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Economic Ideology and the Rise of the Firm as a Criminal Enterprise

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I. INTRODUCTION

Rarely has academic theory been as successful in changing business

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practices and public policy as it was in retooling corporate management over the last forty years. Between 1976 and the present, corporate governance has changed from a managerial system that celebrated stewardship of large business entities in accordance with the interests of multiple stakeholders to a more circumscribed vision of business enterprises as vehicles to enrich their owners. This shift in theory, law, and practice has dismantled the consensus-based management practices of the mid-twentieth century, replacing them with a much narrower focus on short-term fluctuations in share price and out-sized bonuses for the executives who engineer share price increases. The result is a resurgence of two features of the corporate world that disappeared over the previous half-century: boom-bust financial cycles and large-scale financial fraud. This Article will argue that this result is a predictable consequence of the change in executive incentives and only a multi-disciplinary approach that incorporates a criminological perspective can address the intrinsic temptation to use to the corporation as the weapon of choice for those who would become rich at others' expense.

A. Economists' Contribution to the Corporate Debate

The corporate debate is being waged simultaneously in a number of academic disciplines. Legal scholars focus on corporate law, but their analysis of corporate law has been conducted in tandem with economists almost from its inception.[1] During the Great Depression, progressives influenced both the economic analysis and the corresponding policy responses.[2] Starting in the seventies, however, the corporate debate in economics and law has been increasingly dominated by neo-classical scholars who favor a reductionist emphasis on share price and profit maximization, blind adherence to the efficient markets hypothesis as a justification for ignoring the distorting effects of concentrations in power, and a reorientation of management objectives from the firm's multiple constituents—employees, consumers, community, among others—to a single-minded focus on shareholders and short-term

1. Berle and Means' classic work, after all, paired one of the leading corporate law scholars of his era (Berle) with an economist (Means) and the economic documentation of the concentration of power in a small number of individuals was central to the work. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

2. John Kenneth Galbraith, writing in the sixties chronicled the positive effects of the reforms. *See* JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (2d ed. 1971). The first edition was published in 1967. *See also* C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 102 (2002).

maximization of share price.[3] These ideological and scholarly changes have been immensely successful in changing public and private policies, practices, and institutions.

Economists, and therefore most legal scholars, asserted three central policy propositions about corporate law. First, they posited that the proper function of corporate officials is to maximize shareholder value.[4] Second, they applauded economists' proposals to solve the "agency" problem by using modern executive compensation to "align" the interests of the CEO with the shareholders' interests.[5] Third, they argued that corporate law in federal systems, such as the United States, produced a beneficial competition for corporate chartering among the states that ensured corporate law would be self-correcting and move toward optimality.[6] If companies found that they could increase share price, for example, by adopting a charter in Delaware, presumably they would do so, and other states could be expected to respond by adopting similar provisions, further increasing share prices in the other states.[7]

These policy views spring from key assumptions about the world. The paramount metaphor of agency cost economists and legal scholars is social Darwinism—an evolutionary process in which "markets"—absent government "interference"—produce a triumph of the fittest people, institutions, and firms.[8]

Their paramount motif is that the economic world is all about risk. This means that their heroes have always been cowboys—"cowboy" CEOs that they honor as "entrepreneurs" who embrace risk and find ways to profit from it,[9] particularly when it has meant bringing in

3. *See generally* GERALD F. DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RE-SHAPED AMERICA (2009).

4. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001) (academic, business, and governmental elites shared a consensus "that ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; . . . and the market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests.").

5. DAVIS, *supra* note 3, at 20.

6. *Id*. at 48.

7. *Id.* at 67, 176 (noting that some states and countries specialize in different laws attractive to companies and that the competition for corporate friendly legal climates has become international in scope). For a view disputing the conventional description of state competition, see Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

8. DAVIS, *supra* note 3, at 33. *See, e.g.*, Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 9 (2002) (describing management competition as a "tournament").

9. The idea of risk in these critiques, when presented neutrally, often focuses on "risk management," including both excessive risk taking and complacency. *See, e.g.*, George S. Geis,

external CEOs who increase share value by dismantling worker protections and employee benefits.[10]

Their attitude toward fraud is that, absent government "interference," it is episodic and unimportant because markets make it so ephemeral.[11] Their fundamental paradox is that it is the traits despised by the world's major religions—greed and pride—that drive social Darwinism to produce a world in which CEOs reliably act as if they care about their customers and investors and to prevent fraud from becoming material.[12]

Legal scholars have debated each of these assertions, but prior to Lehman's failure, the extreme neo-classical economists, and legal academics influenced by them, dominated the debates.[13] Judge Frank Easterbrook and Professor Daniel Fischel expressed their policy views that favor the superiority of markets in deliberately stark terms. "[A] rule against fraud is not an essential or even necessarily an important ingredient of securities markets."[14] Even today, when the limitations of these theories are far more apparent, they retain their hold on corporate management.[15]

In the wake of the financial crisis, legal scholars have increasingly questioned this dominant paradigm,[16] but what has been missing is a criminological perspective.

B. Criminologists' Contribution to the Debate

White-collar criminologists ask very different questions than pro-CEO economists and tend to favor very different policies. White-collar

Business Outsourcing and the Agency Cost Problem, 82 NOTRE DAME L. REV. 955, 974 (2007). Much of the neo-classical focus, however, has been the downsides of complacency and the failure to take advantage of opportunities for shareholders that might risk management sinecures. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (finding that when CEOs enjoyed a substantial ownership stake in the company, they became more willing to entertain hostile bids or to resist acquisitions unlikely to produce a quick payoff).

10. DAVIS, *supra* note 3, at 90-91.

11. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 283-85 (1991).

12. *See, e.g.*, DAVIS, supra note 3, at 7, 211 (referring to Adam Smith's comment, which has been interpreted to explain "how an invisible hand guided market participants to provide for the well-being of others about whom they may care little").

13. Indeed, prominent law review articles proclaimed that the debate was over. *See* Hansmann & Kraakman, *supra* note 4.

14. EASTERBROOK & FISCHEL, *supra* note 11.

15. *See, e.g.*, Brian R. Cheffins, *The Team Production Model as a Paradigm*, 38 SEATTLE U. L. REV. 397, 397 (2015) (rejecting the notion that the team production model is replacing agency cost theory as a primary form of management).

16. *Id.* (discussing the team production model as a proposed new paradigm).

criminologists have developed three key concepts that explain the fraud epidemics that drive our recurrent, intensifying financial crises.

First, the frauds that drive our recurrent financial crises and cause greater financial losses than all other forms of property crime—combined—are "control frauds."[17] A control fraud is a fraud in which the persons controlling a seemingly legitimate entity use it as a "weapon" to commit fraud.[18] The issue is control, not title, but for the sake of brevity we use "CEO" rather than the phrase "the persons that control the entity." There are many forms of control fraud, but this Article focuses on "accounting control fraud." In finance, accounting is the CEO's "weapon of choice."[19]

Second, fraud becomes serious when policies create a "criminogenic environment."[20] The concept should be congenial to economists and legal scholars influenced by economics, for it looks for factors that create powerful, perverse incentives among CEOs and those that aid and abet their crimes.[21] The truly dangerous criminogenic environments produce epidemics of control fraud.

Third, CEOs can often produce criminogenic environments by creating a "Gresham's" dynamic in which "bad ethics drives good ethics" out of the markets or professions. The economist George Akerlof first identified the dynamic in his 1970 paper on markets for "lemons" that led to his being made a Nobel Laureate in 2001.

> [D]ishonest dealings tend to drive honest dealings out of the market . . . . The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.[22]

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17. *See* William K. Black, *Neo-Classical Economic Theories, Methodology, and Praxis Optimize Criminogenic Environments and Produce Recurrent, Intensifying Crises*, 44 CREIGHTON L. REV. 597, 597-98 (2011).

18. *Id.*

19. *Id.* at 597.

20. *See, e.g.*, Robert Tillman, *Making the Rules and Breaking the Rules: The Political Origins of Corporate Corruption in the New Economy*, 51 CRIM. L. & SOC. CHANGE 73, 73 (2009) (explaining why corporate environments have become "criminogenic"); *see also* William K. Black, *The Department of Justice "Chases Mice While Lions Roam the Campsite": Why the Department Has Failed to Prosecute the Elite Frauds That Drove the Financial Crisis*, 80 UMKC L. REV. 987, 1019 (2012) (explaining the term).

21. Sally S. Simpson, *Making Sense of White-Collar Crime: Theory and Research*, 8 OHIO ST. J. CRIM. L. 481, 492 (2011) ("Beginning with Sutherland, research consistently has shown that some industries are more criminogenic than others and that structural characteristics—especially those related to the political and economic environment of the market—are critical factors associated with white-collar offending.").

22. George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and*

White-collar criminologists, as this Article explains, consider the policies recommended by neo-classical economic theories to be a leading cause of criminogenic environments. The views of criminologists are the polar opposite of the dominant stream of economists on the corporate debate. The paradox is that economists and criminologists make the same core assumptions of generally self-interested conduct and generally rational behavior by corporate officers and employees—yet end up reaching the opposite conclusions.[23]

The legal debate over corporate governance rarely references criminological research or perspectives.[24] The critics of shareholder primacy focus primarily on the model's refusal to consider the interests of other stakeholders, such as consumers or employees.[25] While those who still defend shareholder primacy-use models assume that fraud is trivial and quickly excluded by markets.[26] Yet, at a time of widespread conviction that white-collar crime is pervasive and increasing,[27] this critique has had no influence on public policies relevant to constraining control fraud.[28]

From a criminologist's perspective, the criticism of "shareholder primacy" was at best peripheral, for the accounting control frauds led by CEOs frequently targeted the firm's shareholders and creditors as their principal victims.[29] Criminologists, very much like orthodox economists, tend to make the assumption that CEOs will frequently pursue their self-interest at the expense of the firm, its shareholders, and its creditors. From the criminologist's perspective, we should be so lucky that the

the Market Mechanism, 84 Q. J. ECON. 488, 495 (1970).

