WHO WILL WATCH THE WATCHERS?: ENACTING A CORPORATE OBSERVING BOARD TO INCREASE CONSIDERATION OF STAKEHOLDER INTERESTS

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Modern U.S. corporate law has compelled corporate directors to make decisions that maximize share value regardless of the effect they have on the firm's other stakeholders, like employees, creditors, and suppliers. While shareholder primacy is the norm in the United States, there are competing theories, mainly the stakeholder model, that have cognizable influence not only in the United States but also in foreign states.

Both theories have their drawbacks, but the "short-termism" associated with shareholder primacy can damage a firm's health. Directors make decisions that benefit the firm in the short term but often wipe out long-term value.

This Note proposes a novel solution to this problem that looks to minimally disrupt current practices while also exacting considerable changes to the decision-making process for directors: promulgating a federal rule through the Securities and Exchange Commission to create an "observing board," which will represent specific stakeholder groups.

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INTRODUCTION

In 2018, Verizon was rallying on the back of a healthy economy. Its stock price had risen from $46.29 in March,[1] to $54.94 by October 1,[2] amounting to an 18.7 percent increase in a little over six months. Verizon's directors also announced that they would be increasing the quarterly dividend by 2.1 percent, to 60.25 cents per share.[3] In light of this financial success, it must have been surprising for 44,000 Verizon employees when they heard they had been laid off.[4] After the layoffs, while many workers scrambled to find employment before the holiday season, shareholders of Verizon saw the company's stock price rise to $60.30.[5]

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1. *See Verizon Communications Inc. (VZ): NYSE–Nasdaq Real Time Price*, YAHOO! FIN., https://finance.yahoo.com/quote/VZ [https://perma.cc/2GEP-YMGC] (last visited Oct. 3 2, 2020) (click the chart tab, then look at a five-year chart)

2. *See id.*

3. *See* Lawrence C. Strauss, *Verizon Announces Another Dividend Hike*, BARRON'S (Sept. 6, 2018, 4:52 PM), https://www.barrons.com/articles/verizon-announces-another-dividend-hike-1536267141?mod=article_inline [https://perma.cc/DB58-D8U3].

4. *See* Jeb Su, *Verizon Lays Off 44,000, Transfers 2,500 More IT Jobs to Indian Outsourcer Infosys*, FORBES (Oct. 5, 2018), https://www.forbes.com/sites/jeanbaptiste/2018/10/05/verizon-lays-off-44000-transfers-2500-more-it-jobs-to-indian-outsourcer-infosys/#cb1da5e46f59 [https://perma.cc/U4YE-K5U4]. While Verizon is a big corporation, the combined layoffs and transfers still affected over 30 percent of its workforce. *Id.*

5. *See Verizon Communications Inc. (VZ): NYSE–Nasdaq Real Time Price*, *supra* note 1.

Sequences such as the above are not unique in the current U.S. corporate climate.[6] As a result, the support for corporate governance reform has grown in recent years. Politicians like Elizabeth Warren[7] and Bernie Sanders,[8] chief executives like Jeff Bezos and Jamie Dimon,[9] and prominent investment corporations like BlackRock[10] and Vanguard[11] have reignited debate regarding whether a corporation should address its nonshareholder constituencies. The traditional norm in U.S. corporate law has been that the board of directors owes a duty of loyalty to the shareholders.[12] This duty is often framed as maximizing shareholder wealth.[13]

Critics of "shareholder primacy," however, have posited a different argument that insists the board of directors should consider the interests of all stakeholders of the firm: employees, creditors, suppliers, and the nearby community, among others.[14] These advocates contend that many fundamental assumptions of shareholder primacy are rooted in tenuous

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6. *See generally* Jill Cornfile & Annie Nova, *Unemployment Just Hit 14.7% yet the Market Is Way up. Please Explain!*, CNBC (May 8, 2020), https://www.cnbc.com/2020/05/08/unemployment-is-higher-than-ever-so-why-is-the-market-rallying.html [https://perma.cc/64SF-THKV].

7. Accountable Capitalism Act, S. 3348, 115th Cong. (2018) (sponsored by Senator Elizabeth Warren).

8. *See generally Corporate Accountability and Democracy Plan*, BERNIE, https://berniesanders.com/issues/corporate-accountability-and-democracy [https://perma.cc/9NCG-6NWK] (last visited Oct. 3, 2020).

9. *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'* BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/UMS8-BSZK] (committing to investing in employees, dealing fairly and ethically with suppliers, and supporting the surrounding communities as means of emphasizing all stakeholders). Jeff Bezos and Jamie Dimon, along with 179 other CEOs, are signatories. *See Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE (Aug. 2019), https://opportunity.businessroundtable.org/wp-content/uploads/2019/08/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf [https://perma.cc/35TB-X45G].

10. Larry Fink, *Larry Fink's 2018 Letter to CEOS: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/DH2B-PX3N] (last visited Oct. 3, 2020) (declaring the importance of investing in corporations that benefit all their stakeholders and encouraging companies to put more of an emphasis on their "critical stakeholders").

11. VANGUARD, INVESTMENT STEWARDSHIP: 2018 ANNUAL REPORT 2 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf [https://perma.cc/2LDX-4TUG].

12. *See generally* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), http://umich.edu/~thecore/doc/Friedman.pdf [https://perma.cc/6N2T-ZMUX].

13. *See* Henry Hansmaan & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 450, 468 (2001).

14. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); *see also* ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 135–52 (2003); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 61 (2010).

premises[15] and that corporate models involving all stakeholders offer additional benefits to firms.[16]

In theory, the recent proclamations of distinguished executives and institutional investors are a welcome sign for the adoption of a more stakeholder-centric governance model.[17] However, these statements are likely just lip service to placate the general public.[18] Ultimately, it is the firm's shareholders who to vote to appoint directors.[19] Likewise, only shareholders have a direct right to sue directors.[20] That being the case, there is no real incentive for directors to act at the behest of other stakeholders.[21] This is particularly concerning since this lack of incentive can lead to myopic decisions that harm the firm in the long run. This is known as "short-termism."

Part I of this Note will explore the shareholder primacy and stakeholder models. It will first look at how shareholder primacy became entrenched as the norm in U.S. corporate law. The Note will initially discuss some of the benefits and drawbacks of this model. Then, it will conduct a similar discussion for the stakeholder model by analyzing some circumstances where a firm takes all stakeholders into account and addresses the benefits and disadvantages of this approach.

Part II will observe the issues that arise when firms follow the shareholder primacy model. Here, the Note will focus on short-termism and its adverse effects on corporate health. This part will also examine the link between a stakeholder approach and "long-termism."

Finally, Part III will propose promulgating a new Securities and Exchange Commission (SEC) rule that requires companies of a certain size to create a three-person "observing board," consisting of employee, creditor, and minority shareholder representatives. This solution allows for the board of directors to focus its business strategies on benefitting all stakeholders, not just shareholders.

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15. *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192–94 (2002).

16. *See, e.g.*, Caroline Flammer & Aleksandra Kacperczyk, *The Impact of Stakeholder Orientation on Innovation: Evidence from a Natural Experiment*, 62 MGMT. SCI. 1982, 1984–86 (2016); Jordi Surroca, Josep A. Tribó & Sandra Waddock, *Corporate Responsibility and Financial Performance: The Role of Intangible Resources*, 31 STRATEGIC MGMT. J. 463, 466–72 (2010).

17. *See, e.g.*, Fink, *supra* note 10; *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,' supra* note 9.

18. *See, e.g.*, Jordan Weissmann, *America's Most Powerful CEOs Say They No Longer Only Care About Shareholder Value. Here's How They Can Prove It.*, SLATE (Aug. 21, 2019), https://slate.com/business/2019/08/ceos-shareholder-value-investors-business-roundtable.html [https://perma.cc/CFR9-Z8FY].

19. *See* DEL. CODE ANN. tit. 8, § 211(b) (2020); *see also* Seidman & Assocs. v. G.A. Fin., Inc., 837 A.2d 21, 26 (Del. Ch. 2003). *See generally* Leo E. Strine Jr., *Making It Easier for Directors to "Do the Right Thing"?*, 4 HARV. BUS. L. REV. 235 (2014).

20. *See* DEL. CODE ANN. tit. 8, § 327; Strine Jr., *supra* note 19, at 238.

21. *See generally* Strine Jr., *supra* note 19.

I. COMPETING MODELS: WHO DOES THE CORPORATION CARE ABOUT?

Debate has raged for almost a century over the purpose of a corporation.[22] One's stance in this debate, as well as one's notion as to which interested parties a corporation should prioritize, inevitably depends on which of the two primary schools of thought one adopts. Those who side with Professor Adolf Berle, an early advocate of shareholder primacy, insist that the corporation should only work to maximize the wealth of its shareholders.[23] Alternatively, those who side with Professor E. Merrick Dodd maintain that the corporation should concern itself with all the firm's major stakeholder groups.[24]

Part I.A provides a brief overview of the function of a corporation's board of directors, the board that makes and approves major decisions affecting stakeholders. Part I.B then details the shareholder primacy model. Part I.C details the stakeholder theory.

A. The Board of Directors

Generally, corporations elect a board of directors to manage their business and affairs.[25] The rules guiding board composition, powers, and duties are governed by state law, which means there can be variations depending on the firm's place of incorporation.[26] Due to its corporation-friendly laws, most companies incorporate in Delaware, making its corporate law highly significant in any business-related matter.[27] Thus, this Note will frequently refer to Delaware law for examples and analyses.

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22. *Compare* Adolf A. Berle Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931), *with* E. Merrick Dodd Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

23. *See, e.g.*, William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 147–49 (2008).

24. *See* A. A. Sommer Jr., *Whom Should the Corporation Serve?: The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 54 (1991).

25. *See* DEL. CODE ANN. tit. 8, § 141(a).

26. *See* Cort v. Ash, 422 U.S. 66, 84 (1975).

