

# The Directorist Model of Corporate Governance: Why a Dual Board Structure for Public Corporations is Good for Shareholders, Entrepreneurs, Employees, Capitalism, and Society

Vahid Dejjwakh\*

*This paper builds the case for a new approach to corporate governance, the “Directorist” model, which is a form of stakeholder theory. Part I introduces the relevant concepts and issues facing corporate governance, and the reasons why corporate governance is critical to the health of public corporations. Part II compares the American and German governance systems, and seeks to draw some relevant lessons. Part III explains why the current dominant viewpoint of shareholder primacy is wrongheaded and should be shelved. Part IV argues for the “Directorist” view by using an analogy that compares a public corporation to a school student, shareholders to the student’s parents, and managers to the student’s teachers. Part V fully explains the Directorist model’s dual board structure, function, and advantages. Finally, Part VI concludes by calling for nothing short of the re-humanization of the public corporation as a pivotal component and member of modern society.*

## I. INTRODUCTION: THE CORPORATION, CORPORATE GOVERNANCE, AND GLOBALIZATION

### A. COMPARATIVE ADVANTAGE, CAPITALISM, PUBLIC CORPORATIONS, AND AGENCY THEORY

Homo sapiens-sapiens has been described as the most social of all primates: we live and work in groups, we consume in well-defined groups, and we trade in well-defined groups.<sup>1</sup> The

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\* Vahid Dejjwakh graduated in 2015 from the College of William and Mary with a Juris Doctor and a Master's in Public Policy. He is now a Senior Management and Systems Analyst with the City of Hampton, Virginia, and also enjoys building web applications like [www.thanktime.com](http://www.thanktime.com) in his spare time.

<sup>1</sup> Bernard C. Beaudreau, *World Trade: A Network Approach* (Lincoln: iUniverse, 2004), 2.

classical Ricardian theory of comparative advantage observes that parties always benefit from trade as long as they each specialize in producing the item (or service) with the lowest opportunity cost and in the most quantity that their production possibilities frontier allows.<sup>2</sup> Society's ability to constantly find, to efficiently organize for and allocate resources around, and to ultimately trade at these optimum production possibilities—both at the micro-level within the members of the society and at the macro-level with those on the outside—is economically paramount and socially advantageous. Indeed, besides simply having access to and controlling abundant resources, this ability to fluidly maximize production within the society's existing capacities has arguably been the most significant factor causing the rise and fall of societies and civilizations, even if only because military might is predicated on economic strength.<sup>3</sup>

The modern society's form and most basic structural entity for allocating productive resources and efforts is the corporation. Through the corporation, capital and labor combine to produce goods and services for society. Although the neoclassical and commonly accepted view has been that capitalism is preferable because it allocates resources most efficiently, some suggest that the essential beneficial role of capitalism is actually that it facilitates the creation of better products and services by both plentifully rewarding useful new ventures and also driving less useful ones to extinction through competition in the market.<sup>4</sup> This slightly nuanced perspective thus acknowledges that for the average consumer, the experienced value of capitalism comes not from some theoretical resource allocation efficiency, but from very concrete, measurable, better, and more affordable products and services that actually solve a particular need or problem.<sup>5</sup>

The mechanism for allocating these resources, whether to entirely new markets or to old and existing ones, has been for owners of excess capital to reinvest these into the formation of a

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<sup>2</sup> Stephen S. Golub and Chang-Tai Hsieh, "Classical Ricardian Theory of Comparative Advantage Revisited," *Review of International Economics* 8, no. 2 (2000): 221-34.

<sup>3</sup> Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York: Random House, 1987), 1. "The triumph of any one Great Power [...], or the collapse of another, has usually been the consequence of lengthy fighting by its armed forces; but it has also been the consequence of the more or less efficient utilization of the state's productive economic resources in wartime, and, further in the background, of the way in which that state's economy had been rising or falling, relative to the other leading nations, in the decades preceding the actual conflict...It sounds crudely mercantilistic to express it this way, but wealth is usually needed to underpin military power, and military power is usually needed to acquire and protect wealth."

<sup>4</sup> Eric Beinhocker and Nick Hanauer, "Redefining Capitalism," *McKinsey Quarterly: Insights and Publications* (September 2014), [http://www.mckinsey.com/insights/corporate\\_social\\_responsibility/redefining\\_capitalism](http://www.mckinsey.com/insights/corporate_social_responsibility/redefining_capitalism) (adapted from Eric Beinhocker and Nick Hanauer, "Capitalism Redefined", *Democracy: A Journal of Ideas* 31 (Winter 2014), accessed December 23, 2016, <http://www.democracyjournal.org/31/capitalism-redefined.php>).

<sup>5</sup> Ibid.

corporation, thereby becoming its shareholders, and paying managers to run the corporation, presumably because the shareholders are too diffuse, too busy, or just do not have the technical expertise required to do so themselves.<sup>6</sup> Whether shareholders also necessarily become the owners (and the principals) of the corporation is a question addressed in Parts III and IV of this article.

The separation between the shareholders on the one hand, and the managers (i.e. directors and officers) of the corporation on the other, each with distinct and sometimes conflicting interests, sets up what has long been the most important dilemma in corporate law, known as *agency theory*.<sup>7</sup> As Adolf Berle and Gardiner Means explain in their classic 1932 work, *The Modern Corporation and Private Property*, this dilemma is even more pronounced in *public* corporations, whose shares are traded on a stock exchange like the New York Stock Exchange (NYSE) or the Nasdaq, because the shareholders of public corporations are generally more diffuse and thus individually have less control over the corporation than shareholders in a privately held corporation, where the fewer shareholders have a closer relationship with and influence on management.<sup>8</sup> Corporate governance therefore plays a more important balancing and regulatory role in public corporations than in privately held corporations, which is why this article exclusively deals with public corporations.

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<sup>6</sup> This is of course a simplification. Shareholders elect a board of directors, who in turn hire officers to manage the day-to-day decisions of the company. Nevertheless, this article uses the term “managers” to include both officers and directors because both are traditionally considered agents entrusted with the corporation’s wellbeing. Peter V. Letsou, “Shareholder Voice and the Market for Corporate Control,” *Washington University Law Quarterly* 70, no. 3 (1992): 755, 759.

<sup>7</sup> Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics* 3, no. 4 (1976): 305-308. This article placed agency cost theory at the forefront of corporate law thinking, and describes monitoring costs, bonding costs, and residual loss; J.W. Verret, “Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice,” *Yale Journal on Regulation* 27, no. 2 (2010): 285, 315. This refers to agency theory as the “bedrock of corporate law most frequently cited in its theoretical development”; Michael Klausner, “Fact and Fiction in Corporate Law and Governance,” *Stanford Law Review* 65, no. 6 (2013): 1325-1326. The agency cost problem generally provides “the dominant framework of analysis for corporate law and corporate governance today.”

<sup>8</sup> Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New Brunswick, NJ: Transaction Publishers, 1932), 4-5, 7; Kristian D. Allee, Brad Badertscher and Teri Lombardi Yohn, “Private Versus Public Corporate Ownership: Implications for Future Profitability,” *Kelley School of Business Research Paper Series*, no. 2014-16 (2015): 2, <http://ssrn.com/abstract=2375916>.

## B. THE ROLE OF CORPORATE GOVERNANCE, AND SHAREHOLDER VS. STAKEHOLDER THEORY

Corporate governance performs, in general, three main roles: (1) to check that the managers of the company act in the company's interests and not their own (and thus to reduce agency costs), (2) to provide an overarching nexus for the relationships between the corporation and all of its stakeholders, including shareholders, employees, officers, directors, and creditors, and (3) to further the sociopolitical and economic goals of the dominant interest groups of the country<sup>9</sup> (e.g. shareholder primacy in the United States, codetermination in Germany, etc.).

The different economic landscape in each country nurtures a unique system of corporate governance particularly suited to the needs of that country.<sup>10</sup> Understanding context is very important in not just appreciating the reasons for existing structures, but also in more appropriately suggesting areas for improvement.<sup>11</sup> Each corporate governance system seeks to balance different complex tradeoffs: flexibility vs. stability, innovativeness vs. predictable success, and shareholder vs. stakeholder focus.<sup>12</sup> Understanding the substance and the trajectory of corporate governance reform requires comparative analysis of both law and politics.<sup>13</sup> As William T. Allen wrote in 1992, when he was the Chancellor of the Delaware Court of Chancery, "We cannot begin to understand the processes of law, unless we try to place law in its rich historical and social context."<sup>14</sup> Part II of this article compares corporate governance in Germany and the United States, and seeks to draw some general, globally applicable lessons from these two countries' distinctly different forms of and experiences with capitalism.

The most popular corporate governance theories can be divided into two categories: (1) those that are *shareholder-centric*, focusing on how to best serve shareholder interests, and (2) those that are *stakeholder-centric*, interested in more comprehensively benefiting the community the corporation affects.<sup>15</sup> Although some suggest a third, middle road approach that combines both of these ("the stakeholder-shareholder theory")<sup>16</sup>, doing so is technically unnecessary and

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<sup>9</sup> David Charny, "The German Corporate Governance System," *Columbia Business Law Review* 1998, no. 1 (1998): 145-146; Florian Stamm, "A Comparative Study of Monitoring of Management in German and U.S. Corporations After Sarbanes-Oxley: Where are the German Enrons, Worldcoms, and Tycos?" *Georgia Journal of International and Comparative Law* 32, no. (2004): 813.

<sup>10</sup> Stamm, "Corporate Management After Sarbanes-Oxley," 815.

<sup>11</sup> *Ibid.*, 816.

<sup>12</sup> *Ibid.*

<sup>13</sup> John W. Cioffi, *Public Law and Private Power* (Ithaca: Cornell University Press, 2010), 37.

<sup>14</sup> William T. Allen, "Our Schizophrenic Conception of the Business Corporation," *Cardozo Law Review* 14, (1992): 261-262. Allen is also the writer of the majority opinion in the significant case, *In re Caremark*.

<sup>15</sup> Katharine V. Jackson, "Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis," *Hastings Business Law Journal* 7, no. 2(2011): 309, 329.

<sup>16</sup> *Ibid.*, 343.

redundant, because we can instead merely understand or emphasize that the term “stakeholder” already and by definition includes shareholders, and thereby advocate for a form of stakeholder theory that ensures the interests of all concerned parties are adequately taken into account, including those of shareholders.

Some further suggest an alternative to the currently dominant neoclassical economic theory of the firm as a “nexus of contracts” between *private* parties,<sup>17</sup> which is arguably related to the normative commitment to shareholder primacy.<sup>18</sup> John Cioffi, for example, suggests that corporate governance constitutes a “juridical nexus” of (1) securities law, (2) corporate law, and (3) labor (and employment) law.<sup>19</sup> Instead of the corporation operating in the liberal realm of private law, as the nexus-of-contracts theory would entail,<sup>20</sup> the three components of this juridical nexus are bodies of *public* law, both by virtue of their authoritative allocation of values to achieve societal goals and because they together create an institutional and legal entity (i.e. the corporation) that would otherwise not exist.<sup>21</sup> These three bodies of law jointly define the institutional attributes of the corporation, its internal power relations between managers, shareholders, and employees, and constitute a distinctive corporate governance regime that mediates the interests of the corporation’s principal stakeholders.<sup>22</sup>

#### C. THE EFFECTS OF INTERNATIONALIZATION AND FINANCE CAPITALISM

Another concern that modern corporate governance takes into account comes from the fact that, due to globalization and developments in technology, twenty-first century corporations and markets now compete on the international level not just for labor, but also for capital.<sup>23</sup> This affects corporate governance in two main conflicting ways: (1) rewarding nations with the most capital-friendly rules, thereby encouraging the global adoption of shareholder-centric rules, but also (2) making it harder for multinational companies to abuse foreign labor without facing some

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<sup>17</sup> Jensen and Meckling, “Theory of the Firm,” 305-308.

<sup>18</sup> Cioffi, *Public Law and Private Power*, 41.

<sup>19</sup> *Ibid.*, 38-41.

<sup>20</sup> Melvin A. Eisenberg, “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm,” *Journal of Corporation Law* 24, no. 4, (Summer 1999): 819, 824.

<sup>21</sup> Cioffi, *Public Law and Private Power*, 39.

<sup>22</sup> *Ibid.*, 38-39.

<sup>23</sup> Jackson, “Shareholder-Stakeholder Theory,” 322; Oliver Krackhardt, “New Rules for Corporate Governance in the United States and Germany—a Model for New Zealand?” *Victoria University of Wellington Law Review* 36, no. 2 (August 2005): 319. “The question for smaller countries is how to keep up in the global competition for international investors’ capital.”

sort of consumer and public image backlash, thereby encouraging the adoption of more stakeholder-centric views and pushing for more corporate social responsibility (CSR).

