The Economic Argument for Stakeholder Corporations

Roosevelt Institute Working Paper

Lenore Palladino

June 2019

Large corporations dominate economic and social life—yet their practices prioritize shareholders, CEOs, and senior executives over other stakeholders, business growth, and the economy at large. In the United States, business corporations operate according to a model of "shareholder primacy," which claims that the exclusive purpose of a corporation is to generate returns for shareholders and governance decisions should be exclusively in the hands of shareholders. Ownership of corporate shares is extremely concentrated among the wealthy; the top 10 percent of the population by wealth own over 85 percent of corporate equities (Federal Reserve 2019). This means that large corporations focus on increasing the wealth of a small elite, rather than expanding prosperity for the much broader set of corporate stakeholders--workers[1], suppliers, customers, and the broader public-- who create corporate wealth in the first place.

While many economists that the shareholder primacy model is, and always has been, a "natural law" of the market, its dominance in American corporate governance is only decades old-- and ultimately, shareholder primacy is a failed economic model. The neoliberal economic theory that underlies shareholder primacy is deeply flawed and does not reflect how corporations actually operate and distribute value between stakeholders. By documenting the economic arguments made to support shareholder primacy in the 20th century and showing why these assumptions do not hold, this working paper adds to the growing literature on the effects of corporate shareholder primacy. I argue that shareholder primacy should be replaced by a model of "stakeholder corporations," and I propose several areas of policy reform.

Corporations are legal entities that exist in the United States only once a state government approves their incorporation, which raises the "'abidingly crucial' political question of whether corporations are essentially public or private entities" (Millon 1990). They have tremendous privileges to operate apart from the natural persons who form them and run them. These privileges make the extra requirements of incorporation worthwhile: perpetual existence, limited liability, and the ability to take out debt in the corporate name. Corporations are different from other forms of businesses, such as sole proprietorships or limited liability companies (LLCs), where there is no formal legal separation between the founders that profit and run a business and the business itself. The very purpose of

[1] Throughout this piece I use the terms 'workers' and 'employees' interchangeably, even though there are legal differences between employees and other types of workers that matter in the implementation of stakeholder policies.

incorporating a business is to create an entity that lives on its own; in other words, as not just as an extension of those who provide its capital (Stout 2012). Thus the laws and policies that shape corporate governance must take into account the benefits granted to corporate entities, and the impacts, in turn, that corporations have on the broader society.

In the last four decades, the economic theory of the corporation was rewritten to fit within the dominant neoliberal framework of perfectly efficient "free markets." The entity itself—the corporation—is hypothesized as simply a site for freely negotiated contracts between rational actors, and the privileges granted by public power are erased. As all negotiations between rational actors lead to efficient outcomes, the theory goes, the dominance of shareholders and their exclusive authority in decision-making must be the most efficient structure for corporations.

But the economic theory of shareholder primacy is rooted in an incorrect notion of how shareholders and other stakeholders interact with the corporation. It posits that only shareholders take risks and have incomplete contracts, such that they should be granted exclusive control rights. Other corporate stakeholders like employees and lenders are thought to have complete contracts that guarantee them certain set returns—wages, or a fixed rate of interest on a bond. Their lack of power in governance is predicated on the false idea that only shareholders make variable, or risky, investments in the corporation, and that they therefore are the only group who should discipline corporate management.

The reality of how corporations actually produce goods and services, the disconnection of shareholders from the corporations that they supposedly govern (as opposed to employees who work at a corporation day in and day out), and the societal power of wealthy shareholders to create theories and rules that guarantee them a disproportionate share of wealth, are all erased from the justifications of shareholder primacy. This discredited theory should be replaced by a "stakeholder" corporate model of governance and ownership to transform corporations from extractive institutions that draw more and more wealth towards a small number of people into productive entities where stakeholder earnings are linked to value creation (Lazonick 2017).[2]

This paper first explores the flaws in the economic arguments for shareholder primacy and then presents an alternate theory of stakeholder corporations. I describe concrete policy reforms in corporate governance (how decisions are made, and by whom) and in share ownership (how the value generated is distributed). Corporate decision-making must ensure that key stakeholders have a voice in governance of the business corporation and that decisions are made considering the impact of those decisions on multiple stakeholders because, as I argue, a fundamental stakeholder, the employee, should have a claim on the profits that they help generate through the establishment of employee ownership trusts. Finally, such reforms should require a new articulation of the purpose a business has in incorporating and may require procedural changes in how incorporation is accomplished.

Corporate governance models and norms have changed multiple times since the beginning of business incorporation, and perhaps "the beliefs and circumstances that produced the current round of corporate governance are waning, setting the stage for far-reaching changes" (Dallas 2018). Since the late 1800s, economists and lawyers, and social movements and policymakers, have debated the contours of corporate power. At the turn of the twentieth century, in response to the rise of powerful trusts, the progressive movement pushed for trust-busting. The postwar years saw the rise of 'managerialism' and the large conglomerates. In the 1970s, neoliberal economists and lawyers argued for shareholder primacy, while Ralph Nader pushed for a federal corporate charter. Every new wave of structural change in the economy brings about a new set of questions of who should have power in the corporation. More than 50 years after the rise of neoliberal shareholder primacy, it is time to replace it with a stakeholder corporate model of governance and ownership.

Internal corporate governance is certainly not the only means of checking corporate power: external countervailing power is also necessary. Countervailing power, as developed by John Kenneth

---

[2] There are some economic sectors that would be better-run with wholly public production. In this essay, I do not attempt to develop the argument for public production in certain sectors but instead focus on a new stakeholder model for those sectors that are best privately operated.

