXIS 40 (Del. Ch. Apr. 16, 2002); Milner v. Milner, 361 S.W.3d 615, 620–21 (Tex. 2012).

101. *See generally* Continental Bank v. Phoenix Ins. Co., 101 Cal. Rptr. 392, 392 (Cal. Ct. App. 1972); Kauffman-Harmon v. Kauffman, 36 P.3d 408, 409–410 (Mont. 2001); Snyder v. Freeman, 266 S.E.2d 593, 597–99 (N.C. 1980) (finding an express shareholder agreement for issuance of shares in place of the money owed as a creditor); Commonwealth v. Woodlands Cemetery Co., 13 Pa. D. & C.2d 548, 549-550 (Pa. Ct. Com. Pl.1957) (finding that a corporation established to operate a cemetery and certificate holders were granted rights to the land); Sneed v. Webre, 465 S.W.3d 169, 174 (Tex. 2015) ("Ownership of the entities comprising the family business has remained within the Webre family."); McAlister v. Eclipse Oil Co., 98 S.W.2d 171, 176 (Tex. 1936) (when there are three stockholders, "strictly speaking, the ownership of the stock does not carry with it the equitable title to the corporate property. This simply means, however, that the stockholders have no right to require the corporation to convey to them the legal title to the corporate property. In a larger or real sense the stockholders of a corporation are the beneficial owners of its corporate properties").

102. Cotton v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App. 2006) (referring to the preferred shareholder as "equitable or beneficial owner" with a right to inspect), *overruled on other grounds* Ritchie v. Rupe, 443 S.W.3d 856 (Tex. 2014).

103. *See generally* Humble Oil & Refining Co. v. Blankenburg, 235 S.W.2d 891, 893–94 (Tex. 1951); Aransas Pass Harbor Co. v. Manning, 94 Tex. 558, 563, (Tex. 1901) ("A stockholder, merely as such, has no direct agency in the control of the business of the corporation. He has no direct interest in the property. His right to such property is collateral. But in its last analysis, the stockholders are the beneficial owners of the assets of the corporation. This proceeding is instituted upon the theory, which we think a correct one, that the shareholders are the ultimate owners of the corporate property, and, when the corporation is dissolved and its creditors are satisfied, they hold title to the assets in proportion to their respective shares."); Timbertech, Inc. v. Wallboards, Inc., No. 14-98-00422-CV, 1999 Tex. App. LEXIS 6397, *2 (Tex. App. 1999); ; Zimmerman v. Kyte, 765 P.2d 905, 12 (Wash. Ct. App. 1988).

104. *E.g.*, *Sneed*, 465 S.W.3d at 173–174, (Tex. 2015).

105. Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 930 (2010).

> Admittedly, it is difficult to find very much case law directly addressing the issue of ownership. However, there is a great deal of case law that implicitly reaffirms the traditional view. For example, as discussed earlier, Delaware courts generally insist that the directors of a corporation owe their fiduciary duties 'to the corporation and its shareholders.' Unfortunately, [unlike Delaware,] most of the courts' statements on fiduciary duties are ambiguous. While they do support the traditional view, they also can be interpreted consistently with other theories.[106]

On the contrary, there is law against the traditional assertion, such as a 1932 Texas case, *McClory v. Schneider*, which cites to even earlier cases.

> A transfer of stock of a corporation or a transfer of certificates of stock which only evidence the stock, is held not to be a transfer of the property and assets of the corporation itself. The owner of a share of stock in a corporation owns no part of the capital, and is not the owner nor entitled to the possession of any definite portion of its property or assets. Hence the purchaser of stock in a corporation does not purchase any portion of the corporation's assets, nor is a sale of all the stock of a corporation a sale of the physical properties of the corporation.[107]

Additionally, John Armour shifts the meaning of ownership from ownership of the corporation to ownership of the residual rights.[108]

About 100 years of arguments have yet to settle the question about whether shareholders (particularly those in large, publicly-listed corporations) are owners. Arguments and metaphors are the only underpinnings that exist. So, roughly $22 trillion in the U.S. stock markets exists without any certainty that the investors own anything more than a stock certificate in paper or electronic form, plus the residual after everyone else who does have an identifiable claim on the assets clears those out.

---

106. *Id.*

107. McClory v. Schneider, 51 S.W.2d 738, 741 (Tex. App. 1932).

108. John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. LEGAL STUD. 429, 437 (2007).

Berle and Means rejected both this theory (or tradition) of shareholders owning the corporation, and its opposite theory, that the controlling powers could operate the corporation in their own self-interest,[109] which became known as the "managerialist" theory[110]. Berle and Means instead chose a third course, stating:

> [T]he owners of passive property, by surrendering control and responsibility over the active property, have surrendered the right that the corporation should be operated in their sole interest,—they have released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights, [thus leading] the community . . . to demand that the modern corporation serve not alone the owners or the control but all society, [thereby] balancing a variety of claims by various groups in the community.[111]

The point was not to "line shareholders' pockets regardless of the consequences," but "to bring managerial discretion under legal control."[112] This was in the context of shareholders being middle-class and working-class people who were now holding stocks[113] (not through mutual funds[114]), and not the corporate raiders of the 1970s. This was to further "disperse ownership and economic power widely . . . against the action of powerful elite interest what would want to counteract the threats of the egalitarian operation of the corporation."[115]

B. The Myth of Agency Theory

It is worth looking at the fictions and assumptions in the agency theory literature that created this myth of shareholder value, which has led to the idea that the shareholder's investment time horizon is the guide for

---

109. BERLE & MEANS, *supra* note 4, at 354.

110. Bratton, *supra* note 5, at 1476.

111. BERLE & MEANS, *supra* note 4, at 355–56 (the "community" Berle and Means refer to is synonymous with "stakeholders").

