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The Uneasy Case for Favoring Long-Term Shareholders

Law Working Paper N° 200/2013
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Abstract

This Article challenges a persistent and pervasive view in corporate law and corporate governance: that a firm's managers should favor long-term shareholders over short-term shareholders, and maximize long-term shareholders' returns rather than the short-term stock price. Underlying this view is a strongly held intuition that taking steps to increase long-term shareholder returns will generate a larger economic pie over time. I show, however, that this intuition is flawed. Long-term shareholders, like short-term shareholders, can benefit from managers' destroying value, even when the firm's only residual claimants are its shareholders. Indeed, managers serving long-term shareholders may well destroy more value than managers serving short-term shareholders. Favoring the interests of long-term shareholders could thus reduce, rather than increase, the value generated by a firm over time.

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THE YALE LAW JOURNAL

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ABSTRACT. This Article challenges a persistent and pervasive view in corporate law and corporate governance: that a firm's managers should favor long-term shareholders over short-term shareholders, and maximize long-term shareholders' returns rather than the short-term stock price. Underlying this view is a strongly held intuition that taking steps to increase long-term shareholder returns will generate a larger economic pie over time. I show, however, that this intuition is flawed. Long-term shareholders, like short-term shareholders, can benefit from managers' destroying value—even when the firm's only residual claimants are its shareholders. Indeed, managers serving long-term shareholders may well destroy more value than managers serving short-term shareholders. Favoring the interests of long-term shareholders could thus reduce, rather than increase, the value generated by a firm over time.

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ARTICLE CONTENTS

INTRODUCTION 1558

I. SHORT-TERM VERSUS LONG-TERM SHAREHOLDERS: THE CONVENTIONAL VIEW 1568
- A. The (Undesirable) Interests of Short-Term Shareholders 1568
- B. The (Desirable) Interests of Long-Term Shareholders 1569
- C. Policy Proposals To Favor Long-Term Shareholders 1571
  1. Enhanced Voting and Control Rights 1572
  2. "Loyalty" Shares and Dividends 1573
  3. Tilting the Tax System To Favor Long-Term Shareholders 1574
  4. Summing Up 1575

II. ANALYTICAL BUILDING BLOCKS 1576
- A. Policy Goal: Maximizing Economic Value 1576
- B. Shareholders' Objectives 1578

III. LONG-TERM SHAREHOLDER RETURNS IN A NON-TRANSACTING FIRM 1579
- A. Framework of Analysis 1579
- B. Long-Term Shareholders' "Better" Interests 1581
  1. Short-Term Shareholders 1581
  2. Long-Term Shareholders 1584

IV. LONG-TERM SHAREHOLDER RETURNS IN A REPURCHASING FIRM 1585
- A. The Widespread Use of Repurchases 1585
- B. Analytical Framework: Decoupling Effect of Share Repurchases 1587
- C. Bargain Repurchases 1589
  1. Economic Logic 1589
  2. Evidence of Bargain Repurchases 1590
     a. What Executives Say and Do 1590
     b. Post-Repurchase Stock Returns 1592

V. DESTROYING VALUE IN A REPURCHASING FIRM TO BOOST LONG-TERM SHAREHOLDER RETURNS 1593
- A. Costly Contraction 1594

Electronic copy available at: https://ssrn.com/abstract=2227080

1. How Inefficient Capital Allocation Can Benefit Long-Term Shareholders 1594
2. Must Economic Value Be Sacrificed To Engage in Bargain Repurchases? 1596
B. Costly Price-Depressing Manipulation Around Bargain Repurchases 1597

VI. LONG-TERM SHAREHOLDER RETURNS IN AN ISSUING FIRM 1599
A. Widespread Use of Equity Issuances 1600
1. Acquisition-Related Issuances 1600
2. Seasoned Equity Offerings 1601
a. Firm-Commitment SEOs 1601
b. At-The-Market Offerings 1601
B. Analytical Framework: Decoupling Effect of Equity Issuances 1603
C. Inflated-Price Issuances 1605
1. Economic Logic 1605
2. Evidence of Inflated-Price Issuances 1606

VII. DESTROYING VALUE IN AN ISSUING FIRM TO BOOST LONG-TERM SHAREHOLDER RETURNS 1608
A. Costly Expansion 1608
1. Economic Logic 1609
2. AOL-Time Warner Transaction 1609
3. Must Value Be Destroyed To Issue Overpriced Equity? 1611
B. Costly Price-Boosting Manipulation Around Inflated-Price Equity Issuances 1613
1. Economic Logic 1613
2. Evidence of Costly Price-Boosting Manipulation Around Equity Issuances 1614

VIII. WHEN IS FAVORING LONG-TERM SHAREHOLDERS UNDESIRABLE? 1616
A. Volume of Repurchases and Equity Issuances 1617
1. Can Rarely Transacting Firms Be Identified Ex Ante? 1618
2. Should Firms Be Prohibited from Transacting in Their Own Shares? 1618
B. Managers' Ability To Exploit Information Asymmetry via the Firm 1619
C. The Difficulty of Engaging in Costly Price Manipulation 1620

IX. FURTHER CONSIDERATIONS IN ASSESSING THE DESIRABILITY OF FAVORING LONG-TERM SHAREHOLDERS 1621
A. Non-Shareholders as Residual Claimants 1622
B. Managerial Agency Costs 1625
C. It's Still an Uneasy Case 1626

CONCLUSION 1626

Electronic copy available at: https://ssrn.com/abstract=2227080

Electronic copy available at: https://ssrn.com/abstract=2227080

INTRODUCTION

This Article questions a persistent and pervasive view about the proper objective of corporate governance: that managers should favor long-term shareholders over short-term shareholders and aim to increase long-term shareholder value rather than the short-term stock price. This view is widely shared by leading academics, executives, corporate lawyers, and judges.[1] It is also at the heart of recent reform proposals—in the United States, the United Kingdom, and elsewhere—to give long-term shareholders more power over public companies.[2]

The persistence of this view derives from a widely held and appealing intuition: because managers serving short-term shareholders may destroy economic value to boost the short-term stock price, managers serving long-term shareholders will necessarily generate more economic value over time (a bigger "pie"). The problem with this intuition is that it is wrong, at least for the typical U.S. firm that transacts in (buys and sells) a large volume of its own shares.[3] Yes, managers serving short-term shareholders might destroy economic value to boost the short-term stock price. But in a transacting firm, managers serving long-term shareholders might also destroy economic value to boost the long-term stock price. In fact, long-term shareholders may well benefit more from value destruction than will short-term shareholders. Therefore, favoring long-term shareholders in the typical firm could, paradoxically, reduce the size of the pie created by the firm over time.

A firm's directors and CEO (collectively, its "managers") have at least some incentive to serve shareholders' interests, even if they are not completely faithful agents of the firm's shareholders. How managers respond to this incentive will depend, in part, on shareholders' time horizons. If short-term investors exert greater influence on managers than do long-term shareholders, then managers can be expected to focus on increasing the short-term stock price rather than long-term shareholder value. If long-term shareholders are more powerful than short-term shareholders, then managers can be expected to focus less on the short-term stock price and more on increasing long-term shareholder returns.[4]

1. *See infra* Part I.B.

2. *See infra* Part I.C.

3. *See infra* Parts IV.A, V.A (describing the extent to which firms buy and sell their own shares).

4. For example, directors can be expected to design executive compensation arrangements that reflect the objectives of the firm's most powerful shareholders. If short-term shareholders dominate, pay arrangements can be expected to reward executives for boosting the short-

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Much attention has been focused on the potential problems that can arise when a firm's investor base consists largely of short-term shareholders.[5] In particular, managers seeking to serve short-term shareholders may engage in "short-termism": taking steps that boost the short-term stock price but reduce the economic value created by the firm over the long term. The cost of short-termism is borne by other parties, including long-term shareholders (if any) and future shareholders who purchase shares in the short term.[6]

Short-termism has long been considered a major problem for publicly traded U.S. firms. For decades, legal academics,[7] business school professors,[8] executives,[9] and corporate lawyers[10] have decried the potentially perverse interests of short-term shareholders. The recent financial crisis, which many blame on the influence of short-term shareholders, has renewed and intensified criticism of these investors.[11]

While short-term shareholder interests are roundly criticized, the interests of long-term shareholders are generally all but put on a pedestal. Legal academics[12] and business school professors[13] urge managers to ignore the short-

term stock price. If long-term shareholders dominate, pay arrangements can be expected to reward executives for boosting long-term metrics.

5. *See infra* Part I.A.

6. *See infra* Part III.B.1.

7. *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 696-703 (2010) (arguing that short-term shareholder influence has pernicious effects).

8. *See, e.g.*, Justin Fox & Jay W. Lorsch, *The Big Idea: What Good Are Shareholders?*, HARV. BUS. REV., July-Aug. 2012, at 48 (criticizing the harmful influence of short-term shareholders in U.S. firms); Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.-Oct. 1992, at 65, 66-68 (similar).

9. *See, e.g.*, Bus. & Soc'y Program, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*, ASPEN INST. (Sept. 9, 2009) [hereinafter ASPEN INSTITUTE], http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf [http://perma.cc/QT3H-8RH5] (report critical of short-term shareholders signed by Berkshire Hathaway CEO Warren Buffett and other leading executives).

10. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) (noting that short-term shareholders tend to push companies to take steps that will result in a quick profit, which may come at the expense of economic value creation).

11. *See, e.g.*, Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265 (2012).

12. *See* John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1444, 1484 (1994) (arguing that managers should focus their efforts on maximizing value for long-term shareholders); *cf.* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Gov-*

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term stock price and focus on maximizing value for long-term shareholders.[14] Henry Hansmann and Reinier Kraakman have gone so far as to say a decade ago that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[15] Managers, in turn, appear to have accepted the norm of maximizing long-term shareholder value.[16]

However, even managers who wish to serve long-term shareholders may believe that short-term shareholder pressure prevents them from doing so. Consequently, policymakers are considering various types of proposals to increase the power of long-term shareholders in public companies relative to the power of short-term shareholders.[17] One set of proposals aims to give long-term shareholders more voting rights in the firm.[18] Another set of proposals

ernance, 97 NW. U. L. REV. 547, 573 (2003) (arguing that directors are "obliged to make decisions based solely on the basis of long-term shareholder gain").

13. Porter, *supra* note 8, at 79 (calling for long-term shareholder value maximization to "be identified as the explicit corporate goal").

14. Delaware judges also appear to believe that managers should serve long-term shareholders rather than short-term shareholders. *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 527 (2002) (noting that one can infer from a Delaware Supreme Court decision that "boards must . . . have a duty to maximize long-term shareholder value"); E. Norman Veasey, *The Stockholder Franchise Is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811, 815-16 (2007) (distinguishing between the short-term interests of institutional investors and the interests of the "underlying investors," who are also described as "'long-term' stockholders").

15. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001). The thrust of Hansmann and Kraakman's argument is that social welfare would be maximized if corporate law served shareholder interests rather than those of other stakeholders. But their use of the phrase "long-term" value suggests that they believe that social welfare would be maximized if corporate law served long-term shareholders rather than short-term shareholders.

16. *See, e.g.*, *Principles of Corporate Governance 2005*, BUS. ROUNDTABLE 31 (Nov. 2005), http://www.ibm.com/ibm/governmentalprograms/pdf/BRTCorpGovPrinciples2005.pdf [http://perma.cc/Z62-PG6S] (describing "the paramount duty to optimize long-term shareholder value").

17. *See infra* Part I.C. In response to the perceived power of short-term shareholders, many commentators are also calling for steps to better insulate managers from shareholders generally. *See, e.g.*, Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1646-48 (2013) (identifying various advocates of increased board insulation).

18. COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT 246-47 (2013) (suggesting that "voting control . . . be concentrated on long-term investors"); Fox & Lorsch, *supra* note 8, at 56-57 (suggesting that voting power should increase with length of share ownership); Andrew Haldane, Exec. Dir., Fin. Stability, & Richard Davies, Economist, Fin. Inst. Div., Bank of Eng., Speech at the 29th Société Universitaire Européene de Recherches Financières Colloqium: The Short Long 13 (May 11,

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seeks to increase the number of long-term shareholders by rewarding them with additional dividends or other cash-flow rights.[19] A third set of proposals seeks to increase the number of long-term shareholders by revamping the income tax system to make long-term stock ownership relatively more attractive.[20]

Yet the norm of favoring long-term shareholders over short-term shareholders, and efforts to boost the number and power of long-term shareholders in public companies, are driven by a flawed intuition: that managers serving long-term shareholders will necessarily generate more value over time than managers serving short-term stockholders. I show that in a typical U.S. firm—that is, a firm that transacts heavily in its own shares—managers serving long-term shareholders will not necessarily generate more value over time than managers serving short-term shareholders, and may well generate less. All of the recent efforts to favor long-term shareholders may thus, perversely, reduce the value generated by firms over the long term.[21]

For most of this Article, I focus on a firm in which the only residual claimants on the value created by the firm are the firm's current and future share-

2011), http://www.bis.org/review/r110511e.pdf [http://perma.cc/ZKE4-UFQN] (calling for enhanced shareholder voting rights for long-term investors).

19. For example, economists Patrick Bolton and Frédéric Samama have suggested that long-term shareholders receive "L-shares"—shares entitling them to additional stock in the firm. *See* Patrick Bolton & Frédéric Samama, *Loyalty-Shares: Rewarding Long-Term Investors*, 25 J. APPLIED CORP. FIN. 86 (2013) (suggesting that shareholders receive call options that are exercisable only if they hold their shares for a certain period).

20. For example, the Aspen Institute has proposed a graduated long-term capital gains tax rate, with the lowest rate available only to shareholders that own their stock for a considerable period of time. *See* ASPEN INSTITUTE, *supra* note 9, at 2-3.

21. This Article is part of a larger project of mine that seeks to explore the corporate governance implications of the increasing tendency of U.S. firms to buy and sell large amounts of their own shares. One earlier article focused on the implications of firms' transacting in their own equity for executive compensation arrangements. *See* Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1136-40 (2011) [hereinafter Fried, *Repurchases*] (describing the distortions associated with tying executive pay to the long-term stock price in a transacting firm, and proposing a new approach to executive compensation that eliminates those distortions). Another earlier article focused on the need to bring firm insider trading regulation up to date to prevent insiders from using firms to engage in indirect insider trading. *See* Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801 (2014) [hereinafter Fried, *Insider Trading*] (explaining how the relatively lax disclosure rules applied to firms trading in their own shares lead insiders with large equity positions to use the firm to engage in indirect insider trading, and proposing that disclosure rules be harmonized by applying the same trade disclosure rules to both insiders and firms). This Article builds on the analytical framework developed in these two works to argue that the increasing tendency of firms to buy and sell their own shares requires a fundamental reconsideration of the long and widely held view that regulators and managers should favor long-term shareholders over short-term shareholders.

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holders: the investors who own or will own shares between now and "the long term" (by which I mean the relevant end period, however that period is determined). In other words, the firm's current and future shareholders capture all of the value generated by the firm over time. I will call this a "shareholder-only" firm.

I begin by considering a "non-transacting" shareholder-only firm: one that does not repurchase its own shares or issue additional shares before the long term arrives. I show that, in this type of firm, the conventional view is correct: managers serving long-term shareholders will generate more economic value over time than managers serving short-term shareholders. In particular, long-term shareholders will want managers to maximize the economic pie. Short-term shareholders, on the other hand, may benefit when managers engage in what I call "costly price-boosting manipulation"—actions that boost the short-term stock price at the expense of the pie generated over the long term. Therefore, in such a firm, it is better for the economy, and for investors in the aggregate, if managers seek to maximize long-term shareholder value instead of doing all they can to boost the short-term stock price, regardless of the consequences for the size of the pie.

Most U.S. firms, however, are "transacting." They buy and sell large volumes of their own shares each year: approximately $1 trillion worth market-wide.[22] The magnitude is staggering, not only in absolute terms, but also relative to firms' market capitalization. Over any given five-year period, U.S. firms buy and sell stock equivalent in value to approximately 30% of their aggregate market capitalization.[23] Thus, for example, a company with a market capitalization of $10 billion today can be expected to buy and sell $3 billion of its own shares over the next five years.

I show that, in a transacting firm, managers can boost long-term shareholder payoffs by taking value-destroying steps in the short term. I first consider a "repurchasing firm"—a firm that buys back its own shares before the long term arrives. In a repurchasing firm, long-term shareholder payoffs depend, in part, on the price and quantity of previously repurchased shares. Therefore, long-term shareholders benefit when managers conduct "bargain" repurchases—buybacks at a price below the stock's actual value.

Bargain repurchases need not destroy economic value. In principle, they may merely redistribute a slice of the pie from short-term shareholders to long-term shareholders without shrinking the pie itself. If bargain repurchases are merely value-shifting and not value-destroying, then managers serving long-term shareholders will seek to enrich them either by creating economic value

22. *See infra* Parts IV.A, VI.A.

23. *See infra* Parts IV.A, VI.A.

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(as in the non-transacting firm) or by shifting value, but never by destroying economic value. Thus, as in a non-transacting firm, it would be better for managers to serve long-term shareholders rather than short-term shareholders.

However, I show that managers seeking to boost long-term shareholder payoffs in a repurchasing firm may take two kinds of steps that do destroy value and diminish the economic pie. First, managers may engage in "costly contraction": the undertaking of economically excessive repurchases that divert funds from valuable projects inside the firm to buy back sharply discounted shares. For example, suppose that buying $100 of a firm's temporarily cheap stock would yield a 40% return to long-term shareholders, a return that represents a transfer of value from other shareholders. And suppose that investing that same $100 in a firm project would yield a 30% return ($30) for all the firm's shareholders. Finally, suppose that if the $100 were distributed to selling shareholders in a repurchase, those selling shareholders would earn a 10% return ($10) on the $100 through various investments outside the firm. Thus, if the $100 is distributed in a repurchase, the total amount of value created for shareholders in the aggregate will decline by $20, from $30 to $10. But managers serving long-term shareholders will distribute that $100 through a repurchase rather than invest in the higher-value internal project yielding 30%, because the repurchase diverts enough value from other shareholders to provide long-term shareholders with a 40% return. There is evidence suggesting that firms engaging in share repurchases cut back on valuable activities inside the firm.[24]

Second, managers serving long-term shareholders may engage in costly price-depressing manipulation either to make a bargain repurchase possible or, if the stock is already underpriced, to increase the extent of the bargain. Once a firm decides to repurchase shares, long-term shareholders can benefit if managers engage in value-destroying manipulation to lower the price further before the repurchase occurs. As with costly contraction, such manipulation increases the amount of value transferred to long-term shareholders while shrinking the overall pie. Indeed, firms conducting repurchases engage in such manipulation with the intention of boosting the long-term stock price.[25]

I then turn to consider the case in which a transacting firm issues additional equity before the long term. Here, long-term shareholders' payoffs depend on the price that future shareholders pay for the stock and the amount of shares sold to future shareholders. Managers can serve the interests of long-term shareholders by conducting inflated-price issuances, and this benefit increases with the amount of shares sold.

24. *See infra* Part V.A.2.

25. *See infra* Part V.B.

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Inflated-price issuances, like bargain repurchases, need not be value-destroying. In theory, they may merely redistribute value from future shareholders to long-term shareholders. But managers conducting inflated-price equity issuances purely for the benefit of long-term shareholders can be expected to engage in two types of actions that destroy value.

First, when the stock price is high, managers seeking to boost the long-term stock price may cause the firm to issue shares to acquire assets even if the economic value of those assets declines when they are absorbed into the firm. America Online's (AOL) acquisition of Time Warner in 2000, for $162 billion of stock, is a well-known example of long-term shareholders' benefitting ex post from an issuance that destroyed economic value.[26] The acquisition destroyed so much economic value that AOL and Time Warner were forced to part ways nine years later. Nevertheless, from an ex post perspective, AOL's long-term shareholders undeniably benefitted from the transaction; it enabled them to buy Time Warner's valuable assets at an extremely cheap price. In 2009, their combined stakes in AOL and Time Warner were worth approximately 400% more than the AOL stake they would have held absent AOL's acquisition of Time Warner.[27]

Second, managers conducting inflated-price issuances can further benefit long-term shareholders by engaging in costly price-boosting manipulation (such as earnings manipulation). Such manipulation can transfer even more value to long-term shareholders. As a result, when a firm sells its own shares at an inflated price, the very same pie-reducing strategies that benefit short-term shareholders can serve the interests of long-term shareholders. Indeed, AOL engaged in such value-destroying manipulation when it issued stock to Time Warner shareholders, benefitting AOL's current long-term shareholders to the detriment of its future shareholders.[28] AOL is not alone. There is evidence that firms issuing equity to acquire the assets of other companies systematically engage in value-destroying manipulation to boost the apparent value of the consideration being given to target shareholders.[29]

Given the volume of repurchases and equity issuances undertaken by the typical U.S. firm, the amount of value that managers can transfer to long-term shareholders by exploiting mispricing in firms' securities and engaging in these types of value-destroying manipulations is likely to be substantial. Indeed, a recent study by Richard Sloan and Haifeng You confirms that there already has been a large-scale transfer of value to long-term shareholders in publicly traded

26. The AOL-Time Warner transaction is discussed in more detail *infra* Part VII.A.2.

27. *See infra* Part VII.A.2.

