

From Managers to Markets: Valuation and the Shareholder Wealth Paradigm

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The shareholder wealth paradigm displaced a managerialist model where investors deferred to managers with the expertise to efficiently allocate resources within the firm. The corporate managers who administered such internal capital markets faced less pressure to increase profits than they do today. The conventional explanation of the transition from managerialism to shareholder wealth maximization points to changes in ideology favoring shareholders. This Article argues that a more significant cause of the decline of the managerialist model was a fundamental shift in the way that investors valued companies. As the ability of public companies to internally forecast their performance improved, investors became more confident in predicting the trajectory of corporate earnings. As stock prices increasingly reflected the present value of the company's future performance, it became more important for public companies to demonstrate that their earnings would increase. One way of doing so has been to consistently meet financial projections. Rather than mainly reflecting ideology, shareholder wealth maximization is part of the structure of markets that value stocks based on their future earnings. As investors have recently shifted their valuation methods to deemphasize immediate profitability, some companies may gain more discretion to make meaningful commitments to stakeholders.

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INTRODUCTION

For decades, stock markets have evaluated public company managers based on whether they are maximizing shareholder value. But that was not always the case. As U.S. public corporations came to dominate the economic landscape after World War II, leading economists and commentators observed that corporate managers were not compelled to maximize profits. This managerialist era was characterized by investor deference to managers of large companies who saw themselves as trustees with duties to balance the interests of various corporate stakeholders. In recent years, there has been renewed interest in moving away from the shareholder wealth paradigm.¹

¹ For example, in the fall of 2019, members of the Business Roundtable, an organization comprised of Chief Executive Officers (CEOs) of major public companies, issued a statement declaring that they would no longer work solely to further the interests of their shareholders. Business Roundtable, *Statement on the Purpose of a Corporation* (August 2019), <https://opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf>. A total of 184 CEOs signed a document expressing a “fundamental commitment to all of our stakeholders.” In addition to delivering “long-term value” to shareholders, they committed to creating value for consumers, investing in employees, dealing fairly and ethically with suppliers, and supporting local communities. The statement declared that “[e]ach of our stakeholders is essential.” The statement was a break from the prevailing view that the primary task of

Studying the managerialist model and its decline can provide insight on recent debates concerning corporate purpose.

Managerialism was founded on the belief that professional managers are better at valuing businesses than investors.² Put another way, capital markets within the corporation are more efficient than capital markets without the corporation. As organizations grew larger, the transaction costs for shareholders in valuing the divisions within the boundaries of such firms increased. As management became viewed as a science,³ corporate managers were viewed as more competent than individual retail investors in allocating resources through internal capital markets. Insiders have access to information that gives them an inherent advantage over outsiders in pricing a company's stock.

The prevailing account attributes the fall of managerialism to changes in ideology. Some scholars point to the 1970 publication of Milton Friedman's defense of shareholder wealth maximization in the *New York Times Magazine*.⁴ In September 2020, the *New York Times* compiled reactions to the article from various business executives and academics.⁵ The general sentiment was that Friedman's article had influenced a generation of corporate managers to focus on increasing shareholder value. In addition to shifts in managerial attitudes, shareholders lost faith in the competence of the management teams of public companies. Several corporate scandals during

corporate managers is to increase shareholder value. The Business Roundtable has made similar statements in the past. As late as 1990, it observed that "Corporations are chartered to serve both their shareholders and society as a whole." Business Roundtable, *Corporate Governance and American Competitiveness* (March 1990). However, a 1997 statement by the organization noted that the "paramount duty" of public companies was to shareholders and the interest of corporate stakeholders were "derivative" of such a duty. See Business Roundtable, *Statement on Corporate Governance* (Sept. 1997), <http://www.businessroundtable.org/pdf/11.pdf>.

² See, e.g., William T. Allen, *Our Schizophrenic Conception of the Corporation*, 14 CARDOZO L. REV. 261, 272 (1992) (noting that managerialists believe that managers are better at valuing businesses than capital markets).

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

⁴ See LYNN STOUT, *THE SHAREHOLDER VALUE MYTH* 18 (2012); see also Leo Strine, Jr. & Joey Zwillinger, *What Milton Friedman Missed About Social Inequality*, N.Y. TIMES, Sept. 10, 2020, <https://www.nytimes.com/2020/09/10/business/dealbook/milton-friedman-inequality.html?searchResultPosition=1> (pointing to Friedman's article as the start of an ideological shift that should be reversed in favor of duties to corporate stakeholder).

⁵ *A Free Market Manifesto, Reconsidered*, N.Y. TIMES, Sept. 11, 2020 (revised Sept. 13, 2020), <https://www.nytimes.com/2020/09/11/business/dealbook/milton-friedman-doctrine-social-responsibility-of-business.html?action=click&module=Top%20Stories&pgtype=Homepage>.

the 1970s prompted corporate governance reforms that emphasized the independence of boards.⁶ In their 2001 article noting the wide acceptance of shareholder wealth maximization, Henry Hansmann and Reinier Kraakman noted that “[t]he collapse of the conglomerate movement in the 1970s and 1980s . . . largely destroyed the normative appeal of the managerialist model.”⁷

On closer examination, it is difficult to attribute the shift to the shareholder wealth standard shifts in ideology.⁸ Norms can be influential, but they are often contested. Corporate managers have persistently thought of themselves as taking care of the interests of the corporation as a whole rather than just attending to the narrow needs of shareholders. It is likely that managers would prefer a world in which they have wide discretion that is not questioned by shareholders. While investor attitudes concerning managerial competence shifted during the 1970s, their scrutiny of managerial performance originated before that decade.

This Article develops a new account of the decline of managerialism. It argues that as managerial skill in allocating resources through internal capital markets increased, investors became more confident in the ability to predict a company’s future earnings. Internal projections generated by managers could help inform external projections that could be used to construct predictions of earnings streams. Rather than give credit only for the value of a company’s current earnings, shareholders were willing to incorporate expectations about future earnings growth that were often based on internal corporate forecasts. As shareholders placed greater importance on present value models, it became more important for public companies to demonstrate their potential for earnings growth.⁹

⁶ See, e.g., Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1511-12 (2007) (noting that “the dominant economic position of the United States” enabled managerialism).

⁷ Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 444 (2001).

⁸ As Professor David Millon has noted, the shareholder wealth norm is only “part of a larger ideological, economic, and socio-political phenomenon that now shapes and legitimates business practice in powerful ways.” He observes that this “complex but hugely important story has yet to be told.” See, e.g., David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L.J. 1013, 1042 (2013).

⁹ It is now clear that stock prices reflect the market’s assessment of a company’s future earnings. See, e.g., ROGER L. MARTIN, *FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL* 12-13 (2011) (describing “expectations market” where “[t]he consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company.”); ALFRED RAPPAPORT & MICHAEL MAUBOUSSIN, *EXPECTATIONS INVESTING: READING STOCK PRICES*

By the 1960s, there were two major methods companies used to signal that their earnings would increase. The first, which was largely discredited by the 1980s, was forming a corporate conglomerate. There was a belief that superior management of a wide array of businesses could deliver smooth increases in earnings over time. Markets trusted strong internal capital markets to efficiently move resources within the conglomerate to their best use. The second was to consistently meet market projections of company earnings and revenues. Starting in the 1960s, research analysts who followed company stocks increasingly issued predictions of company earnings and revenue. Companies developed their own projections based on internal information that were often selectively conveyed to market participants. By consistently meeting forecasts of revenue and profits companies demonstrated the skill of their managers and validated market predictions of earnings growth that were incorporated into stock prices.

Projections have increased in importance over time and have facilitated monitoring of corporate managers. Even if investors cannot directly observe the effectiveness of internal capital markets, they can evaluate managerial competence by assessing a company's ability to make accurate predictions and meet them. While projections are an imperfect mechanism for assessing managers and can be manipulated, they reduce the transactions costs of valuing public companies. As a result, shareholders have less reason to defer to the valuations of internal capital markets. Other mechanisms such as takeovers and executive compensation have developed to reduce the agency costs between managers and shareholders. But projections originated before those methods and have been the most persistent mechanism by which shareholders ensure that managers act to maximize profits.

While projections have powerfully shaped corporate purpose, some public companies have escaped the pressure to maximize shareholder wealth in the short-term. As companies have become even larger and more complex, markets are more willing to defer to the expertise of their managers. Investors give companies with significant market power more leeway in demonstrating immediate profitability because they are confident in their long-term prospects. As investors have become more diversified and concerned with social responsibility, their preferences may shift so that they do not place as much weight on short-term results. Proposals have been made to move away from projections as a way of valuing companies on the ground that they emphasize short-term results that do not reflect long-term corporate value.¹⁰

FOR BETTER RETURNS xv (2001) (“Stock prices are the clearest and most reliable signal of the market’s expectations about a company’s future performance.”).

¹⁰ See, e.g., James J. Park, *Do the Securities Laws Promote Short-termism?*, 10 UC IRV. L. REV. 991 (2020) (discussing proposals).

For companies that are able to escape the treadmill of projections, commitments to take into the consideration of stakeholders have the potential to be meaningful.

As valuation shifted from managers to markets, the power of stock markets to define corporate purpose increased.¹¹ The irony of projections was that they were initially a way that shareholders relied on the superior knowledge of management to value companies, and over time evolved to become a common test of managerial competence. Rather than deferring to managerial expertise, markets sought to evaluate it based on whether managers could set ambitious goals and meet them. Projections helped change a world in which shareholders had little power relative to management to one in which they wield significant influence over the goals of the public corporation.

The Article begins by describing the managerialist paradigm in Part I. Part II discusses the prevailing explanations for why managerialism gave way to shareholder wealth maximization. Part III develops a new account of this transition that looks closely at changes in the methods for valuing companies. Part IV discusses the rise of the conglomerate and financial projections as ways that companies could signal earnings growth to investors who were increasingly relying on present value models. Part V concludes by examining how valuation shapes corporate purpose. Projections have become an important but flawed way of reducing agency costs. As some companies escape the discipline of projections and investor preferences have changed, there is a possibility that more companies can make meaningful commitments to stakeholders.

I. THE CONTOURS OF MANAGERIALISM

The deference to corporate executives around the middle of the twentieth century both confirmed and contradicted the prediction of Adolf Berle and Gardiner Means in 1932 that the divergence of interests between managers and shareholders would reduce shareholder value.¹² Berle and Means correctly observed that given the size of public corporations, their

¹¹ The U.S. corporation thus differs from many foreign corporations, which typically operate in markets that do not rely as much on projections and thus do not face as much pressure to privilege shareholder value. *See, e.g.*, JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 64 (2012) (noting that the U.S. is an outlier with respect to its reliance on projections); Jean Tirole, *Corporate Governance*, 69 *ECONOMETRICA* 1, 4 (2001) (“it is widely felt in countries such as Germany, Japan and France that corporations should aim to promote growth, longevity and a secure employment relationship, with profitability being more an instrument than the ultimate goal.”).

¹² ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (1932) (Transaction Publishers edition 1991).

shareholders were dispersed and had little choice than to rely on professionals to control corporate decisions.¹³ This separation of ownership and control would mean that there was no assurance that managers would maximize shareholder wealth.¹⁴ These concerns seemed less important as corporations generally prospered during the decades after World War II. Many commentators writing during this period did not view the failure to maximize shareholder wealth as a problem for shareholders.

Managerialism was accepted in part because internal capital markets were viewed as a more efficient way of allocating resources within the large public corporation than external capital markets. As the science of management advanced, many commentators believed that corporate officers had special expertise that deserved deference. Managers were more capable of assessing the value of projects within the boundaries of the large firm than investors who would have to incur substantial transaction costs to do so. This was especially so because the quality and reliability of information on corporate performance was not as high as it would become in later years. Large companies had market power that enabled them to generate enough earnings so that they had less need to raise funds through stock markets. They were thus not as subject to the scrutiny of capital markets and managers had more discretion to consider the interests of stakeholders.

A. *Internal Capital Markets and Professional Managers*

The distinction between internal markets within the firm and external markets without the firm was introduced by Coase in his article, *The Nature of the Firm*.¹⁵ Firms exist because it is less costly for some transactions to occur inside the firm than through contracts. Rather than rely on the pricing mechanism, managers can simply mandate the movement of resources to their best use. The economist Oliver Williamson thus famously contrasted markets and hierarchies in describing the governance of the public

¹³ *Id.* at 66 (“As the ownership of corporate wealth has become more widely dispersed, ownership of that wealth and control over it have come to be less and less in the same hands.”); see also ALFRED D. CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 451 (1977) (“The creation of a large central office of top managers and their staffs further sharpened the distinction between ownership and control.”).

¹⁴ Berle & Means, *supra* note 12, at 9 (“Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company’s stock that the returns from running the corporation profitably accrue to them in only a very minor degree. . . . The explosion of the atom of the property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.”).

¹⁵ R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

corporation.¹⁶ In telling the story of the rise of the modern corporation, the business historian Alfred Chandler referred to the importance of the visible hand of management that transcended the invisible hand of the markets.¹⁷

As the largest companies became increasingly complex with multiple divisions operating in different regions and industries, internal capital markets developed to allocate funds within their boundaries.¹⁸ In an internal capital market, managers can allocate funds to different projects through fiat rather than by contracting with outside investors to provide funding.¹⁹ To the extent that transaction costs are high in assessing the value of a project, managers within the firm can more efficiently determine whether capital should be invested in that project than outside investors. One view is that company managers have superior expertise with respect to their companies and access to better information than investors.²⁰ This argument was stronger when external capital markets were not as fully developed as they are today.²¹ As Williamson observed in the 1970s, “the transaction costs associated with traditional capital market processes for policing management . . . are considerable.”²²

The development of internal capital markets required advances in managerial science. Coase observed that as firms grow larger, the cost of

¹⁶ OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 142 (1975).

¹⁷ Chandler, *supra* note 13.

¹⁸ See, e.g., Oliver E. Williamson, *The Logic of Economic Organization in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* 90, 107 (Oliver E. Williamson & Sidney G. Winter eds., 1991) (“The general office of the firm can thus be thought of as an internal capital market.”).

¹⁹ See, e.g., George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 *HARV. L. REV.* 1103, 1105 (2004). Capital can be allocated through an internal market in various ways. As Professor Triantis explains: “First the cash flow from one project may be diverted to fund another. Second, assets of one project may be sold and the proceeds transferred to another project. Third, the firm may implicitly borrow against the assets of one project to finance another venture whenever liability is incurred by the organization as a whole, because all of its assets are available to satisfy the creditor.” *Id.* at 1111.

²⁰ See, e.g., Triantis, *supra* note 19, at 1111 (“The advantage of an internal capital market is that it facilitates the delegation of control over switching options from investors to managers, who have superior expertise and access to information regarding available projects.”).

²¹ See, e.g., R. Glenn Hubbard & Darius Palia, *A Reexamination of the Conglomerate Merger Wave in the 1960s: An Internal Capital Markets View*, 54 *J. FIN.* 1131, 1133 (1999).

²² Williamson, *supra* note 16, at 142-43; Oliver E. Williamson, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 150 (1985) (noting that “risks and decisions” are “unpacked with greater precision and confidence internally” and so “internal asset managers can better ascertain whether to continue funding a project than could the capital market.”).

transacting within the firm also rises.²³ Large public corporations require better management than an individual proprietorship.²⁴ Initially, because of management challenges, there was skepticism by some commentators that most businesses could grow beyond a certain size.²⁵ There were predictions that large companies would founder because “no one person or board of directors could successfully master such large organizations in a competitive environment.”²⁶

The sophistication of corporate managers increased significantly after World War II. In a study published in the 1950s, the economist Kenneth Boulding argued that corporations, like other organizations, became larger as the technology of organization improved.²⁷ The growing size of private businesses, government agencies, and non-profit organizations such as churches reflected innovation in management techniques. For example, advances in accounting and statistics enabled better monitoring of business operations.²⁸ Business schools facilitated the adoption of such methods as the number of graduates from MBA programs rose from 110 in 1919 to 3,897 in 1949.²⁹ Such professional education “played a crucial role in gaining legitimacy for the new occupation of management . . . elevating it to a higher social status than it had ever achieved before. . . .”³⁰ Business training was

²³ Coase, *supra* note 15, at 394.

²⁴ *See, e.g.*, W. D. KNIGHT & E. H. WEINWURM, *MANAGERIAL BUDGETING* 7 (1964) (“The management function in modern business is a consequence of the growth of the typical firm to a size too great to be operated by a single individual.”).

²⁵ *See, e.g.*, EDITH TILTON PENROSE, *THE THEORY OF THE GROWTH OF THE FIRM* 18 (1959) (observing that “it was almost universally agreed” that “a firm can get ‘too big’” and that “management or ‘co-ordination’ was a ‘fixed factor’ which would necessarily give rise to diminishing returns and increasing costs of operation at some point.”).

