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Grant M. Hayden, Matthew T. Bodie
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Introduction

In the United States, our large-scale economic enterprises are almost always conducted by corporations. Although a variety of legal options for organizations exist – such as the partnership, the limited liability company (LLC), and the sole proprietorship – the corporation dominates the economic landscape.[1] The corporation (or company) has been described as the "most important organization in the world" and "the basis of the prosperity of the West and the best hope for the future of the rest of the world."[2] When we think of businesses, we think of corporations.

And corporations are booming. Corporate profits have hovered between 9 and 11 percent of the U.S. gross domestic product, the highest sustained average percentage on record.[3] The Tax Cuts and Jobs Act of 2017 dramatically slashed corporate tax bills and funneled billions of additional dollars into corporate coffers.[4] By providing corporations with individualized constitutional and statutory rights of expression, the Supreme Court's decisions in *Citizens United*[5] and *Hobby Lobby*[6] have extended the corporation's powers even more deeply into politics, religion, and culture.

So, what exactly are corporations, and where do they come from? Under our federalized system, corporations are creatures of state law. To form a corporation, the incorporating individuals must file a corporate charter, also known as the articles or certificate of incorporation.[7] Once a corporation is established, control shifts from the entity's incorporators to its board of directors.[8] The board controls the firm and has the ability to legally bind the corporation to its decisions.[9] Shareholders elect the directors at the annual general meeting by in-person voting or the use of proxies.[10] Directors must act in the corporation's interests and are bound by certain fiduciary duties, primarily good faith, care, and loyalty.[11] However, directors generally delegate the actual job of running the business to the officers, who act through a hierarchy of employees headed by the chief executive officer (CEO).[12]

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Even though state corporate law allows for a great deal of organizational flexibility, actual governance structures are remarkably uniform. Delaware corporate law, for example, does not even require a corporation to have a board,[13] and yet all corporations have one. And the basic structure – where shareholders elect the directors, who in turn select the officers to run the corporation – replicates itself in corporations from every state. While there are some variations in governance structures, both among actual corporations and in the guise of potential reforms, the corporate form has remained relatively stable over the last century. And the critical features of corporate governance – who gets to vote, about what, and under what circumstances – have also been settled: the corporate franchise belongs to shareholders and shareholders alone.

Over time, scholars have worked to develop an intellectual framework that supports this central role of shareholders in corporate governance. In the course of their doing so, the role of shareholders within the corporation has evolved from that of absentee landlords to the center of the entire enterprise. The resulting theory of shareholder primacy redesigned the purpose and function of the corporation to revolve around shareholder wealth maximization.[14] And the shareholder primacy norm, a familiar notion even to nonlawyers, now has wide acceptance in both theory and practice.

Along with the shareholder primacy norm, the "nexus of contracts" theory of the corporation is also popular among legal academics.[15] This theory rejects the notion that the corporation is a separate entity and describes it instead as a set of voluntary contractual relationships with the corporation at the center. Under this theory, the corporation does not really exist and is best thought of as a cluster of commercial agreements among a variety of parties. The nexus of contracts framework counsels for a "hands-off" or default-rule approach to corporate law, as the corporation itself is conceived of as a set of voluntarily chosen relationships between different parties.[16]

Although these pillars of modern corporate law theory are both associated with the law and economics movement, their relationship has always been, at best, an uneasy one.[17] Shareholder primacy focuses on the importance of shareholders to the corporation and often trades on the notion that shareholders "own" this entity, the corporation, outright. The nexus of contracts theory, on the other hand, abandons the concept of a separate corporate structure and places all its participants, including shareholders, on an equal contractual footing. At a minimum, the two theories pull in opposite directions.

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In their foundational work on the economics of corporate law, Frank Easterbrook and Daniel Fischel married these two theories into a simple, intertwined structure. Their 1991 book, *The Economic Structure of Corporate Law*,[18] reaffirmed the shareholder primacy norm by arguing that shareholders were the most economically vulnerable of the firm's participants. This vulnerability, coupled with their shared preference for wealth maximization, meant that shareholders should be accorded the basic governance rights of the corporation.[19] Through their sets of separate contracts, the other participants in the corporation, Easterbrook and Fischel contended, agreed to provide shareholders with residual rights to the corporation's profits and the voting rights that come with them.[20] The shareholder primacy norm gave the corporate form its overriding purpose, while the nexus of contracts theory demonstrated that the parties reached this arrangement through voluntary agreements.