27. This Note will primarily focus on Delaware law as it is the most significant and impactful state in terms of corporate law. *See Annual Report Statistics*, DEL. DIV. OF CORPS., https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2018-Annual-Report.pdf [https://perma.cc/UZ6T-WUUS] (last visited Oct. 3, 2020) (noting that 67.2 percent of all Fortune 500 companies are incorporated in Delaware and, as of 2018, 1.4 million legal entities are incorporated in the state). Its judges are considered top-notch and many other states adopt similar approaches to Delaware's corporate law. *See* Alana Semuels, *The Tiny State Whose Laws Affect Workers Everywhere*, ATLANTIC (Oct. 3, 2016), https://www.theatlantic.com/business/archive/2016/10/corporate-governance/502487 [https://perma.cc/5UNU-JXEB] (quoting Vice Chancellor Sam Glasscock III as saying that "Delaware common law is really the national law of corporations for the most part"). Delaware has probably won the race to the top (or the race to the bottom, depending on what aspect of corporate law one discusses) when it comes to corporate law and incorporations. A discussion as to to the reasons why is outside the scope of this Note, but a considerable amount of literature has been published on the subject. *See, e.g.*, Daniel J. H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 382–84 (2005); Marcel

A board's composition and election process are salient drivers of corporate governance and must be addressed in turn. The number of directors on a company's board will vary depending on the corporation's certificate of incorporation and bylaws.[28] These directors are elected by the shareholders as provided in the company's certificate of incorporation.[29] While arrangements may differ, each shareholder is typically entitled to one vote for every share owned.[30] Term lengths of directors also vary depending on the certificate of incorporation and bylaws. A nonstaggered board of directors will sit for election annually.[31] However, if the board is staggered, directors often sit for three-year terms.[32] Staggered boards have begun to fall out of favor, however.[33]

The board of directors owes many duties to the shareholders of the corporation it represents.[34] Primarily, this stems from the reality that the property it manages is not its own but that of the shareholders. The board thus owes a fiduciary duty to the shareholders.[35] However, directors' duties depend on the current financial state of the company.[36] Generally, the duties include a duty to govern the business and affairs of the corporation,[37] "an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders,"[38] and a duty to fully disclose all material information.[39] It is important to note that no state, including Delaware, imposes a rigid duty to maximize shareholder value.[40] Even so,

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Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002) (arguing that states no longer compete and that Delaware has a monopoly).

28. *See* DEL. CODE ANN. tit. 8, § 141(b).

29. *See id.* § 212(a).

30. *See id.* Often, however, a corporation will have different classes of stock that allow for more than a single vote per share. *See Class of Shares*, INVESTOPEDIA, https://www.investopedia.com/terms/c/class.asp [https://perma.cc/9FY7-LWEA] (last visited Oct. 3, 2020).

31. *See* DEL. CODE ANN. tit. 8, § 211.

32. *See id.* § 141(d).

33. *See generally* Lucian Bebchuk et al., *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157 (2013).

34. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049 (Del. Ch. 1996).

35. *See In re* USACafes, L.P. Litig., 600 A.2d 43, 48 (Del. Ch. 1991).

36. More specifically, the duties of directors can differ when the company is solvent versus insolvent, as well as during takeover attempts. *Compare* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986), *with* Kidde Indus., Inc. v. Weaver Corp., 593 A.2d 563 (Del. Ch. 1991).

37. *See* DEL. CODE ANN. tit. 8, § 141(a); *see also* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989). This is one of the most fundamental duties a director has. *See generally* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

38. *Cede & Co.*, 634 A.2d at 360. This includes all shareholders, not just those who specifically elected the director if the corporate bylaws call for a split voting structure. *See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

39. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976); Stroud v. Grace, 606 A.2d 75, 84–85 (Del. 1992).

40. *See, e.g.*, *Paramount Commc'ns, Inc.*, 571 A.2d at 1150; *Revlon, Inc.*, 506 A.2d at 179–81.

most corporations pursue shareholder wealth maximization in harmony with the shareholder primacy model.

B. The Shareholder Primacy Model

The shareholder primacy model is the dominant theory of corporate governance in the United States.[41] Although not recognized as law, it is a clearly established norm that the board of directors must maximize the wealth of the firm's shareholders.[42]

Part I.B.1 discusses the history and current state of the model. Part I.B.2 then analyzes the benefits to an approach that utilizes shareholder primacy. This part will also introduce the drawbacks of this model, although a more comprehensive discussion will be saved for Part II of this Note.

1. The History and Case Law of Shareholder Primacy

The debate surrounding corporate purpose has its origins in a series of articles written by Professors Berle and Dodd in the 1930s.[43] Berle, in his article *Corporate Powers as Powers of Trust*, expounded his trust theory of corporations.[44] He posited that managers were trustees of the shareholders and, therefore, should only use their corporate powers for the benefit of the shareholder.[45] He further stated that there was a limitation to this corporate power, and when managers used their power to the "detriment" of the shareholder, the judiciary should step in.[46] In his 1970 essay for the *New York Times*, Milton Friedman introduced shareholder primacy to the wider public.[47] In the essay, he argued that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits."[48] Since that essay, shareholder primacy has become more entrenched in U.S. corporate law.[49]

Social and political changes in the 1980s further popularized the shareholder primacy model. The deregulatory environment that President Ronald Reagan fashioned helped catalyze shareholder wealth maximization.[50] Likewise, the corporate takeover atmosphere of the 1980s

41. *See* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 1953–54 (2018).

42. *See id.* at 1956–60.

43. *Compare* Berle Jr., *supra* note 22, *with* Dodd Jr., *supra* note 22.

44. *See* Berle Jr., *supra* note 22, at 1074.

45. *See id.* at 1049.

46. *See id.* For an in-depth look at the origins of Berle's positions, see, for example, Bratton & Wachter, *supra* note 23.

47. *See* Friedman, *supra* note 12, at 1.

48. *See id.* at 6.

49. *See* Hansmann & Kraakman, *supra* note 13, at 440–41; Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 650–52 (2004); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277–79 (1998).

50. David J. Berger, *In Search of Lost Time: What If Delaware Had Not Adopted Shareholder Primacy?*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 48, 49–50 (2019).

cultivated a corporate environment ripe for the implementation of the shareholder primacy norm.[51] It became so prevalent in corporate law that in the early twenty-first century, Professors Henry Hansmann and Reinier Kraakman declared there was no serious competitor to the shareholder model and that its "triumph . . . over its principal competitors is now assured."[52] However, the 2007–2008 financial crisis reinvigorated attacks on the shareholder primacy model from scholars and economists.[53] Even so, the model is still the established norm in corporate law.[54]

The case law that established shareholder primacy as the norm in Delaware law sprouted in the early twentieth-century, then took root in two seminal cases in the 1980s.[55] Yet, shareholder primacy's rise began not in Delaware but rather in Michigan, with *Dodge v. Ford Motor Co.*[56] There, the Michigan Supreme Court stated, "[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."[57] It was not until over sixty years later that Delaware, through a series of decisions, adopted a similar view.[58] First in *Unocal Corp. v. Mesa Petroleum Co.*,[59] the Delaware Supreme Court considered whether a board of directors facing a takeover bid could consider the interests of groups other than the shareholders.[60] The court reiterated the "basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders."[61] One year later, in the formative *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[62] the same court addressed whether the board of directors could consider constituencies other than shareholders.[63] The court concluded that a board can consider various constituencies so long as there are "rationally related benefits" for the shareholders.[64] The court made it clear that directors of a corporation need to strive to maximize the wealth of shareholders.[65] The board can consider

51. *See id.* at 50.

52. *See* Hansmann & Kraakman, *supra* note 13, at 468.

53. *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653 (2010).

54. *See* Rhee, *supra* note 41, at 1956–60.

55. *See infra* note 58.

56. 170 N.W. 668 (Mich. 1919).

57. *See id.* at 684. The court uses the term "stockholder," which is interchangeable with "shareholder," the term that this Note prefers.

58. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 26 (Del. Ch. 2010). *See generally* Leo E. Strine Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768–81 (2015).

59. 493 A.2d 946 (Del. 1985).

60. *See id.* at 949.

61. *Id.* at 955; *see also* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). Note that "stockholder" is synonymous with "shareholder."

62. 506 A.2d 173 (Del. 1986).

63. *Id.* at 176.

64. *Id.*

65. *See id.*; *see also* Strine Jr., *supra* note 58, at 769–73.

nonshareholder interests only if they can be justified as benefiting the shareholders as well.[66]

This general proposition was recently validated in *eBay Domestic Holdings v. Newmark*,[67] where the Delaware Court of Chancery started by restating the general principle that directors are fiduciaries of the corporation's shareholders.[68] It went on to state that, since the corporation was for-profit, "directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders."[69] Thus, the court concluded by rejecting a corporate policy that openly admitted to not seeking to maximize the economic value of the firm for its shareholders.[70] These cases demonstrate how embedded shareholder primacy has become in Delaware corporate law, which in turn governs the structure of a large portion of U.S. businesses.[71] Again, it is important to note that there is no statutory provision in Delaware mandating shareholder wealth maximization.[72]

2. Benefits of Utilizing a Shareholder Primacy Model

Several theoretical benefits derive from shareholder primacy, which helped champion the model. The reduction of agency costs is one of the chief advantages of the model.[73] Many argue that directors are agents and act on behalf of the principals, the shareholders.[74] Directors are entrusted with authority by the corporation and its shareholders, and they exercise this authority for a fee.[75] This typically indicates an agency relationship.[76] When the principal can better monitor the agent, there is a strong likelihood that agency costs are diminished.[77] It is straightforward to manage and monitor the agent when the sole measurement is stock price.[78] The agent cannot mask self-motivated decisions.[79] The duty to maximize shareholder wealth compels the agent to act in the best interest of the principal, thereby reducing agency and monitoring costs.

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66. *See id.* at 771.
67. 16 A.3d 1 (Del. Ch. 2010).
68. *See id.* at 26.
69. *See id.* at 34.
70. *See id.* at 35.
71. *See Annual Report Statistics*, *supra* note 27.
72. *See* Rhee, *supra* note 41, at 1956–60.
73. *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489 (2013); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
74. *See* Bainbridge, *supra* note 73, at 565. *See generally* Jensen & Meckling, *supra* note 73.
75. *See* Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 436 (1985).
76. *See id.*
77. *See* Bratton & Wachter, *supra* note 73, at 503.
78. *See* Stout, *supra* note 15, at 1200.
79. *See id.*

The incentive programs many corporations use reinforce the emphasis on reducing agency costs.[80] The salaries and bonuses paid out to managers are often tied directly to share price.[81] Aligning the interests of the shareholders (principals) and the directors (agents) plays into the theme of reducing agency costs.[82]

This potential reduction in costs can then lead to maximization of the company's overall value.[83] Some argue that increases in value can, in turn, lead to greater societal wealth.[84] As the residual claimants to the corporation's assets and earnings,[85] shareholders arguably have the strongest incentive to maximize the corporation's productivity and thus, overall value.[86]

There are also potential drawbacks to shareholder primacy. The most relevant for purposes of this Note is the pervasion of short-termism in corporate decision-making. When the shareholders' interests are paramount, directors may be incentivized to make decisions that increase share value in the short term while creating a long-term detriment to the company.[87] This Note will expand on this issue in Part II.[88] A secondary, yet also significant difficulty of the shareholder primacy model is that it threatens creditor welfare.[89] The worry stems from the fact that, since interests of shareholders and creditors can conflict, decision makers are incentivized to externalize risk onto the firm's creditors when shareholders are prioritized.[90] For example, when a firm pays out dividends or borrows more, shareholders' expected returns increase while the chances of repayment for creditors decreases.[91]

80. *See* STEEN THOMSEN, AN INTRODUCTION TO CORPORATE GOVERNANCE: MECHANISMS AND SYSTEMS 175 (2008).