²⁶ GARY JOHN PREVITS & BARBARA DUBIS MERINO, *A HISTORY OF ACCOUNTING IN AMERICA: AN HISTORICAL INTERPRETATION OF THE CULTURAL SIGNIFICANCE OF ACCOUNTING* 85 (1979).

²⁷ *See, e.g.*, KENNETH E. BOULDING, *THE ORGANIZATIONAL REVOLUTION: A STUDY IN THE ETHICS OF ECONOMIC ORGANIZATION* 49 (1953) (“It has been my main thesis that the organizational revolution of our time has been in the main the result of certain technical changes in the ability to organize: changes both on the physical side in the improvement of transportation and communication, and on the structural side in the forms and skills of organization itself.”); *see also* Penrose, *supra* note 25, at 19 (observing that management adapted to growth in organizations). Years later, technology facilitated the outsourcing of activities outside the firm by improving the ability of companies to monitor contractors. *See, e.g.*, George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 *NOTRE DAME L. REV.* 955, 998-1002 (2007).

²⁸ *See, e.g.*, Boulding, *supra* note 27, at 135 (“Both accounting and statistics are methods of *abstracting* and *condensing* information; i.e., of taking out of a vast mass of reality only those elements which are essential for the purposes of executive decision.”).

²⁹ *Id.* at 195.

³⁰ RAKESH KHURANA, *FROM HIGHER AIMS TO HIRED HANDS* 135 (2007); *see also* Boulding, *supra* note 27, at 27 (“The ‘invention’ of the professional, specialized organizer

viewed as enabling managers to add value to any business.³¹ Some companies developed their own training programs.³² The journalist William Whyte famously documented the rise of the organization man who was immersed in the norms of his company.³³ Whyte described the extensive training program of the electric bulb manufacturer General Electric, which had a staff of 250 instructors and emphasized the “professional” manager.³⁴ The curriculum covered “personnel philosophy, labor relations, law, and most important, the managerial viewpoint.”³⁵

Another view is that management skills not only enabled the formation of larger businesses but arose as businesses grew and required centralized operations. According to Chandler, management techniques were developed primarily by companies that grew through acquisition.³⁶ The large corporations described by Berle and Means were primarily created through the acquisition of smaller companies.³⁷ Systems and procedures were needed to integrate new companies into the existing organizational structure. Central offices to monitor and coordinate multiple corporate divisions became necessary. Over time, “[t]he methods fashioned during the process of

is probably one of the most important developments in the structure of organization relating to the growth of size.”); Morrell Heald, *THE SOCIAL RESPONSIBILITIES OF BUSINESS: COMPANY AND COMMUNITY, 1900-1960* 277 (1970) (“The conception of management as a profession, requiring special training and analytical skills as well as broad social understanding and high ethical standards, had grown steadily since the 1920s.”); Edward S. Mason, *Introduction in THE CORPORATION IN MODERN SOCIETY* 1, 12 (Edward S. Mason, ed. 1960) (observing that “[o]ne of the leading characteristics of well-ordered bureaucracies both public and private – a characteristic justly extolled by the devotees of managerialism – is the increasing professionalization of management.”); FRANCIS X. SUTTON, SEYMOUR E. HARRIS, CARL KAYSEN & JAMES TOBIN, *THE AMERICAN BUSINESS CREED* 357 (1956) (noting importance of “the view of business management as a profession.”); FREDERICK WINSLOW TAYLOR, *THE PRINCIPLES OF SCIENTIFIC MANAGEMENT* 7 (1911) (Norton Library ed. 1967) (seeking to “prove that the best management is a true science, resting upon clearly defined laws, rules, and principles, as a foundation.”).

³¹ See, e.g., MARGARET M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 99 (1995) (“Management came to be regarded as a generic skill that could be learned, taught, and readily transferred from one line of business to the next, as long as managers had the right information available to them.”).

³² IBM created a management school for its executives during the 1950s. See THOMAS J. WATSON, JR., *A BUSINESS AND ITS BELIEFS: THE IDEAS THAT HELPED BUILD IBM* 49 (1963).

³³ WILLIAM H. WHYTE, JR., *THE ORGANIZATION MAN* (1956).

³⁴ *Id.* at 120.

³⁵ *Id.* at 121.

³⁶ Chandler, *supra* note 13, at 415 (“The practices and procedures of modern top management had their beginnings in the industrial enterprises formed by merger rather than those that built extended marketing and purchasing organizations.”).

³⁷ Berle & Means, *supra* note 12, at 42-43.

consolidation and integration . . . were further refined as the company began to grow and to compete oligopolistically with other large integrated enterprises.”³⁸

Regardless of how professional management methods were developed, knowledge and training with respect to such methods conferred authority to corporate managers.³⁹ The unique challenges of running a large company meant that a limited number of specially trained individuals had the skills to be managers.⁴⁰ Shareholders, most of whom were individuals, did not have the expertise to second-guess such managers. Based solely on their knowledge, it was not difficult to conclude that trained executives were better able to allocate resources and value businesses than non-expert investors. While shareholder-owners no longer controlled the large corporation, they gave up control willingly in order to take advantage of the special skills of expert managers.

Either because of the prowess of management or because of generally favorable economic conditions,⁴¹ during the post-World War II era corporate managers had less need to access external capital markets. In many industries just a few companies controlled the national market.⁴² Market power resulted

³⁸ Chandler, *supra* note 13, at 416.

³⁹ The view that managers of large companies had special skills enabling them to transcend the market dates back to the Progressive Era. *See, e.g.*, SAMUEL HABER, *EFFICIENCY AND UPLIFT: SCIENTIFIC MANAGEMENT IN THE PROGRESSIVE ERA 1890-1920* 95 (1964). One hope was that greater efficiency would improve the lives of workers. *See* HERBERT CROLY, *PROGRESSIVE DEMOCRACY* 396-97 (1914).

⁴⁰ *See, e.g.*, JAMES BURNHAM, *THE MANAGERIAL REVOLUTION* 82 (1941) (observing that “through changes in the technique of production, the functions of management become more distinctive, more complex, more specialized, and more crucial to the whole process of production, thus serving to set off those who perform those functions as a separate group or class in society. . .”).

⁴¹ *See, e.g.*, BRIAN CHEFFINS, *THE PUBLIC COMPANY TRANSFORMED* 64 (2019) (observing that share prices generally rose from 1950 to 1968); JOHN KENNETH GALBRAITH, *AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER* 87 (1952) (noting increase in aggregate profits from \$14 billion in 1946 to \$22 billion in 1950). The 1950s saw a significant bull market where the Dow Jones Industrials average more than doubled over the course of the decade. *See* ROBERT SOBEL, *THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET* 327 (1965). Part of the reason for the strong market performance was that the number of stock investors increased significantly. *See, e.g.*, Wyatt Wells, *Certificates and Computers: The Remaking of Wall Street, 1967 to 1971*, 74 *BUS. HISTORY REV.* 193, 194-95 (2000).

⁴² As one text noted: “in each of the following industries one corporation was either the sole seller or controlled the entire supply: virgin aluminum, shoe machinery, bottle machinery, optical glass, nickel, magnesium, and molybdenum. Four producers or less accounted for from 75 to 100 per cent, by value, of the product of industries producing one third, by value, of all manufactured products. Fifty-seven per cent of the value of all manufactured products was accounted for by industries in which the four largest producers,

in significant profits that could be reinvested.⁴³ Because public corporations had less need to sell securities to raise capital, there were fewer times when they would be thoroughly scrutinized by outside investors.⁴⁴ There was no need to provide the extensive disclosure required by a registration statement and mandatory periodic reporting requirements, which were not as developed as they became in the 1970s.⁴⁵ Adolf Berle observed in 1962 that “[m]ajor corporations in most instances do not seek capital. They form it themselves.”⁴⁶

B. *Managerialism and Corporate Purpose*

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

An extensive body of literature during the managerialist period noted that corporations did not face pressure to maximize profits. A 1945 study of corporations by the Brookings Institution noted, “the maintenance of satisfactory profits is a more accurate statement of the profits objective than is complete profits-maximization.”⁴⁷ A Harvard University Dean observed in

when there were that many, turned out half the total value.” GEORGE W. STOCKING & MYRON W. WATKINS, *MONOPOLY AND FREE ENTERPRISE* 47 (1951).

⁴³ DOW VOTAW, *MODERN CORPORATIONS* 105 (1965) (noting that from 1946 to 1953, 64 percent of corporate funds came from internal sources, and from 1954 to 1963, 73 percent of corporate funds came from internal sources).

⁴⁴ Securities sales are especially scrutinized by investors. *See, e.g.*, Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 *AM. ECON. REV.* 650, 654 (1984) (“The principal value of keeping firms constantly in the market for capital is that the contributors of capital are very good monitors of managers.”).

⁴⁵ *See, e.g.*, Park, *supra* note 10, (describing changes in frequency and reliability of periodic disclosure requirements over the 1970s).

⁴⁶ ADOLF A. BERLE, JR., *THE 20TH CENTURY CAPITALIST REVOLUTION* (1954); *see also* WILBERT E. MOORE, *THE CONDUCT OF THE CORPORATION* 227 (1962) (“By retaining earnings the corporation may become self-sustaining.”). Not all commentators agreed that public companies were generally able to avoid the discipline of capital markets by relying on internal funds during this period. *See, e.g.*, John Lintner, *The Financing of Corporations*, in *THE CORPORATION IN MODERN SOCIETY* *supra* note 28, at 166, 177-90 (arguing that reliance on internal funds had not increased and that public companies were still subject to capital market discipline). Over time, retaining earnings to reinvest in other projects, which permitted large companies to avoid the scrutiny of capital markets, became viewed as inefficient. James J. Park, *Shareholder Compensation as Dividend*, 108 *MICH. L. REV.* 323, 355-59 (2009) (summarizing literature on the payment of dividends as a way of reducing agency costs of retained earnings).

⁴⁷ ROBERT AARON GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* xii (1945) (1961 edition).

1958 that “[b]usiness is viewed as a kind of game in which profit has approximately the same significance as one’s golf score.”⁴⁸ The management guru Peter Drucker asserted that “the problem of any business is not the maximization of profit but the achievement of sufficient profit to cover the risks of economic activity and thus to avoid loss.”⁴⁹

Managerialism was consistent with the emerging theory of behavioral economics, which rejected the classical assumption that individuals strive to maximize their utility. Professor Herbert Simon applied the concept of bounded rationality, which acknowledges that individuals do not have perfect knowledge that permits them to make optimal choices, to analyze corporate policy.⁵⁰ He argued that because of the limited ability of organizations to understand their environments, rather than maximize profits, they will “satisfice” and do their best given their limited knowledge.⁵¹ Managers might focus on increasing the size of the firm to reduce the risk of its failure rather than increase its profitability.⁵²

An extensive study of business ideology by several economists published in 1956 described how managerialism shaped the views of corporate managers.⁵³ They looked at advertisements, books, magazines, and other materials from the period 1948 to 1949.⁵⁴ The study found from these documents a “managerial theme” that did not rely on classical economic theory and instead reflecting the societal view that “the actions of individual enterprises are and should be dominated by considerations of the public interest; profit-seeking takes a lesser place.”⁵⁵

If there was no clear path to maximizing profits, there was a stronger argument that corporate managers should have discretion with respect to their long-term plans. One method for increasing earnings over time was for the

⁴⁸ Edward S. Mason, *The Apologetics of ‘Managerialism,’* 31 J. BUS. 1 (1958).

⁴⁹ PETER F. DRUCKER, *THE PRACTICE OF MANAGEMENT* 36 (1954).

⁵⁰ He noted several reasons why rationality is limited: (1) it “requires a complete knowledge and anticipation of the consequences that will follow on each choice. In fact knowledge of consequences is always fragmentary.” (2) “Since these consequences lie in the future, imagination must supply the lack of experienced feeling in attached value to them. But values can be only imperfectly anticipated.” (3) it “requires a choice among all possible alternative behaviors. In actual behavior, only a very few of all these possible alternatives ever come to mind.” HERBERT A. SIMON, *ADMINISTRATIVE BEHAVIOR* 93-94 (1945) (4th edition 1997).

⁵¹ Herbert A. Simon, *Rational Decision Making in Business Organizations*, 69 AM. ECON. REV. 493 (1979); *see also* Williamson, *supra* note 22, at 32, 46 (noting importance of organization in light of bounded rationality).

⁵² *See* Simon, *supra* note 50, at 146.

⁵³ FRANCIS X. SUTTON, SEYMOUR E. HARRIS, CARL KAYSSEN & JAMES TOBIN, *THE AMERICAN BUSINESS CREED* (1956).

⁵⁴ *Id.* at viii.

⁵⁵ *Id.* at 57.

firm to grow in order to win and maintain market power.⁵⁶ Size not only was a challenge for managers, it resulted in the accumulation of resources that could be devoted to research and efficiency improvements that enabled a company to dominate its market.⁵⁷ As the economist Carl Kaysen noted, “the possession of a substantial degree of market power is characteristic of the modern corporation” and “its orientation toward growth and development . . . may be seen simply as a device for maintaining power.”⁵⁸ Such growth was prioritized by some firms over immediate profitability.⁵⁹ Attaining monopoly status meant that profits would eventually come.⁶⁰

Without constant scrutiny of their strategies, managers saw themselves as statesmen who could consider a broad range of interests.⁶¹ Corporate market power not only presented the promise of future profits, it gave managers the discretion to benefit stakeholders.⁶² For example, expanding the size of the company can increase employment and stability.⁶³

⁵⁶ ROBIN MARRIS, *THE ECONOMIC THEORY OF ‘MANAGERIAL’ CAPITALISM* 47, 53, 104 (1964) (“Perhaps a dozen other writers have previously asserted that size or growth will be a major factor in managerial motivation”).

⁵⁷ *See, e.g.*, Stocking & Watkins, *supra* note 42, at 57-61.

⁵⁸ Kaysen, *supra* note 3, at 315.

⁵⁹ For example, car manufacturers after World War II kept car prices down to increase their market share. *See, e.g.*, Knight & Weinwurm, *supra* note 24, at 230.

⁶⁰ *See, e.g.*, Stocking & Watkins, *supra* note 42, at 95 (“Winning in business does not, however, consist merely in getting the better of rivals – that is, making more money or getting a bigger share of the market than any of the others – but in making as much money as possible over the long run.”).

⁶¹ *See, e.g.*, Eugene V. Rostow, *To Whom and For What Ends is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* *supra* note 28, at 46, 60 (noting “flowering of the view that the primary duty of the corporation is not to make as much money as possible for its stockholders, but to advance the public interest in some alternative sense.”); Votaw, *supra* note 43, at 28 (observing that “[t]he aggressive, profit- and power-seeking individualist was replaced by the arbitrator and diplomat whose motivations included organization survival, professional reputation, and equitable balancing of interests, as well as profit-making.”); E. Merrick Jr. Dodd, *For Whom are Corporate Managers Trustees*, 45 *HARV. L. REV.* 1145, 1156 (1932) (noting the increasing view that managers “should concern themselves with the interests of employees, consumers, and the general public. . . .”); *see also* Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 *STAN. L. REV.* 923, 937 (1984) (“corporate managers, likened to civil servants, are envisioned to further selflessly the goals of the community rather than their personal desires.”).

⁶² *See, e.g.*, Carl Kaysen, *The Corporation: How Much Power? What Scope?*, in *THE CORPORATION IN MODERN SOCIETY* *supra* note 28, at 85, 90 (observing that “typically, the large corporation in which we are interested operates in a situation in which the constraints imposed by market forces are loose, and the scope for managerial choice is considerable.”).

⁶³ ROBIN MARRIS, *THE ECONOMIC THEORY OF ‘MANAGERIAL’ CAPITALISM* 5 (1964); *see also* *The Treaty of Detroit*, *FORTUNE MAGAZINE*, July 1950 (describing generous labor deal granted by General Motors to union). Some commentators were skeptical that

The 1956 survey of business ideology found that rather than focus exclusively on shareholders, corporate managers believed that they had “four broad responsibilities: to consumers, to employees, to stockholders, and to the general public. . . .” Moreover, “each group is on an equal footing” and “[s]tockholders have no special priority; they are entitled to a fair return on their investment, but profits above a ‘fair’ level are an economic sin.”⁶⁴ The power of large companies was seen by some as creating obligations to act in the interests of society.⁶⁵ The sentiment that companies should work for the common good was significant enough so that it prompted one concerned commentator to write a *Harvard Business Review* article in 1958 warning against *The Dangers of Social Responsibility*.⁶⁶

Companies could care for other corporate stakeholders partly because shareholders of public companies, who at the time were primarily retail investors rather than institutions, were largely satisfied with fixed returns. One commentator noted that management had wide discretion to pay dividends and need only pay an amount to maintain the attractiveness of the company’s stock as an investment.⁶⁷ The fact that a company could pay a reliable dividend gave investors some assurance that a business was profitable and competently managed.⁶⁸ The stability of dividend payment led one commentator to remark that “stockholders in effect become holders of perpetual bonds.”⁶⁹ There was minimal fear that an investment in a large corporation would become worthless because the largest companies did not fail.⁷⁰ John Kenneth Galbraith observed in the 1960s that “big corporations

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

⁶⁴ SUTTON, ET AL., *supra* note 53, at 65.

