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“Current-Shareholder Bias”

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CURRENT-SHAREHOLDER BIAS

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Abstract

Shareholders in publicly-held firms are conventionally assumed to share an interest in minimizing managerial misbehavior – behavior that reduces the value flowing to a firm’s shareholders over time. But current shareholders – those owning stock today – may actually benefit from certain types of managerial misbehavior, such as price manipulation, that come at the expense of future shareholders. Current shareholders thus have little interest in preventing such misbehavior and may even encourage it. The result is what I call “current-shareholder bias:” managers will be permitted to misbehave in ways that benefit themselves and current shareholders at the expense of future shareholders. Importantly, I show that current-shareholder bias can arise even if all current shareholders are long-term investors. I conclude by considering how current-shareholder bias and its costs can be reduced.

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INTRODUCTION

The classic problem in the governance of widely-held public firms is controlling managerial agency costs.¹ The interests of a firm's managers – its officers and directors -- often diverge from those of the firm's public shareholders. This divergence may lead managers to act in ways that benefit themselves but reduce long-term shareholder value: the value flowing to shareholders over time.² For example, managers may engage in empire building or price manipulation – activities that reduce long-term shareholder value but which make managers better off.

Not surprisingly, there is a large corporate governance literature exploring how managerial agency costs in public companies should be addressed.³ An important and influential strand of the literature argues that control of managerial agency costs should be left exclusively to private ordering: managers and shareholders of a firm should be free to choose the legal arrangements, including the corporate and securities laws, applicable to that firm.⁴ Other prominent commentators argue that managerial agency costs should be reduced by further empowering shareholders -- making it easier for them to replace directors and unilaterally change the firm's governance arrangements.⁵

But while there is considerable disagreement over how managerial agency costs should best be addressed, the analysis generally starts from a common assumption that all of a firm's public investors – both current and future -- share the same goal: minimizing managerial agency costs.⁶ According to this conventional view, a public investor who owns a firm's stock today has the same interest in minimizing managerial agency costs as

¹ See, e.g., Jensen and Meckling (1976).

² I assume that all of the firm's residual cash flow goes to shareholders. Thus, "long-term shareholder value" serves as a proxy for the social value of the firm.

³ There are far too many publications on corporate governance to be cited here. For recent reviews of the corporate governance literature in economics, see ____.

⁴ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 4-8 (1991) (arguing that managers have incentives to adopt beneficial corporate-law arrangements); Roberta Romano, *Theoretical Inquiries in Law* (2001) (arguing that firms and their shareholders should be allowed to choose the applicable securities regulation regime); Roberta Romano, *The Genius of American Corporate Law* 14-17 (1993); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va. L. Rev. 961, 982-83 (2001) (arguing that firms and their shareholders can be counted on to adopt value-maximizing arrangements).

⁵ See, e.g., Bebchuk, *Empowering Shareholders*, Harvard Law Review (2005) .

⁶ Among the few notable exceptions to the conventional approach are Patrick Bolton et. al. ____J. Corp Law, 2005; James Spindler, Rule 10b-5, 2008; Schwarcz 2005. Each of these papers identifies the potential conflict between short-term current shareholders and future shareholders. However, none of these papers systematically analyzes the manifestations and social costs of current-shareholder bias, demonstrates that such bias can arise even if all current shareholders are long-term, or discusses the range of potential solutions, all of which I do in this paper.

a public investor who buys the stock tomorrow, and so on. Thus, each generation of public investors can be counted on to represent – as best as it can -- the interests of the next generation of public investors.

The purpose of this paper is to highlight and explore the implications of an important, but largely overlooked, point: managerial misbehavior that reduces long-term shareholder value may sometimes benefit the firm’s current public shareholders – those who own the stock today -- at the expense of its future public shareholders – those who will buy the stock tomorrow. As a result, current investors may not, contrary to the conventional view, have an incentive to prevent managers from engaging in such misbehavior. Indeed, they may even encourage it. The result is “current-shareholder bias”: managers will be permitted to run firms in ways that benefit current shareholders at the expense of future shareholders and long-term shareholder value.

Consider, for example, managers’ frequent practice of manipulating earnings.⁷ Managers’ compensation arrangements give them a strong incentive to manipulate earnings: such misbehavior increases managers’ cash bonuses, and the price at which they can unload their shares. Such earnings manipulation can impose considerable costs, reducing long-term shareholder value.⁸

Under the conventional view, current shareholders should have an interest in preventing earnings manipulation because it reduces long-term shareholder value. For example, current shareholders should have an incentive to push for compensation arrangements that don’t give managers an incentive to manipulate earnings. But current shareholders about to sell their stock in the short-term have little interest in preventing earnings manipulation. Indeed, current shareholders about to sell their stock may have an incentive to encourage managers to take steps to inflate the stock price, so that they too can unload their shares at a higher price.

While earnings manipulation benefits current shareholders about to sell their stock, it obviously hurts future shareholders: those about to buy the stock. Indeed, future shareholders are harmed in two ways. First, earnings manipulation increases the price at which they buy the stock. Second, such manipulation usually reduces the underlying value of the shares they purchase. Thus, current shareholders have little incentive to control, and may in fact wish to encourage, managerial misbehavior that hurts future shareholders and can reduce long-term shareholder value.

The problem of current-shareholder bias would not arise in a hypothetical “efficient” market where the current stock price reflects long-term share value: the value flowing from the firm to that share over time.⁹ In such a market, any misbehavior by managers

⁷ See infra Part III.A.1.

⁸ Id.

⁹ See infra Part II.A (describing “efficient” markets).

would reduce long-term share value and automatically and immediately be reflected in a lower current stock price. Thus, while managers might wish to engage in such misbehavior, current shareholders, including those about to sell their stock, would have a powerful incentive to prevent it.

However, in real markets, unlike a hypothetical “efficient” market, the current stock price does not always reflect long-term share value.¹⁰ Moreover, managers can manipulate the short-term stock price in various ways, such as through earnings manipulation and real earnings management, that boost the short-term stock price but reduce long-term shareholder value. The deviation between the short-term stock price and long-term shareholder value decouples the interests of current and future shareholders, and leads current shareholders to permit, or possibly even encourage, managerial misbehavior that transfers value from future to current shareholders.

Importantly, current-shareholder bias that this paper seeks to highlight is different from (but related to) the much-discussed problem of “short-termism” among managers and public shareholders. It is widely believed that short-term shareholders pressure managers to take steps to boost the short-term stock price at the expense of long-term shareholder value.¹¹ Policymakers and others have thus considered various ways to give long-term shareholders relatively more power in corporate governance.¹²

However, I show that current-shareholder bias would distort corporate governance, albeit to a lesser degree, even if all current shareholders were long-term shareholders. Consider again managers’ practice of manipulating earnings at the expense of long-term shareholder value. If a firm is not currently issuing any shares, its long-term shareholders will indeed oppose such misbehavior because it reduces the value of their shares. But if, as is often the case, the firm is currently issuing new shares – whether as part of a compensation plan or otherwise – even long-term shareholders may benefit from managers’ manipulating earnings at the expense of long-term shareholder value. The reason is simple: the firm’s issuance of shares in the short-term has the same distributional effects as a transaction in which current shareholders sell part of their ownership interest to future shareholders in short-term. Thus, even long-term shareholders may benefit if managers destroy value manipulating the short-term stock price. Consequently, long-term current shareholders, like short-term current shareholders, may have little interest in controlling such misbehavior and may even have an incentive to encourage it.

I describe two types of managerial misbehavior that are likely to be tolerated or encouraged by current shareholders because they benefit current shareholders. The first is price manipulation: managers may take steps – such as manipulating earnings -- that

¹⁰ See *infra* Part II.B (explaining how markets are not efficient but rather “noisy”).

¹¹ Add cite.

¹² For example, the SEC’s most recently proposed proxy access rules condition access on a shareholder having held his stock for X months.

boost the current stock price but reduce long-term shareholder value. Such price manipulation, I show, can benefit both short-term current shareholders selling their shares as well as long-term current shareholders of firms issuing stock.

The second type of managerial misbehavior that is likely to occur as a result of current-shareholder bias is “cheap” empire building: managers may destroy value by expanding the firm – via acquisition or otherwise – through the sale of overpriced stock. Short-term shareholders are generally indifferent to such expansion as they are about to exit the firm, while long-term shareholders can benefit from it. Although cheap empire building destroys long-term shareholder value, long-term shareholders come out ahead whenever the value transferred from those buying the firm’s shares exceeds the destruction of long-term shareholder value caused by the expansion.

Eliminating current-shareholder bias and its costs is impossible; even reducing current-shareholder bias is not easy. I consider several possible approaches to reducing current-shareholder bias: (1) fundamentally reforming corporate governance either by giving firms the ability to choose their own corporate law and securities law regimes, or by empowering shareholders; (2) by modifying executive compensation arrangements; and (3) by trying to make share prices more accurate.

I first consider the two most well-known proposals for reforming corporate governance generally at public firms: (1) allowing firms and their shareholders to opt out of the federal securities laws and choose all of their own governance arrangements, including the disclosure regime applicable to their firm; and (2) using federal law to further empower current shareholders by making it easier for them to replace directors and unilaterally change the firm’s governance arrangements. The first proposal, freeing firms and their shareholders from mandatory rules and allowing them to choose all of their own governance arrangements, would at best serve the interests of current shareholders, not all shareholders. Giving current shareholders the ability to choose their own arrangements is thus likely not to reduce current-shareholder bias, but rather to increase it. The second proposal, empowering shareholders, reduce managerial misbehavior that hurts current shareholders. However, there is no reason to expect empowering *current* shareholders to try to reduce managerial misbehavior that benefits them and hurts future shareholders.

I then consider the possibility that executive compensation arrangements could address current shareholder bias by giving executives an incentive to maximize long-term shareholder value rather than current shareholders’ payoffs. In fact, I explain that executive compensation could be designed to eliminate managers’ current-shareholder bias, including their incentive to engage in both price manipulation and cheap empire building. In particular, executives could be required to hold their stock for the long-term and buy enough shares whenever the firm issues shares to maintain their pre-issuance proportional ownership of the firm. However, such arrangements would make current shareholders worse off. Thus, we cannot expect current shareholders to push their representatives on the board to adopt the necessary arrangements. Accordingly, such

arrangements are unlikely to be adopted unless there is an unprecedented level of government intervention in pay-setting practices.