Galbraith, referred to blocs of powerful actors that developed in response to strong corporations (Galbraith 1952). Nor would stakeholder governance and ownership necessarily mandate a certain kind of business decision: the “business judgment rule” would still hold, giving boards of directors legal authority to make a wide range of substantive decisions. This paper considers what types of countervailing power should be put into place *inside* the corporation, taking as a given the necessity for the development of external institutions of countervailing power, such as proper governmental regulation and broad-based social organizations, such as unions. But the internal structures within the corporation must not be ignored: stakeholder governance and ownership are needed to rebalance power among stakeholders. The rules that seem to mandate the sole, shortsighted focus on stock price must be rewritten so that other constituencies stop being sacrificed at the altar of shareholder wealth maximization.

The paper proceeds as follows: In Section 1, I describe the economic and legal theory that gave rise to shareholder primacy. In Section 2, I discuss the necessity to replace such theories with a model of stakeholder corporations. In Section 3, I propose policy reforms needed to put a model in place in the United States. Section 4 offers brief conclusions.

ECONOMIC AND LEGAL THEORIES OF SHAREHOLDER PRIMACY

The last one hundred years of economic and legal theories of the corporation have been a contest between shareholder primacy-- first based in theories of ownership and then, with the rise of the law-and-economics movement, in contractual and agency theory-- and stakeholder theory (Ireland 2001). In this section I develop the main arguments made by the most prominent proponents of shareholder primacy, leaving refutation and alternative proposals to the next section. The key argument for shareholder primacy is that shareholders have a meaningfully different relationship to the business corporation than all other corporate stakeholders, either because they are the true ‘owners’, or because they have an incomplete contractual relationship to the corporation while all other groups have complete contracts. Agency theory then builds on this conception of shareholders to argue that corporate management must be solely accountable to shareholders, and its interests must be aligned whether through carrot or stick incentives. I argue in the following section that instead shareholder primacy is best understood as a justification for continuing the economic authority of the investor class (Ireland 2001). But it is critical to lay out the arguments made by theorists of shareholder primacy in both law and economics, because many of their theories have been accepted without objection.

Early 20th and Mid-Century Corporate Governance

The early corporations were their own entities (Hockett and Omarova 2017). In the early Supreme Court case *Dartmouth College,* Chief Justice Marshall referred to corporations as "artificial beings, invisible [and intangible..[their] individuality as being evident in such features as its power to sue and amenity to suit and its durational existence defined without regard to the lives of its shareholders" (Millon 1990). Corporations had to be individually chartered by the state, making clear that these entities only existed because of such public permission, because they contributed positively to the economic development of the early United States. Corporations could forfeit their ability to operate if acted *ultra vires,* outside the bounds of the operating space that public permission had granted them (Talbot 2013).

The rise of trusts and other large corporations brought a surge of new scholarship at the beginning of the twentieth century, who sought to understand how large and complex corporations were similar and different from small, owner-managed firms that were the dominant form of business. Early scholars of the new industrial corporations were grappling with the rise of concentrated capital, and the concurrent spread of 'shareholder democracy' with the birth and subsequent crash of the stock market in 1929 (Ott 2011). Their points of departure varied, though all were writing against the backdrop of rising socialism and fascism, with the aim of preserving American market capitalism. Adolf Berle and Gardiner Means' *The Modern Corporation*, published in 1932, laid out for the first time the problem of "the separation of ownership and control"-- how to understand these new corporations in which the shareholders were not also the managers, and did not have the day-to-day authority over the activities of the business. They concluded that shareholders are the true owners of large corporations, and management must be forced, through carrot or stick, to maximize value for shareholders. A debate ensued between Berle & Means and legal scholar Merrick Dodd, who countered that managers were in fact trustees of the corporation itself--thus positing that the corporation had its own, separate identity-- with a mandate to balance the interests of multiple groups of stakeholders, including shareholders, employees, consumers, and the public (Dodd 1932). However, as Bratton and Wachter argue, Berle believed that corporations were creatures of the public interest, and in his later writings and counsel to FDR, he advocated that corporate leaders should "set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business" (Bratton and Wachter 2007, p. 145). Thus, even the original proponents for what we see today as an argument for shareholder dominance did not discard the notion of corporate social responsibility[3].

University of Chicago economists, working roughly concurrently to Berle & Means, focused on the economic theory for the firm's very existence. Ronald Coase, in his canonical article, *The Nature of the Firm*, published in 1937, took as his question not how was the large modern corporation different from small businesses of old, but instead why was there something called a "firm" in the first place, instead of all transactions occurring efficiently in the market. The "transaction cost" argument claims that firms exist because they provide a more efficient mechanism to reduce transaction costs in certain cases, because direct authority can reduce the costs of making decisions over and over again. The suppression of the price mechanism allowed resource allocation to take place under a central control (Coase 1937). This theory of firms as their own kind of efficient markets was the intellectual antecedent of the 'nexus of contracts' theory that developed later in the century, but the reality of how corporations operated in the postwar era did not align with theories of shareholder primacy.

As the dominance of large corporations grew in the 1950s and 1960s, corporations were run according to "managerialism": decisions were made by powerful managers, counterbalanced by strong labor unions, who exerted power over the terms and conditions of employment throughout the industrial economy (Pressman 2008). Shareholders earned dividends but exercised little daily over the corporation. John Kenneth Galbraith's *New Industrial State* (1967) argued that the modern corporation existed because of the need to plan and organize highly complex processes far into the future, without constant reference to market prices.[4] The short-termism so rampant today was not in operation; rather management and corporate success was in growing market share and profits.[5] Peter

[3] Late Berle exhibited even more of a move away from shareholder primacy: Why have stockholders? What contribution do they make, entitling them to heirship of half the profits of the industrial system ... ? Stockholders toil not, neither do they spin, to earn that reward. They are beneficiaties by position only. Justification for their inheritance must be sought outside of classic economic reasoning.286 (This is Berle in 1967, as quoted in Bratton & Wachter)

[4] The word 'planning' became tainted with a Soviet brush, and a good capitalist could no longer accept that a firm is a sphere of planning.