⁶⁵ *See, e.g.*, MOORE, *supra* note 46, at 9 (“Their very size and the dependence of the economy and the nation on their continuation, removes the privilege of business failure and gives rise to notions of ‘social responsibility.’”).

⁶⁶ Theodore Levitt, *The Dangers of Social Responsibility*, HARV. BUS. REV. Sept-Oct. 1958. As he described the sentiment, “what started out as the sincere personal viewpoints of a few selfless businessmen became the prevailing vogue for them all.” *Id.* at 42. Berle thus conceded that an earlier argument with Professor Merrick Dodd, who argued that corporate powers should be exercised on behalf of the community, had been resolved in favor of Dodd. Berle, *supra* note 46, at 169.

⁶⁷ Penrose, *supra* note 25, at 27.

⁶⁸ Dividends were the primary way that businesses could signal that their earnings were real until the 1990s. *See* ALEX BERENSON, THE NUMBER: HOW THE DRIVE FOR QUARTERLY EARNINGS CORRUPTED WALL STREET AND CORPORATE AMERICA 79 (2003).

⁶⁹ Kaysen, *supra* note 3, at 312.

⁷⁰ *See, e.g.*, Previts & Merino, *supra* note 26, at 252 (“it seemed plausible to most Americans that the economy could be permanently stabilized and security assured. Survival did not seem to be a major problem for most corporate businesses; in fact, during this decade, few large firms failed.”).

do not lose money.”⁷¹ Indeed, some managers saw dangers in reporting strong earnings. One article observed that a “sharp increase in reported profits is very likely to produce the feeling in the minds of the members of the working force that they should participate to a greater extent in such profits, with resulting demands for wage increases, strikes and general industrial unrest.”⁷²

The example of the copy maker Xerox illustrates how market power permits managers to focus on a broad range of concerns. Until it was forced to license its technology in the 1970s, Xerox had a monopoly on copiers that used plain paper instead of more expensive paper treated with chemicals. It grew at unprecedented rates through the 1960s and was able to invest significant amounts in projects outside of its core business. A *New Yorker* article on the company observed that Xerox spent significant amounts on supporting not only local institutions like the University of Rochester, but also the United Nations.⁷³ It described the culture of the “Xerox spirit”, which encouraged “emphasizing ‘human values’ for their own sake.”⁷⁴ In an interview with the magazine, Xerox’s CEO spent more time describing the company’s “non-profit activities and his theories of corporate responsibility” than the business itself.⁷⁵

For some commentators, managerialism foreshadowed a shift away from capitalism.⁷⁶ As large companies became more powerful, they would become similar to government bureaucracies that controlled production decisions. Indeed, many of the advances in large-scale production and organization had been developed through the war effort. Only large firms with the resources to plan and manage would survive over time as competition became more destructive.⁷⁷ Either they would dominate an economy that would no longer be controlled by market forces,⁷⁸ or large corporations would essentially be absorbed into the government and become administrative agencies. Rather than work independently to maximize profits, corporations would essentially serve larger social ends.

⁷¹ GALBRAITH, *supra* note 41, at 82.

⁷² Samuel R. Hepworth, *Smoothing Periodic Income*, 28 ACCOUNT. REV. 32, 33 (1953).

⁷³ John Brooks, *Xerox Xerox Xerox Xerox*, NEW YORKER, April 1, 1967, at 88.

⁷⁴ *Id.* at 49.

⁷⁵ *Id.* at 88.

⁷⁶ See, e.g., GALBRAITH, *supra* note 41, at 4 (noting possibility of socialism); Rostow, *supra* note 61, at 61 (observing that “[i]n England, socialists say that managers have already socialized capitalism, so that it is no longer necessary to invoke the cumbersome formality of public ownership of the means of production.”).

⁷⁷ JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (3d ed. 1950).

⁷⁸ See, e.g., Burnham, *supra* note 40 (arguing that capitalism would be replaced by society dominated by managers).

The managerialist corporation was an influential and powerful social institution. For a time, internal capital markets were viewed as superior in assessing the valuation of a business than external capital markets. Corporate governance was left to professional managers who seemed uniquely qualified to manage large companies. Corporate executives were given significant leeway to consider the interests of corporate stakeholders and often viewed themselves as serving the public interest.

II. CONVENTIONAL EXPLANATIONS FOR THE TRANSITION FROM MANAGERIALISM TO SHAREHOLDER WEALTH

Under the prevailing account, the managerialist paradigm was largely discredited by the 1980s and firmly replaced by the shareholder wealth paradigm during the 1990s. By the 2000s, managers understood that they were to “in all circumstances manage to maximize the market price of the stock.”⁷⁹ As noted earlier, many legal scholars point to changes in ideology as the main reason for the shift. Another view is that “corporate governance mechanisms” such as “the leveraged hostile takeovers and buyouts of the 1980s to the incentive-based compensation, activist boards of directors, and shareholders in the 1990s” prompted “U.S. managers [to] become much more focused on stock prices.”⁸⁰ Professor Jeffrey Gordon has argued that corporate governance itself was influenced by more efficient stock prices that enabled independent directors to monitor managers.⁸¹

This Part describes the major explanations for the rise of the shareholder wealth principle – law, ideology, managerial incentives, and investor preferences. It argues that the conventional story is incomplete and misses developments much earlier than the 1980s that pushed managers to maximize shareholder value.

A. Law

Corporate law requires managers to act in the interests of shareholders. The board of a corporation owes fiduciary duties of care and loyalty to the shareholders. The shareholder wealth paradigm follows naturally from a legal regime that privileges shareholder interests. Because

⁷⁹ William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 658-59 (2010).

⁸⁰ Bengt Holmstron & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 121 (2001).

⁸¹ See Gordon, *supra* note 6.

stock owners benefit from decisions that increase the value of their investment, corporate managers have a duty to implement policies that achieve that goal.

These basic elements of law were in place during the period of managerialism. Yet as noted earlier, there was a general sense that managers were not obligated to maximize corporate profits. It is thus difficult to argue that corporate law compels managers to focus on increasing shareholder wealth. Fiduciary duties tend to impose negative obligations that prevent self-dealing and waste by managers. They do less to affirmatively require corporate managers to pursue strategies to maximize shareholder wealth. As several legal scholars have noted, the business judgment rule gives management wide discretion in choosing business strategies.⁸²

Managerialism was not inconsistent with corporate law because corporate managers could argue that a balanced strategy that considered stakeholder interests was the best way of maximizing profits over time. A law review article published in 1965 by Professor David Ruder observed that while corporate law requires managers to pursue profitability, it gives them significant flexibility to achieve profits over the long-run.⁸³ He wrote that “it is possible at present for corporate management to pursue most public objectives while at the same time acting in a manner consistent with the corporation’s public interest. . . .”⁸⁴

The law did not significantly change to re-emphasize shareholder wealth during the 1960s and 1970s. The managerialist period did not generate much significant corporate law.⁸⁵ Even during the 1980s, when managerialism was clearly in decline, Delaware recognized that managers could legally consider the impact of stakeholders in considering a hostile takeover bid without violating their fiduciary duties. As noted by Professor Ed Rock, the shift “from a manager-centric system to a shareholder-centric system” did not occur “directly through legal change.”⁸⁶

⁸² See Stout, *supra* note 4, at 24-32.

⁸³ See David S. Ruder, *Public Obligations of Private Corporations*, 114 U. PA. L. REV. 209, 216 (1965).

⁸⁴ *Id.* at 227.

⁸⁵ The period of managerialism did not generate much significant corporate law. See, e.g., Harwell Wells, “*Corporation Law is Dead*”: *Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 348 (2013) (assessing argument that corporate law was dead during this period and concluding that “it must be concluded that heroic managerialism did not radically change the substance of corporate law.”).

⁸⁶ Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910 (2013).

B. Ideology

Rather than a legal requirement, shareholder wealth maximization might be viewed as an ideology that became widely adopted by corporate managers and investors. Profit maximization was widely taught in business schools by the 1960s.⁸⁷ As noted earlier, commentators often point to Milton Friedman’s argument that the social responsibility of managers is to “make as much money as possible while conforming to the basic rules of society” as marking a notable shift.⁸⁸ Another explanation was the influence of economic theory. Professor William Bratton explained at the end of the 1980s that “[t]he managerialist consensus recently disappeared, due in part to the successful emergence of the new economic theory in the legal literature beginning around 1980.”⁸⁹

The publication of Michael Jensen and William Meckling’s analysis of agency costs in the public corporation in 1976 created a theoretical framework supporting the shareholder wealth paradigm.⁹⁰ While Berle and Means generally described a separation of ownership and control in public companies, Jensen and Meckling observed that the relationship between managers and shareholders raised similar issues as the relationship between

⁸⁷ See, e.g., JOHN BROOKS, *THE GO-GO YEARS* 156 (1973) (noting influence of Harvard Business School); ROBIN MARRIS, *THE ECONOMIC THEORY OF ‘MANAGERIAL’ CAPITALISM* 72 (1964) (noting that business schools teach profit maximization); ROY C. SMITH, *THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S* 259 (1990) (noting that business schools in the 1960s began teaching that corporations should maximize earnings). In contrast, the shareholder wealth maximization norm is seen as inconsistent with social values in many other countries. See, e.g., Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2073 (2001).

⁸⁸ Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., September 13, 1970. This claim had been made before 1970 by Friedman and other commentators. See, e.g., Eugene M. Lerner, *Capital Budgeting and Financial Management*, in *FINANCIAL RESEARCH AND MANAGEMENT DECISIONS* 72, 73 (Alexander A. Robichek, ed. 1967) (noting “increased awareness that the appropriate goal of the corporation is long-run wealth maximization. Phrased in somewhat less academic jargon, management should be interested in the price of the company’s stock and should try to make it as high as possible.”).

⁸⁹ William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1476 (1989); see also Lynn Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2005 (2013) (“Managerialism appears to have first come under attack and the idea of shareholder primacy seems to have first gained traction in academic.”).

⁹⁰ See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

any agent and principal.⁹¹ Corporate managers are essentially agents of the shareholder-principal. Because it identifies shareholders as the principal in the principal-agent relationship, the agency costs model implies that shareholders should be the focus of corporate governance.⁹² The assumption that agents will pursue their own selfish interests rather than fulfill their fiduciary duties paints a generally negative portrayal of corporate managers. Rather than competent experts, managers were portrayed as taking every opportunity to shirk their duties.⁹³

The agency costs model became influential not only because it was taught in business and law schools,⁹⁴ but because it helped explain events during the 1970s that reduced confidence in the competence of managers. A number of corporate scandals such as the collapse of Penn Central and Equity Funding in the wake of securities fraud and the discovery of the widespread practice of paying corporate bribes by international companies, shook faith that professional managers could be trusted to look after the interests of shareholders.⁹⁵ The poor economy during the 1970s made it difficult for managers to succeed and they may have become too passive after a long period of growth.⁹⁶ As foreign competitors became stronger, the perception that U.S. management expertise was superior declined. An often-cited *Harvard Business Review* article published in 1980 described U.S. managers as “excessively cautious, even passive; certainly overanalytical; and, in general, characterized by a studied unwillingness to assume responsibility and even reasonable risk.”⁹⁷

⁹¹ *Id.* at 309 (noting that “[t]he problem of inducing an ‘agent’ to behave as if he were maximizing the ‘principal’s’ welfare is quite general. It exists in all organizations and in all cooperative efforts – at every level of management in firms.”).

⁹² Stout, *supra* note 4, at 18 (asserting that Jensen and Meckling “implied that managers should seek to serve only shareholders’ interests, not those of customers, employees, or the community.”).

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

⁹⁴ See, e.g., NICOLAS LEMANN, *TRANSACTION MAN: THE RISE OF THE DEAL AND THE DECLINE OF THE AMERICAN DREAM* 119 (2019); Khurana, *supra* note 30, at 324.

⁹⁵ See, e.g., Subcommittee on Reports, Accounting and Management, The Accounting Establishment, S. Doc. No. 34, 95th Cong., 1st Sess. 2 (1976) (“Continued revelations of wrongdoing by publicly owned corporations have caused a new awareness of the importance of accounting practices in permitting such abuses to occur.”); Gordon, *supra* note 6, at 1514-17 (noting scandals resulted in questioning of passive boards).

⁹⁶ See, e.g., KHURANA, *supra* note 30, at 297-300 (describing impact of economic environment on managerialism). Polling showed that the public’s esteem of management declined significantly from 1965 to 1975. See LEONARD SILK & DAVID VOGEL, *ETHICS AND PROFITS: THE CRISIS OF CONFIDENCE IN AMERICAN BUSINESS* 21 (1976).

⁹⁷ Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV. (1980); see also Steve Lohr, *Overhauling America’s Business*

While ideology can be transformative, or perhaps reflect underlying societal developments that foreshadow broader change, it is difficult to measure its influence. The 1970s saw substantial efforts to increase the social responsibility of corporations with respect to ethical and environmental issues.⁹⁸ Five years after Friedman's *New York Times Magazine* article, Ralph Nader, Mark Green, and Joel Seligman described shareholder wealth maximization as the minority view.⁹⁹ Notably, many managers continued to resist adopting the shareholder wealth paradigm and saw themselves as stewards of the corporation. Corporate managers actively resisted hostile takeovers that sought to maximize shareholder wealth during the 1980s.¹⁰⁰ A 1989 survey of boards noted that directors who "adhere to a strict belief in the primacy of the shareholder" are "a true minority."¹⁰¹ Even by the end of the 1980s, it was far from clear that corporate managers had an ideological commitment to shareholder wealth maximization.

C. Management incentives

Any reluctance by corporate managers to adopt the shareholder wealth norm was arguably overcome through changes in executive compensation during the 1990s. During the 1960s and 1970s, executives were paid predominantly through fixed salaries.¹⁰² Because they did not own a significant percentage of their company's stock, their economic fortunes did not significantly rise and fall with the wealth of shareholders. Rather than pay managers like bureaucrats, scholars like Jensen argued that they should be given the incentives of entrepreneurs by increasing their stock compensation. By the 1990s, close to half of the average CEO's compensation was in the

Management, N.Y. TIMES, January 4, 1981 ("there is now a growing consensus, both at home and abroad, that the performance of American management of late has been sorely lacking. . . .").

⁹⁸ See, e.g., Gordon, *supra* note 6, at 1517-18 (describing corporate social responsibility movement of the 1970s).

⁹⁹ See RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION 259 (1976).

¹⁰⁰ See, e.g., Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 122 (2001).

¹⁰¹ JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 39 (1989); *but see* ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE 1 (1986) ("Corporate mission statements proclaiming that the primary responsibility of management is to maximize shareholders' total return via dividends and increases in the market price of the company's shares abound.").

¹⁰² See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990) (finding that CEO compensation was not substantially linked to company performance from 1974 to 1986).

form of stock and options.¹⁰³ As they became more significant shareholders, corporate managers had an additional incentive to focus on increasing shareholder value.¹⁰⁴

While executive compensation likely encouraged managers at the margins to increase shareholder wealth, the shift from salary to stock options came too late to explain the fall of managerialism. Most commentators would agree that increasing a company's stock price was important even before the 1990s. It is more likely that the incentive of managers to increase their wealth became aligned with general corporate incentive to increase shareholder value. Moreover, it is not entirely clear that stock compensation was firmly linked to company performance. Professors Bebchuk and Fried famously argued that pay was not tied to performance during the 1990s and instead reflected captured boards that looked after managerial interests.¹⁰⁵

D. Investor preferences

The final explanation for the fall of managerialism is the most persuasive. Over the 1960s and 1970s, individual investors increasingly invested through institutions.¹⁰⁶ These institutional investors included pension funds, mutual funds, and insurance companies that had the resources to evaluate market information. While it took some time for such large

¹⁰³ See Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 661 (1998).

¹⁰⁴ See, e.g., GERALD F. DAVIS, *MANAGED BY THE MARKETS* 86 (2009) ("Perhaps the most compelling reason for executives' new-found religious devotion to shareholder value was the massive shift in compensation practices that occurred during the 1980s and 1990s."); Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579, 590 (2018) ("shareholder value theory gained traction because it served the purposes of powerful interest groups, including newly emerging 'activist' investors and executives whose compensation, due to 1993 changes in the tax code, increasingly was based on share price.").

¹⁰⁵ See LUCIAN BEBCHUK AND JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 7 (2004).