23. For a recent example discussing differences in the use of the rational actor model, *see* Mark Klock, *Contrasting the Art of Economic Science with Pseudo-Economic Nonsense: The Distinction between Reasonable Assumptions and Ridiculous Assumptions*, 37 PEPP. L. REV. 153 (2010).

24. The word "criminogenic," however, seems to be making its way into the lexicon. *See, e.g.*, Lynn A. Stout, *Killing Conscience: The Unintended Behavioral Consequences of "Pay for Performance"*, 39 J. CORP. L. 525, 555 (2014).

25. In this context, they do, however, discuss the negative implications for the corporation that result from "short-termism." *See, e.g.*, Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265 (2012).

26. Simpson, *supra* note 21, at 492 (contrasting criminologists' views with "the idea (more common in finance or economics) that markets will be self-correcting without intervention").

27. *See* Rachel E. Barkow, *The New Policing of Business Crime,* 37 SEATTLE U. L. REV. 435, 446 (2014) (citing polls showing that more than half the public believes that financial crime contributed to the economic crisis).

28. And some would argue, nor on corporate behavior more generally. *See, e.g.*, Cheffins, *supra* note 15 (contesting evidence of a paradigm shift in corporate behavior).

29. *See, e.g.*, George A. Akerlof & Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, 24 BROOKINGS PAPERS ON ECON. ACTIVITY 1 (1993).

CEO actually seeks to maximize shareholder value by honest means rather than maximizing his or her interests by looting the firm's shareholders and creditors.[30] Criminologists believe that we suffer from "CEO primacy" hiding behind illusory "shareholder primacy."[31]

This Article will bring together the legal, economic, and criminological discussions of corporate governance with an emphasis on the change in corporate cultures that has led to a new era of financial scandals. Part II will describe how corporations can be weapons of fraud. It will also revisit the managerial era of the fifties and sixties, a remarkable period in which corporate scandal and financial booms and busts largely disappeared. This section will also examine the rise of shareholder primacy and its success in dismantling the most effective restraints of the managerial era. Part III will consider the role criminology could play in bringing back more effective (and more honest) management practices. Part IV offers a brief conclusion.

II. THE FIRM AS A WEAPON

> [T]he corporation is always a business concern, not an industrial appliance. It is a means of making money, not of making goods. The production of goods or services, wherever that sort of thing is included among the corporation's affairs, is incidental to the making of money and is carried only so far as will yield the largest net gain in terms of money,—all according to the principal of "what the traffic will bear," or of "balanced return," which underlies all sound business, and more particularly all corporation business.

30. Akerlof and Romer described the behavior as "looting," which they described this way:

> Once owners have decided that they can extract more from a firm by maximizing their present take, any action that allows them to extract more currently will be attractive—even if it causes a large reduction in the true economic net worth of the firm. A dollar in increased dividends today is worth a dollar to owners, but a dollar in increased future earnings of the firm is worth nothing because future payments accrue to the creditors who will be left holding the bag.

Id. at 2. The "owners" to whom Akerlof and Romer referred were savings and loan owners, but the same analysis applies to CEOs in a position to extract current bonuses based on increases in share price.

31. As we will explain below, the change in the governance of corporations makes it easier rather than harder for unscrupulous CEOs to misrepresent earnings, suborn internal controls, and engage in other misconduct in order to increase their own profits at the expense of the companies' long term health. Some shareholders may also gain in the short term, while other shareholders do not. In this context, we use the term "CEO primacy" to mean management of the company to maximize the CEO's financial interest. Shareholder interests, in contrast, are incoherent because of the potential conflict between current shareholders who sell in the short term (who may gain by the CEO's behavior) and future shareholders who may be left holding the bag.

—Thorstein Veblen[32]

With the rise of industrialization came the need for larger systems of managing people and production. The large, publically traded corporation ultimately provided a large part of the answer to those challenges. But the same traits that make large corporations useful for raising capital and organizing workers also make it a potential vehicle for the unscrupulous. Capitalism thus starts not just with the celebration of the corporation but with a debate about whether it should exist at all.[33] Co-existent with the corporation's rise have been financial bubbles and busts, large-scale frauds, and egregious behavior with large-scale societal consequences.[34] The increased scale of business enterprises increased the stakes for investors and communities. In response, economists tend to focus on the upside—the potential upside from the optimal operation of business entitles—while white-collar criminology focuses on the downside. Indeed, white-collar criminology may be most usefully defined by its examination of the role of the corporation as a potential "weapon" that can be primed for criminal purposes. These two perspectives should be thought of as opposite sides of the same coin, echoing the reservations that have been with the corporation since its inception.[35]

Both are rooted in the same phenomena. England experimented with corporate structure in the early days of industrialization, and it quickly became associated with boom and bust financial scandals fueled by "control fraud" and corruption, such as the South Sea Company that so strongly influenced Adam Smith.[36] In *The Wealth of Nations*, Adam

32. Charles R. T. O'Kelley, *Berle and Veblen: An Intellectual Connection*, 34 SEATTLE U. L. REV. 1317, 1338-39 (2011) *citing to* THORSTEIN VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES: THE CASE OF AMERICA 85 (A.M. Kelly 1964) (1923).

33. *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, 314 (2013) ("In the 1890s, Americans vigorously debated whether there should be large corporations at all, and if they should be allowed to exist, how they were to be prevented from harming constituencies, such as communities and small competitors.").

34. In the United States, this was particularly true during an era called "finance capitalism," which dominated the American economy from the late 1890's through the early thirties. In describing the opposition to this movement, Gerald Davis observes, "Faceless monopolies were bad enough, but faceless monopolies controlled by a handful of bankers in New York were worse still." DAVIS, *supra* note 3, at 68.

35. *See* Stanton Wheeler & Mitchell Lewis Rothman, *The Organization as Weapon in White-Collar Crime*, 80 MICH. L. REV. 1403 (1982).

36. *See, e.g.*, John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 8, 28 (noting that because of the risks of corruption, prominent underwriters refused until the end of the nineteenth century to underwrite the common stock of industrial corporations).

Smith wrote that the directors of such companies, "being the managers rather of other people's money than of their own," cannot be expected to "watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own . . . . Negligence and profusion, therefore, must *always* prevail."[37]

Smith's pessimism came from his recognition that the advantages and disadvantages of corporations come from the suppression rather than the vindication of market mechanisms. The advantages include:

> (1) The separation of ownership and control, with the ability to raise capital from a large number of shareholders dispersing risk;[38]
>
> (2) The unlimited life of the corporation, which includes the ability to transfer ownership of the shares and/or management of the company without liquidating the enterprise, facilitating long term planning;[39]
>
> (3) The ability to secure supply chains and a trained labor force as part of a coordinated structure that does not depend on fluctuating market conditions.[40]

Corresponding to these advantages are increased opportunities for mischief that come from:

> (1) The separation of ownership and control, with those making corporate decisions unlikely to bear the financial consequences of those decisions;
>
> (2) The attenuation of moral responsibility: a local shopkeeper bears personal responsibility for shoddy products or ruthless employment practices while Donald Trump casually dismisses the bankruptcy of companies he owns as mere business decisions that have no bearing on his individual moral worth;[41]
>
> (3) The ability to disguise what is really taking place, through complex or hard to follow transactions (e.g., derivatives), arcane corporate

37. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (Glasgow ed. 1976) (emphasis added).

38. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387 (2003) (The ability to lock in investors' capital was the primary advantage over other business forms.).

39. *See, e.g.*, Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 885 (2000); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 320 (1993).

40. Blair, *supra* note 38, at 398-99.

41. And, indeed, the public may never have associated Trump or the executives under him with bankrupt companies, employment decisions, or particular business practices but for his decision to run for President.

structures (e.g., offshore subsidiaries), or disingenuous accounting that disguises a company's financial health;

(4) The capacity to manipulate timing, for example, increasing short-term earnings at the expense of a firm's long term prospects.

The tradeoffs between the advantages and disadvantages of corporate organization are amplified by the interaction with the financial system. If the sole purpose of a firm were to make goods, then the question of debt versus equity financing, use of derivatives, or exotic financial instruments might be an abstract academic exercise—or an immediately practical one. If instead, as Veblen suggested at the turn of the last century, the primary purpose of a firm is to make money, then the financial structure of the firm may be as important to its success as its productive capacity.[42] And in every era, the financial realm may offer more temptations to shave corners than the brick and mortar realm for the reasons noted above: the lack of an executive financial stake, the attenuation of moral responsibility, the lack of transparency, and the temporal separation between actions and consequences. All of these factors pose greater risks with the integration of production and finance.

Given these risks, and the considerable benefits of corporate structure, much of the literature on business associations deals with the issue of the proper incentives: how to align management and shareholder interests, how to deter fraudulent or criminal activity, and how to protect public interests in the operation of important economic sectors such as energy or transportation, the safety of workers and consumers, and the maintenance of efficient markets. The harder issue to assess is the creation of particular ethoses. Why did financial fraud lead to the Great Depression, the savings and loan debacle, and the recent financial crisis, while it is hard to point to similarly consequential business frauds between the thirties and the eighties? Even looking at just a single time period, why do some corporations, Enron[43] or Lehman Brothers,[44] embody the worst of their eras while other companies responding to similar incentives do not?

The answer that any student of business ethics will supply is the importance of company leadership and certainly the management literature emphases on the importance of executive vision and wisdom.

42. *See* VEBLEN, *supra* note 32.

43. *See, e.g.*, James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 448-49 (2004) (explaining culture of Enron).

44. *See* Black, *supra* note 17, at 1009 (describing Lehman practices leading to financial crisis).