81. *See id.*

82. *See id.* at 173–75.

83. *See* Bratton & Wachter, *supra* note 73, at 503.

84. *See id.*

85. A residual claimant is the person who has the remaining claim on a company's net cash flows. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983).

86. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972); Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 57 (1996).

87. *See* David J. Berger, *Reconsidering Stockholder Primacy in an Era of Corporate Purpose*, 74 BUS. L.J. 659, 667 (2019).

88. *See infra* Part II.

89. *See* Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2011 (2013).

90. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1928 (2013).

91. *See* Stout, *supra* note 89, at 2011.

C. The Stakeholder Model

The primary competing view to shareholder primacy is one that emphasizes all the stakeholders of a corporation, not just the shareholders.[92] While rarely utilized by American corporations, the theory still has significant support from scholars.[93] Further, many foreign countries have corporate governance laws that reflect these principles.[94] Recent U.S. corporate law innovations also demonstrate the theory's constant, yet shrouded, presence.[95]

Part I.C.1 will examine the history of this theory in the United States as well as the sparse case law that veers away from strict shareholder primacy. Part I.C.2 will discuss benefit corporations, a newer innovation from states that allows a board of directors to consider actors beyond the shareholder. Part I.C.3 will briefly explore pertinent foreign law that utilizes a stakeholder approach. Finally, Part I.C.4 will consider some of the benefits and drawbacks of the theory.

1. History and Case Law

In contrast to Professor Berle, Professor Dodd argued that corporations should have "a social service as well as a profit-making function."[96] Dodd believed that managers should act as the trustees for the general public and should use their corporations to address social issues.[97] Throughout the twentieth century, however, this view took a back seat to shareholder primacy.[98] It eventually began to creep back into the public eye in the 1980s with R. Edward Freeman's *Strategic Management: A Stakeholder Approach*.[99] The adoption of constituency statutes, which allow directors to consider other constituency groups, by some states in the late 1980s and early 1990s rekindled the debate between shareholder and stakeholder models of corporate governance.[100]

There is some case law suggesting that directors must consider nonshareholder over shareholder interests at times. *Unocal*, for example, indicated that a board of directors could take into account factors unrelated to maximizing shareholder wealth when making decisions in the hostile takeover realm.[101] This decision granted the board of directors great

92. *See generally* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (2010).

93. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

94. *See infra* notes 122–37

95. *See infra* notes 109–20.

96. Dodd Jr., *supra* note 22, at 1148.

97. *See* Bratton & Wachter, *supra* note 23, at 125.

98. *See supra* Part I.B.1.

99. *See generally* Licht, *supra* note 49, at 721–22 (discussing Freeman's "landmark" book).

100. *See id.* at 705.

101. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (stating that one factor a board can consider is "the impact on 'constituencies' other than shareholders (i.e.,

flexibility in defending against takeover attempts. *Paramount Communications, Inc. v. Time Inc.*[102] is another Delaware Supreme Court decision where the court noted that a board of directors "is not under any *per se* duty to maximize shareholder value."[103] Although later decisions have receded from this position,[104] these rulings stand as examples that confer power on directors to do things that do not directly increase shareholder wealth.

2. Benefit Corporations

Kickstarter is a global crowdfunding site whose mission is to "help bring creative projects to life."[105] Since its inception in 2009, over eighteen million people have pledged a collective $5.2 billion to Kickstarter projects.[106] Despite these impressive numbers, Kickstarter does not exist solely to generate revenue for its shareholders. Instead, even though it is a for-profit corporation, Kickstarter's primary purpose is bringing projects to life.[107] It has been permitted to seek these goals since its reincorporation as a benefit corporation in 2015.[108]

A benefit corporation is an entity created under state law[109] that allows for a corporation to pursue goals beyond maximizing shareholder wealth.[110] Benefit corporations serve as a reminder that, while shareholder primacy is the norm, states are willing to claw back at its rigidity and allow for another theory to emerge.[111] In its charter, the benefit corporation outlines its mission and ethical goals, and it is then required to adhere to those objectives.[112] While still a fledgling entity structure,[113] the benefit corporation has slowly become a more prevalent corporate form that emphasizes the collective stakeholders rather than just the shareholders.[114]

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creditors, customers, employees, and perhaps even the community generally)"); *see also* Strine Jr., *supra* note 58, at 768–69.

102. 571 A.2d 1140 (Del. 1989).

103. *See id.* at 1150.

104. *See, e.g.*, Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179–80 (Del. 1986); Quadrant Structured Prods. Co. v. Vertin, 115 A.3d 535, 545–48 (Del. Ch. 2015); eBay Domestic Holdings v. Newmark, 16 A.3d 1, 26 (Del. Ch. 2010).

105. *Hello*, KICKSTARTER, https://www.kickstarter.com/about?ref=global-footer [https://perma.cc/89LS-WLVT] (last visited Oct. 3, 2020).

106. *See id.*

107. *Charter: Kickstarter Is a Benefit Corporation*, KICKSTARTER, https://www.kickstarter.com/charter [https://perma.cc/7ZF7-JNQ5] (last visited Oct. 3, 2020).

108. *See id.*

109. As of this writing, thirty-seven states and the District of Columbia recognize benefit corporations. *See State by State Status of Legislation*, BENEFIT CORP., http://benefitcorp.net/policymakers/state-by-state-status [https://perma.cc/T3AK-DKBD] (last visited Oct. 3, 2020).

110. *See* David G. Yosifon, *Opting Out of Shareholder Primacy: Is the Public Benefit Corporation Trivial?*, 41 DEL. J. CORP. L. 461, 481–83 (2017).

111. *See generally* Berger, *supra* note 50.

112. *See* Yosifon, *supra* note 110, at 480–83.

113. *See* Michael B. Dorff, *Why Public Benefit Corporations?*, 42 DEL. J. CORP. L. 77, 82–86 (2017).

114. *See* DEL. CODE ANN. tit. 8, §§ 361–368 (2020).

Benefit corporations are generally created with the intention to produce a public benefit or benefits in a socially responsible manner.[115] This is made possible by requiring the board of directors to balance the shareholders' interests with the interests of those affected by the firm's conduct, while also taking the corporation's mission and goals into account.[116] As the form is still new, the number of benefit corporations is diminutive as compared to the number of incorporated legal entities.[117] However, between July 2013 and January 2016, the number of public benefit corporations increased nearly twelvefold.[118] This explosion demonstrates that corporations may be more receptive to a stakeholder-oriented approach to governance.

While benefit corporations have increased in popularity with state legislatures over the last five years,[119] they are constantly criticized by corporate law experts.[120] Even so, their prevalence in state corporate statutory schemes highlights that legislatures believe corporate purpose can fall outside the shareholder primacy model. The states that have enacted statutes permitting benefit corporations are a mélange of liberal-leaning and conservative-leaning states, indicating that partisan politics is not a factor in the adoption of these statutes.[121] This further highlights the steady presence of stakeholder ideals in the United States and their emergence in the twenty-first century.

3. German Law as a Comparative Case Study

A number of foreign countries have corporate governance laws that reflect more of a stakeholder approach.[122] Germany, in particular, places considerable emphasis on the employee constituency group.[123] There, corporations are required to have two boards: one managing board that functions similar to the U.S. board of directors (the Vorstand) and one

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115. *Id.* § 362.

116. *Id.* §§ 362, 365(a).

117. *See* Dorff, *supra* note 113, at 84 (stating that there were approximately 1.1 million legal entities registered in Delaware at the end of 2014 and fewer than 300 were public benefit corporations).

118. *See id.* at 84–85.

119. *See State by State Status of Legislation*, *supra* note 109 (showing that, as of this writing, four states have proposed benefit corporation laws pending legislative review).

120. *See, e.g.*, Sherwin D. Abrams, *Decisions, Decisions: Helping Clients Choose the Right Business Entity*, 101 ILL. BAR J. 530, 534 (2013) (asserting that benefit corporations are mere marketing devices); Robert A. Katz & Antony Page, *Sustainable Business*, 62 EMORY L.J. 851, 865 (2013) (arguing that benefit corporations, in reality, may be no different than regular corporations but rather that they attempt to benefit under the guise of being socially conscious); Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 305–306 (2012). Raz claims that most benefit corporation statutes provide little protections from the wants of the shareholders. *Id.* The argument continues that if shareholders want managers to maximize profits, there are no real protections to stop the corporation from doing so. *Id.*

121. *See State by State Status of Legislation*, *supra* note 109.

122. *See, e.g.*, Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMPAR. L. 301, 301 (2013).

123. *See* Katharine V. Jackson, *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L.J. 309, 309–11 (2011).

supervisory board (the Aufsichtsrat).[124] This supervisory council is entirely separate from the management board and has its own powers.[125] The Aufsichtsrat appoints people to the Vorstand for five-year terms while also reviewing firm and management performance over the course of the year.[126] The Vorstand, on the other hand, makes the day-to-day firm decisions but ultimately reports to the Aufsichtsrat.[127] The Aufsichtsrat also has the right to examine the books, records, and assets of the corporation.[128] Further, the Aufsichtsrat must approve the annual financial statements of the company.[129] These powers allow the Aufsichtsrat to choose the firm's decision makers. It also allows them to tightly monitor the Vorstand members.[130] In turn, this should reduce transaction costs due to less information asymmetry. It should also lead to a reduction in agency costs since the Vorstand is more closely monitored.[131]

The composition of the Aufsichtsrat is governed by both Germany's Stock Corporation Act[132] and its Codetermination Act of 1976.[133] The Stock Corporation Act requires the Aufsichtsrat to have at a minimum three members and a maximum that depends on the company's share capital.[134] For those companies that meet the requirements of the Codetermination Act, the Stock Corporation Act requires the Aufsichtsrat be composed of a certain number of employee representatives.[135] The Codetermination Act provides for half the board to be employee representatives.[136] Having employees on a board with authority serves a dual function by allowing employees to better

124. *See id.* at 359.