¹⁰⁶ See, e.g., SECURITIES & EXCHANGE COMMISSION, *INSTITUTIONAL INVESTOR STUDY REPORT* vol. 1 ix (1971) (reporting growth in institutional holdings of New York Stock Exchange securities increased from 31.1 percent in 1962 to 39.4 percent in 1970); TIM CARRINGTON, *THE YEAR THEY SOLD WALL STREET* 28 (1985) (discussing shift in corporate pensions from bond market to stock market, increased popularity of mutual funds, and increase in stock investment by insurance companies); ROY C. SMITH, *THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S* 262 (1990) (noting rise of institutional investors during the 1960s); Sobel, *supra* note 41, at 331 (reporting that the share of equities owned by institutions rose from 12.5 percent to 20 percent over the 1950s).

investors to exercise their clout,¹⁰⁷ institutionalization had a significant impact on stock markets.¹⁰⁸

For various reasons, some institutional investors traded more frequently than the average individual investor. Even though shareholders of public companies were still largely dispersed, institutions were less likely to simply hold an investment passively. The professional managers that headed them sought information about their investments and traded on the information. Some institutional investors, like mutual funds, were judged based on their ability to generate profits, and thus traded more frequently to increase their returns.¹⁰⁹ Because they were informed, they might exercise their right to sell their shares if they were unhappy with a company's prospects. Henry Manne observed that such selling could reduce the company's stock price and increase the possibility that there would be a change in control.¹¹⁰

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

We know that managerialism was discredited by the 1980s, but it is less clear as to why the shareholder wealth paradigm replaced it. It is likely

¹⁰⁷ See, e.g., Holmstrom & Kaplan, *supra* note 100, at 122 (stating that over the 1980s, "capital markets grew more powerful with increased institutional investments.").

¹⁰⁸ Moreover, as defined benefit plans were replaced with defined contribution plans, Americans increasingly invested their personal savings through institutions. See, e.g., Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 911 (2013) (claiming that "changes in the pension system helped to transform corporate governance into a system dominated by the shareholder interest, to the detriment of the managerial model.").

¹⁰⁹ See, e.g., Institutional Investor Study Report, *supra* note 106, at xxii (noting increased volume of trading by institutions); CHRIS WELLES, *THE LAST DAYS OF THE CLUB* 28-31 (1975) (describing frequent trading by mutual funds to increase performance); see also J.A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 64-65 (1958) (describing tendency of institutions to sell rather than influence corporate governance).

¹¹⁰ See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

that a combination of factors played a role in developing the expectation that managers maximize shareholder value. But some must have been more important than others. It is unlikely that law evolved to suddenly influence managerial strategy. Ideology made a difference but its impact was not uniform on managers who often continued to believe that they work on behalf of stakeholders. Executive compensation became a force years after managerialism had failed. Institutional investors brought more sophistication to markets but the account of their influence has not been fully developed.

III. THE PROBLEM OF VALUING FUTURE EARNINGS

Managerialism was possible in part because investors did not systematically analyze the trajectory of public company earnings. This Part describes the state of valuation methods before the shift to the shareholder wealth paradigm. By the 1930s, investors recognized the importance of earnings in valuing stocks and that stock prices reflected a judgment about the future performance of a company. The present value model was introduced around this time, providing a method for valuing profits in later periods. The problem was that investors were not confident that meaningful predictions could be made of a company's earnings. Moreover, for decades, the SEC actively discouraged the use of projections because of the belief that they fueled speculation.

A. *The Shift to Assessing Earnings*

Early financial statement analysis was mainly concerned with the value of a company's assets.¹¹¹ Stock investors looked to the company's balance sheet to verify that its assets were greater than its liabilities.¹¹² The main concern was that a company might inflate the reported value of its assets so that the stock was not backed by anything of value.¹¹³ Rather than view a stock investment as potentially increasing in value, shareholders were mainly concerned that the value of their capital contribution was preserved.¹¹⁴

¹¹¹ PAUL G. MAHONEY, WASTING A CRISIS WHY SECURITIES REGULATION FAILS 46-48 (2015).

¹¹² Knight & Weinwurm, *supra* note 24, at 25 (As one set of commentators noted, “[t]he balance sheet was long regarded as the basic accounting statement, and the formula: assets – liabilities = proprietorship, as the basic accounting formula.”).

¹¹³ Such a practice was known as selling “watered” stock. *See* ROBERT CHARLES CLARK, CORPORATE LAW 710 (1986).

¹¹⁴ At least initially, the value of a company's common stock was fixed. Companies would assign a par value to the stock equal to the investor's capital contribution to the company. *See* CLARK, *supra* note 113, at 707-15. An investor purchasing a stock at par value was essentially making a capital contribution to the firm. *See, e.g.*, WILLIAM ZEBINA RIPLEY, MAIN STREET AND WALL STREET 47-48 (1927). An investor who bought one share of stock

It was not until the start of the twentieth century that income statements became a significant financial report,¹¹⁵ and it was years later before income statements were viewed as very important for valuing a company.¹¹⁶ While income statements could in theory help shareholders assess a company's profitability, in practice investors did not closely scrutinize such earnings.¹¹⁷ Instead, as noted earlier, they were satisfied that the payment of regular dividends was evidence that the company was profitable.¹¹⁸ A dividend could only be legally paid in many states if the company had positive earnings and thus was a tangible sign that a company had earnings.¹¹⁹

By the stock market crash of 1929, market professionals understood that the price of a stock was tied to the company's ability to continue generating earnings. As Edward Smith observed in *Common Stocks as Long Term Investments*, which was published a year before the crash and cited by some as fueling irrational investor optimism, common stocks "represent ownership of property and processes; their value and income return fluctuating with the earning power of the property."¹²⁰ The book did not offer extensive guidance on assessing whether individual companies had such earning power. Instead, it made general observations such as: (1) earnings

with a par value of \$100 would have made a \$100 capital contribution. The par value rule was meant to ensure that a stock was backed by something of value.

¹¹⁵ Previts & Merino, *supra* note 26, at 182, 217.

¹¹⁶ See, e.g., W. A. PATON & A. C. LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 98 (1970 ed.) (noting that "in recent years . . . the income report has supplanted the balance sheet as a focus of attention."); T.A. WISE, THE INSIDERS: A STOCKHOLDER'S GUIDE TO WALL STREET 29 (1962) ("A related difficulty has arisen from the steady shift in emphasis and interest away from the balance sheet and toward the income statement. Investors, security analysts, bankers, and even some creditors have grown more interested in the earnings capacities of companies than in their assets and liabilities."). The publication of Paton and Littleton's *Introduction to Corporate Accounting Standards* in 1940 developed a method matching for revenue and expenses that was influential in increasing the importance of earnings in financial reporting. See JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 160 (2006).

¹¹⁷ Previts & Merino, *supra* note 26, at 218.

¹¹⁸ The practice of paying regular dividends began after World War I. Such payments provided "a measure of assurance as to the return on capital which had formerly not existed for owners of common stock." Sobel, *supra* note 41, at 222.

¹¹⁹ Clark, *supra* note 114, at 708 (noting that "under many statutory schemes directors . . . will not be able to make legal distributions of corporate property to the shareholders unless the value of the property remaining afterwards matches or exceeds the amount of its debt plus its legal capital.").

¹²⁰ EDWARD LAWRENCE SMITH, COMMON STOCKS AS LONG TERM INVESTMENTS 4 (1928) (2012 edition).

will generally increase as the economy grows,¹²¹ and (2) historically, stocks have returned more for investors than bonds.¹²²

The analysis of stocks became more systematic with the publication of the first edition of *Securities Analysis* by Benjamin Graham and David Dodd in 1934. It noted with some skepticism the theory that “[t]he value of a common stock depends entirely upon what it will earn in the future.”¹²³ The book observed that such an approach to valuation fueled the speculation that resulted in the crash of the market. It warned against assuming that past trends in earnings would continue into the future.¹²⁴ Yet it also acknowledged that “by and large a good past record offers better promise for the future than does a poor one.”¹²⁵

Soon after the publication of Graham and Dodd’s *Securities Analysis*, the basic present value model that is used today was published by John Burr Williams in a 1937 book, the *Theory of Investment Value*, which was based on his doctoral thesis at the University of Chicago. Williams argued that the reigning stock valuation models were flawed because “[p]rices have been based too much on current earning power, too little on long-run dividend-paying power.”¹²⁶ Instead, he argued that valuation should be based on the principle that “rational men, when they buy stocks and bonds, would never pay more than the present worth of the expected future dividends, or of the expected future coupons and principal. . . .”¹²⁷ He developed a model where the value of a stock could be calculated by determining the present value of its expected stream of dividends over time. Williams’ modeling of dividends was consistent with the expectation at the time that investors would earn returns through the receipt of dividends rather than capital gains as a company increased its value over time. It provided the basic methodology for assessing whether a stock was trading at a reasonable valuation.

B. The Problem of Predicting Earnings

By the end of the 1930s, knowledgeable stock market analysts thus knew in theory that a company’s stock reflected its future earnings power. The question was how in practice investors could predict those earnings with enough confidence to conclude that a stock valuation was reasonable. The

¹²¹ *Id.* at 5.

¹²² *Id.* at 20.

¹²³ BENJAMIN GRAHAM & DAVID L. DODD, *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES* 307 (1st ed. 1934).

¹²⁴ *Id.* at 314-15.

¹²⁵ *Id.* at 319.

¹²⁶ JOHN BURR WILLIAMS, *THE THEORY OF INVESTMENT VALUE* 171 (1937).

¹²⁷ *Id.* at 5.

present value model could only work if there was a way of objectively and accurately assessing a company's future performance.

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

individuals . . . invest money . . . based primarily on a favorable forecast of the probable future of the enterprise. But since the future is still mercifully concealed from the knowledge of men and investors, the usual criterion for judgment is the record of past experience. This perhaps is why judgment of the market place usually tends to be 'conservative.' As a rule it does not readily or cheaply provide risk capital for new and untried revolutionary inventions, or for expansion of enterprise into the unexplored regions of science (though there are conspicuous exceptions).¹²⁸

A study of U.K. companies in 1966 asked "whether it is possible to predict the future growth of a company by looking at its past results" and found "no consistent pattern of growth that distinguishes one firm from another."¹²⁹ An accounting professor noted in 1971 that "a reasonable doubt should exist regarding the ability of firms to forecast operating results with the degree of accuracy and precision necessary to satisfy the requirements of investors."¹³⁰ NYU Law School Professor Homer Kripke, who was a significant critic of SEC policies prohibiting the disclosure of projections, noted as late as 1979 that "the growth stock theory of investing has a more fundamental difficulty, namely, that there is no empirical basis from which to predict future earnings from past growth."¹³¹ Even today, there is some skepticism about the validity of predictions about earnings, particularly long-term projections.¹³²

¹²⁸ ADOLF A. BERLE, JR., *THE 20TH CENTURY CAPITALIST REVOLUTION* 41-42 (1954).

¹²⁹ I.M.D. LITTLE & A.C. RAYNER, *HIGGLEDY PIGGLEDY GROWTH AGAIN* 9, 31 (1966).

¹³⁰ R. Austin Daily, *The Feasibility of Reporting Forecasted Information*, 46 *ACCOUNT. REV.* 686, 692 (1971).

¹³¹ HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 99 (1979).

¹³² See, e.g., ASWATH DAMODARAN, *INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET* 271 (3rd ed. 2012) ("Although many firms are widely followed by analysts, the quality of growth estimates, especially over longer periods, is poor. Relying on these growth estimates in a valuation can lead to erroneous and inconsistent estimates of value."); ALFRED RAPPAPORT, *SAVING CAPITALISM FROM SHORT-TERMISM: HOW TO BUILD LONG-TERM VALUE AND TAKE BACK OUR FINANCIAL FUTURE* 216 (2011) (observing that investors and analysts "avoid the difficulty of forecasting long-term cash flows" because "they believe that forecasting is too speculative and too time-consuming to be of practical use.").

Even without confidence that future performance could be precisely predicted, markets at times during the age of managerialism assigned high valuations to companies with promise. Towards the end of the 1950s, computer and technology companies enjoyed a speculative boom.¹³³ Investors were willing to pay much more for the stock of such companies than warranted by the level of their past earnings.¹³⁴ The speculation was not just limited to technology companies. Investors became confident in the prospects of large companies with a high degree of market power.¹³⁵ The continually strong performance of the largest companies helped give investors enough confidence to pay a premium in expectation that their growth would continue.¹³⁶

The line between blindly speculating on stocks for their potential and the process of evaluating future earnings is a thin one. An article published in the *Financial Analysts Journal* in 1967 asked whether “Performance” was “The Latest Name for Speculation.”¹³⁷ The research analyst who wrote the article observed that valuation had shifted over the years from “[n]et worth, book value and physical assets”; to “income return, dividends and yield” to “earnings and earnings reliability” to “long-range growth rates of earnings”

¹³³ See, e.g., Sobel, *supra* note 41, at 354-55.

¹³⁴ Sobel, *supra* note 41, at 356 (noting that during the 1950s technology boom, “an important question was how did one figure a correct price for a firm that had no earnings at all.”).

¹³⁵ BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* 122-23 (Rev. Ed. 1973) (suggesting strategy of investing in companies “of substantial size combined with a leading position in the industry.”). Others, though, were skeptical that monopoly power necessarily predicted earnings growth. See, e.g., Little & Rayner, *supra* note 129, at 64 (“we do seem to have shown that managements do not remain above or below average for very long – or, if they do, that such above and below average management can have so feeble an effect on earnings growth that we cannot detect it – and similarly for the monopoly power of firms. Certainly, investors are wrong to think that a few years’ above average rise of earnings is evidence at all that good management, which will result in a continued rise, must be present.”).

¹³⁶ The so-called Nifty Fifty stocks were a group of “premier growth stocks, such as Xerox, IBM, Polaroid, and Coca-Cola, which became institutional darlings in the early 1970s.” JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN: A GUIDE TO SELECTING MARKETS FOR LONG-TERM GROWTH* 96 (1994). Investors “were willing to pay any price at all for the privilege of owning” these stocks because “the growth prospects seemed so certain that the future level of earnings and dividends would, in God’s good time, always justify whatever price they paid.” PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK* 108 (1998); see also MAGGIE MAHAR, *BULL: A HISTORY OF THE BOOM AND BUST, 1982-2004* 41 (2004). The Nifty Fifty warranted a premium over companies “whose fortunes were uncertain because of their exposure to business cycles and competition.” *Id.* One commentator noted at the time a general shift to “pricing stocks not on current earnings or past performance but on projections.” Sobel, *supra* note 41, at 235.

¹³⁷ David L. Babson, *Performance: The Latest Name for Speculation?*, 23 *FIN. ANAL. J.* 129, 130 (1967).

and now “instant earnings growth.”¹³⁸ Given the difficulty of predicting such growth, he asserted that the new focus on company performance “is just a modern word for trading and speculating.”¹³⁹

Even if the present value model is based on what are uncertain guesses about the future, its emergence is notable because it created metrics that not only influenced investors but also corporate behavior. Speculation on stocks has a long history and will always be a part of stock markets. It is difficult for managers to formulate a coherent response to irrational speculation by uninformed traders. In contrast, corporate decisionmakers can adjust their strategies to meet the earnings targets set by knowledgeable analysts.

The prediction of a public company’s earnings was complicated by SEC policy, which until the latter half of the 1970s, prohibited the inclusion of projections in SEC filings. There was no specific rule that banned projections. As Harvard Law School Professor Victor Brudney explained, “[t]he Commission’s opposition was expressed in admonitory releases and in opinions in particular cases than in any general prohibitory regulation under the Securities Act.”¹⁴⁰ As late as 1969, an important study of securities disclosure by SEC Commissioner Francis Wheat was wary that “projections in filed documents might become traps for the unsophisticated who would be prone to attach more significance to such projections than they deserve.” It thus concluded, that “the Commission’s long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission. . . . should not be changed.”¹⁴¹

The SEC’s policy to some extent limited public access to information that could assist them in assessing the future performance of a company. Because management has the best access to information about the company’s performance, such information could aid investors in valuing the company.¹⁴² The SEC’s policy conveyed to investors that projections were not information

¹³⁸ *Id.* at 130.

¹³⁹ *Id.* at 131.

¹⁴⁰ Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 753, n.80 (1989).

¹⁴¹ SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE ’33 AND ’34 ACTS 12 (1969) (Wheat Report); see also HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 15 (1979) (“Defenders of the Commission’s long-maintained insistence on objectivity argued that forecasts involved prophecy, and no one can be an expert on prophecy.”).

¹⁴² See, e.g., Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 634 (1973) (The SEC’s policy of protecting lay investors lead to “the suppression of what should be the absolute key piece of information to any prospective securities investor . . . projections as to future earnings.”); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2379 (1998) (discussing SEC’s ambivalence towards projections).

they should rely on in valuing a stock. Because SEC disclosure through the 1970s did not permit the use of projections, its impact on market valuations was limited. The next Part will discuss how markets became more efficient through private ordering. Managers developed ways to signal to investors that company financial results would continue to improve.

