From Managers to Markets: Valuation and Shareholder Wealth Maximization

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I. INTRODUCTION 436
II. THE MANAGERIALIST CORPORATION 441
A. Internal Capital Markets and Professional Managers......................................442
B. Managerialism and Corporate Purpose 446
III. THE INCOMPLETE EXPLANATIONS FOR THE TRANSITION TO SHAREHOLDER WEALTH MAXIMIZATION...450
A. Law 450
B. Ideology 452
C. Executive Compensation 455
D. Institutional Investors 455
IV. THE PROBLEM OF VALUING FUTURE EARNINGS 457
A. The Shift to Assessing Earnings 457
B. The Problem of Predicting Earnings..459
V. SIGNALING FUTURE EARNINGS..461
A. Conglomerates...462
B. Projections...464
1. Internal Projections..464
2. Market Projections 468
i. From Internal to External Projections..468
ii. Insider Trading Law and the Increasing Importance of Projections.......472
VI. VALUATION AND CORPORATE PURPOSE 476
A. Projections and Agency Costs...477
B. The New Managerialism?...481
VII. CONCLUSION...485

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Wealth Maximization

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During the managerialist period, managers of large public companies were not pressured to maximize profits and had more discretion to consider the interests of stakeholders. According to the conventional story, managers began maximizing shareholder wealth as ideology changed to favor shareholders. This Article argues that a more significant cause of the decline of managerialism was a fundamental shift in the way that investors valued companies.

As public companies became larger and more complex, professional managers developed budgets and forecasts that could be used to allocate resources within internal capital markets. External capital markets began relying on such information to generate predictions of future revenue and earnings. As investors increasingly valued public companies based on such projections, it became important for managers to consistently meet market expectations. Rather than ideology, public companies generally prioritize shareholder wealth maximization because they face pressure to validate prior predictions of their financial performance.

Understanding the role of valuation in shaping the incentives of the public corporation provides a new lens for understanding corporate purpose. If the transition to shareholder wealth maximization was driven by changes in valuation, it is possible that shifts in valuation methods could result in a new managerialism where managers of some companies can make meaningful commitments to consider stakeholder interests.

I. INTRODUCTION

It is now difficult to imagine a time when public company managers did not work primarily to increase returns for shareholders. For decades, it has been widely accepted that public corporations should strive to increase their earnings to satisfy stock markets with little regard for the interests of corporate stakeholders—a practice that has generally been referred to as shareholder wealth maximization.[1] But that was not always the case. As U.S. public corporations came to dominate the economic landscape after World War II, leading economists and commentators observed that corporate managers were not compelled to maximize profits. This managerialist era was characterized by investor deference to managers of large companies who were in the best position to allocate resources to promising projects through internal capital markets.[2] Without the constant

1. It is challenging to precisely define the concept of shareholder wealth maximization. A more abstract formulation is that a corporation maximizes shareholder wealth when it maximizes the present value of its earnings.

2. *See, e.g.*, William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 272 (1992) (noting that managerialists believe that managers are better at valuing businesses than capital markets). For a comprehensive overview of the managerialist period, see BRIAN CHEFFINS, THE PUBLIC

pressure of markets, managers viewed themselves as trustees obligated to balance the interests of various corporate stakeholders.

What happened to the managerialist model? The prevailing account is that ideology changed.[3] Some scholars point to the 1970 publication of Milton Friedman's vigorous defense of shareholder wealth maximization in the *New York Times Magazine* as a turning point in redefining the purpose of the corporation.[4] In addition, corporate scandals during the 1970s contributed to the belief that corporate managers tended to benefit themselves rather than shareholders.[5] Scholars came to associate managerialism with ineffective and inefficient empire building. In their 2001 article noting the wide acceptance of the norm that corporations should increase shareholder value, Henry Hansmann and Reinier Kraakman briefly noted that "[t]he collapse of the conglomerate movement in the 1970s and 1980s . . . largely destroyed the normative appeal of the managerialist model."[6]

If corporate purpose is defined primarily by a set of ideological beliefs, then it should be possible to redefine such purpose by adopting a broader conception of the ends of the corporation.[7] Rather than focusing exclusively on shareholder wealth

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COMPANY TRANSFORMED 39–100 (2019).

3. For a description of ideology as "a means of translating ideas into action," see Edward Rock, *For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose*, 76 BUS. LAW. 363, 386 (2021).

4. *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 18 (2012); *see also* Leo Strine, Jr. & Joey Zwillinger, *What Milton Friedman Missed About Social Inequality*, N.Y. TIMES (Sept. 10, 2020), https://www.nytimes.com/2020/09/10/business/dealbook/milton-friedman-inequality.html?searchResultPosition=1 [https://perma.cc/TAR3-FL5X] (pointing to Friedman's article as the start of an ideological shift that should be reversed in favor of duties to corporate stakeholders). In September 2020, the *New York Times* marked the fiftieth anniversary of the article's publication by compiling reaction pieces from various business executives and academics. *A Free Market Manifesto, Reconsidered*, N.Y. TIMES (Sept. 11, 2020), https://www.nytimes.com/2020/09/11/business/dealbook/milton-friedman-doctrine-social-responsibility-of-business.html?action=click&module=Top%20Stories& pgtype=Homepage [https://perma.cc/W9FY-LL2C].

5. *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1511–17 (2007) (pointing to the collapse of Penn Central and foreign bribes scandal as two events that raised questions about the motives of corporate managers).

6. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 444 (2001); *see also* Dalia T. Mitchell, *From* Dodge *to* eBay: *The Elusive Corporate Purpose*, 13 VA. L. & BUS. REV. 155, 162 (2019) ("In the 1980s, criticism of conglomerates and fears about growing numbers of hostile takeovers, presumably intent on breaking down these large corporations, led the courts to embrace the maximization of wealth for the shareholders as the ultimate corporate purpose.").

7. For example, in the fall of 2019, members of the Business Roundtable, an organization comprised of Chief Executive Officers (CEOs) of major public companies, issued a statement declaring that they would no longer work solely to further the interests of their shareholders. BUSINESS ROUNDTABLE, STATEMENT ON THE PURPOSE OF A CORPORATION (2019), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf [https://perma.cc/5H85-A886]. A total of 184 CEOs signed a document expressing a "fundamental commitment to all of our stakeholders." *Id.* In addition to delivering "long-term value" to shareholders, they committed to creating value for consumers, investing in employees, dealing fairly and ethically with suppliers, and supporting local communities. *Id.* The statement declared that "[e]ach of our stakeholders is essential." The Business Roundtable has made similar statements in the past. As late as 1990, it observed that "[c]orporations are chartered to serve both their shareholders and society as a whole." BUSINESS ROUNDTABLE, CORPORATE GOVERNANCE AND AMERICAN COMPETITIVENESS 4 (1990). However, a 1997 statement by the organization noted that the "paramount duty" of public companies was to shareholders and the interests of corporate stakeholders were "derivative" of such a duty. *See* BUSINESS ROUNDTABLE, STATEMENT

maximization, corporations could simply recommit to giving serious weight to the interests of stakeholders. Another ideological shift could result in the displacement of shareholder wealth maximization as the primary goal of public companies.[8]

But shareholder wealth maximization is much more than an ideology.[9] Its influence cannot be explained simply as a normative commitment to a theory about how corporations should be run. Indeed, managers have consistently resisted the idea that they should only maximize profits for shareholders. Many corporate managers would prefer a world in which they have wide discretion that is not constantly questioned by shareholders. They understand that corporations have a wide range of stakeholders that are essential to their success. They do not strive to maximize shareholder wealth solely because they have defined the corporation's purpose too narrowly.

This Article develops a new account of the shift from managers to markets as the primary driver of corporate purpose. It shows that managerialism became less influential not just because of shifts in ideology but because of fundamental changes in the methods investors used to value public companies. As management came to be viewed as a science that could be mastered,[10] it became evident that stock values were linked to the ability of management teams to develop efficient internal capital markets that generated predictable corporate earnings over time. Investors became more confident that they could develop reliable projections of public company earnings and that stock valuations should depend largely on an assessment of a company's earnings power.[11]

By the 1960s, companies used two major methods to signal the extent of their future earnings. The first, which was largely discredited by the 1980s, was forming a corporate conglomerate. There was a belief that a company that assembled a diverse range of businesses could deliver smooth increases in earnings. The second was to consistently meet market projections of company earnings and revenues. As internal capital markets became more sophisticated, they generated predictions of company financial performance. Market participants began developing their own forecasts of corporate profits, which were often shaped by information obtained from corporate managers. By consistently meeting projections of revenue and profits, companies demonstrated the skill

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ON CORPORATE GOVERNANCE 3 (1997), https://cdn.theconversation.com/static_files/files/693/Statement_on_Corporate_Governance_Business-Roundtable-1997%281%29.pdf?1566830902 [https://perma.cc/8NMY-GVBW].

8. It is far from certain that such an ideological shift is possible. *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine,* 121 COLUM. L. REV. (forthcoming 2021).

9. As Professor David Millon has noted, shareholder wealth maximization is only "part of a larger ideological, economic, and socio-political phenomenon that now shapes and legitimates business practice in powerful ways." He observes that this "complex but hugely important story has yet to be told." David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L.J. 1013, 1042 (2013).

10. *See, e.g.*, Carl Kaysen, *The Social Significance of the Modern Corporation*, 47 AM. ECON. REV. 311, 313 (1957) (noting that the modern corporation is distinguished by (1) scientific management; (2) "weight attached to growth and technical progress"; and (3) "wide-ranging scope of responsibility assumed by management").

11. Today, it is widely accepted that stock prices reflect the market's assessment of a company's future earnings. *See, e.g.*, ROGER L. MARTIN, FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL 12–13 (2011) (describing the "expectations market" where "[t]he consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company"); ALFRED RAPPAPORT & MICHAEL MAUBOUSSIN, EXPECTATIONS INVESTING: READING STOCK PRICES FOR BETTER RETURNS xv (2001) ("Stock prices are the clearest and most reliable signal of the market's expectations about a company's future performance.").

of their managers and validated market predictions of earnings trajectories that had been incorporated into their stock prices.

Of these two methods, projections became the more influential in affecting corporate incentives. Projections of financial performance permit shareholders to: (1) assess managerial competence and (2) assess the commitment of managers to maximize the value of a company. Investors will reward companies that issue ambitious projections of growth and consistently meet them. A company that fails to meet market projections will signal that its managers are not able to competently predict its earnings trajectory. A company that issues unambitious projections will signal that its management is not committed to increasing corporate value. By providing a metric for assessing the ability of corporate managers to increase earnings over time, projections eventually allowed shareholders to seize control over the purpose of the corporation.[12]

Corporate managers mainly strive to increase shareholder wealth not because of their ideological beliefs, but because of the reality that investors constantly assess their performance based on their ability to meet metrics of financial performance. Other mechanisms such as takeovers, executive compensation, and shareholder activism have also played a role in encouraging shareholder wealth maximization.[13] But projections had a significant influence on public companies before those methods emerged and have been the most persistent and pervasive means by which shareholders monitor management.

As valuation shifted from managers to markets, the power of stock markets to define corporate purpose increased.[14] As quarterly projections became the standard, a distinction between short-term and long-term shareholder wealth maximization was created. Companies faced pressure to meet short-term market expectations and often sacrificed stakeholder interests as a result.

The irony of projections was that they were initially a way that shareholders relied on the superior knowledge of management to value companies, and over time evolved to become a heuristic that tested managerial competence. Rather than deferring to managerial expertise, markets sought to evaluate executives based on whether they could set ambitious goals and meet them. Managers of many public companies have little choice but to work to continue generating corporate earnings to maintain their company's valuation. Projections helped change a world in which shareholders had little power relative to management to one in which they wield significant influence over the goals of

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12. It took some time for projections to play a central role in defining corporate purpose. While they were widely disseminated during the 1970s, they had less influence in a challenging economic environment where corporate performance was generally stagnant. Because all companies were performing poorly, there was less pressure on individual companies to demonstrate earnings growth.

13. For example, hedge fund activism has increased in intensity over the last decade, though its frequency has recently declined. *See, e.g.*, Melissa Sawyer & Marc Treviño, *Review and Analysis of 2020 U.S. Shareholder Activism and Activist Settlement Agreements*, SULLIVAN & CROMWELL (Dec. 2, 2020), www.sullcrom.com/shareholder-activism-review-us-2020 [https://perma.cc/BG2F-4PJF] (finding a 30% decline in activist campaigns).

14. The U.S. corporation thus differs from many foreign corporations, which typically operate in markets that do not rely as much on projections and therefore do not face as much pressure to privilege shareholder value. *See, e.g.*, JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 64 (2012) (noting that the U.S. is an outlier with respect to its reliance on projections); Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 4 (2001) ("[I]t is widely felt in countries such as Germany, Japan and France that corporations should aim to promote growth, longevity and a secure employment relationship, with profitability being more an instrument than the ultimate goal.").

the public corporation.

By emphasizing valuation over ideology, this Article provides a new lens for viewing corporate purpose. If the transition from managerialism to shareholder wealth maximization was driven primarily by changes in valuation, it is possible that another set of changes in valuation methods could support a New Managerialism. While projections have powerfully shaped corporate purpose, some public companies have escaped the pressure to maximize shareholder wealth in the short-term, especially in recent years. As companies have become even larger and more complex, shareholders increasingly defer to the expertise of their managers out of necessity. Investors give companies with significant market power more leeway in demonstrating immediate profitability because they are confident in their long-term prospects. Stock markets have permitted companies with strong business models to adopt dual-class structures that essentially eliminate the ability of public shareholders to install a new management team. Public company managers have argued that markets should move away from projections as a way of valuing companies on the ground that they emphasize short-term results that do not reflect long-term corporate value.[15] As investors have become more diversified and concerned with social responsibility, they may focus less on short-term profitability. For companies that can escape the treadmill of projections,[16] commitments to consider the interests of stakeholders have the potential to be meaningful.

It is important to note at the outset that the primary goal of this Article is to provide a novel account of how public companies came to focus on maximizing shareholder wealth. It does not directly engage the broader normative question of whether shareholder wealth maximization increases social welfare or is a desirable norm.[17] It also does not attempt to resolve the related debate about whether a system that generally prioritizes shareholder interests is desirable.[18] Its contribution is to provide a fuller understanding of the fall of managerialism and how investors shape corporate purpose.

The Article is divided into five parts. It describes the managerialist model in Part I. Part II discusses the prevailing explanations for why managerialism gave way to shareholder wealth maximization. Part III examines how valuation methods shifted towards the end of the managerialist period as investors increasingly sought to predict future earnings. Part IV describes how public companies responded as investors increasingly assessed managerial ability to deliver smooth increases in earnings. Part V concludes by examining how projections have influenced corporate purpose and how shifts in valuation methods could permit some companies to do more than maximize shareholder wealth.

15. *See, e.g.*, James J. Park, *Do the Securities Laws Promote Short-Termism?*, 10 U.C. IRVINE L. REV. 991 (2020) (discussing proposals).

16. For more on the impact of this valuation treadmill, see JAMES J. PARK, THE VALUATION TREADMILL: HOW SECURITIES FRAUD THREATENS THE INTEGRITY OF PUBLIC COMPANIES (forthcoming 2022).

17. For a normative and legal defense of shareholder wealth maximization, see Stephen M. Bainbridge, *In Defense of The Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1433–34 (1993) (arguing that it is unfair to allocate value to stakeholders who already have contractual protections).

18. In the public corporation, shareholder wealth maximization can be understood as a corollary of the concept of shareholder primacy, where the corporation treats the interests of its shareholders as paramount. While there is significant overlap between shareholder wealth maximization and shareholder primacy, the two concepts are not identical. A corporation could be composed entirely of shareholders who strongly prefer not to maximize their wealth and they could elect managers who would honor that preference.

II. THE MANAGERIALIST CORPORATION

The deference to corporate executives around the middle of the twentieth century both confirmed and contradicted the prediction of Adolf Berle and Gardiner Means in 1932 that the divergence of interests between managers and shareholders would reduce shareholder value.[19] Berle and Means correctly observed that given the size of public corporations, many of them had dispersed shareholders with little choice but to rely on professional managers to control corporate decisions.[20] This separation of ownership and control would mean that managers did not have a strong incentive to increase shareholder returns.[21] But this concern seemed less important as corporations generally prospered during the decades after World War II. Commentators writing during this period did not view the lack of mechanisms to ensure that managers maximized shareholder wealth as a problem for shareholders.[22]

The managerialist model reflected the reality that for a time, internal capital markets were a more efficient way of allocating resources within the large public corporation than external capital markets. The quality and reliability of information on corporate performance was not as high as it would become in later years. Moreover, as the science of management advanced, many commentators believed that corporate officers had special expertise that deserved deference. Because of their access to information and superior training, managers were more capable of assessing the value of projects within the boundaries of the large firm than investors who would have to incur substantial transaction costs to do so. In addition, large companies had market power that enabled them to generate enough earnings so that they had less need to raise funds through stock markets. They were thus not as subject to the scrutiny of capital markets, giving them more discretion to consider stakeholders' interests.

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19. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (Transaction Publishers ed. 1991).

20. *Id.* at 66 ("As the ownership of corporate wealth has become more widely dispersed, ownership of that wealth and control over it have come to be less and less in the same hands."); *see also* ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 451 (1977) ("The creation of a large central office of top managers and their staffs further sharpened the distinction between ownership and control."). Sarah Haan has documented that during the first half of the twentieth century, a significant percentage of individual shareholders were women, though they collectively owned fewer shares than men. Some commentators (but not Berle and Means) referenced this fact as one reason why shareholders were passive relative to management. *See* Sarah C. Haan, *Corporate Governance and the Feminization of Capital*, 73 STAN. L. REV. (forthcoming 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3740608 [https://perma.cc/E7BB-DEDK].

21. As Berle and Means explained:

> Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree . . . The explosion of the atom of the property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.

Berle & Means, *supra* note 19, at 9.

22. *See, e.g.*, Margaret M. Blair, *Are Publicly Traded Corporations Disappearing?*, 105 CORNELL L. REV. 641, 654 (2020) (noting that "almost no one in [the managerialist] period expressed concern that the problem with big corporations was that corporate managers were unaccountable to shareholders as a result of the separation of ownership and control").

A. Internal Capital Markets and Professional Managers

The distinction between internal markets within the firm and external markets without the firm was introduced by Ronald Coase in his article, *The Nature of the Firm*.[23] Firms exist because it is less costly for some transactions to occur inside a company than through contracts with third parties. For example, rather than hire a temporary worker for each new project, it can be more efficient to employ a permanent worker that managers can deploy to different projects as needed. The economist Oliver Williamson thus famously contrasted markets (which rely on the pricing mechanism) and hierarchies (which rely on managers) in describing the governance of the public corporation.[24] The business historian Alfred Chandler described the importance of the visible hand of management that guided corporations in navigating the invisible hand of the markets.[25]

Corporations have a choice between raising funds from external capital markets and allocating funds they generate from their operations through internal capital markets. As the largest companies grew and increased their market dominance, they generated significant profits that could be reinvested within the firm. They could establish a central office that could oversee the wide range of divisions operating in different regions and markets.[26] An advantage of such an internal capital market is that managers can allocate funds to promising projects through fiat rather than by contracting with outside investors to provide funding.[27] Raising funds from external capital markets can be costly because investors will need to expend transaction costs to evaluate a project. Company managers have superior expertise with respect to their companies and access to better information than investors.[28] This was especially so when public companies were not as transparent as they are today.[29] One difference was that federal periodic disclosure requirements that would eventually provide investors with reliable information on a quarterly basis were not as developed prior to the 1970s.[30] As Williamson observed, "the transaction costs

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23. *See generally* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

24. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 142 (1975).