112. Fenner Stewart, Jr., *Berle's Conception of Shareholder Primacy: A Forgotten Perspective for Reconsideration During the Rise of Finance*, 34 SEATTLE U. L. REV. 1457, 1464, 1478 (2011); *see also* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99, 107–11 (2008).

113. Stewart, *supra* note 112, at 1458, 1462–63.

114. A few mutual funds existed in the late 1920s, but the impetus for the growth and regulation of mutual funds was the Securities and Exchange Act of 1933 and the Investment Company Act of 1940. *See* James E. McWhinney, *A Brief History of the Mutual Fund*, INVESTOPEDIA, http://www.investopedia.com/articles/mutualfund/05/mfhistory.asp [https://perma.cc/CB8P-KRGW].

115. Stewart, *supra* note 112, at 1463.

the corporation's investment horizon. The myth of shareholder value was exposed by Lynn Stout,[116] among others, because of its consequential derailing of corporate governance from the law's view of corporate governance and relations between shareholders and the directors and the corporation.

Despite Berle's essential rejection of the idea of shareholders owning the corporation, Berle's conception of the directors as trustees for the shareholders *in aggregate* in part, led all stakeholders to shift in the 1970s to the *assumption* that shareholders do own the corporation and therefore the corporation should maximize shareholder value.[117] The assumption was in the economic finance literature, first by Milton Friedman,[118] then formally developed as agency theory by Michael Jensen and William Meckling in their article, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*.[119] Jensen and Meckling said the relationship between stockholders and managers looked like an agency relationship, so it must be an agency relationship, which they created for their theory.[120] But they needed more to make this work, so they created a "fiction" that the corporation had contracts with the shareholders:

> We retain the notion of maximizing behavior on the part of all individuals in the analysis to follow.
>
> . . . .
>
> Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency.
>
> . . . .
>
> . . . Unfortunately, the analysis of these more general organizational issues is even more difficult than

116. LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012); Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE. U. L. REV. 1169, 1174 (2013). *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

117. The shift from Berle's conception to the agency conception and shareholder value maximization is chronicled in ROBERT TEITELMAN, BLOODSPORT (2016).

118. *See* Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 6.

119. *See generally* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

120. *Id.* at 308.

> that of the 'ownership and control' issue because the nature of the contractual obligations and rights of the parties: are much more varied and generally not as well specified in explicit contractual arrangements.
>
> . . . .
>
> . . . Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts, independent of whether there is joint production in their sense; i.e., joint production can explain only a small fraction of the behavior of individuals associated with a firm.
>
> It is important to recognize that most organizations are simply *legal fictions* which serve as a nexus for a set of contracting relationships among individuals.
>
> . . . .
>
> The private corporation or firm is simply one form of *legal fiction* which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cashflows of the organization which can generally be sold without permission of the other contracting individuals.[121]

Note that Jensen and Meckling developed two ideas here: one of agency problem and another of imaginary contracts.[122] Eugene Fama abandoned the shareholders-as-owners fiction for his expansion of Jensen and Mecklin's contractual theory.[123]

> The firm is viewed as a set of contracts among factors of production, with each factor motivated by its self-interest. Because of its emphasis on the importance of rights in the organization established by contracts, this literature is characterized under the rubric 'property rights.' . . .
>
> . . . [T]he firm as a set of contracts among factors of production. In effect, the firm is viewed as a team whose members act from self-interest but realize that their destinies depend to some extent on the survival of the team in its competition with other teams. This insight, however, is not carried far enough. In the classical theory,

121. *Id.* at 307–11, 309 n.10 (emphasis added).
122. *Id.* at 307–11.
123. Fama, *supra* note 57, at 289–91.

> the agent who personifies the firm is the entrepreneur who is taken to be both manager and residual risk bearer. . . .
>
> The main thesis of this paper is that separation of security ownership and control can be explained as an efficient form of economic organization within the 'set of contracts' perspective. *We first set aside the typical presumption that a corporation has owners in any meaningful sense.* The attractive concept of the entrepreneur is also laid to rest, at least for the purposes of the large modern corporation. Instead, the two functions usually attributed to the entrepreneur, management and risk bearing, are treated as naturally separate factors within the set of contracts called a firm.
>
> . . . .
>
> However, ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. *In this 'nexus of contracts' perspective, ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of security holders.*
>
> . . . .
>
> . . . [P]ortfolio theory tells us that the optimal portfolio for any investor is likely to be diversified across the securities of many firms. Since he holds the securities of many firms precisely to avoid having his wealth depend too much on any one firm, an individual security holder generally has no special interest in personally overseeing the detailed activities of any firm. In short, efficient allocation of risk bearing seems to imply a large degree of separation of security ownership from control of a firm.[124]

Outside directors are hired to act as referees to the internal contracts and collusion of management.[125] Milton Friedman previously justified using completely unrealistic, even erroneous

124. *Id.* at 289–91 (emphasis added).