Over the last thirty years, this core law and economics position has diverged into multiple approaches. Some theorists, most prominently Lucian Bebchuk, have sought to support shareholder primacy by providing shareholders with stronger legal powers within the corporation.[21] Such powers include the ability to control corporate political spending, the right to access the company's proxy ballot, and a prohibition on staggered boards.[22] Others have adopted approaches with more indirect and diffused shareholder power, such as Steven Bainbridge's director primacy theory[23] and Margaret Blair and Lynn Stout's team production theory.[24] While these board primacy scholars disagree with each other on the appropriate goals of the corporation, they all believe that a governance system that's less responsive to shareholders will allow the board to make better decisions.[25]

Despite the many differences between these competing approaches, all of these theorists, like Easterbrook and Fischel before them, are committed to corporate governance structures where shareholders alone elect board members and vote on other matters of importance. And this governance feature has long been part and parcel of the broader theory of shareholder primacy, which found its strongest justifications in in the work of the law and economics movement. Indeed, despite playing out in many other areas of legal scholarship, that movement has continued to maintain a hammerlock on corporate governance theory. And its original justifications for the exclusive shareholder franchise, many of which are now more than four decades old, continue to be cited, recited, and relied upon by scholars of corporate governance in countless books, articles, and opinion pieces.

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Cracks in the Foundation

It is time to reevaluate the foundational principles of the exclusive shareholder franchise. For too long, the field has rested on faulty assumptions about the preferences of flesh and blood shareholders, has misapplied basic economic and social choice theory, and has failed to question the larger purposes served by the corporate form. Take, for example, the description of a corporation as a nexus of contracts.[26] Although it often hard to tell whether the corporation as contract is intended to be a literal or metaphorical description, there is no doubt that it has done heavy rhetorical work in the service of the law and economics vision of the corporation.[27] If all corporate constituents contractually agree that shareholders alone should have voting rights, then who's to say they've got it wrong? Over time, though, even the most die-hard contractarians have conceded that this description of the corporation is not literally true – there are some key features of modern corporations that cannot be reduced to contract.[28] Indeed, if contracts were sufficient, then there would be no need for corporate law in the first place.

But as corporate governance theorists shifted to using the nexus of contracts more metaphorically, their reliance on contract theory became self-defeating. Easterbrook and Fischel argued that corporate law provides the "ideal" contract that most participants would themselves develop, saving the parties from the transaction costs of developing it on their own.[29] This argument proves too much, though, as the theory then empowers itself with the task of assigning preferences – something that economists are generally loath to do. In fact, the law and economics theory of the corporation turns out to be based on idealized, fictionalized versions of shareholders and other corporate constituents – ones who, coincidentally, happen to agree with normative law and economics principles.[30]

But it's not just the nexus of contracts argument that has collapsed under scrutiny. The principle that all shareholders have a similar interest in the corporate residual – the "leftover" operating profit after all other costs have been paid – has long been central to the idea of shareholder voting.[31] Under the model employed by Easterbrook and Fischel, maximization of the residual maximizes the return to shareholders while leaving all other constituents (such as employees and suppliers) contractually satisfied. Therefore, shareholder control over a corporation will, of necessity, improve social welfare by increasing its residual profits.[32] Shareholders arguably have a single-minded focus on a corporation's

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profits because they are only paid through the residual.[33] This connection between the residual and control, as calibrated by the "one share, one vote" rule, appears to set up the proper incentives for shareholders to focus on maximizing the residual – thereby maximizing overall utility.[34]

Over the last couple of decades, however, this assumption that shareholders have homogeneous interests in wealth maximization has fallen apart.[35] Many shareholders – including majority shareholders, shareholders with disproportionate voting rights, members of voting trusts, bribed shareholders, hedged shareholders, sovereign wealth funds, and employee and management shareholders – have interests in the firm that go beyond a simple desire to maximize the residual.[36] In each case, shareholders have interests that may temper or override their shared interest in the residual. And shareholder heterogeneity is not simply a matter of shareholders with discrete competing interests. Shareholders who are otherwise similarly situated may have different definitions of wealth maximization, with different time horizons or risk preferences.[37] And shareholder wealth maximization is not the same thing as shareholder utility maximization. Oliver Hart and Luigi Zingales have suggested that shareholders do in fact value things other than profit maximization, and that corporate governance should be structured to allow them to express their preferences on trade-offs in corporate decision-making.[38] Shareholder interests, however you define them, are quite heterogeneous, which leaves this second argument in favor of the exclusive shareholder franchise on shaky ground.