25. CHANDLER, *supra* note 20.

26. *See, e.g.*, Oliver E. Williamson, *The Logic of Economic Organization*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 90, 107 (Oliver E. Williamson & Sidney G. Winter eds., 1991) ("The general office of the firm can [] be thought of as an internal capital market").

27. *See, e.g.*, George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1111 (2004). Capital can be allocated through an internal market in various ways. As George Triantis explains:

> First, the cash flow from one project may be diverted to fund another. Second, assets of one project may be sold and the proceeds transferred to another project. Third, the firm may implicitly borrow against the assets of one project to finance another venture whenever liability is incurred by the organization as a whole, because all of its assets are available to satisfy the creditor.

Id. at 1111.

28. *See, e.g.*, *id.* at 1111 ("The advantage of an internal capital market is that it facilitates the delegation of control over switching options from investors to managers, who have superior expertise and access to information regarding available projects.").

29. *See, e.g.*, R. Glenn Hubbard & Darius Palia, *A Reexamination of the Conglomerate Merger Wave in the 1960s: An Internal Capital Markets View*, 54 J. FIN. 1131, 1133 (1999) ("[R]elative to the current period, there was less access by the public to computers, databases, analyst reports, and other sources of company-specific information.").

30. *See, e.g.*, Park *supra* note 15, at 1000–03 (noting that "[u]ntil 1970, the SEC only required public

associated with traditional capital market processes for policing management . . . are considerable."[31]

The development of efficient internal capital markets required advances in managerial science. Coase observed that as firms grow larger, the cost of transacting within the firm also rises.[32] Large public corporations require better management than an individual proprietorship.[33] Initially, because of management challenges, some commentators were skeptical that most businesses could grow beyond a certain size.[34] There were predictions that large companies would founder because "no one person or board of directors could successfully master such large organizations in a competitive environment."[35]

The sophistication of corporate managers increased significantly after World War II. In a study published in the 1950s, economist Kenneth Boulding argued that corporations, like other organizations, became larger as the technology of organization improved.[36] The growing size of private businesses, government agencies, and non-profit organizations such as churches reflected innovation in management techniques. For example, advances in accounting and statistics enabled better monitoring of business operations.[37] Business schools facilitated the adoption of such methods as the number of graduates from MBA programs rose from 110 in 1919 to 3,897 in 1949.[38] Such professional education "played a crucial role in gaining legitimacy for the new occupation of management . . . elevating it to a higher social status than it had ever

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companies to file disclosures on a semiannual basis").

31. WILLIAMSON, *supra* note 24, at 142–43; OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 150 (1985) [hereinafter INSTITUTIONS] (noting that "risks and decisions" are "unpacked with greater precision and confidence internally" and so "internal asset managers can better ascertain whether to continue funding a project than could the capital market").

32. Coase, *supra* note 23, at 394.

33. *See, e.g.*, W. D. KNIGHT & E. H. WEINWURM, MANAGERIAL BUDGETING 7 (1964) ("The management function in modern business is a consequence of the growth of the typical firm to a size too great to be operated by a single individual.").

34. *See, e.g.*, EDITH TILTON PENROSE, THE THEORY OF THE GROWTH OF THE FIRM 18 (1959) (observing that "it was almost universally agreed" that "a firm can get 'too big'" and that "management or 'co-ordination' was a 'fixed factor' which would necessarily give rise to diminishing returns and increasing costs of operation at some point.").

35. GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTING IN AMERICA: AN HISTORICAL INTERPRETATION OF THE CULTURAL SIGNIFICANCE OF ACCOUNTING 85 (1979).

36. *See* KENNETH E. BOULDING, THE ORGANIZATIONAL REVOLUTION: A STUDY IN THE ETHICS OF ECONOMIC ORGANIZATION 49 (1953) ("It has been my main thesis that the organizational revolution of our time has been in the main the result of certain technical changes in the ability to organize: changes both on the physical side in the improvement of transportation and communication, and on the structural side in the forms and skills of organization itself."); *see also* PENROSE, *supra* note 34, at 19 (observing that management adapted to growth in organizations). Years later, technology facilitated the outsourcing of activities outside the firm by improving the ability of companies to monitor contractors. *See, e.g.*, George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 NOTRE DAME L. REV. 955, 998–1002 (2007) (contending that "the same forces opening up the global markets," such as "technology, standardization of business processes, and plunging communication costs," make it "easier and cheaper" for outsourcing parties to mitigate agency risk).

37. *See, e.g.*, BOULDING, *supra* note 36, at 135 ("Both accounting and statistics are methods of *abstracting* and *condensing* information; i.e., of taking out of a vast mass of reality only those elements which are essential for the purposes of executive decision.").

38. RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS: THE SOCIAL TRANSFORMATION OF AMERICAN BUSINESS SCHOOLS AND THE UNFULFILLED PROMISE OF MANAGEMENT AS A PROFESSION 195 (2007).

achieved before . . . ."[39] Their sophisticated training was viewed as enabling managers to add value to any business.[40] Some companies developed their own programs to develop the skills of their managers internally.[41] Journalist William Whyte famously documented the rise of the organization man who immersed himself in the norms of his company.[42] Whyte described the extensive training program of the electric bulb manufacturer General Electric, which had a staff of 250 instructors and emphasized the "professional" manager.[43] The curriculum covered "personnel philosophy, labor relations, law, and most importantly, the managerial viewpoint."[44]

Another view is that management skills not only enabled the formation of larger businesses but emerged out of necessity as corporations grew and required centralized operations. According to Chandler, management techniques were developed primarily by companies that expanded through mergers.[45] The mega-corporations described by Berle and Means were primarily created through the acquisition of smaller enterprises.[46] Systems and procedures were needed to integrate new companies into the existing organizational structure. Central offices to monitor and coordinate multiple corporate divisions became essential. Over time, "[t]he methods fashioned during the process of consolidation and integration . . . were further refined as the company began to grow and to compete oligopolistically with other large integrated enterprises."[47]

Regardless of how professional management methods were developed, knowledge and training with respect to such methods conferred authority to corporate managers.[48]

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39. *Id.* at 135; *see also* BOULDING, *supra* note 36, at 27 ("The 'invention' of the professional, specialized organizer is probably one of the most important developments in the structure of organization relating to the growth of size."); MORRELL HEALD, THE SOCIAL RESPONSIBILITIES OF BUSINESS: COMPANY AND COMMUNITY, 1900–60, 277 (1970) ("The conception of management as a profession, requiring special training and analytical skills as well as broad social understanding and high ethical standards, had grown steadily since the 1920s."); Edward S. Mason, *Introduction* to THE CORPORATION IN MODERN SOCIETY 1, 12 (Edward S. Mason ed., Harv. Univ. Press, 1960) (observing that "[o]ne of the leading characteristics of well-ordered bureaucracies both public and private—a characteristic justly extolled by the devotees of managerialism—is the increasing professionalization of management"); FRANCIS X. SUTTON ET AL., THE AMERICAN BUSINESS CREED 357 (1956) (noting importance of "the view of business management as a profession"); FREDERICK WINSLOW TAYLOR, THE PRINCIPLES OF SCIENTIFIC MANAGEMENT 7 (1911) (Norton Library ed., 1967) (seeking to "prove that the best management is a true science, resting upon clearly defined laws, rules, and principles, as a foundation").

40. *See, e.g.*, MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 99 (1995) ("Management came to be regarded as a generic skill that could be learned, taught, and readily transferred from one line of business to the next, as long as managers had the right information available to them.").

41. For example, IBM created a management school for its executives during the 1950s. *See* THOMAS J. WATSON, JR., A BUSINESS AND ITS BELIEFS: THE IDEAS THAT HELPED BUILD IBM 49 (1963).

42. *See generally* WILLIAM H. WHYTE, JR., THE ORGANIZATION MAN (1956).

43. *Id.* at 120.

44. *Id.* at 121.

45. CHANDLER, *supra* note 20, at 415 ("The practices and procedures of modern top management had their beginnings in the industrial enterprises formed by merger rather than those that built extended marketing and purchasing organizations.").

46. BERLE & MEANS, *supra* note 19, at 42–43.

47. CHANDLER, *supra* note 20, at 416.

48. As Alfred Chandler explained, "[t]he managers of these companies gained control because they, not the outside directors, had the knowledge, experience, and information required to make and implement the strategies essential to keep such enterprises profitable." ALFRED D. CHANDLER, JR., SCALE AND SCOPE, THE DYNAMICS OF INDUSTRIAL CAPITALISM 192 (1990). The view that managers of large companies had special

The unique challenges of running a large company meant that a limited number of specially trained individuals had the skills to be managers.[49] Shareholders, most of whom were individuals, did not have the expertise to second-guess such experts. Based solely on their knowledge, it was not difficult to conclude that trained executives were better able to allocate resources and value businesses than non-expert investors. Shareholder-owners gave up control willingly in order to take advantage of the special skills of professional managers.[50]

Either because of the prowess of management or because of generally favorable economic conditions,[51] during the post-World War II era corporate managers had less need to access external capital markets. In many industries, just a few companies controlled the national market.[52] Market power resulted in significant profits that could be reinvested.[53] Because public corporations had less need to sell securities to raise capital, there were fewer times when they would be thoroughly scrutinized by outside investors.[54] There was no need to provide the extensive and reliable disclosure required by a registration statement and modern periodic reporting requirements. As Adolf Berle observed in 1962, "[m]ajor corporations in most instances do not seek capital. They form it themselves."[55]

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skills enabling them to transcend the market dates back to the Progressive Era. *See, e.g.*, SAMUEL HABER, EFFICIENCY AND UPLIFT: SCIENTIFIC MANAGEMENT IN THE PROGRESSIVE ERA 1890–1920 95 (1964) (discussing the changing views on the role of a manager during this period). One hope was that greater efficiency would improve the lives of workers. *See* HERBERT CROLY, PROGRESSIVE DEMOCRACY 396–97 (1914) (arguing that efficiency in the workplace would lead to greater quality of life for workers).

49. *See, e.g.*, JAMES BURNHAM, THE MANAGERIAL REVOLUTION 82 (1941) (observing that "through changes in the technique of production, the functions of management become more distinctive, more complex, more specialized, and more crucial to the whole process of production, thus serving to set off those who perform those functions as a separate group or class in society.").

50. *See, e.g.*, WILLIAMSON, INSTITUTIONS, *supra* note 31, at 290 (observing that the Berle-Means problem was addressed through internal reform).

51. *See, e.g.*, CHEFFINS, *supra* note 2, at 64 (observing that share prices generally rose from 1950 to 1968); JOHN KENNETH GALBRAITH, AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER 87 (1952) (noting the increase in aggregate profits from $14 billion in 1946 to $22 billion in 1950). The 1950s saw a significant bull market where the Dow Jones Industrials Average more than doubled over the course of the decade. *See* ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET 327 (1965) (analyzing the performance of the stock market over the 1950s). Part of the reason for the strong market performance was that the number of stock investors increased significantly. *See* Wyatt Wells, *Certificates and Computers: The Remaking of Wall Street, 1967 to 1971*, 74 BUS. HIST. REV. 193, 194–95 (2000).

52. As one text noted: "in each of the following industries one corporation was either the sole seller or controlled the entire supply: virgin aluminum, shoe machinery, bottle machinery, optical glass, nickel, magnesium, and molybdenum. Four producers or less accounted for from 75 to 100%, by value, of the product of industries producing one third, by value, of all manufactured products. Fifty-seven percent of the value of all manufactured products was accounted for by industries in which the four largest producers, when there were that many, turned out half the total value." GEORGE W. STOCKING & MYRON W. WATKINS, MONOPOLY AND FREE ENTERPRISE 47 (1951).

53. DOW VOTAW, MODERN CORPORATIONS 105 (1965) (noting that from 1946 to 1953, 64% of corporate funds came from internal sources, and from 1954 to 1963, 73% of corporate funds came from internal sources).

54. Securities sales are especially scrutinized by investors. *See, e.g.*, Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984) ("The principal value of keeping firms constantly in the market for capital is that the contributors of capital are very good monitors of managers.").

55. ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 40 (1954); *see also* WILBERT E. MOORE, THE CONDUCT OF THE CORPORATION 227 (1962) ("By retaining earnings the corporation may become self-sustaining."). Not all commentators agreed that public companies were generally able to avoid the

B. Managerialism and Corporate Purpose

Because they relied on internal capital markets, there was less reason for the managerialist corporation to focus solely on maximizing shareholder profits. Managers had greater leeway to pursue long-term growth rather than immediate profitability. As a result, they had more discretion to consider stakeholder interests alongside shareholder interests.

An extensive body of literature during the managerialist period noted that corporations did not face pressure to maximize profits. A 1945 study of corporations by the Brookings Institution noted that "the maintenance of satisfactory profits is a more accurate statement of the profits objective than is complete profits-maximization."[56] A Harvard University dean observed in 1958 that "[b]usiness is viewed as a kind of game in which profit has approximately the same significance as one's golf score."[57] The management guru Peter Drucker asserted that "the problem of any business is not the maximization of profit but the achievement of sufficient profit to cover the risks of economic activity and thus to avoid loss."[58]

Skepticism that firms should maximize profits was consistent with the emerging theory of behavioral economics, which rejected the classical assumption that individuals maximize their utility. Herbert Simon applied the concept of bounded rationality, which acknowledges that individuals do not have perfect knowledge that permits them to make optimal choices, to analyze corporate policy.[59] He argued that because of the limited ability of organizations to understand their environments, rather than maximize profits, they will "satisfice" and produce the best results given their limited knowledge.[60] His theory would explain why some managers focus on increasing the size of the firm to reduce the risk of its failure rather than pursue a path that may or may not maximize profitability.[61]

If there was no clear path to maximizing profits, there was a stronger argument that corporate managers should have discretion with respect to their long-term plans. A common strategy for increasing earnings over time was to grow a firm to win and

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discipline of capital markets by relying on internal funds during this period. *See, e.g.*, John Lintner, *The Financing of Corporations*, *in* THE CORPORATION IN MODERN SOCIETY, *supra* note 39, at 166, 177–90 (arguing that reliance on internal funds had not increased and that public companies were still subject to capital market discipline). Over time, retaining earnings to reinvest in other projects, which permitted large companies to avoid the scrutiny of capital markets, became viewed as inefficient. *See generally* James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 355–59 (2009) (summarizing literature on the payment of dividends as a way of reducing agency costs of retained earnings).

56. ROBERT AARON GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION xii (2d ed. 1961).

57. Edward S. Mason, *The Apologetics of 'Managerialism'*, 31 J. BUS. 1, 7 (1958).

58. PETER F. DRUCKER, THE PRACTICE OF MANAGEMENT 36 (1954).

59. He noted several reasons why rationality is limited. First, it "requires a complete knowledge and anticipation of the consequences that will follow on each choice. In fact knowledge of consequences is always fragmentary." Second, "[s]ince these consequences lie in the future, imagination must supply the lack of experienced feeling in attached value to them. But values can be only imperfectly anticipated." Third, it "requires a choice among all possible alternative behaviors. In actual behavior, only a very few of all these possible alternatives ever come to mind." HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR 93–94 (4th ed. 1997).

60. Herbert A. Simon, *Rational Decision Making in Business Organizations*, 69 AM. ECON. REV. 493, 498 (1979); *see also* WILLIAMSON, INSTITUTIONS, *supra* note 31, at 32, 46 (noting the importance of organization in light of bounded rationality).

61. Simon, *supra* note 59, at 146.

maintain market power.[62] Size resulted in the accumulation of resources that could be devoted to research and efficiency improvements that enabled a company to dominate its market.[63] As the economist Carl Kaysen noted, "the possession of a substantial degree of market power is characteristic of the modern corporation" and "its orientation toward growth and development . . . may be seen simply as a device for maintaining power."[64] Some firms prioritized such growth over immediate profitability.[65] Attaining monopoly status meant that profits would eventually come.[66]

An extensive study by several economists published in 1956 documented how corporate managers viewed corporate purpose during the managerialist period.[67] The study covered advertisements, books, magazines, and other materials from the period 1948 to 1949.[68] It found from these documents a "managerial theme" that did not rely on classical economic theory and instead reflected the societal view that "the actions of individual enterprises are and should be dominated by considerations of the public interest; profit-seeking takes a lesser place."[69]

Without constant scrutiny of their strategies, managers saw themselves as statesmen who could consider a broad range of interests.[70] Corporate market power not only presented the promise of future profits, it gave managers the discretion to benefit stakeholders.[71] For example, expanding the size of the company can increase employment and stability.[72] Rather than focus exclusively on shareholders, corporate

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62. ROBIN MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM 47, 53, 104 (1964) ("Perhaps a dozen other writers have previously asserted that size or growth will be a major factor in managerial motivation.").

63. *See, e.g.*, STOCKING & WATKINS, *supra* note 52, at 57–61.

64. Kaysen, *supra* note 10, at 315.

65. For example, car manufacturers after World War II kept car prices down to increase their market share. *See, e.g.*, KNIGHT & WEINWURM, *supra* note 33, at 230.

66. *See, e.g.*, STOCKING & WATKINS, *supra* note 52, at 95 ("Winning in business does not, however, consist merely in getting the better of rivals—that is, making more money or getting a bigger share of the market than any of the others—but in making as much money as possible over the long run.").

67. SUTTON, ET AL., *supra* note 39.

68. *Id.* at viii.

69. *Id.* at 57.

70. *See, e.g.*, Eugene V. Rostow, *To Whom and For What Ends is Corporate Management Responsible?*, *in* THE CORPORATION IN MODERN SOCIETY, *supra* note 39, at 46, 60 (describing the "flowering of the view that the primary duty of the corporation is not to make as much money as possible for its stockholders, but to advance the public interest in some alternative sense"); VOTAW, *supra* note 53, at 28 (observing that "[t]he aggressive, profit- and power-seeking individualist was replaced by the arbitrator and diplomat whose motivations included organization survival, professional reputation, and equitable balancing of interests, as well as profit-making"); E. Merrick Jr. Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932) (noting the increasingly held view that managers "should concern themselves with the interests of employees, consumers, and the general public, as well as of the stakeholders . . ."); *see also* Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 937 (1984) ("[C]orporate managers, likened to civil servants, are envisioned to further selflessly the goals of the community rather than their personal desires.").

71. *See, e.g.*, Carl Kaysen, *The Corporation: How Much Power? What Scope?*, *in* THE CORPORATION IN MODERN SOCIETY, *supra* note 39, at 85, 90 (observing that "typically, the large corporation in which we are interested operates in a situation in which the constraints imposed by market forces are loose, and the scope for managerial choice is considerable").