Unfortunately, current-shareholder bias appears inevitable in any system where the stock price can deviate from long-term share value. The extent of current-shareholder bias can be reduced, however, by measures that make stock prices more accurate. I suggest two types of steps that can be taken to improve stock price accuracy. First, regulators should ensure that the regulatory and tax systems adequately incentivize – and refrain from unduly impeding -- short-sellers who detect, profit from, and by their trading reduce, overpricing that can result from price manipulation and encourages cheap empire building. Second, the government should increase liability for managers personally profiting from earnings manipulation. Each of these relatively modest steps would, at little cost, improve stock price accuracy and thereby reduce current-shareholder bias.

The remainder of the paper proceeds as follows. Part I describes corporate governance in an efficient market. It begins by describing the objective of corporate governance arrangements: maximizing long-term shareholder value. It then explains how managerial agency costs may reduce long-term shareholder value and that such costs are mitigated by giving current shareholders the ability to replace directors and, in some cases, block transactions that do not serve their interests. It concludes by explaining that, in an efficient market, current shareholders could be counted on to oppose any managerial misbehavior that reduced long-term shareholder value. Part II explains that markets are not efficient, but rather noisy: stock prices frequently deviate from long-term share value. Part III shows that, in a noisy market, current shareholders may benefit from, and cannot be counted on to oppose, one form of managerial misbehavior that I call “price manipulation:” actions that boost the short-term stock price but reduce long-term shareholder value. Part IV describes a second type of managerial misbehavior that current shareholders benefit from and thus have little incentive to prevent, cheap empire building: the sale of overpriced stock to fund value-wasting projects. Part V discusses various ways that current-shareholder bias can be reduced. A conclusion follows.

I. CORPORATE GOVERNANCE IN EFFICIENT MARKETS

This Part describes how corporate governance arrangements would work in an efficient market: a market where a firm's current stock price reflected long-term share value. Section A explains that, to the extent corporate governance arrangements are designed to increase the value flowing to shareholders, they should maximize long-term shareholder value: the value flowing to current and future shareholders of the firm over time. Section B discusses the problem of managerial agency costs. The firm is run by managers, not shareholders, who may take steps that benefit themselves but reduce long-term shareholder value. Section C explains that, to reduce managerial agency costs, current shareholders are given the ability to replace directors and block certain transactions that may not serve their interests. Section D shows that, in an efficient market, current shareholders have an incentive to use their power to try to prevent managerial misbehavior: actions that reduce long-term shareholder value.

A. The Goal: Maximizing Long-Term Shareholder Value

From an economic perspective, corporate governance arrangements (including both voluntarily adopted arrangements, the state corporate law chosen by the firm, and the mandatory federal securities rules) should give parties an incentive to maximize the total value of the firm: the value flowing to all of those affected by the firm's actions. A dollar flowing to party X is no less valuable than a dollar flowing to party Y. Thus, corporate governance arrangements should not reward parties for actions that merely redistribute value from one group to another without changing the size of the total pie. And these arrangements should certainly not reward parties for redistributing value from one group to another in ways that reduce total value.

For purposes of this paper, I will assume that a firm's ability to adversely affect parties other than shareholders -- such as its creditors, employees, customers, and suppliers -- is properly constrained by legal and non-legal mechanisms other than its corporate governance arrangements.¹³ Accordingly, corporate governance arrangements should be designed to maximize value for shareholders. Thus, these arrangements should not encourage parties to maximize the payoff to only one group of shareholders. Rather, parties should be encouraged to maximize what I call "long-term shareholder value": the value flowing to all of the firm's current and future shareholders over time.¹⁴ From an economic perspective, a dollar flowing to a short-term shareholder is no less or no more valuable than a dollar flowing to a long-term shareholder, and a dollar flowing to a

¹³ This assumption, made purely for expositional convenience, does not affect the paper's analysis or conclusions.

¹⁴ In other work, I have used the term "aggregate shareholder value" instead of "long-term shareholder value" to define the total amount of value flowing to current and future shareholders over time. See Jesse Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 Cal. L. Rev. 1232, 1331 (2005).

current shareholder – one who currently owns stock -- is no less or no more valuable than a dollar flowing to a future shareholder –one who does not yet own the stock. Thus, corporate governance arrangements should not encourage parties to shift value from one group of shareholders to another. And these arrangements should discourage parties from redistributing value from one group of shareholders to another in ways that reduce long-term shareholder value.

Measuring long-term shareholder value is straightforward. It is simply the net amount of value that flows directly or indirectly from the firm to all of its shareholders before all the firm’s shareholders are cashed out. Direct payments from the firm include dividends and payments to repurchase shares, less amounts received from shareholders buying stock from the firm. Indirect payments are any cash paid by an acquirer of the firm to the firm’s shareholders. Trading purely among shareholders in the secondary market has no effect on long-term shareholder value because these trades do not increase the total payout to shareholders. Only direct and indirect payments from the firm can increase the wealth of shareholders as a group.

Importantly, long-term shareholder value is not affected by changes in the current trading price of the stock. To see why this is the case, consider the shares of a firm trading at \$10 per share. \$10 is thus the price at which shares are sold by current shareholders to future shareholders. If the share price moves to \$11, each current shareholder selling a share makes \$1 more per share; however, each future shareholder buying a share spends \$1 more per share. Thus, long-term shareholder value – the amount flowing to all shareholders -- is not affected by the stock price moving to \$11 from \$10. Long-term shareholder value depends solely on the amount of cash flowing from the firm to shareholders over time.¹⁵

B. The Problem of Managerial Agency Costs

Whether or not a firm maximizes long-term shareholder value depends on the decisions of those running the firm. Under U.S. corporate law, it is the board of directors – not shareholders - that decides corporate policy.¹⁶ Directors decide whether to make a particular investment, acquire another firm, issue additional stock, and pay out cash to shareholders. The board also decides whether to retain -- and how to compensate and incentivize --- the chief executive officer (CEO), who in turn has tremendous influence over how the firm is operated.¹⁷ Thus, it is the firm’s managers – its directors and officers – who determine the extent to which long-term shareholder value is generated.

¹⁵ To be sure, an increase in the trading price of the stock may be caused by expectations of larger future cash flows to shareholders from the firm – expectations that may or may not be realized. Thus, I am not claiming that there is no relationship between the trading price and long-term shareholder value. My claim, rather, is that a higher trading price itself does cause an increase in long-term shareholder value.

¹⁶ See, e.g. DGCL 141.

¹⁷ See, e.g., Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004) 17-20, 24-25.

However, the firm's managers cannot be counted on to maximize long-term shareholder value. As is well understood, the interests of the managers of widely-held firms often diverge from shareholders.¹⁸ This divergence may lead managers to "misbehave" -- act in ways that benefit themselves but reduce long-term shareholder value. For example, managers may entrench themselves, extract too much pay, engage in empire building, or fail to downsize when appropriate – all of which reduce long-term shareholder value but make managers better off. The costs resulting from this divergence of interests between managers and shareholders – including the costs of monitoring managers – are called "managerial agency costs."

C. Current Shareholders' Role in Monitoring Managers

To reduce managerial agency costs, corporate governance arrangements give current shareholders some ability to monitor and replace managers that do not serve their interests, as well as the right to block certain transactions. As I explain below, current shareholders have always had direct and indirect influence over corporate decision-making, and this influence has increased over time and is likely to increase in the future.

1. Sources of Current Shareholders' Influence

Current shareholders can exert influence in two ways: by voting out directors and, less importantly, by refusing to approve certain transactions that must be put to shareholder vote.

a. Director Elections

Public shareholders are entitled to vote in annual director elections.¹⁹ In the widely-held firms on which this paper focuses, public shareholders own a majority of each firm's stock. Public shareholders dissatisfied with a firm's directors can thus launch a proxy contest to replace those directors.²⁰ Dissatisfied shareholders can also tender their stock to a hostile acquirer, should one emerge, who can then oust the entire board itself.²¹ The threat of removal via a proxy contest or hostile takeover, in turn, should give directors an incentive to serve current shareholders' interests.

To be sure, there are and have always been substantial impediments to shareholders' ability to replace directors via a proxy contest or by tendering to a hostile bidder. As is well understood, the risk of a proxy contest is low because dispersed public shareholders

¹⁸ See, e.g., Jensen and Meckling (1976).

¹⁹ Add cite.

²⁰ See, e.g., Lucian Bebchuk and Marcel Kahan, California Law Rev. 1990 (describing mechanism of proxy contest).

²¹ Add cite.

face a collective action problem.²² Because each shareholder owns such a small fraction of the firm’s stock, it does not pay for that shareholder to spend time or money investigating the performance of particular directors and seeking to replace those directors not serving her interests. Similarly, the risk of a hostile takeover has been low, in part because of staggered boards and courts’ willingness to let boards deploy poison pills and other defensive measures.²³

However, dispersed public shareholders have always had *some* influence over corporate decision-making. Even though the risk of a proxy contest or hostile tender offer may have been low, it has never been *zero*. There was always some possibility that directors would be replaced through one of these two mechanisms. As a result, even directors of firms where shareholders had very little power were not completely free to ignore shareholders’ preferences in their decision-making.

b. Shareholder Approval for Certain Transactions

A second (but much less important) source of influence for shareholders is their right to veto certain transactions. Corporate law and stock exchange rules require certain corporate actions to be approved by a majority of a firm’s shareholders. Directors must obviously consider shareholders’ preferences when proposing these actions, giving shareholders some additional influence over corporate policy.

Corporate law. Corporate law requires “structural” changes, including statutory mergers, to be approved by a majority of a firm’s shareholders.²⁴ Thus, for example, an acquiring firm’s shareholders must approve a transaction in which a statutory merger involving the acquiring firm is used to purchase the target firm’s assets. If a majority of the acquiring firm’s shareholders oppose the transaction, they can block it. Managers will thus refrain from proposing a transaction unlikely to be supported by shareholders.

Stock Exchange Rules. Stock exchange rules require approval of any stock issuance that would increase the number of outstanding shares by more than 20%.²⁵ Many stock-financed acquisitions will require increasing the number of outstanding shares of the acquirer by more than 20%. Thus, even if such a transaction does not involve a statutory merger of the acquirer that gives the shareholders the right to vote under corporate law, a shareholder vote will be required under the stock exchange rules. Thus, managers can be expected to avoid proposing major stock-based acquisitions likely to be opposed by shareholders.

²² See Bebchuk and Kahan (1990).

²³ See Bebchuk and Fried, *supra* note x, at 211-212.

²⁴ See Clark, *Corporate Law* (1986), at 94.

²⁵ Add cite.