Yet, in looking at the broad changes across different eras, the question of the alignment of interests remains controversial. How do we understand executive motivation?

The answer may be that the relationship between executive and entity is fluid, framed in broad strokes by the surrounding legal culture, the role of finance, the nature of commercial competition, and the executive's relationship to his or her own firm. These factors have changed in dramatic ways across different eras.

A. The Managerial Era[45] *and the CEO as Steward*

> Modern corporations had almost guaranteed workers and executives permanent employment, but this meant that "membership in the modern corporation becomes the single strongest social force shaping its career members in the whole hierarchy above the production line."
>
> —Harwell Wells[46]

Large-scale corporate fraud, particularly the type of financial frauds that threaten entire economies, largely disappeared in the United States from the Great Depression to the 1980s.[47] This occurred with a fundamental reorientation of the purposes of large institutions and the basis for the selection of their leadership.[48]

1. American Post-War Dominance and the Rise of the Managerial Era

The post-war era that ran from 1945 into the mid-seventies now looks like an anomaly. The United States emerged from World War II as the only major industrial power whose economy had not been devastated by the war. By itself, the United States constituted the world's wealthiest market, with few internal barriers to commerce.[49] American companies

45. Modern corporate law scholars use "managerialism" to cover "any theory of the corporation that presents the corporation as a hierarchical entity run by managers with loyalties running chiefly to the corporation rather than shareholders." *See* Wells, *supra* note 33, at 310. Wells prefers the term "heroic managerialism" to describe the immediate post-war era's optimism about the potential of enlightened managers able to govern in accordance with technocratic principles. *Id.*

46. *See* Wells, *supra* note 33, at 324.

47. *See, e.g.*, Cheffins, *supra* note 15, at 404 (noting that serious corporate scandals were "happily, rare").

48. DAVIS, *supra* note 3, at 71-77.

49. *See, e.g.*, Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 698-99 (2004) ("After World War II and the Korean War, the United States was the single, unchallenged economic superpower in the world. Large American corporations were without equal foreign competitors in many markets.").

thus had access to a large domestic market, expanding global opportunities, and relatively little international competition.[50] In retrospect, "the period from the end of the war to the late 1960s seems an economic golden age."[51]

Looking back, however, the period is also anomalous because of the conditions produced by government policies. Income inequality during this period reached a nadir, declining dramatically from the inequality of the "robber baron" era of early industrialization.[52] The same companies that dominated U.S. markets in 1900 still did so in 1960, and most of the largest companies—in 1900 or 1960—were either part of cartel-like groups with large barriers to entry (big auto, big steel) or government regulated utilities (General Electric, Ma Bell).[53]

The period is also an anomaly in terms of corporate governance. Known as the "Managerial Era," it was a period that celebrated technocratic management.[54] As Lynn Stout observes, "[C]orporate directors and professional executives—who usually worked for fixed fees and owned relatively little stock in the company—viewed themselves as stewards or trustees charged with guiding a vital social and economic institution in the interests of a wide range of beneficiaries"; they did not see themselves merely as the agents of shareholders, nor did they see their interests as defined primarily in terms of the size of their paychecks or their bonuses.[55]

By the seventies, an era of "malaise" produced by OPEC driven rises in oil prices, Vietnam era inflation, and the high interest rates designed to cure it, this management system came under attack. Today, however, a revisionist literature suggests that the system outperformed

50. DAVIS, *supra* note 3, at 317 (perception of greater isolation from competition on multiple fronts).

51. Wells, *supra* note 33, at 316.

52. *Id.* ("Between 1945 and 1973, real per capita income doubled, and to a great extent this new wealth was spread widely, as wage inequality fell sharply in the 1940s and did not begin to increase significantly again until the 1970s."). *See also* Claudia Goldin & Robert A. Margo, *The Great Compression: The Wage Structure in the United States at Mid-Century*, 107 Q.J. ECON. 1 (1992) (documenting compression in wages).

53. "As Alfred Chandler showed, many of the corporations that grew to industrial dominance by the 1910s held their commanding positions into the 1970s, which suggested that competition was not alive and well in the upper reaches of the economy. Defense spending effectively sponsored many industries, which operated less in an environment of fierce competition than as part of an 'administered economy,' with steady profits guaranteed by cost-plus contracts. Other industries, including railroads, airlines, finance, and energy production, were so heavily regulated that competition there, too, was muted at best." Wells, *supra* note 33, at 318.

54. *Id.* at 310.

55. Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE U. L. REV. 1169, 1171 (2013).

its successor, not just in terms of the greater public or employee good, [56] but in terms of returns to shareholders.[57] Between 1933, and the beginning of the New Deal, and 1976, the beginning of the assault on managerialism, the S&P 500 produced real compound average annual returns for shareholders of 7.5%.[58] After 1976, this average dropped to 6.5%,[59] and it fell further after 2000. Since 1980, bonds have arguably outperformed stocks as investments for the first time in nearly 150 years.[60]

The idea of technocratic management is often attributed to Berle and Means. They wrote that in the 1930s the most dominant corporations had power akin to a principality—or the medieval church in Europe.[61] In response, managers needed to take into account a broader set of considerations, and the authors predicted that they could ultimately be expected to evolve into a "purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning each a portion of the income stream on the basis of public policy rather than private cupidity."[62] By the 1950s, observers, including Adolf Berle, agreed that this was exactly what had taken place.[63] The transformation happened because as corporations became even more powerful and influential than they had been in the early part of the century, their CEO's social standing came to a much greater degree from their association with the institution.[64] The "corporation man" at mid-century, even in the position of CEO of a behemoth industrial organization, did not have the larger than life stature of an entrepreneurial Henry Ford nor, like hedge fund managers of today, could they walk away from a top

56. *See, e.g.*, Robert Reich, *What Happened to the Moral Center of American Capitalism?*, READER SUPPORTED NEWS (Sept. 5, 2015), http://readersupportednews.org/opinion2/277-75/32223-what-happened-to-the-moral-center-of-american-capitalism.

57. Stout, *supra* note 55, at 1178-79.

58. ROGER L. MARTIN, FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL 63 (2011).

59. *Id*.

60. Stout, *supra* note 55, at 1178-79 (citing Cordell Eddings, Say What? In 30-Year Race, Bonds Beat Stocks, BLOOMBERG (Oct. 31, 2011), http://www.bloomberg.com/news/2011-10-31/bonds-beating-u-s-stocks-over-30-years-forfirst-time-since-19th-century.html).

61. Wells, *supra* note 33, at 314.

62. BERLE & MEANS, *supra* note 1, at 356.

63. *See* Wells, *supra* note 33, at 327 (Berle spoke of "modern directors who were no longer limited to running business enterprises for maximum profit, but are in fact . . . administrators of a community system.").

64. Galbraith, *supra* note 2, at 91-92 (describing the passage of the corporation from the entrepreneur as individual to management by the "technostructure"); *id*. at 178 (noting that esteem is associated with successful corporations, not with individuals).

executive perch with millions in stock options.[65] Instead, they associated success with the rise up the corporate ladder at a single institution, and the higher they rose, the more they associated their own prestige with that of the institution they managed.[66] That prestige rested less on short-term corporate earnings than on longer-term growth and the approval of technocratic peers.[67]

Aside from bragging rights about earnings, the difference between the two eras involves fundamental differences in the definitions of corporate purposes and of the role of the CEO in managing them. Central to those differences is the concept of the firm as an entity; that is, of the large business enterprise as something more than the sum of its parts.[68] This sense of the firm is critical to the idea of stewardship; a CEO cannot have an obligation to something that is no more than a fiction. This idea of managerialism thus depends both on the idea of the firm as having interests greater than a reductive notion of the company's worth as no more than the current value of its share price *and* of a CEO having an obligation to shepherd the company's interests in accordance with some idea greater than fealty to shareholder interests.[69] Today's critics celebrate managerialism's superiority to today's system of shareholder supremacy, but without agreement on the obligations that gave the system its potency.[70] In this analysis, we focus on the factors that reduce use of the corporation to enrich its owners and managers at the expense of other parties.

2. The Managerial CEOs

The managerial period thus differed from management of large business enterprises before and since by the degree to which the CEO measured personal success in terms of something other than personal earnings and financial stature and sought to govern the company in

65. Stout, *supra* note 55.

66. Galbraith, *supra* note 2, at 153-55.

67. *Id.* at 117 (Competitive avarice "is not the sort of thing that a good company man does; a remarkably effective code bans such behavior.").

68. *See, e.g.*, Carl Kaysen, *The Social Significance of the Modern Corporation*, 47 AM. ECON. REV. 311, 313 (1957) (Management, no longer constrained by fierce competition or the need for outside capital, "sees itself as responsible to stockholders, employees, customers, the general public, and, perhaps most important, the firm itself as an institution.").

69. For a more recent description of the role of firm identity in motivating workers, *see* GEORGE AKERLOF & RACHEL KRANTON, IDENTITY ECONOMICS: HOW OUR IDENTITIES SHAPE OUR WORK, WAGES, AND WELL-BEING 59 (2010).

70. For a summary of the challenges to the shareholder primacy ideal, see Cheffins, *supra* note 15, at 422.

accordance with notions broader than earnings or profits.[71] The system was able to do so as a result of the confluence of a number of factors.