Shareholder heterogeneity also undercuts another fairly prominent argument for the exclusive shareholder franchise: the argument from Arrow's theorem. Easterbrook and Fischel first raised concerns, based on Kenneth Arrow's impossibility theorem, that corporate constituents with heterogeneous preferences would be more likely to produce intransitive election results, or voting cycles.[39] This, in turn, would lead firms to "self-destruct."[40] This argument has since been repeated by a wide range of law and economics corporate governance scholars.[41] But this argument, like that from the residual, would appear to be diminished by the fact that shareholders have quite heterogeneous preferences with respect to corporate decision-making. The argument actually has much deeper flaws, and falls apart long before we get to the nature of shareholder preferences. It is based on a misguided application of Arrow's theorem from start to finish.[42]

Finally, it is simply untrue that no other participants in the corporation have an interest in the ongoing profitability of the firm. Employee pay

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and benefits are not static obligations for the corporation to absorb. Wages rise and fall with the fortunes of the business; benefits become more generous as the corporation's revenues increase; bonuses and stock options reflect the overall success of the company. And workers contribute to the overall value of the company in a way that they cannot monetize, without any ownership interests themselves. The corporation controls the ongoing business, owns the company property including the trademark and brand name, and makes the contracts that carry on the business. Employees have no direct representational voice in the organization. So they, too, are vulnerable to opportunism. Because shareholders have operating control over the board, it is not surprising that corporate profits and stock buybacks have skyrocketed, while employee wages have remained stagnant in real terms for decades.[43]

Alternative Approaches

Competing corporate law theories in the law and economics tradition have offered more descriptively realistic stories about corporate law doctrine, but they have failed to cure the ills that beset the basic shareholder primacy model. Stephen Bainbridge's director primacy theory well describes the ambivalence of Delaware corporate law toward the relationship between shareholders and the board of directors.[44] But his theory fails to explain why directors should be given relatively unchecked authority over the operation of the firm. Bainbridge uses Kenneth Arrow's *The Limits of Organization* and its trade-off between authority and accountability to find a "rebuttable presumption in favor of preservation of managerial discretion."[45] However, as Brett McDonnell has explained, this presumption – which Bainbridge rarely finds rebutted – does not find support in Arrow's work.[46] Vesting power in the board of directors may reflect the reality of Delaware corporate law, but it does not explain why society – or even shareholders – are best served by such largely unreviewable power.

Similarly, Margaret Blair and Lynn Stout's team production model accurately takes into account the many participants in the life of the corporation.[47] However, their model also leaves it to the shareholder-elected board to somehow manage these relationships appropriately. Whether they be "Platonic guardians" (Bainbridge)[48] or "mediating hierarchs" (Blair and Stout),[49] there are no governance structures in place to ensure that actual directors live up to the faith that these accounts place in their ability to manage the firm. In both cases, the ultimate check

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on the board is left in the hands of the shareholders alone. And both simply rely on earlier law and economics arguments to justify the retention of the exclusive shareholder franchise. Board primacy provides no independent arguments for the exclusive shareholder franchise.

In contrast to shareholder primacy, stakeholder theory argues that corporate governance should take all stakeholders in the corporate enterprise into account, rather than focusing on shareholder wealth maximization.[50] Also called the communitarian or multifiduciary model,[51] and sometimes coupled with commitments to corporate social responsibility (or CSR),[52] stakeholder theory argues that corporate governance needs to reflect the interests of all the participants within the life of the corporation. Most academic treatments cast a wide net in defining stakeholders and so include shareholders, management, employees, creditors, suppliers, customers, and even the surrounding community. In terms of concrete governance reforms, supporters of stakeholder theory have advocated for weakening shareholder power within the organizational structure and increasing managerial discretion to take other interests into account. As such, they have generally sided with those voices who support greater managerial discretion and restrictions on shareholder rights.[53]

As an oppositional paradigm, stakeholder theory has served to act as a rhetorical brake on some of the excesses of shareholder primacy.[54] But it is not, at least at present, a real theory of firm governance, as it lacks a model for allocating governance rights and responsibilities among the participants.[55] A stakeholder approach might lend itself to a board elected by a variety of stakeholders, but stakeholder theorists have largely acquiesced to the exclusive shareholder franchise. It makes little sense to attack shareholder primacy but then maintain exclusive shareholder control over all the key features of corporate governance.

A Return to the Basics

With a shadow cast over the basic arguments for the exclusive shareholder franchise, we believe it is time to revisit and critically evaluate the justifications for this central feature of modern corporate governance. That task, however, does not mean abandoning the precepts of standard economic and social choice theory. Indeed, as we make our way through this landscape, we will examine the fissures in corporate governance scholarship using the tools of law and economics itself. That is, this book examines, argument by argument, the fundamental components

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of conventional corporate law wisdom largely on their own terms. And we start with the one of the most basic units of standard economics: preferences.

The institutions that comprise modern market-based societies – from large governments to small businesses – employ decision-making structures designed to take account of the preferences of their constituents. They sometimes rely upon compacts or contracts, which are thought to ensure that the preferences of all involved are satisfied.[56] Once institutions reach a certain size and complexity, though, contracts alone cannot do the job: they must resort to some type of voting mechanism to aggregate preferences. This is true of almost all institutions, both political and corporate, that claim to serve some sort of constituency. It is certainly true of the modern corporation.