Although these two forces of internationalization may oppose each other on the issue of stakeholder vs. shareholder theory prominence, other factors have tipped the balance towards shareholder primacy as the current globally-preferred goal of corporate governance.<sup>24</sup> The overall trend converges towards what some have dubbed “finance capitalism,” where the primacy of industrial manufacturing is displaced by the increasing dominance of finance; competition trumps cooperation; ties between industrial and financial capital are loosened; political and economic power is reallocated to the financial sector and is built on a growing class of private investors, on robust and expanding international capital markets, and on sophisticated financial services.<sup>25</sup> The global financial crisis of 2007-2009, however, raised some serious questions about modern finance capitalism, and left both American and German politics in an ideological vacuum.<sup>26</sup>

## II. CORPORATE GOVERNANCE IN GERMANY AND AMERICA: CROSS-POLLINATIONS IN PROGRESS

### A. WHY GERMANY AND THE UNITED STATES?

Comparing corporate governance in the United States and Germany is useful for three main reasons. Firstly, the USA and Germany each constitute robust and dominant economies on the global stage, comprising the two strongest economies of the Western world (i.e. not including China and Japan) as measured by gross domestic product (GDP).<sup>27</sup> The United States wields a disproportionate influence on the development of the global economy,<sup>28</sup> and Germany enjoys a hegemonic role in Europe.<sup>29</sup> Germany is said to have the continent’s strongest as well as biggest economy: Germany’s unemployment rate at 5.4% is less than half of Europe’s average, the country’s budget is balanced, government debt is falling, long-term bond yields are the lowest in

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<sup>24</sup> Cioffi, *Public Law and Private Power*, 26.

<sup>25</sup> *Ibid.*, 25.

<sup>26</sup> *Ibid.*, 229. “The crisis not only demonstrated the increasing instability of modern finance capitalism, it also exposed the power relations underlying it...the financial crisis and Great Recession also undermined support for the political right’s neoliberalism and managerialism, which left American and German politics in an ideological vacuum amid serious legitimacy crises.”

<sup>27</sup> See Appendix A, Figures 1 and 2. The world’s largest economies had the following GDPs (in trillion USD) in 2013: the USA at 16.8, China at 9.2, Japan at 4.9, Germany at 3.7, France at 2.8, and the UK at 2.7.

<sup>28</sup> Cioffi, *Public Law and Private Power*, 18.

<sup>29</sup> “Europe’s reluctant hegemon,” *The Economist*, June 15, 2013, accessed December 24, 2016, <http://www.economist.com/news/special-report/21579140-germany-now-dominant-country-europe-needs-rethink-way-it-sees-itself-and>.

Europe, Germany is the largest creditor country in the Eurozone, and as chief paymaster it has the biggest clout in determining the euro currency's future.<sup>30</sup> The American economy is also so strong and buttressed by such globally respected institutions that some foreign companies leapfrog their relatively poor domestic infrastructure by preferring to list in American exchanges and voluntarily subjecting themselves to American regulation.<sup>31</sup> These two large economies constitute such an important part of the global market that scholars and practitioners of contemporary corporate governance cannot properly comprehend the subject without understanding both systems, especially given the rise of multinational enterprises.<sup>32</sup>

The second reason comes from the fact that Germany and the USA represent the two main types of modern capitalism. The "Varieties of Capitalism" literature suggests that there are two forms of political economies: liberal market economies (LMEs), such as the UK and the USA, and coordinated market economies (CMEs), such as Germany and France.<sup>33</sup> LMEs contain fluid markets where relationships are characterized by the arm's-length exchange of goods and services in a context of competition and in response to price signals.<sup>34</sup> Firms in LMEs adjust their willingness to supply and demand goods or services principally on the basis of the marginal calculations stressed by neoclassical economics, and are intensely attentive to the price of their shares on equity markets since they are more easily subject to hostile takeovers.<sup>35</sup>

In CMEs, on the other hand, firms depend more heavily on non-market relationships and factors to coordinate their activities.<sup>36</sup> Because they have access to "patient capital," CME firms can retain a skilled workforce through economic downturns, and monitor the performance of their executives through extensive systems of "network reputational monitoring" instead of principally through balance sheets as in LMEs.<sup>37</sup> These two significantly different forms of capitalism provide for interesting and useful comparisons, comparisons that have ramifications

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<sup>30</sup> Ibid.

<sup>31</sup> Bruce Kogut, "The Small World of Corporate Governance: An Introduction," in *The Small Worlds of Corporate Governance*, ed. Bruce Kogut (Cambridge, MA: MIT Press, 2012), 11.

<sup>32</sup> Peter Muchlinski, "The Development of German Corporate Law Until 1990: An Historical Reappraisal," *German Law Journal* 14, no. 2 (2013): 339, 341.

<sup>33</sup> Peter A. Hall and David Soskice, "An Introduction to Varieties of Capitalism," in *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, ed. Peter A. Hall and David Soskice (Oxford: Oxford University Press, 2001), 8.

<sup>34</sup> Ibid.

<sup>35</sup> Ibid., 8, 27.

<sup>36</sup> Ibid., 22.

<sup>37</sup> Ibid., 23.

for all the other national economies, whether LMEs or CMEs. Germany is said to be the most important alternative model to the neoliberalism of the United States.<sup>38</sup> Furthermore, the two substantially dissimilar cases provide robust tests of convergent and path-dependent trajectories of political economic development.<sup>39</sup> Germany provides a useful comparison to the United States, because as a CME it is economically more like the Asian “tigers” of Japan, South Korea, and Taiwan, where the state successfully played a dominant role in steering private resources to productive ends, while its more similar culture decreases the magnitude and importance that cultural differences would have in explaining economic differences.<sup>40</sup>

Thirdly and finally, this article contrasts corporate governance in Germany and the United States because both have undertaken significant reforms in the last two decades, which also provide fertile grounds for comparison.<sup>41</sup> These reforms can be helpful in assessing whether corporate governance is accomplishing its goals, whether and which areas require more thinking and tweaking, and finally, whether corporate governance systems are converging. The persistence of corporate governance failures despite reform attempts can also be symptomatic of a more complex and fundamental underlying problem. Before engaging in comparative corporate governance, however, properly understanding the contexts in which the German and the American systems developed is critical.<sup>42</sup>

#### B. CORPORATE GOVERNANCE IN GERMANY: HISTORY AND THE MODERN FIRM

##### 1. HISTORY OF TWENTIETH CENTURY CORPORATE GOVERNANCE IN GERMANY

For the sake of simplicity and the purposes of this paper, the history of corporate governance in Germany over the last century can be broken into three main periods. The first period is the period leading up to and including World War II. The second is the postwar era between the end of WWII in 1945 and the fall of the Berlin wall in 1989. Finally, the reunification of Germany up to the present constitutes the third significant period, ushering in the modern and complex economy that we find today in Germany.

The period from 1916 to 1945 witnessed a fundamental conceptual change in German corporate law thinking; the liberal conception of corporate law was challenged and some major legislative inroads were made.<sup>43</sup> Several factors contributed to this: the two World Wars brought state institutions more in control of private industry; the political turmoil caused by the socialist

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<sup>38</sup> Muchlinski, “The Development of German Corporate Law,” 19.

<sup>39</sup> *Ibid.*, 18.

<sup>40</sup> Masoud Movahed, “The East Asian Miracle: Where Did Adam Smith Go Wrong?,” *Harvard International Review* (blog), October 26, 2014, <http://hir.harvard.edu/archives/7524>.

<sup>41</sup> Cioffi, *Public Law and Private Power*, 41.

<sup>42</sup> Stamm, “Corporate Management After Sarbanes-Oxley,” 815.

<sup>43</sup> Muchlinski, “The Development of German Corporate Law,” 362.



revolution in early post WWI required the Weimar Republic to compromise with the left; the economic crises of 1924 and 1929 negatively impacted German society's perception of the free market; and the Nazi era was explicitly racist, nationalist, and anti-capitalist.<sup>44</sup>

The postwar era, led by the non-liberal Christian Democratic Center-Right, itself influenced by the Social Democratic Center-Left and a powerful labor movement, embraced an economic order that institutionalized economic relations in finance and labor relations.<sup>45</sup> Institutions sought to prevent the recurrence of economic instability and class conflict, which were seen as the root cause of the collapse of the Weimar republic, and to limit state power in response to the trauma of Nazism.<sup>46</sup> The German regime used law and regulation to structure the firm as a largely self-regulating entity that mediated the interests of shareholders and creditors, managers, and labor within a stakeholder model of governance.<sup>47</sup> Long-term goals of stability, prosperity, and security took precedence over the short-term economic interests of the financiers and shareholders.<sup>48</sup> National and sectoral institutional arrangements used corporate governance to create Germany's export-oriented model of "diversified quality production," characterized by high-skill, high-value-added manufacturing, and a relatively egalitarian income distribution scheme.<sup>49</sup>

The third era built on the institutional structures of postwar West Germany, while integrating—at great cost—East Germany into its Europe-oriented, export-based framework.<sup>50</sup> Economic and securities reforms sought to further merge a united Germany not just into the greater project of European economic integration, but also into the global economy.<sup>51</sup> By the 1990s, Germany's postwar economic miracle was over; rising unemployment and slowing growth during the previous decade gave German politicians reasons to question the country's vaunted model of organized capitalism.<sup>52</sup> Germany took measures to protect shareholder interests, and created the country's first federal securities regulator, steadily expanding its powers and ultimately consolidating all financial regulators within one powerful agency.<sup>53</sup>

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<sup>44</sup> Ibid., 362.

<sup>45</sup> Cioffi, *Public Law and Private Power*, 67.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid., 68.

<sup>48</sup> Ibid.

<sup>49</sup> Ibid, 68-69.

<sup>50</sup> Ibid.,142.

<sup>51</sup> Ibid.,142-43.

<sup>52</sup> Ibid.,141.

<sup>53</sup> Ibid.,140-41.

Between 1990 and 2005, Germany's governance regime changed more than it had during the prior half century and arguably since the Industrial Revolution; the resulting corporate governance regime has remained distinctively German, with a pronounced stakeholder orientation, but nevertheless with shareholder protections built to facilitate financial market development and to compete on a global level.<sup>54</sup>

### 2. *The Modern Structure of the German Public Corporation*

Under German company law, a public corporation (*Aktiengesellschaft*, or AG) has a two-tiered board structure with complete separation between its supervisory board (the *Aufsichtsrat*) and its management board (the *Vorstand*), with no overlapping membership between them.<sup>55</sup> The supervisory board appoints and nominally supervises the managing board members and formulates (or at least approves) corporate policies and strategies.<sup>56</sup> For public firms with over 500 employees, the Industrial Constitution Act of 1952 and the Works Constitution Act of 1972 mandates that employees comprise a third of the members of the supervisory board (and the other two thirds voted in by shareholders); for firms with over 2,000 employees, the Codetermination Act of 1976 requires there to be quasi-parity (i.e. 1:1 ratio of shareholder-chosen to employee directors), with the shareholder representative and board chair having a tie-breaking vote.<sup>57</sup> The law bars current management board members from also serving on the supervisory board, which theoretically reduces conflicts of interest, but *former* management board members can ascend to it, and do so in growing numbers.<sup>58</sup>

The supervisory board has no direct power to manage the affairs of the corporation, and must defer to the management board for this.<sup>59</sup> The management board must take into account four main and equal stakeholders: the company itself, shareholders, employees, and the community at large.<sup>60</sup> Creditors may sue the supervisory board members if the AG cannot satisfy its debts,<sup>61</sup> and management board members are also liable to the AG if they fail to heed the demands of the supervisory board and damages ensue.<sup>62</sup>

Another characteristic of the German public corporation is the more dominant role that banks play as shareholders, owning large blocks of shares, and actively influencing the

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<sup>54</sup> *Ibid.*, 140.

<sup>55</sup> *Ibid.*, 70.

<sup>56</sup> *Ibid.*

<sup>57</sup> *Ibid.*, 74.

<sup>58</sup> *Ibid.*, 70.

<sup>59</sup> Stamm, "Corporate Management After Sarbanes-Oxley," 825.

<sup>60</sup> *Ibid.*, 827-28.

<sup>61</sup> *Ibid.*, 827.

<sup>62</sup> *Ibid.*, 826.

membership of the supervisory board.<sup>63</sup> Banks are powerful stakeholders, and as providers of “patient” and “smart” capital, are more likely to encourage long-term thinking.<sup>64</sup> The employee representatives on the supervisory board are also presumably risk averse, and provide another voice favoring long-term growth and thinking.<sup>65</sup> German corporate governance seeks to reduce the great power that the management board has, given that the supervisory board has become too close and beholden to them.<sup>66</sup>

C. CORPORATE GOVERNANCE IN THE UNITED STATES: HISTORY AND THE MODERN FIRM

*I. FROM MANAGERIALISM TO SHAREHOLDER PRIMACY: A BRIEF AMERICAN HISTORY*

The *managerialist*, stakeholder-oriented view of the corporation, as expressed by E. Merrick Dodd of Harvard Law, mostly dominated thinking on corporate governance in the first three quarters of the twentieth century.<sup>67</sup> However, shareholder theory began in the 1970s with the rise of the University of Chicago School of free-market economists.<sup>68</sup> Milton Friedman argued in 1970 that because shareholders “own” the corporation, the only “social responsibility of business is to increase its profits.”<sup>69</sup> Several years later, economist Michael Jensen and business school dean William Meckling published what was to be an even more influential paper, in which they argued that shareholders are the principals of the corporation who hire corporate directors and executives to act as their agents, implying that managers and directors should exclusively serve shareholder interests.<sup>70</sup> They also conveniently assumed, erroneously, that shareholders’ interests were homogeneous and purely financial and that therefore, maximizing shareholder wealth was the sole responsibility of managers.<sup>71</sup>

The legal community was not immune to what by the turn of the millennium had become a rarely questioned dogma.<sup>72</sup> In 2001, corporate law professors Henry Hansmann and Reinier Kraakman from Yale and Harvard, respectively, published an essay entitled *The End of History*

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<sup>63</sup> Ibid., 829.