125. *Id.* at 294.

assumptions, if they made the theory work, and this is informative to cracking the theories of the agency problem and nexus of contracts.

> Truly important and significant hypotheses will be found to have 'assumptions' that are wildly inaccurate descriptive representations of reality, and, in general, the more significant the theory, the more unrealistic the assumptions (in this sense). . . .
>
> To put this point less paradoxically, the relevant question to ask about the 'assumptions' of a theory is not whether they are descriptively 'realistic,' for they never are, but whether they are sufficiently good approximations for the purpose in hand.
>
> . . . .
>
> . . . [T]he "assumptions of a theory" play three different, though related, positive roles: (a) they are often an economical mode of describing or presenting a theory; (b) they sometimes facilitate an indirect test of the hypothesis by its implications and (c) as already noted, they are sometimes a convenient means of specifying the conditions under which the theory is expected to be valid.
>
> . . . .
>
> To state the point more generally, what are called the assumptions of a theory can be used to get some indirect evidence on the acceptability of the hypotheses in so far as the *assumptions can themselves be regarded as implications of the hypothesis*, and hence their conformity with reality as a failure of some implications to be contradicted, or in so far as the assumptions may call to mind other implications of the hypothesis susceptible to casual empirical observation.
>
> . . . .
>
> . . . Complete "realism" is clearly unattainable, and the question whether a theory is realistic 'enough' can be settled only by seeing whether it yields predictions that are good enough for the purpose in hand or that are better than predictions from alternative theories.[126]

126. MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 14–15, 23, 28, 41 (1953).

Thus, according to Friedman, the assumption is valid, however wrong, if it makes the theory work and the theory itself creates and justifies the assumption.

Economist Kenneth Arrow noted the failure of the simple principal-agent economic theory to fit with or explain the complex reality of contracts and complex relations, while the complex fee-functions the theory can generate are not found in actual contracts.[127] Another problem is that imaginary contracts are always welfare-enhancing to both parties but real agreements are not always so, which is a problem for agency theory if the goal is contractual welfare that further obliges all the default rules the economic models of contracts require.[128]

C. The Contractualism Theory That Underlays Agency Theory Is Uselessly Flawed Due to the Absence of Contracts

The agency theory and its sibling, the contractual nexus, were key drivers for the shareholder value maximization ideology that developed in the 1970s and later[129] (although Bratton contends these are also found in earlier conceptions of the corporation).[130] As for the contractual relations used by the shareholders to direct the board of directors in their governance,[131] this is pure fiction because there are absolutely no contracts between the common shareholders and the directors. There is not even a contract in the prospectus or registration statement as to obligations and rights between the corporation, its directors, and its shareholders.[132] Even if stock purchasers were to look at the prospectus (a doubtful assumption after the initial public offering crowd), that would only bear upon the initial purchasers and maybe a couple of buyers beyond that (if one assumes that any of those subsequent stock purchasers looked at the prospectus). But beyond that, how many years out can that original prospectus still be relevant, if even found? (Corporate charters are a

---

127. Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 46–49 (John W. Pratt & Richard J. Zeckhauser, eds., 1985).

128. Anthony T. Kronman, *A Comment on Dean Clark*, 89 COLUM. L. REV. 1748, 1751–52 (1989).

129. *See, e.g.*, TEITELMAN, *supra* note 117; Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 116.

130. *See generally* William W. Bratton, Jr., *The New Economic Theory of the Firm, Critical Perspectives from History*, 41 STAN. L. REV. 1472 (1989).

131. See Peer Zumbansen, *Rethinking the Nature of the Firm: The Corporation as Governance Object*, 35 SEATTLE U. L. REV. 1469, 1484–86 (2012), for an analysis of what Zumbansen calls “contract governance.”

132. The point is self-evident, but has also been raised in Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1411 (1985).

different matter, but they are so generic about engaging in any lawful business as to be nearly useless as a guide for the business plan.) Besides, the stockholders' rights are statutory, as determined by both state corporation law and the Securities and Exchange Acts.[133]

The lack of a contract (strangely and remarkably) does not undermine agency theory because the theorists shift the contracts to a new problem of incomplete contracts, which are filled in with whatever assumptions fix the theory.[134] As Stephen Bainbridge contends, the contract is "viewed as a metaphor rather than as a positive account of economic reality" that refers to "long-term relationships characterized by asymmetric information, bilateral monopoly, and opportunism."[135] This metaphor gets around the legal baggage of consideration, mutuality, and transactions, he says.[136]

Susanna Ripken writes, "These 'contracts' are not true contracts as defined by law, but the economist's notion of contracts as reciprocal arrangements involving mutual expectations between parties,"[137] or as

---

133. Wells calls them contractual, but he means this in contradistinction from the earlier corporate law charters granted by special acts of legislators. Wells, *supra* note 92, at 602. Wells further quotes Elwyn G. Davies, *Reflections of the Amateur Draftsmen of the Ohio General Corporation Act*, 12 WISC. L. REV. 487, 488 n.168 (1937) (noting that the committee of lawyers who drafted the Ohio Act "accepted and used as a basis the contract theory, though aware that when applied to a corporation with any considerable number of shareholders this theory has its limitations and there is no contract in the sense in which the term is commonly understood").