[5] Galbraith's *American Capitalism: Countervailing Power* lays out a model for why, despite great power, managerialism had not produced great executive malfeasance.

Drucker argued that shareholders should have economic rights to dividends based on their shareholding, but no governance authority over the firm (Drucker 1967). The dominant model of lifetime employment and steadily rising wages due to union bargaining power led to a compression in income inequality over the postwar decades (Piketty 2014). Ireland (2001) points out that ironically (due to what followed), prominent economists of the 1950s and 1960s assumed that shareholder dominance has ended, because of their dispersed nature and the power of managers and unions[6].

The Resurgence of Shareholder Primacy: The Corporate "Nexus of Contracts" and a Free-Market Theory of the Corporation

The 1970s marks a structural shift in the economy and in economics, as the crisis in profits prompted the rise of neoliberal economic ideology and policy-making power (Kotz 2015). The resurgence of shareholder primacy in the 1970s was in direct response to the dominance of managers in the 1960s (Hansmann and Kraakman 2000). Worsening economic conditions and the larger ideological shift to neoliberalism and markets as optimizers of social welfare transformed the theory of the corporation. Corporations were re-made to be understood as *markets themselves*, which automatically follow the "fundamental principle of maximizing behavior," (Jensen & Meckling 1976, p. 3). Relations among stakeholders are optimal because they maximize efficiency, transforming inputs into outputs and maximizing the present value of the firm. This transition went hand-in-hand with the broader rise of financialization and the conception of the business corporation as a collection of financial assets (G. Davis 2009; G. Krippner 2011).

The rise of the law-and-economics movement included a range of scholars who laid out new theories of the corporation that justified a sole focus on maximizing shareholder wealth. Henry Manne was one of the first to document the resurgent power of the shareholder class, by pointing attention to the power that the threat of hostile takeovers had on corporate management, claiming that this "held the key to true corporate democracy". Manne (1965) contested the idea that shareholders are tenuously connected to the firm and instead claimed that their ability to quickly sell shares is an important form of discipline on management--the "market for corporate control." Manne's 1965 paper laid out the argument that managers were mere agents to shareholders, and the efficiency of the firm was based

[6] According to Ireland (2001), "In the U.S., Berle began referring to the modern American business system as one of "People's Capitalism" or "Collectivism"36, while J.K.Galbraith talked of shareholders as vestigial, of the subservience of the corporation to society and the state, and of the supersession of the market."

on this ability of shareholders to discipline management who strayed from the goal of maximizing shareholder value. In 1970, Milton Friedman argued in a key New York Times piece, *The Social Responsibility of Business is to Increase its Profits,*

> "Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."

Economists and legal scholars built upon and formalized Friedman and Manne's arguments throughout the 1970s, developing what continues to be the mainstream economic analysis of the corporation today. Crucially, much of their analysis moved beyond the earlier idea that shareholders were owners, because shareholders clearly exercised none of the responsibilities that usually accompany ownership rights, as diversified shareholders were no longer directly involved with the firms whose shares they owned. Instead, this new cohort of economists built upon earlier theories to argue that corporations are "nexus of contracts (Jensen and Meckling 1976):" "it is important to recognize that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals."[7]

The corporation was re-defined as a marketplace where different contracts are freely made, not an entity in and of itself. As properly functioning markets are a priori assumed to be efficient-- allocating resources to those who desire them through the perfect response of supply and demand to the price mechanism--the power of shareholders to elect boards, or to throw them out, was assumed tautologically to be the most efficient structure for corporate governance (Campbell 1997). A corporation is merely rational individuals seeking to maximize their own utility and self-interest by bargaining for and thus creating a web of legal agreements, or contracts. The rights of individuals to the value created by the firm stems from these freely bargained-for contracts. As Armen Alchian and Harold Demsetz (1972) put it, "the firm has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between two people." As neoliberal

[7] Alchain and Demsetz made a similar argument, as did Eugene Fama: the corporation is "just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs".

economists remade the entire economy as an efficient market that optimizes outcomes, firms were theorized to be disciplined by competition in the product markets that simply combined inputs and output in a technologically feasible manner in order to maximize profits. Because the production process was essentially mechanical, where value was efficiently communicated through prices, the messiness of power dynamics was erased.

Shareholder Primacy and Agency Theory

Even with a “nexus of contracts,” there remained a question of why shareholders had exclusive control over governance. Agency theory claims that shareholders must control governance in order to discipline management into serving the interests of the shareholders, the principals, since otherwise management may have other interests, such that “his failure to maximize the value of the firm is perfectly consistent with efficiency” (Jensen and Meckling 1976, p. 2). An agency relationship is one in which principals engage agents to take action on the principles’ behalf in which some amount of authority is delegated to the agents. Agents do not automatically maximize the principles’ utility without some monitoring or fear of repercussion, leading to a welfare loss (a “residual loss ”) for the principal. If he (using this pronoun deliberately) buys a fancier-than-necessary computer for his office, he bears only some of the loss of profit; the shareholders bear the rest of the loss—that is their agency cost. What matters to managers is only their share in the wealth reduction—not all of the wealth lost. This requires the principals—here defined only as outside shareholders to monitor his behavior and induce him through various mechanisms to align his interests with that of his principals. Shareholder governance is justified because it reduces the transaction costs for the principal/ agent relationship (Talbot 2013).

Agency theory went further and claimed that everyone but shareholders is protected by contract, so shareholders, by virtue of the fact that they are the ‘residual claimants’ of corporate profits, must have exclusive control rights in order to induce them to put capital into the corporation (Easterbrook and Fischel 1991). Shareholders are in this way conceived of as needing more persuasion to optimally invest capital than employees are to invest their labor. The tautology is that every group has freely bargained for the rights that it has, therefore those rights are justified. The theory extends further and claims that shareholders do not even need to actually bargain for this authority over the firm--because this shareholder wealth maximization is what they would efficiently bargain for, the fact that they do not bargain is a further efficiency, reducing the transaction costs they would have otherwise spent on bargaining (Easterbrook and Fischel 1991). Limited liability and diversification also no longer undermines shareholders' claim to authority in the firm because it is necessary for shareholders to invest and thus also increases efficiency. Employees and other stakeholders have, under neoclassical theory, fixed claims on the firm, in the form of a wage, or an interest payment for a bondholder, or taxes for the government. Shareholders have the only "variable" claim that is left unfixed by corporate law. The purpose of corporate governance is simply to support these contractual free arrangements made between rational actors.