125. *See* Jun Zhao, *Comparative Study of U.S. and German Corporate Governance: Suggestions on the Relationship Between Independent Directors and the Supervisory Board of Listed Companies in China*, 18 MICH. ST. J. INT'L L. 495, 500 (2010).

126. *See* Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1941–42 (1993).

127. *See id.*

128. *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL I at 1089, last amended by Gesetz [G], July 17, 2017, BGBL I at 2446, § 111 (Ger.), http://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.pdf [https://perma.cc/FC2L-5NXL].

129. *See id.* § 172. This approval can be bypassed if the Aufsichtsrat and Vorstand agree that the statements are to be approved at the shareholder's meeting. *Id.*

130. *See* Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMPAR. L. 555, 559–61 (2000).

131. *See generally id.*

132. *See* Stock Corporation Act, §§ 95–96 (Ger.). The Aktiengesetz is the German Stock Corporation Act and regulates the stock corporation or the Aktiengesellschaft. The Aktiengesellschaft is the German counterpart to the U.S. corporation. *See* Butler, *supra* note 130, at 555, 561 (2000).

133. Mitbestimmungsgesetz [MitbestG] [Codetermination Act], May 4, 1976, BGBL I at 1153, last amended by Gesetz [G], Apr. 24, 2015, BGBL I at 642, art. 7 (Ger.). *See generally* Mark Roe, *German Codetermination and the German Securities Market*, 1998 COLUM. BUS. L. REV. 167.

134. *See* Stock Corporation Act, § 95 (Ger.).

135. *See id.* § 96(1).

136. These employee representatives are split into three groups: workers' representatives, union representatives, and managerial employees' representatives. *See* Hans-Joachim Mertens & Erich Schanze, *The German Codetermination Act of 1976*, 2 J. COMPAR. CORP. L. & SEC. REGUL. 75, 78 (1979).

monitor management while also forcing the managing board to be cognizant of the needs of the labor force.[137]

4. Benefits and Drawbacks of Stakeholder Theory

The number and substance of academic arguments supporting stakeholder models of corporate governance have increased considerably in recent years.[138] It is important to note that there is not one general stakeholder theory but rather a collection of variants that attempt to achieve the same goal—to consider nonshareholders in corporate decision-making—through different means.[139]

Whereas shareholder primacy focuses solely on efficiency, stakeholder models point to other values while still paying attention to efficiency.[140] For example, trust is a vital element of the theory.[141] Some scholars argue that when a corporation secures the trust of its primary stakeholders, the firm value increases.[142] When a corporation balances the interest of multiple constituencies, it appears moral and thoughtful.[143] This allows stakeholders to develop greater trust for the corporation and strengthens the firm's reputation.[144] When a firm rewards its stakeholders, it is more likely they will work amicably with the company.[145] Further, trust can reduce costs.[146] When there is trust, monitoring costs decrease as firm decision makers do not need to be watched as closely.[147] Likewise, it should make the board's monitoring of some stakeholder groups more efficient.[148]

Some theorists also argue that stakeholder theories afford a firm's many constituencies protection of their property rights.[149] The rationale is that

137. *See* Tom C. Hodge, *The Treatment of Employees as Stakeholders in the European Union: Current and Future Trends*, 38 SYRACUSE J. INT'L L. & COM. 91, 123 (2010); Zhao, *supra* note 125, at 500.

138. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248 (1999); Martin Lipton, *It's Time to Adopt the New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2019), https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm [https://perma.cc/L52W-ZJSR].

139. *See* R. Edward Freeman, *The Politics of Stakeholder Theory: Some Future Directions*, 4 BUS. ETHICS Q. 409, 413 (1994).

140. Andrew Keay, *Stakeholder Theory in Corporate Law: Has It Got What It Takes?*, 9 RICH. J. GLOB. L. & BUS. 249, 260 (2010).

141. *See id.*

142. *See id.*

143. *See id.*

144. *Id.*; *see also* JANICE DEAN, DIRECTING PUBLIC COMPANIES: COMPANY LAW AND THE STOCKHOLDER SOCIETY 94, 108 (2001).

145. *See, e.g.*, John Plender, *Giving People a Stake in the Future*, 31 LONG RANGE PLAN. 211, 215 (1998).

146. *See* Keay, *supra* note 140, at 268–69.

147. *See* R. William Ide III & Douglas H. Yarn, *Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust*, 56 VAND. L. REV. 1113, 1119 (2003).

148. *See id.* at 1120.

149. *See, e.g.*, R. Edward Freeman & Robert Phillips, *Stakeholder Theory: A Libertarian Defense*, 12 BUS. ETHICS Q. 331, 338 (2002).

these stakeholders have contributed to the capital of the corporation and thus have some entitlements.[150] Many stakeholders make specific investments in a corporation, much like shareholders do.[151] However, the argument against this is that contracts and regulations generally protect stakeholders. Creditors, specifically large banks, can enter into detailed contracts that provide protections.[152] Similarly, employees and consumers are protected by regulatory bodies.[153] Thus, arguably, there is no reason to give these stakeholders special treatment.[154] Stakeholder theorists retort by arguing there is constantly an inequality in bargaining power due to informational asymmetry.[155]

Critics take up a number of other issues with stakeholder theories. One of the primary and earliest criticisms of stakeholder theories is the difficulty in defining who the stakeholders of a corporation are.[156] Edward Freeman concluded that stakeholders were "any group or individual who can affect or is affected by . . . the organization's objectives."[157] This expansive view of the stakeholder includes governments, environmental groups, and even terrorists.[158] This broad approach highlights how difficult it can be for the board of directors to truly delineate which groups are stakeholders.[159] Some theorists have attempted to distinguish those who influence the firm, such as a terrorist group perhaps, and those who have legitimately invested in the firm.[160] Others have differentiated between primary and secondary stakeholders.[161] The ambiguity of which groups constitute stakeholders makes it more difficult to implement a stakeholder model.

Another criticism of the model is that even if one were to delineate between stakeholder groups, managers and directors would have difficulty balancing interests.[162] After directors have established who the stakeholders

150. *See* Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1171 (1993).

151. *See, e.g.*, Keay, *supra* note 140, at 266 (discussing how employees may undergo specialized training or how suppliers may acquire specialized machinery to benefit the corporation).

152. *See, e.g.*, Stout, *supra* note 89, at 2011; Van Der Weide, *supra* note 86, at 45–47.

153. *See, e.g.*, E. Merrick Dodd Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194, 202–03 (1935).

154. *See* Keay, *supra* note 140, at 292.

155. *See, e.g.*, *id.* at 293 (discussing that, when making contracts, corporate managers have more information to base negotiations off of than stakeholders).

156. *See, e.g.*, Ronald Mitchell et al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. MGMT. REV. 853, 862 (1997).

157. *See* FREEMAN, *supra* note 92, at 46.

158. *See id.* at 53; *see also* Keay, *supra* note 140, at 274.

159. *See* Keay, *supra* note 140, at 274.

160. *See* Thomas Donaldson & Lee Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65, 65, 86 (1995).

161. Primary stakeholders are those with a formal, official, or contractual relationship with the firm, whereas secondary stakeholders do not have these intimate connections. *See* Keay, *supra* note 140, at 274.

162. *See* R. Edward Freeman & John McVea, *A Stakeholder Approach to Strategic Management*, *in* THE BLACKWELL HANDBOOK OF STRATEGIC MANAGEMENT 189, 194 (M. Hitt et al. eds., 2001).

are, they then need to assess and balance the concerns of each group.[163] Even within specific constituencies, there may be divergent interests.[164] The heterogeneity of stakeholder groups makes it nearly impossible for directors to focus in on a single objective.[165] Further, this balancing problem provides a prime opportunity for directors to engage in opportunism.[166]

These issues speak to another criticism of the model: that it is unworkable.[167] When compared to the shareholder primacy model, the stakeholder model is difficult to implement and requires too much analysis of various groups.[168] The model seemingly is too imprecise and takes too much time to be truly viable.[169]

While it has its problems, the stakeholder approach has remained influential and continues to garner support because it addresses important concerns for corporations: ensuring that the firm's decision makers consider all stakeholders. It also compels the board to think about the firm's long-term health and avoids the pernicious effects of short-term business decisions.

II. SHAREHOLDER PRIMACY'S BIG ISSUE: SHORT-TERMISM

While it is the corporate norm in the United States, the shareholder primacy model has serious shortcomings. One of the most significant shortcomings is the short-termism it often causes. Short-termism is the notion that decision makers are shortsighted because they focus on short-term results at the expense of long-term profitability and company value.[170] This can become rampant when institutional investors like hedge funds hold large positions in the company.[171]

Part II.A will discuss who these investors are and their motivations for pursuing short-term strategies. Part II.B will examine other factors that often play a role in short-termism. Part II.C will survey typical short-term tactics and why they can be deleterious to a firm's health. Finally, Part II.D will assess how the stakeholder model induces long-termism and why this is better for a company's health than short-termism.

163. *See* Keay, *supra* note 140, at 277.

164. *See* Steve Letza et al., *Shareholding Versus Stakeholding: A Critical Review of Corporate Governance*, 12 CORP. GOVERNANCE 242, 255 (2004).

165. *See* Michael Jensen, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 7 EUR. FIN. MGMT. 297, 301 (2001); Keay, *supra* note 140, at 279–80.

166. *See* Keay, *supra* note 140, at 277.

167. *See* Elaine Sternberg, *The Defects of Stakeholder Theory*, 5 CORP. GOVERNANCE 3, 5 (1997).

168. *See* Keay, *supra* note 140, at 290.

169. *See* Sternberg, *supra* note 167, at 5.

170. Robert J. Rhee, *Corporate Short-Termism and Intertemporal Choice*, 96 WASH. U. L. REV. 495, 496 (2018).

171. *See infra* notes 174–82.