Certainly the mindset of the generation that emerged from the Depression and World War II was part of the answer. The Depression had discredited the extraordinary bonuses and executive pay of the 1920s. Indeed, the single most shocking revelation in the hearings investigating the causes of the Great Depression was the $1 million a year in income the CEO of National City Bank commanded.[72] Outsized salaries and bonuses became associated with corporate malfeasance, not capitalist success.[73]

Moreover, the economy did not fully recover from the Depression until World War II, and during the war, price controls and moral sanction limited pay increases more generally.[74] While the formal restraints ended after the war, the sense that extraordinarily high compensation was "unseemly" remained.[75] This may have been reinforced by the fact that high marginal tax rates, which increased initially because of outrage at the excesses of the twenties and which stayed high through the war and its aftermath, made salary increases less effective as a way to produce immediate wealth.[76] It was certainly reinforced by the securities laws of the thirties, which mandated disclosure of executive compensation.[77] It may also be true, however, because corporate successes were seen less as the product of an enterprising individual or a revolutionary approach than of collective efforts.[78] Indeed, John Galbraith, in his description of the management

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71. Galbraith, *supra* note 2, at 116 (on relatively modest nature of executive compensation).

72. *See, e.g.*, Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 714 (2010).

73. In *Rogers v. Hill*, the Supreme Court cited with approval a lower court opinion observing that million-dollar compensation packages were "so much beyond fair compensation for services as to make a prima facie showing that the corporation is giving away money." 289 U.S. 582, 591-92 (1933) (citing Rogers v. Hill, 60 F.2d 109, 114 (2d Cir. 1932)).

74. Indeed, "during the 1940s executive compensation at public corporations actually fell, and while it rose afterwards, from the early 1950s to the mid-1970s it grew at a sluggish 0.8% a year. Wells, *supra* note 72, at 758-59.

75. *Id.* at 758, 762.

76. *See, e.g.*, *id.* at 750 ("In 1930, an executive working in New York City making $300,000 a year would have taken home approximately $241,000; by 1940, the same salary would have yielded an after-tax income of only about $111,000.").

77. Galbraith, *supra* note 2, at 119.

78. *See, e.g.*, Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 161 (2003), observing that:

> The Great Depression brought about a vision of large businesses as entrenched behemoths whose destinies were largely independent of anyone's individual actions. The academic view largely mirrored that of the general public, which was that large businesses in the 1950s were faceless bureaucratic organizations where the guiding

practices of the era, even lauded the idea of management by committee, writing that:

> Thus decision in the modern business enterprise is the product not of individuals but of groups . . . . Each contains the men possessed of the information, or with access to the information, that bears on the particular decision together with those whose skill consists in extracting and testing this information and obtaining a conclusion. This is how men act successfully on matters where no single one, however exalted or intelligent, has more than a fraction of the necessary knowledge.[79]

Galbraith maintained further that as executives acted in groups, they had to be able to depend on each other, and because they knew each other's thoughts, actions, and levels of compensation, they could enforce personal codes of conduct. He concluded that the technostructure depended on a high standard of personal honesty and "as a matter of necessity, bans personal profit-making."[80]

The collectivist notions of the era treated management decision-making as part of a technostructure or as products of organization men.[81] Job tenure lengthened, and top management ranks tended to work their way up corporate ladders.[82] Compared to today, CEOs were more likely to stay with a single company for their entire careers, be selected from within corporate ranks, and to hold their positions for longer periods.[83]

> principle was not individual initiative but conformity at all costs, and the leaders of such enterprises, when not actively involved in stifling creativity among their subordinates, were buffoons . . . . In all of these [academic and management] models, the character and individual decision-making ability of the CEO are much less important than other industry and firm-specific factors.

79. Galbraith, *supra* note 2, at 64.

80. *Id.* at 117.

81. *Id.* at 65, 117 (referring to "good company man").

82. *Id.* at 94-95 (noting that of executives at the largest industrial and retail firms, three out of four had been with their firms for more than twenty years and that two-thirds of CEOs at a selection of large firms had also been with the same firm for more than twenty years).

83. *See, e.g.*, DRAKE BEAM MORIN, CEO TURNOVER AND JOB SECURITY: A SPECIAL REPORT 6 (2000). Between 1984 and 2000, the number of CEOs who had been in office for three years or fewer rose from 33% to 45%, while the number of CEOs in office ten years or more declined from 35% to 15%. *Id.* at 9, Table 4. *Average Tenure of CEOs Declined to 8.4 Years, the Conference Board Reports*, PR NEWSWIRE, Apr. 12, 2012, http://www.prnewswire.com/news-releases/average-tenure-of-ceos-declined-to-84-years-the-conference-board-reports-147152135.html (Between 2000 and 2011, CEO tenure declined from about 10 years to 8.4.); Snyder, *supra* note 78, at 163 ("During the 1980s, boards (at the behest of powerful institutional investors) fired up to 50% of the CEOs at America's largest companies. In search of greater shareholder profits, these boards got caught up in what Khurana calls 'messianic mania,' turning away from competent but dull insiders to motivating, flamboyant leaders who would lead the firm to spectacular growth.").

This increased with their identification with the particular company, their internalization of its ethos, and their concern for its long-term well-being—or some would argue—its size, growth, and stability rather than its short-term earnings or share prices.[84] Galbraith emphasized that, while all workers tended to identify with companies during this era, "[a]s one moves through these inner circles, identification and adaptation become increasingly important;" that is, as one reached top management, the identification with the firm became an increasingly critical factor for the exercise of discretion.[85]

Top management saw itself as loyal to the institution and saw the institution as a citizen within a larger polity.[86] Rather than seeing the interests of management and labor, private business and government, sellers and buyers as antagonist, this generation of managers saw them as interdependent; they were all in it together.[87] This mindset came partly from the times; World War II gave way to the Cold War, and the triumph of American business in not only supplying superior arms, but also in better meeting the needs of the electorate was an important part of the country's competition with the Soviet Union.[88] Many observers today reduce the managerial era to the idea that corporate leaders thought of themselves as responsible to multiple stakeholders, such as employees, customers, and communities.[89] But this misses the nature of the decision-making of the era. The managerial era did not seek the maximization of any single end, not even maximization of the collective interests of different corporate stakeholders, at least not in a reductionist sense. Instead, it involved a sense of stewardship of the firm accordance with a more holistic sense of institutional well-being. Galbraith argued that these management principles came from:

> (1) Group based decision-making as the critical factor necessary to large firms; the best decisions resulted from the combination of expertise and exchange; they could not be imposed from above;[90]
>
> (2) The identification of those engaged in discretionary decision-

84. Some argue it also tended to increase CEO concern about company size rather than profits. *See, e.g.*, Charles W.L. Hill & Phillip Phan, *CEO Tenure as a Determinant of CEO Pay*, 34 ACAD. MGMT. J. 707, 715 (1991) ("[A]s tenure grows the relationship between pay and firm size and between pay and firm risk becomes stronger and the relationship between pay and stock returns becomes weaker.").

85. Galbraith, *supra* note 2, at 153.

86. Wells, *supra* note 33, at 327.

87. *Id.* at 319-20 (describing post-war politics of consensus).

88. *Id.* at 310, 320.

89. *Id.* at 329-30.

90. Galbraith, *supra* note 2, at 70.

making with the firm, and their perception that their individual interests and the firm's interests were aligned;[91]

(3) Consistency between the perceived goals of the firm and the larger goals of society, which is another way of restating Charles Wilson's famous proclamation that as the CEO of General Motors, he had believed for years that "what's good for General Motors is good for the America"; and[92]

(4) Sufficient size to secure the autonomy of the decision-making process, both in terms of its independence from government and other external parties and its ability to secure its own survival.[93]

Ironically, in Galbraith's analysis, as firms became more powerful, management felt more compelled to exercise that power on behalf of the public good, and management's ability to do so corresponded with their relative insulation from competitive pressures, the need to raise capital from external sources, and external interference in their business decisions.[94] In a system that minimized the role of pecuniary motivations and internal competition, the era produced a high degree of corporate honesty and social consciousness. Large-scale corporate scandals and boom-bust financial cycles largely disappeared.

B. The Agency Cost Era and the CEO as Capitalist

> These executives are hyper-motivated survivors of a highly competitive tournament . . . who have proven their ability to make money while putting on a veneer of loyalty to the firm. At least some of the new breed appear to be Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions, willing to take great risk as the company moves up and to lie when things turn bad, and nurtured by a corporate culture that instills loyalty to insiders, obsession with short-term stock price, and

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91. *Id.* at 153 (describing the prerequisites for individual identification with the firm).

92. *Id.* at 161. For the Wilson quote, see MORRELL HEALD, THE SOCIAL RESPONSIBILITIES OF BUSINESS: COMPANY AND COMMUNITY, 1900-60, 276 n.8 (1970) (quoting *Excerpts from Two Wilson Hearings Before Senate Committees on Defense Appointments*, N.Y. TIMES, Jan. 24, 1953, at 8).

93. Galbraith, *supra* note 2, at 167-69.

94. Harwell Wells summarizes the observations that corporations at mid-century were unique not just because of their size, but because they were competing in oligopolistic or highly regulated markets and were insulated from intensive competitive pressures. Capable of generating capital internally, they also were independent of capital markets. Buffered from external controls, the largest firms resembled independent states: they could command an army of employees, determine what to produce, set prices, direct scientific progress, decide which communities received new investment, and even set the rate of capital expansion. Wells, *supra* note 2, at 102.

intense distrust of outsiders.

—Larry Ribstein[95]

The agency cost era, that is, the era that began with economic assault on corporate governance, dismantled the elements that brought CEOs, institutions, and society into an apparent alignment of interests. This dismantling is almost certainly a product of the intersection of ideology, changing market conditions, and the increased power of finance, making it difficult to untangle cause and effect. The net result, however, is to recast large firms in very different terms from the firms of the managerial era. Top executives, rather than model fealty to institutional views, represent external constituents such as shareholders. The interests of the firm, rather than reflecting its role as a societally significant actor answerable to multiple constituencies, have been reduced to short-term share prices alone. The firm, rather than seen as an autonomous actor freed from the immediate pressure of competitors and financial markets, is now seen as a less powerful actor subjected to them. And the concept of the firm itself, as an institution capable of defining identity and compelling loyalty, has disappeared from view.