As managers have less of an ownership claim, they have less incentive to "devote significant effort to creative activities such as searching out new profitable ventures" (Jensen and Meckling 1976, p. 12) In part, this means that they may be more content to let worker wages rise to avoid strife in the workplace, since manager financial remuneration is not affected by higher costs: it is shareholders who lose out as employee costs rise. This can be interpreted as encouraging a "carrot" approach to minimizing agency costs rather than a stick approach, so that managers are positively incentivized to see firm profits rise. The problems of ownership and control are thus solved by solving the agency problem—ensuring that management has sufficient motivation and/ or fear of repercussion is focus exclusively on maximizing utility for shareholders, in the form of maximizing shareholder value.[8] But the rise of stock-based pay combined with broadly diversified institutional investors has resulted in executives and board members that are incentivized to increase stock prices regardless of the impact on longer-term shareholders; in other words, their accountability only runs to the activist investors, who do not necessarily have the interests of other shareholders in mind (Zingales 2017).

The rise of the law-and-economics movement meant that the corporation was thus bleached of politics. The concept of the free-market assumes the market brings efficiency; thus the notion that shareholder primacy could instead be a way in which the shareholders exert their influence at the expense of other corporate stakeholders does not enter into the theory. The magic of turning the corporation into something that's just like a market means that "conflicting objectives of individuals

[8] Other authors like Fama thought that managers would be disciplined by their own compensation incentives to ensure the firm's success, while Manne proposed that the 'market for corporate control'-- takeovers by other corporations-- would be enough to ensure that management works to maximize shareholder value. None questioned whether maximizing shareholder value was in fact the right goal for management.

are brought into equilibrium within a framework of contractual relations," (Jensen and Meckling 1976) because markets always efficiently tend towards equilibrium. This move replaces the corporation as a site of contribution and contestation by many stakeholders but that has some content itself with a market-based view: corporations do not exist and so all relations among corporate stakeholders are determined purely by market relationships (Millon 1990). The interests of other constituencies "should be protected by contractual and regulatory means rather than through participation in corporate governance" (Hansmann and Kraakman 2000). The economic efficiency of shareholder primacy was said to justify the "end of history" of corporate law, as shareholder primacy 'naturally' came to dominate all other corporate governance models (Hansmann and Kraakman 2000).

THE ECONOMIC THEORY OF STAKEHOLDER CORPORATIONS

Although the intellectual justifications for shareholder primacy were broad, the resurgence of their power can also be read simply as a re-assertion by the class who could afford to own shares of their right to capture the profits of the firm (Ireland 2001). As the economy entered the 1980s, the coalition of scholars and policymakers who shaped the neoliberal era put considerable emphasis on remaking the corporation to justify shareholder primacy. At issue was to whom the profits of the corporate would flow.

In this section, I argue that shareholder primacy should be replaced with a stakeholder model of the corporation, with several related claims: corporations are social institutions, not "nexus of contracts;" shareholders are not unique risk-takers (or owners); and workers, along with other stakeholder groups, take risks and contribute value to corporate outcomes. The following section will pick up on this analysis and propose specific policy reforms for instituting stakeholder corporate policies. In what follows, I focus on employees as the key group of stakeholders who should be engaged, along with shareholders, in corporate governance and ownership. Future research must consider how and whether other sets of stakeholders should be engaged.

CORPORATIONS ARE ECONOMIC AND SOCIAL INSTITUTIONS, NOT "NEXUS OF CONTRACTS"

Corporations are not simply "nexus of contracts": first, they must have public permission to operate, and thus this market institution is state-constituted; second, they require strategy, organization and finance to actually be innovative enterprises (Lazonick 2014); and third, as a legal matter, corporations are their own separate entities from the human persons who interact with them (Stout 2012). It is foundational to understand that markets are made-- in this case, private corporations exist as entities where multiple stakeholder groups interact because of state "enforcement of norms and requirements." (Talot 2011). As explained by economist William Lazonick's *Theory of the Innovative Enterprise,* shareholder primacy lacks a theory of how corporations actually produce: what causes them to come up with new ideas for products, new marketing strategies, or new means of using resources. No corporation develops new goods and services simply because shareholders buy its equity on the secondary markets. Corporations require strategy, organization, and finance, which depends on a multitude of stakeholders interacting over time to innovate: in other words, produce higher-quality goods and services at lower costs (Lazonick 2017).

The "nexus of contracts" argument ignores the reality that the corporation is its own institution, separate from the stakeholders who contract with each other for various economic transactions. The corporation is not just a "legal fiction," it is a legal *person*, with its own rights (Greenfield 2018). As legal scholar Lynn Stout describes it, "corporations own themselves" (Stout 2012). The very fact that normal individuals part with their hard-earned money and buy corporate shares is because they are protected from taking on the larger risks that come along with running a complex business: those risks and liability for problems created stay within the corporation itself.