134. The contractarian theory of corporate law has been addressed in many articles. A good summary of the history and application is David Millon, *Frontiers of Legal Thought I: Theories of the Corporation*, 1990 DUKE L.J. 201, 229–31 (1990); *see also* Armour & Whincop, *supra* note 108; Susanna E. Ripken, *Corporations Are People Too: A Multi-Dimensional Approach to the Corporate Personhood Puzzle*, 15 FORDHAM J. CORP. & FIN. L. 97, 137, 158–67 (2009). *But see* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989); Brudney, *supra* note 132; Ige Omotayo Bolodeoku, *Contractarianism and Corporate Law: Alternative Explanation to The Law's Mandatory and Enabling/Default Contracts*, 13 CARDOZO J. INT'L & COMP. L. 433 (2005); Ireland, *infra* note 140 (providing a history of contract and property theories back to joint stock companies, which were essentially partnerships in their management). Additionally, a fascinating account of the philosophical, legal, and religious origins of contractualism, written long before the economists employed contract theory in corporate theory, is Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933) ("As the result of the various forces that have thus supported the cult of contractualism there has been developed in all modern European countries (and in those which derive from them) a tendency to include within the categories of contract transactions in which there is no negotiation, bargain, or genuinely voluntary agreement."). A contemporary assessment of contract theories in the contractarian context is Robert C. Clark, *Contracts, Elites and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989).

135. Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 871 (1997).

136. *Id.* Bainbridge contends the board of directors is the nexus of contracts. *Id.* We agree with Bainbridge that the firm has a "nexus," and indeed *is* the nexus. *Id.* at 859. Certainly, the firm has contracts with some of the stakeholders, but we are doubtful of the assertion of a nexus of contracts outside of those contracts, and we disagree that the nexus of contracts is the directors.

137. Ripken, *supra* note 134, at 158.

rules rather than any real type of contract.[138] Robert Clark identifies additional problems with the economic assumption and theory. Specifically, he notes that there is no bargaining, there are no implicit terms, basic fiduciary duties cannot be bargained around, and the role of directors is defined by fiduciary law as developed by case law and corporate statutes.

> No one has shown, and I believe it is clearly not the case, that legislative changes to corporate statutes typically represent efforts merely to codify as general presumptions certain rights and duties that have already become prevalent in actual contracts. Nor are court decisions elaborating the contours of particular fiduciary duties merely filling in the gaps and ambiguities of actual contracts between the litigants in question.[139]

According to Paddy Ireland, what little basis there is for shareholders and directors having a contract traces back to joint stock companies, which looked like partnerships, though the rise of the corporation and limited liability meant the shareholders were no longer anything like partners.

> [W]ith the introduction by the Joint Stock Companies Act 1844 of incorporation by registration, the relationship between the shareholders of most companies and third parties ceased to be contractual at all: third-party creditors now dealt not with a collection of partners liable for each other, but with companies as separate, property-owning, legal (and corporate) entities.
>
> . . . .
>
> . . . [T]he gradual demise of the partnership-based idea of directors as the agents of shareholders reflected the emergence of the company as a property-owning legal person and the erosion of the contractual character of the relationships of shareholders with both directors and one another. Once again, the growing detachment and

138. *See* Fred S. McChesney, *Contractarianism Without Contracts? Yet Another Critique of Eisenberg*, 90 COLUM. L. REV. 1332, 1334 (1990) ("This point goes back to the seminal contractarian model that every graduate student in economics studies. There, Coase defined the firm as the set of agreements by which individuals agree to operate by ongoing rules rather than a series of constantly renegotiated spot contracts. The advantage of contractual rules is the reduction of transaction costs."). *Id.*

139. Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 63 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

> externality of shareholders from 'the company' and the process of production lay at the root of these changes. Indeed, for courts and legislature, struggling to protect the new breed of shareholder and to secure the integrity of the share as a new intangible form of property, there were compelling reasons for moving *away from* a partnership-based, overtly contractual conception of, and approach to, joint stock companies and their constituent relations.[140]

Thus, shareholders do not own corporations, directors are not agents for the shareholders, and contracts between them do not exist.[141] Rather, as Ripken concluded, the shareholders are only "the economist's notion of rational self-interested actors," the corporation "is the center of a mass of contracts," and the result is that "no independent, real corporate entity exists," meaning the corporation itself is a fiction, and the "ownership of the firm also disappears as a meaningful concept."[142] We might say the agency and contract theories have reached escape velocity of the orbit of reality.

D. The Unified Theory of Shareholder Interest Belies the Heterogeneity of Shareholders' Interests and Competencies

Daniel Greenwood argues further that shareholders, in the corporate conception, are fictional.

> Shareholders are a convenient and sometimes extremely misleading metaphor that can prevent us from seeing the real rights and responsibilities at issue. . . . Rather, shareholders are treated as if their entire identity were their share ownership, as if their sole goal in life were to maximize the risk-adjusted present value of the future income stream represented by those shares and as if they

140. Patty Ireland, *Property and Contract in Contemporary Corporate Theory*, 23 LEGAL STUD. 453, 463, 465 (2003).

> With these and other related developments the law relating to joint stock companies increasingly departed from the ordinary principles of agency and contract which underlay the law of partnership. Indeed, by the final decades of the century, the processes of decontractualisation had become so advanced that company law finally separated out from the law of partnership, crystallizing into a fully autonomous, independent, and quite distinctive legal category.