IV. SIGNALING FUTURE EARNINGS

As public companies grew larger and became more complex, it was clear that the competence of management was the critical factor in their success. Superior managers are more likely to generate earnings growth over time than weak managers. Investors that could identify companies with strong management would have more confidence in predicting their future earnings stream. Because it is difficult to directly observe managerial skill, companies sought to convey the competence of their management team to external capital markets. They did so through two methods. The first, which was only successful for a time, was by adopting the strategy of assembling conglomerates that would generate consistent earnings growth. The second was to consistently meet market projections of their financial performance.

A. Conglomerates

Over the 1960s, public corporations increasingly assembled companies operating in different industries.¹⁴³ Rather than focusing on a single industry, managers believed that they could create value by applying their expertise to such conglomerates. As noted earlier, market power gave large corporations access to profits that gave them the resources to expand. The passage of the Celler-Kefauver Act in 1950 increased scrutiny of acquisitions within the same industry but was viewed as less likely to be violated by an acquisition of a company operating in a different industry.¹⁴⁴ Many large corporations responded by buying companies in different markets.¹⁴⁵ By the end of the 1960s, 33 of the companies listed on the Fortune 500 were conglomerates.¹⁴⁶

¹⁴³ See, e.g., J. Fred Weston & Surenda K. Mansinghka, *Tests of the Efficiency Performance of Conglomerate Firms*, 26 J. FIN. 919, 921 (1971) (defining conglomerates as “firms that have entered into a broad program of diversification achieved to a substantial degree by external mergers and acquisitions rather than by internal development.”).

¹⁴⁴ See Celler-Kefauver Act, 15 U.S.C. § 18, 64 Stat. 1125 (1950).

¹⁴⁵ See, e.g., NEIL FLIGSTEIN, *THE TRANSFORMATION OF CORPORATE CONTROL* 195 (1990); GERALD F. DAVIS, *MANAGED BY THE MARKETS* 78 (2009).

¹⁴⁶ See STANLEY C. VANCE, *MANAGERS IN THE CONGLOMERATE ERA* 63 (1971); see also JOHN BROOKS, *THE GO GO YEARS: THE DRAMA AND CRASHING FINALE OF WALL STREET’S BULLISH 60S* 153-54 (1973) (describing 1966-69 as the heyday of conglomerates).

Conglomerates have long been associated with managerialism.¹⁴⁷ The prevailing story is that conglomerates reflected the preference of managers for growth over maximizing profits.¹⁴⁸ Managers assembled conglomerates to reduce the risk that a business setback could endanger their jobs. Managers could also satisfy personal ambitions of power by assembling empires that did not operate efficiently but increased their social status.¹⁴⁹ The strategy failed as experience showed that managers did not have the skills to maximize performance of businesses operating in unrelated industries, undermining the appeal of managerialism.¹⁵⁰

But during the 1960s, conglomerates were viewed as a strategy driven by shareholder value. A 1969 article in *Forbes* asserted that conglomerates “were ideal vehicles for a stock market that had become increasingly performance-minded. . . .”¹⁵¹ The editors of *Fortune* asserted in a book compiling essays on conglomerates that such entities had a “unique approach to maximizing their shareholders’ return,” and “are raising basic questions about the nature of business and the purpose of corporations.”¹⁵² Rather than reflecting the managerialist philosophy, conglomerates reflected a response to shareholders seeking higher profits.¹⁵³

The conglomerate followed from the managerialist belief that superior management could add value to a corporation.¹⁵⁴ Professionally trained managers had the skills to run multiple businesses.¹⁵⁵ Large

¹⁴⁷ See, e.g., Stout, *supra* note 89, at 2007 (describing “conglomerate business structure” as “favored” by “many managerialist boards and executives”).

¹⁴⁸ See, e.g., CHRISTOPHER ELIAS, FLEECING THE LAMBS 86 (1971) (“the conglomerate empires were assembled with little regard for earnings. Only ‘growth,’ a magic word to accompany the numbers, was considered.”); see also John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495, 1500 (1990) (noting tendency of managers to build empires).

¹⁴⁹ See, e.g., Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1915 (2013).

¹⁵⁰ See, e.g., Hansmann & Kraakman, *supra* note 7.

¹⁵¹ *The Multicompanies: Conglomerate, Agglomerate and In-Between*, FORBES, Jan. 1, 1969, 77.

¹⁵² THE CONGLOMERATE COMMOTION 45 (1970).

¹⁵³ See, e.g., J. Fred Weston, *The Nature and Significance of Conglomerate Firms*, 44 ST. JOHN’S L. REV. 66, 71 (1970) (noting that a reason for conglomerates was “the recognition of growth in earnings per share as an improvement factor in the valuation of securities.”). There is mixed evidence that the market viewed conglomerate mergers favorably. See, e.g., Hubbard & Palia, *supra* note 21.

¹⁵⁴ There was some evidence that conglomerates outperformed the market through the late 50s and 1960s. See WILLIAMSON, *supra* note 16, at 173.

¹⁵⁵ See, e.g., FEDERAL TRADE COMMISSION, ECONOMIC REPORT ON CORPORATE MERGERS 73 (1969) (“[t]he timing and increasing frequency of conglomerate mergers, it is alleged, are simple responses of the market to management’s greatly expanded capacity for planning and decision-making.”).

companies had the resources to invest in a central staff that would allocate resources to promising divisions and make investments in new markets and industries.¹⁵⁶ As noted earlier, the belief was that such internal capital markets were more efficient in assessing the performance of individual companies than external markets.¹⁵⁷ Moreover, if better managers were the main determinant of market value, the value of a business could increase when its assets were transferred to a well-run conglomerate.¹⁵⁸

A conglomerate could demonstrate that its assets were managed efficiently by delivering consistent increases in company earnings. In describing the strategy of conglomerates, *Forbes* observed that “the cornerstone of their long-range planning is the realization of a certain minimum annual increase in per-share earnings.”¹⁵⁹ Because the complexity of conglomerates made them difficult to assess, it was especially important for them to deliver strong bottom line financial results. Conglomerates thus had an incentive to develop ambitious forecasts and meet them. The success of one of the more prominent conglomerates, International Telephone & Telegraph (ITT) was attributed in part to its prowess in forecasting. Its CEO was said to teach “all his executives how to think out all their objectives in terms of profits, to set targets and keep to them, to control details with iron discipline. . . .”¹⁶⁰

The diversification of conglomerates could help ensure that earnings were smooth and predictable.¹⁶¹ When one business was struggling, another would be prospering.¹⁶² Managers could allocate capital to the sectors that were most promising and decrease resources to sectors that were less promising. The combination of results-driven management and diversification could generate growth while minimizing risk. The

¹⁵⁶ See, e.g., Chandler, *supra* note 13, at 481.

¹⁵⁷ Williamson, *supra* note 16, at 259. The belief that conglomerates can be efficient persists. See Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 *SCIENCE* 745, 746 (1990) (noting benefits of conglomerate internal capital markets).

¹⁵⁸ Neil H. Jacoby, *The Conglomerate Corporation*, *THE CENTER MAG.*, July 1969, at 48 (“A real social gain occurs when the assets of an enterprise are transferred via merger into the control of a superior management.”).

¹⁵⁹ *The Multicompanies: Conglomerate, Agglomerate and In-Between*, *FORBES*, Jan. 1, 1969, 83.

¹⁶⁰ ANTHONY SAMPSON, *THE SOVEREIGN STATE OF ITT* 128 (1973).

¹⁶¹ See, e.g., *THE CONGLOMERATE COMMOTION*, *supra* note 152, at 4 (“it does appear that certain kinds of conglomerates – those that have made diversification a ‘way of life,’ rather than just a response to trouble – are able to generate superior earnings performance fairly consistently.”).

¹⁶² See, e.g., Corwin D. Edwards, *Conglomerate Bigness as a Source of Power in BUSINESS CONCENTRATION AND PRICE POLICY* 331, 350 (1955) (“The diversification of the large concern minimizes risk by settling loss in one part of the business against profit in another and thereby providing an automatic business risk insurance.”).

conglomerate Textron was described as “achieving stability by balancing one unrelated business against another and attaining growth by setting high investment goals and rigorously pursuing them.”¹⁶³ On the other hand, conglomerates faced pressure to continue their record of stable growth to demonstrate that the strategy was working.¹⁶⁴

Conglomerates delivered earnings increases not only through efficient management but through more questionable methods. One common strategy was to rely on frequent acquisitions to increase revenue and earnings.¹⁶⁵ Because conglomerates were valued highly because of their professional management, the earnings from the acquired company would receive a loftier market valuation.¹⁶⁶ This premium of course assumed that managers could consistently increase the efficiency of the acquired companies. The accounting rules at the time permitted the conglomerate to report the cost of the acquired assets at a conservative book value. Over time, they could sell such assets at market value to generate higher earnings.¹⁶⁷

The era of conglomerates has often been linked to the fall of managerialism. Professional managers furthered their own interests by assembling large empires. On closer inspection, another narrative explains conglomerates. They were a way that public companies could signal that they would generate higher earnings over time for investors.

B. Projections

As Professor Jeffrey Gordon has noted, the fall of managerialism required “external capital markets” to “advance[] relative to internal capital markets in the allocation of capital.”¹⁶⁸ This section will show that such parity became possible as public companies increasingly used projections to allocate capital within internal capital markets. Internal projections could be disseminated to external markets that used them to create their own projections of performance. Reliably meeting external projections could

¹⁶³ *The Multicompanies*, *supra* note 159, at 85.

¹⁶⁴ *See, e.g.*, Sampson, *supra* note 160, at 143 (“Geneen was determined that ITT should present a record of steadily increasing earnings, growing every quarter, to reassure the most skeptical investor that this company, like a liner with stabilizers, was invulnerable to economic storms.”).

¹⁶⁵ *See, e.g.*, ADAM SMITH, *THE MONEY GAME* 188-189, 194 (1968); Brooks, *supra* note 87, at 156-67.

¹⁶⁶ *See, e.g.*, *THE CONGLOMERATE COMMOTION*, *supra* note 161, at 97-99 (1970); Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1199 (1970).

¹⁶⁷ *THE CONGLOMERATE COMMOTION*, *supra* note 161, at 102 (1970); SAMPSON, *supra* note 160, at 144.

¹⁶⁸ Gordon, *supra* note 6, at 1470.

signal that a corporation's management of its internal capital markets was sound.

1. Internal Projections

As public companies grew larger, managers developed budgeting techniques so that they could efficiently allocate resources within the firm. Preparing a corporate budget requires gathering, organizing, and analyzing information relating to various business groups.¹⁶⁹ Among other items, such budgets estimate future sales so that enough products can be manufactured to meet expected customer demand.¹⁷⁰ Managers can later compare actual sales to the forecasted sales in their budget to assess the reliability of their models.¹⁷¹

Internal projections help corporate managers address agency costs that can reduce the efficiency of an internal capital market.¹⁷² Managers of individual divisions have their own incentives that may conflict with the organization's goals. For example, they may lobby for more capital than they can effectively use to increase their status within the corporation.¹⁷³ By requiring divisions to set internal projections, and assessing whether those

¹⁶⁹ There were two main methods for setting forecasts. One approach was for a centralized division to develop budgets that would be distributed to divisions. A second approach was for individual divisions to set their own budgets that would be consolidated. See FRANCIS A. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS 11 (1981).

¹⁷⁰ See, e.g., Knight & Weinwurm, *supra* note 24, at 65 ("The budget is a plan of future performance; therefore, it cannot avoid the problems involved in predicting future events. Even the best forecast will be characterized by uncertainty to some extent.").

¹⁷¹ Knight & Weinwurm, *supra* note 24, at 6 (observing that budgeting "consists essentially of two parts: (1) the preparation of a comprehensive financial plan of operations and (2) the comparison of actual financial results with this predetermined plan.").

¹⁷² A number of commentators have noted the problem of agency costs that can reduce the efficiency of internal capital markets. See, e.g., Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95, 106 (1998) (asserting that consensus view is that "internal capital markets are less efficient than external capital markets because they replace the profit-based-decision-making of investors with the bureaucratic decision-making of corporate executives."); David Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FIN. 2537 (2000) (modeling rent-seeking by divisional managers); Triantis, *supra* note 19, at 1113; see also Hyun-Han Shin & Rene Stulz, *Are Internal Capital Markets Efficient?*, 113 Q. J. ECON. 531 (1998) (finding evidence that capital is not allocated to most promising divisions).

¹⁷³ See, e.g., Timothy F. Malloy, *Regulating by Incentives: Myths, Models, and Micromarkets*, 80 TEXAS L. REV. 531, 574 (2002) (describing competition for capital within the firm).

projections have been met, central managers can better allocate funds to more promising projects.¹⁷⁴

Some large companies were developing and using internal projections by the start of the twentieth century. The business historian Alfred Chandler described how Du Pont, the chemicals company, pioneered corporate budgeting methods starting in 1906. Its management “systematize[d] the making and approval of both operating and capital budgets.”¹⁷⁵ It made both “long- and short-term financial forecasts,” including a “forecast of net earnings” that “determined the maximum amount available for new capital expenditures from retained earnings.”¹⁷⁶ This projection was “computed by multiplying sales department monthly estimates of sales by the accounting department’s estimates of net profit per unit for each product.”¹⁷⁷ The internal earnings forecast was “checked regularly against actual results . . . and increased the possibilities for rational choice between alternative investments and alternative methods of financing them.”¹⁷⁸

A handful of other large companies incorporated forecasts in their own budgets,¹⁷⁹ but it was not until after World War II that budget forecasts were used widely by public companies and techniques for forecasting were systematically developed.¹⁸⁰ One commentator noted that “by the late 1920s,

¹⁷⁴ The monitoring by a central office was viewed as permitting companies to focus on the long-run rather than the short-term interests of divisional managers. *See, e.g.*, Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1223 (1984). Monitoring works best when hard information about divisional performance is available. *See, e.g.*, Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized versus Hierarchical Firms*, 57 J. FIN. 1891 (2002); *but see* Naomi R. Lamoreaux, Daniel M.G. Raff & Peter Temin, *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, NBER Working Paper 9029, at 42 (July 2002) (arguing that internal projections can result in inefficient behavior). The benefits of more efficient monitoring in internal capital markets can be offset by costs such as reduced incentives for entrepreneurship by divisional managers. *See* Robert H. Gertner, David S. Scharfstein & Jeremy C. Stein, *Internal Versus External Capital Markets*, 109 Q. J. ECON. 1211 (1994)

¹⁷⁵ Chandler, *supra* note 13, at 449.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ According to Chandler, a slow-down in demand in 1920 and 1921, prompted companies like General Motors, Sears, Du Pont, General Electric, and U.S. Rubber to respond “by developing techniques that set and adjusted their flows to carefully forecasted future demand.” Chandler, *supra* note 13, at 457. These managerial techniques spread through the 1920s as “new accounting, budgeting, and forecasting methods were becoming normal operating procedures.” *Id.* at 464. Business schools facilitated this spread. *Id.* at 465-66.

¹⁸⁰ *See, e.g.*, ELMER C. BRATT, BUSINESS FORECASTING 238 (1958) (“In line with the functions which the yearly budget came to serve, notably the development of sales targets and financial planning, the practice of making yearly forecasts has spread widely since the war.”).

techniques were available whereby most sales forecasters could prepare reasonable estimates of future sales,” but there was a “lack of data” to make accurate forecasts.¹⁸¹ By the 1950s, “those firms which tried to set up a program of sales forecasting some years ago only to see it fail for lack of data find things changed today.”¹⁸² A number of publications around this time described budget forecasting as a field that was relatively immature but emerging.¹⁸³ A book on managerial budgeting observed that as corporations continued to grow in “size and complexity . . . the need for better tools of prediction has become ever more pressing.”¹⁸⁴

A study published in 1956 provides a snapshot of forecasting practices by companies.¹⁸⁵ The American Management Association circulated a survey at its annual conference to 297 companies. The survey’s results indicated that “[e]ven among the largest firms . . . scientific sales forecasting is comparatively new.”¹⁸⁶ Five years prior to the 1956 conference, only about half of the companies (150 firms) had a central office that handled forecasting.¹⁸⁷ As of the conference, 241 of the 297 companies had centralized forecasting.¹⁸⁸ The most commonly cited use of forecasts was for production planning (262 firms). A significant number of firms used forecasts for budgeting (255 firms) and earnings forecasting (224 firms).¹⁸⁹ The most common bases for company forecasts were past sales trends (278 firms), sales

¹⁸¹ C.M. CRAWFORD, SALES FORECASTING: METHODS OF SELECTED FIRMS 36 (1955).