SHAREHOLDERS AS *RENTIER* INVESTORS

In order to move on from shareholder primacy, it is important to be clear about the actual relationship that shareholders to the corporation. In this section I describe the role of the shareholder as an investor and the type of risk that shareholders actually take. The paradox of shareholders is that they are the corporate stakeholders with both the most and the least power. No less than Eugene Fama called out the notion that shareholders had a stake in a particular company as "absurd" under portfolio theory (Fama 1980). As noted above, shareholder primacy rests on two different kinds of claims: that shareholders are owners, or that shareholders are the corporate constituent with the 'incomplete contract', thus due control rights because everyone else's contracts are best negotiated outside the realm of the corporation. The shareholders who do have power today are the minority shareholder 'activists,' who have leveraged the massive holdings of institutional investors to exercise actual power over boards and corporations, and the private equity funds that take over companies to extract wealth regardless of the impact on future productivity-- the opposite of what an owner is supposed to do (Shin 2018). Notwithstanding these two groups, retail shareholders-- middle-class families invested through 401(k)s or mutual funds-- do not actually exercise control over corporations, nor do they know which corporations they invest in.

Corporate law took the form it did not because shareholder primacy leads to the most efficient market-based outcomes, but because of the political, economic and social dominance of the shareholder class (Ireland 2001). In partnerships, shareholders remain active participants in the business. As the corporate form was established, shareholders were "no longer .. conceptualized as industrial capitalists, as active asset-owning partnership; they were, rather, conceptualized as passie, money-providing 'investors, as money capitalists, owners of income rights external to the company and the process of production" (Ireland 2010). As Paddy Ireland (2010) has argued, "the triumph of the corporate legal form was more the product of the growing political power and needs of *rentier* investors than it was of economic imperatives." The explanation for the introduction of free incorporation and general limited liability and the gradual development of the modern corporate legal form is to be found not in the needs of industry but in the needs of finance (Lazonick 2017). Their emergence is inextricably linked to the rise of the rentier investor.

The ordinary meaning of ownership, as used in Berle & Means, is that the shareholder was like the captain at sea: management plotted the course and steered the ship, but the owner put up the capital and knew that the ship was setting off (Berle and Means 1932). In their words, the direction of the vessel was set by and could only be altered "by the persons having the underlying property interest." This presumes some awareness that the sea is out there and that there is a voyage to be undertaken. None of this makes sense anymore in the context of how we participate in the capital markets. Ownership is held because of some kind of direct investment of funds. What they largely have not done is contributed directly to the corporation's capital-- most shareholders today are *traders*, buying and selling shares from each other, not initial investors in a company's IPO.

Even when most firms go public, they do not do it because they need investment capital, they do it to pay back their initial, private investors (Lazonick 2017). (This reality is different from when Berle & Means first laid out their argument-- In Berle & Means' time, the bulk of corporate growth came from new issuances of stock, which they theorized kept management accountable to suppliers of capital, who they depended on for future growth.) These traders-- those holding corporate stock in a retirement portfolio, for example-- do not think of ourselves as 'owners.' The fact that ownership of corporate shares is intermediated through a very long chain of financial investors, whose interest is often to earn fees through trading volume rather than sustainable growth of corporate wealth, means that retail shareholders are even further cut off from business decisions. The whole point of the corporation is that no humans have liability for its debts or other affairs: the assets and liabilities of the corporation cannot be passed through to the human decision-makers (without 'piercing the corporate veil' because of malfeasance, etc.). So the same way that a creditor could be thought of as having a claim for some collateral for a secured loan, for example, shareholders have a claim for dividends that relate to their holdings. Corporate assets are distinguishable from corporate stock ownership—corporate assets cannot be owned by shareholders (Ciepley 2013).

The later justification for shareholder primacy is that shareholders are the only stakeholder in the corporation with incomplete contracts. Shareholders in the public markets do have a contract in the economic sense: they have the ability to sell their shares, to receive any of the dividends that the corporation declares, or otherwise hold on to their share for as long as they like. Risk is managed through diversification, not through exercising ultimate control over the board of directors and its decision-making. The claim that shareholders have the most risk lumps together diversifiable and undiversifiable risk (Greenfield 2005).

A shareholder of a large public corporation today is not generally taking a risk on the profitability of a given firm. Instead, they are a diversified investor, who scarcely notices the rising and falling particular share price of a given company, because they have reduced their risk by holding a broad cross-section of the market. Of course, they still take a risk that the entire market will fall (as happened in

2009), and that they will not be able to sell their investment when they need to— that liquidity will be low. But they are not the only one taking a risk, and concluding that their risk is different in kind from the risk an employee or bond holder takes no longer makes sense, if it ever did. As even Berle and Means noted, security holders “may be regarded as a hierarchy of individuals, all of whom have supplied capital to the enterprise, and all of whom expect return from it.”

The argument for stakeholder corporations still includes shareholders as one key corporate constituency-- the one who provides liquidity for the corporation’s shares in the capital markets, or who owns a share and the economic and governance rights that come along with it in a private company. Peter Drucker, business guru of the mid-20th-century, argued that shareholders should have economic rights to the gains from dividends or capital gains from the sale of their shares, but no governance authority over the firm whatsoever. The key is that their control is no longer total.

EMPLOYEES AS CO-EQUAL STAKEHOLDERS

In the neoliberal firm, employees are theorized to make no investments that are specific to their employer (Fauver and Fuerst 2004). Employees are costs, or “commodities to be purchased” (Bodie 2016). They hold a completely transferable contract, or at least an incomplete contract in which it is up to them when to exit the firm and easily find new employment. Employees have a fixed claim to remuneration, as opposed to shareholders’ variable claim, in which there is no variation for employees based on the relative success of the corporation.

To give an accurate picture of how corporations actually function, It is necessary to understand employees as making firm-specific investments in the corporation, in which their undiversified risk makes them more deserving of a role of governance than shareholders, not less. Workers-- both legal employees and, in many cases, independent contractors--make a deep investment in the corporation that is not diversified, which depends on the profitability of the corporation (Greenfield 2005; McDonell 2011). Employees must make firm-specific investments to be successful at work, from learning firm-specific production processes to finding ways to please a difficult boss. Employees’ firm-specific investment also is a key driver of improving firm productivity over time. Employees have highly undiversified risk in the corporation where they work, and face significant hardship if their employer shuts down or leaves the country. It is clearly much harder to go on unemployment, relocate, or go back to school for new skills if employment ends than for a shareholder to sell shares out of a diversified portfolio. Clearly there are some shareholders who are also highly un-diversified, such as relatively non-wealthy shareholders who hold the majority of their shares in one particular firm. But the vast majority of shareholders of publicly-traded firms today have well-diversified portfolios. Most employees, however, still hold only one job. Even more, as health care and retirement benefits are structured often as employment benefits, employees' dependence on the success of the firm runs even deeper than income compensation.