Id. at 471.

141. *See, e.g.*, Bower, *supra* note 2, at 53; Brudney, *supra* note 132.

142. Ripken, *supra* note 134, at 158–59.

> had no competing interests that might, even occasionally, warrant taking an action not designed to improve 'shareholder' value.[143]

Additionally, Greenwood states:

> . . . [T]he fictional shareholder is fundamentally different from the human beings who ultimately stand behind the fiction. The law and the legally created structure of corporation and market filter out all the complexity of conflicted, committed, particularly situated, deeply embedded and multi-faceted human beings, leaving only simple, one-sided monomaniacs. Human beings have short lives, spent in particular places with particular relationships to other human beings; they constantly confront the problems of finitude and commitment. Shareholders, in contrast, are in significant senses immortal, uncommitted and universal: They are indifferent as to time and place, language and religion. They are indifferent between projects and personalities. They are understood to care deeply about one important and vital human aim -- profit maximization -- but not at all about numerous others. While the ultimate owners of the shares are specific, situated, conflicted and committed human beings, shareholders in most instances may be thought of more appropriately as a "large, fluid, changeable and changing market."[144]

The problems and failures of corporate governance that emanated from the normative directive of abiding by a myth (as Stout called it) based on theories, in turn based on assumptions generated to justify the theory, have been chronicled in many articles addressing the limits of agency costs and principal control.[145]

> [C]entralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, as some

---

143. Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1029–30 (1996).

144. *Id.* at 1025–26.

145. *See, e.g.*, Hill & McDonnell, *supra* note 50, at 564–70.

> have suggested, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge . . . .[146]

Sitkoff expands on this:

> Active monitoring is not a satisfactory answer to the agency problem. Even if the principal has spelled out what the agent should do in a particular contingency, it is often infeasible for the principal to monitor the agent's compliance with those instructions. Agents are often retained because the principal lacks the specialized skills necessary to undertake the activity on his own. In such a case, the skill deficit that prompted the principal to engage the agent will limit the principal's ability to monitor the agent."[147] Others note there are "principal costs" with having shareholders responsible for the majority of the corporation's decision,[148] and it is probably more efficient to delegate decision-making to "elites" (regulators, judges and legislators, even influential law professors and the American Law Institute with their expertise in relevant fields).[149]

---

146. Bainbridge, *supra* note 54, at 626.

147. Symposium, *The Role of Fiduciary Law and Trust in The Twenty-First Century: A Conference Inspired by The Work of Tamar Frankel: Panel II: An Interdisciplinary View of Fiduciary Law: The Economic Structure of Fiduciary Law*, 91 B.U. L. Rev. 1039, 1041 (2011).

148. Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 770–71 (2017) ("Principal costs occur when investors exercise control, and agent costs occur when managers exercise control. Both types of cost can be subdivided into *competence costs*, which arise from honest mistakes attributable to a lack of expertise, information, or talent, and *conflict costs*, which arise from the skewed incentives produced by the separation of ownership and control. When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs. To avoid such costs, they delegate control to managers whom they expect will run the firm more competently. But delegation separates ownership from control, leading to agent conflict costs, and also to principal conflict costs to the extent that principals retain the power to hold managers accountable. Finally, managers themselves can make honest mistakes, generating agent competence costs."). *Id.*

149. Clark, *supra* note 134, at 1723 ("[E]lites may have access to more and better information relevant to rule making. Elite rule makers may sometimes be better processors of whatever information is available, because of their intrinsic or acquired abilities, or because they are specialists who have the time to focus more carefully on available information, thus reaping economies of scale in its use. . . . Despite the agency costs generated by elitism and the unavoidably imperfect alignment of incentives that bring them about, elite rule making may have net benefits for rule subjects. There is no

Shareholders are not single-minded about corporate policy, but disregard of the shareholders led to minority oppression, which led to the normalization of the idea of shareholder primacy as "a way of forcing homogeneity onto a very diverse set of shareholder interests."[150] As Blair and Stout observed:

> Because American law does not permit shareholders to command the board to action, describing directors as shareholders' "agents" grossly misrepresents at least the legal nature of their relationship. In the eyes of the law, corporate directors are a unique form of fiduciary who, to the extent they resemble any other form, perhaps most closely resemble trustees.[151]

Shareholders are not principals, directors are not the agents for the shareholders, and directors' decisions are not necessarily protected by the business judgment rule if they merely follow the instructions of the shareholders (the nominal alleged principals).[152] Greenwood says:

> The general rule is that directors would be in breach of the law if they accepted such instructions. Like Edmund Burke's statesman, but unlike the Populist legislative model of direction, initiative and referendum, directors are required to exercise independent judgment, not simply to follow their constituents' -- let alone principals' -- orders. Indeed, in the precise opposite of the agency law rule, directors are not necessarily protected in their decisions by turning a matter over to shareholders for decision, and may not defend a shareholder suit on the ground that they were doing no more than they were instructed to do or that they pledged to do prior to their appointment.[153]

---

a priori reason to preclude the possibility that the informational advantages of elite rule making may outweigh the agency costs it creates . . . ."). *Id.* at 1719–20.