28. *See infra* Part VII.B.2.

29. *See infra* Part VII.B.2.

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U.S. firms via equity transactions. The study finds that over the last forty years, an aggregate of over $2.3 trillion has been transferred to long-term investors through bargain repurchases and inflated-price equity issuances.[30] So managers have been annually transferring an average of $50 billion in value to long-term shareholders. Across the market, aggregate value transfer exceeds 20% of aggregate net income, suggesting that almost 20% of the wealth created by publicly traded companies for their long-term shareholders is generated via transfers from other shareholders; for smaller firms, the percentage is much higher, around 50%.[31] To the extent these transfers involve actions such as stock price manipulation or costly contraction, the cost to other shareholders is likely to exceed $50 billion per year. These amounts are likely to increase if, as is proposed, long-term shareholders are given even more power in widely held firms.

My purpose in this Article is not to argue that managers focused on serving long-term shareholders necessarily generate less economic value than managers focused on serving short-term shareholders. Rather, my objective is to show that neither managers serving long-term shareholder interests nor managers serving short-term shareholder interests will seek to maximize the economic value created by the firm over time. Managers faithfully serving either type of shareholder at the expense of the other can be expected to take steps that shrink the pie. Consequently, the case for favoring long-term shareholders is substantially weaker than it might appear.

The fundamental problem with focusing on either short-term or long-term shareholder interests is that neither type of shareholder interest reflects the value flowing to both the firm's current and future shareholders. The short-term stock price does not reflect the value flowing to long-term shareholders and future shareholders. Long-term shareholder value does not fully incorporate the value flowing to short-term shareholders and future shareholders. In sum, both short-term shareholder and long-term shareholder payoffs can be enhanced by managers inefficiently transferring value from other shareholders in the firm, to the detriment of the overall economic pie.

So should long-term shareholders be favored? Ultimately, the desirability of favoring long-term shareholders depends not only on the analysis of the financial interests of short-term and long-term shareholders that I have offered, but also on two additional considerations. These two additional considerations are the interests of non-shareholder "stakeholders" and managerial agency

30. Richard G. Sloan & Haifeng You, Wealth Transfers via Equity Transactions 1 (Aug. 4, 2014) (unpublished manuscript), http://ssrn.com/abstract=2218986 [http://perma.cc/W5JA-NJPW].

31. *Id.* at 19.

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costs. Although a complete analysis of these two considerations is beyond the scope of this project, I address them briefly at the end of the Article.

I first turn to stakeholders. Margaret Blair and Lynn Stout have long pointed out—correctly, in my view—that non-shareholder stakeholders also have residual claims on the corporation.[32] One might believe that these stakeholders are likely to be better off if managers run the firm for the benefit of long-term shareholders rather than short-term shareholders. However, I explain that as a matter of economic theory, the effect of managers' time horizons (that is, whether managers serve short-term or long-term shareholders) on stakeholder welfare is actually indeterminate.[33] Indeed, if markets are as inefficient as many believe, managers faithfully serving long-term shareholders may sometimes seek to squeeze more value from other stakeholders than managers serving short-term shareholders. For example, the long-term shareholders controlling Wal-Mart did not build their fortunes by overpaying employees.[34] Thus, the potential existence of non-shareholder residual claimants may or may not strengthen the case for favoring long-term shareholders.

I next turn to managerial agency costs, which have long been considered one of the most significant problems in the corporate governance of widely held firms.[35] The desirability of giving long-term shareholders relatively more power in the corporation (relative to short-term shareholders) will depend on whether long-term shareholders are better or worse at controlling managerial agency costs. But here, as with stakeholders, it is unclear which type of shareholder is preferable. On the one hand, long-term shareholders' horizons give them a greater interest in controlling managerial agency costs. On the other hand, to the extent that short-term shareholders are willing to accumulate larger positions than long-term shareholders, they may have greater incentives and ability to discipline managers than do long-term shareholders. If the latter effect dominates, favoring long-term shareholders by impeding short-term shareholders may lead to higher managerial agency costs.

All in all, it is unclear whether long-term shareholders' alignment with stakeholder interests and their ability to control managerial agency costs are better or worse than those of short-term shareholders. Therefore, adding stakeholder interests and the control of managerial agency costs to the mix is

32. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 314 n.178 (1999) (explaining that non-shareholder constituencies are also residual claimants on the corporate pie).

33. *See infra* Part IX.A.

34. *See infra* Part IX.A.

35. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 354-55 (1976).

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unlikely to strengthen or weaken the case for favoring long-term shareholders. That case remains much weaker than it might otherwise appear, and it certainly is far from compelling.

Before proceeding, a word about controlling shareholders is in order. The purpose of this Article is to reexamine the desirability of favoring long-term shareholders in a widely held firm where law, regulation, and private ordering can be used to shift power away from short-term shareholders to long-term shareholders. But my analysis also has implications for the large number of firms in which long-term shareholders already dominate: firms with controlling shareholders.[36] While it is well understood that a controlling shareholder may seek to engage in inefficient self-dealing transactions in order to directly transfer value from the corporation to the controlling shareholder,[37] my analysis suggests another problem: controlling shareholders, *qua* long-term shareholders, may also have their firms engage in a variety of other inefficient transactions that transfer value from other shareholders to themselves—namely, costly contraction, costly expansion, and share-price manipulation around repurchases and equity issuances.[38] As far as I can tell, this problem has been largely overlooked.[39] Therefore, the economic costs associated with controlling shareholders may be even higher than is widely believed.

36. Most corporations in Europe, Asia, and Latin America have controlling shareholders. *See* Borja Larrain & Francisco Urzúa I., *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661, 661 (2013). Even in the United States, average insider ownership in publicly traded U.S. firms is over twenty percent. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382 (2009). This figure suggests that controlling shareholders are more common in the United States than is widely believed.

37. *See, e.g.*, Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000).

38. For evidence that these types of value diversion occur in controlled firms, see Jae-Seung Baek et al., *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415, 2445-46 (2006), which finds evidence consistent with the use of equity issuances by controlling shareholders of Korean firms to transfer value to themselves from public shareholders; and Larrain & Urzúa I., *supra* note 36, at 679, which examines equity issuances by controlling shareholders of Chilean firms between 1990 and 2009 and finds evidence consistent with controlling shareholders' timing issuances to transfer value from future shareholders.

39. For example, William Bratton and Michael Wachter recently argued that a controlling shareholder, unlike short-term shareholders, "has no incentive to consider speculative mispricing when determining investment policy." Bratton & Wachter, *supra* note 7, at 714. My analysis suggests that this claim is incorrect, at least when the firm is buying and selling its own shares. A controlling shareholder may well respond to speculative overvaluation by selling shares and investing inefficiently. Furthermore, if value-reducing investment will sufficiently increase the extent of speculative overpricing, managers may well engage in such investment to increase the value that can be transferred from future shareholders.

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This Article is organized as follows. Part I describes the conventional wisdom about short-term and long-term shareholders. Part II lays out my positive and normative assumptions for the analysis. Part III shows that in a nontransacting firm (a firm that does not repurchase or issue any shares), the intuition that managers serving long-term shareholders will generate more value than managers serving short-term shareholders is correct. Part IV shows that in a repurchasing firm, long-term shareholder interests do not align with the maximization of economic value. Part V identifies the various ways in which managers in a repurchasing firm may destroy value to benefit long-term shareholders. Part VI shows that in a transacting firm that issues shares, long-term shareholder interests do not align with economic value maximization. Part VII details the various ways that managers in an issuing firm may destroy value to benefit long-term shareholders. Part VIII describes the circumstances in which managers serving long-term shareholders are more likely to destroy value than managers serving short-term shareholders. Part IX addresses the implications of stakeholders and managerial agency costs for the desirability of favoring long-term shareholders. A conclusion follows.

I. SHORT-TERM VERSUS LONG-TERM SHAREHOLDERS: THE CONVENTIONAL VIEW

This Part describes the conventional view about short-term shareholders (Part I.A) and long-term shareholders (Part I.B). It then surveys recent proposals designed to increase the proportion and power of long-term shareholders in public companies (Part I.C).

A. The (Undesirable) Interests of Short-Term Shareholders

Even the staunchest proponent of shareholder empowerment must be prepared to accept the following proposition: *short-term* shareholder interests do not completely coincide with the goal of maximizing the economic value created by the firm over time. In particular, managers seeking to serve short-term shareholders may engage in "short-termism": taking steps that boost the short-term stock but reduce the size of the pie.[40] The economic cost of any short-termism is borne (at least in the first instance) by other parties with residual claims on the value created by the firm. These residual claimants include both

40. For an explanation of how short-termism can arise even in a fully rational market, see *infra* Part III.B.

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long-term shareholders and those future shareholders who buy shares at an inflated price in the short term.[41]

The question, then, is not whether short-termism can exist, but rather: how bad is it? Some argue that short-termism has been and continues to be a large problem. For several decades, Martin Lipton and his colleagues at Wachtell, Lipton, Rosen & Katz have attacked short-term shareholders for having objectives "not in accordance with the long-term interests of other shareholders and other constituencies."[42] During the 1980s and early 1990s, business thought leaders routinely blamed short-term shareholders for the poor performance of U.S. firms relative to those in Germany and Japan.[43] The recent financial crisis has renewed and intensified criticism of short-term shareholders from legal academics,[44] business school professors,[45] and leading business figures.[46]

B. The (Desirable) Interests of Long-Term Shareholders

While the interests of short-term shareholders are denigrated, the interests of long-term shareholders are exalted. Legal academics of a variety of persuasions have long believed that managers should ignore the short-term stock price and focus on maximizing long-term shareholder value.[47] Even Stephen Bainbridge, who has long argued against shareholder empowerment and for a

41. Other residual claimants on the value generated by the corporation include non-shareholder stakeholders such as employees and communities. *See infra* Part IX.

42. *See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979); Lipton & Rosenblum, *supra* note 10, at 78 (noting the power of short-term shareholders, who may push companies to take steps at the expense of economic value creation).

43. *See, e.g.*, Porter, *supra* note 8 (criticizing the harmful influence of short-term shareholders in U.S. firms, among other problems).

44. *See, e.g.*, Bratton & Wachter, *supra* note 7, at 658-60 (arguing that managers' focus on the short-term stock price played a role in creating the financial crisis and that short-term shareholders should not be further empowered); Dallas, *supra* note 11 (blaming "short-term traders" for the financial crisis and calling for the empowerment of long-term shareholders as one of a number of possible regulatory responses).

45. Fox & Lorsch, *supra* note 8 (arguing that short-term shareholder influence has pernicious effects).

46. *See, e.g.*, ASPEN INSTITUTE, *supra* note 9 (report critical of short-term shareholders signed by Berkshire Hathaway CEO Warren Buffett and other leading executives).

47. *See, e.g.*, Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 359 (2009) (stating that compensation arrangements should be "focused on creating and sustaining long-term shareholder value"); Matheson & Olson, *supra* note 12, at 1444, 1484 (1994) (arguing that managers should focus their efforts on maximizing value for long-term shareholders).

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"director primacy" view of corporate governance, has written that directors should be "obliged to make decisions based solely on the basis of long-term shareholder gain."[48] The wide acceptance of the long-term shareholder value norm is illustrated by the earlier-quoted statement by Henry Hansmann and Reinier Kraakman, that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[49]

America's leading business academics share this view. For example, Harvard Business School's Michael Porter has written that "long-term shareholder value should be identified as the explicit corporate goal. The burden of proof should shift so that managers must explain any decision that is not consistent with long-term shareholder value."[50] Kellogg School of Management's Alfred Rappaport has argued that "management's primary responsibility is to maximize long-term shareholder value," which means "that management's primary commitment is to *continuing shareholders* rather than to day traders, momentum investors, and other short-term-oriented market players."[51]

Significantly, the Delaware Supreme Court has emphasized the importance of serving long-term shareholders over short-term shareholders.[52] Of course, directors owe fiduciary duties to all (current) shareholders.[53] But some shareholders, apparently, are more equal than others. For example, in *Gantler v. Stephens*, the Delaware Supreme Court described "enhancing the corporation's long term share value" as a "distinctively corporate concern[]."[54] And a former Delaware Supreme Court Justice, Norman Veasey, wrote a law review article that distinguished between short-term and long-term shareholders, describing only the latter as the firm's "underlying investors."[55]

48. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003).

49. Hansmann & Kraakman, *supra* note 15, at 439; *cf.* Matheson & Olson, *supra* note 12, at 1484 (arguing that "[t]he focus on longterm shareholders maximizes . . . economic efficiency in the long run").

50. Porter, *supra* note 8, at 79.

51. Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, FIN. ANALYSTS J., May-June 2005, at 65, 69.

52. *Cf.* Black & Kraakman, *supra* note 14, at 527 n.20 (2002) (concluding that the Delaware Supreme Court "signaled . . . long-term shareholder primacy" (citing Paramount Commc'ns, Inc. v. Time, 571 A.2d 1140, 1153 (Del. 1990))).

53. Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 129 (Del. Ch. 2011) ("Directors of a corporation still owe fiduciary duties to *all stockholders*—this undoubtedly includes short-term as well as long-term holders.").

54. 965 A.2d 695, 706 (Del. 2009).

55. Veasey, *supra* note 14, at 815.

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With legal academics, business school professors, and judges all humming the same tune, it is not surprising that managers have fully internalized the norm of maximizing long-term shareholder value. For example, the Business Roundtable, a collection of CEOs from major U.S. corporations that seeks to influence public policy, referred to "the paramount duty to optimize long-term shareholder value."[56] In 2006, the Business Roundtable's Institute for Corporate Ethics and the Chartered Financial Analyst Institute's Centre for Financial Market Integrity produced a report recommending changes in corporate governance to align managers' actions with long-term shareholder interests.[57] Furthermore, the U.S. Chamber of Commerce Center for Capital Markets Competitiveness reports that it advocates policies for the "positive promotion of long-term shareholder value."[58] Firms routinely report in their proxy statements that their primary purpose is to build "long-term shareholder value."[59]

C. Policy Proposals To Favor Long-Term Shareholders

Because of the perceived undesirability of short-term shareholder interests and the perceived desirability of long-term shareholder interests, lawmakers, regulators, and firms are considering and (in some cases) implementing a variety of measures to increase the power of long-term shareholders in public companies relative to the power of short-term shareholders.

As discussed in more detail below, these measures fall into three categories: (1) enhanced voting and control rights for long-term shareholders; (2) enhanced cash flow rights for long-term shareholders, to encourage long-term shareholding; and (3) changes in the tax system designed to increase the relative number of long-term shareholders.

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56. BUS. ROUNDTABLE, *Principles of Corporate Governance 2012*, at 30 (2012), http://businessroundtable.org/sites/default/files/BRT_Principles_of_Corporate_Governance_-2012_Formatted_Final.pdf [http://perma.cc/D5XX-5XW8].

57. Dean Krehmeyer, Matthew Orsagh & Kurt N. Schacht, *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value*, CFA CENTRE FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS (2006), http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2006.n1.4194 [http://perma.cc/Q7KH-MB8Z].

58. *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice*, U.S. CHAMBER COM. CENTER FOR CAPITAL MKTS. COMPETITIVENESS 2 (Mar. 2013), http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf [http://perma.cc/K4QB-SEE2].

59. *See, e.g.*, *Definitive Proxy Statement*, AMAZON.COM, INC. 6 (2013), http://www.sec.gov/Archives/edgar/data/1018724/000119312513151558/d445440ddef14a.htm [http://perma.cc/3H64-XBRQ] ("The Board is responsible for the control and direction of the Company. . . . [A]nd its primary purpose is to build long-term shareholder value.").

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1. Enhanced Voting and Control Rights

A number of prominent business commentators in the United States have suggested that long-term shareholders should receive more voting rights in the firm in order to increase the relative power of each long-term shareholder. For example, Justin Fox and Jay Lorsch have argued for "giving a favored role to long-term shareholders" by increasing voting power with the length of share ownership or simply "restrict[ing] voting in corporate elections of any kind to those who have owned their shares for at least a year."[60] Similar proposals have been floated by academics and regulators in the UK[61] and the EU.[62]

The Aspen Institute's Business and Society Program, a collection of leading executives and corporate governance specialists, has also recommended consideration of such arrangements.[63] The director of this program, Judith Samuelson, has written that corporations should be permitted to overweight the votes of long-term equity-holders so that "only true 'owners' of stock, and not transient 'renters,' . . . have a substantive voice in a company."[64] Similarly, an American Bar Association corporate governance task force has expressed support for exploring the use of such arrangements.[65]

60. Fox & Lorsch, *supra* note 8, at 56-57; *see also* Martin Lipton, Jay W. Lorsch & Theodore N. Mirvis, *A Crisis Is a Terrible Thing To Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake*, WACHTELL, LIPTON, ROSEN & KATZ 4 (May 12, 2009), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16657.09.pdf [http://perma.cc/V9FG-ENDQ] (proposing enhanced voting rights for long-term shareholders).

61. *See, e.g.*, MAYER, *supra* note 18, at 246-47 (suggesting that long-term shareholders be given enhanced voting rights); Haldane & Davies, *supra* note 18 (calling for enhanced shareholder rights for long-term investors).

62. In early 2013, EU Internal Market Commissioner Michel Barnier released a consultation paper exploring ways to reward long-term shareholder commitment, including the possibility of granting additional voting rights to long-term shareholders or linking dividend payments to the holding periods of shares. *See* Alex Barker, *Brussels Aims To Reward Investor Loyalty*, FIN. TIMES, Jan. 23, 2013, http://www.ft.com/intl/cms/s/0/167e60fc-6574-11e2-8b03-00144feab49a.html [http://perma.cc/QE94-4R6B].

63. *See* ASPEN INSTITUTE, *supra* note 9, at 3 (recommending tax reforms, removal of limitations on capital loss deductibility for very long-term holdings, and a minimum holding period or time-based vesting).

64. *See* Rebecca Darr & Judith Samuelson, *Beyond the Crisis: Policies To Foster Long-Termism in Financial Markets*, *in* SECOND SUMMIT ON THE FUTURE OF THE CORPORATION: PAPER SERIES ON RESTORING THE PRIMACY OF THE REAL ECONOMY 1, 6 (Allen White ed., 2009), http://www.summit2020.org/downloads/2nd_Summit_Paper_Series.pdf [http://perma.cc/FHE3-TSHV].

65. *See 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, 151 (2009) (urging consideration of a policy rewarding long-term holding through tax incentives and enhanced voting rights to encourage shareholder interest in long-term investment).

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Federal regulators have also shown sympathy for the view that long-term shareholders should receive special privileges. When the Securities and Exchange Commission was considering its proxy access rule, the Business Roundtable and others sought to restrict access to long-term shareholders.[66] The SEC's final version of the rule in 2010 (which was later invalidated by the D.C. Circuit) responded to these concerns by limiting proxy access to shareholders that had held their shares continuously for at least three years.[67]

Delaware judges, both in their decisions and in other fora, have indicated an acceptance of discrimination in voting rights against short-term shareholders and in favor of long-term shareholders. For example, in *Williams v. Geier*, the Delaware Supreme Court upheld the validity of a charter provision granting superior voting rights to shareholders who held their shares for a continuous three-year period.[68] One of the firm's justifications for this arrangement, which the court did not dispute, was to "[m]aintain [the] ability to maximize long-term value for shareholders."[69]

More informal and indirect approaches to increasing the influence of long-term shareholders have also been proposed. For example, the U.K.'s 2012 Kay Commission report recommended that firms consult "major long-term investors" regarding board appointments.[70] Delaware Supreme Court Chief Justice Leo Strine has similarly urged firms to consult long-term investors when making board appointments.[71]

2. *"Loyalty" Shares and Dividends*

Boosting the number and proportion of long-term shareholders would also increase their power. One set of proposals seeks to convert short-term shareholders into long-term shareholders by rewarding long-term shareholders with additional dividends or other cash-flow rights. For example, economists Pat-

66. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,697-99 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) (discussing the holding period requirement for proxy access and comments on the requirement).

67. 75 Fed. Reg. 56,668 (Sept. 16, 2010) (amending 17 C.F.R. pts. 200, 232, 240, 249), *invalidated by* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

68. 671 A.2d 1368, 1384-85 (Del. 1996).

69. *Id*. at 1372.

70. John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* 63 (July 2012), http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf [http://perma.cc/SH3R-439M].

71. 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, 7 (2010).