One common pro-shareholder argument is that employees' relation to the corporation is best handled outside of corporate law, and instead through labor law, specifically the National Labor Relations Act. Unions play a separate role, and an important one, in allowing employees to collectively bargain for the terms and conditions of their employment, which would not be the role of employee representatives on the board of directors. Under labor law, unions do not bargain over how the business conducts its affairs-- the "core of entrepreneurial control" is limited to management (Bodie 2016)[9]. Bargaining is focused on the all-important questions of dignity and respect at work, expressed through wages, benefits, and working conditions-- but even with a strong union, employees do not have a collective means to weigh in on fundamental corporate decisions, even though they may have a majority of the knowledge that should go into such decisions. Thus, even in an economy with much more significant labor union density, worker representation on boards plays a separate and critical role. Current practice is for boards of directors and corporate executives to nominate new directors exclusively. This leads to compensation negotiations between executives and hand-picked board members, which is at least in part responsible for rising executive compensation. Employee representation on boards could change the norms towards the consideration of the contributions and the interests of shareholders, management, and employees (Bodie 2016). Other forms of employment law-- instituting minimum wages, protecting against harassment at work, or guaranteeing wage

[9] Bodie (2016) describes the limits of collective bargaining clearly: "Bigger issues such as product development, executive compensation, financial structuring, and internal firm governance are not within the ambit of the union's responsibilities or concerns, and the employer has no duty to discuss such issues.95 The idea that the "core of entrepreneurial control"96 is reserved to the employer itself is central to the federal system of collective bargaining...Plus, the union may not insist on talking about these issues, either; to do so would be a failure to bargain in good faith."

payment and in some cases other benefits-- do not create any right to participate in profits or in any form of governance-- profit participation is entirely voluntary.

Besides investor-shareholders and employees, there are many other groups of stakeholders that can be thought of as contributing to corporate success. The question is how to properly draw lines around different groups, and how to fairly ensure representation of groups that are more amorphous than either employees or shareholders. It may be that not all stakeholders should have an equal role in governance. Employees and shareholders may be properly thought of as contributing more than stakeholders that are more removed from regular firm activities. However, both customers and the community, whether narrowly or broadly defined, are contributors to corporate success and impacted by corporate decision-making. Further research must be devoted to analyzing the specific role of customers and community in stakeholder corporations.

POLICIES FOR STAKEHOLDER CORPORATIONS

In order to implement the stakeholder corporate model, two areas of reform are needed: instituting a stakeholder corporate governance model, and creating employee ownership trusts. In this section I discuss specific policy reforms for the United States in each area in turn. To repeat, I focus here on the argument for workers as co-equal stakeholders, but the arguments for stakeholder governance apply to stakeholders beyond workers (and such arguments are worthy of further research and discussion).

STAKEHOLDER GOVERNANCE

Policy reforms are available that can replace shareholder primacy with a new stakeholder corporate model in the United States. Specifically, I propose four legislative reforms: boards of directors should be accountable to all stakeholders, not just shareholders, necessitating a new understanding of board "fiduciary duty"; corporate purpose statements should include a requirement that corporations positively benefit society; multiple stakeholders should elect and be represented on corporate boards; and large corporations should be required to charter federally, in order to enable the substantive reforms[10].

In the United States, corporate law is state law: incorporation is accomplished at the state level, and the “internal affairs doctrine” allows corporations to choose a state for incorporation that is not otherwise tied to their business activities, and to have their corporate internal affairs governed by that state’s rules. Practically, this has meant that for large corporations, Delaware has become the state of choice, due to its historical offerings of very business-friendly corporate law (Greenfield 2005). This means it would be politically very difficult to reform corporate law at the state level, as all it would take is one state to stick with shareholder primacy and corporations could in theory all shift their incorporation to that state in order to avoid stakeholder governance requirements.

The first critical substantive reform is to require boards of directors to be accountable to all corporate stakeholders, instead of shareholders, for all the reasons enumerated above. This does not proscribe a certain kind of decision or outcome, nor does it specify how boards should balance the different interests of stakeholders. For this reason, some will see this as weak reform. However, it is a necessary but not sufficient change in the responsibilities of boards, because it takes away the ability of boards to hide their decisions to pay out billions in stock buybacks while firing employees, for example, behind the excuse that their only consideration is to shareholders. More positively, it would incentivize boards made up of individuals from multiple stakeholder groups the ability to weight the impacts of major corporate decisions on all groups at the table. Courts would still adjudicate board decisions using the business judgment rule, meaning that judges do not rule on the substance of decisions (in the absence of fraud or malfeasance), but do look to see if the board followed proper procedural consideration. Critically, boards would therefore need to show evidence that they had taken the interests of multiple groups of stakeholders into account.

Stakeholders must have a voice in the governance of the corporation: they should participate in electing the board of directors. The board is the ultimate decision-making authority: hiring and firing

[10] An alternative would be to abolish the “internal affairs” doctrine and institute a “real seat” doctrine in which corporations are governed by the laws of the state where they are headquartered or conduct their business affairs, and then work to change law state-by-state.

the chief executive, making major financial decisions, and bearing legal responsibility for the affairs of the corporation. As argued above, employees and other corporate stakeholders play a critical role in the success of business corporations. Firms could not function without employees, customers, suppliers, or the broader public's role in ensuring the institutional framework for success. Just as in the broader political community, all those who are affected by the decisions of an institution and contribute to its success should have voice in its governance. Employee representation and participation on the board of directors is essential for rebalancing power within corporate governance (McDonnell 2011).