<sup>64</sup> Ibid., 831.

<sup>65</sup> Ibid., 835.

<sup>66</sup> Ibid., 845.

<sup>67</sup> Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, (Oakland: Berrett-Koehler Publishers, 2012), 17-18.

<sup>68</sup> Ibid.

<sup>69</sup> Milton Friedman, “The Social Responsibility of Business is to Increase Its Profits,” *New York Times*, September 13, 1970.

<sup>70</sup> Jensen and Meckling, “Theory of the Firm,” 305.

<sup>71</sup> Stout, *The Shareholder Value Myth*, 18.

<sup>72</sup> Ibid., 21.

for *Corporate Law*, in which they declared that academic, business, and governmental elites had reached a consensus that:

...ultimate control over the corporation should rest with the shareholder class; the managers should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; ...and the market value of the publicly traded corporation's shares is the principal measure of the shareholders' interests.<sup>73</sup>

They also held that "the triumph of the shareholder-oriented model of the corporation is now assured," not only in the United States, but also in the rest of the civilized world.<sup>74</sup> Lynn Stout, Distinguished Professor of Corporate and Business Law at Cornell Law School, points out that there were two ironies to the timing of this article: first, Enron—a poster child for maximizing shareholder value, whose managers and employees were famous for their fixation on raising stock price—collapsed a few months after the Hansmann & Kraakman article was published; second, legal scholars were also around that time beginning to point out the truth that the Chicago School economists seemed to have missed: U.S. corporate law does not, and never has, required public corporations to "maximize shareholder value."<sup>75</sup>

To this day, the debate between shareholder primacy and stakeholder theory rages on.<sup>76</sup> In law and business school classes, however, maximizing corporate profits and shareholder value still seems to be the norm that professors emphasize and preach.<sup>77</sup> For better or for worse, law and MBA students are still taught that the primary purpose of the corporation is to maximize shareholder value, and many students graduate thinking that this is how current executives behave when they are making corporate decisions.<sup>78</sup>

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<sup>73</sup> Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law," *Georgetown Law Journal* 89, no. 2 (January 2001): 439, 440-41.

<sup>74</sup> *Ibid.*, 468.

<sup>75</sup> Stout, *The Shareholder Value Myth*, 22-23; David Millon, "Radical Shareholder Primacy," *University of St. Thomas Law Journal* 10, no. 4 (2014): 1013, 1023.

<sup>76</sup> Paul D. Weitzel and Zachariah J. Rodgers, "Broad Shareholder Value and the Inevitable Role of Conscience," *New York University Journal of Law and Business* 12, no. 1 (Fall 2015): 35; Stephen Bainbridge, "A Duty to Shareholder Value," *New York Times*, April 16, 2015.

<sup>77</sup> Stout, *The Shareholder Value Myth*, 105.

<sup>78</sup> *Ibid.*

## 2. THE MODERN STRUCTURE OF THE AMERICAN PUBLIC CORPORATION

Since corporate law is a creature of state law, each of the fifty states has developed its own answers to the problems of corporate governance.<sup>79</sup> This article focuses on the Delaware General Corporations Law because of its prominence as the most important code guiding the affairs of the great majority of large American corporations, particularly public corporations.<sup>80</sup>

Under modern Delaware law, shareholders elect the board of directors, and have the power to remove any director, or the entire board, with or without cause by a majority vote unless the certificate of incorporation provides otherwise.<sup>81</sup> The directors of the company meet several times a year to establish and review the policies of the corporation, hire and fire the executive officers (and review and critique their performance), and approve or reject important long-term decisions, like those related to mergers and acquisitions.<sup>82</sup> The officers manage the day-to-day aspects as agents of the corporation, and report to the board.<sup>83</sup>

The directors are entrusted with the power to manage and direct the business and affairs of the corporation.<sup>84</sup> In discharging this function, the directors owe fiduciary duties of care and loyalty to “the corporation and its shareholders.”<sup>85</sup> Directors cannot use their positions of trust and confidence to further their own interests.<sup>86</sup> The Delaware General Corporation law leaves much room for corporate self-determination through the *business judgment rule*, which is more like a standard of judicial non-review, because it states that judges shall defer to directors on the issue of what is in the business interests of the corporation.<sup>87</sup> The rationale for the rule is the recognition that, because of the risky environment of business, directors need to be free to take risks without a constant fear of lawsuits affecting their judgment.<sup>88</sup>

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<sup>79</sup> Stamm, “Corporate Management After Sarbanes-Oxley,” 817.

<sup>80</sup> Charles R.T. O’Kelley and Robert B. Thompson, *Corporations and Other Business Associations: Cases and Materials, Third Edition* (New York: Aspen Publishers, 1999).

<sup>81</sup> Del. Code Ann. tit. 8, § 211.

<sup>82</sup> Del. Code Ann. tit. 8, § 141(b).

<sup>83</sup> Del. Code Ann. tit. 8, § 142(a).

<sup>84</sup> Del. Code Ann. tit. 8, § 141(a).

<sup>85</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986). Note Part III(A)(1) below (Stout argues *Revlon* was a unique case and does not apply to all public corporations).

<sup>86</sup> *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270 (1939).

<sup>87</sup> Douglas M. Branson, “The Rule that isn’t a Rule—the Business Judgment Rule,” *Valparaiso University Law Review* 36, no. 3 (Summer 2002): 631.

<sup>88</sup> *Gagliardi v. TriFoods Int’l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

Interestingly, Delaware recently (2013) passed a statute to allow the creation of “public benefit corporations” (P.B.C.), which are for-profit corporations intended to produce a public benefit (or public benefits) and to operate in a responsible and sustainable manner.<sup>89</sup>

#### D. COMPARING AND CONTRASTING GERMAN VS. AMERICAN CORPORATE GOVERNANCE

The German stakeholder-based corporate governance system, which incorporates labor viewpoints by mandating as many employee seats on the board as shareholders have, stands in stark contrast to the American tendency to exclusively emphasize shareholder interests. Germany’s mix of constituencies on the supervisory board creates an environment in which management misbehavior is at least theoretically more likely to be detected than in the United States,<sup>90</sup> but the American model may be viewed as being more flexible and business-friendly.<sup>91</sup> The bank-heavy reality of German finance, where banks own large blocks of shares and provide much of the capital for corporations,<sup>92</sup> also differs from the American model of diffuse and disempowered shareholders; statutory restrictions on the size and operations of American banks prevented them from becoming the dominant financial actors that they are in other industrialized nations.<sup>93</sup>

While the German corporate governance regime fosters stability and long-term growth, and is said to weather financial crises better than many other advanced economies,<sup>94</sup> the American model instead incentivizes directors and executives to focus on short-term results.<sup>95</sup> Although management, labor, and other stakeholders may enjoy a common interest in the long-term sustainable growth of the corporation, shareholders may not; as a result, corporate boards in the American shareholder primacy model tend to increasingly make short-term decisions that may prove ruinous for the long-term survival of the company.<sup>96</sup>

### III. TIME TO RETIRE SHAREHOLDER PRIMACY

#### A. THE SHAKY LEGAL FOUNDATIONS OF SHAREHOLDER PRIMACY

Shareholder primacy, which states that the corporation’s goal is to maximize revenue for its shareholders, is currently the prevailing view of the business, academic, and policy elites.<sup>97</sup> It

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<sup>89</sup> Del. Code Ann. tit. 8, § 362(a).

<sup>90</sup> Stamm, “Corporate Management After Sarbanes-Oxley,” 835.

<sup>91</sup> *Ibid.*, 859.

<sup>92</sup> Jackson, “Stakeholder-Shareholder Theory,” 311.

<sup>93</sup> *Ibid.*, 319.

<sup>94</sup> *Ibid.*, 353.

<sup>95</sup> *Ibid.*, 323.

<sup>96</sup> *Ibid.*, 324.

<sup>97</sup> Hansmann and Kraakman, “End of History for Corporate Law,” 440-41.

is also a theory that has outlived whatever usefulness it may have once had,<sup>98</sup> and is now proving to be at best ineffective and arguably counterproductive.<sup>99</sup> Professor Stout presents extensive research in *The Shareholder Value Myth* (2012) to support her conclusion that shareholder primacy is not only a very dangerous and ultimately destructive ideology, but also wrong-headed and unfounded.<sup>100</sup>

#### I. TWO OFTEN MISINTERPRETED CASES

The legal basis for shareholder theory largely comes from two cases: *Dodge v. Ford Motor Company*, a 1919 Michigan Supreme Court decision, and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, a 1986 case from the Delaware Supreme Court.<sup>101</sup> As Stout explains, *Dodge v. Ford* was actually not even a case about a public corporation, but actually about the duty that controlling majority shareholders (i.e. Henry Ford) owed to minority shareholders (i.e. the Dodge brothers) in what was functionally a closely held company.<sup>102</sup> The Michigan Supreme Court's passing comment, routinely cited to support the idea that corporate law requires shareholder primacy, was actually mere dicta and therefore just a tangential observation that has no precedent on future courts.<sup>103</sup> In the past thirty years, the Delaware court, known for its judges with expertise on corporate law, cited *Dodge v. Ford* only once—and not on the question of corporate purpose, but on the question of controlling shareholders' duties to minority shareholders.<sup>104</sup>

*Revlon* is the only significant modern case in which a Delaware court has held an unconflicted board of directors liable for failing to maximize shareholder value.<sup>105</sup> Here, again, the situation was unique: the directors of Revlon had decided that Revlon, a public corporation, would be sold off to a private group of shareholders, thus turning Revlon into a privately held company.<sup>106</sup> The Delaware Supreme Court rightfully held that under these circumstances, the

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<sup>98</sup> Stout, *The Shareholder Value Myth*, 19-20. Stout argues that the shareholder value ideology is appealing as a management guide because it provides a simple, easy to understand, sound-bite-worthy description of what corporations do, and offers a ready-made panacea to every imaginable business problem.

<sup>99</sup> *Ibid.*, 48-49.

<sup>100</sup> *Ibid.*, 3.

<sup>101</sup> *Ibid.*, 30.

<sup>102</sup> *Ibid.*, 26.

<sup>103</sup> *Ibid.* Stout quotes *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919): "There should be no confusion... a business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."

<sup>104</sup> *Ibid.*, 27. Stout refers to *Blackwell v. Nixon*, Civ. A. No. 9041, 1991 WL 194725, at \*4 (Del. Ch. Sept. 26, 1991).

<sup>105</sup> *Ibid.*, 30. Stout refers to *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>106</sup> *Ibid.*

business judgment rule did not apply, because the public corporation would soon cease to be, and directors therefore had a duty to get the best possible price for the selling shareholders—the directors in this case indeed owed a duty to the “corporation and its shareholders.”<sup>107</sup>

2. *SHAREHOLDERS DO NOT OWN THE PUBLIC CORPORATION*

Corporations are independent legal entities that own themselves, just as human beings own themselves: a corporation is a “juridical person” that owns property, is liable for the torts of—and has the authority to be bound by—its agents.<sup>108</sup> No one speaks of owning a church, a university, or a town: they own themselves—the public corporation is no exception.<sup>109</sup> Moreover, ownership entails responsibility: if shareholders were the owners and principals of the corporation, they then would be liable for the torts that their agents commit—they are not. The corporation, on the other hand, *is* liable as principal for the torts that its management or employees commit in the course of employment.<sup>110</sup>

To give shareholders the benefits of the principal-agent relationship, without also holding them responsible for it, is a profound legal inconsistency and legal failure that understandably results in shareholders directly or indirectly pushing agents to take on more risks than they reasonably should.<sup>111</sup> For example, in trying to save \$1 million a day by skimping on safety procedures at the Macondo well, BP ultimately cost its shareholders nearly \$100 billion in the subsequent share price drop from \$60 to less than \$30 in the Deepwater Horizon oil spill of 2010.<sup>112</sup> If shareholders had also been individually legally liable for the actions of the corporation, as indeed they would be if they actually were the corporation’s principals, then perhaps they would have been more proactive about reducing such risks, and more value would have been saved—not to mention the 11 lives that were lost.<sup>113</sup> Interestingly, but not surprisingly, shareholder primacy is even more prevalent in the United Kingdom, where BP is incorporated, than in the United States.<sup>114</sup>

Finally, the other element of the principal-agent relationship is control: principals should

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<sup>107</sup> *Ibid.*, 31.