72. ROBIN MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM 5 (1964); *see also* Daniel Bell, *The Treaty of Detroit*, FORTUNE MAG., July 1950 (describing the generous labor deal granted by General Motors to the United Auto Workers). Some commentators were skeptical that managerialism would result in

managers believed that they had "four broad responsibilities: to consumers, to employees, to stockholders, and to the general public . . . ." Moreover, "each group is on an equal footing" and "[s]tockholders have no special priority; they are entitled to a fair return on their investment, but profits above a 'fair' level are an economic sin."[73] The power of large companies was seen by some as creating obligations to act in the interests of society.[74] The sentiment that companies should work for the common good was significant enough to prompt one concerned commentator to write a *Harvard Business Review* article in 1958 warning against the dangers of social responsibility.[75]

Companies could allocate more resources to other corporate stakeholders partly because shareholders of public companies, who at the time were primarily retail investors rather than institutions, were largely satisfied with fixed returns. One commentator noted that management had wide discretion to pay dividends and need only pay an amount to maintain the attractiveness of the company's stock as an investment.[76] The fact that a company could pay a reliable dividend gave investors some assurance that a business was profitable and competently managed.[77] The stability of dividend payments led one commentator to remark that "stockholders in effect become holders of perpetual bonds."[78] There was minimal fear that an investment in a large corporation would become worthless because the largest companies did not fail.[79] John Kenneth Galbraith observed in the 1960s that "big corporations do not lose money."[80] Indeed, some managers saw dangers in reporting strong earnings. One article observed that a "sharp increase in reported profits is very likely to produce the feeling in the minds of the members of the working force that they should participate to a greater extent in such profits, with resulting demands for wage increases, strikes, and general industrial unrest."[81]

The example of the copier maker Xerox illustrates how market power permitted managers to focus on a broad range of concerns. Until it was forced to license its technology in the 1970s, Xerox had a monopoly on copiers that used plain paper instead of more expensive paper treated with chemicals. It grew at unprecedented rates through

more respect for stakeholder interests. *See, e.g.*, RALF DAHRENDORF, CLASS AND CLASS CONFLICT IN INDUSTRIAL SOCIETY 88 (1959) (predicting that the new managerial class would oppress labor).

73. SUTTON, ET AL., *supra* note 39, at 65.

74. *See, e.g.*, MOORE, *supra* note 55, at 9 ("Their very size and the dependence of the economy and the nation on their continuation, removes the privilege of business failure and gives rise to notions of 'social responsibility.'").

75. Theodore Levitt, *The Dangers of Social Responsibility*, HARV. BUS. REV., Sept.–Oct. 1958, at 41. As he described the sentiment, "what started out as the sincere personal viewpoints of a few selfless businessmen became the prevailing vogue for them all." *Id.* at 42. Notably, around this time Berle conceded that Professor Merrick Dodd had been correct in arguing that corporate powers should be exercised on behalf of the community. BERLE, *supra* note 55, at 169.

76. PENROSE, *supra* note 34, at 27.

77. Until the 1990s, dividends were the primary way that businesses could signal that their earnings were real. *See* ALEX BERENSON, THE NUMBER: HOW THE DRIVE FOR QUARTERLY EARNINGS CORRUPTED WALL STREET AND CORPORATE AMERICA 79 (2003).

78. Kaysen, *supra* note 10, at 312.

79. *See, e.g.*, PREVITS & MERINO, *supra* note 35, at 252 ("it seemed plausible to most Americans that the economy could be permanently stabilized and security assured. Survival did not seem to be a major problem for most corporate businesses; in fact, during this decade, few large firms failed.").

80. GALBRAITH, *supra* note 51, at 82.

81. Samuel R. Hepworth, *Smoothing Periodic Income*, 28 ACCT. REV. 32, 33 (1953).

the 1960s and was able to invest significant amounts in projects outside of its core business. A *New Yorker* article on the company observed that Xerox spent significant amounts on supporting not only local institutions like the University of Rochester but also the United Nations.[82] It described the culture of the "Xerox spirit," which encouraged "emphasizing 'human values' for their own sake."[83] In an interview with the magazine, Xerox's CEO spent more time describing the company's "non-profit activities and his theories of corporate responsibility" than the business itself.[84]

For some commentators, managerialism foreshadowed a shift away from capitalism.[85] As large companies became more powerful, they would become similar to government bureaucracies that controlled production decisions. Indeed, many of the advances in large-scale production and organization had been developed through the war effort. Only large firms with the resources to plan and manage would survive over time as competition became more destructive.[86] Either they would dominate an economy that would no longer be controlled by market forces,[87] or large corporations would essentially be absorbed into the government and become administrative agencies. Rather than work independently to maximize profits, corporations would essentially serve broader social ends.

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The managerialist corporation was an influential and powerful social institution. For a time, internal capital markets had a wide advantage over external capital markets in assessing the valuation of a public corporation. Investors left corporate governance to professional managers who seemed uniquely qualified to manage large companies. Markets gave these corporate executives significant leeway to consider the interests of corporate stakeholders and many executives viewed themselves as serving the public interest.

III. THE INCOMPLETE EXPLANATIONS FOR THE TRANSITION TO SHAREHOLDER WEALTH MAXIMIZATION

Under the prevailing account, the managerialist paradigm was largely discredited by the 1980s and firmly replaced by shareholder wealth maximization during the 1990s. By the 2000s, corporate executives understood that they were to "in all circumstances, manage to maximize the market price of the stock."[88] As noted earlier, many legal scholars point to changes in ideology as the main reason for the shift. Another view is that "corporate governance mechanisms" ranging from "the leveraged hostile takeovers

82. John Brooks, *Xerox Xerox Xerox Xerox*, NEW YORKER, Apr. 1, 1967, at 88.

83. *Id.* at 49.

84. *Id.* at 88.

85. *See, e.g.*, GALBRAITH, *supra* note 51, at 4 (noting the possibility of socialism); Rostow, *supra* note 70, at 61 (observing that "[i]n England, socialists say that managers have already socialized capitalism, so that it is no longer necessary to invoke the cumbersome formality of public ownership of the means of production").

86. *See generally* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (3d ed. 1950).

87. *See, e.g.*, BURNHAM, *supra* note 49 (arguing that capitalism would be replaced by a society dominated by managers).

88. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 658–59 (2010).

and buyouts of the 1980s to the incentive-based compensation, activist boards of directors, and shareholders in the 1990s" prompted "U.S. managers [to] become much more focused on stock prices."[89] Professor Jeffrey Gordon has argued that corporate governance was influenced by more efficient stock prices that enabled independent directors to monitor managers.[90]

This Part describes the major explanations for the rise of shareholder wealth maximization—law, ideology, executive compensation, and institutional investors. It argues that the conventional story is incomplete and misses important market developments during the 1960s and 1970s that created the foundations for a system where public corporations maximize shareholder wealth.

A. Law

Shareholder wealth maximization follows naturally from a legal regime that privileges shareholder interests. Corporate law has long recognized that corporations exist to generate profits for shareholders.[91] The board of a corporation owes fiduciary duties of care and loyalty to the shareholders.[92] Only shareholders can enforce such duties through litigation. Only shareholders have the right to vote in board elections.[93] Corporate law thus sets a broad goal of increasing shareholder wealth for the corporation and gives shareholders the right to intervene if corporate managers fail to deliver.

These basic elements of law were in place during the managerialist era. Yet as noted earlier, there was a general sense that managers were not obligated to maximize corporate profits. Moreover, as Harwell Wells has shown, corporate law did not significantly change to re-emphasize shareholder wealth during the 1960s and 1970s when managerialism started its decline.[94] It is thus difficult to argue that corporate law is what compels managers to focus on a company's financial performance.

Corporate law tends to be aspirational with respect to shareholder wealth. Fiduciary duties mainly impose negative obligations that prevent self-dealing and waste by managers. They do less to affirmatively require corporate managers to pursue strategies to maximize shareholder wealth. As several legal scholars have noted, the business judgment rule gives management wide discretion in choosing corporate strategies.[95] It is

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89. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 140 (2001).

90. *See* Gordon, *supra* note 5, at 1541 ("As stock prices [became] more informative, the directors' monitoring role increasingly consist[ed] of using stock price metrics to measure the firm's performance over time and against relevant intra-industry comparisons.").

91. *See* Bainbridge, *supra* note 17, at 1423.

92. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("The board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners. Accordingly, fiduciary duties are imposed on the directors of Delaware corporations to regulate their conduct when they discharge that function.").

93. This structure has been justified by the fact that shareholders are the residual claimant of the corporation. In contrast, stakeholders are typically protected by contract. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991).

94. *See, e.g.*, Harwell Wells, *"Corporation Law is Dead": Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 348 (2013) (concluding "that heroic managerialism did not radically change the substance of corporate law").

95. *See* STOUT, *supra* note 4, at 24–32. For one formulation of the business judgement rule, see Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting that Delaware's business judgment rule "is a presumption that

thus difficult to assert a legal claim that challenges a course of action as not maximizing profits.

Managerialism was not blatantly inconsistent with corporate law because corporate managers could argue that a balanced strategy that considered stakeholder interests was the best way of maximizing profits over time. A law review article published during the managerialist period by David Ruder observed that while corporate law requires managers to pursue profitability, it gives them significant flexibility to achieve profits over the long run.[96] He wrote that "it is possible at present for corporate management to pursue most public objectives while at the same time acting in a manner consistent with the corporation's public interest . . . ."[97]

Securities regulation changed significantly over the 1970s to mandate quarterly reporting and increase the reliability of financial reporting. But as I have argued elsewhere, it is unclear that simply mandating more frequent disclosure by itself focused corporate managers on generating financial results.[98] Law tends to interact with private ordering in shaping corporate incentives. As noted by Ed Rock, the shift "from a manager-centric system to a shareholder-centric system" did not occur "directly through legal change."[99]

B. Ideology

Rather than a legal requirement, shareholder wealth maximization might be viewed as an ideology that became widely adopted by corporate managers and investors.[100] There are reports that profit maximization was widely taught in business schools by the 1960s.[101] As noted earlier, commentators often point to Milton Friedman's argument that the social responsibility of managers is to "make as much money as possible while

in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

96. *See* David S. Ruder, *Public Obligations of Private Corporations*, 114 U. PA. L. REV. 209, 216 (1965) ("To invoke the protection of [the business judgment] rule, a director need only demonstrate that the activity in which the corporation is engaged can be justified as short term or long term profit maximization. … [P]rofit maximization need not be short term, but can take place over a long period of time."). For a recent articulation of this argument, see Jonathan R. Macey, *Corporate Law as Myth*, 93 S. CAL. L. REV. 923, 949–51 (2020).

97. Ruder, *supra* note 96, at 227.

98. Park, *supra* note 15.

99. Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910 (2013).

100. *See, e.g.*, Lina Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontents*, 11 HARV. L. & POL'Y REV. 235, 242 (2017) (asserting that "[i]nstead of promoting the welfare of workers and communities, for example, executives are socialized to maximize short-term profits and enhance the price of the stock").

101. *See, e.g.*, JOHN BROOKS, THE GO-GO YEARS 156 (1973) (describing the influence of Harvard Business School); ROBIN MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM 72 (1964) (noting that business schools taught profit maximization); ROY C. SMITH, THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S 259 (1990) (reporting that business schools in the 1960s began teaching that corporations should maximize earnings). In contrast, the shareholder wealth maximization norm is seen as inconsistent with social values in many other countries. *See, e.g.*, Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2073 (2001) (stating that shareholder wealth maximization theory is generally understood to be incompatible with public welfare in France, Germany, and Japan).

conforming to the basic rules of society" as marking a notable shift.[102] Another explanation was the influence of economic theory. William Bratton explained in an article published towards the end of the 1980s that "[t]he managerialist consensus recently disappeared, due in part to the successful emergence of the new economic theory in the legal literature beginning around 1980."[103]

The publication of Michael Jensen and William Meckling's analysis of agency costs in the public corporation in 1976 created a theoretical framework that some scholars argue provided a foundation for the shift to shareholder wealth maximization.[104] While Berle and Means generally described a separation of ownership and control in public companies, Jensen and Meckling observed that the relationship between managers and shareholders raised similar issues as the relationship between any agent and principal.[105] Corporate managers are essentially agents of the shareholder-principal. Because it identifies shareholders as the principal in the principal-agent relationship, the agency costs model implies that shareholders should be the focus of corporate governance.[106] Moreover, the assumption that agents will pursue their own selfish interests rather than fulfill their fiduciary duties paints a generally negative portrayal of corporate managers. Rather than competent experts, managers were portrayed as taking every opportunity to shirk their obligation to increase shareholder wealth.[107]

Jensen and Meckling's framework was not the first to emphasize shareholder wealth maximization. Fisher's separation theorem, which concludes that shareholder wealth maximization under certain circumstances is the optimal policy for a corporation given

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102. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., (Sep. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html [https://perma.cc/CRR4-RSZN]. This claim had been made before 1970 by Friedman and other commentators. *See, e.g.*, Brian R. Cheffins, *Stop Blaming Milton Friedman!*, 98 WASH. U. L. REV. 1607, 1616–21 (2021); *see also* Eugene M. Lerner, *Capital Budgeting and Financial Management*, *in* FINANCIAL RESEARCH AND MANAGEMENT DECISIONS 72, 73 (Alexander A. Robichek, ed. 1967) (noting "increased awareness that the appropriate goal of the corporation is long-run wealth maximization. Phrased in somewhat less academic jargon, management should be interested in the price of the company's stock and should try to make it as high as possible.").

103. William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1476 (1989); *see also* Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2005 (2013) ("Managerialism appears to have first come under attack and the idea of shareholder primacy seems to have first gained traction in academia.").

104. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). The journalist Nicholas Lemann highlighted Jensen and Meckling's theory as representing a shift from the "Organization Man," who valued large organizations, to the "Transaction Man," who elevated transactions over organizations. *See generally* NICHOLAS LEMANN, TRANSACTION MAN: THE RISE OF THE DEAL AND THE DECLINE OF THE AMERICAN DREAM (2019).

105. Jensen & Meckling, *supra* note 104, at 309 ("The problem of inducing an 'agent' to behave as if he were maximizing the 'principal's' welfare is quite general. It exists in all organizations and in all cooperative efforts—at every level of management in firms . . . .").

106. STOUT, *supra* note 4, at 18 (asserting that Jensen and Meckling "implied that managers should seek to serve only shareholders' interests, not those of customers, employees, or the community"); *but see* Brian R. Cheffins, *What Jensen and Meckling Really Said About the Public Company* (Univ. of Cambridge Legal Stud. Rsch. Paper Series, Paper No. 29/2020, 2020), http://ssrn.com/abstract=3679405 [https://perma.cc/Z5A2-S34H] (arguing that Jensen and Meckling did not argue for significant changes to public company governance).

107. *See, e.g.*, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 750 (2007) ("As applied in much contemporary scholarship, the agency model simply assumes that directors are scoundrels.").

the diverse preferences of shareholders, was developed during the 1930s.[108] But the agency costs theory's emphasis on the potential for managerial slacking provided a clearer basis for developing corporate governance measures to monitor and incentivize managers.[109]

The agency costs model reinvigorated the idea that there was ongoing tension between the interests of managers and shareholders that should be resolved in favor of shareholders. The framework was widely taught in business and law schools.[110] Its message became more influential as it appeared to explain events during the 1970s that reduced confidence in the competence of managers. Several corporate scandals, such as the collapse of public companies like Penn Central and Equity Funding in the wake of mismanagement and securities fraud, and the discovery of the widespread payment of corporate bribes by international companies, shook faith that professional managers could be trusted to look after the interests of shareholders.[111] The poor economy during the 1970s made it difficult for managers to succeed.[112] As foreign competitors became stronger, the perception of the exceptionalism of U.S. managers declined. An often-cited *Harvard Business Review* article published in 1980 described U.S. managers as "excessively cautious, even passive; certainly overanalytical; and, in general, characterized by a studied unwillingness to assume responsibility and even reasonable risk."[113]

While ideology can be transformative or perhaps reflect underlying societal developments that foreshadow broader change, it is difficult to measure its influence. Five years after Friedman's *New York Times Magazine* article, Ralph Nader, Mark Green, and Joel Seligman described shareholder wealth maximization as the minority view.[114]

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108. Irving Fisher "showed that in an efficient market for capital, a business firm will choose value maximization as a strategy regardless of shareholders' utility preferences for dividends or reinvestment, or their preferences regarding how profits should be spent." Herbert Hovenkamp, *Neoclassicism and the Separation of Ownership and Control*, 4 VA. L. & BUS. REV. 373, 384 (2009). For an argument that corporate law recognizes the need to balance the interests of diverse shareholders, see James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 172–79 (2017).

109. Indeed, Fisher's separation theorem is not as well-known by law professors as agency costs theory. *See, e.g.*, Andrew Verstein, *Wrong-Termism, Right-Termism, and the Liability Structure of Investor Time Horizons*, 41 SEATTLE UNIV. L. REV. 577, 596–97 (2018) (observing that the theorem "has been seldom mentioned in the last forty years in law review articles").

110. *See, e.g.*, LEMANN, *supra* note 104, at 119; Khurana, *supra* note 38, at 324.

111. *See, e.g.*, SUBCOMM. ON REPORTS, ACCT. & MGMT., *The Accounting Establishment*, S. DOC. NO. 34, 94th Cong., 2nd Sess. 2 (1976) ("Continued revelations of wrongdoing by publicly owned corporations have caused a new awareness of the importance of accounting practices in permitting such abuses to occur."); Gordon, *supra* note 5, at 1514–17 (describing scandals that resulted in the questioning of passive boards); Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359, 373–75 (2016) (describing the emergence of corporate governance as a concern after 1970s scandals).

112. *See, e.g.*, KHURANA, *supra* note 38, at 297–300 (describing impact of economic environment on managerialism). Polling showed that the public's esteem of management declined significantly from 1965 to 1975. *See* LEONARD SILK & DAVID VOGEL, ETHICS AND PROFITS: THE CRISIS OF CONFIDENCE IN AMERICAN BUSINESS 21 (1976).

113. Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., July–Aug. 1980, at 67; *see also* Steve Lohr, *Overhauling America's Business Management*, N.Y. TIMES (Jan. 4, 1981), https://www.nytimes.com/1981/01/04/magazine/overhauling-america-s-business-management.html [https://perma.cc/3E5Z-S85W] ("[T]here is now a growing consensus, both at home and abroad, that the performance of American management of late has been sorely lacking . . . .").

114. *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION 259 (1976).

The 1970s saw substantial efforts to increase the social responsibility of corporations with respect to ethical and environmental issues.[115] Many corporate managers continued to resist focusing on solely increasing shareholder wealth and saw themselves as stewards of the corporation.[116] For example, they actively resisted hostile takeovers that sought to maximize shareholder wealth during the 1980s.[117] Corporate governance measures such as increasing the independence of boards to ensure that corporate managers were acting to increase shareholder wealth have until recently been viewed as ineffective.[118] A 1989 survey of boards noted that directors who "adhere to a strict belief in the primacy of the shareholder" are "a true minority."[119] Thus, even by the end of the 1980s, it was far from clear that corporate managers had adopted an ideology of shareholder wealth maximization.

C. Executive Compensation

Any reluctance by corporate managers to maximize shareholder wealth was arguably overcome through changes in executive compensation during the 1990s. Over the 1960s and 1970s, executives were paid predominantly through fixed salaries.[120] Because they did not own a significant percentage of their company's stock, their economic fortunes did not significantly rise and fall with the wealth of shareholders. Rather than pay managers like bureaucrats, scholars like Jensen argued that they should be given the incentives of entrepreneurs by increasing their stock compensation. By the 1990s, close to half of the average CEO's compensation was in the form of stock and options.[121] As they became more significant shareholders, corporate managers had an additional incentive to focus on increasing shareholder value.[122]

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115. *See, e.g.*, Gordon, *supra* note 5, at 1517–18 (describing the corporate social responsibility movement of the 1970s).