For this reason, public choice theory, with its emphasis on the interests of different groups and its analysis of the effects of different structures on outcomes, would seem to present a natural methodology for studying corporate governance.[57] More generally, political theory concerns the allocation and transfer of power in decision-making and the roles of different institutions in the governance of a polity. The purpose of a system of governance is to manage different interests despite the opportunities for conflict.[58]

Examining how voting works in political institutions may also help illuminate some of the arguments around corporate governance. After all, the disagreements over corporate governance law aren't usually about whether corporations should be structured to maximize the preference satisfaction for their constituents, broadly defined, but how best to do so. The same types of questions animate discussions of both political and corporate voting. One central set of questions, of course, is which constituents count and how we identify them and best capture their preferences. But there are other, related questions as well. Should the voting system be direct, representative, or some mixture of the two? If representative, what is the basis for representation, and how responsive should the system be? Questions like these have been the subject of a lot of thought and experience in the political realm; that work can help us think about the structure of governance within the corporation.

Our analysis of the exclusive shareholder franchise also involves the application of a fair amount of economics and its cousin, social choice theory. Standard economic theory, as deployed by scholars in the law and economics tradition, has been driving corporate governance scholarship for decades. But it also makes sense from a broader point of view – that is,

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economic theory *should* give us some insights into corporate governance. Economics endeavors to draw out the implications of the view that people act to best get what they want, given what they believe about their circumstances. This basic insight is used to build models that are intended to explain and predict human behavior, and those models, in turn, may be used to structure incentives in order to achieve certain ends.[59] So it should not be surprising that economics is a useful tool when designing the governance features of corporations, which coordinate a wide range of constituencies in the production of goods or services. Indeed, since economic theory has been particularly successful in explaining and predicting behavior in market settings, its application to corporate governance should be especially fruitful.

A subdiscipline of economics focuses particularly on issues of organization and governance – the theory of the firm. The literature on the theory of the firm asks: Why do we have firms, rather than markets?[60] The theory offers a sustained interdisciplinary inquiry into the nature of firms and their legal representations.[61] While much of the current work in other social sciences, such as psychology and sociology, dovetails with economic theory and provides additional insights into the basic economic models, the theory of the firm offers a starting point for these inquiries and a basis upon which to build an alternative academic narrative.

Social choice theory seeks to describe, in some rigorous way, exactly how we move from individual preferences to group choices. More specifically, the theory focuses on the properties and limitations of the social choice functions (usually, some type of voting procedure) employed to make those moves. And one of the main arguments for the exclusive shareholder franchise finds its ground in one of the signature limitations on social choice functions – Arrow's impossibility theorem. For this reason alone, we will delve into social choice theory. That said, given our focus on corporate voting – and, more generally, preference aggregation – social choice theory helps inform the arguments in much of the rest of the book as well.

So while the core of this book involves a critical examination of the main arguments for the exclusive shareholder franchise, we do not question the basic principles of standard economics and social choice theory thought to underlie those arguments. That is, our critiques are not based on questioning economic approaches to corporate governance (or law more generally). There may, in fact, be some good reasons to question some of the fundamental assumptions and aspects of standard

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economic theory. The theory has been accused of wrongheadedness in using preference fulfillment as the main measure (or very definition) of improved social welfare or, more narrowly, the success of a system of governance.[62] Moreover, some of the assumptions of standard economics have been modified in light of the recent insights and empirical findings of behavioral economics.[63] In this book, we remain agnostic on these kinds of challenges to standard economic theory. We take the principles of standard economics as given. And we take them seriously, perhaps more seriously than some of their most vocal proponents among corporate governance scholars. Thus, in our critiques of the main law and economics arguments, we do not challenge the basic assumptions of standard economics, but instead focus upon their misapplication in corporate governance scholarship.

In a sense, then, this book is a return to the basics. We don't feel the need to go beyond the most fundamental aspects of standard economics and social choice theory to make our arguments – that is something we share with most of the law and economics scholars who write about corporate governance; the democratic, economic, and social choice theory is pretty standard fare. But we will be spending quite a bit of time examining the *application* of those theories to shareholder voting in corporate governance, because corporate law scholars often start with basic economic principles only to discard them when they run into (what they perceive as) problems. We will evaluate their arguments by their own standards; in other words, our critique of current corporate governance theory comes largely from the inside, not the outside, with basic voting rights and preference aggregation theory thrown in for good measure. We hope, in the end, to produce a picture of the corporation that is consistent with these underlying theories and helps inform the evolving theory of the firm.

Plan of the Book

This book makes its case in roughly three sections. In the first section, we look at the purpose and structure of voting in political institutions and corporations. Voting, at its heart, is an effort to aggregate the thoughts and opinions – the preferences – of a group of people around particular candidates or issues. Focusing on preference aggregation as the key aspect of voting, we explain how governments have structured their voting systems to capture (or deflect) the preferences of their constituents, and then apply this understanding to corporations. While the

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