<sup>108</sup> *Ibid.*, 37.

<sup>109</sup> Robert Phillips, *Stakeholder Theory and Organizational Ethics* (San Francisco: Berrett-Koehler Publishers, 2003), 156-57.

<sup>110</sup> The legal doctrine that places responsibility on a principal for the actions of its agents is referred to in the law as *respondeat superior*.

<sup>111</sup> David H. Erkens, Mingyi Hung, and Pedro Matos, “Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide,” *Journal of Corporate Finance* 18, no. 2 (April 2012): 389. This is a study of 296 firms during the 2007-2008 crisis, correlating shareholder primacy with more risk taking.

<sup>112</sup> Stout, *The Shareholder Value Myth*, 1-2.

<sup>113</sup> *Ibid.*

<sup>114</sup> *Ibid.*, 85.



be able to control the actions of the agents—shareholders have very little, if any, real control over managers.<sup>115</sup> Although movements in favor of shareholder activism may be seeking to remedy this, these movements will hastily subside the moment we condition granting their wishes on also imposing liability upon these shareholder-wannabe-principals.

Stout also disagrees with the often-cited proposition that shareholders are the owners of the corporation because they are the only residual claimants to the corporation, i.e. they own the retained earnings of the corporation after all debts are paid.<sup>116</sup> Although shareholders may have rights to whatever is left of a *dead* corporation (i.e. undergoing bankruptcy proceedings), they only receive dividends from a *living* corporation if the board of directors so decides; but the directors are under no legal obligation to issue dividends and may instead choose to raise executive or employee salaries, make charitable contributions, or invest in research and development, for example.<sup>117</sup> The employees, therefore, may in practice be just as much residual claimants to the living corporation's retained earnings as shareholders are; the directors have full discretion to decide what to do.<sup>118</sup>

#### B. THE DESTRUCTIVE EFFECTS OF SHAREHOLDER PRIMACY

##### I. *SHAREHOLDER PRIMACY IS NOT PARTICULARLY GOOD AT REDUCING AGENCY COST*

Some maintain that even if shareholder primacy has no stable ground in corporate law, there are normative reasons for adopting it.<sup>119</sup> The argument, as put forward by Frank Easterbrook and Daniel Fischel in 1991, is that shareholder primacy is necessary to give a clear mandate to managers as to their duty, because otherwise managers would be unable to strike the right balance between catering to both shareholders and the community, and would result in catering to neither.<sup>120</sup> Shareholder value advocates like professor Stephen Bainbridge from UCLA School of Law still rely upon this reasoning today.<sup>121</sup> The theory may sound reasonable,

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<sup>115</sup> Phillips, *Stakeholder Theory and Organizational Ethics*, 72-73.

<sup>116</sup> Stout, *The Shareholder Value Myth*, 38-41.

<sup>117</sup> *Ibid.*, 40.

<sup>118</sup> *Ibid.*, 41.

<sup>119</sup> *Ibid.*, 45.

<sup>120</sup> Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991), 38.

<sup>121</sup> Bainbridge, *A Duty to Shareholder Value*. Bainbridge states: "If directors were allowed to deviate from shareholder wealth maximization, they would inevitably turn to indeterminate balancing standards, which provide no accountability. As a result, directors could be tempted to pursue their own self-interest. If closing the plant would benefit directors, they could point to shareholder interests to justify their decision. But if, on the other hand, keeping it open would benefit directors, they could just as easily point to concerns for employees."

but there is no evidence to support it: cross-sectional analyses and event studies seeking to measure the alleged advantages of shareholder theory have at best been inconclusive.<sup>122</sup> One study found that the stock prices of companies that came closer to the shareholder primacy model, as measured by having more institutional shareholders and more independent (outside) directors, actually did worse.<sup>123</sup>

If shareholder primacy truly made public corporations better managed and more valuable, we would have seen an increase in initial public offerings (IPO)—but the opposite has been happening.<sup>124</sup> Correlating with the rise of shareholder primacy thinking has been a decrease in IPOs: consulting group Grant Thornton has found that from 1997 to 2009, the number of public companies listed on U.S. stock exchanges declined by 39% in absolute terms, and by 55% when adjusted for GDP growth.<sup>125</sup> This should not necessarily indicate that shareholder primacy has caused this reduction in IPOs, as there are obviously many other complex factors at work,<sup>126</sup> but this decrease in the options available to public investors should at least cause some concern as to the health of the status quo.<sup>127</sup> For Michael Dell, founder, CEO, and Chairman of Dell Inc., however, privatizing Dell was the right move exactly because it freed the company from the destructive, short-term focus that results when the board has to cater to investors.<sup>128</sup>

## 2. CORPORATIONS ARE MORE DISTINCT AND SEPARABLE THAN SHAREHOLDERS

People often think negatively of corporations as fictitious and abstract entities, while

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<sup>122</sup> Stout, *The Shareholder Value Myth*, 48-49.

<sup>123</sup> “Corporate Constitutions: The World Knows Less about What Makes for Good Corporate Governance Than It Likes to Think,” *The Economist*, October 30, 2010, <http://www.economist.com/node/17359354>; Erkens, Hung and Matos, “Corporate Governance in the 2007-2008 Financial Crisis,” 389.

<sup>124</sup> Stout, *The Shareholder Value Myth*, 54.

<sup>125</sup> David Weild and Edward Kim, *Grant Thornton Capital Market Series: A Wake-Up Call for America*, (New York: Grant Thornton, 2009), 1.

<sup>126</sup> For example, the increase in the quarterly reporting requirements of public corporations puts them at a higher disadvantage against private companies, who are able to deploy strategies more discreetly and rapidly. However, public corporations also benefit from access to more capital and are seen as more prestigious than private companies, so the net effect is unclear. See Allee et al., “Private Versus Public Corporate Ownership,” 9-10.

<sup>127</sup> Stout, *The Shareholder Value Myth*, 55.

<sup>128</sup> Michael Dell, “Going Private Is Paying Off for Dell,” *Wall Street Journal*, November 24, 2014, accessed March 30, 2017, <http://www.wsj.com/articles/michael-dell-going-private-is-paying-off-for-dell-1416872851>. “As a private company, Dell now has the freedom to take a long-term view. No more pulling R&D and growth investments to make in-quarter numbers. No more having a small group of vocal investors hijack the public perception of our strategy while we’re fully focused on building for the future. No more trade-offs between what’s best for a short-term return and what’s best for the long-term success of our customers. For example, in the past year we have made investments of several hundred million dollars in areas with significant time horizons, such as cloud and analytics, that might not have been feasible in today’s environment for public companies.”

viewing shareholders as being more real and therefore more relatable and likeable.<sup>129</sup> However, although corporations are indeed merely legal entities, corporations are more easily identifiable as distinct and separate, owning very real property, while the idea of shareholders as a single, homogeneous group, whose interests are the same and easy to identify, is a fiction.<sup>130</sup> Shareholders are ultimately diverse: some seek short-term returns, but others are in it for the long-term; some are myopic and do not care about the environment or poor labor standards, but others want their corporation to act conscientiously.<sup>131</sup> Identifying the interests of the corporation is therefore easier to do, in some ways, than trying to capture the interests of its “shareholders” as a whole.

3. *SHAREHOLDER PRIMACY LEADS TO UNCONSCIONABLE, SHORT-TERM THINKING BECAUSE OF THE SHAREHOLDER-FUND MANAGER AGENCY PROBLEM*

There are, however, at least some practical reasons to viewing shareholders as a mostly homogeneous, self-interested, and profit-seeking group. Institutional shareholders dominate today’s stock market and own about three quarters of the stock of the one thousand largest U.S. corporations.<sup>132</sup> Shareholders often invest through these institutions, like pension funds or mutual funds, and largely have no knowledge of, or control over, what companies they actually are invested in; shareholders thus relinquish any moral responsibility they might otherwise have felt as *individuals*, and leave the decision-making, and proxy voting, to their institutional fund managers.<sup>133</sup> This creates what is today perhaps an even more significant problem in corporate governance than the shareholder-corporate manager agency problem: the *shareholder-fund manager* agency problem.

Shareholders have very little control over, and oversight of, what the fund managers do, and indirectly incentivize fund managers to squeeze profits out of corporations.<sup>134</sup> As Stout puts it, we should not be surprised to see a pension fund manager invest in corporations that cut costs by outsourcing jobs to China and India—even if many of the jobs that are outsourced belonged to the employees contributing to the pension fund, i.e. the shareholders.<sup>135</sup> That is because these fund managers actually do care more about company profits and share price than any secondary considerations of a nonfinancial nature, because they are compensated or at least rewarded in

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<sup>129</sup> Stout, *The Shareholder Value Myth*, 59-60.

<sup>130</sup> *Ibid.*

<sup>131</sup> *Ibid.*, 60.

<sup>132</sup> Millon, "Radical Shareholder Primacy," 1040.

<sup>133</sup> Stout, *The Shareholder Value Myth*, 66.

<sup>134</sup> *Ibid.*, 90-91.

<sup>135</sup> *Ibid.*, 91-92.

their career advancement prospects based on how well their portfolio is doing *that year*.<sup>136</sup> They thus not only care mostly about share price, but also about *short-term* share price. In 1960, the annual share turnover for firms on the NYSE was only 12 percent, implying an average holding period of over eight years.<sup>137</sup> By 1987, the figure had risen to 73 percent, or an average holding period of a year and four months.<sup>138</sup> In 2008, the average turnover rate had reached 311 percent annually, implying an average holding period of less than four months.<sup>139</sup> Mutual funds guru and Vanguard Funds founder Jack Bogle describes the mutual fund industry as having become a “rent-a-stock” industry.<sup>140</sup>

Mutual funds, hedge funds, and other fund managers in turn pressure directors and executives to pursue strategies that produce short-term gains without any concern for long-term value.<sup>141</sup> Part of the problem is that these strategies to “unlock shareholder value” may be advantageous to one company in the short term, but will lead to reducing aggregate shareholder wealth, especially over the long term.<sup>142</sup> Stout compares this to “fishing with dynamite,” which might increase the catch of one fisherman one or two times, as all the dead fish float up to the surface, but ultimately results in the classic “Tragedy of the Commons” problem: no more fish left in the sea.<sup>143</sup> One survey of 400 corporate finance officers found that a full 80 percent reported that they would cut expenses like marketing or product development in order to make their quarterly earnings targets, even if they knew doing so would likely hurt long-term performance.<sup>144</sup> This is understandable, given the pressures facing executives, since a corporation’s failure to reach earnings targets during quarterly reports can trigger large-scale selloffs and consequent declines in share price—a fate that currently, for executives, might mean

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<sup>136</sup> Ibid. 67.

<sup>137</sup> William W. Bratton, “Hedge Funds and Governance Targets,” *Georgetown Law Review* 95, no. 5 (June 2007): 1410.

<sup>138</sup> Ibid.

<sup>139</sup> Leo E. Strine, “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?” *The Business Lawyer* 66, no. 1 (November 1, 2010): 11.

<sup>140</sup> John C. Bogle, “Reflections on the Evolution of Mutual Fund Governance.” *Journal of Business and Technology Law* 1, no. 1 (2006): 47.

<sup>141</sup> Stout, *The Shareholder Value Myth*, 67; Strine, “One Fundamental Corporate Governance Question We Face,” 139.

<sup>142</sup> Stout, *The Shareholder Value Myth*, 50-51.

<sup>143</sup> Ibid., 51.

<sup>144</sup> John R. Graham, Cam Harvey, and Shiva Rajgopal, “Value Destruction and Financial Reporting Decisions,” *Financial Analysts Journal* 62, no. 6 (November 1, 2006): 27-39.

the loss of their job.<sup>145</sup>

#### 4. SHAREHOLDER PRIMACY BRINGS OUT OUR INNER WORST

On an even more fundamental level, shareholder primacy is disturbing because it sanctions, justifies, and encourages antisocial behavior.<sup>146</sup> Most humans, given the social nature of homo sapiens-sapiens, would choose to cooperate and share their goods with others.<sup>147</sup> However, research also shows that people act more selfishly if they believe others would act selfishly, and when they think their selfishness imposes only a small cost, or no cost, on others.<sup>148</sup> The standard shareholder-oriented model teaches that it is not only acceptable, but also morally correct, for shareholders to pressure managers to raise share price in any way possible, without regard for how the corporation's actions impact stakeholders, society, or the environment.<sup>149</sup> As a result, shareholder value thinking reduces shareholders to their "lowest moral denominator," and encourages them to behave in antisocial and psychopathic ways that they otherwise would not.<sup>150</sup> This phenomenon is even more accentuated by the shareholder-fund manager agency problem.<sup>151</sup> Institutional fund managers have no problem pressing boards to replace company officers that do not promptly deliver high returns, a situation that has actually decreased the average tenure length of CEOs and perverted the incentive structure of company managers.<sup>152</sup>

#### C. TRADITIONAL SHAREHOLDER PRIMACY, OR SHAREHOLDER PRIMACY LITE

Recent corporate governance scholarship has responded to the problems of shareholder primacy by arguing that focusing on a broader concept of shareholder interests—and not solely on shareholder *financial* wellbeing—properly leaves room for conscience in the boardroom and for including the nonfinancial, social interests of shareholders.<sup>153</sup> This more general sense of shareholder theory, referred to as *traditional shareholder primacy* by David Millon and as the

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<sup>145</sup> Douglas J. Skinner and Richard G. Sloan, "Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio," *Review of Accounting Studies* 7, no. 2 (2002): 289; Millon, "Radical Shareholder Primacy," 1041.