116. *See, e.g.*, Cheffins, *supra* note 102, at 1624–27 (arguing that impact of Friedman's statement during the 1970s was uncertain).

117. *See, e.g.*, Bengt Holmstrom & Steven N. Kaplan, *supra* note 89, at 122 ("Managers initially fought takeovers with legal maneuvers and by enlisting political and popular support.").

118. *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 884 (1991) (concluding that "[o]utside directors presently lack an incentive to act as ongoing monitors of [managerial] performance"). Notably, conceptions of the independent director changed over time. During the 1970s, some commentators viewed independent directors as helping ensure corporate responsibility. *See, e.g.*, Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982) (discussing whether independent directors are a substitute for regulatory controls).

119. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 39 (1989); *but see* ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE 1 (1986) ("Corporate mission statements proclaiming that the primary responsibility of management is to maximize shareholders' total return via dividends and increases in the market price of the company's shares abound.").

120. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225–26 (1990) (finding that CEO compensation was not substantially linked to company performance from 1974 to 1986).

121. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 661–62 (1998).

122. *See, e.g.*, GERALD F. DAVIS, MANAGED BY THE MARKETS 86 (2009) ("Perhaps the most compelling reason for executives' new-found religious devotion to shareholder value was the massive shift in compensation practices that occurred during the 1980s and 1990s."); Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579, 590 (2018) ("[S]hareholder value theory

While executive compensation likely encouraged managers to increase shareholder wealth, the shift from salary to stock options came too late to explain the fall of managerialism. This Article will show that even before managers had a strong personal incentive to increase their company's stock price, there was a general corporate incentive to increase shareholder wealth. Moreover, it is not entirely clear that stock compensation has been firmly linked to company performance. Lucian Bebchuk and Jesse Fried notably argued that pay was not tied to performance during the 1990s and instead reflected decisions by captured boards that looked after managerial interests.[123]

D. Institutional Investors

The final conventional explanation for the fall of managerialism is the most persuasive. Over the 1960s and 1970s, individual investors increasingly invested through institutions.[124] These institutional investors included pension funds, mutual funds, and insurance companies that had the resources to evaluate market information. While it took some time for such large investors to exercise their clout,[125] institutionalization significantly impacted stock markets.[126]

For various reasons, many institutional investors traded more frequently than the average individual investor. Sophisticated professional managers sought information about stocks to beat the market. Some institutional investors, often mutual funds, were judged based on their ability to generate profits and thus bought and sold more frequently to increase their returns.[127] Because they were informed, they might exercise their right to sell their shares if they were unhappy with a company's prospects. Henry Manne famously observed in the 1960s that such selling could reduce the company's stock price and increase the possibility that there would be a change in control.[128]

gained traction because it served the purposes of powerful interest groups, including newly emerging 'activist' investors and executives whose compensation, due to 1993 changes in the tax code, increasingly was based on share price").

123. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 7 (2004).

124. *See, e.g.*, SEC. & EXCH. COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT vol. 1 ix (1971) (reporting that institutional holdings of New York Stock Exchange securities increased from 31.1% in 1962 to 39.4% in 1970); TIM CARRINGTON, THE YEAR THEY SOLD WALL STREET 28 (1985) (discussing a shift in corporate pensions from bond market to stock market, popularity of mutual funds, and increase in stock investment by insurance companies); ROY C. SMITH, THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S 262 (1990) (describing the rise of institutional investors during the 1960s); SOBEL, *supra* note 51, at 331 (reporting that the share of equities owned by institutions rose from 12.5% to 20% over the 1950s).

125. *See, e.g.*, Holmstrom & Kaplan, *supra* note 89, at 122 (stating that over the 1980s, "capital markets grew more powerful with increased institutional investments.").

126. Moreover, as defined benefit plans were replaced with defined contribution plans, Americans increasingly invested their personal savings through institutions. *See, e.g.*, Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 911 (2013) (claiming that "changes in the pension system helped to transform corporate governance into a system dominated by the shareholder interest, to the detriment of the managerial model").

127. *See, e.g.*, INSTITUTIONAL INVESTOR STUDY REPORT, *supra* note 124, at xxii (noting increased volume of trading by institutions); CHRIS WELLES, THE LAST DAYS OF THE CLUB 28–31 (1975) (describing frequent trading by mutual funds to increase performance); *see also* J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER 64–65 (1958) (describing the tendency of institutions to sell rather than influence corporate governance).

128. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110

While the timing of the rise of institutional investors coincided with the decline of managerialism, the literature has not developed a robust description of the mechanisms by which institutional investors encouraged shareholder wealth maximization. Institutional investors were trading more but what drove their trading? If they were trading simply based on technical analysis of past stock price movements, there would be little impact on corporate behavior. Trading would need to be driven by assessments of managerial performance for it to impact corporate decision-making. How were those assessments made? The literature has left the exact impact of institutional investors on the incentives of corporations unexamined.

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We know that managerialism was weakened by the 1980s, but it is less clear as to why. It is likely that a combination of factors played a role in pressuring managers to maximize shareholder value. But some must have been more important than others. Law did not evolve to suddenly influence managerial strategy. Ideology made a difference, but its impact was not uniform on managers who often continued to believe that they worked on behalf of a broad range of stakeholders. Executive compensation only became a force years after managerialism had failed. Institutional investors brought more sophistication to markets but the account of their influence on corporate managers has not been fully developed.

IV. THE PROBLEM OF VALUING FUTURE EARNINGS

Managerialism was accepted in part because investors believed that they were at a disadvantage relative to managers in valuing public companies. It was only when investors became more confident that they could accurately assess corporate value that they could meaningfully challenge managers. This Part describes the state of valuation methods before the shift to shareholder wealth maximization. By the 1930s, investors recognized the importance of earnings in valuing stocks and that stock prices reflected a judgment about the future performance of a company. The present value model was introduced around this time, providing a method for valuing profits earned in later periods.[129] The problem was that investors were not confident that they could make meaningful predictions of a company's earnings. Moreover, for decades, the SEC actively discouraged companies from publicly disclosing financial projections because of the belief that they fueled speculation.

A. The Shift to Assessing Earnings

Early financial statement analysis was mainly concerned with the value of a

(1965).

129. The present value model is the standard way of valuing any asset. The first step of the model is to estimate the expected earnings or cash flows that the asset will generate. The second step of the model adjusts for the fact that earnings in later years will be worth less than earnings in the present by discounting the value of the future earnings to what they would be worth if they had been earned today. The sum of the discounted earnings reflects the value of the asset. *See, e.g.*, James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 534–37 (2009).

company's assets.[130] Such assets were usually physical things such as land or machinery that could be valued at cost. Stock investors looked to the company's balance sheet to verify that its assets were greater than its liabilities.[131] The main concern was that the company might inflate the reported value of these assets so that the stock was not backed by anything of worth.[132] Rather than view a stock investment as potentially increasing in value, shareholders were mainly concerned that the value of their capital contribution was preserved.[133]

It was not until the start of the twentieth century that income statements became a significant financial report,[134] and it was years later before they were viewed as very important for valuing a company.[135] While income statements could in theory help shareholders assess a company's profitability, in practice investors did not closely scrutinize such earnings.[136] Instead, as noted earlier, they were satisfied that the payment of regular dividends was evidence that the company was profitable.[137] A dividend could only be legally paid in many states if the company had positive earnings and thus was a tangible sign that a company was not suffering losses.[138]

By the stock market crash of 1929, market professionals understood that the price of a stock was tied to the company's ability to continue generating earnings. As Edward Smith observed in *Common Stocks as Long Term Investments*, which was published a year before the crash and cited by some as fueling irrational investor optimism, common stocks "represent ownership of property and processes; their value and income return

130. PAUL G. MAHONEY, WASTING A CRISIS: WHY SECURITIES REGULATION FAILS 46–48 (2015).

131. KNIGHT & WEINWURM, *supra* note 33, at 25 (as one set of commentators noted, "[t]he balance sheet was long regarded as the basic accounting statement, and the formula: assets – liabilities = proprietorship, as the basic accounting formula"); *see also* EDWARD S. JENSEN, STOCK MARKET BLUEPRINTS 47 (3d ed. 1977) (noting fundamental approach that based valuation on balance sheets).

132. Such a practice was known as selling "watered" stock. *See* ROBERT CHARLES CLARK, CORPORATE LAW 710 (1986).

133. At least initially, the value of a company's common stock was fixed. Companies would assign a par value to the stock equal to the investor's capital contribution to the company. *Id.* at 707–15. An investor purchasing a stock at par value was essentially making a capital contribution to the firm. *See, e.g.*, WILLIAM ZEBINA RIPLEY, MAIN STREET AND WALL STREET 47–48 (1927). An investor who bought one share of stock with a par value of $100 would have made a $100 capital contribution. The par value rule was meant to ensure that a stock was backed by something of value.

134. PREVITS & MERINO, *supra* note 35, at 182, 217.

135. *See, e.g.*, W. A. PATON & A. C. LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 98 (3d ed. 1970) (noting that "in recent years . . . the income report has supplanted the balance sheet as a focus of attention"); T.A. WISE, THE INSIDERS: A STOCKHOLDER'S GUIDE TO WALL STREET 29 (1962) ("A related difficulty has arisen from the steady shift in emphasis and interest away from the balance sheet and toward the income statement. Investors, security analysts, bankers, and even some creditors have grown more interested in the earnings capacities of companies than in their assets and liabilities."). The publication of Paton and Littleton's *Introduction to Corporate Accounting Standards* in 1940 developed a method for matching revenue and expenses that was influential in increasing the importance of earnings in financial reporting. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 160 (2006).

136. PREVITS & MERINO, *supra* note 35, at 218.

137. The practice of paying regular dividends began after World War I. Such payments provided "a measure of assurance as to the return on capital which had formerly not existed for owners of common stock." SOBEL, *supra* note 51, at 222.

138. CLARK, *supra* note 132, at 708 (noting that "under many statutory schemes directors . . . will not be able to make legal distributions of corporate property to the shareholders unless the value of the property remaining afterwards matches or exceeds the amount of its debt plus its legal capital").

fluctuating with the earning power of the property."[139] However, the book did not offer extensive guidance on assessing whether individual companies had such earning power. Instead, it made general observations such as: (1) earnings will generally increase as the economy grows,[140] and (2) historically, stocks have returned more for investors than bonds.[141]

The analysis of stocks became more systematic with the publication of the first edition of *Securities Analysis* by Benjamin Graham and David Dodd in 1934. It described with some skepticism the theory that "[t]he value of a common stock depends entirely upon what it will earn in the future."[142] The book observed that such an approach to valuation fueled the speculation that resulted in the crash of the market. It warned against assuming that past trends in earnings would continue into the future.[143] Yet it also acknowledged that "by and large a good past record offers better promise for the future than does a poor one."[144]

Soon after the publication of Graham and Dodd's *Securities Analysis*, the basic present value model that is used today was published in John Burr Williams' 1937 book, the *Theory of Investment Value*, which was based on his doctoral thesis at the University of Chicago. Williams argued that the reigning stock valuation models were flawed because "[p]rices have been based too much on current earning power, too little on long-run dividend-paying power."[145] Instead, he argued that valuation should be based on the principle that "rational men, when they buy stocks and bonds, would never pay more than the present worth of the expected future dividends, or of the expected future coupons and principal. . . ."[146] He developed a model where the value of a stock could be calculated by determining the present value of its expected stream of dividends over time. Williams' modeling of dividends was consistent with the expectation at the time that investors would primarily earn returns through the receipt of dividends. It provided the basic methodology for assessing whether a stock was trading at a reasonable valuation.

B. The Problem of Predicting Earnings

By the end of the 1930s, knowledgeable stock market analysts thus knew in theory that a company's stock reflected its future earnings power. The question was how in practice investors could predict those earnings with enough confidence to conclude that a stock valuation was reasonable. The present value model could only work if there was a way of objectively and accurately assessing a company's future performance.

Like Graham and Dodd, other leading commentators expressed doubt that a company's earnings could be predicted. They believed that investors could do little more than make rough guesses based on the company's past performance. As Adolf Berle observed in 1954:

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139. EDGAR LAWRENCE SMITH, COMMON STOCKS AS LONG TERM INVESTMENTS 4 (rprt. 2012) (1928).
140. *Id.* at 5.
141. *Id.* at 20.
142. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 307 (1934).
143. *Id.* at 314–15.
144. *Id.* at 319.
145. JOHN BURR WILLIAMS, THE THEORY OF INVESTMENT VALUE 171 (1937).
146. *Id.* at 5.

> Individuals . . . invest money . . . based primarily on a favorable forecast of the probable future of the enterprise. But since the future is still mercifully concealed from the knowledge of men and investors, the usual criterion for judgment is the record of past experience. This perhaps is why judgment of the market place usually tends to be 'conservative.' As a rule it does not readily or cheaply provide risk capital for new and untried revolutionary inventions, or for expansion of enterprise into the unexplored regions of science (though there are conspicuous exceptions).[147]

A study of U.K. companies in 1966 asked "whether it is possible to predict the future growth of a company by looking at its past results" and found "no consistent pattern of growth that distinguishes one firm from another."[148] An accounting professor noted in 1971 that "a reasonable doubt should exist regarding the ability of firms to forecast operating results with the degree of accuracy and precision necessary to satisfy the requirements of investors."[149] NYU Law School Professor Homer Kripke, who was a significant critic of SEC policies prohibiting the disclosure of projections noted as late as 1979 that "the growth stock theory of investing has a more fundamental difficulty, namely, that there is no empirical basis from which to predict future earnings from past growth."[150]

Despite this skepticism, markets often assigned high valuations to companies with promise. For example, towards the end of the 1950s, investors were willing to pay much more for the stock of computer and technology companies than was warranted by their past earnings.[151] Speculation was not just limited to technology companies. Investors became confident in the prospects of large companies with a high degree of market power.[152] The continually strong performance of the largest companies helped give

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147. ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 41–42 (1954).

148. I.M.D. LITTLE & A.C. RAYNER, HIGGLEDY PIGGLEDY GROWTH AGAIN 9, 31 (1966); *see also* Jensen, *supra* note 131, at 70 ("*Projected* earnings are not easy to make or secure and this is why the stock market is not an exact science and why even the best of analysts will differ in their opinions.").

149. R. Austin Daily, *The Feasibility of Reporting Forecasted Information*, 46 ACCOUNT. REV. 686, 692 (1971).

150. HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 99 (1979). Even today, there is some skepticism about the validity of predictions about earnings, particularly long-term projections. *See, e.g.*, ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 271 (3d ed. 2012) ("Although many firms are widely followed by analysts, the quality of growth estimates, especially over longer periods, is poor. Relying on these growth estimates in a valuation can lead to erroneous and inconsistent estimates of value."); ALFRED RAPPAPORT, SAVING CAPITALISM FROM SHORT-TERMISM: HOW TO BUILD LONG-TERM VALUE AND TAKE BACK OUR FINANCIAL FUTURE 216 (2011) (observing that investors and analysts "avoid the difficulty of forecasting long-term cash flows" because "they believe that forecasting is too speculative and too time-consuming to be of practical use").

151. SOBEL, *supra* note 51, at 356 (noting that during the 1950s technology boom, "an important question was how did one figure a correct price for a firm that had no earnings at all.").

152. BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR 122–23 (rev. ed. 1973) (suggesting a strategy of investing in companies "of substantial size combined with a leading position in the industry"). Others, though, were skeptical that monopoly power necessarily predicted earnings growth. As one study reported:

> [W]e do seem to have shown that managements do not remain above or below average for very long—or, if they do, that such above and below average management can have so feeble an effect on earnings growth that we cannot detect it—and similarly for the monopoly power of firms. Certainly, investors are wrong to think that a few years' above average rise of earnings is evidence

investors enough confidence to pay a premium with the expectation that the companies' growth would continue.[153]

The line between blindly speculating on stocks for their potential and the process of evaluating future earnings is a thin one. An article published in the *Financial Analysts Journal* in 1967 asked whether "performance" was "the latest name for speculation."[154] The research analyst who wrote the article observed that valuation had shifted over the years from "[n]et worth, book value and physical assets," to "income return, dividends and yield" to "earnings and earnings reliability" to "long-range growth rates of earnings" and now "instant earnings growth."[155] Given the difficulty of predicting such growth, he asserted that the new focus on company performance "is just a modern word for trading and speculating."[156]

Investor prediction of a public company's earnings was complicated by SEC policy, which until the latter half of the 1970s, prohibited the inclusion of projections in SEC filings.[157] There was no specific rule that banned projections, but as Harvard Law School Professor Victor Brudney explained, "[t]he Commission's opposition was expressed in admonitory releases and in opinions in particular cases more than in any general prohibitory regulation under the Securities Act."[158] As late as 1969, an important study of securities disclosure by SEC Commissioner Francis Wheat warned that "projections in filed documents might become traps for the unsophisticated who would be prone to attach more significance to such projections than they deserve." It thus concluded that "the Commission's long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission . . . should not be changed."[159]

The SEC's policy of discouraging the publication of corporate projections limited public access to information that could assist markets in assessing the future performance of a company. Management could not broadly communicate their superior knowledge of

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at all that good management, which will result in a continued rise, must be present.

Little & Rayner, *supra* note 148, at 64.

153. The so-called Nifty Fifty stocks were a group of "premier growth stocks, such as Xerox, IBM, Polaroid, and Coca-Cola, which became institutional darlings in the early 1970s." JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN: A GUIDE TO SELECTING MARKETS FOR LONG-TERM GROWTH 96 (1994). Investors "were willing to pay any price at all for the privilege of owning" these stocks because "the growth prospects seemed so certain that the future level of earnings and dividends would, in God's good time, always justify whatever price they paid." PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 108 (1998); *see also* MAGGIE MAHAR, BULL: A HISTORY OF THE BOOM AND BUST, 1982–2004 41 (2004). The Nifty Fifty warranted a premium over companies "whose fortunes were uncertain because of their exposure to business cycles and competition." *Id.* One commentator noted at the time a general shift to "pricing stocks not on current earnings or past performance but on projections." SOBEL, *supra* note 51, at 235.

154. David L. Babson, *Performance: The Latest Name for Speculation?*, 23 FIN. ANAL. J. 129, 130 (1967).

155. *Id.*; *see also* H. IGOR ANSOFF, THE NEW CORPORATE STRATEGY 16 (1988 ed. 1965) ("Starting in the 1950s, concern with assuring future profitability has become more important.").

156. Babson, *supra* note 154, at 131.

157. Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1115 (1987).

158. Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 753, n.80 (1989).

159. SEC. & EXCH. COMM'N, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 12 (1969) [hereinafter Wheat Report]; *see also* KRIPKE, *supra* note 150, at 15 ("Defenders of the Commission's long-maintained insistence on objectivity argued that forecasts involved prophecy, and no one can be an expert on prophecy.").

a company's prospects to investors.[160] Moreover, the SEC's policy conveyed that projections were not information that investors should rely on in valuing a stock. The next Part will discuss how market participants developed ways of predicting company earnings despite the SEC prohibition.