Stock exchange rules also require shareholder approval for equity-based compensation plans.²⁶ Such plans set limits on the amounts and terms of the equity granted to executives and employees. Shareholder rejection of a plan would not prevent managers from compensating themselves and other employees. They could always rely exclusively on non-equity compensation arrangements – arrangements that might be more costly to shareholders.²⁷ Thus shareholders are generally unlikely to reject equity-based compensation plans proposed by managers. Nevertheless, shareholders cannot be counted to always approve such plans, and there is evidence that managers tailor plans to win shareholder approval.²⁸ The need to get shareholder approval for equity-compensation plans thus provides another source of influence for shareholders.

2. Recent Trends Increasing Current Shareholders' Influence

Over the last twenty-five years, a number of trends have strengthened shareholders' influence over boards. First, ownership has become more concentrated, reducing shareholders' collective action problem. The percentage of shares of public companies held by institutions – such as pension funds, mutual funds, and hedge funds has increased from 8% in 1950 to 60% in 2006.²⁹

To be sure, most of these institutions are generally passive, and are unlikely to initiate a campaign to replace management. However, their size and sophistication make it easier for institutional shareholders to pressure (or even replace) directors should they choose to do so. And the rise of proxy advisor firms such RiskMetrics and Glass Lewis has reduced information-collection and coordination costs for these investors,³⁰ increasing the likelihood that they will pressure boards when dissatisfied with directors' performance. Directors must therefore pay much more attention to the preferences of institutional investors than to the preferences of individual investors.

In addition, shareholders have successfully pressured boards to take steps to make directors more vulnerable to replacement. Dozens of firms have been pressured to dismantle their staggered boards,³¹ and this trend is expected to continue.³² In companies with charter-based staggered boards (staggered boards that cannot be destaggered without

²⁶ [Get cite for NYSE rule]

²⁷ See Bebchuk and Fried, *supra* note x, at 196-97.

²⁸ Add cite.

²⁹ See Kahan and Rock, *The Embattled CEO* (working paper, 2008), at 9.

³⁰ See Kahan and Rock, *supra* note x, at 20.

³¹ According to one recent study, the incidence of staggered boards among S&P 500 companies has declined from 57% in 2003 to 36% in 2007, and among small S&P 600 companies, from 61% in 2003 to 55% in 2007. See Kahan and Rock, *supra* note x, at 9.

³² See Kahan and Rock, *supra* note x, at 22.

board approval), it takes two consecutive annual shareholder meetings to replace a majority of the directors. Most acquisitions cannot go forward unless the target's poison pill has been withdrawn by its board. Thus, when a target company has a staggered board, a potential acquirer must wait at least a year just to eliminate the poison pill. The dismantling of a staggered board thus increases the risk of a hostile takeover, which in turn makes directors more interested in serving shareholders.

Moreover, hundreds of companies have agreed to adopt a majority-voting standard for directors. The default voting standard under corporate law for director elections is plurality voting: the directors who receive the most votes are elected. Thus if a management-nominated director runs unopposed, as is almost always the case, the director can be elected with a single vote. Under a majority-voting standard, in contrast, the director will not be elected unless he receives a majority of the votes cast. If the director gets more "withhold" votes than "yes" votes, he cannot take a seat on the board. Majority voting allows shareholders to target individual directors for replacement without having to identify, recruit, and solicit votes for an opposing candidate. It is thus expected to give shareholders of majority-vote firms considerably more influence over directors.³³

In addition, the federal government appears on the verge of adopting two measures that will, if adopted, increase shareholders' influence further. The first is shareholder access to the corporate proxy.³⁴ Currently, shareholders who wish to nominate their own candidate for a director seat must prepare, print, and mail a proxy statement. Shareholder access to the corporate proxy will require firms to include directors nominated by shareholders in the firm's own proxy statement, reducing the cost to shareholders of challenging management-nominated directors. This, in turn should increase shareholders' ability to influence boards.

Second, Congress is now considering "say-on-pay" legislation that would mandate an advisory vote by shareholders on executives' compensation arrangements. Although such a vote is non-binding, most directors would be embarrassed if shareholders vote against the pay arrangements approved by the board. They can thus be expected to consider shareholders' preferences more carefully when crafting executive compensation arrangements. In the UK, which has had "say-on-pay" for several years, directors now frequently consult with large shareholders before finalizing executive pay arrangements, and that these pay arrangements are more performance-sensitive.³⁵ If the UK's experience is any guide, executive pay arrangements here will also better reflect current shareholders' preferences. All of this suggests that shareholders' influence will continue to grow in the future.

³³ See Rock and Kahan, *supra* note x, at 22-24. Relatedly, amendments to NYSE's Rule 452 will reduce the ability of brokers – who typically side with management – to vote the shares of stockholders who decline to vote. [get cite] This is expected to make it more difficult for directors opposed by at least some shareholders to obtain a majority of the votes cast.

³⁴ Add cite.

³⁵ See Fabrizio Ferri and David Maber (2008).

D. Current Shareholders' Interests in an Efficient-Market World

As we have just seen, the current shareholders of widely-held public companies have always had some influence over boards, and this influence has been increasing over time and is likely to increase further. To the extent current shareholders have influence over boards, they can be expected to try to prevent managerial misbehavior – acts that reduce long-term shareholder value -- that hurt current shareholders. But how a particular type of managerial misbehavior affects current shareholders depends on the extent to which markets are efficient: that is, the extent to which the current stock price reflects long-term share value. As I will now show, in a truly efficient market, current shareholders would have an incentive to try to prevent any form of managerial misbehavior.

To see why current shareholders have an incentive to try to prevent managerial misbehavior in an efficient market, consider the following simple example. ABC Corporation has a single share outstanding, a fraction of which is owned by a current “long-term” shareholder and the remainder of which is owned by a current “short-term” shareholder. The long-term shareholder will hold her equity until the firm is liquidated or sold in the long-term. The short-term shareholder will sell his equity in the short-term. The person buying that equity in the short-term is a “future shareholder” who will hold the stock until ABC is liquidated in the long-term. There are thus three categories of shareholders: a current long-term shareholder who will hold his stock until the firm is liquidated; a current short-term shareholder who will sell his stock in the short-term; and a future shareholder who will buy the stock in the short-term and hold it for the long-term.

Management is considering misbehaving by engaging in an action X, before short-term trading occurs, that will reduce ABC’s value by \$1 per share by the time it is liquidated or sold in the long-term.³⁶ Action X will thus reduce long-term shareholder value – the value flowing to all shareholders over time – by \$1. Action X may or may not also affect the trading price in the short-term. However, any such short-term price effect will merely redistribute value between current short-term shareholders and future shareholders. It has no effect on the value flowing to all shareholders over time, and thus does not affect long-term shareholder value.

If the market is efficient, it should be easy to see that all of ABC’s current shareholders will have an incentive to oppose X. First, consider the long-term shareholder. If X occurs, she will get less for her equity when she is cashed out in the long-term. Accordingly, she will have an incentive to oppose X.³⁷

³⁶ Action X does not involve the issuance of shares. Thus, ABC continues to have one share outstanding after X occurs.

³⁷ Note that the long-term shareholder would oppose X regardless of the accuracy of the short-term stock price because, in this simple example where ABC is not issuing shares in the short-run, the short-term stock price does not affect her.

Next consider the short-term shareholder. Given his intent to sell stock in the short term, he does not care directly about long-term share value or the effect of X on long-term value. All he cares about is the short-term stock price. Thus, he would not oppose X if X increases the short-term stock price, whatever its effect on long-term share value. However, in an efficient market, the short-term stock price equals the long-term share value. As a result, if X occurs the short-term stock price will be \$1 lower. Thus, even though the short-term shareholder cares only about the short-term stock price, he will oppose X.

In short, in an efficient market, all current shareholders – both those holding their stock for the long-term and those expecting to sell their stock in the short-run – are hurt by and thus have an incentive to oppose managerial actions that reduce long-term shareholder value. Put another way, in such a market, current shareholders' interests coincide with the objective of corporate governance: maximizing long-term shareholder value.

As we will see in Part II, however, markets are not efficient but often noisy – with prices departing from long-term share value. And as we will see in Parts III and IV, in noisy markets current shareholders may sometimes not be hurt by managerial misbehavior, but instead benefit from it.

II. The Reality of Noisy Stock Prices

We saw in Part I that, in an efficient market, current shareholders would have an incentive to try to prevent any managerial misbehavior – actions that reduce long-term shareholder value.

This Part explains that markets are in fact often not efficient. Section A describes why many academics have long believed that markets are efficient: that informed traders would quickly enter the market if they detected any deviation between the stock price and share value and their trading would push the stock price to its “correct” value. Section B explains why, in the real world, there are limits to informed traders’ ability and incentive to engage in the arbitrage necessary to ensure correct stock pricing.

A. Conditions for Market Efficiency

In the 1960s and 1970s, economists began to believe that markets were efficient: stock prices accurately reflect, based upon public information, the expected value of discounted future cash flows to shareholders (“shareholder value”). Economically-oriented legal scholarship, which began during this period, adopted the efficient-market view and it continues to underlie an important and influential strand of the corporate governance literature.³⁸

The efficient-market view is certainly plausible. Investors buying or selling a stock – and therefore setting its price – have a strong incentive to value the stock correctly. The price emerging out of their trading could conceivably reflect the best possible estimate of its value. To the extent that the firm withholds information, buyers might assume the worst, driving the price down. Thus, firms would have an incentive to provide information and make that information credible.

The efficient-market view acknowledges that there may well be “irrational” investors or “noise traders” (so-called because they value investments based on meaningless “noise” rather than fundamental value) willing to trade at a price that is too high or too low, which could cause temporary deviations from the stock’s true value. But the view assumes that arbitrage by “rational” investors will immediately detect any such deviation from true value and rush in to buy or sell the stock, quickly returning the price to its “true” value.

B. The Real World: Noise Traders and Limits to Arbitrage

³⁸ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1165-68 (1981). Roberta Romano, *The Genius of American Corporate Law* 14-17 (1993); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va. L. Rev. 961, 982-83 (2001).

Several decades after the efficient-market view was developed, many economists began coming around to the view that stock markets are, in fact, not that efficient.³⁹ According to this view, there are limits on more informed arbitrageurs' ability to correct the deviation from true value resulting from noise trading. Below, I describe two of the most important limitations to the arbitrage necessary to keep market efficient: noise trader risk, and barriers to short-selling.