1. Ideology and the Remaking of Corporate Governance

The remaking of large firms is almost certainly a product of a confluence of events. During the mid-seventies, the American economy hit hard times, with Dow Jones Industrial Average losing nearly half its value, due in part to the OPEC oil embargo and high rates of inflation.[96] By this point as well, other industrialized nations, which had rebuilt after the devastation of World War II, were now making inroads into American markets, particularly in critical industries such as auto and steel.[97]

Moreover, the executives climbing corporate ladders in the seventies and eighties were no longer the cautious organization men shaped by the Depression and World War II. The new generation coming of age during the relatively secure fifties and sixties felt less constrained by bureaucratic regularities and, inside corporations and without, were more eager to shake things up.[98]

95. Ribstein, *supra* note 8, at 9.

96. Stout, *supra* note 55, at 1172-73.

97. Indeed, Galbraith in the eighties admitted that he had underestimated the need to deal with foreign competition. *See* John Kenneth Galbraith, *Time and the New Industrial State*, 78 AM. ECON. REV. 373 (1988).

98. Galbraith further confessed to giving insufficient weight to the "sclerotic" tendencies of

Perhaps the most influential piece encouraging them to do so was Jensen and Meckling's "The Theory of the Firm."[99] This article denied the central importance of the firm itself as a factor determining objectives and motivating behavior. They wrote:

> Viewing the firm as the nexus of a set of contracting relationships among individuals also serves to make it clear that the personalization of the firm implied by asking questions such as "what should be the objective function of the firm," or "does the firm have a social responsibility" is seriously misleading. *The firm is not an individual*. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may "represent" other organizations) are brought into equilibrium within a framework of contractual relations. In this sense the "behavior" of the firm is like the behavior of a market; i.e., the outcome of a complex equilibrium process. We seldom fall into the trap of characterizing the wheat or stock market as an individual, but we often make this error by thinking about organizations as if they were persons with motivations and intentions.[100]

Dismissing the corporation as an entity important in itself allowed the new group of theorists to address the question of which people were the real parties in interest. Their answer was the shareholders who "owned" the corporation,[101] and they therefore returned to the work of Berle and Means to say that the central problem of corporate governance was the conflict between managers and shareholders, given the risk that the mangers would seek to advance their own interests at the expense of the corporation's owners.[102] The new school of thought was labelled "agency-cost" theory since they cast the problem in terms of the use of non-owner managers to run corporate entities.[103] In the managerial era,

bureaucracies to multiply themselves, growing unnecessarily and replicating that which had always been done. *Id.* at 376.

99. *S*ee Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976).

100. *Id.* at 311.

101. Lynn Stout objects, however, that "[s]hareholders cannot own corporations because corporations are legal entities that own themselves. What shareholders really own is a contract with the corporation, called a 'share of stock,' which carries very limited rights. Similarly, corporations are their own residual claimants, with boards of directors enjoying the legal discretion to either retain the residual or use it to benefit many different groups, including not just shareholders but also creditors, employees, customers, and the community." Stout, *supra* note 55, at 1174.

102. Finance economists claim that shareholders are the ultimate "owners" and sole "residual claimants" in corporations, which implies that economic efficiency is served when corporate directors and executives maximize "shareholder wealth" (typically measured by stock price). See EASTERBROOK & FISCHEL, *supra* note 11, at 36-37.

103. *See, e.g.*, Geis, *supra* note 9, at 959 ("[I]t is now well established that the separation of

these agents were seen as superior to shareholders and entrepreneurs in their ability to balance competing interests;[104] in the new era, they were seen as complacent shirkers, unwilling to seize opportunities for the corporation that might threaten their comfortable sinecures.[105] The abuse that had concerned Berle and Means, however, was the existence of control blocks that used corporate structure to fleece the great mass of powerless individual shareholders, a group that had grown dramatically during the stock market bubble of the twenties.[106] The agency cost theorists, however, were far more concerned about such abuses as overuse of the corporate jet, excessive compensation, rejection of hostile takeover bids that might change the company (and worse, the management),[107] and the failure to dismantle the caution and bureaucracy they associated with the managerial era.[108]

Ironically, for a group supposedly worried about excessive compensation,[109] the solution was to better align management interests with shareholders through changing executive compensation to rely more on bonuses, typically in the form of stock options.[110] In addition, the theorists sought to end large firms' relative insulation from market pressures by invigorating the market for corporate control,[111] encouraging more of a mix of equity and debt financing, and otherwise tying measures of firm health to the thing of greatest interest to

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ownership and control can unleash a wide variety of bad manager behavior, such as shirking, lavish compensation, entrenchment, and excessive risk-taking—collectively referred to as agency costs.").

104. Indeed, Galbraith has described shareholders as the group with the greatest emphasis on monetary incentives and the least identification with the firm's identity and mission. Galbraith, *supra* note 97.

105. Geis, *supr*a note 9, at 959.

106. BERLE & MEANS, *supra* note 1, at 46. Indeed, one commentator of the period observed that "the fat boys, no longer content with their ancient perquisite of milking the public, are now engaged in the dizzy and lofty job of squeezing their own shareholders dry!" Stuart Chase, Editorial, Professor Quixote, THE NATION, Mar. 9, 1927, at 264.

107. *See, e.g.*, Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95, 101 (1998); Shleifer & Vishny, *supra* note 9 (finding that when CEOs enjoyed a substantial ownership stake in the company, they became more willing to entertain hostile bids or to resist acquisitions unlikely to produce a quick payoff).

108. Geis, *supra* note 9, at 974 (identifying agency costs with "at least four broad areas of concern: (1) insufficient effort or shirking; (2) lavish compensation or self-dealing; (3) entrenchment; and (4) poor risk management").

109. *Id.*

110. See, e.g., Randall Morck et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 J. FIN. ECON. 293, 311-12 (1988); David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAN. L. REV. 611, 618 (2011).

111. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

shareholders: stock price.[112]

A powerful coalition embraced the proposals. In economics, in particular, the new theories quickly became orthodoxy.[113] As Galbraith explained, assuming that managers seek to maximize profits "simplifies the economists' lives."[114] Profit maximization is a precise standard; balancing different interests is not.[115] Its reductionist nature makes it relatively easy to model economic behavior through the use of equations and sophisticated statistical techniques.[116] Evaluating how well corporate managers balance interests or serve the corporation's long term interests, on the other hand, is a more difficult undertaking that may be impossible to quantify.[117] Academic theorists accordingly embraced this theory as "an elegant and seemingly scientific explanation of corporations that fit nicely into the law and economics methodology that, beginning in the 1980s, had begun to dominate elite law schools."[118]

For lawyers from the time of the iconic Berle-Means debate of 1930 forward, the corporate management debate had two unsatisfying alternatives: recognize corporations as serving multiple constituencies and defer to management determinations of corporate purposes or give weight to shareholder primacy as the corporation's sole legally enforceable obligation.[119] For economists, the issue went deeper. It is not

112. *See* Hansmann & Kraakman, *supra* note 4.

113. *See id.* at 440-41; s*ee also* Stout, *supra* note 55, at 1178 ("Shareholder primacy became dogma: an omnipresent belief system that was seldom questioned, rarely justified, and so widely accepted that many of those who embraced it could not even recall when they first encountered it.").

114. Galbraith, *supra* note 2, at 129.

115. Indeed, Jensen maintained that:

> What is commonly known as stakeholder theory, while not totally without content, is fundamentally flawed because it violates the proposition that any organisation must have a single-valued objective as a precursor to purposeful or rational behaviour . . . . It is logically impossible to maximise in more than one dimension at the same time . . . . [T]elling a manager to maximise [several objectives] leaves the managers with no objective. The result will be confusion and lack of purpose that will fundamentally handicap the firm in its competition for survival.

Michael C. Jensen, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 7 EUR. FIN. MGMT. 297, 300-01 (2001).

116. *See, e.g.*, DAVIS, *supra* note 3, at 51 (describing management studies tied to share price).

117. *See* Licht, *supra* note 49, 707 (Calling on management to take the interests of all constituencies into account "is essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group.").

118. Stout, *supra* note 55, at 1174.

119. *Compare* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1153 (1932) (arguing that corporations should be seen as having obligations to multiple stakeholders), *with* A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-68 (1932) (responding that obligations to multiple parties would make fiduciary duties unenforceable). *See also* Hansmann & Kraakman, *supra* note 4, at 440-41 (concluding that the debate had been finally settled).

just that economists could not model, in elegant equations, the managerial era's vision of the corporation as a social institution accountable to multiple stakeholders. Instead, they either did not see the invisible threads that tied together executives in large corporations as part of a shared enterprise, or to the extent that they did see them, they saw the threads as bureaucratic constraints that stood in way of efficiency and progress. Even in the sixties, Galbraith wrote of the economists' resistance to the very idea of non-maximizing values that stood apart from market-driven profits as a measure of value.[120]

Today, we also see the two sides (those favoring reductionist, share-priced centered measures that validate existing hierarchies versus those who favor broader, multi-faceted obligations that balance the interests of multiple constituencies) in terms of cognitive styles, with those favoring certainty and hierarchy on one side and those comfortable with ambiguity and preferring equality on the other.[121] This makes corporate theory a site of ideological division. However, it also has remade the interest-based relationships associated with business entities, separating the interests of shareholders and management from those of other stakeholders.

2. The CEO as shareholder

Perhaps the most consequential change to come from the new movement was the change in the role of the CEO. A shift in the nature of executive compensation was instrumental in the change.[122] Executive compensation, which in the managerial era had not been particularly generous, became dramatically more so.[123] Between 1980 and 1994, use of stock options grew by 683%, with the average grant to the top executive rising from $155,000 to $1.2 million[124] and continuously growing after that. Between 1993 and 2014, the percentage of CEO compensation attributable to incentive pay increased from 35% to

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120. Galbraith, *supra* note 2.