V. SIGNALING FUTURE EARNINGS

As public companies became distinguished by their ability to hire professional managers, investors realized that they could identify companies with strong management that was more likely to generate earnings into the future. Better managers would develop more efficient internal capital markets that could deliver more predictable earnings growth. As stock traders began evaluating managerial skill, managers had an incentive to signal their competence to markets. They did so primarily through two methods. The first, which was only successful for a time, was by adopting the strategy of assembling conglomerates that would generate consistent earnings over time. The second was to convey the predictability of their earnings by consistently meeting market projections.

A. Conglomerates

By the 1960s, public corporations increasingly grew by acquiring companies operating in different industries.[161] Rather than focusing on a single business, managers believed that they could create shareholder value by creating such conglomerates. As noted earlier, market power gave large corporations the ability to generate internal capital that gave them the resources to acquire other corporations. The passage of the Celler-Kefauver Act in 1950 increased scrutiny of acquisitions within the same industry,[162] creating incentives to acquire companies operating in diverse industries.[163] By the end of the 1960s, 33 of the companies listed on the Fortune 500 were conglomerates.[164]

Conglomerates have long been associated with managerialism, particularly its negative aspects.[165] The prevailing story is that conglomerates reflected the preference of managers for growth over maximizing profits.[166] Managers assembled conglomerates to

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160. *See, e.g.*, Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 634 (1973) (claiming that the SEC's policy of protecting lay investors led to "the suppression of what should be the absolute key piece of information to any prospective securities investor . . . projections as to future earnings"); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2379 (1998) (discussing SEC's ambivalence towards projections).

161. *See, e.g.*, J. Fred Weston & Surenda K. Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms*, 26 J. FIN. 919, 921 (1971) (defining conglomerates as "firms that have entered into a broad program of diversification achieved to a substantial degree by external mergers and acquisitions rather than by internal development").

162. *See* Celler-Kefauver Act, 15 U.S.C. § 18, 64 Stat. 1125 (1950).

163. *See, e.g.*, NEIL FLIGSTEIN, THE TRANSFORMATION OF CORPORATE CONTROL 195 (1990); DAVIS, *supra* note 122, at 78.

164. *See* STANLEY C. VANCE, MANAGERS IN THE CONGLOMERATE ERA 63 (1971); *see also* BROOKS, *supra* note 101, at 153–54 (describing 1966–69 as the heyday of conglomerates).

165. *See, e.g.*, Stout, *supra* note 103, at 2007 (describing "conglomerate business structure" as "favored" by "many managerialist boards and executives").

166. *See, e.g.*, CHRISTOPHER ELIAS, FLEECING THE LAMBS 86 (1971) ("[T]he conglomerate empires were assembled with little regard for earnings. Only 'growth,' a magic word to accompany the numbers, was considered."); *see also* John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1500 (1990) (noting the tendency of managers to build empires).

reduce the risk that a business setback could endanger their jobs. Managers could also satisfy personal ambitions of power by putting together empires that did not operate efficiently but increased their social status.[167] The strategy failed as experience showed that managers did not have the skills to maximize performance of businesses operating in unrelated industries, undermining the appeal of managerialism.[168]

But initially, conglomerates were also viewed as a strategy driven by shareholder value. A 1969 article in *Forbes* asserted that conglomerates "were ideal vehicles for a stock market that had become increasingly performance-minded."[169] The editors of *Fortune* explained that such entities had a "unique approach to maximizing their shareholders' return," and "are raising basic questions about the nature of business and the purpose of corporations."[170] Rather than solely reflecting the desire to reduce risk, conglomerates also reflected a response to shareholders seeking higher profits.[171]

The conglomerate followed from the managerialist belief that superior management could add value to a corporation.[172] Professionally trained managers had the skills to run multiple businesses.[173] Large companies had the resources to invest in a central staff that would allocate resources to promising divisions and make investments in new markets and industries.[174] As noted earlier, for a time, such internal capital markets were more efficient in assessing the performance of individual companies than external markets.[175] Moreover, if better managers were the main determinant of market value, the value of a business could increase when its assets were transferred to a well-run conglomerate.[176]

A conglomerate could demonstrate that its assets were managed efficiently by delivering consistent increases in company earnings. In describing the strategy of conglomerates, *Forbes* observed that "the cornerstone of their long-range planning is the realization of a certain minimum annual increase in per-share earnings."[177] Because the complexity of conglomerates made them difficult to evaluate, it was especially important for them to deliver strong bottom-line financial results. Conglomerates thus had an

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167. *See, e.g.*, Rock, *supra* note 99, at 1915 (noting that because managers in larger enterprises are better compensated, "managers have a private incentive to expand—even when doing so is not justified by the returns to shareholders").

168. Hansmann & Kraakman, *supra* note 6, at 444.

169. *The Multicompanies: Conglomerate, Agglomerate and In-Between*, FORBES, Jan. 1, 1969, at 83.

170. THE EDITORS OF FORTUNE, THE CONGLOMERATE COMMOTION 45 (1970).

171. *See, e.g.*, J. Fred Weston, *The Nature and Significance of Conglomerate Firms*, 44 ST. JOHN'S L. REV. 66, 71 (1970) (noting that a reason for conglomerates was "the recognition of growth in earnings per share as an improvement factor in the valuation of securities"). There is mixed evidence that the market viewed conglomerate mergers favorably. *See, e.g.*, Hubbard & Palia, *supra* note 29, at 1133–34; John G. Matsusaka, *Takeover Motives During the Conglomerate Merger Wave*, 24 RAND J. ECON. 357, 358 (1993) (finding that conglomerate mergers brought more value to shareholders than non-conglomerate mergers).

172. There was some evidence that conglomerates outperformed the market through the late 1950s and 1960s. WILLIAMSON, *supra* note 24, at 173.

173. *See, e.g.*, FED. TRADE COMM'N, ECONOMIC REPORT ON CORPORATE MERGERS 73 (1969) ("[t]he timing and increasing frequency of conglomerate mergers, it is alleged, are simple responses of the market to management's greatly expanded capacity for planning and decision-making").

174. *See, e.g.*, CHANDLER, *supra* note 20, at 481.

175. WILLIAMSON, *supra* note 24, at 259. The belief that conglomerates can be efficient persists. *See* Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 746 (1990) (noting the benefits of conglomerate internal capital markets).

176. Neil H. Jacoby, *The Conglomerate Corporation*, CENTER MAG., July 1969, at 48 ("A real social gain occurs when the assets of an enterprise are transferred via merger into the control of a superior management.").

177. *The Multicompanies*, *supra* note 169, at 83.

incentive to develop ambitious forecasts and meet them. The success of one of the more prominent conglomerates, International Telephone & Telegraph (ITT) was attributed in part to its prowess in forecasting. Its CEO was said to teach "all his executives how to think out all their objectives in terms of profits, to set targets and keep to them, to control details with iron discipline . . . ."[178]

The diversification of conglomerates could help ensure that earnings were smooth and predictable.[179] When one business was struggling, another would be prospering.[180] Managers could allocate capital to the sectors that were most promising and decrease resources to sectors that were less promising. The combination of results-driven management and diversification could generate profits growth while minimizing risk. The conglomerate Textron was described as "achieving stability by balancing one unrelated business against another and attaining growth by setting high investment goals and rigorously pursuing them."[181] On the other hand, conglomerates faced pressure to continue their record of stable growth to demonstrate that the strategy was working.[182]

Conglomerates delivered earnings increases not only through efficient management but through more questionable methods. One common strategy was to rely on frequent acquisitions to increase revenue and earnings.[183] Because conglomerates were valued highly due to their superior management, the earnings from the acquired company would support a loftier market valuation when they became part of the conglomerate's income statement.[184] This premium, of course, assumed that managers could consistently increase the efficiency of the acquired companies. Another advantage to the strategy was that accounting rules at the time permitted the conglomerate to report the value of the acquired assets at a conservative book value. Over time, they could sell such assets at market value to generate higher earnings.[185]

Conglomerates can be understood as a way of addressing the problem of predicting future earnings. The theory was that a strong management team operating in a diverse range of businesses could generate predictable earnings growth over time. Investors could thus be comfortable assigning conglomerate stocks high valuations that accounted for the value of such future earnings. While in practice, the strategy had mixed results, its prevalence was a sign of how stock valuation methods had started to emphasize future performance.

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178. ANTHONY SAMPSON, THE SOVEREIGN STATE OF ITT 128 (1973).

179. *See, e.g.*, THE EDITORS OF FORTUNE, *supra* note 170, at 4 ("[I]t does appear that certain kinds of conglomerates—those that have made diversification a 'way of life,' rather than just a response to trouble—are able to generate superior earnings performance fairly consistently.").

180. *See, e.g.*, Corwin D. Edwards, *Conglomerate Bigness as a Source of Power*, *in* BUSINESS CONCENTRATION AND PRICE POLICY 331, 350 (1955) ("The diversification of the large concern minimizes risk by settling loss in one part of the business against profit in another and thereby providing an automatic business risk insurance.").

181. *The Multicompanies*, *supra* note 169, at 85.

182. *See, e.g.*, SAMPSON, *supra* note 178, at 142 ("Geneen was determined that ITT should present a record of steadily increasing earnings, growing every quarter, to reassure the most skeptical investor that this company, like a liner with stabilizers, was invulnerable to economic storms.").

183. *See, e.g.*, ADAM SMITH, THE MONEY GAME 188–89, 194 (1968); Brooks, *supra* note 101, at 156–67.

184. *See, e.g.*, THE EDITORS OF FORTUNE, *supra* note 170, at 97–99 (1970); Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1199 (1970).

185. THE EDITORS OF FORTUNE, *supra* note 170, at 102; SAMPSON, *supra* note 178, at 144; *but see* Matsusaka, *supra* note 171, at 359.

B. Projections

A broader set of developments made shareholder wealth maximization a priority for a wider range of public companies. As Professor Jeffrey Gordon has noted, the fall of managerialism required "external capital markets" to "advance[] relative to internal capital markets in the allocation of capital."[186] One source of such parity was that federal disclosure obligations increased over the 1970s.[187] But disclosure has a limited impact on valuation because it looks primarily to the past rather than the future.[188] It was not until companies developed meaningful internal projections of their performance and such information was disseminated to investors that a more meaningful parity was possible.

1. Internal Projections

As public companies grew larger, managers developed budgeting techniques so that they could efficiently allocate resources within the firm. Preparing a corporate budget requires gathering, organizing, and analyzing information relating to various business groups.[189] One function of such budgets is to estimate future sales so that enough products can be manufactured to meet expected customer demand.[190] Managers can later compare actual sales to the forecasted sales in their budget to assess the reliability of their models.[191]

Internal projections help corporate managers address agency costs that can reduce the efficiency of an internal capital market.[192] Managers of individual divisions have their own incentives that may conflict with the organization's goals. For example, they may lobby for more capital than they can effectively use to increase their status within the corporation.[193] By requiring divisions to set internal projections, and assessing whether those projections have been met, central managers can better allocate funds to

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186. Gordon, *supra* note 5, at 1470.

187. Park, *supra* note 15, at 1000–03.

188. Kripke, *supra* note 184, at 1171.

189. There were two main methods for preparing forecasts. One approach was for a centralized division to develop budgets that would be distributed to divisions. A second approach was for individual divisions to set their own budgets that would be consolidated. *See* FRANCIS A. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS 11 (1981).

190. *See, e.g.*, KNIGHT & WEINWURM, *supra* note 33, at 65 ("The budget is a plan of future performance; therefore, it cannot avoid the problems involved in predicting future events. Even the best forecast will be characterized by uncertainty to some extent.").

191. KNIGHT & WEINWURM, *supra* note 33, at 6 (observing that budgeting "consists essentially of two parts: (1) the preparation of a comprehensive financial plan of operations and (2) the comparison of actual financial results with this predetermined plan").

192. A number of commentators have noted that agency costs can reduce the efficiency of internal capital markets. *See, e.g.*, Patrick Bolton & David S. Scharfstein, *Corporate Finance, The Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95, 106 (1998) (describing consensus view that "internal capital markets are less efficient than external capital markets because they replace the profit-based-decision-making of investors with the bureaucratic decision-making of corporate executives."); *see generally* David Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FIN. 2537 (2000) (modeling rent-seeking by divisional managers); Triantis, *supra* note 27, at 1113 (noting that agents may allocate capital for personal benefit at the cost of their employer); Hyun-Han Shin & Rene Stulz, *Are Internal Capital Markets Efficient?*, 113 Q.J. ECON. 531, 531–33 (1998) (finding evidence that capital is not allocated to the most promising divisions).

193. *See* Timothy F. Malloy, *Regulating by Incentives: Myths, Models, and Micromarkets*, 80 TEX. L. REV. 531, 574 (2002) (describing competition for capital within the firm).

more promising projects.[194]

Some of the largest companies were developing and using internal projections by the start of the twentieth century. The business historian Alfred Chandler described how Du Pont, the chemicals company, pioneered corporate budgeting methods around that time. Its management "systematize[d] the making and approval of both operating and capital budgets."[195] It made both "long- and short-term financial forecasts," including a "forecast of net earnings" that "determined the maximum amount available for new capital expenditures from retained earnings."[196] This projection was "computed by multiplying sales department monthly estimates of sales by the accounting department's estimates of net profit per unit for each product."[197] The internal earnings forecast was "checked regularly against actual results . . . and increased the possibilities for rational choice between alternative investments and alternative methods of financing them."[198]

A handful of other large companies incorporated forecasts in their own budgets,[199] but it was not until after World War II that budget forecasts were used widely by public companies and techniques for forecasting were systematically developed.[200] One commentator noted that "by the late 1920s, techniques were available whereby most sales forecasters could prepare reasonable estimates of future sales," but there was a "lack of data" to make accurate forecasts.[201] By the 1950s, "those firms which tried to set up a program of sales forecasting some years ago only to see it fail for lack of data find things changed today."[202] A number of publications around this time described budget forecasting as a field that was relatively immature but emerging.[203] A book on

194. The monitoring by a central office was viewed as permitting companies to focus on the long run rather than the short-term interests of divisional managers. *See, e.g.*, Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1223 (1984). Monitoring works best when hard information about divisional performance is available. *See, e.g.*, Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized versus Hierarchical Firms*, 57 J. FIN. 1891, 1893 (2002); *but see* Naomi R. Lamoreaux et al., *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History* 42 (Nat'l Bureau of Econ. Rsch., Working Paper No. 9029, 2002) (arguing that internal projections can result in inefficient behavior). The benefits of more efficient monitoring in internal capital markets can be offset by costs such as reduced incentives for entrepreneurship by divisional managers. *See generally* Robert H. Gertner et al., *Internal versus External Capital Markets*, 109 Q.J. ECON. 1211 (1994).

195. CHANDLER, *supra* note 20, at 449.

196. *Id.*

197. *Id.*

198. *Id.*

199. According to Chandler, a slow-down in demand in 1920 and 1921 prompted companies like General Motors, Sears, Du Pont, General Electric, and U.S. Rubber to respond "by developing techniques that set and adjusted their flows to carefully forecasted future demand." CHANDLER, *supra* note 20, at 457. These managerial techniques spread through the 1920s as "new accounting, budgeting, and forecasting methods were becoming normal operating procedures." *Id.* at 464. Business schools facilitated this spread. *Id.* at 465–66.

200. *See, e.g.*, ELMER C. BRATT, BUSINESS FORECASTING 238 (1958) ("In line with the functions which the yearly budget came to serve, notably the development of sales targets and financial planning, the practice of making yearly forecasts has spread widely since the war.").

201. C.M. CRAWFORD, SALES FORECASTING: METHODS OF SELECTED FIRMS 36 (1955).

202. *Id.*

203. One publication observed that "[b]usiness forecasting, recognized as a separately organized activity of a business enterprise is, however, a relatively new development in the art of business management." CONTROLLERSHIP FOUND, INC., BUSINESS FORECASTING: A SURVEY OF BUSINESS PRACTICES AND METHODS 1 (1950). Another study noted that "[v]arious sales-forecasting approaches have been developed, for the most part by individual companies, on a trial-and-error basis. There is very little literature available on sales-forecasting practices. The techniques in use, essentially quite simple, place primary emphasis on trend extension." AM.

managerial budgeting observed that as corporations continued to grow in "size and complexity . . . the need for better tools of prediction has become ever more pressing."[204]

A study published in 1956 provides a snapshot of forecasting practices by companies.[205] The American Management Association circulated a survey at its annual conference to 297 companies. The results indicated that "[e]ven among the largest firms . . . scientific sales forecasting is comparatively new."[206] Five years before, only about half of the companies (150 firms) had a central office that handled forecasting.[207] By the time of the conference, more than three-quarters of the companies (241 firms) had centralized forecasting.[208] The most commonly cited use of forecasts was for production planning (262 firms). A significant number of firms used forecasts for budgeting (255 firms) and earnings forecasting (224 firms).[209] The most common bases for company forecasts were past sales trends (278 firms), sales department estimates (255 firms), and judgment and hunches (230 firms).[210] Almost all of the firms prepared an annual forecast (286 firms), but less than half of the companies prepared quarterly forecasts (128 firms).[211] Only one in seven companies used a "high-speed electronic computer" to prepare their forecasts.[212]

By the 1950s, it was possible for one commentator to note that "forecasting and budgeting are the basis of 'operation planning,' which in turn is the essential basis of efficient management."[213] Internal corporate forecasts were used by high-level management for a wide array of purposes. According to the American Management Association, "[i]n the financial division, the sales forecast becomes the basis of budgeting and planning for inventory levels, cash requirements, and estimates of income and disbursements."[214] Budgets and forecasts permitted professional managers to efficiently plan and allocate resources within the firm.[215] Divisions that proved they could be profitable would merit greater capital than those that did not.[216] For example, Thomas

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MGMT. ASS'N, INC., SALES FORECASTING: USES, TECHNIQUES, AND TRENDS (1956). A book on business forecasting explained that "[t]he immaturity of forecasting is indicated by the fact that there are still companies which operate with a dual system: one forecast for sales planning and quota making, and another for financial-control purposes." BRATT, *supra* note 200, at 263.

204. KNIGHT & WEINWURM, *supra* note 33, at 65.

205. AM. MGMT. ASS'N, INC., *supra* note 203.

206. *Id.* at 143. An earlier survey found that 36 of 37 companies prepared "formal annual forecasts of sales." CONTROLLERSHIP FOUNDATION, INC., *supra* note 203, at 16. It noted that "[t]he sales forecast is the basis for the sales budget, the profit and loss budget and various expense budgets." *Id.* at 20.

207. AM. MGMT. ASS'N, INC., *supra* note 203, at 144.

208. *Id.*

209. *Id.* at 148.

210. AM. MGMT. ASS'N, INC., *supra* note 203, at 151.

211. *Id.* at 153.

212. *Id.* at 75.

213. BRATT, *supra* note 200, at 266.

214. AM. MGMT. ASS'N, INC., *supra* note 203, at 23.

215. *See, e.g.*, KNIGHT & WEINWURM, *supra* note 33, at 55 ("Budgeting may be regarded as a tool of top management, acting through the budgeting staff, to coordinate the activities of subordinate departments with each other, with company-wide goals and objectives, and with the over-all criterion of reasonable return on investment."); *see also* AM. MGMT. ASS'N, INC., *supra* note 203, at 21 ("Such a forecast is an essential guide to management for future planning.").