150. Hayden & Bodie, *supra* note 43, at 480, 502.

151. Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 116, at 291.

152. *See* Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 726–28, 731 (2006).

153. Greenwood, *supra* note 143, at 1041. Greenwood later agrees that shareholders are useful to the agency metaphor and guide the directors to put aside their own interests. *See id.* at 1044. But

A case that evinces this lack of shareholder authority to direct the corporation is *Trinity Wall Street v. Wal-Mart Stores, Inc.*,[154] where the court affirmed Wal-Mart's exclusion of a shareholder proposal that sought to compel Wal-Mart to stop the sale of high-capacity assault rifles. The court said Wal-Mart was right to exclude the proposal because it pertained to an ordinary business operations, and thus came within the SEC rule 14a-8(i)(7), which "allows a company to exclude proposals that 'deal . . . with a matter relating to the company's business operations.' 17 C.F.R. § 240.14a-8(i)(7)."[155]

III. CONSERVATORSHIPS

Finance literature offers a bridge from the concept of agency theory to a notion of the assets of the corporation as the key focus for governance. Oliver Williamson argues that the claims of the various providers of capital (e.g., debt and equity) are themselves "governance structures."[156] In the Williamsonian view, the nature of the firm's assets plays a large role in how those assets should be financed. "Redeployable" assets can be financed by "rules" (debt financing), while those assets that are "non-redeployable" are better financed by equity since they require more discretion.[157] While agency theory and Williamson's view have some similarities because they both focus on discretion of the equity component, there is a key difference in the fundamental unit of analysis.[158] In the Williamson framework,[159] the transaction, as opposed to the agent, is the fundamental unit of analysis.[160]

The transaction-based view of the firm allows a broader conception of governance in an era where shareholder–manager agency leads to the irreconcilable challenges of stock investor horizon or, even more broadly,

---

this is the same as the directors' statutory duties to act in the interests of the corporation and not in their own self-interest.

154. 792 F.3d 323, 352 (3d Cir. 2015), *cert. dismissed*, 136 S. Ct. 499 (2015).

155. *Id.*; *see also* Med. Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated on other grounds*, 404 U.S. 403 (1972) (where the plaintiff sought to require Dow Chemical to include a shareholder proposal to stop the manufacture and sale of napalm then used in the Vietnam War. The court of appeals required the company to include the proposal, calling the shareholders "the true beneficial owners of the corporation").

156. *See generally* Oliver E. Williamson, *Corporate Finance and Corporate Governance*, 43 J. FIN. 567 (1988).

157. *Id.* at 567, 580 n.24, 581.

158. *Id.* at 571.

159. *Id.*

160. *See generally* Oliver Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979).

stock investor objective. The transactions cost view of corporate governance returns the emphasis to the nature of the firm's assets. Shareholders, be they rapid traders or long-term holders, have a residual claim on firm assets. To the extent that corporate managers deploy capital other than equity, they share in the governance of the claims on firm assets. If the nature of the firm's assets aligns with the use of both debt and equity, then the overall value of the enterprise may increase, assuming there are real world frictions such as deductibility of interest.[161]

Thus, the shift from a shareholder-centric view of the firm to an asset-based view of the firm allows those who make operating and financing decisions to view the value of the firm more from a basis of assets than from a view of equity claims. This argument does not presuppose that managers (or any individual agent) do not act in their own interest. Notwithstanding these motives, the goal of acting on behalf of the *corporation* aligns better with a focus of what makes the corporation itself unique—its assets. The nature of the assets drives the major decisions of corporate finance, including capital structure, capital budgeting, and working capital management. "The conflict of interest between debt and equity over investment or distribution policy or capital structure implicates the economic question of whether the goal of the corporate decision-maker should be to maximize stockholders' value rather than enterprise (and possibly creditors') value if its decision affects those values differently."[162]

The financial model of transactions involving all assets aligns reasonably well with the conservatorship model of the corporation, whereby the directors are subject to fiduciary obligations of loyalty and to avoid self-dealing.[163] Here, the directors are to act in the best interest of the corporation. This fits with the actual statutory duties imposed on directors: to act in the best interest of the corporation. For example, California's Corporations Code provides:

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders . . . .[164]

Under Connecticut law,

---

161. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261, 261–97 (1958).

162. Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 645 (1997).

163. *Id.* at 601.

164. CAL. CORP. CODE § 309(a) (West 2017).

> [a] director shall discharge his duties as a director, including his duties as a member of a committee: (1) In good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.[165]

Georgia law provides, "A director shall discharge his duties as a director, including his duties as a member of a committee: (1) In a manner he believes in good faith to be in the best interests of the corporation . . . ."[166] A few states insert this in the indemnity authorization statutes. For example, Delaware law allows indemnity for the director "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . . ."[167] Similarly, New York law allows for indemnification where a director "acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation . . . ."[168]

The conservatorship model reconceives the directors as trustees rather than as mere agents for the amorphous and diverse group of shareholders, and, as Brudney says about fiduciaries, the exclusive benefit principle owed by the fiduciaries starts with "thick restrictions that substantially hamper their freedom to act with respect to, or to alter their state-imposed obligations to their beneficiaries."[169] "The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares."[170]

> While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to

165. CONN. GEN. STAT. § 33-756 (2017).

166. GA. CODE ANN. § 14-2-830(a)(1) (2017) (prior to May 9, 2017, amendment); *see also* MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(c) (West 2017); MICH. COMP. LAWS ANN. § 450.1541a (West 2017); N.C. GEN. STAT. ANN. § 55-8-30 (West 2017); OR. REV. STAT. ANN. § 60.357 (West 2017); TEX. BUS. ORG. CODE ANN. § 22.221 (West 2017); VA. CODE ANN. § 13.1-690 (West 2017); WASH. REV. CODE ANN. § 23B.08.300 (West 2017).