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rick Bolton and Frédéric Samama have suggested that long-term shareholders receive "L-shares" – shares entitling them to additional stock in the firm.[72] Under the Bolton and Samama proposal, buy-and-hold investors would get a free call option, or warrant, if they held their shares for a pre-specified period of time (three years, for example).[73]

Several European firms have already modified their corporate arrangements to give long-term shareholders more cash-flow rights vis-à-vis short-term shareholders. For example, the French firms L'Oreal, Electricité de France, Air Liquide, and Credit Agricole have all offered or will offer extra dividends to long-term shareholders.[74] Air Liquide is also giving long-term shareholders extra shares.[75] Similar arrangements have been proposed in the Netherlands and the U.S.[76]

3. Tilting the Tax System To Favor Long-Term Shareholders

A third set of proposals seeks to increase the number of long-term shareholders by revamping the income tax system to make long-term stock ownership relatively more attractive. For example, the Aspen Institute has proposed a graduated long-term capital gains tax rate, with the lowest rate available to shareholders who own their stock for the longest period of time.[77] The Aspen Institute has also proposed increasing the deductibility of long-term capital losses.[78] Similarly, Vanguard's John Bogle has suggested eliminating the tax deductibility of short-term capital losses and increasing the tax rate on ordinary income generated by stock trading.[79]

72. Bolton & Samama, *supra* note 19, at 88 (suggesting that shareholders receive call options that are exercisable only if they hold their shares for a certain period).

73. *Id*. at 89.

74. *Id*. at 95.

75. *Id.*

76. *See a Different Class: Would Giving Long-Term Shareholders More Clout Improve Corporate Governance?*, ECONOMIST, Feb. 18, 2010, http://www.economist.com/node/15544310 [http://perma.cc/YUL9-QTMU] (reporting a similar proposal in the Netherlands); Al Gore & David Blood, *A Manifesto for Sustainable Capitalism: How Businesses Can Embrace Environmental, Social and Governance Metrics*, WALL ST. J., Dec. 14, 2011, http://online.wsj.com/news/articles/SB10001424052970203430404577092682864215896 [http://perma.cc/5QHG-YQNC] (suggesting that firms provide loyalty shares to long-term investors).

77. *See* ASPEN INSTITUTE, *supra* note 9, at 3.

78. *See id.*

79. *See* John C. Bogle, *The Clash of the Cultures*, 37 J. PORTFOLIO MGMT. 14, 25 (2011) (calling for the elimination of tax deductibility for short-term capital losses and an increased tax on income from stock trading).

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The Aspen Institute is trying to rally support for a tax on transactions in the stock market.[80] Such a tax was first proposed by John Maynard Keynes in the 1930s[81] and later endorsed by economists Joseph Stiglitz and Larry Summers in the late 1980s.[82] One of the main purposes of such a securities tax is to make short-term stock ownership less attractive and thereby increase the proportion of long-term shareholders in public firms.[83]

4. Summing Up

The conventional view is simple. Short-term shareholders have undesirable interests: their payoffs do not align with economic value creation over time. Accordingly, these shareholders pressure managers to act in ways that destroy economic value. The solution to this problem is that managers should run the firm for the benefit of long-term shareholders and should seek to maximize long-term shareholder value. Indeed, it might well be desirable to give long-term shareholders more power in the corporation so that managers focus less on maximizing the short-term stock price and more on maximizing long-term shareholder value.

As we will see, long-term shareholder interests *are* better (that is, better aligned with economic value creation) than short-term shareholder interests in a particular firm: one that does not transact in its own shares. However, it is far from clear that long-term shareholder interests are better than short-term shareholder interests in the typical U.S. firm, which heavily buys and sells its own shares. In such a firm, long-term shareholders may have worse interests. Therefore, shifting power to long-term shareholders might actually reduce the value generated by the firm over time.

80. *See* ASPEN INSTITUTE, *supra* note 9, at 3 (proposing a tax on securities transactions to discourage short-term trading).

81. *See* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 159-60 (Harcourt Brace 1964) (1936).

82. *See* Joseph E. Stiglitz, *Using Tax Policy To Curb Speculative Short-Term Trading*, 3 J. FIN. SERVS. RES. 101, 108-09 (1989) (arguing that a transaction fee could lead to an increase in the relative number of long-term investors, causing managers to shift their focus to the long run); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERVS. RES. 261 (1989) (similar).

83. *See* Stiglitz, *supra* note 82, at 109.

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II. ANALYTICAL BUILDING BLOCKS

This Part provides two critical building blocks for my analysis. Part II.A outlines what I take to be the policy objective of corporate governance regulation: maximizing "economic value"—the (net) economic output generated by the firm, from today through the long term. Part II.B describes my assumptions about short-term and long-term shareholders' objectives.

A. Policy Goal: Maximizing Economic Value

I take it as given that the regulation of public companies should be designed to maximize the economic value created by a typical firm over time.[84] In particular, I assume that it is desirable to maximize the net economic output of the firm from today until "the long term"—the relevant end point, however that end point is determined.[85] The net economic output of the firm is simply the value of assets distributed or retained by the firm less the value of assets contributed to the firm. I call this maximand "economic value," or, more figuratively, "the pie."

To focus the analysis, I will for now consider a "shareholder-only" firm. That is, I assume that the only residual claimants on the economic pie are the firm's current shareholders (who own shares now) and future shareholders (who will buy its shares in the future, but before the long term arrives).[86] As a result, economic value is equivalent to the net amount of value flowing to current and future shareholders through the long term—cash they receive from the firm *less* cash (or other assets) they transfer to the firm.[87]

84. *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 28 & n.79 (2d ed. 2009) (urging the use of Kaldor-Hicks efficiency as the criterion for evaluating corporate law and corporate governance arrangements).

85. Because of the need to discount for the time value of money and risk, future cash flows are less valuable in present dollar terms than are current cash flows. So the long term might be the future point in time when the present value of the cash flow becomes immaterial. Alternatively, the long term might be the future point in time when the firm ceases to be publicly traded.

86. I also assume that the firm's equity consists entirely of one class of common shares.

87. I ignore prior asset flows to and from the firm as "sunk" and focus only on asset flows between the firm and shareholders in the period that starts today and ends in the long term. The assumption that current and future (common) shareholders are the firm's only residual claimants is, of course, a simplification. Other stakeholders, such as creditors, preferred shareholders, and employees, may also be affected by the firm's actions. And from an economic perspective, it is desirable to maximize the total value flowing to all of these stakeholders. Thus, assessing whether it would be desirable to shift power from short-term

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In effect, I treat current and future shareholders as if they collectively were a "sole owner" of the corporation. Such a hypothetical sole owner would wish to maximize the net amount flowing to it over time—the amount withdrawn from the corporation (via dividends and repurchases) less the amount invested in the firm (through the purchase of equity from the firm).

To be sure, the premise that it is desirable to maximize the net value flowing to all shareholders of the firm (both current and future), rather than *current shareholder* value, might be questioned. In the U.S., directors generally owe a fiduciary duty to the firm and its current shareholders; future shareholders are not owed a fiduciary duty until after they have acquired stock in the firm.[88] One might therefore believe that a firm should be run to maximize the value flowing solely to *current shareholders*.

From an economic perspective, however, a dollar flowing to a current shareholder is no more or less valuable than a dollar flowing to a future shareholder (ignoring, of course, the time value of money). Consequently, there is no economic reason for policymakers or analysts, in assessing policy proposals (including proposals designed to shift power to long-term shareholders), to weigh these dollars differently.[89] Accordingly, I assign the same weight to every dollar flowing to or from a firm's shareholders, whether the dollar flows to a current or future shareholder before the long term arrives.[90]

shareholders to long-term shareholders depends on how such a shift affects other residual claimants. I take up this issue *infra* Part IX.

88. *See, e.g.*, Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1049 (2005) ("Directors and management, at least in the United States, have a fiduciary duty *only* to investors holding an existing property right or equitable interest to support such a duty—i.e., current investors."); *cf.* Corp. Prop. Assocs. 14 Inc. v. CHR Holding Corp., Civ. A. No. 3231-VCS, 2008 WL 963048, at *4 (Del. Ch. Apr. 10, 2008) ("[T]he Delaware Supreme Court has consistently held that directors do not owe fiduciary duties to future stockholders." (quoting Feldman v. Cutaia, Civ. A. No. 1656-N, 2006 WL 920420, at *6 n.37 (Del. Ch. Apr. 5, 2006))).

89. *See* Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 16 (2005) (arguing that managers and the board should treat all shareholders—including future shareholders—equally to maximize the firm's long-term economic value).

90. Perhaps recognizing the lack of an economic rationale for distinguishing between current and future shareholders, authorities in other common law systems, such as the U.K., have made explicit that directors owe a fiduciary duty to both current and future shareholders. *See, e.g.*, Simon Goulding & Lilian Miles, *Regulating the Approach of Companies Towards Employees: The New Statutory Duties and Reporting Obligations of Directors Within the United Kingdom*, *in* RESEARCH HANDBOOK ON CORPORATE LEGAL RESPONSIBILITY 88, 89 (Stephen Tully ed., 2005) (interpreting U.K. corporate law to, in most cases, require directors to advance the interests of "present and future" shareholders).

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B. Shareholders' Objectives

My focus in this Article is on the *objectives* of short-term and long-term shareholders – that is, the outcomes they want the firm's managers to produce. I assume that short-term shareholders will sell their entire equity interest in the short term, and that long-term shareholders will sell their entire equity in the long term, and not engage in any equity transactions in the short term. In other words, I assume "ideal types."[91] I will also assume that shareholders seek the highest possible financial return from their investment in the firm, given their holding period. Therefore, they will want managers to maximize the stock price in the period when they will be selling their shares: short-term shareholders will seek a higher short-term stock price, while long-term shareholders will seek a higher long-term stock price.[92]

In most of my analysis, I abstract from short-term and long-term shareholders' *abilities* to achieve their objectives. That is, I put aside the problem of managerial agency costs: namely, that managers, who directly control the firm, will pursue their own interests rather than those of either short-term shareholders or long-term shareholders. In Part IX, I will briefly consider the possibility that short-term and long-term shareholders may differ in their abilities to

91. The assumption that short-term and long-term shareholders are ideal types is made mostly for ease of exposition. The analysis would not be affected if long-term shareholders engaged in a relatively small amount of stock transactions in the short term. However, the analysis would change if long-term shareholders engaged in meaningful amounts of stock transactions in the short term. Consider, for example, an investor that sells 50% of its interest in the short term and 50% of its interest in the long term. That investor would be as interested in (ideal-type) short-term shareholder payoffs as in (ideal-type) long-term shareholder payoffs, and thus (unlike either ideal-type shareholder) not favor steps that favor one type of shareholder at the expense of the other. Or consider a "constant-share" long-term shareholder that sells shares whenever the firm repurchases shares and buys shares whenever the firm issues shares so as to keep the long-term shareholder's percentage equity ownership constant. As I have explained elsewhere, the fact that a constant-share long-term shareholder's payoff would fully internalize the potentially adverse effects of repurchases and equity issuances on other shareholders would perfectly align the shareholder's interest with pie maximization. *See* Fried, *Repurchases*, *supra* note 21, at 1136-40 (putting forward a constant-share approach to executive compensation and demonstrating that giving an executive long-term equity and requiring the executive to maintain the same percentage of the firm's equity as the firm buys and sells its own shares would tie the executive's payoff to the pie created by the firm over time). My analysis in this Article thus implicitly assumes that long-term shareholders' short-term trading, if any, is sufficiently modest that their interests can reasonably be captured by those of an ideal-type long-term shareholder.

92. In a firm that issues dividends, both short-term and long-term shareholders care not just about stock price appreciation during the relevant period but about their total return, which includes dividends. I assume, for simplicity, that the firms used as examples in this Article do not issue dividends. This assumption does not affect any of the analysis or conclusions.

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reduce managerial agency costs. Until then, however, my focus is solely on the *objectives* of short-term shareholders and long-term shareholders.

III. LONG-TERM SHAREHOLDER RETURNS IN A NON-TRANSACTING FIRM

The conventional view is that managers serving long-term shareholders will generate more value over time than managers serving short-term shareholders. This Part shows that the conventional view is correct in a shareholder-only firm that does not transact in its own shares.

Part III.A introduces a simple analytical framework for examining the relationship between shareholders' returns and economic value in a non-transacting shareholder-only firm. Part III.B describes long-term and short-term shareholders' returns in this setting. In such a firm, long-term shareholder returns are purely a function of the size of the economic pie. In contrast, short-term shareholder returns are not.

A. Framework of Analysis

Consider a hypothetical non-transacting shareholder-only firm, ABC Corporation, in a three-period setting: (1) today; (2) the short term; and (3) the long term. The long term is the relevant end period. The short term is a future point in time, occurring before the long term.

ABC Corporation's situation in the three periods is as follows:

- *Today:* ABC has two shares outstanding. One share is held by short-term shareholders (denoted "ST"). One share is held by long-term shareholders (denoted "LT").

- *Short term:* Short-term shareholders sell their one share to future shareholders (denoted *F*).[93] The sale price is $\$P$ per share. The price $\$P$ may or may not reflect the share's actual (full-information) value.

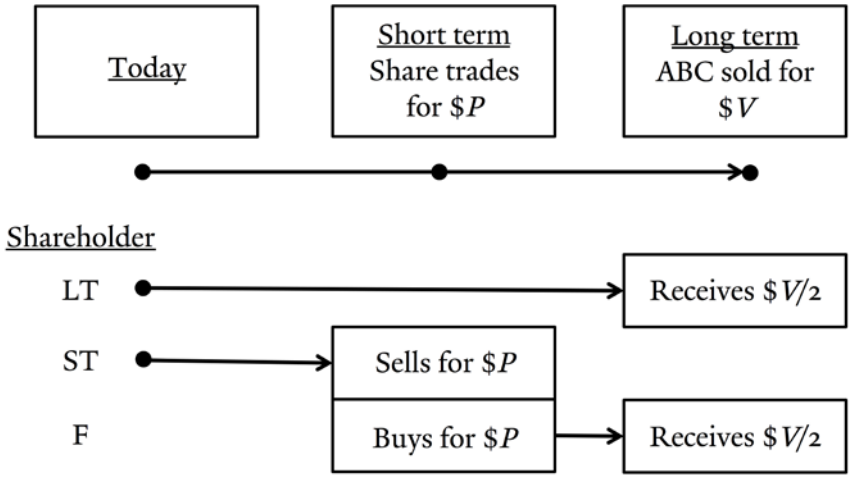
93. The short-term shareholder might have already held shares in ABC for many years and thus colloquially be considered a "long-term shareholder." In my framework, this investor is considered a short-term shareholder because, as of today, it will sell its shares in the short term rather than in the long term.

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- *Long term:* ABC's assets are sold for $\$V$ in cash, which reflects their actual value.[94] A total of $\$V$ is distributed to long-term shareholders and future shareholders. Because each type of shareholder holds one share, long-term shareholders receive $\$V/2$ and future shareholders receive $\$V/2$.

The sequence of events is illustrated in Figure 1 below.

Figure 1.
ABC AS A NON-TRANSACTING FIRM



Between today and the long term, the only cash flowing between ABC and its shareholders is the payment of $\$V$ made by ABC to long-term shareholders and future shareholders when ABC's assets are sold in the long term. Accordingly, economic value—the net amount of value flowing from ABC to ABC's shareholders over time—is $\$V$.[95] Economic value (the pie), and the net

94. Throughout, I assume that ABC's assets are correctly valued in the long term. In other words, ABC's long-term stock price reflects the actual value of ABC's shares in the long term. This assumption, which is made solely for ease of exposition, is not critical to the Article's analysis or conclusions.

95. Again, I ignore asset flows between ABC and its shareholders before today as "sunk." In the examples in this Article, I ignore the time value of money (or, alternatively, assume it is ze-

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amounts flowing to short-term shareholders and long-term shareholders, are summarized in Table 1 below.

Table 1.
SHAREHOLDER PAYOFFS AND THE PIE IN A NON-TRANSACTING FIRM

Short-Term Shareholders	Long-Term Shareholders	Future Shareholders	The Pie
$\$P$	$\$V/2$	$\$(V/2 - P)$	$\$V$

B. Long-Term Shareholders' "Better" Interests

In a non-transacting shareholder-only firm, short-term shareholder interests may not align with pie maximization, but long-term shareholder interests always will.

1. Short-Term Shareholders

Short-term shareholders will want managers to maximize the short-term stock price ($\$P$) at which they will sell shares to future shareholders. In a rational market, $\$P$ would reflect the best possible estimate (based on public information) of $\$V$. And in a rational market with full information, $\$P$ would equal $\$V$. Accordingly, in a full-information rational market, managers serving short-term shareholders would strive to maximize the pie.

But in the real world, future shareholders do not have full information about the value of a firm's stock.[96] Future shareholders must rely on information provided by managers. Managers, in turn, can engage in "price-boosting manipulation"—providing information to make the firm appear more valuable than it really is, thereby boosting the price that future shareholders will pay for the stock. Indeed, short-term shareholders will want managers to engage in price-boosting manipulation because it will increase their returns.

ro). This assumption, made purely for convenience, does not affect the analysis or conclusions.

96. In the real world, markets not only may lack full information but also may not be rational. Indeed, many economists hold the view that real-world markets are not rational but "noisy." *See, e.g.*, ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000). To keep things simple, I will generally assume that markets are rational. But this assumption is not necessary for any of my analysis or conclusions. Both short-term and long-term shareholders' interests are likely to diverge from pie maximization whether markets are rational or noisy.

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If price-boosting manipulation were always economically costless—that is, if it would not reduce the size of the pie—then short-term shareholders' interests would be consistent with pie maximization. Short-term shareholders would want managers to boost the short-term stock price through manipulation, and managers serving short-term shareholders would do so. But no value would be destroyed in the process. Instead, value would merely be transferred from one type of shareholder (future shareholders) to another (short-term shareholders) without any reduction in the size of the pie as a whole.[97]

However, short-term shareholders can also benefit from, and therefore will want managers to engage in, *costly* price-boosting manipulation—manipulation that boosts the short-term stock price but destroys economic value.[98] Because short-term shareholders care only about the short-term stock price, any corporate action that boosts the short-term stock price serves their interest, even if it destroys value.

Using the analytical framework introduced in Part III.A, suppose that managers could engage in an action X that boosts the short-term stock price $\$P$ by \$1 and reduces $\$V$ by \$0.25. X would destroy \$0.25 of economic value. But short-term shareholders would want managers to engage in X because X boosts $\$P$, the price at which short-term shareholders unload their shares.

Managers already engage in a variety of practices that constitute costly price-boosting manipulation. One practice is earnings manipulation: reporting earnings different from the "correct" amount of earnings given the firm's actual business activity and cash flows.[99] Another practice is real earnings management: the postponing of desirable transactions or premature acceleration of transactions to boost short-term accounting results and the short-term stock

97. If markets are rational, then future shareholders will fully discount for the possibility of price-boosting manipulation. Ex ante, price-boosting manipulation will not transfer value from future shareholders to short-term shareholders, on average.

98. One might wonder why I use the awkward term "costly price-boosting manipulation" rather than more compact and well-known terms such as "short-termism" or "managerial myopia." I resort to this ungainly expression because, as I explain in Part VII.B, actions that increase the short-term stock price but reduce the economic pie can not only serve short-term shareholders, but can also increase the *long-term* stock price on behalf of the *long-term* shareholders of the firm when the firm is issuing stock. Indeed, managers serving long-term shareholders of issuing firms engage in the very same types of value-reducing activities as managers serving short-term shareholders.

99. *See* Ilia D. Dichev et al., *Earnings Quality: Evidence from the Field*, 56 J. ACCT. & ECON. (SUPP. 1) 1, 3 (2013) ("The CFOs in our sample estimate that, in any given period, roughly 20% of firms manage earnings and the typical misrepresentation for such firms is about 10% of reported [earnings per share]."). Such manipulation reduces economic value to the extent that the firm devotes resources to adjusting its earnings.

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price at the expense of long-term economic value.[100] Each of these strategies shrinks the economic pie but makes the short-term stock price higher than it would otherwise be.[101]

While managers certainly engage in costly price-boosting manipulation, they may do so to enrich themselves rather than to enrich short-term shareholders.[102] Indeed, only a few published studies have found evidence of a link between short-term shareholders and costly price-boosting manipulation.[103] Therefore, many legal academics are skeptical that pressure from short-term shareholders *causes* managers to engage in value-destroying activities.[104] But

100. For evidence that managers engage in real earnings management, see, for example, Sugata Roychowdhury, *Earnings Management Through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 335-36 (2006). Roychowdhury finds evidence consistent with managers' overproducing goods and manipulating discretionary expenditures in a manner that boosts reported earnings but does not appear to increase economic value. See also John R. Graham et al., *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYSTS J. 27, 31 fig.4 (Nov.-Dec. 2006), which reports the results of a survey of over 400 senior financial executives in which eighty percent reported that, to meet an earnings target, they were willing to reduce discretionary spending on R&D, advertising, and maintenance, as well as delay starting projects, even if the actions reduced long-term cash flow.