1. Noise Trader Risk

The most important reason better informed investors will not always enter the market in sufficient volume to correct deviations from fundamental value is “noise trader risk.” The noise traders who have pushed the stock price away from its actual value may, through their continued trading, cause the stock price to remain either too high or too low. Whatever irrationality is causing mispricing to occur could also cause the stock to become *even more* mispriced in the short term. The mispricing that the better informed investor hopes to exploit could persist for a long time, or even get worse, forcing the informed investor to unwind the position at a loss.⁴⁰

2. Barriers to Short-Selling

A second reason for the persistence of deviations from true value is that there are barriers to short-selling. When a stock is overpriced, correction of the deviation requires informed investors to short the stock. However, there are often significant barriers to short-selling. Consequently, short-selling is undertaken by only very few sophisticated investors.⁴¹

³⁹ For contributions to, and reviews of the burgeoning literature on market inefficiency, see Nicholas Barberis and Richard Thaler, *A Survey of Behavioral Finance*, in *Handbooks of the Economics of Finance* (ed G.M Constantinides, M. Harris, and R. Stulz, North Holland 2003); Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (2000); David Hirshleifer, *Investor Psychology and Asset Pricing*, 56 J. Fin. 1533-1597 (2001); Kent Daniel, David Hirshleifer, and Siew Hong, *Investor Psychology in Capital Markets: Evidence and Policy Implications*, 49 J. Mon. Econ. 139 (2002) (surveying the literature on investor psychology).

⁴⁰ Consider the case of Siamese Twin Stocks – stocks of two companies (“A” and “B”) that offer claims on identical cash flows because these companies jointly own all of the shares of a third company (“C”). See Froot and Dagora (JFE, 1999). Notwithstanding the fact that Siamese Twin Stocks have claims on the same cash flow, they typically trade at different prices, for years or even decades. The now infamous Long-Term Capital Management (the hedge fund founded by several Nobel-prize winning economists and prominent Wall Street investment bankers) learned the hard way about noise trader risk. LTCM bought a relatively undervalued Siamese Twin and shorted the overvalued Twin. Over time, the mispricing gap did not decline but rather increased. When the hedge fund failed several years after entering the position, LTCM was forced to unwind the position at a loss of several hundred million dollars.

⁴¹ See Andres Almazan, Keith C. Brown, Murray Carlson and David Chapman, *Why Constrain Your Mutual Fund Managers*, 73 J. Fin Econ. 289-321 (2004) (reporting that only 30% of mutual funds are allowed to sell short, and only 2% actually sell short).

Costs of acquiring shares and maintaining the short position. First, there are often large costs to opening and maintaining a short position. One must find a broker that has stock to lend. The broker can lend stock only if one of the broker's customers owns the stock and has agreed to lend that stock out. In many cases, brokers do not have stock to lend to short sellers,⁴² or charge a very high price.⁴³ The lack of shortable shares can thus make shorting very expensive, or in some cases impossible.

Even if the broker has stock to lend, these shares are not on indefinite loan. The lender has the right to demand return of the shares at any time. Thus, even if a short-seller's prediction that the stock price will decline turns out to be correct in the long run, the short-seller can be forced to close his position in the short run at a price higher than the short sale, inflicting a substantial loss.⁴⁴ Thus, even if shares are available for shorting, the risk that the shares must be returned before the stock prices "correct" introduces additional risk.

Tax treatment and regulatory limits. Other costs and barriers to short-selling come from government policy. First, any gain on short sales is taxed at short-term rates, even if the short position has been open for more than a year. For taxable investors, this makes short-selling less attractive, everything else equal, than taking a long position.⁴⁵ Second, the SEC has in the past imposed an uptick rule on short-selling: short-sales could take place only if the stock price had moved up in the last trade. The SEC is currently considering a new variant of this rule. An uptick rule prevents short-sellers from trading and thereby pushing the stock price down when the stock price has recently fallen but is still overvalued.

⁴² See Lamont and Thaler (2003). An alternative to selling short is buying a put. But buying a put will not, by itself, directly push down the price of a stock. It will only increase the price at which puts trade. Even if the purchase of puts pushed down the stock price, it is not possible to buy put options on the stock of many public companies. And, in those cases where put options are available but stock for shorting is not, put options will command a high premium, making them expensive.

⁴³ See Gene D'Avolio, The Market for Borrowing Stock, 66 J.Fin. Econ. 271-306 (2002) (finding that the fees for borrowing certain stocks for shorting can reach almost 30-50% per year).

⁴⁴ See Andrei Shleifer and Robert Vishny, The Limits of Arbitrage, 52 J. Fin. 35-55 (1997).

⁴⁵ See Michael Powers, David Schizer, and Martin Shubik, Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short-Sales (working paper, 2003).

III. PRICE MANIPULATION

As we saw in Part I, current shareholders have increasing influence over corporate policy that, in an efficient market, they would try to use to prevent managerial misbehavior: actions that reduced long-term shareholder value. But, as we saw in Part II, stock prices are often noisy – departing from long-term share value. This Part explains that, when stock prices are noisy, current shareholders cannot be expected to try to prevent managers from engaging in “price manipulation:” actions that boost the short-term stock price but reduce the value flowing to current and future shareholders over time.

Section A describes two common types of price manipulation, earnings manipulation and real earnings management. Section B explains that current shareholders – including short-term and even in some cases long-term shareholders -- may have insufficient incentive to prevent price manipulation. Section D explains that future shareholders are hurt by price manipulation, although price manipulation does not necessarily cause future shareholders to underperform current shareholders.

A. Types of Price Manipulation

In this paper, I use the term “price manipulation” to refer to actions that boost the short-term stock price but reduce long-term shareholder value: the value flowing to current and future shareholders over time. There are a number of ways to engage in price manipulation. However, because stock prices are driven by short-term earnings, most forms of price manipulation involve some form of “earnings management:” taking steps to ensure that reported short-term earnings boost, or at least support, the current stock price.⁴⁶ Indeed, according to Michael Jensen, “earnings management” has been considered an integral part of every top manager’s job for the last two decades.⁴⁷ Below I will focus on the two types of earnings management commonly used for price manipulation: (1) earnings manipulation and (2) real earnings management.

1. Earnings Manipulation

Earnings manipulation is the practice of adjusting reported earnings relative to the “correct” level of reported earnings given the firm’s actual business activity and cash flows. In many cases, earnings manipulation is “illegal”: it violates GAAP (Generally

⁴⁶ In some cases, it is in executives’ interest to manage earnings down. See Guojin Gong, Louis Henock, and Amy Sun, *Earnings Management and Firm Performance Following Open-Market Repurchases*, 63 J. Fin. 947 (2008)(reporting that firms adjust accruals to decrease their reported earnings before stock repurchases); Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 Cal. L. Rev. 1326 (2005) (explaining that managers use repurchases to buy stock from selling shareholders at a low price).

⁴⁷ See also Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 Fin. Man. 5 (2005).

Accepted Accounting Principles) and, if later detected and determined to have a big enough impact on reported earnings, requires the firm to restate its earnings. In other cases, however, earnings manipulation is “legal”: it involves discretionary judgment calls within GAAP.

There is substantial evidence that executives engage in both illegal and legal earnings manipulation, particularly around the time they sell stock in their firms. For example, firms in which annual option exercises are particularly high tend to have higher discretionary accruals (and therefore higher reported earnings) in those years and lower discretionary accruals and earnings in the subsequent two years.⁴⁸ And firms that fraudulently misstate their earnings have a higher level of selling activity—measured by number of transactions, number of shares sold, or the dollar amount of shares sold.⁴⁹

It is not difficult to find dramatic examples of the link between earnings manipulation and insider selling from the last decade. For example, Gary Winnick, the CEO of Global Crossing, sold more than \$700 million worth of shares in the year before the firm filed for bankruptcy, while the company was allegedly inflating sales revenues.⁵⁰ Qwest insiders sold more than \$2 billion of stock while they were overstating revenues. Shortly thereafter, Qwest stock fell more than ninety-five percent.⁵¹

There is also evidence that illegal earnings manipulation reduces long-term shareholder value. For example, firms that restated their financial statements following SEC allegations of accounting fraud from 1996 through 2002 collectively paid an extra

48. See Eli Bartov & Partha Mohanram, *Private Information, Earnings Manipulations, and Executive Stock-Option Exercises*, 79 ACCT. REV. 889 (2004). See also Steven Huddart & Henock Louis, Stock Returns, Earnings Management, and Insider Selling During the 1990s Stock Market Bubble 32 (June 26, 2006) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=912214 (reporting that managers tend to inflate earnings more before high levels of insider selling).

49. Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998). See also Messod D. Beneish, *Incentives and Penalties Related to Earnings Overstatements that Violate GAAP*, 74 ACCT. REV. 425, 454 (1999)(finding that managers of firms whose earnings were overstated tended to sell at a high rate before the overstatements were corrected); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 63 (2006) (finding that top managers of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms); Shane A. Johnson, Harley E. Ryan & Yisong S. Tian, Managerial Incentives and Corporate Fraud: The Sources of the Incentives Matter 25 (Nov. 8, 2007) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960 (finding that executives at firms that commit fraud exercise significantly larger fractions of their vested options than other executives).

50. Henny Sender & Rebecca Blumenstein, *Questioning the Books: Global Crossing Creditors Review Sales, Swaps*, WALL ST. J., Feb. 25, 2002, at A6.

51. *Id.*

\$320 million in taxes as a result of overstating their earnings by \$3.36 billion,⁵² which enabled managers to sell their shares at a higher price. And Fannie Mae incurred over \$1 billion in expenses cleaning up its books after giving its executives a compensation arrangement that encouraged them to illegally manipulate earnings.⁵³ Sometimes, the costs are much greater. The manipulation of earnings by Enron executives destroyed a business with an estimated \$30 billion of social value.⁵⁴ And this was just a single firm.

Partly in response to the widespread practice of earnings manipulation, Congress adopted the Sarbanes Oxley Act (SOX).⁵⁵ One of the principal aims of SOX was to increase the accuracy of financial reporting. Among other things, SOX created a new government oversight board for the accounting industry and attempted to improve internal controls.⁵⁶ SOX may have reduced somewhat insiders' ability to misreport earnings. However, it certainly has not eliminated that ability. In 2006, four years into the post-SOX era, the number of earnings restatements filed by public companies reached an all-time record: 1876.⁵⁷

2. Real Earnings Management

Real earnings management is the practice of making business decisions for the purpose of boosting short-term accounting results rather than maximizing long-term shareholder value. For example, executives can prop up short-term earnings by postponing desirable investments, or by accelerating revenue-generating transactions that would create more long-term value if they were delayed.