Corporations, granted public permission to operate, should be held to a standard of contributing positively to society. What this means pragmatically is that they should be held responsible for the creation of negative externalities, such as climate change, that they are part of creating but are not held responsible for. Currently, corporate purpose statements on corporate charters are simply that companies will stay within the bounds of the law, but there is no additional requirement. Benefit corporations commit to a corporate purpose statement that they will create a materially positive benefit on society. Significant questions about how this would be adjudicated remain. What level of materially positive benefit is required? Who can bring a claim that a company is not living up to this standard? However difficult to answer these questions may be, leaving them unasked poses greater risks to the economy and society.

EMPLOYEE OWNERSHIP TRUSTS

A second area for policy reform is to broaden share ownership to include workers. Employee ownership creates an economic right to a share of profits when businesses do well, as well as a voice in making the major decisions of the corporation. Corporate law should require that corporations grant equity shares of the corporation to their employees, in a collectively-held trust, in order to recognize employees as crucial stakeholders in the creation of value. Granting employees equity shares would mean that when corporate executives decide on the level of dividends paid out to investors, the people who actually create the company's value share in the rewards

“Employee ownership” is a tricky concept because other shareholders are not truly owners in the everyday sense of the word: corporations, as a legal matter, own themselves. Employee ownership refers to the ownership of shares of the corporation, not unlimited rights to the corporation itself. Along with the ownership of a share comes the right to receive a portion of the profits-- the dividends-- if the company’s management chooses to pay out some portion of the profit to shareholders. Less tangibly, employee ownership gives workers the ability to vote for the company’s board of directors and other major decisions that the company’s shareholders traditionally make.

The employees that currently own shares where they work are the top employees. CEO ‘equity-based compensation,’ or compensation that is tied to share prices in some way, has risen dramatically as policymakers sought to incentivize management to keep shareholder reward as their north star by linking their pay to shareholder value. Policy could establish the norm that all employees in large corporations participate in equity ownership through employee ownership trusts. Once funds are in a trust, then the shares are not available to be resold. The stakes are not a wealth asset that is freely transferable by the employee, and indeed the employee does not have to purchase the stake, and so they cannot sell the stake when they leave employment. Rather, they are granted an ownership stake in the employee collective trust, and their stake remains in the trust when they move to a different job. What they have as a result of the ownership stake is the right to receive economic dividends-- a share of profits- and the right to engage in the governance of the firm. This would complement representation on the board and the shift in the board’s fiduciary duty described above.

This collective determination of governance is crucial. The workers’ assets would vote in a bloc, not as fragmented share. This would require the development of democratic mechanisms within the trust to ensure that the trustees do not blindly promote their own agenda to the detriment of the goals of the entire workforce. Acting together, the trust would serve as a way for employees to directly engage in the business affairs of the corporation as a stakeholder, participating in the big decisions that determine their futures. Under U.S. law, negotiations between labor unions and corporate management cannot touch on business decisions--instead discussion is limited to the terms and conditions of employment. This has locked U.S. workers out of collaborative participation in improving business productivity. By engaging as owners of shares, employees will have the same rights to weigh in as investors do today- in mergers and acquisitions, liquidation, and electing the individuals who make the other major decisions-- the board of directors.

CONCLUSIONS

Certainty is elusive: A transition to stakeholder corporations does not guarantee that we can solve some of our most pressing issues, including climate change or inequality. Because the business judgment rule would still hold, there can be no assumption that any business outcomes would automatically change. However, a change in the balance of power among the main decision-making body, and a change in the requirements for what corporate leaders must consider when making decisions, allows us to project the kinds of decisions that could turn out differently and draws initial conclusions about how society could be impacted (Bodie 2016). The analysis of the corporation as a "nexus of contracts" must be replaced with a more appropriate understanding of how corporations operate and how they create value. Only then can economic and legal theory support the functioning of a productive and prosperous economy and society.

REFERENCES

Board of Governors of the Federal Reserve System. 2019. “Distributional Financial Accounts.” Updated March 22, 2019. https://www.federalreserve.gov/releases/efa/efa-distributional-financial-accounts.htm

Alchian, Armen and Harold Demsetz. 1972. “Production, Information Costs, and Economic Organization.” The American Economic Review 62, no. 5: 777-795.

Berle, Adolf and Gardiner Means. 1932. The Modern Corporation. London, UK: Routledge.

Bodie, Matthew. 2016. “Income Inequality and Corporate Structure.” Saint Louis School of Law Legal Studies Research Paper Series No. 2015-6. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2747429

Bratton, William and Michael Wachter. 2008. “Shareholder Primacy’s Corporatist Origins: Adolf Berle and the Modern Corporation.” Journal of Corporation Law 34: 99. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1021273

Ciepley, David. 2013. “Beyond Public and Private: Toward a Political Theory of the Corporation.” American Political Science Review 107, no. 1. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2484826

Dallas, Lynne. 2017. “Is There Hope for Change? The Evolution of Conceptions of 'Good' Corporate Governance.” San Diego Law Review 54, no.3. https://ssrn.com/abstract=3026266 or http://dx.doi.org/10.2139/ssrn.3026266

Dodd, Merrick. 1932. “For Whom Are Corporate Managers Trustees?” *Harvard Law Review*45, no. 7 (May):1145-1163. https://www.jstor.org/stable/1331697?seq=1#page_scan_tab_contents

Drucker, Peter. 1967. “The Effective Decision.” Harvard Business Review. https://hbr.org/1967/01/the-effective-decision

Easterbrook, Frank and Daniel Fischel. 1991. Economic Structure of Corporate Law. Cambridge, MA: Harvard University Press. https://www.amazon.com/Economic-Structure-Corporate-Law/dp/0674235398

Fama, Eugene. 1980. "Agency Problems and the Theory of the Firm." Journal of Political Economy 88: 288. https://pdfs.semanticscholar.org/0911/d3805b290d1618ed900d3ba4772bc6b35879.pdf

Fauver, Larry and Michael Fuerst. 2006. “Does good corporate governance include employee representation? Evidence from German corporate boards.” Journal of Financial Economics 82, no. 3:673-710. https://www.sciencedirect.com/science/article/pii/S0304405X06001140

Friedman, Milton. 1970. “The Social Responsibility of Business is to Increase its Profits.” The New York Times Magazine, September 13, 1970. http://umich.edu/~thecore/doc/Friedman.pdf.