101. Importantly, costly price-boosting manipulation does not necessarily cause the short-term stock price to become "inflated"—that is, exceed its true (full-information) value. After costly price-boosting manipulation occurs, the short-term stock price may still be lower than the stock's true value. However, the short-term stock price will be higher than it would be if, everything else equal, managers had not engaged in costly price-boosting manipulation. And the economic pie will be smaller. *See, e.g.*, Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 656-61 (1989) (considering a model in which managers forgo beneficial investments to inflate current earnings and boost the current stock price, and future shareholders rationally discount current earnings accordingly).

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

103. *See* Natasha Burns et al., *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 444 (2010) (examining firms that restated earnings between 1997 and 2002 and finding that ownership by "transient institutions"—those that trade actively and rapidly in search of profits—is associated with an increase in the likelihood and severity of an accounting restatement); Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 307 (1998) (finding that firms with more short-term shareholders are more likely to cut R&D expenses to meet short-term targets).

104. *See, e.g.*, Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1643-44 (2013) (arguing that there is little evidence that short-term shareholder influence undermines long-term value creation); George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 149-50 (2010) (noting that there is very little evidence of short-termism); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1085 (2007) ("[T]he empirical evidence on the extent and magnitude of myopia

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whatever one's view on this empirical question, there is no escaping the conclusion that short-term shareholder interests are not perfectly aligned with pie maximization.[105]

2. Long-Term Shareholders

Now consider long-term shareholders. Long-term shareholder interests are straightforward. As Table 1 makes clear, long-term shareholders' payoff ($\$V/2$) rises and falls with economic value ($\$V$).[106] In a non-transacting shareholder-only firm, long-term shareholder interests are aligned with maximizing the economic pie.

Accordingly, managers loyally serving long-term shareholders will seek to generate more value than managers loyally serving short-term shareholders. The conventional view and intuition about long-term shareholder interests is correct—at least for a non-transacting, shareholder-only firm.

***

Most firms, however, aggressively transact in their own shares. Indeed, publicly traded firms in the U.S. buy and sell, in aggregate, approximately $1 trillion of their own shares each year.[107] As we will see in the next four Parts, when firms buy and sell their own shares, long-term shareholder returns become decoupled from pie maximization and can be boosted by steps that actually destroy value. In such firms, neither short-term shareholder interests nor

is sketchy at best."); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 979 (2013) (arguing that there is not enough evidence of corporate short-termism to justify changes in corporate law).

105. If markets are rational, then short-term shareholders cannot systematically benefit from costly price-boosting manipulation. But managers seeking to boost the short-term stock price still engage in costly price-boosting manipulation at the "moment of truth"—the point when they must decide whether to exploit an opportunity to do so. *See, e.g.*, Stein, *supra* note 101, at 659-61. If markets are noisy rather than rational, the problem is much worse: short-term shareholders can benefit both ex post and ex ante from costly price-boosting manipulation. *See* Patrick Bolton et al., *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD. 577 (2006) (presenting a model in which managers serving short-term shareholders in a speculative market will engage in costly price-boosting manipulation).

106. Recall that I am assuming that the long-term stock price reflects the economic value of ABC's assets (here, $\$V$). To the extent that the long-term stock price could be manipulated by ABC's managers, long-term shareholder interests could become decoupled from pie maximization. For example, ABC's managers, seeking to serve long-term shareholders, might take steps that increase ABC's apparent value by $2 ($1 per share) but reduce $\$V$ by $0.50.

107. *See infra* Parts IV.A, VI.A.

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long-term shareholder interests align with pie maximization, and it becomes an open question as to which shareholders' interests are better aligned with pie maximization.

IV. LONG-TERM SHAREHOLDER RETURNS IN A REPURCHASING FIRM

In this Part, I examine the interests of long-term shareholders in a repurchasing firm. Part IV.A describes the widespread use of repurchases by U.S. firms. Part IV.B modifies the analytical framework presented in Part III to explain how stock buybacks change the relationship between long-term shareholders' interests and economic value. Part IV.C shows that long-term shareholders benefit when managers buy back stock at a cheap price; it also provides evidence that managers currently engage in such "bargain repurchases."[108]

A. The Widespread Use of Repurchases

Publicly traded U.S. companies increasingly distribute cash through repurchases rather than through dividends.[109] Over 90% of U.S. public firms that distribute cash to stockholders do so through share repurchases.[110] In 2007, S&P 500 firms distributed almost $600 billion through repurchases,[111] and total repurchases market-wide reportedly reached $1 trillion.[112] While repurchase volumes declined during the financial crisis, they have since returned to pre-

108. My goal in this Part and the next Part is not to systematically compare long-term and short-term shareholder interests in a repurchasing firm. Rather, my objective is to show that repurchases in a shareholder-only firm decouple long-term shareholder interests from economic value maximization. Therefore, I focus here on long-term shareholder interests in a repurchasing firm. However, in passing I will mention whether the various actions taken to serve long-term shareholder interests in a repurchasing firm are consistent or inconsistent with short-term shareholder interests. In Part VIII, I describe the factors that are likely to affect whether long-term or short-term shareholder interests are better aligned with pie maximization in a shareholder-only firm.

109. *See generally* Douglas J. Skinner, *The Evolving Relation Between Earnings, Dividends, and Stock Repurchases*, 87 J. FIN. ECON. 582 (2008) (comparing the percentages of firms that pay dividends, firms that repurchase shares, and firms that do both).

110. *See id.* at 583 (detailing "the declining propensity to pay dividends").

111. *See* Standard & Poor's, *S&P 500 Buybacks Set Record of $589 Billion in 2007*, PRNEWSWIRE (Apr. 7, 2008), http://www.prnewswire.com/news-releases/sp-500-buybacks-set-record-of-589-billion-in-2007-57123197.html [http://perma.cc/533Q-FZ5J].

112. *See* Paul A. Griffin & Ning Zhu, *Accounting Rules? Stock Buybacks and Stock Options: Additional Evidence*, 6 J. CONTEMP. ACCT. & ECON. 1 (2010).

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crisis levels: S&P 500 firms repurchased $475 billion of shares in 2013 and were expected to repurchase nearly $600 billion of shares in 2014.[113]

The volume of these share repurchases is substantial relative to firms' market capitalizations. Goldman Sachs reports that over the past decade, including the financial-crisis years, S&P 500 firms completed buybacks totaling 3% of their market capitalization per year on average.[114] In other words, over a five-year period, firms can be expected to distribute through share repurchases approximately 15% of their market capitalization. While many firms distribute more, and many less, the typical firm is likely to repurchase a substantial amount of its own stock.

The overwhelming majority of share repurchases take the form of "open market repurchases" (OMRs).[115] In an OMR, the firm repurchases its shares in the open market through a broker. The transactions are anonymous: shareholders are unaware that the firm is buying shares as the repurchases are occurring. Investors learn about the transactions only after the end of the quarter, typically one to four months after the transactions occur, when the firm reports the prior quarter's monthly share repurchases.[116]

To be sure, investors are aware that an OMR *might* be occurring. A firm cannot conduct an OMR unless its board has previously announced that it has authorized an OMR.[117] However, such an authorization is not binding on the firm. Firms do not commit – and are not obligated – to buy back any stock.[118] In fact, one study found that almost 30% of firms announcing repurchases do not buy back a single share within the fiscal year in which the repurchase announcement occurs, and about 15% do not buy back any shares within four fis-

113. See Sam Ro, *The Rate of Share Buybacks Has Doubled in the Last Decade*, BUS. INSIDER (Apr. 5, 2014, 12:40 PM), http://www.businessinsider.com/sp-500-stock-buyback-history-2014-4 [http://perma.cc/9KWK-6TAX] (reporting Goldman Sachs research on share buybacks).

114. *Id.*

115. *See* Monica L. Banyi et al., *Errors in Estimating Share Repurchases*, 14 J. CORP. FIN. 460, 460 (2008). Most other repurchases take the form of a "repurchase tender offer" (RTO), in which the firm offers to buy back its own stock directly from shareholders, usually at a premium over the market price. RTOs can also be used for bargain repurchases. *See* Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 421 (2000).

116. For a description of the regulatory framework applicable to OMRs, see Fried, *Insider Trading*, *supra* note 21, at 812-15.

117. *See id.* at 813.

118. *See* David L. Ikenberry & Theo Vermaelen, *The Option To Repurchase Stock*, 25 FIN. MGMT. 9, 12 (1996) (explaining that, by indicating that actual repurchases will depend on "market conditions," managers give themselves the option to repurchase stock if it turns out to be cheap without revealing managers' actual intentions).

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cal years of the announcement year.[119] Therefore, investors will not know with certainty that the firm is repurchasing shares until months after the company starts buying back shares.[120]

OMRs can generate some benefits for shareholders, such as providing a more tax-efficient payout mechanism than dividends.[121] But, as we will see below, OMRs also have a dark side. Managers may use OMRs to transfer value from short-term shareholders to long-term shareholders in ways that shrink the pie.

B. Analytical Framework: Decoupling Effect of Share Repurchases

To see how share repurchases decouple long-term shareholder interests from economic value, we will modify the analytical framework introduced in Part III to consider the scenario in which ABC Corporation repurchases its own equity in the short term for $\$P$. For now, I assume that the repurchase does not increase or decrease the size of the pie.

The three periods are as follows:

- *Today:* ABC has two shares outstanding. One share is held by short-term shareholders (denoted "ST"). One share is held by long-term shareholders (denoted "LT").

- *Short term:* Short-term shareholders sell their one share to ABC. The sale price is $\$P$ per share. The price $\$P$ may or may not reflect the share's actual (full-information) value.

- *Long term:* ABC's assets are sold for $\$(V\text{-}P)$ in cash, which reflects their actual value. The amount $\$(V\text{-}P)$ is distributed to long-term shareholders, who in the long term hold 100% of ABC's equity.

119. *See* Utpal Bhattacharya & Stacey Jacobsen, The Share Repurchase Announcement Puzzle: Theory and Evidence 3-4 (Nov. 2013) (unpublished manuscript), http://ssrn.com/abstract=250049 [http://perma.cc/B5UN-ZKZN] (analyzing firms announcing share repurchase programs in the period 1985 to 2012).

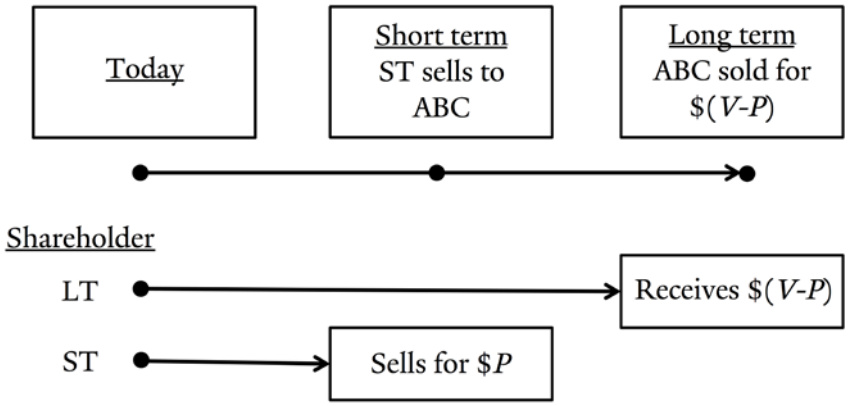
120. *See* Fried, *Insider Trading*, *supra* note 21, at 814-15.

121. Explanations of the potential benefits of repurchases are explored and analyzed in Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323, 1336-40 (2005).

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Because short-term shareholders sell their equity for $\$P$ per share to ABC rather than to future shareholders, there are no future shareholders in this scenario. The sequence of events is illustrated in Figure 2 below.

Figure 2.
ABC AS A REPURCHASING FIRM



Although ABC's value in the long term is different from what it was in the non-transacting-firm scenario ($\$(V\text{-}P)$ instead of $\$V$), the pie—the amount of value flowing to shareholders over time—is the same: $\$V$. The amount $\$(V\text{-}P)$ flows to long-term shareholders in the long term and the amount $\$P$ flows to short-term shareholders in the short term.[122]

The pie and payoffs to shareholders are summarized in Table 2 below.

Table 2.
SHAREHOLDER PAYOFFS AND THE PIE IN A REPURCHASING FIRM

Short-Term Shareholders	Long-Term Shareholders	Future Shareholders	The Pie
$\$P$	$\$(V\text{-}P)$	N/A	$\$V$

Unlike in the non-transacting-firm scenario, in a repurchasing firm there is now a disconnect between long-term shareholder returns and economic value.

122. Again, this example ignores the time value of money.

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As $\$P$ falls, long-term shareholders' payoff increases even though the pie remains unchanged.

C. Bargain Repurchases

The analysis in Part IV.B suggests that managers can conduct "bargain repurchases"—OMRs at a cheap price—to transfer value from short-term shareholders to long-term shareholders. And there is considerable evidence that they do just that.

1. Economic Logic

As I have shown elsewhere, a share repurchase has the same distributional consequences as a transaction in which the shareholders whose shares are repurchased directly sell their stock to the remaining shareholders at the repurchase price.[123] As a result, a repurchase at a low price (that is, a price lower than the no-transaction intrinsic value of the stock) transfers value from selling shareholders to non-selling shareholders.[124]

We can see this in terms of our ABC example. In non-transacting ABC (where there is no repurchase), the long-term shareholder will receive $\$V/2$ for its equity. In the event of a repurchase, it will receive $\$(V\text{-}P)$. The repurchase payout will exceed the no-repurchase payout if and only if $\$P < \$V/2$. Thus, when the short-term stock price is lower than the no-transaction intrinsic value of the firm's shares, long-term shareholders will be better off if the repurchase occurs than if it does not.[125]

Warren Buffett, in explaining why Berkshire Hathaway seeks to buy its own stock at a low price, puts it much more colorfully:

123. *See* Fried, *supra* note 121, at 1344-46.

124. When a firm buys stock at a price below its actual value, the precise distributional effects depend on whether the redeeming shareholders (here, the short-term shareholders) would have otherwise sold their shares to future shareholders for the same price. If so, the redeeming shareholder cannot be said to "lose" any value as a result of the bargain repurchase. Instead, the bargain repurchase deprives would-be future shareholders of a gain. For ease of exposition, however, I will generally assume (unless otherwise specified) that it is only the redeeming shareholders that lose money as a result of the bargain repurchase.

125. I am continuing to assume that ABC's long-term stock price reflects the value of the stock in the long term. But again, this assumption is not critical to my analysis or conclusions. Rather, all that is required is that ABC's managers expect that buying shares in the short term at a low price (or selling shares in the short term at a high price) will boost the long-term stock price.

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> [T]here is no surer way [of making money for continuing shareholders] than by buying an asset—our own stock—that we know to be worth *at least* x for less than that—for .9x, .8x or even lower. (As one of our directors says, it's like shooting fish in a barrel, *after* the barrel has been drained and the fish have quit flopping.) . . . And the more and the cheaper we buy, the greater the gain for continuing shareholders.[126]

2. Evidence of Bargain Repurchases

Warren Buffett is not the only CEO who has figured out that bargain repurchases can generate long-term shareholder value. Evidence that managers engage in bargain repurchases has been steadily accumulating. This evidence includes (a) executives' own statements and behavior and (b) post-repurchase stock returns, which are discussed in turn below.

a. What Executives Say and Do

When one wishes to understand why executives engage in a particular kind of transaction (such as share repurchases), it is often helpful to ask them. This is exactly what several economists did; they used a confidential survey to ask executives about their firms' payout policies. According to Alon Brav and his colleagues, "The most popular response for all repurchase questions on the entire survey is that firms repurchase when their stock is a good value, relative to its true value: 86.4% of all firms agree or strongly agree with this supposition."[127] Importantly, these economists reported, "executives tell us that they accelerate (or initiate) share repurchases when their company's stock price is low."[128]

But there was probably no need to use a confidential survey to elicit this information. Executives should be willing to say the same things publicly. After all, firms frequently and openly describe repurchase programs as designed to buy shares at favorable prices for long-term shareholders. For example, in a 2013 press release, UnitedHealth Group announced that it increased its share

126. Letter from Warren Buffet, Chairman of the Bd., to Shareholders of Berkshire Hathaway Inc. (Feb. 25, 2012), http://www.berkshirehathaway.com/letters/2011ltr.pdf [http://perma.cc/N8C2-DY7G].

127. Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483, 514 (2005).

128. *Id.*

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repurchase program to buy stock at low prices for the benefit of long-term shareholders.[129]

UnitedHealth Group's willingness to acknowledge openly that it uses inside information to stealthily acquire shares at a low price from short-term shareholders to transfer value to long-term shareholders would be shocking in a world in which managers believed that they owed the same duty to all shareholders. But managers have been repeatedly told—by leading legal academics, business school professors, and (perhaps most importantly) Delaware judges—that they should maximize long-term shareholder value, even at the expense of short-term shareholders. There is simply no reason for managers to be circumspect.

Managers do, in fact, use inside information to time repurchases. One recent study found that firms systematically buy stock at low prices in each quarter, often transferring large amounts of value to long-term shareholders.[130] In one firm, 7.76% of the total market capitalization was shifted from selling shareholders to long-term shareholders in this manner.[131] Unsurprisingly, this study also found that managers' tendency to exploit non-public information in timing repurchases increases with insider equity ownership—that is, the extent to which their interests are aligned with those of long-term shareholders.[132] Other recent studies have reported similar results.[133]

129. *UnitedHealth Group Board Increases Shareholder Dividend 32%; Renews Share Repurchase Program*, UNITEDHEALTH GRP. (June 5, 2013), http://www.unitedhealthgroup.com/Newsroom/Articles/Feed/UnitedHealth%20Group/2013/0605shareholderdividend.aspx [http://perma.cc/U6NZ-LGZ3] (reporting that the "renewed share repurchase program strengthens and extends our ability to repurchase shares at favorable prices for the benefit of long term shareholders" (quoting David S. Wichmann, Executive Vice President and Chief Financial Officer, UnitedHealth Group)).

130. *See* Amadeo De Cesari et al., *The Effects of Ownership and Stock Liquidity on the Timing of Repurchase Transactions*, 18 J. CORP. FIN. 1023, 1034 (2012).

131. *Id.* at 1046.

132. *Id.* at 1038-39.

133. *See* Azi Ben-Rephael et al., *Do Firms Buy Their Stock at Bargain Prices? Evidence from Actual Stock Repurchase Disclosures*, 18 REV. FIN. 1299 (2013) (finding, in a sample of firms during the years 2004 to 2009, that firms buy back their shares at a lower than average price, and that firm repurchase activity is positively related to firm insiders buying shares for their personal portfolios); Amy K. Dittmar & Laura Casares Field, *Can Managers Time the Market? Evidence Using Repurchase Price Data* (Mich. Ross Sch. of Bus. Working Paper No. 1234, May 2014), http://ssrn.com/abstract=2423344 [http://perma.cc/TL68-Q7DL] (finding, in a sample of firms during the years 2004 to 2011, that firms buy back their shares at a lower than average price, and that firms whose insiders bought shares for their own portfolios bought at particularly low prices).

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b. Post-Repurchase Stock Returns

The movement of stock prices following repurchases also suggests that many repurchases are driven by the desire to buy stock at a low price. Researchers have repeatedly found that companies announcing OMRs experience, on average, cumulative abnormal (market-adjusted) returns of approximately 25% over the next four years.[134] These abnormal returns suggest that firms announcing OMRs were, on average, 20% undervalued at the time of the OMR announcement.

However, as I noted earlier, many firms announcing OMRs do not actually buy back any stock.[135] We would expect firms that announce OMRs and then actually repurchase shares to be more undervalued, on average, than all firms announcing OMRs. Indeed, one study found that "value" firms (those with a high book-to-market ratio) that had announced repurchases and subsequently repurchased more than 4% of their shares in the following year experienced average four-year post-announcement abnormal returns of 57%.[136] These subse-

134. *See, e.g.*, Konan Chan et al., *Economic Sources of Gain in Stock Repurchases*, 39 J. FIN. & QUANTITATIVE ANALYSIS 461, 463 (2004) (finding that shares of firms announcing repurchases earn abnormal returns of 6.7% in the first year following the announcement and 23.6% over the subsequent four years); Urs Peyer & Theo Vermaelen, *The Nature and Persistence of Buyback Anomalies*, 22 REV. FIN. STUD. 1693, 1699 tbl.2 (2009) (finding, in a large sample of firms announcing OMRs, a 24.25% cumulative market-adjusted return over the forty-eight months following OMR announcements). Such large abnormal post-announcement returns are also found outside the United States. *See* Alberto Manconi et al., *Buybacks Around the World: Market Timing, Governance and Regulation* 18-21 (Eur. Corp. Governance Inst. Fin. Working Paper No. 436/2014, Aug. 2014), http://ssrn.com/abstract=2330807 [http://perma.cc/X8VG-663] (finding, in a large sample of non-U.S. firms announcing repurchases, similar abnormal returns over the four years following repurchase announcements).