Because real earnings management does not violate the accounting rules as long as all transactions are reflected properly in a firm's financial statements, SOX cannot prevent or deter it. Indeed, real earnings management appears to have increased after

52. Merle Erickson, Michelle Hanlon & Edward L. Maydew, *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 406 (2004).

53. *Fannie Mae's Profit Slashed: Restatement Erases \$6.3 Billion After Accounting Scandal*, CHI. TRIB., Dec. 7, 2006, at 3; see Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 809-12 (2005) (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings).

54. Jensen, *supra* note x, at ____.

55. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

56. Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 113-17 (2005).

57. David Reilly, *Restatements Still Bedevil Firms—Overall Total Hits a Record as Big Companies Improve; Backdating's Messy Wake*, WALL. ST. J., Feb 12, 2007 at C7.

SOX as managers appear to have substituted that form of price manipulation for earnings manipulation.⁵⁸

A well known case upholding executives' legal ability to engage in real earnings management even though it destroys long-term shareholder value is *Kamin v. American Express*, a New York state case featured in many corporate law casebooks. *Kamin v. Amex* involved a shareholders' derivative suit against the directors of American Express (Amex). Plaintiffs alleged that the Amex board breached its fiduciary duty by distributing shares of Donaldson, Lufkin & Jenrette ("DLJ") to Amex shareholders rather than selling the shares at a loss and enjoy a tax benefit. The DLJ shares had declined substantially in value since Amex had purchased them. The board considered two alternative transactions: (1) selling the DLJ stock at a loss; or (2) distributing the DLJ stock as a dividend. The sale of DLJ stock would have given rise to a capital loss, allowing Amex to obtain a capital loss deduction. This deduction, in turn, would have reduced Amex's taxable income and saved Amex around \$8 million in taxes, thereby boosting Amex's net worth. However, the sale of the stock would also give rise to a loss that, for accounting purposes, would have been charged to income, and therefore reduce Amex's reported earnings for the year. The distribution of the DLJ stock as a dividend, on the other hand, would have no effect on Amex's tax obligation or its reported earnings. Although the sale of the stock would have maximized Amex's long-term shareholder value – the total value flowing to current shareholders and future shareholders, the board chose to distribute the DLJ stock as a dividend because, the board concluded, a sale would reduce reported earnings and lower the stock price. The court dismissed the plaintiffs' complaint, concluding that the directors were protected under the "business judgment rule," which shields disinterested, informed directors acting in good faith from fiduciary-duty liability for their business decisions.⁵⁹

One might wish to believe that the willingness of AMEX's managers to destroy long-term shareholder value for the sake of reporting better earnings is unusual. But in a 2004 survey of CFOs, 78% reported that they would be willing to give up economic value to report the desired amount of quarterly earnings.⁶⁰ The CFOs told the researchers that they would reduce discretionary spending on R&D, advertising, and maintenance, as well as delay starting projects to boost earnings, even if it reduced long-term cash flow. According to the economists who conducted the survey, "Managers appear to be willing to burn "real value" for the sake of reporting desired accounting results."⁶¹ Thus, AMEX

58. Daniel A. Cohen, Aisyasha Dey & Thomas Z. Lys, *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes Oxley Periods*, ACCT. REV. (forthcoming 2008) (manuscript at 29), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=813088.

59. Although this case was decided in a New York court, there is little doubt that most state courts interpreting their corporate laws would follow this approach. Indeed, there has never been a case in which officers or directors have been held liable for violating fiduciary duties for wasting corporate assets in order to prop up the stock price. See Franklin Gewirtz (2004).

60. See John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, The Economic Implications of Corporate Financial Reporting (working paper, 2005).

61. Id. at 15.

managers' decision to throw away \$8 million to report higher earnings puts them wholly within the mainstream of executive behavior.

B. Current Shareholders' Interest in Price Manipulation

This Section explains that current shareholders, including in some cases long-term shareholders, may have little interest in preventing price manipulation even though it reduces long-term shareholder value. Indeed, they may encourage executives to engage in this form of misbehavior.

1. Short-Term Shareholders

Many shareholders of public companies are short term – they will sell their stock within a year or within the next several few months. Institutional investors hold an increasingly large fraction of the shares of public companies.⁶² These shareholders generally, although not always, do not hold stock for the long-term. As a result, the average holding period for NYSE stocks is about one year, while the average holding period for NASDAQ stocks is about four months.⁶³ These averages indicate that, while there may be many long-term shareholders, a large percentage of the shares in firms on these exchanges is turned over in less than one year.

These short-term shareholders care only about the short-term stock price, not long-term value. They will accordingly favor price manipulation that leads to a higher short-term price, even if it reduces long-term shareholder value. During the several months that they own the stock, short-term shareholders can thus be expected to support, or at least not oppose, directors who tolerate or encourage price manipulation on the part of executives.

Consider the short-term Amex shareholders who owned stock in Amex when its managers decided to distribute the DLJ stock as a dividend (rather than sell the DLJ stock and take a tax loss that would have increased long-term shareholder value). To the extent the board's maneuver led to a higher short-term stock price for Amex, short-term shareholders plainly benefited from the decision to distribute the stock as a dividend even though it reduced long-term shareholder value: they were able to sell their stock at a higher price. To the extent that they had any ability to influence the board while they held stock of Amex, they would not have used that ability to discourage the board from making that particular value-wasting decision.

2. Long-Term Shareholders

Some policymakers and academics have recognized that the short-term stock price may not always reflect long-term value, and that the interests of short-term shareholders

⁶² See supra Part II.B.

⁶³ Add cite.

may not always be aligned with value-maximization.⁶⁴ They have accordingly recommended that long-term shareholders be given more governance rights than short-term shareholders. For example, recent proposals to give shareholders greater access to the corporate proxy have limited such rights to shareholders holding stock for at least one year, and many recommend that shareholders using this access mechanism also be required to hold their stock for at least one year thereafter.⁶⁵

But while long-term shareholders' interests are more closely tied to long-term shareholder value than short-term shareholders', even long-term shareholders may favor price manipulation that reduces long-term shareholder value: the value to flowing all shareholders of the corporation over time. In particular, long-term shareholders may favor price manipulation when, as is often the case, the firm itself is issuing equity in the short-term.

As I will explain in more detail in Part IV, most publicly-traded firms continue to issue equity after undergoing an IPO. The new shares are issued to employees as part of stock-option compensation plans; to raise capital for operations and strategic investments; and for acquisitions in which the acquirer stock is used as currency for the deal. Altogether, firms issue hundreds of billions of dollars of stock each year to new investors.

As I have explained elsewhere, an equity offering by the firm is economically equivalent to a two-part transaction in which (a) continuing shareholders (including long-term shareholders) personally sell shares to the new investors (future shareholders) at the offering price and (b) all shareholders (current and future shareholders) buy stock from the firm pro rata at the offering price.⁶⁶ Thus, the firm's sale of equity in the short-term is economically similar to the long-term shareholders personally selling equity in the short-term. They, like short-term shareholders, accordingly have an interest in seeing a higher short-term stock price, even if some value must be destroyed to achieve that higher stock price.

The following numerical example should help illustrate this point. Consider publicly traded firm ABC that has a single current shareholder owning one share. There are two periods: the short-term and the long-term, when the firm is liquidated and its value distributed pro rata to shareholders. ABC's single current shareholder is long-term: she holds the share until ABC is liquidated. ABC will issue one share in the short-term to a future shareholder. Before the sale, the short-term stock price is \$10 and the long-term value of ABC (the amount its shareholders will receive when it is liquidated in the long-term) is \$10.

⁶⁴ Add cites.

⁶⁵ Add cites.

⁶⁶ See Jesse Fried, Tying Pay to Long-term Shareholder Value (working paper, 2009).

Suppose that if ABC's managers do not manipulate the stock price, ABC will sell its second share for \$10 and ABC's long-term value (to be shared pro rata by the current long-term shareholder and the future shareholder buying the second share) will be \$20. However, before issuing that share, ABC's managers have the ability to manipulate the stock price in a way that increases the price ABC gets for its second share by \$3, but destroys \$1 of ABC's long-term value. After the sale, ABC's long-term value will thus be \$22 (\$10+\$13-\$1). What would ABC's single long-term shareholder prefer? If ABC's managers do not manipulate the stock price and ABC issues the second share for \$10, the long-term shareholder gets \$10 (\$20/2) in the long-term. If ABC's managers manipulate the stock price and ABC issues the second share for \$13, the long-term shareholder gets \$11 (22/2). ABC's long –term shareholder will thus prefer that ABC engage in value-wasting price manipulation.

This is an important result: if markets are noisy and firms are issuing equity in the short-run, even long-term shareholders may favor actions that reduce long-term shareholder value: the value flowing to all shareholders of the firm over time. Interestingly, there is evidence that executives manipulate the stock price around equity offerings to increase the amount transferred from new investors,⁶⁷ especially when the issued stock is being used to acquire another company.⁶⁸

To be sure, long-term shareholders will oppose price manipulation in certain cases. If the firm is not selling equity in the short-term, or if the firm is selling equity but there is too much destruction of long-term shareholder value, long-term shareholders will not favor such manipulation.⁶⁹ But the critical point is that even if there are long-term shareholders –shareholders who hold their stock until the firm is liquidated or sold -- those shareholders cannot always be counted on to oppose value-wasting price manipulation.

C. Effect on Future Shareholders

The cost of price manipulation that benefits short-term and (in some cases) long-term shareholders falls on future shareholders – those who buy the shares at the manipulated

⁶⁷ See S. Teoh, Ivo Welch, and T.J Wong, Earnings Management and the Underperformance of Seasoned Equity Offerings, 50 J. Fin. Econ. 1935 (1998).

⁶⁸ See Erickson and Wang (1999); Louis (2004); Baik, Kang and Morton (2007); Botsari and Meeks (2008), and Gong, Louis, and Sun (2008). But see Raunqaa S. Pungaliya and Anand M. Vijh, Do Acquiring Firms Manage Earnings (working paper, 2008) (questioning studies finding earnings manipulation in stock acquisitions).

⁶⁹ Continuing with the example in the text, the long-term shareholder of ABC would not support price manipulation that increased the stock-price by \$3 if it burned more than \$3 of value. In contrast, a short-term shareholder of ABC would support such price manipulation regardless of its effect on long-term shareholder value.

price.⁷⁰ By definition, price manipulation leads future shareholders to buy stock at a higher price while at the same reducing the long-term value of that stock. Price manipulation thus causes future shareholders to pay more for less.