121. Licht, *supra* note 49.

122. The other major factor was the wave of corporate takeovers in the eighties, fueled by the Reagan Administration's changes in anti-trust policy. That wave ended, however, in the nineties without a major shift in corporate behavior or practices, so we will not discuss it here. It nonetheless contributed to the shake-up in management attitudes as companies whose share prices were seen as low or underperforming became takeover targets. *See* DAVIS, *supra* note 3, at 84-86 (describing the effect as a corporate "bust-up" that shocked corporate America and contributed to the instantiation of shareholder primacy).

123. *See, e.g.*, Dallas, *supra* note 25, at 320-21.

124. Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1378 (2002).

85%.[125] During the same period, average worker pay stagnated.[126] By 2013, the pay ratio between CEOs and average wage workers was 331:1 and the pay ratio between CEOs and minimum wage workers was 774:1.[127] Executive compensation increased dramatically, and as the value in executive stock options fluctuated in accordance with share price, their personal interests corresponded more closely with those of shareholders—and less so with those of other corporate stakeholders.[128]

The change in compensation was not the only factor changing executive perspectives. In the managerial era, executives typically spent their entire lives at a single corporation. In the new era, companies "increasingly sought outside CEOs rather than promoting them from within."[129] During the same period, management tenure declined,[130] and CEOs faced greater risk of dismissal, particularly if share prices did not increase, than they had during the managerial era.[131]

The combination of winner-take-all compensation systems, in which top performers earned outsized bonuses, shorter employment tenure, and greater insecurity succeeded in changing management orientation. It also undermined the links between executives and firms. Larry Ribstein described the emergence of a new breed of executives who are the "hyper-motivated survivors of a highly competitive tournament."[132] These executives, socialized to believe that their out-sized compensation packages are a measure of their worth, have the proven "ability to make money while putting on a veneer of loyalty to the firm."[133] In this world, the marker of the success is not the quality of their stewardship or the health of the companies, but the size of executive bank accounts,[134] accounts they keep when they leave top

125. Stout, *supra* at note 24, 533.

126. JUNE CARBONE & NAOMI CAHN, MARRIAGE MARKETS: HOW INEQUALITY IS REMAKING THE AMERICAN FAMILY 46 (2014).

127. *Executive Paywatch: High Paid CEOs and the Low Wage Economy*, AFL-CIO, http://www.aflcio.org/Corporate-Watch/Paywatch-2014 (last visited June 12, 2015).

128. Dallas, *supra* note 25.

129. DAVIS, *supra* note 3, at 50-51.

130. Between 2000 and 2011, CEO tenure declined from about 10 years to 8.4. *See Average Tenure of CEOs Declined to 8.4 Years, the Conference Board Reports*, *supra* note 83.

131. Executives also faced greater risk of dismissals if stock earnings did not increase. *See* Andrew C.W. Lund & Gregory D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 695 (2011) (indicating that CEO terminations can be linked to share price performance); DAVIS, *supra* note 3, at 106 (indicating that the same is true for the CEOs of the largest banks).

132. Ribstein, *supra* note 8, at 9.

133. *Id.*

134. *See, e.g.*, Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 717-18 (2005) ("CEO pay

positions after what may be relatively short periods in the CEO chair.

3. The Resurrection of Finance

Reinforcing the change in executive orientation was the increased importance of finance. A hallmark of the managerial era was the insulation of large corporations from the need to raise capital by their ability to finance their own projects through use of retained earnings.[135] Jensen and Meckling argued that not only equity, but debt financing increased market ability to monitor management performance.[136] Indeed, in the nineties, Jensen argued that increased debt would speed the departure of inefficient dinosaurs from the corporate scene.[137] Since the original Jensen and Meckling article in the seventies, the influence of the financial system generally has increased.

By the end of the twentieth century, the powerless individual investors that concerned Berle and Means had largely given way to institutional investors. The cost of investing in mutual funds had declined significantly,[138] and when employers began to shift from defined benefit to defined contribution plans in the eighties, the role of such funds greatly expanded.[139] The percentage of households with stock market investments increased from 20% to 52% between 1983 and 2001, fueling the stock market boom of the nineties.[140] By 2005, three-quarters of the average large firm's ownership was in the hands of institutional investors.[141] These investors, however, have not necessarily played an outsized role on corporate boards.[142]

After 2000, however, mainstream institutional shareholders began offering backing for hedge fund activists, "which set the stage for hedge funds to emerge as meaningful governance players."[143] Brian Cheffins writes that the hedge funds activists today compel executives in

is the most significant validation and form of recognition a chief executive receives, and high pay is more salient than other possible measures of a CEO's success and value to the firm.").

135. Wells, *supra* note 2.

136. Jensen & Meckling, *supra* note 99.

137. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 847 (1993) ("In industry after industry with excess capacity, managers fail to recognize that they themselves must downsize; instead they leave the exit to others while they continue to invest. When all managers behave this way, exit is significantly delayed at substantial cost of real resources to society.").

138. DAVIS, *supra* note 3, at 212.

139. *Id.*

140. *Id.* at 213.

141. *Id.*

142. Cheffins, *supra* note 15, at 427.

143. *Id.* at 430-31.

American public corporations to treat shareholder value as an even higher priority than they did in the late nineties.[144] These investors target what they see as underperforming companies.[145] They typically acquire a sizeable holding in a publicly traded company and then agitate for increased emphasis on increased share prices, stock buybacks, a one-off dividend payments, or the sale of weak divisions.[146] Sometimes, they even press for liquidation of the company.[147] Activist influence increased after the financial crisis, though companies have won some victories in the courts,[148] and other entities avoid hedge fund influence by refusing to take their companies public.[149]

4. Corporate Culture Remade

These changes have fundamentally remade corporate cultures and the relationship between top management and the rest of the firm.

The immediate effect is on the identity of a CEO. Top executives shift from a focus on stewardship of an institution in which they feel a part to competitors in a tournament in which they are expected to display their financial prowess.[150] CEOs think of their high pay as a sign of their success, and seek out the actions that generate high pay as validating their proficiency, as a necessary part of good management.[151] Troy Paredes argues that the result breeds overconfidence—and egotism, hubris, and arrogance.[152] In the managerial era, corporate decisions came from consensus based procedures.[153] In the new era, new CEOs, often brought in from outside and paid more than insiders because of their supposed superiority, can dictate outcomes.[154] The CEO often does so

144. *Id.* at 419.

145. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 75, 80-82 (2011).

146. *Id.* at 53.

147. *Id.*

148. Cheffins, *supra* 15, at 425.

149. *See* Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of "Nexus of Contracts" Theory*, 109 MICH. L. REV. 1127 (2011).

150. Ribstein, *supra* note 8.

151. Paredes, *supra* note 134, at 717-18.

152. *Id.* at 675. *See also* Dallas, *supra* note 25, at 321 ("Studies show that when power within an organization becomes more centralized in a CEO, politics within the organization increases, resulting in the CEO receiving less critical feedback and thus becoming less accountable.").

153. Indeed, observers continue to find, as Galbraith did, that "a committee is actually a more efficient way of running a large and complex modern corporation than relying on a powerful and charismatic leader." Dallas, *supra* note 25, at 322.

154. Paredes, *supra* note 134, at 686 (emphasizing the CEOs ability to command deference).

through command of the firm's internal incentive system, with the highest bonuses and recognition going to those who advance the CEO's agenda.[155] The CEO has a strong incentive to do so in a way that focuses on short term share prices. Lynne Dallas writes that "[t]he new managerialism is characterized by . . . corporate decision making that involves second guessing stock market reactions. This environment often encourages a short-term focus that ignores the underlying economic health of the corporation to the detriment of the long-term interests of shareholders and other stakeholders."[156]

Empirical studies confirm the result. Dallas reports that in a 2005 survey of 401 financial executives, they confirmed that they would take action that decrease the value of their firms to meet earnings expectations.[157] Over 80%[158] of the executives said they would decrease discretionary spending, such as advertising expenses, maintenance expenses, and research and development expenses, to meet earnings targets. Over 50%[159] would delay a new project to boost apparent earnings even it added to the firm's overall expense or otherwise did not

155. Within the corporate law literature, there is substantial disagreement about the relative roles of the CEO and the Board and the respective power allocated to each of them. This debate, however, is tangential to the questions presented here. Both CEOs and Boards tend to favor the emphasis on short term changes in share price, and powerful Boards often tend to increase the pressure on the CEO to focus primarily if not exclusively on share price. Accordingly, while some Boards may constrain CEO self-dealing or overt criminality, most contribute to the change in corporate culture described in this article, even if they have a degree of independence. Moreover, Boards, which tend to include a mix of executives of other corporations and institutional or activist investors, often know each other and share similar perspectives and interests even if the CEO did not choose them. Corporate boards thus tend to reinforce the tendency to see corporations as tools to advance shareholder interests, and they increase the CEO's identification not with the company, its employees, or customers, but with the investor class that dominates corporate boards. The net effect that CEOs have relatively more power than they did in the managerial era to advance the interests of shareholders at the expense of other stakeholders and simultaneously less power, in most corporations, to make decisions that advance long term corporate interests (or the interests of multiple stakeholders) at the expense of short term share prices because they face increased risk that they corporate boards will replace them if they do so. *Compare* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (arguing that the increased power of CEOs vis-à-vis boards explains the increase in executive compensation), *with* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS (2002) (maintaining that independent boards increase CEO compensation as part of the search for CEOs who will boost share prices for the benefit of institutional investors). *See also* DAVIS, *supra* note 3, at 96-99 (on "American cronyism" and the tendency of boards to protect their own, even when engaged in wrongdoing).

156. Dallas, *supra* note 25, at 320-21.

157. *Id.* at 280 (citing John R. Graham et al., *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYSTS J. 27, 27-28 (2006)).

158. *Id.* (citing Graham, *supra* note 157, at 31).