135. *See supra* Part IV.A. There are at least two reasons why managers announcing OMRs may not follow through with any repurchases. First, managers might announce a repurchase that they have no plan to conduct simply to boost the stock price so they can unload their own shares at a higher price. *See* Fried, *supra* note 121, at 1351-56 (developing the argument that executives can use repurchase announcements for false signaling and providing anecdotal accounts of such false signaling). Indeed, a recent paper finds evidence of such "false signaling." *See* Konan Chan et al., *Share Repurchases as a Potential Tool To Mislead Investors*, 16 J. CORP. FIN. 137, 139 (2010) (finding evidence consistent with the fact that executives at poorly performing firms make share repurchase announcements without an intention to repurchase shares). Second, managers may announce an OMR to give the firm an option to acquire stock at a cheap price—an option that they may decline to exercise if the stock price does not turn out to be low. *See* Ikenberry & Vermaelen, *supra* note 118, at 10-11.

136. In contrast, firms that did not subsequently repurchase any shares experienced no observable post-announcement abnormal (that is, market-adjusted) returns. *See* Konan Chan et al., *Do Managers Time the Market? Evidence from Open-Market Share Repurchases*, 31 J. BANKING & FIN. 2673, 2676, 2686-88 (2007).

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quent returns provide additional evidence that managers currently use repurchases to shift value from selling shareholders to long-term shareholders.[137] Indeed, such studies have led economists to conclude that repurchasing stock at a low price has become a widespread practice.[138]

Not surprisingly, there is evidence of a link between managerial stock ownership (which aligns managers with long-term shareholder interests) and the propensity to undertake bargain repurchases. One study found that abnormal returns following repurchase announcements, which are associated with pre-repurchase underpricing, are positively correlated with pre-buyback executive stock ownership.[139] Another study compared executive stock ownership in two types of repurchasing firms: (1) relatively infrequent repurchasers, which are likely to engage in opportunistic bargain repurchasing when the stock price is low; and (2) relatively steady repurchasers, which are likely to repurchase shares to acquire stock for employee-option programs and to distribute cash rather than to buy back stock at a low price. It found that relatively infrequent repurchasers tend to have higher levels of executive ownership.[140] Both of these studies suggest that executives are more likely to engage in bargain-price repurchases when their interests are more aligned with those of long-term shareholders.

V. DESTROYING VALUE IN A REPURCHASING FIRM TO BOOST LONG-TERM SHAREHOLDER RETURNS

Part IV explained that managers can and do use bargain repurchases to shift value from selling shareholders to long-term shareholders. If these bargain repurchases were economically costless, they would merely shift value among different types of shareholders without reducing the size of the pie. Managers could boost long-term shareholder returns without destroying value.

137. For an explanation of why U.S. insider trading law enables managers to use inside information in deciding when the firm should repurchase shares, see Fried, *Insider Trading*, *supra* note 21 (explaining that much insider trading by firms is legal under current law and that illegal insider trading is often difficult to detect and deter, especially given the lax reporting requirements imposed on firms trading in their own shares).

138. *See, e.g.*, Malcolm Baker & Jeffrey Wurgler, *Market Timing and Capital Structure*, 57 J. FIN. 1, 28-29 (2002) (reporting that equity market timing–having the firm buy shares at a low price and issue shares at a high price–is an "important aspect" of actual corporate finance practice).

139. *See* Elias Raad & H.K. Wu, *Insider Trading Effects on Stock Returns Around Open-Market Stock Repurchase Announcements: An Empirical Study*, 18 J. FIN. RES. 45, 57 (1995).

140. *See* Murali Jagannathan & Clifford Stephens, *Motives for Multiple Open-Market Repurchase Programs*, 32 FIN. MGMT. 71, 71-72 (2003).

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Unfortunately, however, the use of bargain repurchases can give rise to economic costs that shrink the pie.

This Part describes two such costs. Part V.A explains that the use of bargain share repurchases to boost long-term shareholder returns can destroy economic value by inefficiently shrinking the firm. Part V.B explains that managers can, and do, benefit long-term shareholders by engaging in costly price-depressing manipulation around share repurchases.

A. Costly Contraction

The use of bargain repurchases to benefit long-term shareholders can lead to "costly contraction": managers seeking to buy back stock at a low price may give up economically valuable projects to fund the repurchase, reducing the total amount of value available to all the firm's shareholders over time.

1. How Inefficient Capital Allocation Can Benefit Long-Term Shareholders

From an economic perspective, a firm should distribute cash to shareholders via a repurchase (or dividend) if, and only if, total economic value will be increased.[141] For example, suppose that the firm is considering distributing $100 in cash. If an outside project would yield a 15% return and an inside project would yield 10%, the cash should be distributed. But if the best outside project available to shareholders would yield a 10% return and an inside project would yield a 15% return, then the cash should not be distributed.

Importantly, from this perspective, the firm's stock price should not be a relevant consideration in determining whether the firm should distribute cash via a repurchase. The stock price affects only the distribution of value among different types of shareholders. The only relevant consideration is whether the total economic pie will be bigger or smaller as a result of the repurchase.

However, as we saw in Part IV, managers make payout decisions based on the stock price: when the stock price is low, they initiate or accelerate repurchases. When managers use an extraneous factor such as the stock price to determine the timing of payout, payout policy can become distorted from an economic perspective.

Consider our simple analytical framework involving ABC Corporation. Recall that, absent a repurchase (or equity issuance), the payoff to long-term shareholders is $\$V/2$. If there is a repurchase, and no value is created or destroyed, then the payoff to long-term shareholders is $\$(V\text{-}P)$. Therefore, long-

141. *See* Fried, *Repurchases*, *supra* note 21, at 1135.

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term shareholders benefit (assuming no value is created or destroyed) from a repurchase whenever $\$P < \$V/2$. If, however, $\$X$ of economic value must be destroyed to effect the repurchase, long-term shareholders will still be better off with a repurchase as long as $\$(V\text{-}P\text{-}X) > \$V/2$, that is, whenever $\$P < \$(V/2\text{-}X)$.

It might be helpful to offer a numerical example. Suppose that ABC has $110 in fixed assets and $80 in cash that, if invested in a firm project, will yield a return of 12.5% (or $10). Assume, for simplicity, that any cash distributed by ABC will generate a 0% return outside the firm. If ABC does not repurchase a share in the short term, $\$V$ will equal $200 ($110+$80+$10), and the long-term shareholder payout ($\$V/2$) will equal $100. Suppose that, in the short term, ABC's shares trade at $80. If ABC repurchases a single share for $80, $\$V$ will equal $190 ($110+$80), and the long-term shareholder payout $\$(V\text{-}P)$ will equal $110. The long-term shareholder payout is higher if managers distribute cash that would generate $10 more economic value inside the firm.[142]

Who loses if ABC's managers distribute cash that could generate a larger return inside the firm? Not the short-term shareholder, who would have sold its share for $80 in any event (but to a future shareholder, rather than to ABC). Indeed, if we relax the example's assumptions a little bit and consider the possibility that the repurchase might boost the short-term stock price (by, among other things, increasing competition for the short-term shareholder's share), then the repurchase might actually benefit the short-term shareholder. The loser is the future shareholder, which would have purchased a share for $80 (assuming, as I do in the example, that the repurchase does not boost the short-term stock price) that is actually worth $100.

From a *current*-shareholder perspective, the outcome of costly contraction might not be objectionable. The long-term shareholder and the short-term shareholder come out ahead, jointly and perhaps even individually. But from an economic perspective, which takes into account the size of the total pie produced by the firm over time for all of its shareholders, current and future, destroying $10 of economic value to boost the payouts for current shareholders is undesirable.

142. *Cf.* Onur Bayar et al., *Payout Policy Under Heterogeneous Beliefs: A Theory of Dividends Versus Stock Repurchases, Price Impact, and Long-Run Stock Returns* 3-4 (Oct. 2013) (unpublished manuscript), http://ssrn.com/abstract=2287322 [http://perma.cc/KW2E-2D5A] (offering a model in which the existence of heterogeneous beliefs about the value of a firm's project may cause managers seeking to maximize the long-term stock price to underinvest in the project in order to buy back shares at a low price).

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2. Must Economic Value Be Sacrificed To Engage in Bargain Repurchases?

One might argue that a firm repurchasing its stock should be able to pursue both the valuable project *and* buy back stock that trades at a low price. In a world of perfectly efficient capital markets, this objection would have considerable force: the firm should be able to borrow cheaply enough to buy its own stock and invest in valuable new projects.[143]

However, as I have explained elsewhere,[144] a firm may not be able to borrow enough money to fund the desirable project while also buying back stock at a low price. First, as economists have long understood, the information asymmetry between lenders and the firm may make it difficult for the firm to borrow money cost-effectively.[145] From their perches inside the firm, managers may understand that the firm's prospects are good. But lenders outside the firm, who have less information than the managers, may not be as confident. They may insist on loan terms that make the costs of financing the desirable project higher than the benefits.

Second, the firm's contractual arrangements with other lenders might impede additional debt financing. Even if Lender *A* were willing to lend to the firm on cost-effective terms, loan covenants with Lenders *B*, *C*, and *D* might bar the firm from borrowing additional funds (from Lender *A* or any other creditor).[146] While renegotiation is possible in theory, it might be difficult in practice, particularly if the borrower must simultaneously renegotiate with multiple creditors to obtain the modifications needed to facilitate the new investment.

In short, firms may need to choose between engaging in a bargain price repurchase and funding desirable projects. Indeed, empirical evidence suggests that repurchases often divert cash that would otherwise be used for research and development and other productive investments in the firm.[147] For example, one study found that repurchases appear to have a significantly negative effect

143. Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187, 187 (1984).

144. *See* Fried, *Repurchases*, *supra* note 21, at 1125-26.

145. *See* Myers & Majluf, *supra* note 143.

146. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 879 (1996) (noting that the difficulty of specifying all possible contingencies is likely to cause covenants to be over-inclusive in some respects).

147. *See, e.g.*, Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises*, 40 J. ACCT. RES. 359, 359 (2002) (finding evidence that firms that repurchase shares to satisfy option exercises exhibit subsequent declines in performance because the repurchases divert cash from productive investments).

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on a firm's short-term investments and R&D, with a doubling of repurchases leading to an 8% reduction in R&D expenditures.[148]

B. Costly Price-Depressing Manipulation Around Bargain Repurchases

We saw in Part III that managers serving short-term shareholders may engage in costly price-*boosting* manipulation to lift the short-term stock price. We will now see that managers serving long-term shareholders may engage in costly price-*depressing* manipulation to reduce the short-term stock price around bargain repurchases; indeed, there is evidence that such costly price manipulation already occurs around repurchases.

As Part IV explained, long-term shareholder returns in a repurchasing firm depend on the price at which the firm buys its own shares. Long-term shareholders benefit when the repurchase price is low (relative to the no-transaction value of the stock); the lower the price, the better off long-term shareholders will be. Managers repurchasing cheap shares in the short term can therefore benefit long-term shareholders by further depressing the short-term stock price.[149]

Importantly, managers can help long-term shareholders by manipulating the stock price around repurchases even when some economic value is sacrificed. In particular, assuming that long-term shareholders' losses from value destruction are lower than the benefit of the reduced repurchase price, long-term shareholders will prefer that managers engage in costly price-depressing manipulation.[150]

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148. *See* Alok Bhargava, *Executive Compensation, Share Repurchases and Investment Expenditures: Econometric Evidence from US Firms*, 40 REV. QUANTITATIVE FIN. & ACCT. 403, 419-20 (2013) (concluding that repurchases, especially those that appear to be driven by executive stock ownership, appear to have a significantly negative effect on a firm's investments and research and development, with a doubling of repurchases leading to an 8% reduction in R&D expenditures).

149. Note that long-term shareholders benefit from such manipulation even if the pre-manipulation stock price is high relative to its actual value. If the pre-manipulation stock price is high, but managers must conduct the repurchase anyway (perhaps to acquire shares for employee stock-option programs), then reducing the stock price benefits long-term shareholders by reducing the cost to them of indirectly acquiring high-price stock.

150. Consider again ABC Corporation from Part IV.B. ABC initially has two shares outstanding (one held by long-term shareholders and one held by short-term shareholders). It is liquidated in the long term. ABC will repurchase short-term shareholders' single share in the short term. There are two scenarios:

No Manipulation Scenario: Suppose that, if ABC does not depress its short-term stock price, it will buy back a single share from its short-term shareholders for $10 and distribute $10 to the holders of its other share in the long term. In other words, $\$P$ = $10, and $\$V$ = $20.

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In fact, there is evidence that managers manipulate prices before and during repurchases, deliberately driving earnings and stock prices down to increase the amount of value transferred to long-term shareholders. One study examined 1720 OMR announcements between 1984 and 2002 that were followed by actual repurchases during the quarter of the announcement or the following quarter.[151] The study found significant negative earnings manipulation among firms that announced and conducted OMRs, but not among firms that announced OMRs but did not conduct them.[152]

Not surprisingly, downward earnings manipulation was more aggressive in firms in which the equity ownership of the CEO was higher—that is, when the CEO's interests were more aligned with the interests of long-term shareholders.[153] This finding strongly suggests that, the more the board and management focus on maximizing long-term shareholder value, the more likely managers will be to engage in costly price-depressing manipulation.

To be sure, long-term shareholders will not always benefit from costly price manipulation. If costly price manipulation destroys too much of the pie, then long-term shareholders will be made worse off. But the important point is that, just as short-term shareholders can benefit from costly price-boosting manipulation that lifts the short-term stock price, long-term shareholders can benefit from costly price-depressing manipulation of a kind that reduces the short-term stock price when the firm is repurchasing shares.

It is also worth noting that unlike costly contraction, which can benefit short-term shareholders and hurts (would-be) future shareholders, costly

Costly Manipulation Scenario: Now suppose that ABC can engage in price-depressing manipulation (say, earnings management) in the short term that reduces the short-term stock price $\$P$ by \$2 (from \$10 to \$8). Assume that the manipulation reduces economic value ($\$V$) by \$1. ABC can thus buy back a single share for \$8, but must give up an additional \$1 of value to do so. The repurchase, coupled with costly price-depressing manipulation, thus reduces $\$V$ from \$20 to \$19. In the long term, the value of ABC's remaining share (held by long-term shareholders) is \$11 (\$20-\$8-\$1).

Managers serving long-term shareholders will engage in costly price-depressing manipulation around the repurchase because it boosts long-term shareholder payout from \$10 to \$11. But \$1 of economic value is lost: in the No Manipulation Scenario, the pie ($\$V$) is \$20 (\$10 distributed in the long term and \$10 distributed in the short term); in the Costly Manipulation Scenario, the pie is \$19 (\$11 distributed in the long term, and \$8 distributed in the short term).

151. *See* Guojin Gong et al., *Earnings Management and Firm Performance Following Open-Market Repurchases*, 63 J. FIN. 947, 956-57, 983 (2008) (reporting that firms adjust accruals to decrease their reported earnings before stock repurchases); *cf.* Dichev et al., *supra* note 99, at 30 (reporting that 40% of earnings management is income-decreasing).

152. *See* Gong et al., *supra* note 151, at 948.

153. *See id.* at 983.

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price-depressing manipulation hurts short-term shareholders and benefits future shareholders by causing the former to sell, and enabling the latter to buy, at a lower price. Because this manipulation is value-destroying, the benefit to long-term shareholders and future shareholders will, by definition, be less than the cost to short-term shareholders.

***

We have seen that managers seeking to serve long-term shareholders may cut back on economically desirable investments to buy stock at a low price and, when repurchasing shares, waste resources trying to drive the stock price down. We should not be surprised that managers in fact engage in these value-wasting activities. They have been told by legal academics, business school professors, and the courts not only that it is permissible to shift value from short-term shareholders to long-term shareholders, but also that it may well be the managers' duty to do so. And, of course, managers have compensation arrangements tied to long-term shareholder value that incentivize them to act in this manner.

VI. LONG-TERM SHAREHOLDER RETURNS IN AN ISSUING FIRM

We now turn to the "mirror image" of repurchases: equity issuances. Like share repurchases, equity issuances decouple long-term shareholders' interests from pie maximization. As we will see in Part VII, long-term shareholders in an issuing firm, like long-term shareholders in a repurchasing firm, can benefit when managers take steps that reduce the economic pie.

Part VI.A describes the widespread use of equity issuances. Part VI.B modifies the analytical framework presented in Part III to explain how equity issuances change the relationship between long-term shareholders' interests and economic value. Part VI.C shows that long-term shareholders benefit when managers sell stock at an inflated price, and it provides evidence that managers currently engage in such "inflated-price" issuances.[154]

154. Just as my objective in Parts IV and V was not to systematically compare the interests of short-term shareholders and long-term shareholders in repurchasing firms, my goal in this Part is not to systematically compare the interests of long-term and short-term shareholders in issuing firms. Rather, my objective is to show that issuances decouple long-term shareholders' interests from value maximization in a shareholder-only firm. Therefore, I focus here primarily on long-term shareholder interests, although I will mention in passing how various value-destroying transactions that benefit long-term shareholders in an issuing firm affect short-term shareholders. In Part VIII, I describe factors that are likely to affect wheth-

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A. Widespread Use of Equity Issuances

The typical publicly traded firm not only repurchases shares, but also issues a considerable amount of shares over its life as a public firm. Indeed, issuances typically exceed repurchases. For example, during each of the years in the period from 1993 to 2002, an average of 66.5% of large firms made *net* stock issues (issuances less repurchases).[155] Strikingly, these net stock issuances averaged 7.5% of assets, which is on the same order of magnitude as net debt issuances.[156] The fact that net issuances are so common and so large suggests that the dollar volume of share issuances is the same order of magnitude as the dollar volume of repurchases. Interestingly, the aggregate share count for S&P 500 firms has remained relatively stable over the last decade,[157] suggesting that the number of shares issued is in the same ballpark as the number of shares repurchased. The dollar volume of repurchases averages approximately 15% of a firm's market capitalization over five years.[158] It appears that equity issuances are of a similar magnitude, and thus that the total volume of equity issuances and repurchases are approximately 30% of a firm's market capitalization over five years.

While almost all repurchases take the form of OMRs, equity issuances come in a variety of flavors. I will focus on two of the most important: (1) acquisition-related issuances and (2) seasoned equity offerings.[159]

1. Acquisition-Related Issuances

Acquirers often issue equity to provide currency for purchasing the shares of a target company, in part because the use of equity rather than cash can pro-

er long-term or short-term shareholder interests are better aligned with pie maximization in a shareholder-only firm.

155. *See* Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549, 551 (2005).

156. *Id.* The figure for smaller firms was 12.6%, about twice as much as their net debt issues. *Id.*

157. *See FactSet Buyback Quarterly*, FACTSET (June 19, 2013), http://www.factset.com/websitefiles/PDFs/buyback/buyback_6.19.13 [http://perma.cc/EL83-98A8].

158. *See supra* Part IV.A.

159. A third important flavor is equity issuances made in connection with executive and employee compensation programs. For example, among the largest 200 firms in 2007, the range of shares allocated to equity compensation plans ranged from 0.92% of outstanding shares to 62.6% of outstanding shares, with the median around 10.5%. *See 2008 Equity Stake Study: Study of the Top 200 Corporations*, PEARL MEYER & PARTNERS, LLC 2 (2009), http://www.pearlmeyer.com/Pearl/media/PearlMeyer/PDF/2008PMPEquityStakeStudy.pdf [http://perma.cc/3MJM-H5Z6].

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vide a tax benefit to the target shareholders.[160] An example of such an acquisition (and one to which we will return in Part VII.A) is AOL's acquisition of Time Warner in 2000 for $162 billion in equity.

2. Seasoned Equity Offerings

Seasoned equity offerings (SEOs) raise cash to fund operations and strategic investments, or to pay down debt.[161] Many firms engage in SEOs, and the amount of stock sold is substantial.[162] SEOs come in two forms: "firm commitment" and "at-the-market" (ATM).

a. Firm-Commitment SEOs

Until relatively recently, SEOs were almost always "firm-commitment": the firm arranges to sell a specified number of shares at a fixed price through an underwriter that guarantees to sell the shares at that price and then offers the shares to investors.[163] When the market learns of a firm-commitment SEO, the stock price tends to fall.[164] The market's reaction to SEO announcements is not surprising, as an issuance may signal that the stock is overvalued.

b. At-The-Market Offerings

In part due to the adverse effect of firm-commitment SEOs on the stock price, firms have taken advantage of recent regulatory changes to issue stock via so-called "at-the-market" SEOs.[165] In an ATM, the firm sells shares directly

160. *See* Fama & French, *supra* note 155, at 554 (explaining the tax advantage of using acquirer-firm stock to purchase shares of targets).