216. *See, e.g.*, MOORE, *supra* note 55, at 120 ("For all units that have 'profit accountability,' meaning that they have revenue as well as expenditures, a favorable balance is clearly a mark of success and an unfavorable balance a mark of failure. The unit that is more than self-supporting has a much greater chance of getting a

Watson, Jr., President of IBM, reported that in the 1950s, the company organized itself into divisions and "started to emphasize profit as the measure of each division's performance."[217] The economist John Kenneth Galbraith noted the care with which large companies developed and used projections.[218] For Galbraith, superior planning is what distinguished large from small firms and permitted them to uniquely manage the uncertainty of economic fluctuations.[219]

The emergence of these sophisticated techniques for projecting financial performance helped justify managerialism. As large organizations became more complex, it took professional managers immersed in the business to fully understand their operations. With access to internal information, and their experience running the firm, managers had unique knowledge that supported their control of the public corporation.

2. *Market Projections*

i. *From Internal to External Projections*

As internal company forecasts became more sophisticated, market participants understandably were interested in obtaining them.[220] By the 1960s, research analysts that wrote reports on company stocks for investors were common and published their own estimates of annual earnings for public companies.[221] A 1963 SEC Study of Securities Markets noted the increasing number of broker-dealers with employees whose job it was to "'research' particular securities and industries; in many firms he is called an 'analyst.'"[222] These research analysts primarily serviced the institutional investors that

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favorable hearing on budgetary increases than one that is living on relief.").

217. WATSON, JR., *supra* note 41, at 50. General Electric similarly instituted short-term sales and profitability targets for its divisions in the 1950s. *See* NOEL M. TICHY & STRATFORD SHERMAN, CONTROL YOUR DESTINY OR SOMEONE ELSE WILL: LESSONS IN MASTERING CHANGE—THE PRINCIPLES JACK WELCH IS USING TO REVOLUTIONIZE GENERAL ELECTRIC 45 (Harper Collins Publishers 1994) (1993). Until that time, General Electric did not systematically centralize control over its various departments. *See* CHANDLER, *supra* note 48, at 220.

218. *See, e.g.*, GALBRAITH, *supra* note 51, at 355 (observing that in all major business endeavors, "there are careful projections of output, careful control of prices; careful steps to see that the projections of output are validated in the greatest possible measure by consumer response; and careful steps to see that the things needed for production—labor, components, machinery—are available in the requisite amounts at the anticipated prices at the right time.").

219. Another commentator noted the link between market power and forecasting, observing that "possession of market power means that within very broad limits a firm can manage its prices and therefore its profits, too." MICHAEL D. REAGAN, THE MANAGED ECONOMY 76 (1963). He pointed to "the recently burgeoning phenomenon of profit 'targets' in large corporations" such as General Motors and U.S. Steel that were "relatively independent of market forces." *Id.* at 76–77.

220. One article proposed making internal projections directly available to investors. *See, e.g.*, James R. Wilkinson & Lloyd D. Doney, *Extending Audit and Reporting Boundaries*, 40 ACCT. REV. 753, 754 (1965) ("This added information would give the investor a greater insight into management's expectations for future earnings and dividends as well as an improved basis for making computations of capitalization and the value of the capital stock of the firm.").

221. Stock research analysts have been active since at least the 1920s. *See* LIVINGSTON, *supra* note 127, at 113.

222. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, pt. 1, at 332 (1st Sess., 1963). Brokerage firms increasingly focused on providing research starting in the late 1950s. *See* CARRINGTON, *supra* note 124, at 30; SOBEL, *supra* note 51, at 342 (noting the fifties could be called the "Age of Analysis").

emerged around this period. Analysts would typically issue reports with recommendations about individual stocks. The study explained that "at the core of almost all recommendations is the projection."[223] It stated that in analyst reports, "[p]rojections of estimated earnings are conspicuous throughout."[224]

Earnings projections issued by research analysts were systematically compiled and disseminated by the end of the 1960s.[225] The S&P Earnings Forecaster was first published in 1967 and initially provided annual forecasts from several analysts for about 1500 companies. The I/B/E/S database, which was used primarily by brokers, began in 1972 and also provided annual projections.[226] Before long, it was clear that markets relied on such forecasts in valuing companies.[227]

The increasing importance of projections to investors can be traced by looking at revisions to the standard investment treatise *Securities Analysis* by Benjamin Graham and David Dodd. Its first two editions had no chapter on earnings projections. Its second edition noted that investors were primarily concerned with a company's past earnings "as an indicator of future earnings."[228] However, it noted that the "clue" provided by this record "is never thoroughly reliable and it frequently turns out to be quite valueless."[229] The third edition of *Securities Analysis* was published in 1951 and had a chapter called "Projections of Earnings and Dividends."[230] The introduction of the chapter observed that "practicing analysts dislike to 'stick their necks out'—to use the invariable phrase—by projecting the average earnings and dividends for a number of years ahead."[231]

By the fourth edition of *Securities Analysis* published in 1962,[232] Graham and Dodd had more confidence in projecting company earnings. As the "Projection of Earnings and Dividends" chapter observed:

> For the usual company—i.e., one not designated as a 'growth' enterprise—it is customary to estimate earnings only for the current or the coming twelve months. By contrast, in order to justify the high multipliers of current earnings commanded by many growth stocks, it becomes necessary to project the expanding earnings quite far into the future. The many analysts who favor companies of this type find no difficulty in making such far-reaching

223. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, *supra* note 222, at 346.

224. *Id.*

225. *See, e.g.*, LEES, *supra* note 189, at 31 (describing sources that compiled analyst projections).

226. William S. Gray, *The Role of Forecast Information in Investment Decisions*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS 35, 65 (Prem Prakash & Alfred Rappaport eds., 1974).

227. *See, e.g.*, Dan Givoly & Josef Lakonishok, *The Information Content of Financial Analysts' Forecasts of Earnings*, 1 J. ACCT. & ECON. 165, 166 (1979) ("The keen interest of investors in future earnings and the weight they assign to them is manifested by, among other things, the number of brokerage houses that produce earnings forecasts on a regular basis and by the attention devoted by the financial community to the issue of the disclosure of management earnings forecasts.").

228. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 506 (2d ed. 1940).

229. *Id.*

230. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 412 (3d ed. 1951).

231. *Id.*

232. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES (4th ed. 1962).

forecasts.[233]

The fourth edition chapter extensively discussed techniques for forecasting earnings.

Analyst projections were often informed by management projections.[234] Corporate managers could easily develop projections that would be useful to investors based on the company's internal projections. For example, the retailer J.C. Penney began compiling sophisticated budgets starting in the early 1960s.[235] It started issuing forecasts based on these internal budgets in the mid-1960s as its business model became more complicated and difficult for investors to understand.[236] As one court noted in deciding a securities fraud lawsuit relating to projections issued by the agri-business Monsanto, the company's projections "were consistent with, and fairly and accurately reflected, internal documents carefully prepared for budgetary, planning and review purposes and were based upon the best data available at the time of the statements."[237] Presumably, internal forecasts would be made in good faith by managers who used them for their own budgeting. The court thus found that the company's external projections had a reasonable basis and were not meant to defraud investors.[238]

Few companies consistently disclosed projections of their performance directly to the general public.[239] One survey reported its finding that "[i]n the opinion of respondents, many companies currently generate corporate forecasts but these forecasts are seldom made available either to analysts or to the general public. Important information which would influence investment decisions is contained in these corporate forecasts."[240] The SEC's policy of prohibiting such projections surely contributed to the reluctance of public companies to widely release such information.

Rather than circulate their forecasts publicly, many public companies disseminated projections privately to research analysts. By doing so, they increased the confidence of markets that estimates of their future performance were grounded in reliable information.[241] Managers would communicate their forecasts to select analysts at

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233. *Id.* at 450.

234. FAF Special Committee on Corporate Forecasts, *Proposals by the Federation for Systematic Disclosure*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR 1, 14 (Fin. Analysts Fed'n ed., 1973) ("Management has special knowledge of internal factors and a greater sensitivity to its particular environment. It has some control over the outcome. Thus, forecasts by both analysts and management are useful to investors.").

235. Isadore Barmash, *Penney-Pinching: Budget Process Detailed and Long*, N.Y. TIMES, Feb. 20, 1972, at F1.

236. Kenneth S. Axelson, *An Executive's Views on the Forecasting of Earnings*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 35.

237. Dolgow v. Anderson, 53 F.R.D. 664, 676–79 (E.D.N.Y. 1971).

238. *Id.*

239. Wallace E. Olson, *Statement of the American Institute of Certified Public Accountants on Estimates, Forecasts and Projections of Economic Performance Before the Securities and Exchange Commission*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 203, 207 (reporting results of survey that "[o]nly 12% of the companies release forecasts in general communications media").

240. Samuel S. Stewart, Jr., *Research Report on Corporate Forecasts*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR, *supra* note 234, at 75, 84; *see also* William S. Gray III, *Proposal for Systematic Disclosure of Corporate Forecasts*, 29 FIN. ANALYSTS J. 64, 65 (1973) ("only a modest number of companies now release specific dollar forecasts of earnings or earnings per share for a period of a year or longer").

241. As Judge Frank Easterbrook noted years after the SEC reversed its policy:

> If you view investors as easily misled and unable to appreciate the uncertainty of predictions, you try to keep such information out of their hands. You will not succeed. Investors value securities

conferences or meetings. One commentator observed in 1974 that "[b]y far the most important channel of communication for [management forecast] information . . . is direct contact with the analyst in a management conference or in analysts' meetings."[242] The SEC's Advisory Committee on Corporate Disclosure did an extensive survey of research analysts in 1977 and reported that "virtually all analysts participating in the survey obtained forecast data in some form from company management."[243] The fourth edition of Graham and Dodd described the "major reliance on direct contacts with company executives" by analysts who often met privately with managers at meetings "where executives of many companies have addressed securities-analyst societies and answered searching questions."[244] It then discussed the importance of such meetings for assessing the quality of management.

It is important to note that this system of voluntary disclosure had its flaws. Information about forecasts was not provided consistently. As the Advisory Committee noted, "[m]any companies are not as willing to talk to analysts when they are having unfavorable economic results."[245] Other commentators expressed skepticism about the quality of information conveyed to analysts.[246] But the prevalence of such disclosure indicated that this flow of information was important to stock markets.

Companies not only communicated internal information to influence analyst projections, they also used conversations with analysts to set internal performance goals.[247] If market participants made it clear that a certain level of performance was

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> because of beliefs about how firms will do tomorrow, not because of how they did yesterday. If enterprises cannot make predictions about themselves, then securities analysts, newspaper columnists, and charlatans have protected turf. There will be no predictions aplenty outside the domain of the securities acts, predictions by persons whose access to information is not as good as the issuer's. When the issuer adds its information and analysis to that assembled by outsiders, the collective assessment will be more accurate even though a given projection will be off the mark.

Wieglos v. Commonwealth Edison Co. 892 F.2d 509, 514 (7th Cir. 1989).

242. Gray, *supra* note 226, at 50; FAF Special Committee on Corporate Forecasts, *supra* note 234, at 15 (reporting survey results finding that "[b]y far the most important channel of communications for this information, however, is direct contact with the analyst in a management conference or in analysts meetings"). As one commenter described the system:

> Anyone who has ever worked in Wall Street will know that although for regulatory reasons a profit forecast never finds a place in registration statements or prospectuses, it will circulate freely 'underground.' It will be passed 'confidentially' over the telephone and mentioned at underwriters' meetings: 'earnings per share next year will be $5.20 compared with $4.60' says the managing underwriter. No source for this projection is given and no liability is accepted for it. Nothing is written and, it would appear, no remedy lies if the forecast is not achieved. The professional investor therefore will have his black market profit forecast – the general public will remain in blissful ignorance.

John Hull, *Profit Forecasts – the English Experience*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 19, 20.

243. COMM. OF INTERSTATE AND FOREIGN COM., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 57 (Nov. 3, 1977).

244. GRAHAM & DODD, *supra* note 232, at 452.

245. COMM. OF INTERSTATE AND FOREIGN COM., *supra* note 243, at 91.

246. *See, e.g.*, ELIAS, *supra* note 166, at 81 ("When analysts do go out, they often settle for a meeting with a member of a company's corporate relations staff, a financial flunky assigned to develop optimistic facts and figures by omitting any negative implications.").

247. A former insider of GE described the interaction between the company and its analysts:

necessary to achieve a certain stock price, managers could use these expectations to set goals within the company. Thus, internal projections not only influenced external projections, but external projections also influenced internal projections.

The increasing importance of forecasts during the 1960s and 1970s is evidence of a substantial shift during that period in the way that markets valued public companies. By 1978, the SEC reversed itself and announced a policy of "encourag[ing] companies to disclose management projections whether or not included in Commission filings."[248] However, the SEC has never required companies to issue projections. Thus, this flow of information has occurred mainly apart from the disclosure mandates of the securities laws.

ii. Insider Trading Law and the Increasing Importance of Projections

The influence of projections on valuation decisions was also evidenced by the concurrent development of insider trading doctrine under SEC Rule 10b-5, which prohibits securities fraud.[249] By the 1970s, companies not only shared projections with analysts, some warned analysts when they would miss a projection.[250] Despite the emerging law of insider trading, some executives felt compelled to curry favor with

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> In the 1950s, Cordiner initiated Investor Relations as one of the new corporate functional services. This organization's job was to help create realistic expectations among the investment analysts and then communicate the expectations internally so that the operating and executive officers understood the right level of profitability to achieve. This is now called 'meeting Wall Street's expectations,' and it's an almost universal corporate practice, but it was truly unique in the 1950s.

WILLIAM E. ROTHSCHILD, THE SECRET TO GE'S SUCCESS 172 (2007).

248. Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, Securities Exchange Act Release No. 15305 (Nov. 7, 1978). The new policy did not require companies to disclose projections but permitted them to voluntarily include them in official filings. The change in policy reflected a fundamental shift in the SEC's disclosure regime. *See, e.g.*, JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 672 (3d ed. 2003) ("the transformation of the Commission's mandatory disclosure system, beginning in the early 1970s, from its emphasis on historical or 'hard' information and general prohibition of 'soft' or predictive information, to its additional emphasis on forward looking information, represented the single most important development in the agency's then greater than 60 years' experience administering disclosure requirements").

249. 17 C.F.R. § 240.10b-5.

250. There appear to have been a wide range of practices with respect to selective disclosure of forecasts. Not all companies used selective disclosure in the same way. One commentator found:

> increasing evidence of discriminatory disclosure of forecast data by corporate management. At the same time as many companies announced their projections publicly, a number of others communicated their expectations to a select few. Favored analysts might be advised of current budget data either directly or by letting them know that their estimates were 'in the ballpark.' Through a variety of devices, many corporations sought to be sure that 'market' estimates of their earnings were not far off the mark while still not taking any public position on the projected results. While the overwhelming majority of such efforts were done in good faith, the end result was lack of knowledge as to what forecasts were those of management as opposed to those of analysts working independently. In a few cases, there was evidence of selective disclosure to institutional investors interested in the stock and unfair use of such insider information.

J. C. Burton, *Forecasts: A Changing View from the Securities and Exchange Commission*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 81, 86.

research analysts who primarily served institutional investors.[251] After the Supreme Court held that tipping analysts for corporate purposes did not violate Rule 10b-5, companies for a time freely conveyed information relating to their projections to analysts.

As noted earlier, companies provided information to analysts because they wanted to build credibility with respect to their projections.[252] The main risk in relying on a forecast is that it may be incorrect, either because the forecast is inaccurate or because of unforeseen circumstances. By warning analysts of a miss, managers could reduce that risk and provide an incentive for the analyst to recommend the company's stock to clients. Thus, a company like J.C. Penney was said to provide analysts with information "avoiding any 'surprises' in earnings results."[253] One way of doing so was to inform analysts when their projections were too high.[254] Typically, an analyst would ask the company to review a projection and comment on whether it was accurate. One study noted that "most" companies "stated that they tell the analyst if he is beyond the range of reasonableness."[255] By doing so, they indirectly conveyed their knowledge of internal forecasts to markets without issuing their own public forecast, and thus avoided some accountability should the forecast not be met.[256] A more questionable method was to warn analysts when a company would not meet a prior projection. The Chairman of the SEC observed in a 1973 speech that "[i]n recent years, we have seen . . . cases where companies trip all over themselves trying to protect friendly analysts from being surprised by a bad earnings report."[257]

In 1968, the U.S. Court of Appeals for the Second Circuit issued its decision in *Texas Gulf Sulphur*,[258] which held that trading on material inside information violated

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251. Analysts working for broker-dealers had an incentive to provide such information to institutional clients who would then direct commission business to the broker-dealer. *See, e.g.*, Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J.L. ECON. & POL'Y 311, 316 (2008).

252. There are reasons why companies might find it in their interest to favor large shareholders. *See, e.g.*, Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 283–84 (2001).

253. Kenneth S. Axelson, *An Executive's Views on the Forecasting of Earnings*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 35, 36.

254. ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 89 (2002) (describing practices where "companies would increasingly leak to analysts what they thought their earnings would be . . . to help shape, and thus avoid missing, the analysts' consensus forecast").

255. Wallace E. Olson, *Statement of the American Institute of Certified Public Accountants on Estimates, Forecasts and Projections of Economic Performance Before the Securities and Exchange Commission*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 203, 207; *see also* Gray *supra* note 226, at 65 (noting that many companies "confirm publicly or privately" the accuracy of analyst forecasts).

256. *See, e.g.*, *ABA Statement on Securities Exchange Act Release No. 9844*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 129, 150 ("Frequently confirmation will be sought from the issuer with respect to the accuracy of the projection; sometimes such confirmation is forthcoming, sometimes management simply indicates it believes the projection is inaccurate, sometimes management responds to the effect the projection is not 'out of the ball park,' other times management chooses to remain silent. The issuer's dilemma is that confirmation may have the effect of making an analyst's projection in effect the issuer's; and if the projection is inaccurate and goes out uncorrected, the market in the issuer's securities could be misled.").

257. G. Bradford Cook, Chairman, Sec. and Exch. Comm'n, Speech before the New York Society of Security Analysts: The Role of the Investment Analyst in the Evolving Market System 9 (Mar. 17, 1973), http://www.sec.gov/news/speech/1973/032773cook.pdf [https://perma.cc/6JJM-KEEM].

258. 401 F.2d 833 (2d Cir. 1968) (en banc).