Importantly, price manipulation does not necessarily cause future shareholders to systematically lose money or under-perform current shareholders. When markets are noisy, the performance of each “generation” of shareholders depends not only on the “long-term” value of the stock and the amount of price manipulation in the short-term but also on the amount of “exogenous” (non manipulation-related) noisiness of the stock price in the short-term. In some cases, there may be sufficient exogenous negative noise that, even after price manipulation, a firm’s stock price in the short-run is still below its long-run value.

For example, suppose that managers may engage in price manipulation X that would reduce long-term share value by \$1. Suppose that, absent X, ABC’s short-run stock price would have been \$10 while its long-term per share value would have been \$15. With X, however, ABC’s short-run stock price is \$11 and its long-term value is \$14 per share. Absent X, ABC’s future shareholders would have profited \$5 per share (\$15-\$10). After X, ABC’s future shareholders profit \$3 per share (\$14-\$11). ABC’s future shareholders thus profit from buying ABC stock in the short-run, even though managers have manipulated the stock price and reduced long-term shareholder value – the amount of value flowing to all shareholders over time.

⁷⁰ If the price manipulation does not benefit long-term shareholders but rather hurts them – as would be the case if the manipulation takes place when the firm is not issuing equity – they will bear some of the cost along with future shareholders.

IV. Cheap Empire Building

We saw in Part IV that both short-term and long-term current shareholders may have little incentive to prevent executives from engaging in price manipulation: steps that boost the short-term stock price at the expense of long-term shareholder value. This Part describes a different type of misbehavior that short-term and long-term shareholders will also have little interest in preventing: cheap empire building -- the sale of overvalued equity for projects that reduce long-term shareholder value.

A. Equity-Financed Over-Expansion

1. Firms' Sales of Overpriced Stock

After undergoing an IPO, most publicly-traded firms continue to issue shares throughout their life.⁷¹ These shares are issued to employees as part of stock-option compensation plans;⁷² to raise capital for operations and strategic investments; and pursuant to acquisitions in which the acquirer stock is used as consideration for the acquired company's stock or assets. Although each type of equity issuance has its own purpose, all enable the firm to use less of its own cash; the higher the sale price of the equity, the more cash the firm will have.⁷³ All in all, firms issue hundreds of billions of dollars of stock each year to new investors.⁷⁴

An equity offering is economically equivalent to a two-part transaction in which (a) continuing shareholders (long-term shareholders) personally sell shares to the new investors (future shareholders) at the offering price and (b) all shareholders (current and future shareholders) buy stock from the firm pro rata at the offering price.⁷⁵ The second

⁷¹ See Eugene F. Fama and Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. Fin. Econ. 549 (2005) (reporting that 86% of the firms in their sample issued stock between 1992-2003).

⁷² Most publicly companies issue shares to give executives and lower level employees either restricted stock or stock options as part of their compensation package. Among the largest 200 firms in 2007, the range of shares allocated to equity compensation plans ranged from .02% of outstanding shares to 62.6% of outstanding shares, with the median around 10.5%. Pearl Meyer's 2008 Equity Stake Study, p.2.

⁷³ For example, equity compensation in part substitutes for cash compensation: the more equity compensation an employee receives, the less the firm has to pay in cash. Thus, the greater the value of the restricted stock (or stock options) given to employees, the less the firm must pay in cash. A higher stock price can thus be expected to save some of the firm's cash – cash that can be distributed to long-term shareholders when the firm is eventually liquidated or acquired.

⁷⁴ In May 2009 alone, there was almost \$70 billion of stock issued by already-public companies. See Jeff Benjamin, *Equity issues Hitting Market at Record Pace*, Investment News (June 29, 2009) available at <http://www.investmentnews.com/article/20090628/REG/306289977>.

⁷⁵ See Jesse Fried, *Tying Pay to Long-term Shareholder Value* (working paper, 2009).

part of the transaction has no distributional consequences, but the first one does. An equity offering thus transfers value from future shareholders (new investors) to current shareholders when the offering price exceeds the value of the stock.⁷⁶

Indeed, there is evidence that firms conduct equity offerings when the stock is overpriced, particularly for the purpose of buying other firms' assets at a discount.⁷⁷ As I noted in Part III, there is also evidence that executives manipulate the stock price up around equity offerings to increase the amount transferred from new investors,⁷⁸ especially when the stock is being used to acquire another company.⁷⁹

2. Value-Destroying Expansion

The use of overpriced equity-offerings can easily distort corporate investment decisions, substantially reducing long-term shareholder value. Consider, for example, the problem of firms using overpriced equity to buy target companies whose combination with the acquirer does not create synergy value but rather destroys value. In such a case, every \$1 billion transferred from future shareholders is likely to confer less than \$1 billion of benefit on current shareholders. But the shareholders of the acquiring firm may benefit if the acquiring firms' equity is sufficiently overpriced to compensate for the value destruction caused by the transaction.

A well-known example is America Online's (AOL) stock-financed acquisition of Time Warner. At the time of the acquisition, AOL's shares were richly valued. Despite the fact that AOL paid a high premium for Time Warner (48% based on the announcement-day closing price), and there were no synergy gains, AOL's long-term shareholders benefited from the transaction because AOL's equity turns out to have been

⁷⁶ See Andrei Shleifer and Robert W. Vishny, Stock Market Driven Acquisitions, 70 J. Fin. Econ. 295 (2003) (proposing that overvalued firms engage in stock-financed acquisitions in order to obtain hard assets at a discount); Matthew Rhodes-Kropf and S. Viswanathan, Market Valuation and Merger Waves, 59 J. Fin. 2685 (2004) (similar). See also Michael C. Jensen, Agency Costs of Overvalued Equity, 34 Fin. Man. 5 (2005).

⁷⁷ See Pavel G. Savor and Qi Lu, Do Stock Mergers Create Value for Acquirers? (working paper, ___), at 3 (finding that a sample of stock-financed acquirers that complete their acquisition outperform a control sample of stock-finance acquirers that fail to complete their acquisition by 25-30% over a three year horizon). M. Dong, David Hirshleifer, and S.H. Teoh, Do Overvalued Firms Raise More Capital (working paper, 2007). Ming Dong, David Hirshleifer, and Siew Hong Teoh, Stock Market Misvaluation and Corporate Investment (working paper, 2007) (finding that misvaluation leads to increased investment in overvalued firms issuing equity). See also Daniel Bradley, Brandon Cline, and Qin Lian, DO Insiders Practice What they Preach? Informed Option Exercises Around Acquisitions (working paper, 2009) (finding that, around the announcement of stock-financed acquisitions, insiders of the acquiring firm exercise stock options and sell the underlying shares, which is consistent with the acquirer stock being over-priced).

⁷⁸ See S. Teoh, Ivo Welch, and T.J Wong, Earnings Management and the Underperformance of Seasoned Equity Offerings, 50 J. Fin. Econ. 1935 (1998).

⁷⁹ See Erickson and Wang (1999); Louis (2004); Baik, Kang and Morton (2007); Botsari and Meeks (2008), and Gong, Louis, and Sun (2008).

overpriced at the time.⁸⁰ Apparently, the “discount” for Time Warner exceeded the value destroyed by the transaction.

The problem of cheap empire building can easily be illustrated with a simple example. Suppose that ABC Corporation, with one share outstanding, is worth \$100 as a stand-alone company. The shareholders of DEF Corporation, with a stand-alone value of \$200, are willing to sell the company to ABC for \$200. Suppose that the transaction would cause ABC to incur \$10 in transaction costs and generate no synergy benefits. Thus, the combined ABC-DEF has a value of \$290 (\$100+\$200-\$10).

Although the “correct” value of ABC’s single share is \$100, suppose that ABC can issue a second share to finance the acquisition at a price of \$200 because the market erroneously values the combined ABC-DEF at \$400 (rather than \$290). If ABC does not pursue the transaction, its current shareholders will own a share worth \$100. If ABC pursues the transaction, its current shareholders will own 50% of combined ABC-DEF, with a value of \$145. ABC’s shareholders will thus favor, or at least not oppose, the acquisition by ABC of DEF, even though it destroys \$10 of long-term shareholder value.⁸¹

Importantly, the sale of over-priced stock may lead to value destruction even if no other company is acquired through a stock-based acquisition. Suppose, for example, that the market overvalues ABC’s equity because investors are overly optimistic about its line of business. ABC may issue additional equity to expand its business by purchasing more assets and hiring more employees even though the economic return on such expansion is negative. Such expansion may destroy long-term shareholders value, but still be profitable for current shareholders if the stock is sold at a sufficiently high price.⁸²

B. Current Shareholders’ Interest

Current shareholders could take steps to prevent executives from engaging in cheap empire building. As Part I explained, shareholders must approve any merger of the firm or any issuance of new shares exceeding 20% of the outstanding shares. Thus, in

⁸⁰ See Pavel G. Savor and Qi Lu, Do Stock Mergers Create Value for Acquirers? (working paper, ____), at 1. Combining AOL and Time Warner proved so unsuccessful that Time Warner eventually decided to spin off AOL. See Richard Perez-Pena, Time Warner Board Backs AOL Spinoff, New York Times (May 28, 2009), available at http://www.nytimes.com/2009/05/29/business/media/29warner.html?_r=1.

⁸¹ Note that DEF shareholders do not necessarily lose money in the above transaction. As soon as they receive ABC stock, they are free to sell it in the market. Thus DEF shareholders may well receive \$200 from the sale of their firm. However, as I explain shortly, either DEF shareholders or those buying shares directly or indirectly from DEF shareholders end up losing money.

⁸² In principle, current shareholders would be better off if the managers, after selling the overpriced stock, simply distributed the cash to the current shareholders. However, the new investors must be told what the firm is planning to do with the proceeds of the equity issuance. If the firm were to inform new investors that the firm was simply going to distribute the proceeds to its shareholders, the market may realize that the sale has no purpose other than to use overpriced stock to transfer value from new investors to current shareholders, causing the stock price to drop.

most cases, shareholders can directly block transactions that reduce long-term shareholder value. They can also indirectly block transactions by threatening to remove directors who approve such transactions. But neither current short-term shareholders nor current long-term shareholders will generally have any incentive to do so.

1. Short-term shareholders

Because short-term shareholders expect to sell their shares in the short-term, they are affected by cheap empire building only to the extent it affects the short-term stock price. As long as the empire building does not reduce the short-term stock price, short-term shareholders cannot be expected to oppose it. And if cheap empire building boosts the short-term stock price, short-term shareholders can be expected to support it. Thus current short-term shareholders may generally have little interest in preventing cheap empire building.