161. *See id*. at 573-75 (describing various purposes for stock issuances, including SEOs).

162. *See* Fangjian Fu, *Overinvestment and the Operating Performance of SEO Firms*, 39 FIN. MGMT. 249, 250 (2010) (reporting that, in a sample of 2873 SEOs from 1980 to 1999, outstanding shares increased by an average of 26%).

163. *See* B. Espen Eckbo et al., *Security Offerings*, *in* 1 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 233, 243 (B. Espen Eckbo ed., 2007) (reporting that firm commitment underwritings are "the primary choice of publicly traded U.S. firms" and explaining that an underwriter syndicate guarantees the proceeds of the issue).

164. *Id.* at 315-18 (surveying studies of firm-commitment SEOs in the United States and reporting that, on average, there are significantly negative stock-price reactions to announcements of these transactions); Tim Loughran & Jay R. Ritter, *The New Issues Puzzle*, 50 J. FIN. 23, 30 n.6 (1995) (collecting sources documenting that the stock price drops when an SEO is announced).

165. *See* Matthew T. Billett et al., *At the Market (ATM) Offerings* 2 n.1, 4 nn.5-6 (Nov. 12, 2013) (unpublished manuscript), http://ssrn.com/abstract=2178052 [http://perma.cc/9MU2

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(and quietly) on the market through a sales agent.[166] A firm need not—and typically does not—announce these sales as they are occurring, much as firms do not announce OMR transactions as they take place.

Indeed, ATMs are marketed as a way for firms to issue shares quickly when the price appears favorable without alerting the market to the issuance in real time[167] (which might cause the stock price to fall). As a recent article by several securities lawyers put it, an ATM enables "the issuer [to] opportunistically take advantage of stock price movements."[168]

To be sure, investors know that an ATM *might* occur. Before conducting an ATM, the firm must have an effective shelf registration statement (including a prospectus) on file with the SEC.[169] In these disclosures, the firm must indicate either the maximum number of shares to be sold or the maximum proceeds from the sales, and the firm must identify the sales agent.[170]

However, these pre-transaction disclosures do not provide much useful information to future shareholders, for two reasons. First, these disclosures can be updated at any time to increase the ceiling on the number of shares to be sold. As a result, investors do not know the maximum number or value of shares that will actually be sold. Second, the filing of these disclosures does not compel the firm to enter into a single transaction. Like an OMR announcement, an ATM filing gives a firm the option, but not the obligation, to trade in its shares on the open market. Investors will not learn of a sale until months after it takes place.[171] Consequently, managers have considerable ability to

-52NP] (describing how regulatory changes in 2005 and 2008 led to ATM issuances increasing from 1% of total SEO volume in 2008 to 10% of total SEO volume in 2012); Sigitas Karpavicius & Jo-Ann Suchard, *Institutional Ownership and the Rise of Shelf Offerings in U.S. Equity Raisings* 12 (June 6, 2012) (unpublished manuscript), http://ssrn.com/abstract=1566730 [http://perma.cc/9LM5-NG69] (explaining that, from 1997 to 2007, the fraction of equity issued through traditional SEOs dropped from 82% to 19%).

166. For a discussion of these offerings and their requirements, see James D. Small III et al., *The Resurgence of United States At-the-Market Equity Offerings to Raise Capital in Volatile Equity Markets*, 4 CAP. MARKETS L.J. 290, 291-300 (2009).

167. *See* David M. Carter et al., *ATM Offerings—Flexible, Opportunistic Access to Capital*, MARTINDALE-HUBBELL (Oct. 25, 2010), http://www.martindale.com/securities-law/article_Troutman-Sanders-LLP_1171318.htm [http://perma.cc/9NG8-6FCN] (claiming that "ATM offerings . . . permit[] timely, opportunistic access to the capital markets" in part because of "minimal real-time disclosure of sales activity").

168. Small III et al., *supra* note 166, at 291.

169. *Id.* at 295-96.

170. *Id.* at 296.

171. Like firms conducting OMRs, firms conducting ATMs need not publicly disclose any information about ATM transactions until after the end of the quarter in which the transactions took place. *See id.* at 302 (noting that some firms conducting ATMs disclose information only on quarterly Form 10-Q filings). Indeed, while firms conducting OMRs must

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transfer value from future shareholders to long-term shareholders through stealth sales of shares on the open market.

B. Analytical Framework: Decoupling Effect of Equity Issuances

To see how equity issuances decouple long-term shareholders' interests from the pie, we modify the analytical framework introduced in Part II to consider the scenario in which ABC Corporation issues a third share in the short term for $\$P$. I assume that the issuance does not create or destroy economic value.

The periods are as follows:

- *Today:* ABC has two shares outstanding. One share is held by short-term shareholders (denoted "ST"). One share is held by long-term shareholders (denoted "LT").

- *Short term:* Short-term shareholders sell their one share to future shareholders (denoted *F*). ABC also sells an additional share to future shareholders. As a result, future shareholders acquire two shares. In both transactions, the sale price is $\$P$ per share. The price $\$P$ may or may not reflect the share's actual (full-information) value.

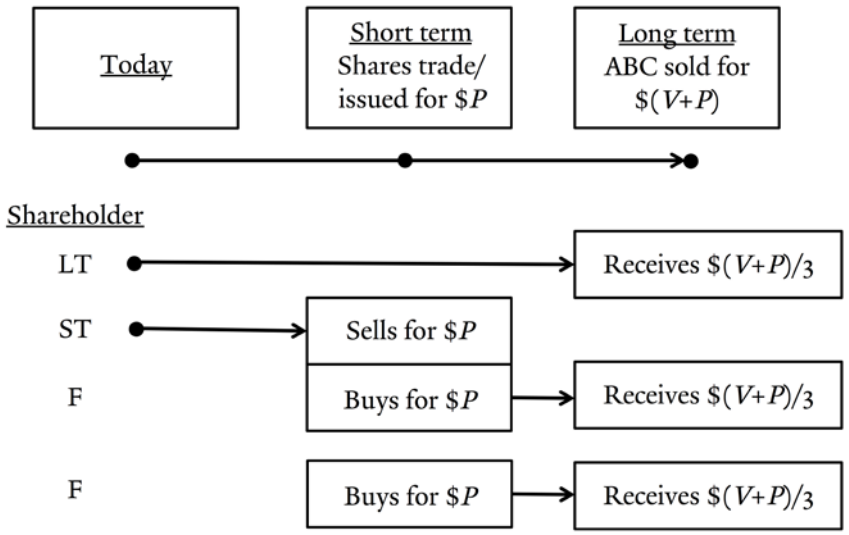
- *Long term:* ABC's assets are sold for $\$(V+P)$ in cash, which reflects their actual value. The amount $\$(V+P)$ is distributed to long-term shareholders and future shareholders. There are a total of three shares outstanding, so the holder of a share receives $\$(V+P)/3$. Long-term shareholders receive $\$(V+P)/3$. Each future shareholder also receives $\$(V+P)/3$, for a total to future shareholders of $\$2(V+P)/3$.

The sequence of events is illustrated in Figure 3 below.

disclose the number of shares repurchased in each month of the preceding quarter and the average price paid for each share, *see supra* Part IV.A, no such breakdown is required for ATMs. In general, firms need report (for the preceding quarter) only the total number of shares issued and the proceeds from those sales. Small III et al., *supra* note 166, at 302.

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Figure 3.
ABC AS AN ISSUING FIRM



Although ABC's value in the long term is different from what it was in the non-transacting case ($(V+P)$ instead of V), economic value—the amount of value flowing to shareholders over time—is the same: V. The amount $(V+P)$ flows to long-term shareholders and future shareholders in the long term, and $P flows *from* future shareholders to the firm in the short term.

The economic pie and payoffs to the different types of shareholders are summarized in Table 3 below.

Table 3.
SHAREHOLDER PAYOFFS AND THE PIE IN AN ISSUING FIRM

Short-Term Shareholders	Long-Term Shareholders	Future Shareholders	The Pie
$P	$(V+P)/3	$2[-P+(V+P)/3]	$V

Unlike in the non-transacting case, but as in the repurchasing case, there is a disconnect between long-term shareholder returns and the pie. As $P increases, long-term shareholders' payoff rises, but the pie remains the same. Put another way, the equity issuance converts a long-term shareholder into a par-

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tial short-term shareholder (one whose payoff is also linked to $\$P$, the short-term stock price).

C. *Inflated-Price Issuances*

The analysis offered in Part VI.B suggests that managers can transfer value from future shareholders to long-term shareholders by conducting "inflated-price issuances"—equity offerings at a price higher than the stock's actual value. Indeed, they frequently do so.

1. *Economic Logic*

An equity issuance has analogous distributional effects to a share repurchase. A share repurchase transfers value from short-term shareholders to long-term shareholders when the stock price is lower than its actual value. A stock issuance transfers value from future shareholders to long-term shareholders when the stock price is higher than its actual value. Hence, managers can benefit long-term shareholders by selling stock at an inflated price.[172]

We can see this in terms of our ABC example. When ABC does not issue equity (or repurchase stock), long-term shareholders will receive $\$V/2$ for their equity. But if ABC issues one share for $\$P$, long-term shareholders will receive $\$(V+P)/3$ for their equity. If $\$P > \$V/2$, long-term shareholders are better off.

Who loses from the sale of overpriced equity? In our example, the losers are future shareholders, who buy overpriced shares. But stepping outside this framework for a moment, we should note that a firm's sale of stock might not increase the number of shares purchased by future shareholders; rather, it might decrease the shares sold by short-term shareholders, who are partially displaced by the firm's selling activity. If future shareholders buy the same number of shares, and short-term shareholders sell fewer shares, then short-term shareholders will lose from the sale of overpriced equity.

Of course, in the real world, a firm's sale of stock can be expected to have at least some negative effect on the short-term stock price. This price effect, on which I do not focus, would also need to be taken into account to fully determine which shareholders win and which shareholders lose, and by how much. But the precise identity of the losing shareholders and the extent of their loss

172. *See* Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J. FIN. ECON. 295 (2003) (proposing that overvalued firms engage in stock-financed acquisitions so that their long-term shareholders can benefit from obtaining hard assets at a discount); *see also* Matthew Rhodes-Kropf & S. Viswanathan, *Market Valuation and Merger Waves*, 59 J. FIN. 2685 (2004) (similar).

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are both irrelevant to the point that I wish to emphasize here—namely, that long-term shareholders are better off when the firm sells overpriced stock.

2. Evidence of Inflated-Price Issuances

We saw in Part III that many managers acknowledge that their firms repurchase shares when the price is low.[173] Similarly, and not surprisingly, many managers also acknowledge that they issue shares when they believe the stock price is "high."[174] Moreover, just as empirical studies repeatedly find that managers tend to conduct repurchases at low prices, there is considerable evidence that managers conduct equity issuances—either to acquire other firms or to raise cash—when the stock is overpriced.

Turning first to acquisition-related issuances, firms tend to use overpriced stock as consideration in acquisitions.[175] Such acquisitions benefit the long-term shareholders of the acquiring firms by enabling the acquiring firms to purchase assets with overvalued currency, reducing the effective purchase price paid.[176]

Equity issuances for cash show a similar pattern. There is evidence, going back decades and from around the world, that traditional SEOs are, on average, overpriced.[177] A recent paper examining 2600 SEOs between 1992 and

173. *See* Brav et al., *supra* note 127, at 514.

174. *See* John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 J. FIN. ECON. 187, 216 tbl.8 (2001) (reporting results of a survey of 392 CFOs about their decision making around capital structure).

175. *See, e.g.*, Ming Dong et al., *Does Investor Misvaluation Drive the Takeover Market?*, 61 J. FIN. 725, 757 (2006) (finding that overpriced firms are more likely to try to acquire other firms that are less overpriced); Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?*, 52 J. FIN. 1765, 1775 (1997) (finding that managers of acquiring firms use stock to pay for the acquisitions when their firms' stock is likely to be overvalued and cash when their firms' stock is likely to be undervalued); Matthew Rhodes-Kropf et al., *Valuation Waves and Merger Activity: The Empirical Evidence*, 77 J. FIN. ECON. 561, 600-01 (2005) (concluding that the "vast majority" of mergers "involve highly overvalued bidders").

176. *See* Pavel G. Savor & Qi Lu, *Do Stock Mergers Create Value for Acquirers?*, 64 J. FIN. 1061, 1063-64 (2009) (finding that the shares of a sample of stock-financed bidders that completed their acquisitions outperformed a control sample of stock-financed bidders that failed to complete their acquisitions by about 25% to 30% over a three-year horizon, and demonstrating that the outperformance was due to the successful bidders' ability to acquire cheap assets).

177. *See, e.g.*, Baker & Wurgler, *supra* note 138, at 2 (reporting that equity market timing—having the firm buy shares at a low price and issue shares at a high price—is an important aspect of actual corporate finance practice); Loughran & Ritter, *supra* note 164, at 25, 47 (examining 3702 SEOs between 1970 and 1990, and finding evidence consistent with the fact that firms

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2010 suggests the magnitude of this benefit. It finds that firms timing traditional SEOs boost average returns to long-term shareholders by approximately 3% over the subsequent three years.[178] Importantly, and not surprisingly, the propensity to engage in inflated-price issuances appears to increase with insider equity ownership—that is, as managers' interests become more aligned with those of long-term shareholders.[179]

Although ATMs are relatively new, the evidence now emerging is consistent with insiders' using ATMs to sell overvalued equity. For example, one recent study finds that ATMs are announced after significant stock price run-ups and that the market reacts negatively to their announcement.[180] This study also finds that actual sales under ATM programs are executed after the stock price has recently risen and market conditions are relatively favorable.[181] These findings should not be surprising, since ATMs are marketed to firms as a method of enabling managers to issue shares quickly when the price appears favorable without alerting the market to the issuance and causing the stock price to fall.[182] We can expect ATMs, like traditional SEOs, to be used to transfer value from future shareholders to long-term shareholders.[183]

"announce stock issues when their stock is grossly overvalued," that the market fails to revalue these firms' shares appropriately, and that these shares remain "overvalued when the issue occurs"); Jeffrey Pontiff & Artemiza Woodgate, *Share Issuance and Cross-Sectional Returns*, 63 J. FIN. 921, 943-44 (2008) (finding evidence of post-SEO stock underperformance in a recent sample of U.S. SEOs). Equity issuances outside the U.S. also tend to be overpriced. Brian J. Henderson et al., *World Markets for Raising New Capital*, 82 J. FIN. ECON. 63, 66 (2006) (examining equity issuances around the world and concluding that "firms are more likely to issue equity when the stock market appears to be overvalued").

178. *See* Ilona Babenko et al., *Agency Implications of Equity Market Timing* 54 (Ariz. State Univ., Working Paper, 2013) (reporting that, for firms timing SEOs, the average additional three-year return created for long-term shareholders was 3.21%).

179. *See* Eric R. Brisker et al., *Executive Compensation Structure and the Motivations for Seasoned Equity Offerings,* 40 J. BANKING & FIN. 330, 331 (2014) (finding that managers owning relatively large amounts of equity are more likely to engage in inflated-price issuances than other managers); *cf.* Sudip Datta et al., *Executive Compensation Structure and Corporate Equity Financing Decisions*, 78 J. BUS. 1859, 1886-87 (2005) (finding, in a sample of 444 SEO announcements occurring between 1992 and 1999, that the market reacted more negatively to announcements by firms in which managers owned more equity).

180. *See* Billett et al., *supra* note 165, at 17-18 (finding, in a sample of ATMs between 2008 and 2012, that ATMs are announced following abnormal stock price increases and that their announcements are associated with an average negative abnormal stock decline of 3%).

181. *See id.* at 23-24 (finding that more positive stock returns in the prior quarter lead to larger actual issuances in the current quarter).

182. As one practitioner's article candidly stated, in an at-the-market SEO, "the issuer can opportunistically take advantage of stock price movements." Small III et al., *supra* note 166, at 291.

183. For an explanation of why U.S. insider trading law enables managers to use inside information in deciding when the firm should issue shares, see Fried, *Insider Trading*, *supra* note

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It is worth pausing here to reflect on the fact that corporate lawyers in the United States feel comfortable advising firms to adopt arrangements that allow managers to transfer value from future shareholders to current shareholders. In a regime such as the United Kingdom's, in which managers are considered to owe a fiduciary duty to both current and future shareholders,[184] lawyers might think twice before advising firms to use inside information to secretly sell shares to future shareholders at a price that benefits current shareholders. But in the United States, where it is considered self-evident that managers owe a duty only to current shareholders[185] and therefore can and should use any legal means to transfer value from future shareholders to current shareholders, advising firms to do so might seem not only natural but also desirable.

VII. DESTROYING VALUE IN AN ISSUING FIRM TO BOOST LONG-TERM SHAREHOLDER RETURNS

Part VI explained that managers can and do use inflated-price issuances to shift value from future shareholders to long-term shareholders. If these issuances were economically costless, then they would merely shift value among different types of shareholders without reducing the size of the pie. Unfortunately, however, managers serving long-term shareholders may destroy economic value through inflated-price issuances to enrich long-term shareholders.

This Part examines two types of potential economic costs associated with inflated-price issuances. Part VII.A explains that managers using inflated-price equity issuances to benefit long-term shareholders may engage in "costly expansion"—inefficiently moving assets from outside to inside the firm. Part VII.B explains that managers engaged in inflated-price issuances can further benefit long-term shareholders by engaging in costly price-boosting manipulation around the issuances.

A. Costly Expansion

Managers serving long-term shareholders may increase the size of the firm through the sale of overpriced equity, even though the expansion may destroy economic value.

21, at 822-24 (explaining that some kinds of insider trading by firms is legal under current law and that illegal insider trading is often difficult to detect and deter, especially given the lax trade reporting requirements imposed on firms conducting ATMs).

184. *See supra* note 90.

185. *See supra* note 88.

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1. Economic Logic

We saw in Part V that a repurchase can reduce economic value by distributing cash that, from the perspective of all the firm's current and future shareholders, could generate higher returns if invested in the firm's own projects. Analogously, an equity issuance can reduce economic value if the equity issuance causes the firm to absorb assets that would generate more value outside the firm. Furthermore, just as long-term shareholders can benefit from managers' sacrificing valuable in-firm projects to buy back stock at a low price, they can benefit from managers' acquiring assets at a discount through the use of overpriced stock that would generate more economic value outside the firm.[186]

2. AOL-Time Warner Transaction

Do real-life long-term shareholders actually benefit from the sale of overpriced equity to finance a value-destroying acquisition? From an ex post perspective, one can certainly find many examples in which long-term shareholders of acquirers benefit from value-wasting acquisitions financed with inflated

186. A numerical example involving ABC Corporation from Part VI.B may help clarify. As before, ABC initially has two shares outstanding and is liquidated in the long term. One share is held by long-term shareholders, the other by short-term shareholders. Consider two scenarios:

No Expansion Scenario: Suppose that, if ABC does not issue another share prior to the long term, future shareholders will buy the short-term shareholders' single share in the short term, and ABC will distribute $20 to the holders of its two shares in the long term. In other words, $\$V = \$20$. The no-transaction value of each of ABC's two shares in the long term will be $10 ($\$V/2$).

Costly Expansion Scenario: Now suppose that ABC can conduct an equity issuance in the short term when $\$P$ (the short-term stock price) equals $14 ($4 more than its actual value of $10), selling a share directly to future shareholders (who also purchase the short-term shareholders' share). ABC's value in the long term is $\$(V + 14 + X)$, where X is the change in value caused by the equity issuance. Assume that the $14 received increases ABC's value by $13, from $20 to $33, because $1 of value is lost as a result of moving assets into the firm. (In other words, $X = -\$1$.) Thus, in the long term, the value of each of ABC's three shares, including the one held by long-term shareholders, is $11.

Managers serving long-term shareholders will expand the firm, because it increases long-term shareholders' payout from $10 to $11. However, the expansion reduces economic value. In the No Expansion Scenario, the pie is $20; in the Costly Expansion Scenario, the pie is $19 ($33 distributed in the long term less $14 received from shareholders in the short term).

For a similar example showing that executives compensated with stock may engage in costly expansion to boost the value of their own equity, see Fried, *Repurchases*, *supra* note 21, at 1135.

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stock. If there were a poster child for such a transaction, it would likely be AOL's acquisition of Time Warner in 2000.[187]

AOL used $162 billion of stock to acquire Time Warner.[188] The companies had roughly equivalent market capitalizations before the merger. A hypothetical AOL shareholder owning 2% of AOL before the merger thus would have ended up with approximately 1% of the combined firm.