<sup>146</sup> Stout, *The Shareholder Value Myth*, 100-101.

<sup>147</sup> *Ibid.*, 97. As many as 97 percent of subjects in a study chose to cooperate in some social dilemma games. In addition, "the vast majority of people are willing to make at least small personal sacrifices to follow their conscience."

<sup>148</sup> *Ibid.*, 100.

<sup>149</sup> *Ibid.*, 100-101.

<sup>150</sup> *Ibid.*, 101.

<sup>151</sup> See III(B)(3) above.

<sup>152</sup> Strine, "One Fundamental Corporate Governance Question We Face," 14-16.

<sup>153</sup> Millon, "Radical Shareholder Primacy," 1013-14; Weitzel and Rodgers, "Broad Shareholder Value and the Inevitable Role of Conscience."

“Broader Shareholder Value Norm” by Paul Weitzel and Zachariah Rodgers, still holds that managers owe a fiduciary duty primarily to shareholders, but distinguishes itself from *radical* shareholder primacy by maintaining that because shareholders care about more than just profits, managers do not have a duty to maximize shareholder wealth.<sup>154</sup>

Traditional shareholder primacy seems like a nicer, more acceptable version of shareholder theory, because it presents a more human, heterogeneous picture of shareholders, whose interests purportedly include doing what is good for society as a whole, and what is good for the corporation in the long term.<sup>155</sup> Traditional shareholder primacy is also more in line with what the law currently *requires*.<sup>156</sup>

As a model to account for and guide management strategy, however, this view is at best highly optimistic, and at worst profoundly and dangerously naïve. Traditional shareholder primacy would work if individual shareholders were personally actively involved in overseeing the corporation, voting for corporate directors, and voicing their conscientious opinions about how the corporation should be run. The reality, of course, as previously discussed, presents a completely different picture.<sup>157</sup> Because shareholders let fund managers make investment decisions for them, thereby relinquishing any sense of moral responsibility they might otherwise feel as individuals, and because fund managers have very real incentives to focus on short-term financial returns, traditional shareholder primacy *in practice* therefore suffers from many of the same problems of radical shareholder primacy. Millon actually alludes to this, but fails to take the important next deductive leap.<sup>158</sup>

Even if shareholders were to begin taking more of an interest in the companies they are invested in, and somehow rendered fund managers irrelevant—an unlikely scenario—the primary criticism of stakeholder theory would now also apply to traditional shareholder theory. As the argument would go: managers would be unable to balance all the conflicting values and interests of shareholders, and would thereby more easily act to benefit themselves and cheat. In some ways, traditional shareholder primacy is merely stakeholder theory, but couched in a different and deceptive name. Furthermore, even if managers were not legally required to

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<sup>154</sup> Millon, “Radical Shareholder Primacy,” 1043-44; Weitzel and Rodgers, “Broad Shareholder Value and the Inevitable Role of Conscience,” 40.

<sup>155</sup> Weitzel and Rodgers, “Broad Shareholder Value and the Inevitable Role of Conscience,” 8. This refreshingly contrasts with the radical shareholder primacy’s assumption of shareholders as a homogenous, abstract and exclusively self-interested group; Stout, *The Shareholder Value Myth*, 60.

<sup>156</sup> Weitzel and Rodgers, “Broad Shareholder Value and the Inevitable Role of Conscience,” 23; Millon, “Radical Shareholder Primacy.”

<sup>157</sup> Individual shareholders relinquish this duty to fund managers, who are incentivized to squeeze profits out of corporations. See the discussion in Part III (B)(3) above.

<sup>158</sup> Millon, “Radical Shareholder Primacy,” 1041-42.

maximize shareholder wealth, the radical shareholder primacy viewpoint has become so pervasive in our culture that, absent a paradigm shift in corporate thinking completely away from a focus on shareholders, managers would continue to perceive that such was indeed their duty.<sup>159</sup> For reasons that will become more apparent in Part IV, traditional shareholder primacy is still as fundamentally problematic as its more radical but perhaps more honest counterpart. At the root of this problem lies the question: is society to be used to further the interests of the corporation, or is the corporation a legal construct, built to function within and for the purposes of society?<sup>160</sup>

#### IV. WHY A “DIRECTORIST” VIEW OF CORPORATE GOVERNANCE MAKES SENSE

##### A. GOVERNANCE LESSONS FROM SCHOOL TEACHERS, STUDENTS, AND PARENTS: AN ANALOGY

The introductory remarks in Part I of this article expressed the virtues of capitalism (and the corporation) as creating useful products and services for society. Shareholder theory has corrupted this understanding by turning the focus instead on the financial rewards and wellbeing of one segment of the participants in capitalism—i.e., the shareholders<sup>161</sup>—and minimizing the corporation’s own independence, goals, and purpose. Perhaps an analogy would be useful to illustrate this dynamic, and why some form of stakeholder theory should be at the core of corporate governance.

Imagine the tripartite relationships between students, parents, and teachers (using “teachers” in a broad sense that includes all school officials, like principals). Parents come together and entrust teachers with the care and development of their children, perhaps for the same reasons that shareholders entrust managers with the care and development of the corporation: they are too busy or lack the technical expertise to do so themselves.

##### *I. THE ANALOGY’S IMPLICATIONS FOR RADICAL SHAREHOLDER PRIMACY*

Radical shareholder primacy would be comparable to insisting that the goal of teachers is to please parents by ensuring that their students get continuously better grades. Obviously, just as a student cannot get anything better than an A or A+, so too do shareholders at some point

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<sup>159</sup> Stout, *The Shareholder Value Myth*, 53.

<sup>160</sup> Or, as Stout puts it: “We created corporations; now we share the planet with them. The relationship between our two species can be symbiotic or predatory.” *Ibid.*, 103.

<sup>161</sup> If we think of capital and labor as the two participants in capitalism, and shareholders as the owners of capital, then laborers are those forgotten by shareholder primacy.

become unrealistic and profoundly ignorant (and arrogant) if they think the corporation could perform any better than it already is.<sup>162</sup>

The analogy provides some more useful insights. Students certainly will benefit over the remainder of their lifetime from having had a teacher who focused on the right qualitative and long-term goals, and who pushed them to actually work hard and gradually become better. Parents would want their child's long-term success, and would consider but not exaggerate the importance of their child's quarterly report cards—especially if the teacher or child explains the reasons for a poor grade. Managers who focus on the right goals that benefit the corporation, and not on the company's fluctuating share price, will indirectly reward shareholders throughout the corporation's lifetime.

Conversely, if corporate governance continues to tell managers that their goal is to ensure shareholders get a nice share price from the corporation, we will continue to see artificially exaggerated and unsustainable share prices through clever accounting and harmful cost cutting, respectively, that eventually result in some devastating and shattering news for some companies.<sup>163</sup> The Sarbanes-Oxley requirements of having an audit committee run by independent board directors might reduce the likelihood of executives “cooking the books” but will not eliminate its occurrence, and will do nothing to stop the short-term focus of public corporations, because the incentive structure of shareholder primacy still encourages this behavior.<sup>164</sup>

Teachers who are rewarded based on how their students perform on a standardized quantitative test will sacrifice subjects that are critical to the students' long-term wellbeing, like history or art, while also encouraging students to learn superficially for the test, and subjecting them to increased and unnecessary stress.<sup>165</sup> The standardized tests' emphasis on “skill drill and

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<sup>162</sup> Stout, *The Shareholder Value Myth*, 71-72. Stout refers to the *efficient market hypothesis*: “Suppose a company is doing well; the firm is operating at peak performance and looks as if it can hum along at peak performance indefinitely. The stock market will incorporate this expectation of optimal future performance into today's stock price. How then can a CEO raise stock prices any further?”

<sup>163</sup> E.g., Enron, Worldcom, Waste Management, etc.

<sup>164</sup> Roger Martin, *Fixing the Game* (Boston: Harvard Business School Publishing, 2011), quoted in Steve Denning, “The Dumbest Idea in the World: Maximizing Shareholder Value,” *Forbes*, November 28, 2011, <http://www.forbes.com/sites/stevedenning/2011/11/28/maximizing-shareholder-value-the-dumbest-idea-in-the-world/>. Martin writes, “Our theories of shareholder value maximization and stock-based compensation have the ability to destroy our economy and rot out the core of American capitalism. These theories underpin regulatory fixes instituted after each market bubble and crash. Because the fixes begin from the wrong premise, they will be ineffectual; until we change the theories, future crashes are inevitable.”

<sup>165</sup> Valeria Strauss, “13 Ways High-stakes Standardized Tests Hurt Students,” *Answer Sheet* (blog), *The Washington Post*, March 11, 2014, <https://www.washingtonpost.com/news/answer-sheet/wp/2014/03/10/13-ways-high-stakes-standardized-tests-hurt-students/?utmterm=.919599259f52>.



kill” fails to stimulate children’s imagination and limits their natural curiosity,<sup>166</sup> just like some argue that focusing on share price cripples managers’ and employees’ ability to think creatively, and ultimately harms the corporation’s long-term growth.<sup>167</sup> The recent scandal in Atlanta Public Schools, where teachers, to earn bonuses or just keep their jobs, participated in a widespread cheating scandal by changing their students’ scores on standardized tests,<sup>168</sup> is a testament to this profoundly flawed incentive structure, not too dissimilar from the Enron debacle.<sup>169</sup> Bob Schaeffer, public education director of nonprofit organization FairTest, believes that Atlanta is just “the tip of the iceberg,” because “[c]heating is a predictable outcome of what happens when public policy puts too much pressure on test scores.”<sup>170</sup>

When students fail to learn the right long-term, life lessons, it is not only they and their parents who will ultimately suffer when the students are adults, but the entire ecosystem (of friends, family, and coworkers) that the student has built—including the student’s employer—also takes a hit. Similarly, when a corporation is crippled by short-term thinking and fails, it is not only the corporation and the shareholders who suffer, but the entire ecosystem that is held together by the corporation, including employees, their families, and all the businesses they frequent—in other words, the entire economy—is damaged as well.<sup>171</sup>

We may criticize the analogy by arguing that some shareholders simply cannot wait to reap the rewards of a corporation’s long-term planning, and instead expect and need a quick

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<sup>166</sup> Ibid.

<sup>167</sup> Peter Mead, co-founder of the Abbott Mead Vickers (AMV) advertising agency in the UK, explains that part of the company’s success was due to making employees feel comfortable, reducing anxiety, and not focusing on share price, because “Creativity is one of the last remaining legal ways of getting an advantage over the opposition, and anxiety doesn’t foster creativity.” Matthew Gwyther, “How To Be Nice And Beat The Rest,” *Management Today*, September 1, 2000, <http://www.managementtoday.co.uk/news/411902/nice-beat-rest-peter-mead-co-founder-ad-agency-abbott-mead-vickers-urges-bosses-capture-unfair-share-employees-heads-hearts-for-people-business/>.

<sup>168</sup> Ashley Fantz, “Prison Time for Some Educators in Cheating Scandal,” *CNN*, April 14, 2015, <http://www.cnn.com/2015/04/14/us/georgia-atlanta-public-schools-cheating-scandal-verdicts/>.

<sup>169</sup> Kurt Eichenwald, *A Conspiracy of Fools* (New York: Broadway Books, 2005), 328. Even Jeff McMahon, one of the few executives at Enron who did things “right” (i.e. in the interests of Enron), despite paying a price for it in the form of receiving lower compensation, admitted the intense pressures he faced: “Here’s the CFO of the company, a few weeks before bonuses are paid, telling me to close the deal under bad terms. I didn’t do it, we got it fixed and done right. But, man, that was major pressure.”

<sup>170</sup> Max Blau, “Why the Atlanta Cheating Scandal Failed to Bring About National Reform,” *The Guardian*, April 1, 2015, accessed March 30, 2017, <http://www.theguardian.com/us-news/2015/apr/01/atlanta-cheating-scandal-education-reform>.

<sup>171</sup> Martin, *Fixing the Game*, quoted in Denning, “The Dumbest Idea in the World,” 12.

return and exit strategy. The thinking would be that such shareholders are not like the parents in our analogy, who would have more to gain from their children's long-term success than from what good grades can temporarily offer, but are perhaps more like gamblers betting on what the student's next report card will look like: they "buy" if they think the student will do better, or "short" if they think it will be a tougher semester. The argument would be that allowing gamblers to do this increases the shares' liquidity and worth, which ultimately trickles down to increasing the capital that the corporation receives in an IPO.