A. Who Are Short-Term Investors and What Motivates Them?

When the purpose of a corporation is maximizing shareholder wealth and not benefiting all stakeholders, directors often introduce proposals that benefit the firm in the short term while hurting it in the long term. Short-termism is the notion that decision makers act shortsightedly by focusing on short-term results at the expense of long-term profitability and company value.[172] Many scholars argue that short-termism is inauspicious because, in adopting short-term strategies to pump up share price, the firm sacrifices long-term health.[173]

Typically, investors with short-term views are hedge and mutual funds.[174] Actively managed hedge and mutual funds have clients paying high fees, expecting high rates of return on their investments.[175] Fund managers who are judged on their performance over four quarters are likely to support corporate management strategies that increase stock price in the short term.[176] These fund managers can then turn around and sell those positions. Thus, it is not surprising many mutual funds have a yearly turnover of 100 percent or more of their equity holdings.[177] Likewise, many hedge funds hold their equity shares for less than two years.[178] This greatly differs from the majority of investors who invest for the long term.[179] Over fifty million households are retail investors and around 54 percent of U.S. households own stocks.[180] These investors usually invest as a means to fund retirement or education, goals that require a long-term investment strategy.[181] So, in reality, only a select few emphasize the short term, yet these are the institutional investors with meaningful clout.[182]

The percentage of U.S. public equities managed by institutional investors has risen from around 7 to 8 percent of market capitalization in the 1950s to around 67 percent in 2010.[183] In the largest U.S. corporations, institutional

172. *See* Rhee, *supra* note 170, at 496.
173. *See id.*
174. *See* Stout, *supra* note 89, at 2017.
175. *See* STOUT, *supra* note 93, at 46.
176. *See id.*
177. *See id.*
178. *See id.*
179. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: SECOND QUARTER 2019, at 2–4 (2019), https://www.federalreserve.gov/releases/z1/20190920/z1.pdf [https://perma.cc/5VPR-RPC6]; *see also* STOUT, *supra* note 93, at 46.
180. *Retail Investor*, INVESTOPEDIA (Mar. 31, 2020), https://www.investopedia.com/terms/r/retailinvestor.asp [https://perma.cc/N48F-WUDH].
181. *See* Leo E. Strine Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 12 (2010); *see also* Stout, *supra* note 89, at 2016.
182. *See* Stout, *supra* note 89, at 2009.
183. Marshall E. Blume & Donald B. Keim, Institutional Investors and Stock Market Liquidity: Trends and Relationships 4 (Aug. 21, 2012) (unpublished manuscript), http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf [https://perma.cc/FC6K-HTJG]; *see also* MATTEO TONELLO & STEPHAN RABIMOV, THE CONF. BD., 2010 INSTITUTIONAL INVESTMENT REPORT 12, 22–28 (2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707512 [https://perma.cc/Y47H-3YPJ].

investors owned, in the aggregate, 73 percent of the outstanding equity.[184] These institutional investors include pension funds, mutual funds, exchange traded funds, insurance companies, and hedge funds. It is important to note that these investors vary considerably, including in their organizational structures, regulatory requirements, and investment strategies.[185] One result of the significant institutional ownership equity is an increase in shareholder engagement from companies.[186] While this can be seen as a positive,[187] it can also lead to undesirable results.[188] Institutional investors that hold large stakes in corporations can play an "activist" role and dictate to directors exactly what they are looking for; by doing so, they can exercise considerable influence over the firm.[189] If a fund manager has the resources, the manager can initiate a proxy contest,[190] instigate a publicity campaign against the board,[191] or even look at takeover options if dissatisfied with management.[192] Thus, larger institutional investors, through various strategies, can often compel a board of directors to adopt corporate strategies that mirror their funds' strategies. These fund strategies are often geared toward pumping up share value in the short term at the expense of long-term firm health.[193] Therefore, it is typical for these institutional investors to look for short-term profits.

B. Other Factors Contributing to Short-Termism

In addition to the pressures from activist funds, CEOs often feel pressure to meet short-term expectations from other external sources. Quarterly reporting is a more recent phenomenon that many believe is linked to short-

184. *See* TONELLO & RABIMOV, *supra* note 183, at 22 (looking at the one thousand largest U.S. corporations).

185. Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Institutional Investors: Power and Responsibility (Apr. 19, 2013), https://www.sec.gov/news/speech/2013-spch041913laahtm#P21_2801 [https://perma.cc/CC7X-4RYV].

186. *See* Holly Gregory et al., *Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*, 65 BUS. LAW. 107, 112 (2009).

187. *See* Giovanni Strampelli, *Knocking at the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor Engagement in Law and Practice*, 12 VA. L. & BUS. REV. 187, 191 (2018) (stating that private meetings with firm directors and management can create company value).

188. Insider trading is seen as a serious issue when there is behind-the-scenes dialogue between influential institutional investors and corporate managers. *See* 17 C.F.R. § 243.100(a) (2019) (discussing the federal regulation against disclosures of material nonpublic information).

189. *See, e.g.*, Rhee, *supra* note 170, at 499 (explaining that these fund managers can coerce company managers through publicity campaigns and proxy contests).

190. *See id.*

191. *See id.*

192. *See* Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform?: Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721, 722, 743–44 (2003).

193. It is again important to note that not all funds have these short-term strategic outlooks, and thus a generalization that all hedge and mutual funds focus on the short-term is not fair.

termism.[194] The SEC has required quarterly reporting, in the shape of a 10-Q submission, from public companies since the 1970s.[195] These reports have become a core tool used by analysts to value a company.[196] Often when a company does not meet analyst expectations, share price tumbles. Therefore, it is common for companies to use questionable accounting techniques[197] or other means to artificially inflate the company's 10-Q.[198] These techniques, like share buybacks or minimization expenses for employee salaries and benefits, can damage a firm's long-term health.[199]

Executive compensation is another external force that can compel short-termism. It is normal for a CEO and other executives to have a large part of their compensation tied to the company's performance.[200] Often the metrics that compensation is tied to encourage short-term strategies and risk-taking over the long term.[201] CEOs and other managers will often turn to layoffs, decreases in research and development, and changes to accounting practices to buoy the firm's short-term financial position.[202] These all have negative long-term effects for the health of a business.

C. Short-Term Tactics and Why They Hurt the Firm

The board of directors will use various strategies to pump up short-term share value.[203] Issuing dividends and repurchasing outstanding shares are two methods companies will often incorporate. In 2014, the volume of stock buybacks reached $550 billion.[204] While these buybacks can be a logical way for companies to use surplus cash, they simultaneously reduce opportunities to invest in innovation, human capital, or other areas that may help the firm in the long term. The Tax Cuts and Jobs Act[205] is a prime example of companies lobbying for short-term schemes to the detriment of

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194. *See, e.g.*, W. Randy Eaddy, *A Case for Eliminating Quarterly Periodic Reporting: Addressing the Malady of Short-Termism in U.S. Markets with Real Medicine*, 74 BUS. LAW. 387, 390–92 (2019) (arguing that short-term reporting leads to short-termism because managers focus on short-term solutions in order to prop up share price).

195. *See id.* at 389.

196. *See id.*

197. *See id.* at 400–01; Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, The "Numbers Game" (Sept. 28, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt [https://perma.cc/3N25-6NLY].

198. *See, e.g.*, Levitt, *supra* note 197; Stout, *supra* note 89, at 2017.

199. *See* William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV., Sept. 2014, at 46, 50–54.

200. *See* Gregg M. Galardi & Bruce Grohsgal, *Executive Compensation and the Great Recession*, DEL. LAW. Fall 2010, at 24, 27.

201. *See id.* (discussing how AIG purchased tens of billions of dollars worth of credit default swaps that triggered executive employee bonuses but ultimately proved costly when the government had to bail out the insurance giant).

202. *See supra* notes 1–6.

203. *See supra* Part II.B.

204. *See* Ben Levisohn, *Benefitting from the Buyback Lull*, BARRON'S (Mar. 27, 2015, 8:01 PM), https://www.barrons.com/articles/benefiting-from-the-lull-in-stock-buybacks-1427500898 [https://perma.cc/G4AM-22V9].

205. Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of 16, 26, and 43 U.S.C.).

long-term health. The Act cut the corporate tax rate from 35 percent to 21 percent.[206] President Donald Trump believed this reduced rate would increase corporations' cash surpluses leading to more jobs, contributions to employees, and contributions to the rest of the country.[207] Instead, corporate directors primarily used this cash influx to buy back outstanding shares, inflating stock prices and, in turn, increasing executive compensation.[208]

Management and boards also often engage in "earnings management."[209] This involves decision makers delaying favorable transactions or hastening transactions in order to prop up accounting results for quarterly reports.[210] Regardless of why directors do this,[211] earnings management frequently results in shortsighted decisions that harm the firm in the long term.[212]

All these strategies can destroy long-term value in a firm. For example, when a firm repurchases shares, it forgoes using some of its surplus cash on investments in research and development and human capital to increase share price.[213] While many defend buybacks and point to research showing minimal adverse effects,[214] it is more plausible that many repurchase plans end up harming a firm's long-term value.[215] While likely not as detrimental, dividends can be used in a similar manner. They allow the corporation to reward its shareholders, particularly those with sizable positions, instead of investing in innovation.[216] It should be noted that many corporations can

206. *See id.* § 13001(b), 113 Stat. at 2096–98 (codified as amended in scattered sections of 26 U.S.C.).

207. *See* President Trump, Remarks at Signing of H.R. 1, Tax Cuts and Jobs Bill Act, and H.R. 1370 (Dec. 22, 2017, 10:45 AM), https://www.whitehouse.gov/briefings-statements/remarks-president-trump-signing-h-r-1-tax-cuts-jobs-bill-act-h-r-1370 [https://perma.cc/GAD3-VLJW]; Donald J. Trump (@realDonaldTrump), TWITTER (Dec. 20, 2017, 6:32 AM), https://twitter.com/realDonaldTrump/status/943489378462130176 [https://perma.cc/5DE4-EDWJ].

208. *See* Matt Egan, *Tax Cut Scoreboard: Workers $6 Billion; Shareholders $171 Billion*, CNN BUS. (Feb. 16, 2018, 7:42 AM), https://money.cnn.com/2018/02/16/investing/stock-buybacks-tax-law-bonuses/index.html [https://perma.cc/T9DY-LR53].

209. Sugata Roychowdhury, *Earnings Management Through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 335–36 (2006); *see also* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1581–82 (2015).

210. *See* Fried, *supra* note 209, at 1581–82.

211. *See id. See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 183–85 (2004).

212. *See* Fried, *supra* note 209, at 1582.

213. *See* Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 307 (1998); J. W. Mason, *Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment*, ROOSEVELT INST. (Feb. 25, 2015), https://rooseveltinstitute.org/wp-content/uploads/2020/07/RI-Disgorge-the-Cash-201502.pdf [https://perma.cc/7YL4-BVET] (showing that there is a correlation between increased stock buybacks and long-term decline in corporate investment); *see also* Lenore Palladino, *The $1 Trillion Question: New Approaches to Regulating Stock Buybacks*, 36 YALE J. ON REGUL. BULL. 89, 90, 94 (2018). *But see* Jesse M. Fried & Charles C. Y. Wang, *Are Buybacks Really Shortchanging Investment?*, HARV. BUS. REV. Mar.-Apr. 2018, at 88, 90–91.