This transaction is now widely seen as a disaster.[189] There can be little doubt, from an ex post perspective, that the acquisition destroyed economic value. The expected synergy benefits failed to materialize. In fact, AOL and Time Warner parted ways nine years later,[190] suggesting that synergy effects were actually *negative*. The economic costs of this failed marriage included the transaction costs associated with combining and then splitting the businesses, as well as the negative synergy costs incurred while keeping the two firms stapled together.

Nevertheless, AOL's long-term shareholders appear to have benefitted from the transaction. When AOL and Time Warner separated in 2009, AOL was worth $2.5 billion, while Time Warner was valued at about $36 billion,[191] for a combined value of about $39 billion. Assuming AOL would have been worth the same ($2.5 billion) in 2009 had it not acquired Time Warner in 2000, our hypothetical 2% AOL shareholder would (absent the merger) have owned shares worth $50 million. Instead, as a result of the merger, that shareholder would have owned 1% of AOL (an interest worth $25 million) and 1% of Time Warner (an interest worth $360 million), for a total value of approximately $385 million—more than seven times the value of her hypothetical no-transaction stake in AOL.

To be clear, I am not claiming that the AOL-Time Warner deal was driven by AOL managers seeking to serve long-term shareholders through costly ex-

187. *See* Tim Arango, *How the AOL-Time Warner Merger Went So Wrong*, N.Y. TIMES, Jan. 11, 2010, http://www.nytimes.com/2010/01/11/business/media/11merger.html [http://perma.cc/7VHH-M73H] (reporting that the 2000 deal valued the combined firm at $350 billion, and that ten years later the combined value of the companies, which have since separated, was about one-seventh of their combined value on the day of the merger).

188. *See* Daniel Okrent, *AOL-Time Warner Merger: Happily Ever After?*, TIME, Jan. 24, 2000, http://content.time.com/time/magazine/article/0,9171,995889,00.html [http://perma.cc/NM4S-3STJ] (reporting that the transaction was an all-stock acquisition for about $162 billion of AOL stock).

189. *See, e.g.*, Arango, *supra* note 187 (reporting that the AOL-Time Warner transaction is taught in business schools as the "worst in history").

190. *See* W. David Gardner, *AOL Completes Spin-Off from Time Warner*, INFO. WEEK (Dec. 10, 2009), http://www.informationweek.com/e-commerce/aol-completes-spin-off-from-time-warner/d/d-id/1085495 [http://perma.cc/RV48-V8QS].

191. *Id.*

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pansion. AOL's managers may or may not have believed that AOL was overpriced, and they may or may not have believed that the merger would destroy economic value. I describe AOL's acquisition of Time Warner simply to offer a concrete example of how long-term shareholders *can benefit* ex post from a transaction that destroyed economic value.

3. Must Value Be Destroyed To Issue Overpriced Equity?

We have seen that long-term shareholders can be made better off if their firm issues overpriced equity for value-wasting acquisitions (rather than refrains from doing so). But long-term shareholders would be even better off if the firm could use inflated-price issuances to acquire assets that do not decrease in value when brought into the firm. In particular, long-term shareholders would prefer managers of firms with overpriced stock to either (a) acquire assets, via an acquisition-related issuance, that do not decrease in value when brought into the firm; or (b) engage in an SEO and invest the cash in a way that enhanced (or at least did not waste) economic value.

However, in many situations, these two alternatives might either be unavailable or deliver less value to long-term shareholders than costly expansion. Consider first the possibility of conducting an acquisition-related issuance aimed at bringing "good" assets (assets that do not lose value when acquired) into the firm. To begin, the firm may be at its optimal scale and scope, so that expanding the firm can only shrink the economic pie. In addition, even if the firm could be expanded in ways that did not reduce long-term economic value, it may not always be possible to find and acquire good assets during the window when the acquirer's stock is overpriced. If good assets are unavailable during this window, long-term shareholders might be better off if managers engage in a value-destroying acquisition rather than no acquisition at all.[192]

Next, consider the possibility of conducting an SEO (and not mis-investing the cash). In theory, long-term shareholders would be better off if managers did not engage in a value-wasting acquisition, but instead sold overpriced equity for cash and then either kept or distributed the cash to shareholders, avoiding any shrinkage of the pie. But a firm conducting an SEO, whether traditional or ATM, must inform its old and new investors of the purpose of the

192. An overpriced acquirer could, in theory, avoid significant value destruction by using its stock to purchase the stock of a target, keeping the target in a subsidiary, and then spinning it off to shareholders. But its plans to do so would need to be disclosed to the market, which would then infer that the acquirer's stock was overpriced and revalue the shares, making it more difficult for the firm to issue overpriced equity.

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financing.[193] If the firm announces that it will take all of the funds raised and hold them in cash or distribute them to shareholders, then investors are likely to infer that the firm is issuing stock merely to exploit the fact that it is overpriced.[194] Investors might then lower their valuations of the firm, making it more difficult for the firm to sell overpriced equity through the SEO. Thus, managers can be expected to indicate that the money raised will be used for investment.

Not surprisingly, there is evidence that managers conducting SEOs to sell overpriced stock normally accumulate excessive capital rather than distribute the cash to shareholders. One study, by Robert Chirinko and Huntley Schaller, examined publicly traded U.S. firms during the period from 1980 to 2004 and concluded that high-priced firms with poor investment opportunities accumulated between 15% and 45% of excessive capital while they were overpriced.[195] Another study of firms undertaking SEOs between 1980 and 1999 found that these firms dramatically increased investment rather than retiring debt or increasing working capital, and that this spike in investment tended to reduce returns on assets by an economically and statistically significant amount.[196]

In sum, the "first best" outcome for long-term shareholders of a firm with overvalued stock that cannot efficiently absorb new assets would be for managers to issue overpriced shares and distribute the cash to the firm's shareholders. But managers must disclose the purpose of the equity issuance, and disclosing that managers will distribute the issuance proceeds to shareholders will clearly signal that the firm is issuing shares solely because they are overpriced, causing the stock price to fall. Therefore, the "second best" outcome for long-term

193. *See, e.g.*, U.S. SEC. & EXCH. COMM'N, REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933, OMB No. 3235-0073, at 10 (Form S-3), http://www.sec.gov/about/forms/forms-3.pdf [http://perma.cc/XMP2-74HZ] (requiring a stock issuer to furnish the information required by Item 504 of Regulation S-K, namely the "principal purposes for which the proceeds are to be used").

194. *See, e.g.*, Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 262 & n.65 (2009).

195. *See* Robert S. Chirinko & Huntley Schaller, *Do Bubbles Lead to Overinvestment?: A Revealed Preference Approach* (CESifo Working Paper No. 3491, 2011), http://ssrn.com/abstract=1865173 [http://perma.cc/FRJ7-Y89Q] (examining publicly traded U.S. firms during the period 1980 to 2004 and concluding that high-priced firms with poor investment opportunities accumulated between 15% and 45% of excessive capital while they were overpriced); *see also* Ming Dong et al., *Stock Market Misvaluation and Corporate Investment* 4 (Munich Personal RePEc Archive, Paper No. 3109, 2007), http://mpra.ub.uni-muenchen.de/3109 [http://perma.cc/XZ4S-GFJ6] (finding that cash raised by overpriced firms issuing equity is used to increase investment).

196. *See* Fu, *supra* note 162, at 250-51.

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shareholders may well be for managers to engage in costly expansion, rather than refrain from issuing the equity.

B. Costly Price-Boosting Manipulation Around Inflated-Price Equity Issuances

Just as managers serving long-term shareholders may engage in costly *price-depressing* manipulation around bargain repurchases to further depress the stock price, these managers may engage in costly *price-boosting* manipulation around inflated-price issuances to further boost the stock price. Indeed, there is evidence that managers routinely manipulate the stock price around equity issuances.[197]

1. Economic Logic

We saw in Part VI that long-term shareholder payoffs depend on the price at which the firm issues additional shares. Long-term shareholders benefit when the issuance price is high (relative to the no-transaction value of the stock). The higher the stock price, the greater the benefit. Thus, managers issuing shares at an inflated price can boost long-term shareholder returns by raising the issuance price.[198]

Importantly, managers can serve the interests of long-term shareholders by manipulating the stock price around issuances even if some economic value must be sacrificed to do so. In particular, as long as long-term shareholders' losses from the value destruction are lower than their benefit from an issuance at a higher price, long-term shareholders will prefer that managers engage in costly price-boosting manipulation.[199]

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197. *See infra* Part VII.B.2.

198. Similarly, if managers were required to issue stock when the issuance price is low (say, to raise capital when cheaper sources of capital are unavailable), then manipulating the stock price so that it is higher would benefit long-term shareholders by reducing their losses on the cheap issuance.

199. Consider again ABC Corporation from Part VI.B. As before, it has two shares outstanding initially (one held by long-term shareholders), and will be liquidated in the long term. In the short term, ABC will sell a third share to future shareholders. Consider two scenarios:

No Manipulation Scenario: Suppose that, if ABC does not manipulate its short-term stock price, it will sell a third share at the short-term stock price ($\$P$) for $10, and it will distribute $30 to the holders of its three shares in the long term ($\$V$ = $30-$10 = $20). The no-manipulation price of each of ABC's three shares in the long term, including that held by long-term shareholders, will be $10 ($30/3).

Costly Manipulation Scenario: Now suppose that, by destroying $1 of value, ABC's managers can boost the short-term stock price by $4. Instead of having $30 to distribute to the holders of three shares in the long term, there will be $33 ($4 extra received from future

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To be sure, long-term shareholders will not always benefit from costly price manipulation. If costly price manipulation destroys too much economic value, then long-term shareholders will be made worse off. But the critical point is that even long-term shareholders, just like short-term shareholders, *may* benefit from costly price-boosting manipulation.[200]

2. *Evidence of Costly Price-Boosting Manipulation Around Equity Issuances*

Managers already engage in costly price-boosting manipulation around equity offerings—both acquisition-related issuances and SEOs. Turning first to acquisition-related issuances, managers engage in earnings manipulation when issuing stock to acquire another company.[201] One study of mergers announced between January 1992 and December 2000 found that, in acquisitions in which acquirer-firm stock is used as consideration, acquiring firms show significant positive accruals in the quarter before the announcement.[202]

AOL again offers a useful illustration. During the period in which AOL acquired Time Warner, AOL's managers engaged in aggressive, costly price-

shareholders, less $1 value destroyed). In the long term, each of ABC's shares will be worth $11.

Managers serving long-term shareholders will engage in costly price-boosting manipulation because it will boost long-term shareholder payoffs from $10 to $11. But such manipulation will reduce economic value. In the No Manipulation Scenario, the pie is $20: $30 is distributed to shareholders in the long term, and $10 is received from shareholders in the short term. In the Costly Manipulation Scenario, the pie is $19: $33 is distributed to shareholders in the long term, and $14 is received from shareholders in the short term.

200. One potential form of costly price-boosting manipulation is illegal earnings manipulation. If such manipulation is detected, the firm can be required to pay damages. In terms of my framework, illegal earnings manipulation that occurs in the short term might lead to the payment of damages by the firm in the long term. One might thus wonder how this particular form of costly price-boosting manipulation can benefit long-term shareholders.

However, it might be difficult to prove (let alone detect) illegal earnings manipulation before the long term arrives. If such manipulation is detected, the firm might be able to settle the case for a relatively small amount. And any damages paid will not come solely at the expense of long-term shareholders; part of any damages paid by the firm will come (indirectly) out of the pockets of the injured future shareholders. Therefore, in expectation, long-term shareholders may well be able to benefit even from this form of costly price-boosting manipulation.

201. *See, e.g.*, Merle Erickson & Shiing-wu Wang, *Earnings Management by Acquiring Firms in Stock for Stock Mergers*, 27 J. ACCT. & ECON. 149, 151 (1999) (finding, in a sample of stock-financed mergers between 1985 and 1990, that acquirers managed earnings upward before announcing the merger).

202. *See* Henock Louis, *Earnings Management and the Market Performance of Acquiring Firms*, 74 J. FIN. ECON. 121, 134, 136 tbl.4 (2004) (finding that acquiring firms overstate earnings prior to stock-for-stock acquisitions).

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boosting manipulation: they massively inflated advertising revenues.[203] The combined entity was later sued by the SEC, the Justice Department, and shareholders, and forced to pay $2.5 billion to investors and the government.[204] (The settlement somewhat reduced the gains accruing to AOL's long-term shareholders from the costly price-boosting manipulation that occurred before and during the acquisition.)[205]

Next, consider SEOs. Firms conducting traditional SEOs may attempt to boost their stock prices by engaging in real earnings management,[206] earnings manipulation,[207] or a combination of the two. One study, examining 1511 completed traditional SEOs during the period from 1987 to 2006, found that firms conducting these SEOs engaged in both accruals management and real earnings management.[208]

Given that long-term shareholders are the investors most likely to benefit from costly price-boosting manipulation around equity issuances, it is not sur-

203. *See* David A. Vise, *Time Warner Settles AOL Cases for $510 Million*, WASH. POST, Dec. 16, 2004, http://www.washingtonpost.com/wp-dyn/articles/A1430-2004Dec15.html [http://perma.cc/5ZME-TXFC] (reporting that AOL agreed to pay the government $510 million to settle criminal and civil allegations that AOL manipulated its revenue before the acquisition).

204. *See id.*; *Time Warner in $2.5B Fraud Settlement*, CNN MONEY, Aug. 3, 2005, http://money.cnn.com/2005/08/03/news/fortune500/timewarner_settlement/index.htm [http://perma.cc/FCM5-AEL8] (reporting that Time Warner will pay $2.4 billion to shareholders who acquired AOL or Time Warner stock during the inflation period).

205. AOL's example suggests that the imposition of Rule 10b-5 liability on the corporation can be used to deter securities fraud when there are long-term shareholders. *Cf.* James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 13 AM. L. & ECON. REV. 359 (2011) (presenting a model in which Rule 10b-5 improves corporate governance by forcing long-term shareholders to bear part of the cost of misreporting in the short term).

206. *See, e.g.*, Natalie Mizik & Robert Jacobson, *Earnings Inflation Through Accruals and Real Activity Manipulation: Its Prevalence at the Time of an SEO and the Financial Market Consequences* (June 4, 2007) (working paper), http://ssrn.com/abstract=1031006 [http://perma.cc/MK6Q-2JUF] (finding that firms conducting SEOs engage in real-earnings management, leading to temporary overvaluation of the firm by the market).

207. *See, e.g.*, Siew Hong Teoh et al., *Earnings Management and the Underperformance of Seasoned Equity Offerings*, 50 J. FIN. ECON. 63, 64-65 (1998) (reporting that seasoned equity issuers raise pre-issuance reported earnings by altering discretionary accruals, and that this manipulation lowers post-offering returns).

208. *See* Daniel A. Cohen & Paul Zarowin, *Accrual-Based and Real Earnings Management Activities Around Seasoned Equity Offerings*, 50 J. ACCT. & ECON. 2, 11 (2010) (finding use of both accrual-based and real earnings management in a sample of 1511 SEOs between 1987 and 2006); *see also* S.P. Kothari et al., *Managing for the Moment: The Role of Real Activity Versus Accruals Earnings Management in SEO Valuation* 26-27 (working paper, 2012) (finding, in a sample of pre-Sarbanes Oxley SEOs, that real earnings management is likely to be a bigger driver of overvaluation than earnings manipulation).

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prising that firms with large shareholders (which tend to be long-term shareholders) are more likely to engage in earnings manipulation around equity offerings than firms without such blockholders. For example, one recent examination of 1372 firm-commitment SEOs found that firms' accruals increase around the SEOs when there are large outside shareholders that own more than 5% of the firm's stock, but found that there is no increase in the absence of such shareholders.[209] This study suggests that costly price-boosting manipulation around equity issuances may, in fact, be designed to serve the interests of long-term shareholders.

VIII. WHEN IS FAVORING LONG-TERM SHAREHOLDERS UNDESIRABLE?

Parts IV through VII have demonstrated that, when a firm buys or sells its own shares, managers seeking to boost long-term shareholder returns may well take steps that destroy economic value. Neither short-term shareholder interests nor long-term shareholder interests align fully with pie maximization. Rather, each type of shareholder will want managers to maximize the payout to her own group, even if those steps may reduce the size of the pie—the value flowing to all shareholders—short-term, long-term, and future—over time.

One cannot be confident, a priori, that long-term shareholder interests are necessarily better- or worse-aligned with pie maximization than are short-term shareholder interests. Short-term shareholders benefit from costly price-boosting manipulation. Long-term shareholders benefit from costly contraction, costly expansion, and costly price manipulation (price-boosting around equity issuances, price-depressing around repurchases). Each type of shareholder, therefore, is characterized by its own set of "vices."[210]

209. *See* Katherine Guthrie & Jan Sokolowsky, *Large Shareholders and the Pressure To Manage Earnings*, 16 J. CORP. FIN. 302, 318 (2010).

210. In considering the "vices" of each type of shareholder, it is important to know whether short-term shareholders might independently benefit from the various types of value-reducing actions that I have identified as benefitting long-term shareholders. If so, the cost of favoring long-term shareholders over short-term shareholders would be lower.

We have seen, however, that the value-destroying actions benefitting long-term shareholders are likely to have mixed effects on short-term shareholders. Costly contraction repurchases may slightly benefit short-term shareholders by pushing up the short-term stock price. Costly expansion issuances, on the other hand, are likely to hurt short-term shareholders by lowering the short-term stock price. Costly price manipulation will benefit or hurt short-term shareholders, depending on whether the price is being manipulated up or down. Because it seems unlikely that short-term shareholders will systematically benefit from the types of value-destroying actions that benefit long-term shareholders, I will assume here that they do not.

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While it is difficult to make sweeping statements about whose interests are better aligned with all the firm's shareholders over time, it is possible to identify factors that will tend to make long-term shareholders *worse* representatives than short-term shareholders, at least in the shareholder-only firm (in which shareholders are the only residual claimants) that I have been considering so far.

A. Volume of Repurchases and Equity Issuances

As we saw in Part III, managers serving long-term shareholder interests in a non-transacting firm will seek to maximize the pie. However, as we saw in Parts IV through VII, share repurchases and equity transactions decouple the interests of long-term shareholders from pie maximization and may well encourage managers serving long-term shareholders to destroy value (that is, to pursue long-term shareholder interests at the expense of the pie).

In the U.S., publicly traded firms buy and sell approximately $1 trillion of their own shares each year.[211] A typical U.S. firm buys and sells 30% of its market capitalization over a five-year period.[212] Obviously, some firms buy and sell more than 30%; others, less. The higher the volume of repurchases and equity issuances, the more likely it is that long-term shareholder interests will be less aligned with pie-maximization than are short-term shareholder interests.

By contrast, the lower the volume of repurchases and equity issuances, the more likely it is that long-term shareholder interests will be better (that is, more closely aligned with pie maximization) than short-term shareholder interests. Consider, for example, a firm that rarely transacts in its own shares—that is, an (essentially) non-transacting firm. In such a firm, long-term shareholder interests will almost inevitably be better aligned with pie maximization than short-term shareholder interests. This raises two policy-related questions explored below: (1) Can rarely transacting firms be identified in advance? (2) Should firms be prohibited from transacting in their own shares?

211. *See supra* Parts IV.A (providing evidence that share repurchases typically exceed $500 billion per year), VI.A (providing evidence suggesting that equity issuances are of the same magnitude as share repurchases).

212. *See supra* Parts IV.A (providing evidence that share repurchases over five years amount to 15% of total stock market capitalization), VI.A (providing evidence suggesting that equity issuances are of the same magnitude as share repurchases).

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1. Can Rarely Transacting Firms Be Identified Ex Ante?

Is it possible to identify firms today that, in the future, will only rarely transact in their own shares? One might think that long-term shareholders in firms that have rarely transacted in their own shares in the past are more likely to be better representatives of shareholder interests going forward. Unfortunately, however, it is difficult to know whether a firm that has rarely transacted in the past will continue to rarely transact in the future. To begin, the degree to which a firm has transacted in its own shares in the past can be expected to depend, in part, on the historic divergence between share price and share value: the smaller the historic divergence, the less likely the firm will have transacted in its own shares. But the fact that the stock price did not historically diverge much from share value does not necessarily mean there will be little divergence in the future.

Second, the degree to which a firm has until now transacted in its own shares may depend on long-term shareholders' historic influence on management. If long-term shareholder influence has been weak, then the firm may not have fully exploited divergences between the share price and share value to buy stock at a cheap price and sell stock at an expensive price. But if long-term shareholders gain more power in that firm, we can expect that firm to transact more in the future than it has in the past, everything else remaining equal. So shifting power to long-term shareholders in rarely transacting firms may well turn these firms into frequently transacting firms.

In short, we can confidently conclude that, in a rarely transacting firm, managers serving long-term shareholder interests are likely to generate more value than managers serving short-term shareholder interests. But since the magnitude of market mispricing and the degree of long-term shareholder influence may change in a firm over time, we have little idea as to which firms will rarely transact in the future.