But this criticism is actually a validation of why shareholder primacy is wrong-headed. We can allow gamblers to bet on the student's report card, which captures the benefits of liquidity, but do we want them to also have a say on what the child should value in life, the kind of persons the child should befriend or eventually marry, or what the child's diet should consist of? Any parent would be appalled by the mere suggestion. We should similarly be appalled by the thought that short-term shareholders should ultimately have such a comparably wide latitude over a corporation as influencing mergers and acquisitions, who the employees are, and how it should conduct its business.<sup>172</sup>

### *2. The Analogy's Implications for Traditional Shareholder Primacy*

The analogy is also useful because of the even more basic question of how much attention managers should pay to shareholders. In the traditional shareholder primacy model, which supposedly leaves room for long-term thinking and "conscience in the board room," managers should still only care about the interests of shareholders,<sup>173</sup> which is tantamount to teachers focusing on the interests of their students' parents. Even this more general view of shareholder theory is therefore flawed, for the same reasons why teachers should not focus their energies on pleasing parents, which include at least three fundamental reasons.

Firstly, and most importantly, children have conflicting interests with—and are separate individuals from—their parents. Although teachers should certainly take the parents' advice and concerns into consideration—and in extreme cases may cause frustrated parents to register their child in another school if teachers do not—their duty is primarily to their students, and not to parents. Since students are not always in a position to evaluate whether teachers are fulfilling this duty, the school principal is tasked with this responsibility.<sup>174</sup>

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<sup>172</sup> See, for example, Carl Icahn and other activist shareholders' influence on management and major corporate decisions. "Anything you can do, Icahn do better," *The Economist*, February 15, 2014, accessed March 27, 2017, <http://www.economist.com/news/business/21596556-pressure-companies-activist-shareholders-continues-grow-anything-you-can-do>.

<sup>173</sup> Weitzel and Rodgers, "Broad Shareholder Value and the Inevitable Role of Conscience," 1.

<sup>174</sup> "The School Principal As Leader: Guiding Schools to Better Teaching and Learning," Wallace Foundation, accessed December 05, 2016, <http://www.wallacefoundation.org/knowledge-center/school-leadership/effective->

Teachers should get fired not because they failed to ask and implement the parents' suggestions, but only because they actually abused a student, or disagree with the principal's vision and approach to education. It is more often the case that teachers never even interact with most of their students' parents, just like managers have very little exposure to all the company's diverse, numerous, and constantly changing shareholders. Just as the law punishes teachers and principals who abuse students, so too does the law already punish officers and directors who abuse the corporation for their personal benefit—we do not need shareholder primacy to enforce this.

In a Kantian *categorical imperative* sense, the quality and sanctity of the classroom would be profoundly compromised if teachers viewed their students not as ends in and of themselves, but as mere means and objects to further the interests of their parents.<sup>175</sup> A school counselor or principal trying to understand what a specific child wants and needs may find clues in what the child's parents want and need, but to equate the child's interests with the parents' interests is to ignore the reality that the child is influenced by, needs, and values other constituents besides his or her parents. The child may be heavily influenced by and dependent on his parents in early years, but at some point ceases to rely on his parents and becomes more dependent on mentors and peers. Indeed, most people would think there is something profoundly wrong with a forty-year-old man who still is primarily motivated by what his mom wants him to do. Although the corporation depends heavily on original shareholders to raise capital during an IPO, the corporation simply ceases to get any benefits from subsequent shareholders, and instead relies more on its directors, employees, suppliers, and customers for further growth.

The corporation is therefore a distinctly different legal entity, separate from its shareholders, and containing interests and stakeholders that sometimes conflict with shareholders' interests.<sup>176</sup> Managers should listen to what shareholders have to say, but ultimately owe their fiduciary duty to the corporation, not to the shareholders. Managers would abuse the corporation if they thought of it as a mere means to satisfy the ends of the shareholders—and indeed, they often do.<sup>177</sup> The board of directors, being responsible for the corporation's vision, culture, purpose, identity, and long-term success, is the voice of the

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principal-leadership/Documents/The-School-Principal-as-Leader-Guiding-Schools-to-Better-Teaching-and-Learning-2nd-Ed.pdf.

<sup>175</sup> We may, however, be more comfortable with viewing education as a means to satisfy the interests of society, just like viewing corporations as means to satisfy the needs of society.

<sup>176</sup> Stout, *Shareholder Value Myth*, 37.

<sup>177</sup> Graham et al., "Value Destruction and Financial Reporting Decisions," 31.

corporation. Company managers therefore owe their secondary fiduciary duty to the board of directors, the same way that teachers owe their secondary duty to the school's principal or school board.<sup>178</sup>

The second reason why teachers should not think of pleasing parents as their main goal is that teachers are educational professionals who have been trained and selected to cater to students because they have expertise and experience in a child's developmental needs, and know how to manage a classroom, while parents are specializing in a different profession or field. This trade between parents and teachers benefits both parties, since it allows both to focus on what they are each better at doing, à la Ricardian theory of comparative advantage. A baker should not presume to give advice to a seamstress on how to sow, and a seamstress should defer to the baker on how to make a good loaf of bread.

Similarly, managers have more experience regarding how to grow and manage a corporation than shareholders, who are far removed from the corporation, lack the technical expertise, or just have not spent as much time with the corporation as the managers have. This point parallels Dodd's discussion of the managerialist view of corporate governance.<sup>179</sup> Interestingly, although Bainbridge subscribes to the view that the goal of directors is to maximize shareholder value, he nevertheless still advocates for director control of the corporation ("director primacy") and against shareholder activism for the same reasons discussed here.<sup>180</sup>

Thirdly and finally, teachers should not think of their principal duty as catering to their students' parents, because doing so is impractical and actually makes teachers less accountable. Because teachers cannot interact with all of the parents of the students in their classroom, they have to assume that the only thing parents want is for their children to get good report cards. But this may be an incorrect assumption for some parents, who may want their children to simply learn, and who actually pay very little attention to their children's report cards. Similarly, if managers think their duty is to shareholders, who are so numerous and constantly changing that managers cannot possibly survey all of them, managers will have to rely on an assumption that shareholders only want good news during quarterly reports, and will do whatever they can to satisfy this demand. This may actually result in making the managers less accountable to the shareholders that value long-term growth.

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<sup>178</sup> Section C below further articulates why a "directorist" model of corporate governance makes sense, and then Part V more fully examines how the model would work, and what it would entail.

<sup>179</sup> E. Merrick Dodd, Jr., "For Whom Are Corporate Managers Trustees?" *Harvard Law Review* 45, no. 7 (1932): 1145, 1153.

<sup>180</sup> Stephen M. Bainbridge, "Director Primacy: The Ends and Means of Corporate Governance," *Northwestern University Law Review* 97, no. 2 (2003): 572-574.

B. WHY THE “DIRECTORIST” VIEW, A FORM OF STAKEHOLDER THEORY, SHOULD PREVAIL

I. THE “JURIDICAL NEXUS” AS A MORE APPROPRIATE CONCEPT THAN NEXUS-OF-CONTRACTS

Shareholder primacy—whether the traditional or radical form—still usually includes the nexus-of-contracts concept of the firm as its structural justification.<sup>181</sup> The theory goes that if we let all major stakeholders—founders, managers, employees, and shareholders—contract their way on their own and come to an agreement that works for everyone, they themselves will eventually settle on some form of agreement that is tantamount to shareholder primacy, i.e. that the goal of the corporation is to produce revenue for shareholders, and managers have a fiduciary duty only to, and should direct corporate resources towards, shareholder interests.<sup>182</sup> The purported reasoning for this is that employees and managers will already be able to protect their interests through employment law remedies, but shareholders can only rely on corporate governance to ensure managers are not acting self-interestedly.<sup>183</sup>

The nexus-of-contracts theory of the firm works fairly well for privately held corporations, but is flawed on three levels as a model for public corporations. Firstly, and perhaps most fundamentally, although such a negotiation between stakeholders might take place in an IPO, when the corporation and shareholders actually transact with and “choose” each other, every subsequent shareholder becomes a shareholder without any say or input from the corporation, managers, employees, or the non-selling remaining shareholders. Even if we accept that subsequent shareholders simply assume the contract that the original IPO shareholders established, surely we can understand why elements of partnership law should then be adopted to mediate situations when a party to the original contract does not want to become partners with a new, untrustworthy party. Under partnership law, the partnership has to be abolished and recreated every time the partners change. This is not the case for publicly traded corporations, where stakeholders only choose each other in the IPO and there is no subsequent renegotiation; the nexus-of-contracts presumption is therefore profoundly incorrect.

Secondly, the argument that the outcome of such negotiations would inevitably result in shareholder primacy is itself questionable and unsubstantiated by empirical evidence. In fact, the

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<sup>181</sup> Martin Petrin, “Reconceptualizing the Theory of the Firm—from Nature to Function,” *Penn State Law Review* 118, no. 1 (2013): 9-10.; Millon, “Radical Shareholder Primacy,” 1034; Cioffi, *Public Law and Private Power*, 41; Jackson, “Stakeholder-Shareholder Theory,” 335-338.

<sup>182</sup> Ian B. Lee, “Efficiency and Ethics in the Debate About Shareholder Primacy,” *Delaware Journal of Corporate Law* 31, no. 2 (2006): 533, 538.

<sup>183</sup> *Ibid.*

evidence is pointing to the opposite: increasing numbers of corporations, from Google to LinkedIn, are structuring their IPOs such that shareholders actually have little to no real power over the corporation.<sup>184</sup>

Thirdly, although shareholders during the time of Berle and Means did not have any protection besides those afforded by corporate governance, securities regulations have evolved so much over the last three decades that securities laws now protect shareholder interests just as much as—and perhaps even more than—employment law protects employee interests.

## 2. DIRECTORIST THEORY IS ALREADY ENSHRINED IN THE LAW

Viewing the corporation as the principal to whom managers owe their fiduciary duty is theoretically sound, because the corporation owns itself, and as a distinct legal entity is liable for the torts of, and is bound by the actions of, its agents.<sup>185</sup> However, in an internal legal dispute between shareholders and managers (especially directors) over what is in the interests of the corporation, the corporation cannot speak its mind: someone, or a group of people, needs to be responsible for articulating what is in the interest of the corporation, and why.<sup>186</sup>

The board of directors has traditionally held this duty. Per *In re Caremark*,<sup>187</sup> directors are already personally liable for fraud if they steal from the corporation, or for negligence if they fail to implement the right procedures to check on the actions of the company's agents.<sup>188</sup> For this reason, directors have more of a claim to be the principals of the corporation than shareholders do, since shareholders are not liable for the acts of the corporation's agents. The

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<sup>184</sup> Steven D. Solomon, "A Deeper Look at LinkedIn's Structure," *New York Times*, May 12, 2011, accessed March 30, 2017, <http://dealbook.nytimes.com/2011/05/12/a-deeper-look-at-linkedins-structure/>. This outlines LinkedIn's staggered board, dual voting structure, and other provisions designed to reduce shareholder activism; Will Hutton, "Power Shift in America as Wall Street Bows to Silicon Valley," *The Guardian*, April 18, 2015, accessed March 30, 2017, <http://www.theguardian.com/commentisfree/2015/apr/19/wall-street-courting-silicon-valley-new-shift-in-power>. Hutton writes, "Almost all the great west coast hi-tech giants—from Google to Linked In—have ensured that, while Wall Street can buy their shares, it can't buy the accompanying controlling votes. Control stays with the founders, whose privileged shares often have 10 times the voting rights of the ordinary shares offered to Wall Street."

<sup>185</sup> Stout, *Shareholder Value Myth*, 37.

<sup>186</sup> Most corporate law scholars would agree that judges should not be the ones to decide, and that the *business judgment rule* is therefore useful and necessary.

<sup>187</sup> *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959, (1996).

<sup>188</sup> For example: "The directors of Enron and Worldcom, in particular, were held liable for the fraud that occurred: Enron directors had to pay \$168 million to investor plaintiffs, of which \$13 million was out of pocket (not covered by insurance); and Worldcom directors had to pay \$36 million, of which \$18 million was out of pocket." Renée Adams, Benjamin E. Hermalin, and Michael S. Weisbach, "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey," NBER Working Paper 14486, National Bureau of Economics Research, Cambridge, MA, 2008, 1, <http://www.nber.org/papers/w14486>.

board of directors is the heart and mind of the public corporation; the shareholders are the feet that got the corporation off the ground in the IPO; the employees are the hands that do the corporation's work.