¹⁸² *Id.*

¹⁸³ One publication observed that “[b]usiness forecasting, recognized as a separately organized activity of a business enterprise is, however, a relatively new development in the art of business management.” CONTROLLERSHIP FOUNDATION, INC., BUSINESS FORECASTING: A SURVEY OF BUSINESS PRACTICES AND METHODS 1 (1950). Another study noted that “[v]arious sales-forecasting approaches have been developed, for the most part by individual companies, on a trial-and-error basis. There is very little literature available on sales-forecasting practices. The techniques in use, essentially quite simple, place primary emphasis on trend extension.” AMERICAN MANAGEMENT ASSOCIATION, INC., SALES FORECASTING: USES, TECHNIQUES, AND TRENDS (1956). A book on business forecasting explained that “[t]he immaturity of forecasting is indicated by the fact that there are still companies which operate with a dual system: one forecast for sales planning and quota making, and another for financial-control purposes.” BRATT, *supra* note 180, at 263.

¹⁸⁴ Knight & Weinwurm, *supra* note 24, at 65.

¹⁸⁵ AMERICAN MANAGEMENT ASSOCIATION, INC., SALES FORECASTING: USES, TECHNIQUES, AND TRENDS (1956).

¹⁸⁶ *Id.* at 143. An earlier survey found that 36 of 37 companies prepared “formal annual forecasts of sales.” Controllership Foundation, Inc., *supra* note 183, at 16. It noted that “[t]he sales forecast is the basis for the sales budget, the profit and loss budget and various expense budgets.” *Id.* at 20.

¹⁸⁷ *Id.* at 144.

¹⁸⁸ *Id.* at 144.

¹⁸⁹ *Id.* at 148.

department estimates (255 firms), and judgment and hunches (230 firms).¹⁹⁰ Almost all of the firms prepared an annual forecast (286 firms), and less than half of the companies prepared quarterly forecasts (128 firms).¹⁹¹ Only one of seven companies used a “high-speed electronic computer” to prepare their forecasts.¹⁹²

By the 1950s, it was possible for one commentator to note that “forecasting and budgeting are the basis of ‘operation planning,’ which in turn is the essential basis of efficient management.”¹⁹³ Internal corporate forecasts were used by high level management for a wide array of purposes. According to the American Management Association, “[i]n the financial division, the sales forecast becomes the basis of budgeting and planning for inventory levels, cash requirements, and estimates of income and disbursements.”¹⁹⁴ Budgets and forecasts permitted professional managers to efficiently plan and allocate resources within the firm.¹⁹⁵ Divisions that proved they could be profitable would merit greater capital than those that did not.¹⁹⁶ For example, Thomas Watson, Jr., the President of IBM, noted that in the 1950s, the company organized itself into divisions and “started to emphasize profit as the measure of each division’s performance.”¹⁹⁷ The economist John Kenneth Galbraith noted the care with which large companies developed and used projections.¹⁹⁸ For Galbraith, superior

¹⁹⁰ *Id.* at 151.

¹⁹¹ *Id.* at 153.

¹⁹² *Id.* at 75.

¹⁹³ Bratt, *supra* note 180, at 266.

¹⁹⁴ American Management Association, Inc., *supra* note 185, at 23.

¹⁹⁵ See, e.g., Knight & Weinwurm, *supra* note 24, at 55 (“Budgeting may be regarded as a tool of top management, acting through the budgeting staff, to coordinate the activities of subordinate departments with each other, with company-wide goals and objectives, and with the over-all criterion of reasonable return on investment.”); see also Richard D. Crisp, AMERICAN MANAGEMENT ASSOCIATION, INC., SALES FORECASTING: USES, TECHNIQUES, AND TRENDS 18, 21 (1956) (“Such a forecast is an essential guide to management for future planning.”).

¹⁹⁶ See, e.g., MOORE, *supra* note 46, at 120 (“For all units that have ‘profit accountability,’ meaning that they have revenue as well as expenditures, a favorable balance is clearly a mark of success and an unfavorable balance a mark of failure. The unit that is more than self-supporting has a much greater chance of getting a favorable hearing on budgetary increases than one that is living on relief.”).

¹⁹⁷ WATSON, JR., *supra* note 32, at 50. GE similarly instituted short-term sales and profitability targets for its divisions in the 1950s. See NOEL M. TICHY & STRATFORD SHERMAN, CONTROL YOUR DESTINY OR SOMEONE ELSE WILL: LESSONS IN MASTERING CHANGE – THE PRINCIPLES JACK WELCH IS USING TO REVOLUTIONIZE GENERAL ELECTRIC 45 (1993) (1994 edition).

¹⁹⁸ See, e.g., GALBRAITH, *supra* note 41, at 355 (observing that in all major business endeavors, “there are careful projections of output, careful control of prices; careful steps to see that the projections of output are validated in the greatest possible measure by consumer response; and careful steps to see that the things needed for production – labor, components,

planning is what distinguished large from small firms and permitted them to uniquely manage the uncertainty of economic fluctuations.

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

2. Market Projections

a. From Internal to External Projections

As internal company forecasts became more sophisticated, market participants understandably were interested in obtaining them.¹⁹⁹ By the 1960s, research analysts that wrote reports on company stocks for investors were common and publishing their own estimates of annual earnings for public companies.²⁰⁰ A 1963 SEC Study of Securities Markets noted the increasing number of broker-dealers with employees whose job it was to “‘research’ particular securities and industries; in many firms he is called an ‘analyst.’”²⁰¹ These research analysts primarily serviced the institutional investors that emerged around this period. Analysts would typically issue reports with recommendations about individual stocks. The Study explained that “at the core of almost all recommendations is the projection.”²⁰² It stated that in analyst reports, “[p]rojections of estimated earnings are conspicuous throughout.”²⁰³

machinery – are available in the requisite amounts at the anticipated prices at the right time.”).

¹⁹⁹ One article proposed simply making internal projections directly available to investors. *See, e.g.,* James R. Wilkinson & Lloyd D. Doney, *Extending Audit and Reporting Boundaries*, 40 ACCT. REV. 754 (1965) (“This added information would give the investor a greater insight into management’s expectations for future earnings and dividends as well as an improved basis for making computations of capitalization and the value of the capital stock of the firm.”).

²⁰⁰ Stock research analysts had been active since at least the 1920s. *See* Livingston, *supra* note 109, at 113.

²⁰¹ REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, 88TH CONGRESS, 1ST SESSION, PART 1 332 (April 3, 1963). Brokerage firms increasingly focused on providing research starting in the late 1950s. *See* Carrington, *supra* note 106, at 30; Sobel, *supra* note 41, at 342 (noting the fifties could be called the “Age of Analysis”).

²⁰² REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, *supra* note 201, at 346.

²⁰³ *Id.*

Earnings projections issued by research analysts were systematically compiled and disseminated by the end of the 1960s.²⁰⁴ The S&P Earnings Forecaster was first published in 1967 and initially provided several analyst forecasts for about 1500 companies. The I/B/E/S database, which was used primarily by brokers, began in 1972 and also provided annual projections.²⁰⁵ Before long, it was clear that markets relied on such forecasts in valuing companies.²⁰⁶

The increasing importance of projections to investors can be traced by looking at revisions to the investment treatise *Securities Analysis* by Benjamin Graham and David Dodd. Its first two editions had no chapter on earnings projections. Its second edition noted that investors were primarily concerned with a company's past earnings "as an indicator of future earnings."²⁰⁷ However, it noted that the "clue" provided by this record "is never thoroughly reliable and it frequently turns out to be quite valueless." The third edition of *Securities Analysis* was published in 1951 and had a chapter called "Projections of Earnings and Dividends".²⁰⁸ The introduction of the chapter observed that "practicing analysts dislike to 'stick their necks out' -- to use the invariable phrase -- by projecting the average earnings and dividends for a number of years ahead."²⁰⁹

By the fourth edition of *Securities Analysis* published in 1962, Graham and Dodd had more confidence in projecting company earnings.²¹⁰ As the chapter observed:

²⁰⁴ See, e.g., FRANCIS A. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS 31 (1981) (describing sources that compiled analyst projections).

²⁰⁵ William S. Gray, *The Role of Forecast Information in Investment Decisions*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS 35, 65 (Prem Prakash & Alfred Rappaport eds., 1974).

²⁰⁶ See, e.g., Dan Givoly & Josef Lakonishok, *The Information Content of Financial Analysts' Forecasts of Earnings*, 1 J. ACCT. & ECON. 165, 166 (1979) ("The keen interest of investors in future earnings and the weight they assign to them is manifested by, among other things, the number of brokerage houses that produce earnings forecasts on a regular basis and by the attention devoted by the financial community to the issue of the disclosure of management earnings forecasts.").

A more anecdotal account came from the interview of investment adviser for the Rockefeller family: "If you have good information on what a stock's future earnings will be, he says, you can do a pretty good job of predicting its future price. If a company's earnings start to vary from Mr. Lee's projections, he starts looking for more information about what's going on within the company." CARTER F. HENDERSON & ALBERT C. LASHER, 20 MILLION CARELESS CAPITALISTS 254 (1967).

²⁰⁷ BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 506 (2d ed. 1940).

²⁰⁸ BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 412 (3d ed. 1951).

²⁰⁹ *Id.* at 412.

²¹⁰ BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 450 (4th ed. 1962).

For the usual company – i.e., one not designated as a ‘growth’ enterprise – it is customary to estimate earnings only for the current or the coming twelve months. By contrast, in order to justify the high multipliers of current earnings commanded by many growth stocks, it becomes necessary to project the expanding earnings quite far into the future. The many analysts who favor companies of this type find no difficulty in making such far-reaching forecasts.²¹¹

The chapter was expanded from the prior edition and discussed techniques for forecasting earnings.

Analyst projections were often informed by management projections.²¹² Management could easily develop external projections based on their internal projections. The retailer J.C. Penney began compiling sophisticated budgets starting in the early 1960s.²¹³ It started issuing forecasts based on these internal budgets in the mid-1960s as its business model became more complicated and difficult for investors to understand.²¹⁴ As one court noted in deciding a securities fraud lawsuit relating to projections issued by the agricultural company, Monsanto’s projections “were consistent with, and fairly and accurately reflected, internal documents carefully prepared for budgetary, planning and review purposes and were based upon the best data available at the time of the statements.”²¹⁵ Presumably internal forecasts would be made by good faith by managers who used them for their own budgeting. The court thus found that the company’s external projections had a reasonable basis and were not meant to defraud investors.

Few companies consistently disclosed projections of their performance directly to the general public.²¹⁶ One survey reported its finding that “[i]n the opinion of respondents, many companies currently generate corporate forecasts but these forecasts are seldom made available either to

²¹¹ *Id.* at 450.

²¹² FAF Special Committee on Corporate Forecasts, *Proposals by the Federation for Systematic Disclosure*, in DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR 1, 14 (Financial Analysts Federation, ed. 1973) (“Management has special knowledge of internal factors and a greater sensitivity to its particular environment. It has some control over the outcome. Thus, forecasts by both analysts and management are useful to investors.”).

²¹³ Isadore Barmash, *Penney-Pinching: Budget Process Detailed and Long*, N.Y. TIMES, Feb. 20, 1972, at F1.

²¹⁴ Kenneth S. Axelson, *An Executive’s Views on the Forecasting of Earnings*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 35, 35.

²¹⁵ *Dolgow v. Anderson*, 53 F.R.D. 664, 678 (E.D.N.Y. 1971).

²¹⁶ Wallace E. Olson, *Statement of the American Institute of Certified Public Accountants on Estimates, Forecasts and Projections of Economic Performance Before the Securities and Exchange Commission*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 203, 207 (noting finding of survey that “[o]nly 12 per cent of the companies release forecasts in general communications media.”).

analysts or to the general public. Important information which would influence investment decisions is contained in these corporate forecasts.”²¹⁷ The SEC’s policy of prohibiting such projections surely contributed to the reluctance of public companies to widely release such information.

Rather than circulate their forecasts publicly, many public companies disseminated projections privately to research analysts. By doing so, they increased the confidence of markets that estimates of their future performance were grounded in reliable information.²¹⁸ Managers would communicate their forecasts to select analysts at conferences or meetings. One commentator observed in 1974 that “[b]y far the most important channel of communication for [management forecast] information . . . is direct contact with the analyst in a management conference or in analysts’ meetings.”²¹⁹ The

²¹⁷ Samuel S. Stewart, Jr., *Research Report on Corporate Forecasts*, in DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR *supra* note 212, at 75, 84; *see also* William S. Gray III, *Proposal for Systematic Disclosure of Corporate Forecasts*, FIN. ANAL. J. 64, 65 (Jan.-Feb. 1973) (“only a modest number of companies now release specific dollar forecasts of earnings or earnings per share for a period of a year or longer.”).

²¹⁸ As Judge Frank Easterbrook noted years after the SEC reversed its policy:

If you view investors as easily misled and unable to appreciate the uncertainty of predictions, you try to keep information out of their hands. You will not succeed. Investors value securities because of beliefs about how firms will do tomorrow, not because of how they did yesterday. If enterprises cannot make predictions about themselves, then securities analysts, newspaper columnists, and charlatans have protected turf. There will be no predictions aplenty outside the domain of the securities acts, predictions by persons whose access to information is not as good as the issuer’s. When the issuer adds its information and analysis to that assembled by outsiders, the *collective* assessment will be more accurate even though a given projection will be off the mark.

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

²¹⁹ William S. Gray, *The Role of Forecast Information in Investment Decisions*, *supra* note 205, at 35, 50; FAF Special Committee on Corporate Forecasts, *Proposals by the Federation for Systematic Disclosure*, in DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR *supra* note 212, at 1, 15 (reporting survey results finding that “[b]y far the most important channel of communications for this information, however, is direct contact with the analyst in a management conference or in analysts meetings.”).

As one commenter described the system:

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

John Hull, *Profit Forecasts – the English Experience*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 19, 20.

SEC's Advisory Committee on Corporate Disclosure did an extensive survey of research analysts in 1977 and reported that "virtually all analysts participating in the survey obtained forecast data in some form from company management."²²⁰ The fourth edition of Graham and Dodd described the "major reliance on direct contacts with company executives" by analysts who often met privately with managers at meetings "where executives of many companies have addressed securities-analyst societies and answered searching questions."²²¹ It then discussed the importance of such meetings for assessing the quality of management.

It is important to note that this system of voluntary disclosure had its flaws. Information about forecasts was not provided consistently. As the Advisory Committee noted, "[m]any companies are not as willing to talk to analysts when they are having unfavorable economic results."²²² Other commentators expressed skepticism about the quality of information conveyed to analysts.²²³

Companies not only communicated internal information to influence analyst projections, they used conversations with analysts to set internal performance goals.²²⁴ If market participants made it clear that a certain level of performance was necessary to achieve a certain stock price, managers could use these expectations to set goals within the company. Thus, internal projections not only influenced external projections, external projections could influence internal projections.

The increasing importance of forecasts is evidence of a substantial shift in the way that markets valued public companies. By 1978, the SEC reversed itself and announced a policy of "encourag[ing] companies to disclose management projections whether or not included in Commission

²²⁰ REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 57 (Nov. 3, 1977).

²²¹ *Id.* at 452.

²²² REPORT OF THE ADVISORY COMMITTEE, *supra* note 220, at 91.

²²³ *See, e.g.,* ELIAS, *supra* note 148, at 81 ("When analysts do go out, they often settle for a meeting with a member of a company's corporate relations staff, a financial flunky assigned to develop optimistic facts and figures by omitting any negative implications.").

²²⁴ A former insider of GE described the interaction between the company and its analysts:

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

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

filings.”²²⁵ Rather than trust completely in management’s ability to assess various projects, investors closely monitored earnings to track company performance. As budgeting and management techniques improved, internal budgets informed external projections.

b. Tipping and the Increasing Influence of Projections

The increasing influence of projections in valuation is illustrated by the increasing amount of selective disclosure about whether a company would meet its projections. Companies not only shared projections with analysts, they warned analysts when they would miss a projection.²²⁶ Despite the emerging law of insider trading, some executives felt compelled to curry favor with research analysts who primarily served institutional clients.²²⁷

²²⁵ Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, Securities Exchange Act Release No. 15305 (Nov. 7, 1978). The new policy did not require companies to disclose projections but permitted them to voluntarily include them in official filings. The change in policy reflected a fundamental shift in the SEC’s disclosure regime. *See, e.g.*, JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 672 (3d Ed. 2003) (“the transformation of the Commission’s mandatory disclosure system, beginning in the early 1970s, from its emphasis on historical or “hard” information and general prohibition of “soft” or predictive information, to its additional emphasis on forward looking information, represented the single most important development in the agency’s then greater than 60 years’ experience administering disclosure requirements.”).

²²⁶ There appear to have been a wide range of practices in selective disclosure of forecasts. Not all companies used selective disclosure in the same way. One commentator found:

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

J. C. Burton, *Forecasts: A Changing View from the Securities and Exchange Commission*, in *PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS*, *supra* note 205, at 86.

²²⁷ Analysts of broker-dealers had an incentive to provide such information to institutional clients who would then direct commission business to the broker-dealer. *See, e.g.*, Stanislav Dolgoplov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J.L. ECON. & POL’Y 311, 316 (2008).