167. DEL. CODE ANN. tit. 8, § 145(b) (West 2017). *See generally* Frederick Hsu Living Trust v. ODN Holding Corp., No. 12108-VCL, 2017 Del. Ch. LEXIS 67, at *60–61 (Del. Ch. Apr. 14, 2017); *In Re* Trados, Inc. Shareholder Litig. 73 A.3d 17, 38 (Del. Ch. 2013).

168. N.Y. BUS. CORP. LAW § 722(a) (McKinney 2017).

169. Brudney, *supra* note 162, at 598.

170. *In re* Trados, 73 A.3d at 38 (quoting Paramount Commc'ns. Inc. v. Time Inc., No. 10670, 1989 WL 79880, at *30 (Del. Ch. July 14, 1989)).

> manage the business and affairs of the corporation, subject however to a fiduciary obligation.[171]

Thus, the directors' duties cannot be reduced to mere contractual relations to be waived away by the beneficiaries because the power to consent by the beneficiary (whether by the corporation or the shareholders) is constrained.[172] This also means the directors' responsibility is higher than the business judgment rule, which can be used "to justify the board's decision as long as judicial review, within the parameters of the business judgment rule presumption, can devise a minimum proper rationale for the decision."[173] The distinction is noted in *In Re Trados Shareholder Litigation*,[174] which also allows three levels of review depending on the alleged misconduct.

> [E]ven though modern corporate law, as currently written, has shied away from describing corporate directors explicitly as 'trustees,' contemporary corporate theory has more or less explicitly moved back to the (original) notion that a trust relationship exist between the corporation's directors/managers and its other participants and factors of production, and that those trust

171. *Id.* (quoting TW Services, Inc. v. SWT Acquisition Corp., No. 10298, 1989 WL 20290, at *8 n.14 (Del. Ch. Mar. 2, 1989)).

172. Brudney, *supra* note 162, at 606. *But see* Frank H. Easterbrook & Daniel R. Fischel, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1416 (1989) (using the economic agency model to argue that anything voluntary—meaning the ability to enter the transaction or not—is a contract, and fiduciary duties are merely "free" terms the parties would have bargained for but can accomplish "costlessly in advance." *Id.* at 1428, 1445. Additionally, "the dynamics of the market drive [managers] to act as if they had investors' interests at heart. It is almost as if there were an invisible hand" because "how are members of state legislatures or other alternative rule-givers to do better?" *Id.* at 1419, 1432.).

173. René Reich-Graefe, *Deconstructing Corporate Governance: The Mechanics of Trusting*, 38 DEL. J. CORP. L. 103, 121–22 (2013); *cf.* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 89–90 (2004) ("Two conceptions of the business judgment rule compete in the case law. One treats the rule as a standard of liability. Hence, for example, some courts and commentators argue that the business judgment rule shields directors from liability so long as they act in good faith. Others contend that the rule simply raises the liability bar from mere negligence to, say, gross negligence or recklessness. Alternatively, however, the business judgment rule can be seen as an abstention doctrine. In this conception, the rule's presumption of good faith does not state a standard of liability but rather establishes a presumption against judicial review of duty of care claims. The court therefore abstains from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith."); *see also* Brudney, *supra* note 162, at 635 ("Judicial review of the board's decision in terms of 'business judgement' further supports the idea of the discretion available to parties in a 'mere' contractual relationship. While the phenomenon can be explained, it is hard to see how it can be justified.").

174. 73 A.3d at 43.

> relationships secure and control the fidelity and diligence of the former with regard to the firm investment interests of the latter.[175]

The earlier notion of trust relationships was espoused most notably by Merrick Dodd,[176] who asserted that directors should consider all the interests of capital, labor, and the public. This is a fiduciary duty. Some old cases did describe directors as trustees, or having a role in the nature of trustees, for the corporation and the shareholders—though not strictly a trustee, mostly because the directors do not hold title.[177] For example, in *Stewart v. Harris* (and other cases noted in the footnote below):

> ". . . Directors and managing officers, in addition to their functions as mere agents, occupy a double position of partial trust. They are quasi or sub modo trustees for the corporation with respect to the corporate property, and they are quasi or sub modo trustees for the corporation with respect to the corporate property, and they are quasi or sub modo trustees for the stockholders with respect to their shares of the stock." The Supreme Court of the United States, in *Jackson v. Ludeling*, 21 Wall. 616, 22 L. Ed. 492, declared that "the managers and officers of a company, where capital is contributed in shares, are in a very legitimate sense trustees, alike for its stockholders and its creditors, though they may not be trustees technically and in form."[178]

---

175. Reich-Graefe, *supra* note 173, at 117–18. We reject the proposal to create a new layer of oversight, an "equity trustee," to oversee the directors, proposed in Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717 (2010).

176. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1154–55 (1932) ("That there are three groups of people who have an interest in that institution. One is the group of fifty-odd thousand people who have put their capital in the company, namely, its stockholders. Another is a group of well toward one hundred thousand people who are putting their labor and their lives into the business of the company. The third group is of customers and the general public.").

177. *See, e.g.*, Quinn v. Forsyth, 158 S.E.2d 686, 691 (Ga. App. 1967) ("[W]hile a corporate director does not hold title and is not a strict trustee, 'he does occupy a fiduciary relation to the stockholders with reference to their shares of stock, and this relationship obtains when such director is dealing with an individual stockholder in the purchase of such stockholder's shares.'" (quoting Manning v. Wills, 17 S.E.2d 261, 266 (Ga. 1941))).

178. Stewart v. Harris, 77 P. 277, 280 (Kan. 1904) (first quoting POMEROY, EQUITY JURISPRUDENCE § 1090) (second quoting Jackson v. Ludeling, 88 U.S. 616, 619 (1874)); *see also* Oliver v. Oliver, 45 S.E. 232, 233–34 (Ga. 1903); Steinfeld v. Nielsen, 139 P. 879, 888–89 (Ariz. 1913); Atkinson v. Marquart, 541 P.2d 556, 558 (Ariz. 1975); Williams v. Queen Fisheries, Inc., 469 P.2d 583, 585 (Wash. App. 1970) ("Corporate officers and directors occupy a fiduciary relationship

The conservatorship model is similar to the concept of "mediating hierarchs," proposed by Blair and Stout:

> who must balance the competing needs and demands of shareholders, creditors, customers, suppliers, executives, rank-and-file employees, and even the local community . . . .
>
> . . .
>
> In reality, directors simply do not behave the way the principal-agent model predicts. They reward many groups with larger slices of the corporate pie when the pie is growing, and spread the loss among many when the pie is shrinking. Far from providing evidence that directors are doing something wrong by imposing 'agency costs' on shareholders, this observation suggests directors may be doing exactly what team production analysis says they should be doing—acting as mediating hierarchs who balance the conflicting interests of the many members who make up a healthy and productive corporate team.[179]

Bratton also engages the concept of the mediating hierarch's role, envisioning a director with the flexibility to adjust between relational contracts, discrete contracts, various parties, and capable of drawing on models of trust, agency, contract, and fiduciary principles. "A mediative conception of the [corporate] law can thus be useful, despite modest theoretical aspirations. It encourages better understanding of the 'tough questions.' Where two valid, but inconsistent, normative directives come to bear on a problem, mediation is required."[180] Additionally, Brudney observes that the economic principal-agency model that presumes self-

---

to a private corporation and shareholders thereof akin to that of a trustee . . . ."); Burt v. Irvine Co., 47 Cal. Rptr. 392, 406 (1965) ("It is hornbook law that directors, while not strictly trustees, are fiduciaries . . . ." (quoting Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. App. 1952))).

179. Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 152, at 738–39.

180. William W. Bratton, Jr., *Public Values, Private Business, and U.S. Corporate Fiduciary Law*, *in* CORPORATE CONTROL AND ACCOUNTABILITY: CHANGING STRUCTURES AND THE DYNAMICS OF REGULATION 23, 24–25 (Joseph McCahery et al. eds., 1993) ("Corporate law, by accepting disagreement on norms as an integral part of social and economic life, thereby helps us live with institutions despite disagreement. Corporate law must encompass entity and contract, fiduciary and contract, state and contact, trust and agency, self-interest and co-operation, welfare and goodwill, mandate and facilitation, so as to serve as a nexus of communicative action that contributes to corporate institutional stability.") *Id.* at 33.

interest and contractual incentives actually reduces the state-imposed fiduciary duties and allows the agents "to engage in conflicts of interest transactions or otherwise to serve themselves . . . at the possible expense of public stockholders."[181]

The conservatorship model can also include the interests of other capital-providing stakeholders, such as stockholders and debt-holders, and many stakeholders beyond that, such as labor and communities, which is what both Dodd and Berle wanted in their conceptions of shareholder rights.

CONCLUSION

The ownership of a large, publicly-traded corporation is typically quite different from the ownership of a close or private corporation. Shareholder investment horizons in publicly traded firms are wildly different, varying from milliseconds to centuries. For a corporate director to act as an agent of this group of principals does nothing but beg questions about how it could be done. The answer is this: directors are not agents of the shareholders but are fiduciaries to the corporation itself, and they are obliged to manage the corporation in its best interest. The agency theory of shareholders that developed in the 1970s is not based on—and is, in fact, contrary to—corporate law. While legal fictions are recognized in the law, the agency theory was an economic fiction to justify a theory—a theory that then mutated into doctrine and mandated conformity to the theory rather than to law and practice. In contrast, Berle's fiction of shareholder ownership was to create public benefit for widely held shares by a large shareholding population. That might still be realized through the institutional holdings where retirement savings are held, but trying to ascertain those many, diverse shareholders' investment time horizons is unlikely to result in any guidance to directors, and should not provide guidance for corporate investment decisions.

181. Brudney, *supra* note 163, at 623.