159. *Id.* (citing Graham, *supra* note 157, at 31).

advance the company's interests.[160] Nor is the result limited to financial firms. Another study looked at 6,642 companies during the period from 1986 to 2005.[161] These firms also increased reported earnings by cutting support for research and development and marketing. [162] Professor Mizik, who conducted the study of non-financial firms, divided them into two categories: myopic (because of their focus on only near-term results) and non-myopic.[163] He found that any initial benefit to shareholders from the myopic behavior was outweighed by the under-performance of these firms in the following four years.[164] Yet, "contrary to the efficient market hypothesis," the firms' share price did not take the long (or even medium) term negative effects into account in valuing share stock prices; instead, it rewarded the myopic behavior if they produced an increase in reported earnings.[165]

The interaction between institutional investors, hedge fund activists, and corporate management increases the effect. Dallas reports, that over the last decade, "technological changes and a decline in transaction costs per trade have fueled an increase in trading volume, an increase in stock turnover, and a decline in stock holding periods."[166] From 2005 to 2009, daily trading volume in NYSE-listed stock increased 181%, from 2.1 billion shares to 5.9 billion shares.[167] Professionally-managed mutual funds trade more frequently than individual accounts, and hedge funds trade at double the rates of the mutual funds.[168] It is therefore unsurprising that the average holding period of stock has significantly declined from seven years in 1960 to two years in 1992 and seven and one-half months in 2007.[169] For hedge funds the holding periods are even less.[170] Traders who do not intend to hold stocks are, in effect, speculating on short term fluctuations in share price, and managers know that they can boost share prices on at least a short term basis by manipulating earnings, share buybacks, firm announcements, and other matters that affect the traders' beliefs about the company rather than long term fundamentals.[171]

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160. *Id.* at 280-81.
161. *Id.* at 280.
162. *Id.*
163. *Id*.
164. *Id.* at 280-81.
165. *Id.*
166. *Id.* at 297.
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id*.
171. *Id.* at 297-98.

All of these factors increase the incentive to "cheat." The more that transient shareholders dominate share ownership, the greater the likelihood that a firm will misreport financial information and weaken the firm's internal controls.[172] Even without outright lying or misrepresentation, the reorientation of companies toward an emphasis on short term share prices increases the incentives to take actions that are not necessarily in the companies'—or the nation's—interests. Corporations, for example, have dramatically increased their tendency to buy back outstanding shares, almost entirely for the purpose of boosting short term share prices. The result makes the corporation less able or willing to invest in new facilities or equipment that might boost production.[173] Companies also have been eager to lay off employees when the layoffs boost corporate bottom lines, even if the company will need similar employees in the future and it may cost more to rehire similar workers later.[174] These actions often have long term negative consequences for firm health.[175] They can contribute to financial "bubbles," as a rising market may increase speculative activity and the temptation to manage earnings even further,[176] which makes financial markets more volatile. They also lower the quality of the information on which trades are based.

III. A CRIMINOLOGICAL PERSPECTIVE

A. Criminology vs. Economics

The divide between economic and criminological views of the corporation transcends corporate governance. These broader policy implications are powerful and, we will argue, immensely destructive. The shift in the corporate debate from one grounded in facts to one

172. *Id.* at 305. Indeed, an empirical analysis of different equity based incentives shows that while this behavior may not be consistent with the efficient markets hypothesis, it is consistent with the economic theory of crime. *See* Shane A. Johnson, Harley E. Ryan, Jr. & Yisong S. Tian, *Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter*, 13 REV. FIN. 115, 115 (2009) (Managers with larger linear incentives may be more likely to commit fraud in an attempt to avoid severe price declines.).

173. William Lazonick calls stock buybacks "weapons of value destruction" and argues executives who make these corporate allocation decisions use stock buybacks to boost their companies' stock prices and manage quarterly earnings "because, through their stock-based pay, they are personally incentivized to make these allocation decisions." *See* William Lazonick, *The Financialization of the U.S. Corporation: What Has Been Lost, and How It Can Be Regained*, 36 SEATTLE U. L. REV. 857, 888 (2013).

174. For an explanation of these changes, *see* DAVIS, *supra* note 3, at 90-91.

175. Dallas, *supra* note 25, at 305-06.

176. *Id.*

based on ideology has undermined the integrity of American institutions[177] and is central to the change in corporate culture.[178] The neoclassical economic and criminological views diverge on the following issues:

First, "markets" are self-correcting absent government "interference." Criminology instead looks at the structural factors that contribute to criminality, whether they come from government *or* the private sector.[179] This analysis has been successful in reducing street crime, and it assumes that the existence of laws—and the government role in enforcing them—is an important factor in the level of crime and fraud.[180] Indeed, even defenders of the rational actor model agree that "fraud destroys markets,"[181] and criminologists tend to see fraud prevention, like other types of crime prevention, as a matter or appropriate policing.[182] From this perspective, the reduced role for financial regulators that preceded the financial crisis was the equivalent of taking the cops off the beat.[183] George Akerlof received a Nobel Prize in Economics in large part for a paper showing that the predictable response to pervasive fraud is a "lemons market" in which the market "corrects" for fraud by permanently reducing prices in the entire market—or in other cases destroying the market altogether.[184]

Second, regulation is almost certainly unnecessary and harmful. Indeed, former Federal Chairman Alan Greenspan, who confessed that he was "blinded by ideology," in the run up to the financial crisis simply did not believe in regulation and therefore refused to intervene in the face of numerous appeals to do something about the predatory lending

177. Berle, for example, co-authored with an economist because it allowed him to present an empirical analysis of the corporate practices that led to the Great Depression. *See* BERLE & MEANS, *supra* note 1.

178. *See* DAVIS, *supra* note 3, at 245-46 (describing the cynical belief of corporate executives that they can create their own realities and boost short term shares prices if they can convince investors to believe the company's hype about future prospects).

179. Simpson, *supra* note 21, at 492.

180. *See, e.g.*, Barkow, *supra* note 27 (comparing community policies strategies with approaches to white collar crime).

181. *See* Klock, *supra* note 23, at 182.

182. *See* Barkow, *supra* note 27.

183. *See* Black, *supra* note 20, at 993 (2012) ("Each of our recent financial crises has been triggered by deregulatory efforts that simultaneously remove structural restraints, regulatory tripwires that deter the development of imprudent (and ultimately fraudulent) practices, and enforcement resources. I call these the three 'de's': deregulation, desupervision and decriminalization. The result allows control frauds to grow unchecked.").

184. *See* Akerlof, *supra* note 22, at 489-90 (introducing the lemon analogy in the context of car sales); DAVIS, *supra* note 3, at 170 (on the importance of legal and corporate governance institutions to the existence of stock exchanges).

and other abuses that contributed to the housing bubble.[185] In contrast, white-collar criminology sees effective regulation as a tripwire that identifies and corrects problems before they grow out of control, contributing to confidence in markets.[186] In this sense, if regulators are the equivalent of the cops on the beat, regulations are the equivalent of the traffic laws and the traffic lights kept in good working order.

Third, inequality is highly desirable. Inequality is essential to ensure that employees and officers have the correct incentives to excel.[187] Inequality is necessary to produce a "hyper-meritocracy."[188] Inequality is also vital to limit the CEO's perverse incentive to loot the firm or otherwise abuse the shareholders. Indeed, economist Roger Myrson, in his Nobel lecture, claimed that only CEOs of "great" wealth are likely not to abuse "their" firms and shareholders.[189] The paramount defense of economists of modern executive compensation, mentioned above, is that the dramatic increase in CEO compensation has "aligned" the interests of the CEO and the shareholders and minimized "agency" concerns. Instead, the opposite is true. The managerial era, whatever its limitations, was an era of relative equality that produced a greater emphasis on one's reputations within corporate circles.[190] Top executives, while paid well, were not paid that much more than others by today's standards.[191] Most studies find, however, that non-monetary incentives work better than monetary ones in promoting group cohesion and restraining fraud[192] and that increased emphasis on financial incentives creates a culture of "greed" that attracts individuals more likely to believe that they are justified in doing whatever is necessary to

185. *See* June Carbone, *Once and Future Financial Crises: How the Hellhound of Wall Street Sniffed Out Five Forgotten Factors Guaranteed to Produce Fiascos*, 80 UMKC L. REV. 1021, 1053 (2012).

186. *See* Barkow, *supra* note 27; WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY (2013).

187. *See, e.g.*, Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1590-91 (2005) (explaining some positive benefits of tournaments in firms).

188. *See, e.g.*, Stout, *supra* note 24, at 532 (describing views that the relative lack of bonuses and monetary incentives during the managerial era were hopelessly backward and inefficient).

189. Roger B. Myerson, *Prize Lecture: Perspectives on Mechanism Design in Economic Theory*, NOBELPRIZE.ORG (Dec. 8, 2007), http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2007/myerson-lecture.html.

190. *See* Goldin & Margo, *supra* note 52; Stout, *supra* note 24, at 532-33 (on corporate performance during the managerial era).