214. *See* Fried, *supra* note 209, at 1584–92.

215. *See* Lazonick, *supra* note 199 (explaining that by repurchasing shares, companies have less to invest in their employees and innovation); Stout, *supra* note 89, at 2017 (discussing the toxic effect that short-term speculators can have on a business).

216. *See* Lazonick, *supra* note 199.

concurrently pay out dividends and invest.[217] These short-term strategies wipe out significant long-term value from a corporation by redistributing cash to investors with no long-term benefit.[218] Many scholars point out that short-termism has broader social effects and has led to financial crises in the past.[219] They also argue that short-termism contributes to income inequality.[220] When a company pays out a dividend to its shareholders or buys back stock, it is directing money to investors, who are typically wealthy,[221] instead of its employees.

D. The Preferred Model: The Stakeholder Model and Long-Termism

Incorporating a stakeholder model would likely reduce short-termism. Nearly all stakeholders benefit from a firm's long-term success. A significant reason why firms engage in short-termism is to conciliate institutional investors.[222] Compelling the board of directors to examine all stakeholder groups would make it more difficult for the board to implement short-term strategies like share repurchase plans or dividend payments.[223] Important stakeholder groups like employers, creditors, suppliers, and the surrounding community would all benefit from long-term strategies like investment in human capital, research and development, or even in increased employee wages.[224] Even most shareholders would benefit from these strategies in the long term.[225] Adopting a stakeholder-oriented theory of corporate governance would impel decision makers to take on more long-term strategies that would not destroy firm value.

III. WATCHING THE WATCHERS: THE OBSERVING BOARD

The shareholder primacy norm causing corporations to adopt short-term investment strategies is a serious issue for societal welfare.[226] As such, a

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217. *See, e.g.*, Johnson & Johnson, Annual Report 2018, at 15–16 (Form 10-K) (Dec. 30, 2018) (showing Johnson & Johnson paid out a dividend while also investing in research and development).

218. *See* Lazonick, *supra* note 199.

219. *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1283 (2002); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 268 n.7, 269 (2012); Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1657 (2011); Rhee, *supra* note 170, at 500.

220. *See, e.g.*, Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* 4, 12–13, 15–17 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24085, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3082268 [https://perma.cc/LDE3-RWQG] (discussing how the stock market surged in the 1990s while wages remained somewhat stagnant and how stock ownership is greater within wealthy families).

221. *See id.*

222. *See* Strine Jr., *supra* note 58, at 788, 790–92.

223. *See* Keay, *supra* note 140, at 256–57.

224. *See* Stout, *supra* note 89, at 2017.

225. *See generally id.*; Surroca, *supra* note 16, at 466–72.

226. *See supra* Part II.C.

number of solutions have been proposed by politicians[227] and scholars.[228] However, none of these propositions have been adopted.[229] This Note proposes creating a second observing board that is composed of employee, creditor, and minority shareholder representatives. These observers will have limited but defined power that should help gear the managing board (the regular board of directors) toward strategies that involve all stakeholders. First, in Part III.A, this Note will determine the best means to implement a solution, addressing the question of whether this is something best left for the corporations themselves, for the states, or for the federal government to implement. Then, in Part III.B, this Note will propose a new type of board and analyze how it will help curtail short-termism by pressuring the managing board of directors to look at all stakeholders.

A. A Federal Solution

In crafting the appropriate response to the issue of shareholder primacy, it is essential to determine the implementation process. The type of solution will vary depending on who enacts it. For example, if the corporation implements the solution, it will likely be more cultural than anything else.[230] If the states themselves decide to implement solutions, the answers to the shareholder primacy problem may vary state by state, and the courts would probably craft solutions through case law.[231] If the SEC promulgates a new rule that aims to solve the issue,[232] it would probably involve corporate disclosure, consistent with the semi-strong form of the efficient market hypothesis.[233] Finally, if Congress enacts legislation addressing the issue, the legislation could mix and match disclosure and substantive remedies like

227. *See, e.g.*, Stock Buyback Reform and Worker Dividend Act of 2019, S. 2391, 116th Cong. (2019); Accountable Capitalism Act, S. 3348, 115th Cong. (2018); The Reward Work Act, S. 2605, 115th Cong. (2018); *Corporate Accountability and Democracy Plan*, *supra* note 8.

228. *See, e.g.*, J. Haskell Murray, *Adopting Stakeholder Advisory Boards*, 54 AM. BUS. L.J. 61, 94–106 (2017); Jeffrey N. Gordon, *Addressing Economic Insecurity: Why Social Insurance Is Better Than Corporate Governance Reform*, THE CLS BLUE SKY BLOG (Aug. 21, 2019), https://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform [https://perma.cc/36TN-YPB6]; Lipton, *supra* note 138;.

229. None of the politician-proposed solutions have passed through Congress and been signed into law. Likewise, courts have not given much credence to the proposed solutions of scholars.

230. *See* Lipton, *supra* note 138.

231. *See generally* Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM J. CORP. & FIN. L. 225, 259–61, 259 n.112 (2005) (explaining that federal courts have rulemaking authority derived frm their constitutional powers).

232. *See Investor Bulletin: An Introduction to the U.S. Securities and Exchange Commission-Rulemaking and Laws*, U.S. SEC. & EXCH. COMM'N (Aug. 20, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_rulemaking.html [https://perma.cc/6JS5-NFB9] (outlining where the SEC's rulemaking authority derives from).

233. *See generally* Basic Inc. v. Levinson, 485 U.S. 224, 225, 248 (1988) (discussing the fraud-on-the-market theory, which stands for the proposition that stock prices reflect all publicly available information).

the Dodd-Frank Wall Street Reform and Consumer Protection Act[234] and the Sarbanes-Oxley Act of 2002[235] did.

Having the SEC promulgate a new rule makes the most sense for dealing with this issue.[236] This is a middle ground between letting corporations handle the issue themselves and getting Congress directly involved, and it also avoids an uneven patchwork of state law. An internal approach taken by corporations would not lead to success. Despite being the easiest way to implement any solution, the incentives of the board of directors and chief officers are not aligned with many of the stakeholders' incentives.[237] Their self-interest likely will prevent any real, meaningful change from occurring.[238] Likewise, a state-by-state approach would be inefficient and extremely difficult to implement.[239] Many states have already entrenched shareholder primacy in their common law.[240] Without intervention from the state legislatures, changing this presumption would require considerable time and creative lawyering.[241] It is also doubtful that state legislatures, independent of the courts, could enact real change. The various state constituency statutes illustrate the futility of state legislatures in creating meaningful change in corporate law.[242]

On the other end of the spectrum, using Congress to implement a solution would likely create ineffective laws. While Congress has the authority to implement corporate governance legislation,[243] it is not the most competent when it comes to dealing with complex governance issues.[244] In contrast, the SEC has more specialized resources, more particularized knowledge, and is likely more efficient than Congress.[245] The highly specialized knowledge of corporate law required falls outside the expertise of Congress given the significant experience and time required to cultivate this competence.[246] Another issue with Congress is that its members can easily be influenced.[247]

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234. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

235. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the U.S.C.).

236. There are various ways that an agency can promulgate a rule. This Note will focus on informal rulemaking via notice and comment. *See* Administrative Procedure Act, 5 U.S.C. § 553.

237. *See supra* notes 190–208.

238. *See supra* notes 190–208.

239. *See infra* notes 240–42.

240. *See, e.g.*, Strine Jr., *supra* note 58, at 768 (discussing that it is clear that Delaware corporate law requires directors to make shareholder welfare their sole end).

241. *See, e.g.*, Aranson v. Schroeder, 671 A.2d 1023, 1027 (N.H. 1995) (stating that "fundamental changes in our jurisprudence must be brought about sparingly"); Falcone v. Middlesex Cnty. Med. Soc'y, 170 A.2d 791, 799 (N.J. 1961) (stating that "[t]he persistent movement of the common law . . . is soundly marked by its gradualness").

242. *See, e.g.*, Strine Jr., *supra* note 58, at 767–68.

243. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the U.S.C.); *see also* Heminway, *supra* note 231, at 248–52.

244. *See* Heminway, *supra* note 231, at 274.

245. *See id.* at 334–48.

246. *See id.* at 271–76.

247. *See id.* at 264–75.

This, in turn, can water down any piece of legislation.[248] There are formal and informal influences on congressional members.[249] A final issue with Congress is its inefficiency, resulting in part from the number of steps required to pass a bill.[250] A particular bill can remain in committee or in one of the houses for months and it can ultimately take considerable time to pass a bill.[251] Thus by allowing Congress to craft legislation, there is a good chance the law looks drastically different by the time it is effective. The sheer amount of time it would take to pass the bill and the various compromises will create a law that looks nothing like the original proposed act.

Allowing the SEC to implement a rule would solve most of these issues. First, the SEC has authority to promulgate a rule of this sort.[252] Since the solution proposed is disclosure-based in nature, this remains within the purview of the SEC.[253] The SEC is the most competent agency to deal with this situation. In the past, both courts and the president have deferred to SEC decisions on financial and corporate issues.[254] Further, the SEC has a lengthy history of rulemaking, strengthening the argument that it is the most appropriate entity to implement a solution to this corporate governance issue.[255] Compounding this is the fact that the SEC is less partisan than Congress.[256] While SEC commissioners are nominated by the president, nominations are staggered so as to not allow a president to nominate every member during the president's four-year term.[257] Independent agencies, while still subject to some influences, generally are better equipped to resist political pressures.[258] It should be noted, however, that there is a concern of "agency capture," through which corporations can influence the SEC in

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248. *See id.* at 307–12.

249. Formal influences on Congress include those of the president and the executive branch. More informal influences include those of party affiliation and the media. *See* Michael Fitts & Robert Inman, *Controlling Congress: Presidential Influence in Domestic Fiscal Policy*, 80 GEO. L.J. 1737, 1756 (1992); Peter E. Quint, *Reflections on the Separation of Powers and Judicial Review at the End of the Reagan Era*, 57 GEO. WASH. L. REV. 427, 440 (1989).

250. *See* Heminway, *supra* note 231, at 265–68.