After the Supreme Court held that tipping analysts for corporate purposes did not violate Rule 10b-5, companies for a time freely conveyed information relating to their projections to analysts.

As noted earlier, companies provided information to analysts because they wanted to build credibility with respect to their projections.²²⁸ The main risk in relying on a forecast is that it may be incorrect, either because the forecast is inaccurate or because of unforeseen circumstances. By warning analysts of a miss, managers could reduce that risk and provide an incentive for the analyst to recommend the company's stock to clients. Thus, a company like J.C. Penney was said to provide analysts with information "avoiding any 'surprises' in earnings results."²²⁹ The Chairman of the SEC observed in a 1973 speech that "[i]n recent years, we have seen . . . cases where companies trip all over themselves trying to protect friendly analysts from being surprised by a bad earnings report."²³⁰

Even when companies did not provide direct warning of a forecast miss, they were willing to provide input on analyst forecasts. Typically, an analyst would ask the company to review a projection and comment on whether it was accurate. One study noted that "most" companies "stated that they tell the analyst if he is beyond the range of reasonableness."²³¹ By doing so, they indirectly conveyed their knowledge of internal forecasts to markets without issuing their own forecast they might be accountable for if it was not

²²⁸ There are reasons why companies might find it in their interest to favor large shareholders. See, e.g., Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271 (2001).

²²⁹ Kenneth S. Axelson, *An Executive's Views on the Forecasting of Earnings*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 35, 36.

²³⁰ G. BRADFORD COOK, THE ROLE OF THE INVESTMENT ANALYST IN THE EVOLVING MARKET SYSTEM, SPEECH BEFORE THE NEW YORK SOCIETY OF SECURITY ANALYSTS 9 (Mar. 17, 1973), <http://www.sec.gov/news/speech/1973/032773cook.pdf>.

²³¹ Wallace E. Olson, *Statement of the American Institute of Certified Public Accountants on Estimates, Forecasts and Projections of Economic Performance Before the Securities and Exchange Commission*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 203, 207; see also Gray *supra* note 205, at 65 (noting that many companies "confirm publicly or privately" the accuracy of analyst forecasts).

met.²³² By shaping analyst forecasts they could avoid becoming subject to projections that they might miss.²³³

By 1968, the U.S. Court of Appeals for the Second Circuit had issued its decision in *Texas Gulf Sulphur*,²³⁴ which held that trading on material inside information violated SEC Rule 10b-5 (which prohibits securities fraud) unless it was disclosed beforehand to the public. Because it did not limit this duty to individuals with a fiduciary duty to the corporation, the decision raised questions about whether market participants could trade on information relating to projections that had only been disclosed to a few privileged recipients. Some commentators took the position that forecast information could not be traded on unless it was widely disseminated.²³⁵ Others were skeptical that insider trading law should prohibit such selective disclosure. Arthur Fleischer, who had played a role in developing the SEC's initial prohibition of insider trading, discussed the situation where "[c]ompany officials . . . are often confronted with projections made by brokerage firms and investment banking houses and asked to confirm these figures." He took the position that "it would be appropriate to call the analyst's attention to any egregious error in his assumptions or

²³² See, e.g., *ABA Statement on Securities Exchange Act Release No. 9844*, in PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 205, at 129, 150 ("Frequently confirmation will be sought from the issuer with respect to the accuracy of the projection; sometimes such confirmation is forthcoming, sometimes management simply indicates it believes the projection is inaccurate, sometimes management responds to the effect the projection is not 'out of the ball park,' other times management chooses to remain silent. The issuer's dilemma is that confirmation may have the effect of making an analyst's projection in effect the issuer's; and if the projection is inaccurate and goes out uncorrected, the market in the issuer's securities could be misled.").

²³³ ARTHUR LEVITT, TAKE ON THE STREET WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 89 (2002) (describing practices where "companies would increasingly leak to analysts what they thought their earnings would be. . . . to help shape, and thus avoid missing, the analysts' consensus forecast.").

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

²³⁵ See, e.g., FAF Special Committee on Corporate Forecasts, *Proposals by the Federation for Systematic Disclosure*, in DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR *supra* note 212, at 1, 26 ("Management forecast information is of such importance to investors that it would seem to fall in the class of information subject to the insider trading rules. Thus share transactions by management personnel privy to internal budgets and forecasts might be inhibited by these rules. Any forecast information that is released should be fairly disseminated to all investors.").

Some market participants became more conservative in their information gathering practices after the decision. See, e.g., GILBERT EDMUND KAPLAN & CHRIS WELLES, THE MONEY MANAGERS 109 (1969) ("And because of recent controversy over what constitutes insider trading, Fidelity is going to place increasing emphasis on talking to a company's competitors and suppliers, and less talking to its officers.").

calculations.”²³⁶ A treatise on insider trading by Professor William Painter, who generally supported insider trading regulation, noted in commenting on *Texas Gulf Sulphur* that “[t]he common practice of welcoming visits from brokers, investment advisers and others and briefing them on recent corporate developments, as well as answering their all too pointed inquiries can hardly be discontinued merely because of uncertainty about what may lawfully be disclosed.”²³⁷ Painter took the position that “the corporate benefits flowing from friendly relationships with security analysts and investment counselors are too great to justify any policy of corporate isolationism.”²³⁸

The SEC took the stance that selective disclosure of material information relating to company projections violated Rule 10b-5.²³⁹ In 1968, it sought an injunction against Glen Alden, a mining company, prohibiting it from “disclosing material information in violation of Section 10(b) . . . to any selected persons for the purpose of giving an advantage to such persons in connection with the market purchase or market sale of securities of Glen Alden Corporation. . . .”²⁴⁰ It noted that in private meetings, the company had conveyed “sales, earnings and cash flow projections for Glen Alden and each of its divisions for the years 1968 to 1972, projected acquisitions and other material information concerning the affairs of Glen Alden and its related companies.”²⁴¹ The SEC thus attempted to broadly prohibit even the dissemination of projections by public companies.²⁴² The SEC’s policy may have had some effect on corporate selective disclosure. A report by the Conference Board found that while 78% of the companies in its survey provided assistance to analysts in 1973, only 65% did so in 1981.²⁴³

The legal scholar Henry Manne criticized the SEC’s position and argued that insider trading was a critical way of conveying information to the market. Because the SEC had discouraged public disclosure of forecasts, information critical to a stock’s valuation was not included in SEC disclosure.²⁴⁴ He argued that often only “insiders in a company or an industry . . . can possibly make realistic valuation assessments” and “earnings

²³⁶ Arthur Fleischer, Jr., *Corporate Disclosure/Insider Trading*, HARV. BUS. REV. (1967).

²³⁷ WILLIAM H. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 345 (1968).

²³⁸ *Id.*

²³⁹ For an overview of the SEC’s enforcement efforts in this area, see Dolgoplov, *supra* note 227, at 343-49.

²⁴⁰ SEC v. Glen Alden Corp., 1968 U.S. Dist. LEXIS 12081, at *4 (Aug. 7, 1968).

²⁴¹ *Id.* at *2-3.

²⁴² The SEC has often sought to extend broad principles through enforcement. See James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007).

²⁴³ FRANCIS A. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS 25 (1981).

²⁴⁴ See Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 571 (1970).

estimates”.²⁴⁵ Selective disclosure was a way that managers could provide information that might be too speculative to include in an SEC filing but would be useful to analysts in valuing a stock.

In its 1983 decision in *Dirks*,²⁴⁶ the Supreme Court permitted a company official to selectively disclose projections information to third parties so long as he did not receive a personal benefit from the disclosure. The insurance company Equity Funding inflated its income by fabricating sales of insurance policies that had not actually been issued. It did so to create the appearance that its earnings were growing. Dirks was a research analyst who learned of the fraud from someone inside the company and passed on the information to his clients. The SEC argued that this was insider trading and brought a case against Dirks. The Court disagreed and held that there was no insider trading because the company official who disclosed the information did not personally profit from the disclosure and thus did not breach a fiduciary duty to the company.²⁴⁷ Without a violation of some duty, there was no deception that made the transmission of the information part of a fraud that would violate Rule 10b-5.

Dirks was an important case because it permitted public companies to communicate with analysts and investors about their projections. So long as it was done for corporate purposes, such selective disclosure did not violate Rule 10b-5. The Supreme Court in *Dirks* specifically acknowledged the important role of analysts in facilitating the process of valuing securities. In doing so, it noted that it was “commonplace” for analysts to “ferret out and analyze information” that “cannot be simultaneously available to all of the corporation’s stockholders or the public generally.”²⁴⁸ Professor Adam Pritchard describes evidence from internal Supreme Court documents that Justice Powell considered the situation of the analyst in crafting the *Dirks* standard.²⁴⁹

After *Dirks*, selective disclosure from managers to analysts with respect to projections was viewed by many market participants as a legitimate practice. A *New York Times* profile on a research analyst published in 1985 observed: “Before he publishes [earnings forecasts]” the analyst “bounces them off managements. First Boston bends further. New analysts there must show corporate brass drafts of reports before they are published.”²⁵⁰ A *Fortune* magazine article in 1991 noted: “Analysts have always relied on

²⁴⁵ *Id.* at 572.

²⁴⁶ 463 U.S. 646 (1983).

²⁴⁷ Manne, *supra* note 244, at 660-63.

²⁴⁸ *Id.* at 658-59.

²⁴⁹ Adam C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMUL. REV. 857, 863 (2015).

²⁵⁰ N.Y. TIMES, Oct. 27, 1985, at F8.

tidbits that the general public may not know; indeed, they would hardly be doing their job if all they could tell you is what they, and you, could read in the papers or in annual reports.”²⁵¹ While the SEC maintained its position that selective disclosure was problematic, Professor John Coffee in the early 1990s described the validity of the SEC’s position as “doubtful” and that prohibiting selective disclosure with respect to projections would result in more stock market volatility.²⁵²

It was not until well after the paradigm of shareholder wealth maximization was well-entrenched that the SEC was able to pass a rule that prohibited selective disclosure. In 2000, the SEC passed Regulation FD,²⁵³ which requires companies to publicly disclose any material information before it is conveyed to research analysts. Because it has been enforced infrequently, the rule has not completely stopped the flow of information to analysts.²⁵⁴ As evidenced by the U.S. Court of Appeals for the Second Circuit’s 2014 decision in *U.S. v. Newman*, even after Regulation FD had been in effect for a decade, analysts still sought and received company input about the accuracy of their models.²⁵⁵ As I have argued elsewhere, such selective disclosure undermines the integrity of a mandatory disclosure regime that has become more extensive.²⁵⁶ But regardless of the continued propriety of selective disclosure, these examples show the continued focus of markets on whether companies are meeting projections.²⁵⁷

²⁵¹ Anne B. Fisher, *Can You Trust Analysts’ Reports?*, FORTUNE 195, 198 (1991 Investors’ Guide).

²⁵² John C. Coffee, Jr., *Disclosures to Analysts are Risky*, NAT’L L.J., Feb. 1, 1993, at 19; *but see* Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1038 (1990) (arguing that selective disclosure does not increase market efficiency).

²⁵³ 17 C.F.R. § 243.100.

²⁵⁴ *See* Thomas Gryta, Serena Ng, & Theo Francis, *Analysts Steered to “Surprises”*, WALL ST. J., Aug. 5, 2016, at A1; Serena Ng & Thomas Gryta, *Analysts Say ‘Buy’ to Win Special Access*, WALL ST. J., Jan. 20, 2017, at A1; Serena Ng & Anton Troianovski, *How Some Investors Get Special Access to Companies*, WALL ST. J., Sept. 27, 2015; *see also* ROBERT G. ECCLES, ET AL., *THE VALUEREPORTING REVOLUTION: MOVING BEYOND THE EARNINGS GAME* 73 (2001) (noting common practice of exchanging information between analysts and companies and questioning whether Regulation FD will stop it).

²⁵⁵ *United States v. Newman*, 773 F.3d 438, 454–55 (2014). The Second Circuit later raised questions about its earlier decision in *Newman*. It set forth a standard where “a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it.” *United States v. Martoma*, 894 F.3d at 74 (2d Cir. 2017). This standard appears to permit selective disclosure for a “corporate purpose.”

²⁵⁶ *See* James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WIS. L. REV. 1133.

²⁵⁷ As the leading text on valuation observes:

V. VALUATION AND CORPORATE PURPOSE

The increasing willingness of markets to value companies based on their future earnings made it difficult for managerialism to survive. Because managerialism rested on the assumption that skilled managers could create shareholder wealth over time, investors sought ways to distinguish those companies that had superior management. While the conglomerate faded as a way of signaling continued earnings growth,²⁵⁸ projections only increased in importance. They became a way that external markets could assess the competence of managers in allocating resources through internal capital markets. The ability to deliver smooth earnings increases was prized by investors calculating the present value of future earnings. The imperative to produce such earnings has persistently affected corporate purpose. Managers are willing to cut costs, manage expenditures, or even commit fraud to meet projections.²⁵⁹

Even with the dominance of the shareholder wealth paradigm, aspects of managerialism still survive. Some companies with market power or compelling long-term plans can escape the pressure of meeting short-term market expectations. As investor preferences change, the pressure to focus on projections may abate. For companies that can escape the valuation treadmill, commitments to stakeholders have the potential to be meaningful.

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

Damodaran, *supra* note 132, at 283.

²⁵⁸ Economic conditions over the 1970s made it difficult for conglomerates to succeed. *See, e.g.,* WELLES, *supra* note 109, at 32 (describing 1969-1970 stock market collapse and poor performance of stock market during the 1970s). Critics viewed conglomerates as too bureaucratic and inefficient to adapt to a more difficult economic climate. *See, e.g.,* WALTER ADAMS & JAMES BROCK, *THE BIGNESS COMPLEX* 43-45 (1986). Because of its poor performance, by the 1980s there was a so-called conglomerate discount where the market value of a conglomerate was lower than the market value of its individual businesses. *See, e.g.,* GERALD F. DAVIS, *MANAGED BY THE MARKETS* 85 (2009). However, there is still debate among economists about whether such a conglomerate discount exists. *See, e.g.,* John D. Martin & Akin Sayrak, *Corporate Diversification and Shareholder Value: A Survey of Recent Literature*, 9 J. CORP. FIN. 37 (2003) (reviewing literature).

²⁵⁹ For example, Xerox, which faced little pressure to generate profits in the 1960s, paid a \$10 million penalty to resolve SEC charges of securities fraud.

A. Projections and Agency Costs

Projections are not only a way of facilitating the valuation of public companies, they are also a potent way of aligning the interests of corporate managers and shareholders. In order to increase or even maintain its stock price, a public corporation must consistently meet market expectations. The failure to do so can signal that management is not competent or putting other priorities before the company's earnings. Investors have shown that they value not only earnings growth but smoothness in reported earnings.²⁶⁰

Projections help reduce monitoring costs for shareholders. It is extremely difficult for shareholders to assess the faithfulness and competence of their managerial agents,²⁶¹ especially as businesses have become more complex.²⁶² Rather than attempting to observe managerial skill directly, projections offer metrics that shareholders can use to determine whether managers are acting in their interests. Because analyst projections are often informed by management projections, they enable markets to evaluate the skill of managers in budgeting and forecasting.²⁶³ The ability to consistently meet projections is evidence that a management team is increasing shareholder wealth.²⁶⁴

²⁶⁰ See, e.g., Eli Bartov, Dan Givoly & Carla Hayn, *The Rewards to Meeting or Bearing Earnings Expectations*, 33 J. ACCT. & ECON. 173 (2002) (finding higher quarterly returns for firms that meet expectations); Ron Kasnik & Maureen F. McNichols, *Does Meeting Earnings Expectations Matter? Evidence from Analyst Forecast Revisions and Share Prices*, 40 J. ACCT. RES. 727 (2002) (finding that firms meeting expectations have higher stock prices than firms that do not).

²⁶¹ See, e.g., M. P. Narayan, *Managerial Incentives for Short-Term Results*, 40 J. FIN. 1469 (1985) (noting difficulty of monitoring managerial competence).

²⁶² See, e.g., Jeremy Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. ECON. 655, 657 (1989) (noting importance of short-term signals when projects are difficult to assess).

²⁶³ See, e.g., Joshua Ronen & Simcha Sadan, *SMOOTHING INCOME NUMBERS: OBJECTIVES, MEANS, AND IMPLICATIONS* 45 (1981); Bruce Alan Mann, *Prospectuses: Unreadable or Just Unread? – A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 230 (1971) (“corporate management is constantly planning future expansion and making financial commitments on the basis of internal projections. . . . the financial success of the corporation is dependent upon management’s skill in estimating future revenues, expenses and operating levels.”).