SEC Rule 10b-5 (which prohibits securities fraud) unless it was disclosed beforehand to the public. Because it did not limit this duty to individuals with a fiduciary duty to the corporation, the decision raised questions about whether market participants could trade on information relating to projections that had only been disclosed to a few privileged recipients. Some commentators took the position that forecast information could not be traded on unless it was widely disseminated.[259]

Others were skeptical that insider trading law should prohibit such selective disclosure.[260] A treatise on insider trading by William Painter, who generally supported insider trading regulation, noted in commenting on *Texas Gulf Sulphur* that "[t]he common practice of welcoming visits from brokers, investment advisers and others and briefing them on recent corporate developments, as well as answering their all too pointed inquiries can hardly be discontinued merely because of uncertainty about what may lawfully be disclosed."[261] Painter took the position that "the corporate benefits flowing from friendly relationships with security analysts and investment counselors are too great to justify any policy of corporate isolationism."[262]

The SEC adopted the stance that selective disclosure of material information relating to company projections violated Rule 10b-5.[263] In 1968, it sought an injunction against Glen Alden, a mining company, prohibiting it from "disclosing material information in violation of Section 10(b) . . . to any selected persons for the purpose of giving an advantage to such persons in connection with the market purchase or market sale of securities of Glen Alden Corporation. . . ."[264] It noted that in private meetings, the company had conveyed "sales, earnings and cash flow projections for Glen Alden and each of its divisions for the years 1968 to 1972, projected acquisitions and other material information concerning the affairs of Glen Alden and its related companies."[265] The SEC thus attempted to prohibit the selective dissemination of projections by public companies.[266]

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259. *See, e.g.*, FAF Special Committee on Corporate Forecasts, *Proposals by the Federation for Systematic Disclosure*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR, *supra* note 234, at 1, 26 ("Management forecast information is of such importance to investors that it would seem to fall in the class of information subject to the insider trading rules. Thus, share transactions by management personnel privy to internal budgets and forecasts might be inhibited by these rules. Any forecast information that is released should be fairly disseminated to all investors.").
Some market participants became more conservative in their information gathering practices after the *Texas Gulf Sulphur* decision. *See, e.g.*, GILBERT EDMUND KAPLAN & CHRIS WELLES, THE MONEY MANAGERS 109 (1969) ("And because of recent controversy over what constitutes insider trading, Fidelity is going to place increasing emphasis on talking to a company's competitors and suppliers, and less talking to its officers.").

260. Arthur Fleischer, who played a role in developing the SEC's initial prohibition of insider trading, discussed the situation where "[c]ompany officials . . . are often confronted with projections made by brokerage firms and investment banking houses and asked to confirm these figures." He took the position that "it would be appropriate to call the analyst's attention to any egregious error in his assumptions or calculations." Arthur Fleischer, Jr., *Corporate Disclosure/Insider Trading*, HARV. BUS. REV., Jan.–Feb. 1967, at 129, 134.

261. WILLIAM H. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 345 (1968).

262. *Id.*

263. For an overview of the SEC's enforcement efforts in this area, see Dolgopolov, *supra* note 251, at 343–49.

264. SEC v. Glen Alden Corp., 1968 U.S. Dist. LEXIS 12081, at *4 (Aug. 7, 1968).

265. *Id.* at *2–3.

266. The SEC has at times sought to extend broad principles through enforcement. *See* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 630 (2007).
The SEC's policy may have had some effect on corporate disclosure. A report by the Conference Board found

The legal scholar Henry Manne criticized the SEC's position and argued that insider trading was a critical way of conveying information to the market. Because the SEC had discouraged public disclosure of forecasts, information critical to a stock's valuation was not included in SEC disclosure.[267] He argued that often only "insiders in a company or an industry . . . can possibly make realistic valuation assessments" and "earnings estimates."[268] Selective disclosure was a way that managers could provide information that might be too speculative to include in an SEC filing but would be useful to analysts in valuing a stock.

In its 1983 decision in *Dirks*,[269] the Supreme Court permitted a company official to selectively disclose projections information to third parties so long as he did not receive a personal benefit from the disclosure.[270] *Dirks* was an important case because it permitted public companies to communicate with analysts and investors about their projections. So long as it was motivated by a corporate purpose, such selective disclosure did not violate Rule 10b-5. The Supreme Court in *Dirks* specifically acknowledged the important role of analysts in facilitating the process of valuing securities. In doing so, it noted that it was "commonplace" for analysts to "ferret out and analyze information" that "cannot be simultaneously available to all of the corporation's stockholders or the public generally."[271]

After *Dirks*, selective disclosure from managers to analysts with respect to projections was viewed by many market participants as a legitimate practice. A *New York Times* profile on a research analyst published in 1985 observed: "Before he publishes [earnings forecasts]" the analyst "bounces them off managements. First Boston bends further. New analysts there must show corporate brass drafts of reports before they are published."[272] A *Fortune* magazine article in 1991 noted: "Analysts have always relied on tidbits that the general public may not know; indeed, they would hardly be doing their job if all they could tell you is what they, and you, could read in the papers or in annual reports."[273] While the SEC maintained its position that selective disclosure was problematic, John Coffee in the early 1990s described the validity of the SEC's position as "doubtful" and that prohibiting selective disclosure with respect to projections would result in more stock market volatility.[274]

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in 1973 that 78% of the companies in its survey provided information to assist analysts, only 65% did so in 1981. LEES, *supra* note 189, at 25.

267. *See* Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 571 (1970).

268. *Id.* at 572.

269. Dirks v. SEC, 463 U.S. 646, 663–67 (1983).

270. The insurance company Equity Funding inflated its income by fabricating sales of insurance policies. It did so to create the appearance that its earnings were growing. Dirks was a research analyst who learned of the fraud from someone inside the company and passed on the information to his clients. The SEC argued that this was insider trading and brought a case against him. The Court disagreed and held that there was no insider trading because the company official who disclosed the information did not personally profit from the disclosure and thus did not breach a fiduciary duty to the company. Without a violation of some duty, there was no deception that made the transmission of the information part of a fraud that would violate Rule 10b-5. *See id.*

271. *Id.* at 658–59. Professor Adam Pritchard describes evidence from internal Supreme Court documents that Justice Powell was well aware of the situation of the analyst in crafting the *Dirks* standard. Adam C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 863 (2015).

272. N.R. Kleinfield, *The Many Faces of The Wall Street Analyst*, N.Y. TIMES, Oct. 27, 1985, at F8.

273. Anne B. Fisher, *Can You Trust Analysts' Reports?*, FORTUNE, Oct. 1991, at 195, 198.

274. John C. Coffee, Jr., *Disclosures to Analysts are Risky*, NAT'L L.J., Feb. 1, 1993, at 19; *but see* Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1038 (1990) (arguing

The propriety of selective disclosure has been debated extensively over the decades.[275] The persistence of the issue is not only evidence of the difficulty of regulating insider trading, but evidence that markets have relied heavily on projections in valuing public companies.[276] Corporations selectively disclose information about their internal projections to analysts so that they will have more confidence in predicting the future trajectory of their earnings.[277]

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that selective disclosure does not increase market efficiency). There is thus an argument that the selective dissemination of information of projections increased the efficiency of stock markets. The strong form of the efficient markets hypothesis predicts that markets incorporate information that is not available to the public. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555–56 (1984). The substantial evidence of selective disclosure relating to projections explains why stock prices can exhibit such strong-form efficiency. A benefit of such efficiency is that markets will correctly value companies. On the other hand, the importance of projections undermines one view of efficient markets—that they reflect the superior skill and insight of investors. The fact that investors continue to focus on short-term projections indicates that they are reliant on heuristics in assessing the long-term prospects of a corporation. Far from being a flawless machine, the stock market relies on a variety of potentially flawed metrics in assessing the value of companies. Such selective disclosure results in advantages to privileged investors who benefit from their connections rather than their investing acumen.

275. In 2000, the SEC passed Regulation FD, 17 C.F.R. § 243.100, which requires companies to publicly disclose any material information before it is conveyed to research analysts. Because it has been enforced infrequently, the rule has not completely stopped selective disclosure to analysts. *See, e.g.*, Thomas Gryta, et al., *Analysts Steered to "Surprises"*, WALL ST. J., Aug. 5, 2016, at A1; Serena Ng & Thomas Gryta, *Analysts Say 'Buy' to Win Special Access*, WALL ST. J., Jan. 20, 2017, at A1; Serena Ng & Anton Troianovski, *How Some Investors Get Special Access to Companies*, WALL ST. J. (Sept. 27, 2015, 10:24 PM), https://www.wsj.com/articles/how-some-investors-get-special-access-to-companies-1443407097 [https://perma.cc/V8D6-UEYS]; *see also* ROBERT G. ECCLES, ET AL., THE VALUE REPORTING REVOLUTION: MOVING BEYOND THE EARNINGS GAME 73 (2001) (noting common practice of exchanging information between analysts and companies and questioning whether Regulation FD will stop it).

As evidenced by the U.S. Court of Appeals for the Second Circuit's 2014 decision in *U.S. v. Newman*, even after Regulation FD had been in effect for a decade, analysts still sought and received company input about the accuracy of their models. *United States v. Newman*, 773 F.3d 438, 454–55 (2d. Cir. 2014). The Second Circuit later raised questions about its earlier decision in *Newman*. It set forth a standard where "a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it." United States v. Martoma, 894 F.3d 64, 74 (2d Cir. 2017). This standard appears to permit selective disclosure for a "corporate purpose."

Recently, the SEC brought a case against AT&T alleging it disclosed information to research analysts that led them to reduce their forecasts. AT&T responded to the action by arguing it would "only serve to chill productive communications between companies and analysts . . . ." Dave Michaels & Drew FitzGerald, *SEC Alleges AT&T, 3 Employees Tipped Off Wall Street*, WALL ST. J. (Mar. 5, 2021, 6:17 PM), https://www.wsj.com/articles/sec-alleges-at-t-3-employees-tipped-off-wall-street-11614982784 [https://perma.cc/52J4-N856].

276. As the leading text on valuation observes:

> Analysts sometimes have access to private information about the firms they follow that may be relevant in forecasting future growth. This avoids answering the delicate question of when private information becomes illegal inside information. There is no doubt, however, that good private information can lead to significantly better estimates of future growth. In an attempt to restrict this type of information leakage, the SEC issued new regulations preventing firms from selectively revealing information to a few analysts or investors. Outside the United States, however, firms routinely convey private information to analysts following them.

DAMODARAN, *supra* note 150, at 283.

277. As I have argued elsewhere, such selective disclosure undermines the integrity of a mandatory disclosure regime that has become more extensive. *See generally* James J. Park, *Insider Trading and the*

VI. VALUATION AND CORPORATE PURPOSE

The prevailing emphasis on ideology as the reason corporations maximize shareholder wealth has obscured the role of valuation in creating incentives to increase corporate earnings. This Part will argue that valuation is an important driver of corporate purpose and that significant changes in valuation methods are a prerequisite for a shift from shareholder wealth maximization. There are early signs of such a shift.

A. Projections and Agency Costs

Over time, the willingness of markets to value companies based on their future earnings profoundly affected the way that corporations were managed. While the conglomerate faded for a time as a way of signaling earnings potential,[278] projections only increased their influence over public companies. The reliance of projections as a valuation metric created the foundation for the shift to shareholder wealth maximization. Without projections, it was difficult for markets to assess whether managers were maximizing profits. As the economist Armen Alchian observed, "where foresight is uncertain, 'profit maximization' is *meaningless* as a guide to specifiable action."[279] Projections helped address the uncertainty of predictions of future earnings and thus influenced the decisions of investors and corporate managers.

As discussed earlier in this Article, some commentators view the agency costs framework developed by Jensen and Meckling as the reason why corporate managers now focus on increasing shareholder wealth. But the academic idea that corporate managers are agents that should serve the interests of shareholders was not by itself sufficient to focus corporations on maximizing profits.

The increasing use of projections that started in the 1960s and accelerated over the 1980s provided a concrete mechanism that helped re-focus companies on shareholder wealth. Projections are not only a way of facilitating the valuation of public companies, they are also a potent way of aligning the interests of corporate managers and shareholders. They permit investors to monitor: (1) the competence of managers; and (2) the commitment of managers to increasing shareholder value. Projections were a potent way of reducing agency costs years before executive compensation practices changed and boards became more independent.

Consistently meeting projections became widely seen as a sign that a corporation

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Integrity of Mandatory Disclosure, 2018 WIS. L. REV. 1133.

278. Economic conditions during the 1970s made it difficult for conglomerates to succeed. *See, e.g.*, ROBERT HELLER, THE NAKED MANAGER FOR THE NINETIES 47 (1995) (noting weak earnings growth of largest companies from 1973 to 1983 and the "destruction of the conglomerate myth"); Malcolm S. Salter & Wolf A. Weinhold, *Diversification via Acquisition: Creating Value*, HARV. BUS. REV., July–Aug. 1978, at 166 (describing low stock values of conglomerates); WELLES, *supra* note 127, at 32 (describing 1969–1970 stock market collapse and poor performance of stock market during the 1970s). Critics viewed conglomerates as too bureaucratic and inefficient to adapt to a more difficult economic climate. *See, e.g.*, WALTER ADAMS & JAMES BROCK, THE BIGNESS COMPLEX: INDUSTRY, LABOR, AND GOVERNMENT IN THE AMERICAN ECONOMY 43–45 (1986). Because of this poor performance, by the 1980s there was a so-called conglomerate discount where the market value of a conglomerate was lower than the market value of its individual businesses. *See, e.g.*, DAVIS, *supra* note 122, at 85. However, there is still debate among economists about whether such a conglomerate discount exists. *See generally* John D. Martin & Akin Sayrak, *Corporate Diversification and Shareholder Value: A Survey of Recent Literature*, 9 J. CORP. FIN. 37 (2003) (reviewing studies of conglomerate discount).

279. Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 211 (1950).

was well-managed.[280] When businesses are complex, it is extremely difficult for shareholders to assess the faithfulness and competence of their managerial agents.[281] As noted earlier, during the managerialist period, investors thus deferred to managers who had better access to information. But as superior management became a significant determinant of a company's market value,[282] it became clear that markets needed to evaluate the ability of managers to effectively allocate corporate resources.[283] Company managers that deliver predictable earnings prove that they can accurately forecast earnings growth and follow through on their plans. There is evidence that companies that meet market expectations are rewarded with a higher stock price.[284] Companies that miss projections can see their stock price plummet as markets reassess their assumptions about their earnings growth.[285] Projections are thus both a carrot and a stick that incentivize public companies to consistently deliver promised results.[286]

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280. *See, e.g.*, DOMINIC DODD & KEN FAVARO, THE THREE TENSIONS: WINNING THE STRUGGLE TO PERFORM WITHOUT COMPROMISE 86 (2007) (noting that "meeting these expectations becomes an end in itself—a test of credibility"); Yuji Ijiri, *Improving Reliability of Publicly Reported Corporate Financial Forecasts*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 226, at 161, 186 ("It is perhaps safe to say that investors will treat reliable forecasts as a sign of a well-managed corporation just as they treat smooth earnings growth as the same indicator."); Jennifer W. Tucker & Paul A. Zarowin, *Does Income Smoothing Improve Earnings Informativeness?*, 81 ACCT. REV. 251, 253 (2006).

281. *See, e.g.*, Jeremy Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 657 (1989) (noting importance of short-term signals when projects are difficult to assess); M. P. Narayan, *Managerial Incentives for Short-Term Results*, 40 J. FIN. 1469 (1985) (noting difficulty of monitoring managerial competence).

282. As Alfred Chandler described:

> The success of the enterprise in the marketplace depended heavily, therefore, on the product-specific and function-specific knowledge and skills of the middle managers in the functional departments of production, distribution, purchasing, and research, and, just as important, on their ability to coordinate, evaluate, and motivate. The long-term profitability of the enterprise depended even more on the top managers who recruited and motivated the middle managers, monitored and coordinated their activities, and determined the continuing strategies for market share and the growth of the enterprise. Combining such managerial skills was the critical element in determining the strength or weakness of the organizational capabilities of an enterprise.

CHANDLER, *supra* note 48, at 230.

283. Joshua Ronen & Simcha Sadan, SMOOTHING INCOME NUMBERS: OBJECTIVES, MEANS, AND IMPLICATIONS 45 (1981); Bruce Alan Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 230 (1971) ("corporate management is constantly planning future expansion and making financial commitments on the basis of internal projections . . . the financial success of the corporation is dependent upon management's skill in estimating future revenues, expenses and operating levels").

284. *See, e.g.*, Eli Bartov, et al., *The Rewards to Meeting or Beating Earnings Expectations*, 33 J. ACCT. & ECON. 173, 175 (2002) (finding higher quarterly returns for firms that meet expectations); Lawrence D. Brown & Marcus L. Caylor, *A Temporal Analysis of Quarterly Earnings Thresholds: Propensities and Valuation Consequences*, 80 ACCT. REV. 423, 425 (2005); Ron Kasnik & Maureen F. McNichols, *Does Meeting Earnings Expectations Matter? Evidence from Analyst Forecast Revisions and Share Prices*, 40 J. ACCT. RES. 727, 728 (2002) (finding that firms meeting expectations have higher stock prices than firms that do not).

285. *See, e.g.*, Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio*, 7 REV. ACCT. STUD. 289 (2002) (finding that growth stocks had an especially adverse reaction to earnings misses). Companies were often punished for missing earnings towards the end of the 1990s. *See* Arthur Levitt, Chairman, Sec. and Exch. Comm'n, Remarks at the NYU Center for Law and Business: The "Numbers Game" (Sept. 28, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt [https://perma.cc/HN6A-CZFS].

286. This system results in an incentive to manipulate earnings results to create the appearance of smooth

Projections also permit managers to demonstrate their commitment to increase corporate earnings. Companies that convey ambitious projections can signal that they are not satisfied with average performance. In contrast, companies that do not convey high expectations may signal that they are not as driven to increase shareholder wealth.

Projections have advantages over other ways of monitoring management such as the payment of dividends and disclosure of past financial results. While a regular dividend is evidence that a company continues to be profitable, it conveys limited information about a company's prospects for growth. A company can only pay dividends if it has sufficient free cash flow. In contrast, projections can be made of revenue streams that have not yet been actualized. A projection can also provide information that is not conveyed by a financial statement that summarizes past performance. Managers can issue projections reflecting private information about new developments that will generate trajectories of growth or decline that cannot be extrapolated from a company's income statement.[287]

As with other monitoring methods, projections are not always an effective way of reducing agency costs. One issue is that it can be difficult to interpret the significance of the failure to meet a projection. Missing a forecast could mean that market assumptions about a company's future earnings must be completely reevaluated.[288] On the other hand, missing a projection may only mean that there was an unanticipated setback that will not affect future earnings. Another limitation to projections as a monitoring tool is that managers can manipulate them. Managers may issue projections that are unrealistically high in order to inflate a company's stock price. They might misapply accounting standards or business decisions to meet ambitious projections to convey the impression that their strategies are successful.[289]

Because they address the problem of agency costs so effectively, projections have significantly shaped corporate purpose. The impact of projections was muted during the 1970s partly because poor macro-economic conditions reduced expectations of growth. But as noted earlier, the pressure to meet earnings expectations was significant enough by the 1970s to generate reports of significant accounting manipulation to meet analyst

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earnings. Claire Hill explains how stock markets take into account a certain level of "beautification" of earnings. Claire A. Hill, *Why Financial Appearance Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 147–48 (1997).

287. As one accounting professor observed: "since one of the manager's roles is to choose the firm's optimal production level, the firm's market value at the end of the period will be a function of investors' perceptions of his ability to anticipate future changes in the firm's economic environment and adjust the firm's production plan accordingly. While this ability cannot be directly observed by investors, the manager can provide some information about it by releasing an updated earnings forecast each period when and if the manager observes any changes that period in the firm's economic condition." Brett Trueman, *Why Do Managers Voluntarily Release Earnings Forecasts?*, 8 J. ACCT. & ECON. 53, 54 (1986); *see also* Amir Barnea, et al., *Classificatory Smoothing of Income with Extraordinary Items*, 51 ACCT. REV. 110, 110 (1976) (noting the need for management to convey "knowledge about firm's future earnings" despite "conventional accounting practices, which do not permit direct forecasts").