2. Long-term Shareholders

Now consider long-term shareholders, shareholders who hold their stock until the firm is liquidated or sold. Long-term shareholders will benefit from cheap empire building to the extent it increases the long-term stock price. That is, they gain from cheap empire building when the value transferred from future shareholders through the sale of overpriced equity exceeds their share of the loss of value caused by the value-wasting expansion. In those cases, at least, long-term shareholders cannot be counted on to oppose this type of value-wasting transaction.

C. Effect on Future Shareholders

While current shareholders will often benefit from cheap empire building, future shareholders – those who directly or indirectly buy the stock issued by the acquiring firm – are hurt. Importantly, unlike in the case of price manipulation, where future shareholders can still profit from their investment if the post-manipulation price is still low relative to its actual value, future shareholders (collectively) always lose money from cheap empire building.

To return to the example above. Suppose ABC issues a second share to finance the acquisition at a price of \$200 because the market erroneously values the combined ABC-DEF company at \$400 (when it would in fact be worth \$290). DEF owners give up a company worth \$200 for a stock they value at \$200 but is in fact worth only \$145. If DEF owners hold onto the stock, they lose \$55. To the extent they sell the stock for \$200 to another buyer, that buyer loses \$55, and so on.

V. Toward Minimizing Current-Shareholder Bias

Having seen that current-shareholder bias can distort corporate governance and reduce long-term shareholder value, I now turn to consider how best to address it. Unfortunately there is no easy solution for the problem of current-shareholder bias.

As Section A explains, the two types of corporate governance reform that have received the most attention – returning corporate governance arrangements completely to private ordering, and using federal legislation to empower shareholders – will not solve the problem of current-shareholder bias. Neither private ordering nor empowering *current* shareholders can be expected to reduce managers' incentive or ability to transfer value from future shareholders to current shareholders.

Section B then shows that executive compensation arrangements could in principle be structured to eliminate managers' incentive to transfer value from future shareholders to current shareholders. However, current shareholders, who indirectly have influence over compensation decision-making, would have little interest in pushing for such arrangements. Thus implementation of such arrangements would require an unprecedented level of government intervention in executive compensation arrangements.

Current-shareholder bias arises because stock prices are noisy. Section C offers two policy proposals aimed at reducing stock price noisiness and, indirectly, at curbing current-shareholder bias. First, the government should reduce barriers to short-selling. Second, the federal clawback rule introduced by Sarbanes Oxley should be expanded to better deter executives from certain types of price manipulation. Both of these modest reforms would, I show, reduce the problem of current-shareholder bias.

A. Fundamental Corporate Governance Reform?

The United States currently has a system in which a publicly traded firm is subject to federal securities regulation and the corporate law of the state in which it is domiciled. Although there is a growing overlap between state corporate law and federal securities law, state corporate law focuses on the allocation of power within the firm between shareholders and managers, and federal securities laws mainly impose disclosure requirements on the firm. Publicly traded firms are free to choose their own corporate law arrangements by incorporating in the state of their choice, but are not free to opt out of the federal securities laws, which are mandatory.

Corporate governance reformers fall into two main camps. The first camp, which advocates a return to private ordering, argues that firms should be free to choose both their corporate law arrangements and disclosure arrangements. The second camp, which advocates empowering shareholders, argues that state corporate law gives shareholders too little power and that the federal government should override state corporate law and

increase shareholders' power. As I explain below, neither of these types of reforms would (whatever their other merits) solve the problem of current-shareholder bias.

1. Return to Private Ordering

Until the 1930s, publicly traded firms were free to choose both their own corporate-law and disclosure arrangements. In the 1930s, the federal government imposed mandatory disclosure requirements on stock-exchange traded firms, requirements that were subsequently imposed on large over-the-counter firms and, eventually, on every company with over 500 record-holders. The requirements themselves have expanded over time, most recently with the Sarbanes Oxley Act. The disclosure requirements under the U.S. securities laws are more extensive than disclosure requirements in most (if not all) other advanced economies. They are coupled with anti-fraud rules that can be used to impose personal liability on corporate insiders violating the disclosure laws.

There is considerable evidence that the imposition of mandatory disclosure has improved price accuracy in US and other public markets.⁸³ This should not be surprising. Although noise traders are not fully rational, and make mistakes that more informed traders do not, they are less likely to push a firm's stock away from fundamental value if there is more accurate information about that firm in the public domain. The more information noise traders have, the less likely they are to push the stock price away from fundamental value for long periods of time. And when informed traders have more information, they are more likely to enter the market when the stock price appears to deviate from fundamental value – buying stocks when they are undervalued and selling stocks (or selling stock short) when they are overvalued.⁸⁴

However, a number of prominent academic commentators – including Roberta Romano – have argued that mandatory disclosure under the federal securities laws should be eliminated.⁸⁵ Instead, managers and shareholders should be allowed to choose the disclosure regime applicable to their firm, just as they are free to choose its corporate law arrangements. States and nations would then have an incentive to compete with each other to offer “optimal” disclosure regimes to firms, just as states have an incentive to compete to offer “optimal” corporate law rules. Recently, a number of academics have put forward a more modest version of this proposal, arguing that shareholders of a firm should be allowed to opt out of the Sarbanes Oxley Act.⁸⁶

⁸³ Add cite.

⁸⁴ By improving the trading decisions of noise traders, increased disclosure also facilitates short-selling by reducing noise trader risk.

⁸⁵ See, e.g., Roberta Romano, 2001 Theoretical Inquiries in Law (arguing that firms and their shareholders should be allowed to choose the applicable securities regulation regime).

⁸⁶ See, e.g., Larry E. Ribstein and Henry N. Butler, “Where was SOX?”, Forbes (December 22, 2008), available at <http://www.forbes.com/forbes/2008/1222/028.html>.

My own view is that many firms, if given the freedom to choose their own disclosure arrangements, are unlikely to provide arrangements that are optimal for their current shareholders.⁸⁷ But even if managers and current shareholders could be counted on to adopt disclosure arrangements that were optimal for current shareholders, the analysis I have offered in this paper suggests that managers and current shareholders could not be counted on to adopt disclosure arrangements that provide a desirable level of protection for all shareholders, including future shareholders. For example, to the extent a particular disclosure arrangement would improve stock price accuracy and reduce the ability of managers to engage in price manipulation and cheap empire building, current shareholders may not wish to support it. At best, firms could be expected to seek disclosure regulations that maximize the value available to current shareholders – not to all shareholders.

Interestingly, the imposition of the securities laws in the 1930s led to a reduction in overpricing of IPOs on those US stock exchanges where firms had previously voluntarily provided little disclosure.⁸⁸ This finding provides evidence that firms and their given shareholders, when given discretion, cannot be counted on to adopt disclosure arrangements that take into account the interests of future shareholders.

In short, a return to private ordering around disclosure arrangements is likely to increase, not decrease, current shareholder-bias. Indeed, the analysis offered here suggests that, as managers figure out new strategies for exploiting lacunae in the disclosure rules to transfer value from future shareholders, the disclosure rules must continually be strengthened to close these gaps.

2. Empowering Shareholders

While the private-ordering camp argues that the federal government's role in corporate governance should be reduced, a number of legal academics and economists have argued that the federal government should take a more assertive role and use federal law to give shareholders more power in the corporation. In particular, they have argued that the federal government should make it easier for public shareholders to replace directors. In fact, both Congress and the SEC are currently considering proposals that will make it easier for public shareholders to use corporate proxy machinery to nominate directors and to get rid of directors who do not receive a majority of the votes cast.⁸⁹

⁸⁷ See Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135 (2009).

⁸⁸ See Carol Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, __ Am. Econ. Rev. __ (1989).

⁸⁹ See Part I supra.

As I have indicated in other work, I support such measures.⁹⁰ By putting directors' jobs at more risk, empowering shareholders is likely to induce directors to focus more on shareholders' interests rather than managers. Empowering shareholders is thus likely to reduce a range of managerial agency costs and improve corporate performance.

However, the analysis of this paper suggests that even fully empowering shareholders is unlikely to reduce all managerial agency costs. In particular, it is unlikely to reduce those types of managerial misbehavior, such as price manipulation, that tend to benefit current shareholders at the expense future shareholders. Current shareholders have little incentive to use whatever power they have to curb misbehavior that benefits them.

Because a number of commentators and policymakers have expressed concern that short-term shareholders may favor actions that reduce long-term corporate value, a number of shareholder-empowering reform proposals focus on giving long-term shareholders relatively more influence in corporate governance. For example, the SEC's proxy access proposal provides access only to a shareholder that has held its shares for at least one year. And some commentators have suggested that shareholders using the access mechanism be required to hold their shares for an additional year thereafter.

The analysis I offered suggests that empowering long-term shareholders is likely to be more effective at reducing current-shareholder bias than empowering shareholders generally: long-term shareholders are less likely than short-term shareholders to permit or encourage managers to take steps that reduce shareholder value. Indeed, in firms that do not issue equity, true long-term shareholders (shareholders who hold the stock until the firm is sold or liquidated) do not have an incentive to permit any managerial misbehavior that reduces shareholder value.

However, the analysis I offer suggests that in a typical firm – which does issue equity -- even true long-term shareholders have an incentive to permit certain types of managerial misbehavior. In particular, long-term shareholders can benefit from price manipulation when the firm sells equity and from the firm selling equity at an inflated price for projects that reduce long-term shareholder value. Thus selectively empowering long-term shareholders cannot be expected to eliminate these types of misbehavior.⁹¹

⁹⁰ See Bebchuk and Fried, Pay Without Performance, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard University Press, 2004); Fried, Option Backdating and Its Implications, 65 WASH. & LEE L. REV. 853 (2008).

⁹¹ Those who are critical of proposals to empower shareholders might argue that empowering shareholders is likely to exacerbate current-shareholder bias. That is, they may claim that giving current shareholders more power may cause executives to favor them more at the expense of future shareholders, leading to more price manipulation and more "cheap" empire building. However, given the current structure of compensation arrangements, it is generally in executives' own interest to engage in price manipulation and cheap empire building. Executives can thus be expected to continue to engage in these activities whether or not shareholders are further empowered. And even if empowering current shareholders increased the severity of certain types of managerial misbehavior, this cost would likely be small relative to the much larger benefit of reducing all the other forms of managerial misbehavior that hurt current shareholders, such

B. Fixing Executive Compensation?

Having seen that private ordering and empowering current shareholders are unlikely to reduce current-shareholder bias, we now turn to the possibility of executive compensation reform as a means to tackle the problem. Managers engage in price manipulation and cheap empire building in large part because their compensation arrangements give them financial incentives to do so. As I explain below, executive compensation arrangements could be designed to substantially reduce or even eliminate managers' incentive to engage in both price manipulation and cheap empire building. However, such arrangements would make current shareholders worse off. Thus, we cannot expect them to be adopted without an unprecedented level of government intervention.