Galbraith, John Kenneth. 1952. American Capitalism: The Concept of Countervailing Power. London, UK: Routledge.

Galbraith, John Kenneth. 1967. New Industrial State. Princeton, NJ: Princeton University Press.

Greenfield, Kent. 2006. The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities. Chicago,IL: University of Chicago Press.

Hansmann, Henry and Reinier Kraakman. 2000. “The end of history for Corporate Law.” Geo. L.J. 89: 439. https://heinonline.org/HOL/LandingPage?handle=hein.journals/glj89&div=20&id=&page=&t=1560796617

Hockett, Robert C. and Omarova, Saule T.. 2016. “The Finance Franchise.” Cornell Legal Studies Research Paper No. 16-29. http://dx.doi.org/10.2139/ssrn.2820176

Holmberg, Susan. 2017. “Fighting Short-Termism with Worker Power.” The Roosevelt Institute. http://rooseveltinstitute.org/wp-content/uploads/2017/10/Corp-Gov_FINAL.pdf.

Holmberg, Susan. 2018. “Who Are the Shareholders?” The Roosevelt Institute. http://rooseveltinstitute.org/who-are-shareholders/.

Ireland, Paddy. 2001. “Defending the Rentier: Corporate Theory and the Reprivatization of the Public Company.” in The Political Economy of the Company, edited by John Parkinson, Andrew Gamble, and Gavin Kelly. Hart, Oxford, pp. 141-173.

Jackson, Gregory. 2010. “Understanding Corporate Governance in the United States.” Hans Bockler Stiftung Working Paper. https://econpapers.repec.org/paper/zbwhbsarb/223.htm

Jensen, Michael, and William Meckling. 1976. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” Journal of Financial Economics, no. 4 (October): 305-360. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043

Kotz, David. M. 2015. The Rise and Fall of Neoliberal Capitalism. Cambridge, MA: Harvard University Press.

Krippner, Greta R. 2011. Capitalizing on Crisis: The Political Origins of the Rise of Finance. Cambridge, MA: Harvard University Press.

Lazonick, William. 2017. “Innovative Enterprise Solves the Agency Problem.” Institute for New Economic Thinking https://www.ineteconomics.org/research/research-papers/innovative-enterprise-solves-the-agency-problem.

Lazonick, William. 2014a. “Innovative Enterprise & Shareholder Value.” The Academic-Industry Research Network. AIR Working Paper no. 14-03/01. https://www.theairnet.org/files/research/WorkingPapers/Lazonick_InnovativeEnterpriseandShareholderValue_AIR-WP14_0301.pdf.

Lazonick, William. 2014b. “Profits Without Prosperity.” Harvard Business Review. September. https://hbr.org/2014/09/profits-without-prosperity

Manne, Henry. 1965. “Mergers and the Market for Corporate Control.” The Journal of Political Economy 73, no. 2:110-120. https://are.berkeley.edu/~cmantinori/prclass/Manne.pdf

McDonell, Brett. 2011 “Strategies for an Employee Role in Corporate Governance.”Wake Forest Law Review 46: 429. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1986916.

Millon, David. 1990. “Theories of the Corporation.” Duke Law Journal: 201-262. https://scholarship.law.duke.edu/dlj/vol39/iss2/2

Ott, Julia. 2011. When Wall Street Met Main Street. Cambridge, MA: Harvard University Press.

Piketty, Thomas. 2014. Capitalism in the 21st Century. Cambridge, MA: Harvard University Press.

Pressman, Steven. 2008. “John Kenneth Galbraith and the Post Keynesian Tradition in Economics.” Review of Political Economy 20, no. 4: 475-489. https://www.tandfonline.com/doi/abs/10.1080/09538250802354616

Shin, Jang-Sup. 2018. “The Subversion of Shareholder Democracy and the Rise of Hedge-Fund Activism.” INET Working Paper. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3226103

Stout, Lynn. 2012. The Shareholder Value Myth. Oakland, CA: Berrett-Koehler Publishers.

United States. Cong. Senate. The Accountable Capitalism Act of 2018. 115th Cong. 2nd sess. S. 3348. Washington: Office of Senator Warren. https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act. pdf.

Talbot, Lorraine. 2013. Progressive Corporate Governance for the 21stCentury. Oxford, UK: Routledge.

Weil, David. 2014. The Fissured Workplace: Why Work Became So Bad for So Many and What Can Be Done to Improve It. Cambridge, MA: Harvard University Press.

Wolff, Edward N. 2017. “Household Wealth Trends in the United States, 1962-2016: Has Middle Class Wealth Recovered?” NBER Working Paper No.24085.http://www.nber.org/papers/w24085.pdf.

Wolff, Edward. 2018. “The Decline of African-American and Hispanic Wealth Since the Great Recession.” NBER Working Paper No. 25198. https://www.nber.org/papers/w25198

Yosifon, David. 2018. Corporate Friction: How Corporate Law Impedes American Progress and What to Do About It. New York, NY: Cambridge University Press.

Zingales, Luigi. 2017. “Towards a Political Theory of the Firm.” Journal of Economic Perspectives, 31, no. 3:113-30. https://www.aeaweb.org/articles?id=10.1257/jep.31.3.113