288. *See, e.g.*, DODD & FAVARO, *supra* note 280, at 78 (noting that "[e]arnings announcements are the latest piece of information the capital markets have for judging long-term potential"); RAPPAPORT, *supra* note 119, at 161 ("investors often see long-term implications in current information, including reported earnings, and use the latest results to reassess a company's prospects").

289. Towards the end of the 1990s, the SEC brought a significant number of cases alleging accounting fraud by public companies to meet earnings projections. *See, e.g.*, James J. Park, *Securities Class Actions and Severe Frauds*, *in* EDWARD ELGAR RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION (Sean Griffith, Jessica Erickson, David Webber & Verity Winship eds., 2018).

forecasts.[290] The influence of analyst projections increased as they became commonly made on a quarterly basis by the end of the 1980s and thus required greater attention to short-term results.[291] As valuation increasingly focused on a company's future performance, the problem of securities fraud became a significant issue for public companies.[292] It is now common for corporate managers to report that they face pressure to meet market projections.[293]

Projections created a distinction between short-term and long-term shareholder wealth maximization. As quarterly projections became the norm, companies faced pressure to meet market expectations of short-term financial performance. Managers now have an incentive to compromise the interests of stakeholders such as employees and consumers to meet market forecasts. Long-term capital investment in research and development that may produce value over time can be limited in favor of strategies that boost profits in the short term.

While there are other reasons why corporations focus on maximizing shareholder wealth, projections have been the most persistent and important. The hostile takeovers that targeted public company managers were largely stymied by the end of the 1980s with the passage of anti-takeover statutes and judicial approval of strong takeover defenses.[294] As noted earlier, the increase in equity-related compensation for executives created incentives to maximize shareholder value, but this shift did not occur until the 1990s. Linking executive pay to stock prices increased the personal incentive of managers to issue ambitious projections and meet them, but even before the 1990s, corporations made efforts to deliver smooth earnings to investors. While there is an argument that the emphasis on shareholder wealth became even more potent during the 1990s, the heightened emphasis on meeting short-term market expectations during this period can at least partly be explained by the increasing importance of quarterly (rather than annual) projections and was not solely the result of changes in pay packages. If companies were

290. George Getschow, *Slick Accounting Ploys Help Many Companies Improve Their Income*, WALL ST. J., June 20, 1980, at A1 (noting that accounting manipulation dated back to the 1960s and 1970s but had become more sophisticated).

291. *See, e.g.*, RAPPAPORT, *supra* note 119, at 3 (noting that "[c]orporate executives obsess over meeting Wall Street's quarterly earnings expectations"). The focus on quarterly reporting was not quite complete by the start of the 1980s. A survey of public companies in 1981 found that 60% prepared quarterly forecasts. *See* LEES, *supra* note 189, at 9. However, there was some pressure to deliver quarterly results even before the wide dissemination of quarterly projections. *See, e.g.*, Steve Lohr, *Overhauling America's Business Management*, N.Y. TIMES, January 4, 1981, at 6 ("their survival in office—depends on producing the steady quarter-to-quarter increase in profits that so please the financial community."). On the other hand, it is unclear that failing to meet projections will necessarily result in a change in management. *See, e.g.*, HELLER, *supra* note 278, at 234 (observing that "[m]anagements regularly survive many years of missing announced targets without much damage, even to their self-esteem").

292. *See* PARK, *supra* note 16.

293. *See, e.g.*, DODD & FAVARO, *supra* note 280, at 70 (finding in survey of 192 executives that "81 percent said they would often or sometimes be prepared to cut spending on R&D, marketing, or IT; 77 percent said they would often or sometimes delay a project to meet a short-term earnings goal, even if the project would be profitable"); John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 32–35 (2005).

294. *See, e.g.*, CHEFFINS, *supra* note 2, at 156 ("Takeovers did much to displace managerial capitalism but their impact on public company executives was rather fleeting."); Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); Guhan Subramanian et al., *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008*, 65 BUS. LAW. 685 (2010).

not valued based on their ability to meet projections, corporate managers would have had an incentive to increase the value of their stock compensation by pursuing more balanced strategies for creating shareholder value.

Even if public companies were to widely adopt corporate purpose statements de-emphasizing the importance of shareholders, many corporate managers would still have good reason to focus on increasing corporate earnings. A company that does not consistently verify projections of its performance may find that its market value will decline. Without a strong stock price, a company will not be able to access capital markets on favorable terms. Funds that could be used to pay workers higher wages, invest in R&D, open new offices, provide service to customers, and donate to local communities will not be available.

The power of performance metrics can be illustrated by considering the example of law schools in the United States. Law school deans are not indoctrinated by an ideology that they should increase the size of their libraries or increase the amount they spend on each of their students. But these metrics matter for the U.S. News & World rankings and cannot be ignored for a law school to prosper. Neglecting such metrics can result in a lower ranking, which makes it more difficult to perform well with respect to such metrics in the future. Just as metrics rather than ideology have a significant influence on the behavior of law schools, there is a case that metrics have a stronger influence than ideology in the U.S. public corporation.

U.S. stock markets are unique in their reliance on projections. For example, in Europe, public companies are generally not required to issue financial reports on a quarterly basis.[295] It is thus unsurprising that increasing shareholder wealth is not viewed by much of the world as the corporation's primary purpose. While there are other reasons why foreign public companies look after stakeholder interests, without the pressure to meet quarterly projections there is less of an imperative to focus on maximizing profits.

Perhaps the irony of the influence of projections as a monitoring tool is that they originated within the corporation. Advances in the effectiveness of internal capital markets initially justified deference to managers. Over time, as external projections became more informed because they relied on internal projections, they not only reflected managerial expertise but tested it. Projections, which reflect managerial expertise, were a significant reason why managerialism was displaced by the pressure to maximize shareholder wealth.

B. The New Managerialism?

The thesis of this Article suggests that for public companies to make meaningful commitments to stakeholders, they must somehow transcend the valuation pressures that incentivize them to focus on shareholder wealth. The influence of investors has been strong for decades now but the transition from managerialism has never been complete. Some companies are able to escape the pressure of projections and have some discretion to take a broader view of corporate purpose. Investor preferences, at least on the surface, are shifting in ways that could permit companies to emphasize social responsibility.[296] It

295. The EU has created a presumption that member states will not impose periodic reporting mandates that require filings more frequently than a semi-annual basis. This policy was based in part on the belief that quarterly reporting encourages short-termism. *See* Council Directive 2013/50, 2013 O.J. (L 294) 13 (EC).

296. *See, e.g.*, Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not*

is too early to declare that a New Managerialism has arrived but there is strong pressure for alternatives to the prevailing emphasis on maximizing shareholder wealth.

While many conglomerates were dismantled, large public companies have continued to grow through mergers and acquisitions. There was significant consolidation of financial institutions over the 1990s as banking became a national and then an international industry.[297] Technology companies have also grown larger through a combination of market power and acquisitions.[298] The ability of multi-divisional companies to deliver consistent earnings has continued to justify such consolidation.[299] As the complexity of public corporations has grown, only a handful of elite managers have the experience and ability to lead them. The sheer size of public companies also makes it difficult for shareholders to meaningfully question corporate managers.[300]

One of the most interesting developments in corporate governance has been the willingness of sophisticated investors to accept arrangements such as dual-class stock that virtually eliminates the power of shareholders to choose the company's managers.[301] Such governance structures, which have been adopted by some of the most prominent technology companies as they went public, are consistent with the belief that founders of such companies are exceptional managers with an idiosyncratic vision that requires them to operate without interference from shareholders.[302] Without the prospect of a change in control, the management of dual class companies have more freedom to pursue long-term strategies.[303]

Another important development is that investors are willing to give some public companies sufficient time to develop market power without generating profits immediately. It is now common for companies with significant losses to go public at high valuations because shareholders believe in their long-term strategy. The stock market has given companies like Amazon years to implement long-term strategies to achieve market power without maximizing profits for many years.[304]

Executives of several of the largest public companies have actively worked to

Market Value, 2 J.L. FIN. ACCT. 247 (2017) (arguing that when shareholders are prosocial that shareholder wealth maximization does not maximize shareholder welfare).

297. JAMES FREEMAN & VERN MCKINLEY, BORROWED TIME: TWO CENTURIES OF BOOMS, BUSTS, AND BAILOUTS AT CITI 11, 189 (2018).

298. TIM WU, THE CURSE OF BIGNESS: ANTITRUST IN THE NEW GILDED AGE 73 (2018).

299. For example, over the 1990s, the size and diversity of the conglomerate General Electric permitted it to reliably meet projections of growing earnings. *See, e.g.*, THOMAS GRYTA & TED MANN, LIGHTS OUT: PRIDE, DELUSION, AND THE FALL OF GENERAL ELECTRIC 20, 160 (2020); THOMAS F. O'BOYLE, AT ANY COST: JACK WELCH, GENERAL ELECTRIC, AND THE PURSUIT OF PROFIT 115 (1998).

300. While shareholder activism has increased for many public companies, it is still rare with respect to the largest public companies. One study reports that more than 80% of activist campaigns over the last five years were directed at companies with a market capitalization of below $10 billion. *See* SULLIVAN & CROMWELL, *supra* note 13, at 21.

301. *See, e.g.*, Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019) (arguing that nonvoting shares lower the cost of capital because investors who value governance will pay more for voting shares that are not diluted by shares held by investors who do not value governance).

302. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 580 (2016).

303. The benefits of long-termism might be offset by the ability of controlling shareholders to extract personal benefits from the corporation. *See, e.g.*, Albert H. Choi, *Concentrated Ownership and Long-term Shareholder Value*, 8 HARV. BUS. L. REV. 53 (2018).

304. Lina M. Khan, *Amazon's Antitrust Paradox*, 726 YALE L.J. 710, 747–53, 787–88 (2017).

undermine a system that evaluates them through short-term metrics. Warren Buffett and Jamie Dimon, both of whom head large conglomerates, proposed several years ago that companies no longer issue their own earnings forecasts to reduce the market's reliance on projections.[305] Without guidance from within the corporation, analysts would be less able to prepare informed external forecasts that companies feel compelled to meet. But such a strategy is only realistic for companies that have attained a certain level of success so that investors are willing to trust that their performance will continue.[306] For other companies, the need to use projections to signal their commitment and ability to increase earnings will continue.[307]

There is evidence that in recent years, investors have changed in ways that will permit public companies to do more to prioritize the interests of stakeholders. As shareholders have become increasingly diversified, some scholars have claimed that there is less pressure on companies to compete because investors will buy their shares regardless of their relative performance.[308] Instead of pushing companies within an industry to win market share, investors may be content with a situation where companies do not seek to disrupt the status quo.[309] The reduction of competition could harm

305. Jamie Dimon & Warren E. Buffett, *Short-Termism is Harming the Economy: Public Companies Should Reduce or Eliminate the Practice of Estimating Quarterly Earnings*, WALL ST. J. (June 6, 2018, 10:00 PM), https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801 [https://perma.cc/5P9B-2BAY]; *see also* Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution: Shareholders Are Getting Serious About Sustainability*, HARV. BUS. REV., May–June 2019, at 106 (proposing that companies "eliminate earnings guidance" and focus on explaining progress on ESG goals); RAPPAPORT, *supra* note 150, at 136 (proposing that public companies stop providing earnings guidance).

306. In times of economic turmoil when it is too difficult to project performance, markets have accepted that companies will generally not be able to provide reliable guidance. Arne Pholman & Oliver Reynolds, *Why Economic Forecasting is so Difficult in the Pandemic*, HARV. BUS. REV., May 18, 2020, https://hbr.org/2020/05/why-economic-forecasting-is-so-difficult-in-the-pandemic?registration=success [https://perma.cc/U3NL-T6Z6].

307. Indeed, the pressure of the quarterly reporting system has been great enough so that there have been proposals to end quarterly disclosure. *See, e.g.*, Dave Michaels et al., *Trump Asks SEC to Ease Earnings Reporting*, WALL ST. J., Aug. 18, 2018, at A1; David Benoit, *Time to End Quarterly Reports, Law Firm Says*, WALL ST. J. (Aug. 19, 2015), https://www.wsj.com/articles/time-to-end-quarterly-reports-law-firm-says-1440025715 [https://perma.cc/UHE4-MFAQ].

308. The concern of passivity by investors is longstanding. As institutional investors came to own a larger percentage of company shares, it became more difficult for such investors to exit their positions. Active portfolio management became difficult for such investors. *See, e.g.*, Gilson & Kraakman, *supra* note 118, at 866–67. Because investors are increasingly allocating money to low-cost index funds, the incentive for fund managers to invest in corporate governance efforts has declined. As Lucian Bebchuk and Scott Hirst have argued, because they charge lower fees, there is a greater divergence between the interests of index fund managers and investors because the managers capture only a small percentage of any gains from efforts to improve corporate governance. *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2052–59 (2019). While the lack of incentive for index funds to engage in governance can be viewed as an agency cost, it could also reflect the preferences of investors who would prefer not to pay for efforts to increase governance that may or may not impact firm value.

309. *See, e.g.*, José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1518 (2018) (observing that "not explicitly demanding or incentivizing tougher competition between portfolio firms may allow managers to enjoy the 'quiet life', and thus lead to an equilibrium with reduce competition and sustained high margins"); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270 (2016) (arguing that investors need not communicate preferences because managers understand that diversified investors will not want competition). *See generally* Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives* (Working Paper No. 511/2017, 2021),

consumers but might benefit other corporate stakeholders such as employees whose jobs are more stable without competition. In addition, the increasing number of investors who are concerned about corporate social responsibility could shift corporate policy away from immediate profitability.[310] At least on the surface, public companies must claim that they are acting in ways consistent with broader social norms.

Companies that can transcend the pressure of markets will have more leeway to make meaningful commitments to corporate stakeholders other than shareholders.[311] The Business Roundtable's 2019 statement that promised to consider the interests of stakeholders has been criticized by prominent commentators as rhetoric that will not be translated into meaningful action.[312] It is likely that such a commitment will not impact companies that are in a position where they must continue to meet short-term market expectations. But there is no reason why public companies with exceptional management teams, market power, and strong long-term strategies cannot pursue a balanced strategy that does more than focus on shareholders.[313]

There is good reason to be skeptical of the benefits of a New Managerialism, should it ever come to fruition. Some corporate managers will take advantage of discretion to allocate resources to favor their selfish interests. The dangers of short-termism should be balanced against the danger of the risk of overinvestment in long-term projects with nebulous prospects.[314] Stakeholders will compete for any rents that are generated by a company's market power.[315] It has been difficult to develop effective ways of measuring

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papers.ssrn.com/sol3/papers.cfm?abstract_id=2802332 [https://perma.cc/BK4D-DHEE] (finding executive compensation is less performance sensitive in firms with common ownership). *But see* C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392 (2020) (finding lack of empirical support for passivity argument); Menesh Patel, *Common Ownership, Institutional Investors, and Antitrust*, 82 ANTITRUST L.J. 279 (2018) (arguing that the impact of common ownership depends on the context); Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221 (2018) (raising doubts about the link between ownership and concentration).

310. *See, e.g.*, Michal Barzuza et al., *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020) (arguing that index funds will push for corporate responsibility as they market themselves to millennial investors).

311. The argument that corporate purpose should go beyond the maximization of shareholder wealth has been voiced more frequently in recent years. Professor Colin Mayer argues that "corporate law should prioritize purpose" and "require companies to articulate their purposes, incorporate them in their articles of association, and above all demonstrate how they credibly commit to the delivery of purpose." COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD 23 (2018).

312. *See, e.g.*, Stephen M. Bainbridge, *Making Sense of The Business Roundtable's Reversal on Corporate Purpose*, 46 J. CORP. L. 285, 318 (2021) (concluding that the statement "allowed a handful of social justice warrior CEOs to signal their virtue, but likely will prove to be window dressing for most"); Lucian Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 130–39 (2020) (finding that signatories of statement did not seek approval of their boards or change their corporate governance guidelines).

313. One view is that for stakeholderism to succeed, it must be voluntarily adopted by corporate managers. R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 74 (Cambridge Univ. Press ed. 1984).

314. *See, e.g.*, Michal Barzuza & Eric Talley, *Long-term Bias*, 1 COLUM. BUS. L. REV. 104, 155–56 (2020).

315. *See, e.g.*, Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. 1463, 1468 (2001); *see also* Daniel A. Crane, *Antitrust and Wealth Inequality*, 101 CORNELL L. REV. 1171, 1188–89 (2016) (noting that monopoly rents may be captured by mid-level managers and employees rather than shareholders); Khan & Vaheesan, *supra* note 100, at 242–43 (noting that workers captured monopoly rents in the past but may not have the leverage to do so today).

whether corporate decisions benefit stakeholders.[316] In catering to stakeholders, managers can lose focus and a business can squander its competitive advantage.[317]

Even if there is a danger that a New Managerialism is inefficient, so long as it mainly governs a subset of public companies, there is the potential for experimentation by firms that have the opportunity to do more than increase shareholder wealth. Large public companies may learn that they are still able to prosper without focusing entirely on relentlessly increasing profits.

Some inefficiency may be worth bearing in the name of more fairly distributing the wealth created by a successful business among stakeholders. It is worth studying whether managerialism results in meaningful benefits for stakeholders and whether law and policy should in some way support it.[318]

VII. CONCLUSION

As shareholder wealth maximization has become increasingly criticized, it is worth re-examining its origins. While changes in ideology had a role in the decline of the managerialist model, a shift in the way investors valued companies was a more significant reason why public companies became focused on shareholder wealth. The irony of the rise of shareholders over the last several decades is that it had its origins in the increasing faith markets had in the competence of managers. As managers sought to increase confidence in the earnings potential of their companies, they sought to find ways to signal that their earnings would increase over time. As internal projections became more useful, they migrated outside the walls of the corporation and became an external metric by which shareholders could ensure that managers were focusing on shareholder wealth. Notably, this system of evaluation arose through private ordering despite the opposition of the SEC.

For public companies to transcend shareholder wealth maximization, to the extent that such a move is desirable, there must be more than a change in ideology. Because prevailing valuation methods require corporate managers to demonstrate that they have the competence to generate earnings into the future, for many companies, it will not be possible to escape the need to maximize shareholder wealth. However, meeting projections is not the only way that companies can convince investors of their future earnings potential. Some exceptional companies can prosper without delivering short-term results. A New Managerialism may permit some companies to meaningfully commit to considering the interests of stakeholders.

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316. FREEMAN, *supra* note 313, at 178 (noting that the "issue of how to keep score with stakeholders is at once trivial and impossibly difficult").

317. *See* Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 1 (2001) (concluding that stakeholder focus "strikes three rocks: dearth of pledgeable income, deadlocks in decisionmaking, and lack of clear mission for management").

318. To the extent that broadening corporate purpose is a desirable goal, there is an argument against recent proposals to discourage "bigness" in corporations. *See, e.g.*, WU, *supra* note 298, at 132–33. If companies with market power can do more to consider the interests of stakeholders, it could be problematic to break-up those companies and replace them with smaller companies that will vigorously compete with each other. Such competition would have benefits such as lower prices for consumers and lessen the political power of large companies, but it would also mean that the resulting smaller companies would need to constantly focus on delivering short-term results.