191. Stout, *supra* note 24, at 532.

192. *See, e.g.*, AKERLOF & KRANTON, *supra* note 69, at 59 (2010); LYNN STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE 169 (2010).

prosper.[193]

Fourth, power is not a legitimate subject of economic inquiry. For economists, the rise of crony capitalism is a political issue.[194] In contrast, Berle and Means and Galbraith made power a central focus of analysis.[195] Attitudes toward power help explain a central dilemma in the corporate governance debate. Those who favor shareholder primacy see other theories as indeterminate or impractical because of the lack of a precise standard.[196] On the other hand, those who favor managerialism want managers to balance various corporate interests.[197] While they may agree that the standard is less pristine, they wish to equip managers to push back against other players in the name of the corporation.[198] Rather than see these other players (such as activist shareholders) as the product of impersonal market forces, they see the other interests as having "power" and therefore the ability to rig the rules of the market to advance their own interests. Today, a primary example may be hedge fund managers, who have sufficient political clout to have gained favorable tax treatment of their earnings, who use the combination of technological advances and regulatory evasion to obscure the nature of their trading activities, and who have formed the right political and business alliances to be able to pressure corporate boards and managers.[199] Shareholder primacy theorists either see the activist investors as enforcing market discipline or predict that the market will find ways to counter their activities. Those who analyze the same developments in terms of power relationships, however, see the hedge fund managers as acquiring power to advance their own interests at the expense of others through the combination of tax subsidies that give them a competitive advantage over unsubsidized entities and the ability to subvert the transparency on which financial markets have been based since the passage of the security laws. Without their political power, the

193. For an excellent description of these effects, see Stout, *supra* note 24, at 553 ("[A]ccording to crowding out theory, . . . associating a particular kind of behavior or interaction with monetary payments changes the social context, making the interaction look like a market transaction in which purely selfish behavior is deemed appropriate."); *see id.* at 558 (firms that offer large financial incentive are more likely to attract selfish opportunists).

194. *See* DAVIS, *supra* note 3, at 96-98 (describing the replication of the small number of executives controlling American corporations and their relationship to each other).

195. *See, e.g.*, JOHN KENNETH GALBRAITH, AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER 196-200 (1952).

196. *See* discussion *infra*.

197. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 292-309 (1999) (discussing the nature of directors' duties).

198. *See id.*

199. *See* Cheffins, *supra* note 15.

SEC, rather than the market, would reset the rules of the road. Managers who identified with their companies rather than their offshore bank accounts might also have been more inclined to oppose the activists. The balance of competing interests, seen in light of the power relationships, both underscores the hollow nature of short term share price as an appropriate measure of firm interests (because the existence of powerful unregulated entities distorts the markets' price mechanisms) and substitutes a different measure of firm interests, one that underscores the need to be able to strengthen the firm against hostile forces.

Criminology seeks to identify the way these factors create criminogenic environments that make fraud more likely. Executive compensation has been a major factor in priming corporate cultures for fraud. Lynn Stout writes:

> Pay-for-performance schemes can create criminogenic environments that first tempt honest individuals into unethical or illegal behavior, then invite them to adopt looser views about what is unethical or illegal in the first place. It is sometimes said in the business world that pressure makes diamonds. We should bear in mind it also makes felons.[200]

B. The Peace Bridge that Became the Bridge to Nowhere

Prominent economists, lawyers, criminologists, and regulators knowledgeable about accounting fraud came together in 1993 in a multi-disciplinary collaboration that produced the first meaningful economic model of control fraud. The famous 1993 article by George Akerlof and Paul Romer had a title that captured the mutual thesis—"Looting: The Economic Underworld of Bankruptcy for Profit."[201] Akerlof and Romer ended their article with a paragraph addressed to their fellow economists in order to emphasize their key message to their discipline.

> Neither the public nor economists foresaw that the [S&L deregulations] of the 1980s were bound to produce looting. Nor, unaware of the concept, could they have known how serious it would be. Thus the regulators in the field who understood what was happening from the beginning found lukewarm support, at best, for their cause. Now we know better. If we learn from experience, history need not repeat itself.[202]

200. Stout, *supra* note 24, at 555.
201. Akerlof & Romer, *supra* note 29, at 60.
202. *Id.*

Given the prominence of the scholars from multiple disciplines and the great success of the savings and loan regulators in responding to the fraud epidemic that drove the second, far more destructive phase of the debacle, there was real hope that Akerlof and Romer's work would serve as a bridge between the economists and the criminologists and financial regulators. Unfortunately, Akerlof and Romer's belief that economists now "know better" proved unduly optimistic. Economists overwhelmingly ignored the multi-disciplinary collaboration and drove anti-regulatory policies that "were bound to produce looting."[203] Effective regulators were replaced with senior anti-regulators who ignored the warnings of "the regulators in the field who understood what was happening from the beginning . . . ."[204] The results were catastrophic.

C. The Productive Development in the Legal Academy—Critiques of Executive Compensation

Prior to Lehman's failure, one powerful critique of a central pathology of the pro-CEO economic policies arose in the legal academy. The legal academy began to document that the claim that CEOs designed their compensation systems to "align" their interests with the shareholders was false.[205] Instead, as we discuss, the data confirmed criminologists and regulators' observation that modern executive and professional compensation was crafted to create perverse incentives that magnified the propensity of CEOs, other corporate officials, and "independent" "professionals" to act in criminal and abusive fashions. Unfortunately, these data did not lead to any change in policy.[206]

One of the more remarkable transformations has been Michael Jensen's agreement that the modern compensation principles he fathered have in fact proved counterproductive.[207] Michael Jensen is one of the world's best-known finance experts and the intellectual father of modern executive compensation.[208] In a transformation that is close to unique by

203. *Id.;* Black, *supra* note 186.

204. Black, *supra* note 186.

205. *See, e.g.*, Stout, *supra* note 24 (describing literature).

206. *Id.* at 536 (noting that would-be reformers, rather than question the effectiveness of ex-ante financial incentives, have called for recalibration and greater use of incentives).

207. Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 44-45 (Harvard Bus. Sch., Working Paper No. 44, 2004), http://ssrn.com/abstract=561305 (discussing how equity-based compensation led to unwise acquisitions, increased risk, aggressive accounting, and even corporate fraud).

208. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (1990).

such a prominent scholar, Jensen has become a powerful critic of his progeny on the grounds that it creates perverse incentives that are so powerful that they make wealth-minimizing behavior by corporate officials the norm.[209]

The massive number of fraud convictions of elite corporate officers and accompanying investigations arising from our two prior financial crises—the savings and loan debacle and the Enron-era frauds—ended any real debate as to the causes of those crises.[210] In the current crisis, however, the initial assertion by the Obama administration was that fraud was not a material contributor to the crisis. Pro-CEO economists and law and economics scholars made the same claim.[211] Most economic studies failed to even consider fraud.

The claims that the market cannot produce fraud, however, are now rarely made. Scores of investigations have documented hundreds of thousands of felonies harming hundreds of trillions of dollars in transactions.[212] Criminologists have documented the three epidemics of accounting control fraud (appraisal fraud, liar's loans, and the fraudulent sale of fraudulently originated loans through fraudulent "reps and warranties") that hyper-inflated the residential real-estate bubble and drove the financial crisis. We show that younger economists, typically from very conservative worldviews, have now published a series of studies confirming the endemic nature of the frauds led by the lenders.[213] These studies generally do not investigate why the lenders engage in the frauds, but the chasm between the criminology and the economics and law and economics literatures on corporations may be closing.

209. *Id*.

210. *See* H.R. REP. No. 101-54(I), 301 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 97; 1990 WL 111608, at 1 (statement of the Hon. Nicholas Mavroules of Massachusetts) ("[T]he savings and loan scandal has rapidly become a powerful example of flagrant abuse of trust and leadership. Financial criminals must be brought to justice and their inequities should not be paid for by the American people.").

211. Indeed, one of the Republican Commissioners on the Commission charged with investigating the causes of the financial crisis absolved Wall Street and placed the blame for the crisis solely on government policies to boost home ownership. *See* Carbone, *supra* note 185, at 1052.

212. In particular, *see* FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 198, 343 (2011).

213. *See, e.g.*, Johnson, Ryan & Tian, *supra* note 172 (Managers with larger linear incentives may be more likely to commit fraud in an attempt to avoid severe price declines.).

D. The Contribution to the Corporate Debate by Other Academic Disciplines

Management, accounting, and business ethics scholars also have a literature that deals with issues and policies that overlap with the matters that economists, legal scholars, and criminologists research. Criminologists find each of these contributions to be useful even when they disagree with the policy views and theories. Business ethicists tend to stress "tone at the top"—but almost invariably assume implicitly that the CEO who sets such a tone will set a lawful tone. Management scholars have an active literature praising narcissism as a positive trait for a CEO.[214] Criminology has long identified narcissism as criminogenic.

The accounting literature is also a hidden gem that is too often ignored by economists and law and economics scholars.[215] It takes fraud by corporate leaders seriously. Unfortunately, there is very little[216] multi-disciplinary work by economists in collaboration with accountants or criminologists.

IV. CONCLUSION

Large business enterprises in the United States have been remade as vehicles designed to enrich senior executives and outside investors who may hold own stock for relatively short periods. Despite increasing literature on the negative effects of these changes, no proposals for reorientation of corporate culture have taken hold. Stout and Blair's work in the late nineties has been enormously influential within the academy, and their critique of corporate practices has been widely influential, but there is little evidence of a coalition forming to implement their proposals. Instead, most of the debate remains mired in the question of which management teams do a better job of raising share prices rather than creating alternative or more holistic measures of management performance. The time has come to realize that the solution

214. *See, e.g.*, Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, the Inevitable Cons*, 82 HARV. BUS. REV. 92 (2004).

215. *See, e.g.*, DAIN C. DONELSON, MATTHEW EGE & JOHN M. MCINNIS, INTERNAL CONTROL WEAKNESSES AND FINANCIAL REPORTING FRAUD (2015).

216. *See, e.g.*, PETERSON K. OZILI, FORENSIC ACCOUNTING AND FRAUD: A REVIEW OF LITERATURE AND POLICY IMPLICATIONS (2015) (summarizing accounting literature and noting its lack of influence on policy). For recent interdisciplinary explorations of accounting fraud, see David J. Cooper, Tina Dacin & Donald Palmer, *Fraud in Accounting, Organizations and Society: Extending the Boundaries of Research*, 38 ACCT. ORG. & SOC'Y 440 (2013) (discussing need for research that goes beyond the typical accounting discussion that focused on fraud detection).

lies not with corporate governance specialists, but with a broader interdisciplinary examination of human motivation and healthy communities.