251. *See How Laws Are Made and How to Research Them*, USA.GOV (Sept. 17, 2020), https://www.usa.gov/how-laws-are-made [https://perma.cc/4FSB-JVE9].

252. *See* Heminway, *supra* note 231, at 253–55.

253. *See id.* at 256.

254. *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327, 332–333 (Del. Ch. 1997) (discussing the features that make the SEC a competent agency); Presidential Statement on Signing the Securities Litigation Uniform Standards Act of 1998, 34 WEEKLY COMP. PRES. DOC. 2247, 2248 (Nov. 3, 1998) (containing statement of former President Bill Clinton: "I am aware of and agree with the expert views on this issue of the Securities and Exchange Commission").

255. *See* Heminway, *supra* note 231, at 288–89.

256. *See, e.g.*, Roberta S. Karmel, Former Comm'r, U.S. Sec. & Exch. Comm'n, Threats to the SEC's Independence (Nov. 2016), *in* BUS. L. TODAY, Dec. 20, 2016, at 1, 1–2.

257. *See* WILLIAM N. ESKRIDGE JR. ET AL., CASES AND MATERIALS ON LEGISLATION AND REGULATION: STATUTES AND THE CREATION OF PUBLIC POLICY 935–36 (5th ed. 2014).

258. *See* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 562 (2001).

adopting less stringent rules.[259] While this is a legitimate concern, the competence and relative independence of the SEC outweighs the fear of agency capture, making it the appropriate body to implement this solution.

However, there are drawbacks to this approach. First, agency rule promulgation takes time.[260] The SEC would need to research the solution, submit a rule proposal, wait and review the comments it receives on that proposal, and then potentially implement those comments and go through the comment period again.[261] Still, due to the recent swell of support concerning stakeholder rights, there may be greater urgency for a speedy implementation. Another potential downside to having the SEC implement the change is the vagueness and uncertainty that often surrounds new rules.[262] This often leads to three types of costs: learning, uncertainty, and development.[263] Learning costs are the costs that are required in having judges, lawyers, firms, and other individuals educate themselves on the new rule.[264] Uncertainty costs are those incurred because of the doubt around the new rule. These costs may include taking action to fill in the gaps and ambiguities surrounding the rule or the increased legal services a firm might need.[265] Finally, development costs are associated with a firm altering its business practices to adhere to the new law.[266] For the solution this Note proposes, those costs would reflect the costs associated with adding three representatives. Conducting the representatives' elections and including additional information on proxy solicitations are specific examples of such. Other than the additional costs that rulemaking produces, companies may also decide to incorporate outside the United States if what the SEC promulgates is too burdensome.[267] However, this threat seems hollow. Ultimately, the U.S. has one of the best equipped legal systems to handle corporate law issues.[268] Companies value having a trustworthy and predictable legal system. Despite the issues that come with SEC rule promulgation, having the agency implement the solution makes the most sense.

259. *See, e.g.*, Roberta S. Karmel, *Outsider Trading on Confidential Information—a Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 127 (1998) (arguing that the SEC's concern about securities analysts is an example of agency capture).

260. *See Fast Answers: Rulemaking, How It Works*, U.S. SEC. & EXCH. COMM'N (Apr. 6, 2011), https://www.sec.gov/fast-answers/answersrulemakinghtm.html [https://perma.cc/5VZC-K3CH].

261. *See id.*

262. *See* Heminway, *supra* note 231, at 334–48.

263. *See id.*

264. *See id.* at 334.

265. *See id.* at 338.

266. *See id.* at 342.

267. *See generally Corporate Inversion*, INVESTOPEDIA (May 4, 2020), https://www.investopedia.com/terms/c/corporateinversion.asp [https://perma.cc/ZBG7-ZDEE] (discussing how companies relocate operations from the United States to other countries for lower tax rates and less strict corporate governance rules).

268. *Elizabeth Warren's New Bill Will 'Destroy Capitalism': Harvard Expert*, CNBC POWER LUNCH (Aug. 15, 2018, 3:19 PM), https://www.cnbc.com/video/2018/08/15/elizabeth-warrens-new-bill-will-destroy-capitalism-harvard-expert-accountable-capitalism-act-income-inequality-employee-ceo.html [https://perma.cc/2GVN-67EF].

B. The Observing Board

This Note proposes the SEC promulgate a new rule to help curb the shareholder primacy norm and, in turn, spur long-term business strategies from the board of directors. Specifically, the rule should require corporations of a certain size to add a three-person observing board. By mandating large corporations to have a three-person observing board, firms will feel pressured to consider all stakeholder groups, not only shareholders. This observing board will consist of one employee representative, one creditor representative, and one minority shareholder representative. Part III.B.1 will detail these positions and the rationale behind having representatives for these specific constituencies. Part III.B.2 will then examine the powers of this observer board, which bear some resemblance to the powers of the Aufsichtsrat in Germany.[269]

1. The Election and Composition of the Observing Board

The observing board will contain three members: representatives of the employees, creditors, and minority shareholders of the firm. These are constituencies whose representations in the boardroom will have the largest impact for all the firm's stakeholders.[270] These board members will be elected in specific ways to ensure that all members of each constituency group have a say in their representative.

First, the employees will elect their representative through a plurality voting system conducted on the company's intranet. Each employee, regardless of position within the company, will have one vote. One vote per person ensures that upper management cannot plant someone more aligned with their interests on the board. It also allows for the rank-and-file employees to have the greatest say in who represents them. The hitch with this is that Delaware law does not allow employees to nominate directors.[271] Requiring disclosure from companies that do not nominate the director that has been suggested by the employees would provide a work-around for this issue. The employees would still have their election process and nominate someone, and the board would then have the option of actually putting this person on the ballots. If they chose not to, they would be required to disclose why they did not incorporate the nominee of the employees. This would have a similarly coercive effect for the board of directors because the board would have to explain its decision to forgo employees' nominee in its proxy statement.

As for the nomination process, the employee representative will be self-nominated. While independence from the company may seem important, these concerns are largely overblown. It is unlikely that any elected

269. *See supra* Part I.C.3.

270. *See, e.g.*, Murray, *supra* note 228, at 94 n.150 (stating that a good place to look for the major stakeholder groups would be on the Benefit Corporation website, which includes information on shareholders and employees).

271. *See* DEL. CODE ANN. tit. 8, § 112 (2020).

employee will be so disputatious that the employee's job is put in danger. There are advantages to having an actual employee as a representative, primarily that it is likely to help increase transparency between management and the workers. The representative can immediately relay concerns and issues other employees are having to the board, without having to go through a middleman. This should increase efficiencies and rapport between the groups.

The employees' representation on the board is essential for the observing board to work as intended. Employees are interested in the long-term health of the firm at which they are employed.[272] While critics argue that employees are able to contract for their employment, the reality is that most workers in the United States, particularly those at will, do not have the same protections as shareholders.[273] Thus, generally, a worker's best job protection is a healthy firm.

Having employees represented on the observer board will also help in establishing trust and through that trust, better dissemination of information. It is hard to quantify the importance of trust in a firm,[274] but it is clear that by having workers represented in board discussions, more trust will form between directors and officers and the rest of the firm's employees.[275] An increase in trust should lead to more open lines of communication between the directors and employees. Directors can act faster and more efficiently in making decisions involving labor, factories, equipment, and the like, thus reducing firm transaction costs.[276] Some argue that in systems with advisory boards, communications are chilled because directors and officers fear leaks and have a general lack of trust.[277] However, with strict confidentiality agreements and enforcement of those agreements, this fear should dissipate and allow for the managing board to talk more openly.

The creditor representative selection process will operate differently than the employee process. First, it is important to note that the creditor representative will primarily represent creditors holding unsecured debt. These are the creditors with the lowest priority in a bankruptcy proceeding and are most likely to lose their investment. Thus, they care more about the firm's long-term health than other creditors.[278] Choosing a representative

272. *See* Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 309 (1998) (discussing that workers are not diversified in their labor investments and that they have a strong concern about firms' financial health because they face unemployment if the company falters).

273. *See id.*

274. *See, e.g.*, René Reich-Graefe, *Deconstructing Corporate Governance: The Mechanics of Trusting*, 38 DEL. J. CORP. L. 103, 105–09 (2013).

275. *See* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1809 (2001) (discussing how language can cultivate trust and contractarian talk can stifle it).

276. *See* Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1005–06 (1998); *see also* Hodge, *supra* note 137, at 123.

277. *See* Jan Lieder, *The German Supervisory Board on Its Way to Professionalism*, 11 GERMAN L.J. 115, 149 (2010).

278. *See* 11 U.S.C. § 507.

will require looking at all the unsecured debt offerings. The trustee of the bank or trust company of the largest outstanding offering will serve as the creditor representative.[279] It is worth mentioning that Delaware allows for corporations to give creditors the right to vote.[280] However, in practice, this is nonexistent when the firm is solvent.[281] The process outlined above is responsive to this reality. Rather than allowing creditors to vote, a custom that seemingly no corporation has allowed for, the representative will be chosen based on preexisting criteria. One potential problem with this approach is that the same trustee could sit on the board for decades. However, the rule will require that after serving a maximum of three one-year terms, the trustee of the bank of the next largest outstanding offering will take over. If the offering becomes due during a term, that trustee becomes ineligible. This system ensures that the creditor representative is someone who has a stake in the long-term health of the firm but also forecloses the opportunity for corruption. Another problem is that some creditors, like trade creditors, may have various conflicting interests that could result in a competitor receiving confidential information. Inserting a trustee precludes this potential for impropriety.

Again, like with the employee representative, the creditors have no legal entitlement to nominate a director. A similar workaround like the one outlined above with the employee nominee could be fashioned for the creditor representative. If the presumptive creditor nominee is not selected by the board, the board would be compelled to explain why in its proxy statement.

Having a creditor representative further strengthens the long-term focus of the observing board. Those holding onto unsecured debt from a firm want their principal returned at the end of the loan term. While some might argue that creditors are already protected contractually,[282] the protections are much weaker for holders of unsecured debt.[283] They typically do not want the firm engaging in risky, short-term behavior that could be detrimental to the long-term health of the firm.[284]

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279. *See, e.g.*, DEL. CODE ANN. tit. 8, § 221 (2020) (showing that the Delaware code already allows for creditors to be "deemed to be stockholders" if the certificate of incorporation so provides). In this context, a trustee is a financial institution that is appointed by an issuer of debt to enforce the terms of the indenture. The trustee acts as the agent of the holders of the debt securities.

280. *See id.*

281. *See generally* 3 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 18:3 (3d ed. 2019).