3. *THE DIRECTORIST APPROACH EMBRACES A RESPONSIBILITY TO ALL STAKEHOLDERS*

The Directorist approach understands that the nature of the corporation, with its many stakeholders, is inherently complex, and governance therefore *requires* a balancing act.<sup>189</sup> The Directorist approach says that the directors, as the heart and mind of the corporation, decide what the culture and purpose of the corporation is, and how the corporation will set about to achieve it. The shareholders and employees may both give advice, but neither has a direct vote on the matter: the shareholders' only vote is on deciding who gets to vote, i.e. who sits on the board of directors. Employees in the United States currently do not have any say on who sits on the board.

C. WHAT STAKEHOLDER THEORY, AND THE DIRECTORIST MODEL, IS AND IS NOT

Stakeholder theory is based on the realization that managers, shareholders, and employees are all corporate insiders who each bear a significant level of residual risk regarding the performance of the corporation, and each compete for control over corporate decision-making and allocation of resources.<sup>190</sup> This tripartite structure excludes debt holders on the grounds that these players protect their risk and interests via collateralization and risk-adjusted interest rates.<sup>191</sup> It is the goal of the board of directors, as a "mediating hierarchy," to harness these resources towards the efficient production of the corporation's duties.<sup>192</sup>

As a form of stakeholder theory, the *directorist* model emphasizes the nature of the corporation as a distinct and separate entity that owes some sort of obligation to those who are affected by its actions.<sup>193</sup> The stakeholders in this corporate entity include not only the various forms of capital (debt and equity) and labor (management and employees), but also the

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<sup>189</sup> Stout, *Shareholder Value Myth*, 108. Stout writes, "[Shareholder primacy] ignores the obvious human capacity to balance, albeit imperfectly, competing interests and responsibilities. Every day, parents with more than one child must balance the interests of competing siblings (not to mention balancing their children's welfare against their own). Judges routinely balance justice against judicial efficiency. Teachers balance the interests of students who are quick against those who are slow, professors balance teaching demands against research and scholarship, shopkeepers balance the hope of making one more sale against the desire to get home in time for the family dinner."

<sup>190</sup> John W. Cioffi, *Public Law and Private Power*, 38.

<sup>191</sup> *Ibid.*, 38.

<sup>192</sup> Margaret M. Blair and Lynn A. Stout, "Specific Investment: Explaining Anomalies in Corporate Law," *Journal of Corporation Law* 31, no. 3 (Spring 2006): 719,738.

<sup>193</sup> Viet D. Dinh, "Codetermination and Corporate Governance in a Multinational Business Enterprise," *Journal of Corporation Law* 24, no. 4 (Summer 1999): 975, 985.

immediate community and general society.<sup>194</sup> Managerial opportunism is no more a problem in stakeholder theory than in shareholder theory, because stakeholder theory does not require managers to serve two masters—only one: the corporation.<sup>195</sup> Indeed, as we will see in Part V, the dual board structure of the directorist model will actually do more to reduce opportunism than shareholder primacy’s theoretical emphasis does.

The directorist model is similar to Bainbridge’s “director primacy” model in the sense that both recognize that shareholders should not have any direct or indirect decision-making control over the public corporation.<sup>196</sup> However, the directorist model profoundly deviates from director primacy on the question of what directors should push for: the former adopts a stakeholder approach to this question, and the latter maintains what Millon refers to as *radical shareholder primacy*.

Some may think that stakeholder theory requires that the interests of all stakeholders be equally weighed, as in the German model: but that is not the case; managers have a duty to prioritize.<sup>197</sup> Normative stakeholders, i.e. those to whom the corporation owes a moral duty, take precedence over derivative stakeholders.<sup>198</sup>

## V. FLESHING OUT THE DIRECTORIST MODEL: ENTREPRENEURS, STRUCTURE, AND AGENCY COST

### A. THE DIRECTORIST MODEL’S DUAL BOARD STRUCTURE AND STAKEHOLDER APPROACH

#### I. THE STRUCTURE AND PURPOSE OF THE DUAL BOARD OF DIRECTORS

The Directorist model of corporate governance is founded on the premise that the corporation is the principal, the company CEO and other executives are the corporation’s agents, and the board of directors is the heart and mind of the corporation. The board of directors decides what is in the interests of the corporation, and therefore indirectly becomes the principal of the corporation, controlling and checking the efforts of the company’s agents. In exchange for this power, directors take on personal liability as principals, should a plaintiff succeed at piercing the corporate veil, or at proving director negligence or fraud.

In deciding what is in the interests of the corporation, the board of directors should, as a whole, adopt a stakeholder approach, because it represents the interests of the corporation better

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<sup>194</sup> Ibid.

<sup>195</sup> Phillips, *Stakeholder Theory and Organizational Ethics*, 21.

<sup>196</sup> Stephen M. Bainbridge, “Director Primacy,” 563.

<sup>197</sup> Phillips, *Stakeholder Theory and Organizational Ethics*, 160.

<sup>198</sup> Ibid., 124-25. For example, a multinational company employing foreign labor has a moral duty to ensure the safety and human rights condition of its employees. Derivative stakeholders are those groups whose claims must be accounted for by managers due to their potential effects upon the normative shareholders.



than the shareholder approach, for all the reasons previously identified in Parts III and IV. To better structure this approach to management strategy, and taking a cue from German corporate governance, the board of directors shall be comprised of two distinctly different types of directors: (1) *outside directors*, representing the interests of and owing a fiduciary duty to (and only to) shareholders, and (2) *council members*, representing the interests of and owing a fiduciary duty to (and only to) the employees of the corporation.<sup>199</sup>

The council members may be seen as the heart of the corporation, focusing on the identity (i.e. culture) and long-term health of the corporation, and ensuring the corporation is a respected and purpose-driven member of society. Outside directors may be seen as the mind, dealing with the logistics and financial concerns of the short term, and ensuring the corporation is paying its bills and earning a living. Council members should probably have shorter tenures (e.g. facing reelection every two years) than outside directors, since the desires and wishes of employees are more complex and fluid than those of shareholders, and getting employees to vote is cheaper than getting shareholders to do so, but that's outside the scope of this paper.

#### *2. Eligibility and Duties of the Two Directorship Types*

The shareholders shall have exclusive voting rights in electing and replacing outside directors, and employees shall similarly have exclusive rights in doing so for council members. One may be (but need not be) a shareholder to be eligible to become an outside director, but may not concurrently be an employee of the company, nor be a director for any other public company. Everyone—employees, shareholders, or community members—is eligible to become a council member, as long as they are not a director for any other public company. Requiring both director types to commit to only one public corporation ensures their fuller participation, loyalty, and contribution. Because employees have more to lose than shareholders do from a poor or unsupervised management decision that results in hurting the company—employees lose their main source of livelihood while shareholders lose investments—the employees will likely elect council members who will take a more proactive role in overseeing and questioning management than shareholder-elected directors typically do.

Some have suggested that adopting the German model of labor participation on the board would not work in the United States, since the employment-at-will doctrine prevalent in American culture and law would allow executives to fire an employee for his actions as a director, which would effectively compromise the employee board member's independence.<sup>200</sup>

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<sup>199</sup> See Appendix A, Figure 3.

<sup>200</sup> Tien Glaub, "Lessons from Germany: Improving on the U.S. Model for Corporate Governance," *International Law and Management Review* 5, no. 2 (Spring 2009): 244-45.

However, because the council member in the directorist model need not be an employee of the company (and thus could retain his council membership even if fired as an employee), and would be paid a director salary that is probably higher than his salary as an employee, the council member would thus be free to advocate on behalf of his fellow employees without fear of losing his job as an employee. A council member who is also an employee would also not sacrifice his responsibilities as an employee, since doing so would cause him to lose the esteem of his coworkers, thereby ensuring his demise as a council member.

Council members may take into account the interests of non-employee stakeholders like the community, the environment, or even shareholders, but ultimately owe fiduciary duties only to employees. Similarly, outside directors may themselves individually decide whether they want to adopt a radical shareholder primacy view, i.e. focusing on maximizing share price, or a traditional shareholder primacy view—either one is fine and justifiable within the context of a directorist model. One of the outside directors shall be the financial expert currently required by Sarbanes-Oxley, but the audit committee shall also include at least one (non-CEO) council member, which will provide an additional check on management. Similarly, the compensation committee shall require at least one of each director type, which will provide better checks on the corporation. Together, the heart and mind shall guide the corporation's overall growth and vision for the future.

The CEO, being elected and evaluated by the whole board of directors (i.e. both outside directors and council members), plays two different roles: that of an officer *and* that of a director. While acting in her capacity as a board member, the CEO shall owe a fiduciary duty to (and only to) employees, and may thus be counted as a council member. This makes sense, since the CEO is perhaps the only one on the board of directors who interacts with employees on a day-to-day basis, and better understands the reality of what employees deal with. Requiring the CEO by law to represent the interests of the employees on the board would provide the CEO with a mandate to do so without fearing repercussions from the outside directors. In her capacity as CEO, however, her sole duty would be to the corporation and indirectly to the entire, stakeholder-based, board of directors. Therefore, although as a board member the CEO might have voted in the *minority* view, her role as an officer would be to nevertheless enact the decision of the *majority* of the board—indeed, her tenure as CEO may depend on it.

Interestingly, other senior management, upon retirement or discharge from the public corporation, may have nevertheless developed significant goodwill or experience to become prime candidates for either an outside directorship or council membership. For example, if the chief financial officer (or really any employee) is discharged or undermined by the CEO (or any other manager) for persistently advocating for a contrarian view that is actually in the long-term interests of the corporation, the larger stakeholder community may reward him by voting him in

either as an outside director or a council member. Effectively, this serves as a non-legal (but not illegal) whistleblowing protection that may inspire every employee to become a check on the corporation, and thus reduces the shareholder-corporate manager agency cost problem.

### *3. FLEXIBILITY AND SUSTAINABILITY OF THE DIRECTORIST MODEL*

The important question then naturally becomes: what should the right balance be between the number of outside directors versus the number of council members? Therein lies part of the beauty of the directorist model: the answer is simply whatever the founders decide to enshrine in the corporation's articles of incorporation. Some entrepreneurs may opt for a 5:1 ratio, others for a 1:1, giving a tie-breaking vote to the CEO, or any other possible combination, including an employee-focused, 1:5 board. The diversity of possibilities should also interest economists, because this may prove to create very interesting realms for study, comparing and contrasting the IPO generated from, or the long-term successes of, public corporations with differing ratios of outside directors to council members.

The only requirement, and really the only significant nominal change to current Delaware law, would be that there has to be at least one (non-CEO) council member on the board of directors (and at least one outside director, though most would probably already want a few). The formal implications would not be too different, since many public corporations already choose to include at least one director with some background in philanthropy or otherwise tasked with ensuring the corporation's goodwill. The structural change, however, would give more power to council members to advocate on behalf of their non-shareholding constituents, since such would be their clear and sole fiduciary duty.

This dual approach to corporate governance properly solves the problems of shareholder primacy while also addressing the valid concerns that shareholder value advocates have of stakeholder theory. By creating two distinct classes of directors, the directorist model's dual board structure settles Bainbridge's main problems with stakeholder theory by giving all directors a clear mandate as to whom their fiduciary duties belong. The dual board structure also ensures that activist shareholders never are able to fully control the board of directors, especially if the company's articles of incorporation create more positions for council members than for outside directors.

The structure would also liberate executives from the shackles of share-price tyranny, since, by virtue of no longer owing a duty to shareholders but instead to a stakeholder-based board of directors, executives will no longer view share price as their sole concern. This will potentially allow for more long-term thinking, creativity, and value creation: how much more would also become quantifiable through future economic studies of public corporations with

differing outside-director-to-council-member ratios. When the two different types of directors meet and exchange ideas in the boardroom, they will think more creatively and comprehensively, because they will by default be more diverse, representing two distinctly different stakeholders. The clashing of ideas and priorities will ultimately lead to what is best for the public corporation itself.

#### B. THE DIRECTORIST MODEL AND TEAM PRODUCTION THEORY

*Team Production theory* suggests that the board of directors are “mediating hierarchs” who must balance the competing needs and demands of shareholders, creditors, customers, suppliers, executives, employees, and even the community, in a way that protects the investments that each of these stakeholders has brought to the team, in order to keep the corporation alive, healthy, and growing.<sup>201</sup> In other words, directors are empowered to make sure every team member gets enough trade surplus from their contribution to ensure that they remain motivated and stay with the team, i.e. the corporation.<sup>202</sup> A stakeholder approach captures benefits that accrue only under conditions of near unanimity of cooperation.<sup>203</sup>

The *directorist* model fits squarely within team production theory, and explains why directors should not prioritize the interests of shareholders above those of other stakeholders.<sup>204</sup> Some may question as to why shareholders would participate in an IPO knowing they will not get to vote on all of the corporation’s board of director positions (i.e. they will have no say on filling council member positions). The evidence suggests that they already are willing to accept less control.<sup>205</sup>

## VI. CONCLUSION: TOWARDS THE HUMANIZATION OF THE PUBLIC CORPORATION

### A. SUMMARY AND OVERVIEW

Capitalism has brought Western society, and the world, much good—our collective standard of living has perhaps never been higher. At the same time, however, there are very real reasons to feel apprehensive. Finance capitalism has turned the public corporation into a dangerous creature that sacrifices the wellbeing of tomorrow for the whims of today. The August

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<sup>201</sup> Margaret M. Blair and Lynn A. Stout, “Specific Investment,” 738.