1. Preventing Price Manipulation

Executives engage in price manipulation because their compensation arrangements give them a strong incentive to engage in such misbehavior. In our 2004 book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Lucian Bebchuk and I showed that executive pay is excessively tied to short-term stock prices, encouraging them to focus on short-term results even when they came at the expense of long-term value.⁹² Managers are permitted to unwind their equity positions on a regular basis, often at the time of their choosing. They have also been permitted to keep bonuses and the proceeds of stock sales based on inflated earnings.

As we have shown, one could substantially reduce executives' incentive to engage in price manipulation.⁹³ Currently, managers are generally free to cash out their equity once it vests. We explain that managers should not be able to freely unwind their equity once it vests. Rather, they should be "blocked" from cashing out the equity for a specified period of time after vesting. Once executives are permitted to unwind the equity, the payoffs to unwinding equity should be based on the average price over a sufficiently long-period rather than the price on a particular date. Such an approach, we show, would all but eliminate executives' interest in manipulating the stock price around dispositions.

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as entrenchment, excessive compensation, failure to downsize, and empire building through means other than the issuance of overpriced stock.

⁹² Lucian Bebchuk and Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard University Press, 2004), chapter 14 (analyzing problems resulting from the broad freedom of executives to unload equity incentives in the short-run).

⁹³ See Bebchuk and Fried, Reforming Executive Pay (working paper, 2009).

⁹⁴ The imposition of long-term holding requirements and tying the payoffs from unwinding to the average stock price would not eliminate managers' incentive to engage in price manipulation when the firm itself sold shares. But I explain below how that particular incentive could also be eliminated.

However, it is far from clear that current shareholders would favor compensation arrangements designed to tie executive pay to the long-term stock price and reduce price manipulation. Shareholders expecting to sell their shares within the next several months benefit when executives engage in price manipulation. They will be hurt if executives sacrifice the short-term stock price for long-term value. Thus while current long-term shareholders would favor such an arrangement, current short-term shareholders would not. Unless long-term shareholders have sufficient influence in the firm, one should not expect current shareholders to push for arrangements that reduce price manipulation.

2. Preventing Cheap Empire Building

Cheap empire building – the sale of overpriced equity to finance value-reducing expansions – increases the long-term stock price. Executives would thus continue to benefit from cheap empire building even if executives’ payoffs are tied to the long-term stock price.

However, as I explain elsewhere, executives could be compensated in ways that deterred them from issuing overvalued equity to transfer value from future shareholders.⁹⁵ In particular, executives could be required to buy, at the issue price, a fraction of the stock issued by the firm equal to executives’ proportional ownership in the firm. Suppose that an executive holds a certain fraction of the firm’s equity at a particular point in time (say, 2%). Thus, if the firm issues 100,000 new shares in a secondary offering, the executive would be required to buy, at the same prices the firm was receiving for the new stock, 2000 of the new shares. Because the effect of such a rule would be to keep the executive’s ownership percentage constant through the transaction (in this case, 2%), I call this the “constant-share” approach.⁹⁶

The intuition behind the constant-share approach is simple: by requiring the executive to participate in equity issuances as a buying shareholder in the same proportion as he owns stock in the company, the executive’s wealth will depend on the effects of his decisions on both current and future shareholders, not just on current shareholders. As a result, the executive will have an incentive to have the firm issue stock only if the issuances increase long-term shareholder value: the value flowing to all shareholders of the firm over time.

However, neither current short-term nor current long-term shareholders can be expected to favor the constant-share approach. The constant-share approach reduces executives’ incentives to sell overvalued equity in certain situations – those in which the transaction will reduce long-term shareholder value but would increase the long-term stock price. In such situations, all current shareholders would benefit from the transaction. Thus, the constant-share approach is unlikely to be implemented unless it

⁹⁵ See Fried, Tying Pay to Long-Term Shareholder Value (working paper, 2009).

⁹⁶ Under the constant-share approach, executives would be required, when the firm repurchases shares, to sell a fraction of their shares at the repurchase price. See *Id.*

were mandated by the federal government – an intrusion into the substantive regulation of executive pay that would be unprecedented and probably unacceptable politically.

C. More Modest Steps

We have seen that two main fundamental corporate governance reform proposals – returning to private ordering and empowering shareholders – are unlikely to reduce current-shareholder bias because neither type of reform makes it more difficult for managers to transfer value from future shareholders to current shareholders. We also saw that executive compensation arrangements could be structured to give managers an incentive to treat all shareholders – both current and future – equivalently, there is little reason to expect such arrangements to be adopted voluntarily or imposed by the federal government.

This Section offers two modest proposals that are likely to reduce current-shareholder bias and are within the realm of the politically possible. Current shareholder bias and the associated distortions -- price manipulation and cheap empire building -- arise because stock prices are noisy and are often manipulable by managers. The noisier are stock prices, and the more easily prices are manipulated by managers, the greater the costs of these distortions are likely to be. Each of the proposals I offer below is designed to make stock prices more accurate.

1. Empower Short-Sellers

As I have explained, one of the reasons that stock prices can deviate from long-term share value is that short-selling is risky and difficult: noise trader risk may cause the short-seller to lose money, and there are significant costs and barriers to short-selling, such as finding stock to borrow to sell short.⁹⁷ To improve stock price accuracy, the government should take steps to reduce these costs to short-selling.

First, the government should try to reduce tax and regulatory barriers to short-selling. There is no reason to tax short-sale gains at the short-term rate when the position is open for at least a year. Instead, such gains should be taxed at the lower long-term rate.⁹⁸ Indeed, given all of the other costs to short-selling, it may well be desirable to tax even short-term short-sale gains at the long-term rate.

There is also mounting evidence that the uptick rule and other regulatory limits on short-sales reduce sale price accuracy.⁹⁹ While some regulation of short-sales may be needed to reduce the risk of bear runs (concerted short-selling designed to cause panic and push the price down further), the available evidence and the analysis presented in this paper suggests that too much regulation would be undesirable.

⁹⁷ See supra Part II.B.

⁹⁸ See Michael Powers, David Schizer, and Martin Shubik, *supra* note x.

⁹⁹ Add cite.

Second, the government should consider whether it makes sense to facilitate a market for lending shares, or even require shareholders to lend their shares to short-sellers. Under current arrangements, shareholders can choose to not lend their shares to short-sellers. In practice, most individual shareholders agree to lend their shares as part of the standard brokerage arrangement, and many institutional investors are eager to lend their shares because of the large fees they collect from brokers facilitating these arrangements.¹⁰⁰ But there may be firms where very few current shareholders choose not to lend their shares, which would make short-selling expensive or impossible and overpricing more likely. And while the refusal of current shareholders to lend their shares may benefit managers and current shareholders, it is likely to lead to overpricing and actions that reduce long-term shareholder value.

2. Expand the Federal Clawback

Although the federal securities laws mainly impose disclosure obligations on publicly traded firms, including the disclosure of executive pay, they also *substantively* regulate some aspects of executive pay. Substantive pay regulation began in the 1930s when executives were prohibited from selling their firms' shares short¹⁰¹ and from making short-swing profits.¹⁰² In the 1960s, the federal courts interpreted Rule 10b-5 to prohibit executives (and other insiders) from trading on material nonpublic information, further expanding the scope of federal substantive pay regulation.¹⁰³

The Sarbanes Oxley Act of 2002 introduced an additional restriction on executive pay. Under Section 304 of the Sarbanes Oxley Act, the CEO and CFO of a firm required to restate earnings under certain conditions must give back to the company any profits realized from the sale of stock made within that 12-month period following the filing of a misleading financial statement.¹⁰⁴ This claw-back rule somewhat reduces managers' incentive to engage in earnings manipulation, one of the forms of price manipulation associated with current-shareholder bias.

Unfortunately, the SOX rule applies only in special circumstances that involve "misconduct." Moreover, it can only be enforced by the SEC, which has limited

¹⁰⁰ Add cite.

¹⁰¹ Section 16(c) of the 34 Act.

¹⁰² Section 16(b) of the 34 Act.

¹⁰³ See Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303 (1998).

¹⁰⁴ Section 304 of SOX requires the CEO and CFO of a firm forced to restate earnings to return to the firm any bonus or other incentive- or equity-based compensation received within twelve months of the misleading financial statement, or any profits realized from the sale of stock during that period. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (Supp. II 2002).

resources and cannot pursue every case of earnings manipulation. Indeed, it has generally been invoked only in cases where executives were criminally convicted of fraud.¹⁰⁵ Thus, Section 304 is unlikely to deter misreporting in run-of-the-mill cases not involving criminal fraud.

Given that earnings manipulation continues to be widespread, and that current shareholders may lack an incentive to prevent it, it would be desirable to expand Section 304 in two ways. First, the “misconduct” requirement should be eliminated: to the extent a CEO or CFO obtains any additional payout based on misstated earnings, that additional payout should be returned to the company whether or not misconduct can be proved. Requiring proof of misconduct reduces the likelihood that an executive manipulating earnings will be required to give back payments received as a result of price manipulation, undermining the deterrent effect of the rule. And there is no economic cost to recovering from executives payments to which they would not have been contractually entitled had the firm properly reported its earnings. Dropping the “misconduct” requirement will thus better deter executives from engaging in price manipulation at no cost.

Second, the government should give private investors the right to bring recovery actions under Section 304. Hundreds of firms restate their earnings downwards each year. In many of these firms, executives have profited from previously overstating earnings: they received higher bonuses or sold their stock for more money than they could have had the firm properly reported its earnings. Because of the SEC’s limited resources, only a handful of these executives are ever forced to return these extra payouts to the firm. This under-enforcement problem could be addressed by giving shareholders the right to bring actions against executives, just as shareholders have the right to enforce the short-swing provisions of Section 16(b) of the 34 Act.¹⁰⁶ Giving more parties the right to bring actions under Section 304 would further deter executives from engaging in price manipulation.

CONCLUSION

[TO BE COMPLETED]

¹⁰⁵ See Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?* 2 J. BUS. & TECH. L. 277, 299 (2007).

¹⁰⁶ Such lawsuits would, of course, not actually be brought by shareholders, but rather be initiated by plaintiffs’ lawyers who would get a cut of the recovery (just as they get part of the 16(b) payments made by offending executives back to their firms).