282. *See* Van Der Weide, *supra* note 86, at 45–47.

283. *See* Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 651 n.10 (1996) (discussing how contract law largely governs creditor protections and that there is no common law that protects the holder of unsecured debt, leaving the creditor short on protection).

284. It should also be noted that the unsecured debt of non-blue-chip companies, with riskier credit agency ratings, can mirror stock prices. Thus, when share price goes up, company bonds may trade at a premium. Alternatively, when share price decreases, the bonds may trade at a discount.

Even though this perspective is identical to that of the employee representative, there are clearly situations where their interests could diverge. For example, if a firm was considering issuing a new class of debt to fund investment in a new factory, the employee representative would likely approve of this as it would create more jobs, while the creditor representative would probably be opposed to the suggestion of creating more debt. Thus, while their perspectives may be similar, there are important distinctions between the employee and creditor representatives that make each necessary.

Finally, the minority shareholders will elect their representative in a similar manner to that of the general election process for directors.[285] In determining who can vote on the shareholder representative, the rule will mirror SEC Rule 14a-8 for shareholder proposals.[286] The floor requirement will look identical to Rule 14a-8: to vote, one must hold $2000 worth of the firm's stock continuously for at least one year. The rule will add a ceiling of $100,000 for voting purposes. This would allow only those shareholders who hold between $2000 and $100,000 of the company's stock continuously for one year to vote for the minority shareholder representative. A process like this ensures that the minority shareholder representative is someone whose incentives are aligned with the typical shareholder.[287]

The Delaware code does allow for corporations to adopt a bylaw that permits individuals nominated by shareholders to be included in a proxy statement.[288] Thus the questions that arose with employees and creditors electing a representative are not issues here.

The voting process for the minority shareholder representative will be indistinguishable from the election process for ordinary directors. On the proxy statement, below the candidates for the regular board, there will be a list of the nominees for the representative spot. Under each candidate's name, there will be a short summary of pertinent information.[289] Shareholders will then vote for one individual.[290] The board of directors will not give a recommendation for any specific candidate. This process is desirable because it combines feasibility, since it mirrors the method already in place, and accessibility, since it allows for shareholders to easily cast a knowledgeable vote.

By being represented on the observing board, minority shareholders act as an important counterbalance to the employees and creditors, while sharing some similar incentives to those of the other groups. Shareholders, regardless of the number of shares they hold, are going to be less risk averse than

285. *See supra* notes 28–33.

286. *See* 17 C.F.R. § 240.14a-8(b) (2019).

287. *See supra* Part II.A.

288. *See* DEL. CODE ANN. tit. 8, § 112 (2020).

289. Information may include background, qualifications, prior work history, and any other affiliations.

290. Since it would be too costly to produce different proxy statements for the shareholders eligible to vote for a representative, the system would allow everyone to vote for the representative and then on the back end, only the votes of the shareholders who qualify would count.

employees and creditors.[291] Shareholders can diversify their investments across a broad spectrum of companies. This allows for a greater risk threshold. If a firm investment fails, it may mean employees get laid off or creditors do not recoup their investments but shareholders can take the loss and move on. Having a group willing to embrace risk is important for the observing board so as to prevent complete suppression of risk. Risky investments are important for many firms to undertake.[292] Additionally, the minority shareholder representative will still have a long-term view because minority shareholders tend to make long-term investments to fund, for example, education or retirement.[293] Thus, by including minority shareholders, the observing board provides a perspective that appreciates some risk, while remaining long-term oriented.

2. The Powers of the Observing Board

The powers of this board, while limited, are strong enough to change the decision-making of the board of directors. Striking the right balance is crucial.[294] If the observing board has too little power, the managing board will not take it seriously and no real change will occur.[295] On the other hand, giving the observing board too much power may effect the managing board's business judgment.[296] Therefore, the observing board needs legitimate but restrained powers. These powers will be disclosure-based since mandating disclosure can have a prominent effect on director decision-making,[297] while also not providing substantive power to the observers. This disclosure solution is also desirable as it is not a radical upheaval of current law.

One of the most basic powers of the observers is their quorum power. For the managing board of directors to establish a quorum, at least two observers must be present. This will safeguard against the managing board meeting without all members of the observing board present. It will also increase transparency between the two boards, something that is essential for crafting effective disclosure.[298] Most importantly, since observers will be required to submit various disclosures, as discussed below, they must be present to monitor board meetings. Ideally these observers will also participate in board meetings, particularly by bringing up issues raised by their respective groups. This will likely be most useful for the employees because their day-to-day is affected by many of the board's decisions. The goal of this approach is also

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291. *See* WILLIAM A. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 344 (5th ed. 2016).

292. *See generally* Renee M. Jones, *The Irrational Actor in the CEO Suite: Implications for Corporate Governance*, 41 DEL. J. CORP. L. 713, 725 (2017).

293. *See supra* Part II.A.

294. *See* Tien Glaub, *Lessons from Germany: Improving on the U.S. Model for Corporate Governance*, 5 BYU INT'L L. & MGMT. REV. 235, 241 (2009).

295. *See id.*

296. *See id.*

297. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1239–42 (1999).

298. *See, e.g.*, Eaddy, *supra* note 194, at 401–02.

to increase transparency within the firm. By having a direct line of communication to the managing board of directors, it is reasonable to assume the firm will become more efficient.[299]

The primary power of the observers is their authority and obligation to submit various disclosure documents. This power is indispensable for shifting the board of directors' focus from purely the shareholder. The first required disclosure that each observer must make will be in a proxy statement. This can easily be implemented by amending the requirements for Schedule 14A, which dictates the information required in a proxy statement.[300] Each observer will draft a summary discussing business and compensation highlights and the observer's stance on those decisions. These summaries will be on the first page of the proxy statement, immediately following the table of contents. Then, for each proposal, including the election of directors, each observer will disclose the observor's stance and provide a brief summary of its potential impact on its constituency group. This will include both management and shareholder proposals governed by Rule 14a-8. So, when the board of directors nominates individuals for board spots, each observer would disclose a position on the candidate and whether they recommend voting for or against each candidate. Likewise, if management proposed issuing additional stock, each observer would briefly comment on the potential impact of the decision on the relevant constituency and whether they recommend voting for or against the proposal.

These disclosures and recommendations from the observers serve important purposes. First, they give shareholders more perspectives to consider when voting on proposals. Typically, a shareholder gets a recommendation exclusively from the board of directors that is inherently one-sided.[301] Allowing the observers to disclose their constituencies' views should reduce costs by providing the principal (the shareholder) with better information regarding the proposed activities of the agent.[302] These disclosure measures should also lead to the board of directors focusing more on other stakeholders. If the firm proposes engaging in a short-term activity, like a share repurchase plan, those shareholders seeking long-term value can read the thoughts of the observers and may decide to sell their shares and invest elsewhere. Thus, it is likely that the Schedule 14A disclosures from the observers will reduce agency costs while also pushing the board of directors to consider all stakeholders.

Each observer will also make a year-end disclosure as part of the company's 10-K submission, a corporation's annual report that summarizes the company's financial performance. In this disclosure, the representative

299. *See* Keay, *supra* note 140, at 257.

300. *See* 17 C.F.R. § 240.14a (2019).

301. Shareholder proposals also contain an explanation from the shareholder who proposed the idea, but the board of directors has the ability to respond and get the last word in.

302. *See generally* Iris H-Y Chiu, *Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK*, 38 DEL. J. CORP. L. 983, 989–91 (2014) (discussing how economists believe disclosure enhances liquidity and reduces monitoring costs).

will provide: (1) the potential risks facing its constituency group in the upcoming fiscal year; (2) the major transactions of the past fiscal year and how each has, and will continue to, impact the specific group; and (3) an outlook of the upcoming fiscal year specific to the representative's constituency. These disclosures will serve a similar purpose to those in the proxy statement. While the minority shareholder disclosure will heavily mirror the regular 10-K submission, the creditor and employee report will provide a clearer picture of the potential risks, along with commentary on the firm's decisions. This again provides more well-rounded insight into the health of the firm. Ideally it will also make the board of directors more wary of undertaking actions that directly harm other stakeholder groups. If it does, its decision will be reflected in the year-end report and cannot be concealed. This will force directors to think harder before engaging in a short-term action. Having a year-end report from each representative that outlines forward-looking risks and expectations will create more robust disclosures that investors can use. The hope is that directors, cognizant of this, will conduct greater deliberations before undertaking an action that exclusively benefits the shareholder, allowing them to at least consider the other stakeholders.

The observers will have various other powers, like the ability to access the firm's financial records and to suggest a course of action for major decisions. Allowing the observers to access the firm's records reinforces the goal of increased transparency and gives the representatives more information on which to base their disclosures. While some believe that giving nondirectors or managers access to sensitive records may lead to leaks,[303] this fear is probably overblown. Even so, to protect against the potential divulgence of confidential, sensitive information, each representative would sign a number of confidentiality agreements. Another power for the observers is letting the representatives suggest a course of action for major firm decisions, something similar to the disclosures they make in Schedule 14A filings. However, it varies in the fact that the representative can suggest a specific plan and, if that plan is not adopted, the board of directors must explain why. This rule would adopt a number of the elements of Rule 14a-8 regarding shareholder proposals.[304] This power allows for shareholders to get a fuller disclosure of the potential issues with a board's course of action before initiating the action. This enables shareholders to be better informed of the potential risks and arguments against the proposed action. Likewise, this disclosure will allow for a more accurate reflection of share price. These two powers will reinforce the importance of transparency and disclosure of other long-term stakeholder perspectives. The goal is that the board of directors will consider the positions of nonshareholders when making decisions. If they do not, it will be disclosed and share price will likely decline. These powers, while not substantive, have enough bite to affect real change.

303. *See, e.g.*, Bainbridge, *supra* note 276, at 1061; Hodge, *supra* note 137, at 127.
304. *See* 17 C.F.R. § 240.14a-8.

CONCLUSION

The public's frustration with corporate America has begun to boil over, as reflected in the statements of politicians and corporate executives. The shareholder primacy norm and its often negative consequences must slowly be dismantled so that corporations can also consider other firm stakeholders. Doing so will help reduce the influence of powerful institutional investors, while allowing firms to focus more on long-term profits. An advantageous way to achieve this is through an SEC rule that creates positions for three board observers representing different constituency groups. Having an employee, minority shareholder, and creditor representative come together to form an observing board will create more varied disclosure and will provide stakeholders with a more forceful voice, compelling the board of directors to take them into account.