2. Should Firms Be Prohibited from Transacting in Their Own Shares?

When presenting this work, I have often been asked whether firms should simply be prohibited from transacting in their own shares. Such a prohibition would eliminate all of the distortions I have identified in this Article. It would also tie long-term shareholders' payoffs to the value flowing to all of the firm's

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shareholders over time. This, in turn, would substantially strengthen the case for favoring long-term shareholders.[213]

In my view, from the perspective of society as a whole, there is likely to be substantial benefit to sharply limiting, if not eliminating, public firms' ability to repurchase their own shares. As I have explained elsewhere, the marginal social benefit of enabling a firm to engage in share repurchases, given its ability to distribute cash through a regular dividend or a special dividend, is fairly limited.[214] On the other hand, the social costs of repurchases, which go beyond those described in this Article, are likely to be considerable.[215]

Equity issuances, however, are indispensable. While a firm with excess cash that cannot repurchase its own shares can always distribute the excess cash through a dividend, there is no alternative to an equity issuance for a firm that needs additional equity capital. So even if repurchases were prohibited, which is unlikely to happen any time soon, firms would (and should) still be permitted to issue shares. In short, we are likely always to have transacting firms and, therefore, a disconnect between long-term shareholder returns and the size of the pie.

B. Managers' Ability To Exploit Information Asymmetry via the Firm

The desirability of having managers pursue long-term shareholder interests will depend, in part, on managers' ability to buy shares at a cheap price and sell shares at an inflated price. This ability, in turn, will depend on the degree of mispricing in markets, the efficiency of markets in absorbing information

213. However, as I will explain in the next Part, other considerations, such as the need to control managerial agency costs, may still make it undesirable to tilt the balance of power from short-term shareholders to long-term shareholders.

214. *See* Fried, *supra* note 121, at 1336-40 (describing share repurchases' benefits for shareholders and explaining why they are either trivial or represent wealth transfers from other parties).

215. In this Article, I have described two social costs associated with the use of share repurchases to further the interests of long-term shareholders: (1) they can cause managers to distribute too much cash when the stock is underpriced, and (2) they can cause managers to waste value by manipulating the stock price downwards. In addition, there are social costs associated with the use of repurchases to further the interests of short-term shareholders and managers. First, managers seeking to unload some of their own shares or serve short-term shareholders may use share repurchases to mechanically boost the short-term stock price through a price pressure effect, even if the cash used could generate more economic value inside the firm. Second, managers may use share repurchases to manipulate earnings per share (EPS) and boost their EPS-based bonuses, even if the cash could generate more social value if left inside the firm. *See, e.g.*, Heitor Almeida et al., *The Real Effects of Share Repurchases* 7 (Univ. of Ill. at Urbana-Champaign, working paper, 2014) (finding "suggestive evidence" that "firms are willing to sacrifice valuable investments to finance share repurchases" designed to boost EPS).

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about repurchases and equity issuances, and the degree to which managers can hide from investors information about the firm's ongoing share repurchases and equity issuances. The greater the degree of mispricing and inefficiency, and the looser the disclosure regulations for repurchases and equity issuances, the more likely it is that managers serving long-term shareholders will destroy more value than managers serving short-term shareholders.

For example, and as discussed earlier, U.S. firms can purchase shares secretly through open market repurchases (OMRs) and sell shares secretly through at-the-market offerings (ATMs); this enables firms more easily to exploit differences between the share price and share value. Elsewhere, I have argued that firms trading in their own shares should be subject to the same disclosure requirements that apply to the firms' insiders trading in those same shares.[216] Imposing such disclosure requirements would make it more difficult for managers to use inside information in share repurchases and equity issuances, and it would therefore better align long-term shareholder interests with the creation of economic value.

In short, managers serving long-term shareholders are more likely to destroy value if, for any given volume of repurchases and equity issuances, managers can easily exploit informational asymmetry when having the firm buy and sell its own shares.

C. The Difficulty of Engaging in Costly Price Manipulation

Both short-term shareholders and long-term shareholders can benefit from costly price manipulation. But the costly price manipulation that benefits long-term shareholders is likely to destroy considerably less value than the costly price-boosting manipulation that benefits short-term shareholders.

First, costly price manipulation can benefit long-term shareholders only if the firm is repurchasing or issuing shares. By contrast, costly price-boosting manipulation can benefit short-term shareholders whether or not the firm is transacting in its own shares. Because firms may not constantly repurchase or issue shares, at any given time managers serving long-term shareholders are less likely to engage in price-boosting manipulation than managers serving short-term shareholders.

Second, because they have continuing interests in the firm, long-term shareholders are hurt ex post by costly price manipulation that destroys too much economic value; by contrast, short-term shareholders are not. Consequently, when managers engage in costly price manipulation for long-term

216. Fried, *Insider Trading*, *supra* note 21, at 834-35 (proposing that firms, like their insiders, be required to disclose trades within two business days).

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shareholders, it is likely to be less destructive than when managers engage in costly price manipulation for short-term shareholders.

Therefore, everything else being equal, the harder it is for managers to engage in costly price manipulation, the more likely it is that short-term shareholder interests will be better (more closely aligned with pie maximization) than long-term shareholder interests. For example, consider a world in which costly price manipulation is impossible, but in which long-term shareholders can benefit from costly contraction and costly expansion. In such a world, long-term shareholder interests will be *less* aligned with pie maximization than short-term shareholder interests.

IX. FURTHER CONSIDERATIONS IN ASSESSING THE DESIRABILITY OF FAVORING LONG-TERM SHAREHOLDERS

My purpose has been to show that managers serving long-term shareholder interests, like managers serving short-term shareholder interests, may act in ways that destroy economic value. Managers serving long-term shareholders may not generate more value over time than managers serving short-term shareholders. Indeed, they may well generate less. Proposals to increase the number and power of long-term shareholders could thus lead to a smaller pie, not a larger one.

My analysis has focused on a highly stylized setting with two important simplifications. First, I have focused on a shareholder-only firm, where shareholders are the only residual claimants on the value generated by the firm. In other words, I have ignored other stakeholders. Second, I have assumed that managers seek to advance the interests of either short-term or long-term shareholders rather than to benefit themselves at shareholders' expense; in other words, I have abstracted from managerial agency costs. In most firms, however, there are likely non-shareholder residual claimants and, more importantly, managerial agency costs. Ultimately, the desirability of favoring long-term shareholders will depend, at least in part, on the effects of increasing the relative power of long-term shareholders on non-shareholder residual claimants and managerial agency costs.

In this Part, I briefly touch on these two issues. Part IX.A discusses the degree to which favoring long-term shareholders is likely to benefit or hurt non-shareholder residual claimants. Part IX.B addresses the degree to which favoring long-term shareholders is likely to increase or decrease managerial agency costs. In both of these discussions, I implicitly assume that the corporation is a simple non-transacting firm; accordingly, the financial interests of long-term shareholders are more closely aligned with shareholder pie maximization than with the interests of short-term shareholders. My goal here is not to provide a complete analysis of these issues. Rather, it is to explain why it is far from clear

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that considerations of stakeholders and managerial agency costs strengthen the case for favoring long-term shareholders.

A. Non-Shareholders as Residual Claimants

My analysis so far has considered a firm in which the only residual claimants on the value generated by the firm are its current and future shareholders. However, while shareholders might be the most important residual claimants on the economic pie created by the firm, they are clearly not the *only* residual claimants. Other parties, such as employees and creditors, may also be affected by managers' decision making. Indeed, the existence of such non-shareholder residual claimants has led prominent legal academics such as Margaret Blair and Lynn Stout to argue for a "stakeholder approach" to corporate governance: corporations should be run for the benefit of all stakeholders with residual claims on the corporation, not just shareholders.[217]

How would the presence of non-shareholder residual claimants affect the desirability of favoring long-term shareholders? It is believed that managers serving short-term shareholders will take steps that harm other stakeholders to boost the short-term stock price.[218] On the other hand, it is claimed that managers seeking to benefit long-term shareholders will (or should) directly serve these constituencies as a means to that end.[219] The idea that stakeholders are better off if managers seek to serve long-term shareholders rather than short-term shareholders is intuitively appealing.

However, intuition can lead one astray. Neither short-term nor long-term shareholder interests can be counted on to align with the interests of non-shareholder parties. For example, managers serving either short-term share-

217. *See, e.g.*, Blair & Stout, *supra* note 32, at 250-51 (1999) (explaining that non-shareholder constituencies are also residual claimants on the corporate pie).

218. *See, e.g.*, MAYER, *supra* note 18, at 185-86 (short-term shareholders press managers to take steps that harm non-shareholder stakeholders).

219. *See, e.g.*, Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 702 (2006) (stating that "proponents of the long-term view of shareholder primacy would contend that such a view accommodates non-shareholder issues . . . because 'stakeholder' concerns, such as giving money to charity or behaving responsibly towards employees and customers, inure to the benefit of shareholders in the long-term"); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 62 (2010) (advocating the view that attention to stakeholder interests is a means to generate long-term shareholder wealth).

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holders or long-term shareholders may have an incentive to transfer value to shareholders and away from long-term stakeholders or creditors.[220]

Indeed, one of the very problems associated with "short-termism" may lead managers serving long-term shareholders to squeeze more value from these non-shareholder stakeholders than managers serving short-term shareholders. Critics of short-termism typically argue that the stock market cannot properly value investments with a long-term payoff.[221] The market sees only the short-term costs associated with these investments, not the long-term benefits. As a result, managers serving short-term shareholders will not undertake such investments.

But if the stock market does not properly value investments with a long-term payoff, it is unlikely to properly reflect the present value of future savings from cost-minimizing or cost-reducing steps at the expense of non-shareholder residual claimants. Thus, short-term shareholders may well derive less benefit than long-term shareholders from "investing" in strategies that shift value from non-shareholder constituencies to shareholders over time.

Suppose, for example, that in XYZ Corporation the only residual claimants on the value generated by the firm are shareholders and employees. A union is seeking to organize XYZ employees. If the union succeeds, wages will rise. The present value of the extra wages, which represents a transfer from shareholders to employees, is $500 million. XYZ's managers can thwart the union and prevent a wage increase by inefficiently idling a factory for a month, reducing current earnings by $300 million. Assume that, from an economic perspective, idling the factory is undesirable: it destroys $300 million of value. Assume further that all of this information is public. However, the market has difficulty properly valuing the extra cash that will flow to shareholders over time if wages do not increase.

If managers serve long-term shareholders, then they will idle the factory because the move will save long-term shareholders $200 million ($500 million less $300 million). But if managers serve short-term shareholders, they may not shut down the factory. To the extent the market impounds the $300 million short-term loss, but has difficulty impounding the $500 million long-term gain, such a move could lower the short-term stock price, thereby hurting short-term shareholders. If managers serving short-term shareholders believe that idling the factory will depress the short-term stock price, then they may refrain from doing so.

220. *See* Roe, *supra* note 104, at 1004 (noting that corporate "[b]ad behavior could be long-term or short-term").

221. *See* Bratton & Wachter, *supra* note 7, at 661, 700.

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Wal-Mart may well provide an instructive illustration. The firm is well known for keeping employee wages extremely low, even as compared to other large discount retailers.[222] Indeed, some analysts have suggested that its workers are so poorly paid that they are forced to make much greater use of public health and welfare programs than the employees of similar firms,[223] costing taxpayers upwards of $3000 per employee annually in public benefit programs.[224] These low wages are reportedly maintained via aggressive anti-union tactics.[225] These tactics are employed not to benefit short-term shareholders, but rather to serve the interests of the long-term shareholders who control the firm: members of the Walton family.[226]

I don't bring up Wal-Mart to criticize or defend the firm's labor practices. Rather, I use the Wal-Mart example to illustrate the simple point that managers serving long-term shareholders cannot automatically be expected to treat non-shareholder constituencies better than managers serving short-term shareholders. To the extent that markets are not efficient, they might treat them even worse.

222. According to Ken Jacobs et al., "Controlling for differences in geographic location, Wal-Mart workers in the United States earn an estimated 12.4 percent less than retail workers as a whole, and 14.5 percent less than workers in large retail in general." Ken Jacobs et al., *Living Wage Policies and Big-Box Retail: How a Higher Wage Standard Would Impact Walmart Workers and Shoppers*, UNIV. OF CAL., BERKELEY CENTER FOR LAB. RESEARCH & EDUC. 1-2 (2011), http://laborcenter.berkeley.edu/pdf/2011/bigbox_livingwage_policies11.pdf [http://perma.cc/AR3P-LRED].

223. *See* Arindrajit Dube et al., *Firm Entry and Wages: Impact of Wal-Mart Growth on Earnings Throughout the Retail Sector*, UNIV. OF CAL., BERKELEY INST. FOR RESEARCH ON LAB. & EMP'T 36-37 (2007), http://www.escholarship.org/uc/item/22s5k4pv.pdf [http://perma.cc /K2MX-X8RA].

224. *See* DEMOCRATIC STAFF OF H. COMM. ON EDUC. AND THE WORKFORCE, THE LOW-WAGE DRAG ON OUR ECONOMY: WAL-MART'S LOW WAGES AND THEIR EFFECT ON TAXPAYERS AND ECONOMIC GROWTH 10 (2013), http://democrats.edworkforce.house.gov/sites/democrats.edworkforce.house.gov/files/documents/WalMartReport-May2013.pdf [http://perma.cc/AQM4-VLJG].

225. These tactics include sending managers to eavesdrop on employees, warning employees that they will lose benefits if they organize, and even firing workers for their union activity. *See Discounting Rights: Wal-Mart's Violation of US Workers' Right to Freedom of Association*, HUM. RTS. WATCH (May 1, 2007), http://www.hrw.org/reports/2007/04/30/discounting-rights-0 [http://perma.cc/P34S-HU2W]; *see also* Gary Gereffi & Michelle Christian, *The Impacts of Wal-Mart: The Rise and Consequences of the World's Dominant Retailer*, 25 ANN. REV. SOC. 573, 581-82 (2009), http://ssrn.com/abstract=1523785 [http://perma.cc/FG3W-AQP3].

226. Renee Dudley, *Wal-Mart Board Seen at Risk of Losing Independent Voices*, BLOOMBERG NEWS, June 6, 2013, http://www.bloomberg.com/news/2013-06-06/wal-mart-board-seen-at-risk-of-losing-independent-voices.html [http://perma.cc/QJ49-MGWC] (reporting that Wal-Mart is considered a controlled corporation because of the Walton family's ownership of more than 50% of Wal-Mart's equity).

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Of course, even if managers serving long-term shareholders do treat non-shareholder residual claimants better than managers serving short-term shareholders, the question remains as to whether managers loyally serving long-term shareholders will generate a bigger economic pie than managers loyally serving short-term shareholders. Even if long-term shareholder interests are more closely aligned with those of non-shareholder constituencies, they could still be less aligned with *overall* pie maximization than are short-term shareholder interests.

B. Managerial Agency Costs

My analysis has considered a firm in which managers loyally serve either short-term shareholders or long-term shareholders. In the real world, there are managerial agency costs: managers will tend to act in ways that benefit themselves at the expense of shareholders.[227] Indeed, shareholders' ability to minimize managerial agency costs is one of the most important challenges in the corporate governance of widely held firms. Therefore, the desirability of steps to favor long-term shareholders will depend in large part on how these steps affect shareholders' ability to reduce managerial agency costs.

On the one hand, it is possible that managerial agency costs would be lower if long-term shareholders had more power. If markets are not efficient, then the benefit of reducing managerial agency costs may not be fully reflected in the short-term stock price. In such a scenario, long-term shareholders may have a greater interest in reducing managerial agency costs than short-term shareholders because they hold their shares for a longer time.[228] Long-term shareholders may find it easier to evaluate managerial performance because they are more familiar with it. Moreover, managers may be more willing to bend to the demands of long-term shareholders than the demands of short-term shareholders, knowing that the long-term shareholders are there to stay.

On the other hand, favoring long-term shareholders at short-term shareholders' expense could also *increase* managerial agency costs. Many long-term shareholders might (everything else being equal) not be willing to hold as concentrated a position in the stock as short-term shareholders, reducing their incentive to monitor managers. There may also be certain types of shareholders, such as activist hedge funds, that are particularly capable of monitoring and

227. *See, e.g.*, Jensen & Meckling, *supra* note 35, at 308-09. For example, managers may entrench themselves, engage in value-destroying manipulation to boost their compensation, build inefficient empires, or fail to downsize when appropriate – all of which shrink the pie.

228. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 863 (1992).

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disciplining managers but cannot or will not commit to holding stock for the very long term.[229] Their ability to induce desirable change in firms will decline as long-term shareholders acquire more power. Therefore, shifting power away from short-term shareholders to long-term shareholders could lead to either lower or higher managerial agency costs.

C. It's Still an Uneasy Case

In Part VIII, I described the factors affecting whether managers serving long-term shareholders will generate more or less long-term economic value than managers serving short-term shareholders—assuming a world where shareholders are the only residual claimants and there are no managerial agency costs. In short, in this simple setting, it is far from clear that favoring long-term shareholders will increase the size of the pie when the firm transacts in its own shares. Indeed, favoring long-term shareholders may well decrease the size of the pie in a transacting firm.

In this Part, I have briefly described two other considerations: (1) the possibility that non-shareholder "stakeholders" are also residual claimants on the pie; and (2) managerial agency costs. We have seen that, in the context of any firm (including a non-transacting firm), favoring long-term shareholders may benefit or hurt non-shareholder stakeholders and may reduce or increase managerial agency costs. Thus, when these two considerations are added to the mix, the case for favoring long-term shareholders at any firm could become weaker or stronger. In short, even after accounting for these two factors, the case for favoring long-term shareholders is not compelling.

CONCLUSION

The power of short-term shareholders, it has been argued, leads to "short-termism": managers feel pressured to boost the short-term stock price at the expense of maximizing the size of the economic pie created by the firm over time. To counter short-termism, academics and policymakers, as well as leading business executives and corporate lawyers, have proposed various reforms

229. *See generally* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) (describing the monitoring benefits generated by the presence of short-term hedge funds); *see also* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013). For evidence that these short-term hedge funds benefit long-term shareholders, see Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. (forthcoming 2015), http://ssrn.com/abstract=2291577 [http://perma.cc/5BRZ-GHCB].

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aimed at increasing both the number and power of long-term shareholders relative to short-term shareholders. These proposals appear to reflect the strongly held intuition that managers serving long-term shareholders are likely to generate more economic value over time than managers serving short-term shareholders.

In this Article, I have shown that this intuition is flawed, at least for the typical U.S. firm—one that heavily buys and sells its own shares. On average, U.S. firms trade 30% of their own shares over a five-year period.[230] In transacting firms, managers can benefit long-term shareholders merely by transferring wealth from other shareholders through bargain repurchases and inflated-price issuances. Indeed, almost 20% of the wealth created for long-term shareholders today is generated by managers using repurchases and equity issuances to transfer wealth from other shareholders.[231] In a transacting firm, long-term shareholders, like short-term shareholders, can benefit from managers' deliberately destroying value. In particular, long-term shareholders can benefit when managers underinvest in firm projects to buy back stock at a low price, overinvest in projects to sell stock at a high price, manipulate the stock price downward around the time of repurchases, and manipulate the stock price upward around the time of equity issuances. There is evidence suggesting that managers seeking to increase long-term shareholder value engage in these very activities,[232] which may well destroy more value than short-termism. As a result, reforms that further favor long-term shareholders in the typical firm could actually reduce the size of the pie created by the firm over time.

My analysis indicates that it is ultimately an empirical question as to which shareholders—short-term or long-term—have interests that are better aligned with a firm's creation of economic value over time. One of my purposes in writing this Article is to encourage academics to take up this question.[233] Determining whether managers serving long-term shareholders are likely to generate more value than managers serving short-term shareholders is crucial for properly evaluating proposals for regulatory intervention, as well as new pri-

230. *See* Parts IV.A, VI.A.

231. *See* Sloan & You, *supra* note 30.

232. *See supra* Parts V.A.2, V.B, VII.A.2, VII.B.2.

233. One way to begin to answer the question of whether long-term shareholders or short-term shareholders have interests that are more aligned with the creation of economic value over time would be to investigate whether long-term shareholder returns, the standard metric used for evaluating firm and managerial performance, accurately reflect the amount of value flowing to all of the firm's shareholders over the relevant period (aggregate shareholder value). To the extent that long-term shareholder returns deviate substantially from aggregate shareholder value, there is a higher likelihood that long-term shareholder interests are less aligned with economic value generation than are short-term shareholder interests.

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vate ordering arrangements. It is not enough to assume, as many do, that it will be desirable to strengthen the hand of long-term shareholders in public companies simply because they hold their shares for a longer time than short-term shareholders.

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