<sup>202</sup> *Ibid.*

<sup>203</sup> Phillips, *Stakeholder Theory and Organizational Ethics*, 89.

<sup>204</sup> Margaret M. Blair and Lynn A. Stout, “Specific Investment,” 738.

<sup>205</sup> Steven D. Solomon, “A Deeper Look.” LinkedIn shareholders were not deterred by the IPO’s staggered board, dual voting structure, and other provisions designed to reduce shareholder activism; Will Hutton, “Power Shift in America.” Many of the Silicon Valley giants are attracting shareholders regardless of the much more limited power given to shareholders.

2013 creation of the Delaware public benefit corporation (P.B.C.),<sup>206</sup> although well intentioned, is like offering a cool bicycle to someone who has just crashed his only car, on which he relied to commute back and forth to work every day: it's a nice gesture, but at some point, he will need to actually either repair the car or buy a new one.

We need not be stuck in the system we have built: we may enact changes by passing statutes, and look to other corporate governance schemes for inspiration. The German model, with its dual board structure, may not necessarily work in the United States, but provides a starting place for comparison. The German division between the supervisory board and the management board is for the most part unnecessary in the United States, since requiring some directors to be independent (“outside”) already reduces conflicts of interest. However, the German inclusion of labor representation on the board is insightful, especially for its ability to encourage the corporation to adopt a long-term focus.

More long-term thinking and stability is what the American public corporation needs. By allowing employees to elect a certain number of directors, corporate governance would both ensure that employees feel they have a voice in the future of their corporation, while also reducing the corrosive, myopic effects of shareholder primacy. Indeed, the more important concern of corporate law today is no longer ensuring that managers do not become opportunistic, but should be finding ways to reduce the short-term thinking and opportunism of shareholders' actual and only agents: the fund managers.

Giving a seat to some directors who are not focused on shareholder primacy but instead on the health of the employees, community, and consumers of the corporation, will properly realign the public corporation with the long-term goals of shareholders. This will therefore reduce the shareholder-fund manager agency cost problem. By allowing the entrepreneurs and founders to decide how many outside directors and council members the corporation shall have, corporate governance will be able to produce a wealth of data that economists could use to better address the question of what the ideal constituents of a public corporation should be. At the same time, American corporate governance would retain its flexibility and not become overburdened by the German parity codetermination requirements.

#### B. SHAREHOLDER RETURNS ARE THE REWARDS, NOT THE GOAL, OF CAPITALISM

As public corporations become increasingly globalized, multinational enterprises, and therefore not always subject to government regulation, they themselves become almost like

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<sup>206</sup> Daniel Fisher, “Delaware 'Public Benefit Corporation' Lets Directors Serve Three Masters Instead of One,” *Forbes*, July 17, 2013, accessed March 30, 2017, <https://www.forbes.com/sites/danielfisher/2013/07/16/delaware-public-benefit-corporation-lets-directors-serve-three-masters-instead-of-one/#1324e1eea278>.

sovereign states.<sup>207</sup> Today, public corporations are understandably among the most powerful social entities on earth, expected not only to fuel free-market economics, but also to carry the burdens once thought to belong to government and religion: health care, child care, protection of privacy, providing a sense of purpose and meaning (i.e. to employees), and education.<sup>208</sup> Many corporations are now indeed more powerful than entire countries: the ten biggest corporations make more money than most countries in the world *combined*.<sup>209</sup> We should no longer kid ourselves by thinking of the corporation as belonging only to its shareholders, because doing so dangerously and irresponsibly produces disruptive effects that actually undermine the benefits of capitalism. Jack Welch, the retired Chairman and CEO of General Electric, who was once seen as one of the foremost advocates of shareholder primacy, now has concluded: "...shareholder value is the dumbest idea in the world... Shareholder value is a result, not a strategy... Your main constituencies are your employees, your customers and your products."<sup>210</sup>

The public corporation is a human institution, serves human needs, and is subject to human complexity. Let us humanize it by welcoming it once more as it was when originally created: a social, public institution, accountable to all its stakeholders.<sup>211</sup>

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<sup>207</sup> Jackson, "Towards a Stakeholder-Shareholder Theory," 331.

<sup>208</sup> Phillips, *Stakeholder Theory*, 1.

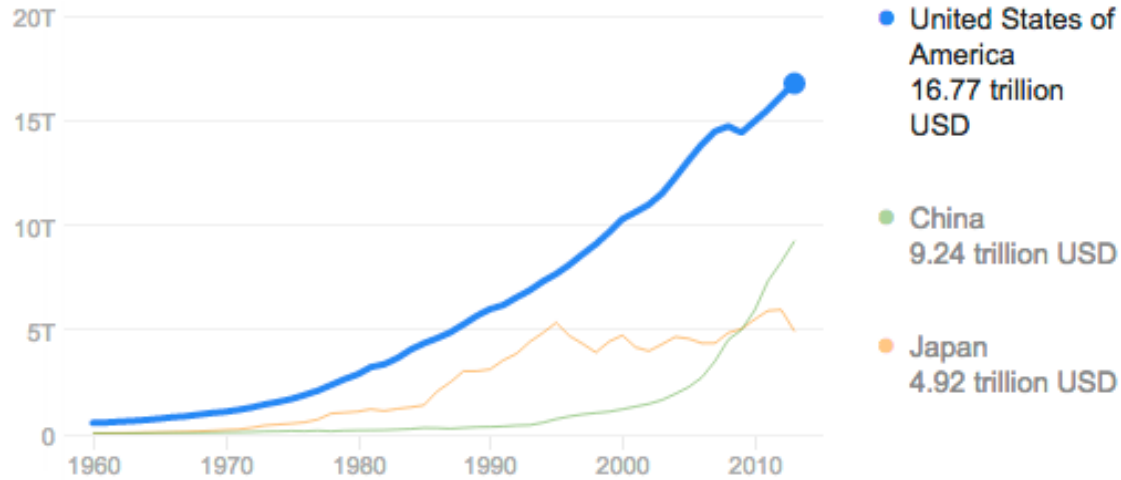
<sup>209</sup> Phillip Inman, "Study: Big Corporations Dominate List of World's Top Economic Entities," *The Guardian*, September 12, 2016, accessed March 30, 2017, <https://www.theguardian.com/business/2016/sep/12/global-justice-now-study-multinational-businesses-walmart-apple-shell>.

<sup>210</sup> Francesco Guerrera, "Welch Denounces Corporate Obsessions," *Financial Times*, March 13, 2009, accessed December 19, 2016, <http://www.ft.com/cms/s/0/3ca8ec2e-0f70-11de-ba10-0000779fd2ac.html#axzz3Wlza1DNm>.

<sup>211</sup> Jonathan Rowe, "Corporations & the Public Interest: A Look at How the Original Purpose Behind Corporate Charters Has Been Lost," *In Context*, no. 41 (Summer 1995): 26, accessed December 19, 2016, <http://www.context.org/iclib/ic41/rowe/>. This discusses how charters for corporations were originally granted in the Anglo-American tradition for the creation of public goods, such as towns and railroads.

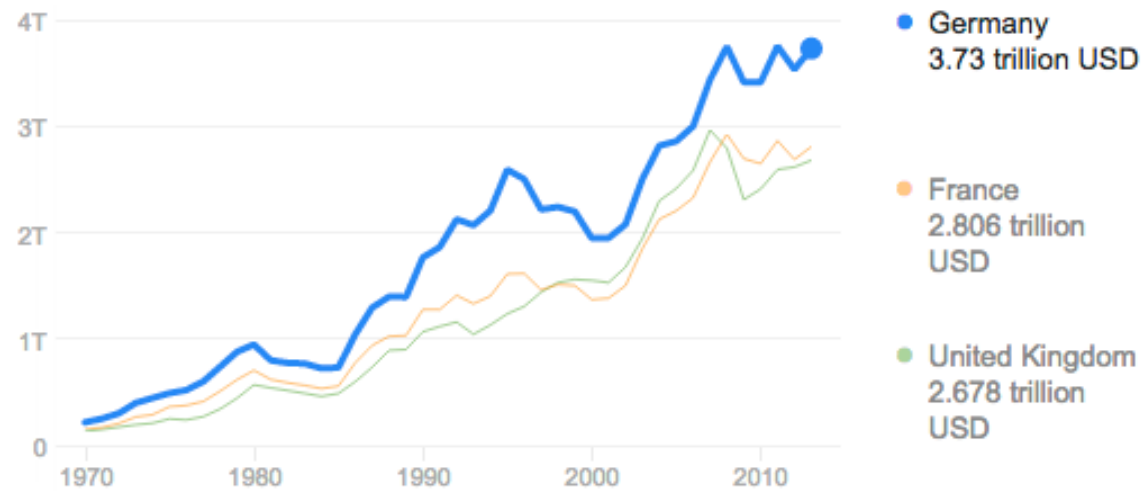
APPENDIX

**Figure 1: GDPs of USA, China, and Japan, 1960-2013**



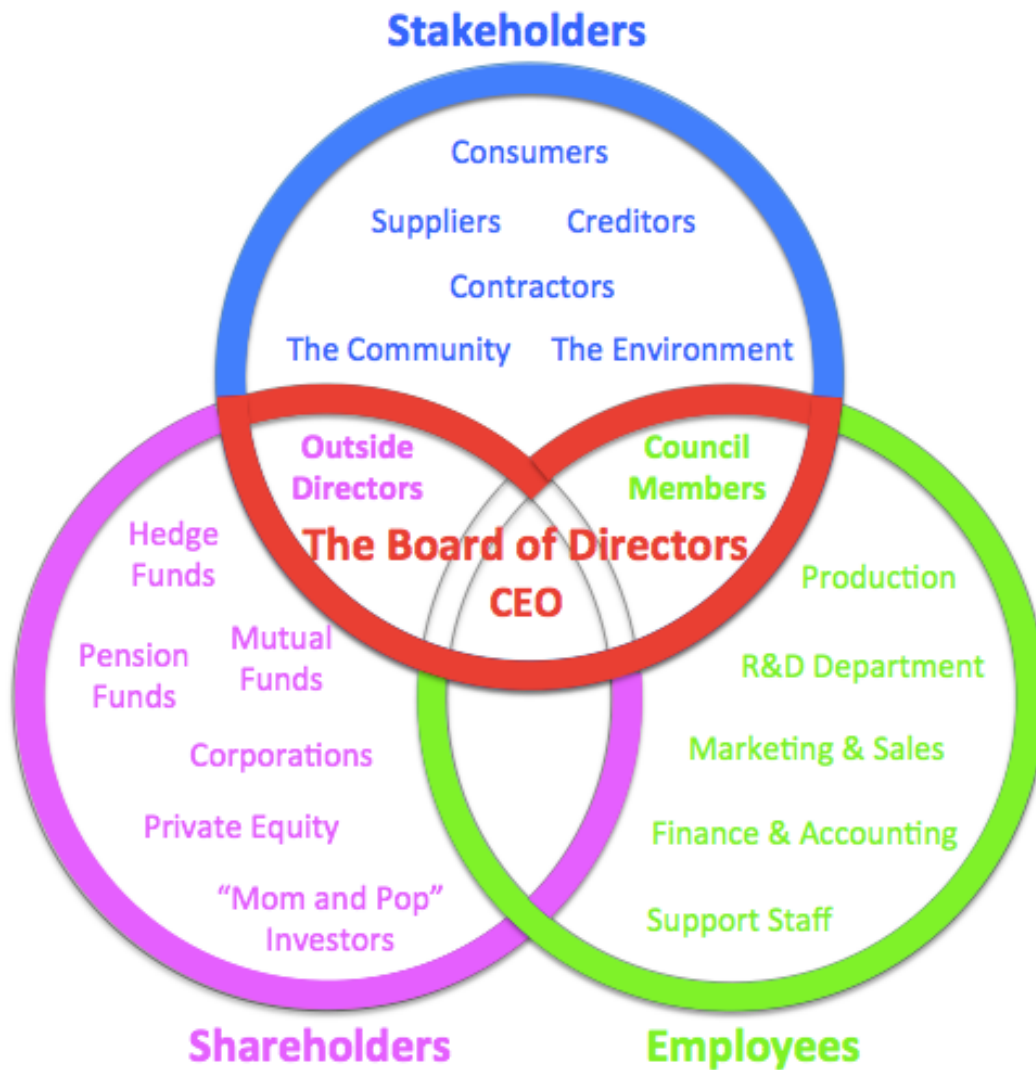
Source: World Bank, 2015

**Figure 2: GDPs of Germany, France, and the UK, 1970-2013**



Source: World Bank, 2015

**Figure 3. The Directorist Model of the Public Corporation**



Source: Deiwakh, 2015