²⁶⁴ See, e.g., DOMINIC DODD & KEN FAVARO, *THE THREE TENSIONS: WINNING THE STRUGGLE TO PERFORM WITHOUT COMPROMISE* 86 (noting that “meeting these expectations becomes an end in itself – a test of credibility.”); Yuji Ijiri, *Improving Reliability of Publicly Reported Corporate Financial Forecasts*, in *PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS*, *supra* note 205, at 161, 186 (“It is perhaps safe to say that investors will treat reliable forecasts as a sign of a well-managed corporation just as they treat smooth earnings growth as the same indicator.”); Jennifer W. Tucker & Paul A. Zarowin, *Does Income Smoothing Improve Earnings Informativeness?*, 81 ACCOUNT. REV. 251, 253 (2006).

Projections have advantages over other ways of monitoring management such as the payment of dividends and disclosure. While a regular dividend is evidence that a company continues to be profitable, because the amount of the dividend is usually constant, it conveys limited information about a company's prospects. Disclosure of past financial results allows investors to monitor agents and can serve as the basis for generating projections.²⁶⁵ However, past success by itself does not necessarily predict the future. A projection can convey information that is not conveyed by financial results. Managers can issue projections that convey private information about new developments that will generate trajectories of growth or decline that cannot be extrapolated from past performance.²⁶⁶

As with other monitoring methods, projections are not always an effective way of reducing agency costs. One issue is that it can be difficult to interpret the significance of the failure to meet a projection. Missing a forecast could mean that market assumptions about a company's future earnings must be reevaluated.²⁶⁷ On the other hand, missing a projection may mean that there was an unanticipated setback that will not affect future earnings. Another limitation to projections as a monitoring tool is that managers can manipulate them. Managers can issue projections that are unrealistically high in order to inflate a company's stock price. They might misapply accounting standards or business decisions in order to meet ambitious projections to convey the impression that their strategies are successful.²⁶⁸

²⁶⁵ See, e.g., Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

²⁶⁶ As one accounting professor observed: "since one of the manager's roles is to choose the firm's optimal production level, the firm's market value at the end of the period will be a function of investors' perceptions of his ability to anticipate future changes in the firm's economic environment and adjust the firm's production plan accordingly. While this ability cannot be directly observed by investors, the manager can provide some information about it by releasing an updated earnings forecast each period when and if the manager observes any changes that period in the firm's economic condition." Brett Trueman, *Why Do Managers Voluntarily Release Earnings Forecasts?*, 8 J. ACCT. & ECON. 53, 54 (1986); see also Amir Barnea, Joshua Ronen & Simcha Sadan, *Classificatory Smoothing of Income with Extraordinary Items*, 51 ACCOUNT. REV. 110, 110 (1976) (noting the need for management to convey "knowledge about firm's future earnings" despite "conventional accounting practices, which do not permit direct forecasts.").

²⁶⁷ See, e.g., Dodd & Favoro, *supra* note 264, at 78 (noting that "[e]arnings announcements are the latest piece of information the capital markets have for judging long-term potential."); Rappaport, *supra* note 132, at 161 ("investors often see long-term implications in current information, including reported earnings, and use the latest results to reassess a company's prospects.").

²⁶⁸ Towards the end of the 1990s, the SEC brought a significant number of cases alleging accounting fraud by public companies to meet earnings projections. See, e.g., James J. Park, *Securities Class Actions and Severe Frauds*, in EDWARD ELGAR RESEARCH

It is worth noting that the selective dissemination of information of projections likely increased the efficiency of stock markets.²⁶⁹ The strong form of the efficient markets hypothesis predicts that markets incorporate information that is not available to the public.²⁷⁰ The substantial evidence of selective disclosure relating to projections explains why stock prices exhibit such strong-form efficiency. A benefit of such efficiency is that markets will correctly value companies.

On the other hand, the importance of projections undermines one view of efficient markets – that they reflect the superior skill and insight of investors. The fact that investors continue to focus on short-term projections indicates that they are reliant on heuristics in assessing the long-term prospects of a corporation. Far from being a flawless machine, the stock market relies on a variety of potentially flawed metrics in assessing the value of companies. Such selective disclosure results in advantages to privileged investors who benefit from their connections rather than their investing acumen.

Perhaps because they address the problem of agency costs so effectively, projections have shaped managerial priorities and influenced corporate purpose. Up to the present day, corporate managers have reported that they face pressure to meet market projections.²⁷¹ Meeting earnings expectations became important enough that by the 1980s there were reports of significant accounting manipulation to meet analyst forecasts.²⁷² The influence of analyst projections increased as they became commonly made on a quarterly basis by the end of the 1980s.²⁷³ As valuation increasingly

HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION (eds. Sean Griffith, Jessica Erickson, David Webber & Verity Winship 2018).

²⁶⁹ As noted earlier, this was a controversial argument made by Henry Manne. *See* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 77–101 (1966).

²⁷⁰ *See, e.g.,* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555-56 (1984).

²⁷¹ *See, e.g.,* Dodd & Favoro, *supra* note 264, at 70 (finding in survey of 192 executives that “81 percent said they would often or sometimes be prepared to cut spending on R&D, marketing, or IT; 77 percent said they would often or sometimes delay a project to meet a short-term earnings goal, even if the project would be profitable.”); John R. Graham, et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCOUNT. & ECON. 3, 32–35 (2005).

²⁷² *Slick Accounting Ploys Help Many Companies Improve Their Income*, WALL ST. J., June 20, 1980, at A1 (noting that accounting manipulation dated back to the 1960s and 1970s but had become more sophisticated).

²⁷³ *See, e.g.,* Rappaport, *supra* note 132, at 3 (noting that “[c]orporate executives obsess over meeting Wall Street’s quarterly earnings expectations.”). The focus on quarterly reporting was not quite complete by the start of the 1980s. A survey of public companies in 1981 found that 60% prepared quarterly forecasts. *See* FRANCIS A. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS 9 (1981). However, there was some pressure to deliver quarterly results even before the wide dissemination of quarterly

focused on a company's future prospects, the problem of securities fraud became a significant issue for public companies.²⁷⁴

For companies that are subject to the pressure of projections, it is difficult to do more than focus on short-term financial performance. A market forecast offers a simple but powerful metric that measures corporate success. The interests of stakeholders such as employees and consumers may be compromised to the extent that they prevent companies from meeting market forecasts. Long-term capital investment in research and development that produces positive externalities for society can be limited in favor of strategies that boost profits in the short-term.

While there are other reasons why corporations focus on maximizing shareholder wealth, projections have been the most persistent and important. The hostile takeovers that target incompetent managers ebbed and flowed and were largely stymied during the 1980s with the passage of anti-takeover statutes and judicial approval of strong takeover defenses.²⁷⁵ Executive compensation has increased the incentive to meet projections, but did not shift to change managerial incentives until the 1990s. Moreover, there are persistent questions as to whether such compensation effectively aligns managerial incentives to increase shareholder value.²⁷⁶

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

U.S. stock markets are exceptional in their reliance on quarterly projections. Public companies in other jurisdictions are not subject to

projections. *See, e.g.*, Steve Lohr, *Overhauling America's Business Management*, N.Y. TIMES, January 4, 1981 ("their survival in office – depends on producing the steady quarter-to-quarter increase in profits that so please the financial community.").

²⁷⁴ *See* JAMES J. PARK, THE VALUATION TREADMILL: HOW SECURITIES FRAUD BECAME A PROBLEM FOR PUBLIC COMPANIES (forthcoming).

²⁷⁵ *See, e.g.*, Cheffins, *supra* note 41, at 156 ("Takeovers did much to displace managerial capitalism but their impact on public company executives was rather fleeting."); Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); Guhan Subramanian, et al., *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008*, 65 BUS. LAW. 685 (2010).

²⁷⁶ *See* Bebchuk & Fried, *supra* note 105.

projections and may not even be required to report on a quarterly basis.²⁷⁷ It is thus unsurprising that shareholder wealth is not viewed by much of the world as defining corporate purpose. While there are other reasons why foreign public companies look after stakeholder interests, without projections there is less of an imperative to focus on maximizing profits.

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

B. The New Managerialism?

The influence of the shareholder wealth paradigm has been strong for decades now but the transition from managerialism has never been complete. Some companies are able to escape the pressure of projections and have some discretion to take a broader view of corporate purpose. Investor preferences, at least on the surface, are shifting in ways that could permit companies to do more to emphasize social responsibility.²⁷⁸ It is too early to declare that a New Managerialism has arrived but there is strong pressure for alternatives to the prevailing approach to corporate purpose.

While many conglomerates were dismantled, large companies have continued to grow through merger. There was significant consolidation with respect to financial institutions over the 1990s. Technology companies have also grown larger through a combination of market power and acquisitions. As the complexity of public corporations has increased, only a handful of elite managers have the experience and ability to lead them. Some of the most successful companies were built by entrepreneurs who are said to have idiosyncratic vision that is uniquely responsible for their success.²⁷⁹

²⁷⁷ For example, Europe has rejected mandatory quarterly reporting on the ground that it encourages short-termism. See, e.g., Bhojraj, S. & R. Libby, *Capital Market Pressure, Disclosure Frequency-Induced Earnings/Cash Flow Conflict and Managerial Myopia*, 80 ACCT. REV. 1 (2005).

²⁷⁸ See, e.g., Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCT. 247 (2017) (arguing that when shareholders are prosocial that shareholder wealth maximization does not maximize shareholder welfare).

²⁷⁹ Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 580 (2016).

One of the most interesting developments in corporate governance has been the acceptance of arrangements such as dual stock capitalization that virtually eliminates the corporate governance power of shareholders.²⁸⁰ Such agreements, which have been notably used by some major technology companies, are consistent with the belief that founders are exceptional managers who are uniquely qualified to guide a company without interference from shareholders. Without the prospect of a change in control, the management of such companies have the freedom to pursue long-term strategies rather than meet short-term projections.

Even without dual class stock, some companies have developed strong enough market power to insulate themselves from the pressure to generate profits. The stock market has given companies like Amazon significant leeway to implement long-term strategies to achieve market power without immediate profitability.²⁸¹ It is not uncommon for companies with significant losses to go public at high valuations because of the belief in a long-term strategy.

Executives of some of the largest public companies have actively worked to move beyond evaluation by short-term metrics. Warren Buffet and Jamie Dimon, both of whom head large conglomerates, proposed several years ago that companies no longer issue their own earnings forecasts to reduce the market's reliance on projections.²⁸² Over a long period, such a strategy is only realistic for companies that have attained a certain level of success so that investors are willing to trust that their performance will continue.²⁸³ For other companies, the pressure of projections will continue.²⁸⁴

There is evidence that in recent years, investors have changed in ways that will permit public companies to consider the interests of stakeholders.

²⁸⁰ See, e.g., Dorothy Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019) (arguing that nonvoting shares lower the cost of capital because investors who value governance will pay more for shares that are not diluted by shares held by investors who do not value governance).

²⁸¹ See, e.g., Lina Khan, *Amazon's Antitrust Paradox*, 726 YALE L.J. 710, 747-53, 787-88 (2017).

²⁸² See Jamie Dimon & Warren E. Buffett, *Short-Termism is Harming the Economy: Public companies should reduce or eliminate the practice of estimating quarterly earnings*, WALL ST. J., June 6, 2018, <https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801>; see also Rappaport, *supra* note 131, at 136 (proposing that public companies not provide earnings guidance).

²⁸³ In unusual times when it is too difficult to project performance, markets have accepted that companies will generally not be able to provide reliable guidance.

²⁸⁴ Indeed, the pressure of the quarterly reporting system has been great enough so that there have been proposals to end quarterly disclosure. See, e.g., Dave Michaels, et al., *Trump Asks SEC to Ease Earnings Reporting*, WALL ST. J., Aug. 18, 2018, at A1; David Benoit, *Time to End Quarterly Reports, Law Firm Says*, WALL ST. J. (Aug. 19, 2015), <https://www.wsj.com/articles/time-to-end-quarterly-reports-law-firm-says-1440025715>.

As shareholders have become increasingly diversified, some scholars have claimed that there is less pressure on companies to compete because investors will buy their shares regardless of their relative performance.²⁸⁵ Instead of pushing companies within an industry to compete and win market share, investors may be content with a situation where companies do not seek to disrupt the status quo.²⁸⁶ The reduction of competition could harm consumers but might benefit other corporate stakeholders such as employees whose jobs are more stable without competition. In addition, the increasing number of investors who are concerned about corporate social responsibility could shift corporate policy.²⁸⁷ At least on the surface, public companies must claim that they are acting in ways consistent with broader social norms.

Companies that can transcend the pressure of markets should have more leeway to make meaningful commitments to stakeholders.²⁸⁸ The Business Roundtable's 2019 statement committing to consider the interests of stakeholders has been criticized by prominent commentators as cheap talk.²⁸⁹ While such a commitment will not be meaningful for companies that are in a position where they must continue to meet short-term market expectations, there is no reason why public companies that have strong long-

²⁸⁵ One notable study finds evidence that common ownership results in higher prices than would be charged without common ownership. See José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

²⁸⁶ See, e.g., Azar, et al., *supra* note 285, at 1518 (observing that “not explicitly demanding or incentivizing tougher competition between portfolio firms may allow managers to enjoy the ‘quiet life’, and thus lead to an equilibrium with reduce competition and sustained high margins.”); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270 (2016) (arguing that investors need not communicate preferences because managers understand that diversified investors will not want competition); *but see* C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392 (2020) (finding lack of empirical support for passivity argument).

²⁸⁷ See, e.g., Michal Barzuza, Quinn Curtis & David Webber, *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. (forthcoming 2020) (arguing that index funds will push for corporate responsibility as they market themselves to millennial investors).

²⁸⁸ The argument that corporate purpose should go beyond the maximization of shareholder wealth has been voiced more frequently in recent years. Professor Colin Mayer argues that “corporate law should prioritize purpose” and “require companies to articulate their purposes, incorporate them in their articles of association, and above all demonstrate how they credibly commit to the delivery of purpose.” COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD 23 (2018).

²⁸⁹ See, e.g., Stephen M. Bainbridge, *Making Sense of The Business Roundtable's Reversal on Corporate Purpose*, UCLA Law & Economics Research Paper No. 20-03 (2020); Lucian Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, CORNELL L. REV. (forthcoming).

term strategies cannot pursue a balanced strategy that does more than focus on shareholders.²⁹⁰

There is good reason to be skeptical of a New Managerialism. Some corporate managers will take advantage of their discretion to not maximize shareholder value to favor their own selfish interests. Stakeholders will compete for any rents that are generated by a company's market power.²⁹¹ In catering to stakeholders, managers can lose focus and a business can squander its competitive advantage.²⁹²

Despite the problems of managerialism, so long as it mainly governs a subset of public companies, the costs of managerial discretion are unlikely to threaten our economic prosperity. Some inefficiency may be worth bearing in the name of fairly distributing the wealth created by a successful business among stakeholders.

CONCLUSION

As the shareholder wealth paradigm has become widely criticized, it is worth re-examining its origins. While changes in ideology had a role in the shift to shareholder wealth, the shift in the way that investors valued companies was a more significant reason why public companies focus on increasing shareholder wealth. Moving to a new paradigm will require more than simply a change in ideology. The irony of the rise of shareholders over the last several decades is that it had its origins in the increasing faith markets had in the competence of managers. As managers sought to increase confidence in the earnings potential of their companies, they sought to find ways to signal that their earnings would increase. As internal projections became more useful, they migrated outside the walls of the corporation and

²⁹⁰ To the extent that broadening corporate purpose is a desirable goal, there is an argument against recent proposals attempting to discourage “bigness” in corporations. *See, e.g.,* TIM WU, *THE CURSE OF BIGNESS: ANTITRUST IN THE NEW GILDED AGE* 132-33 (2018). If companies with market power are able to do more to consider the interests of stakeholders, it could be problematic to break-up those companies and replace them with smaller companies that will vigorously compete with each other. Such competition would have benefits such as lower prices for consumers and lessen the political power of large companies, but it would also mean that the resulting smaller companies would need to constantly focus on delivering short-term results.

²⁹¹ *See, e.g.,* Mark J. Roe, *Rents and their Corporate Consequences*, 53 *STAN. L. REV.* 1463, 1468 (2001); *see also* Daniel A. Crane, *Antitrust and Wealth Inequality*, 101 *CORNELL L. REV.* 1171, 1188-89 (2016) (noting that monopoly rents may be captured by mid-level managers and employees rather than shareholders); Lina Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontents*, 11 *HARV. L. & POL'Y REV.* 235, 242-43 (2017) (noting that workers captured monopoly rents in the past but may not have the leverage to do so today).

²⁹² Jean Tirole, *Corporate Governance*, 69 *ECONOMETRICA* 1 (2015) (concluding that stakeholder focus “strikes three rocks: dearth of pledgeable income, deadlocks in decisionmaking, and lack of clear mission for management.”).

because an external metric by which shareholders could ensure that managers were focusing on shareholder wealth. Notably, this system of evaluation arose through private ordering despite the opposition of the SEC. Controversial practices such as selective disclosure of information that continue even today are evidence of the importance of market projections.

Because the managerial focus on shareholder wealth is a rational response to prevailing valuation methods, for many companies, it will not be possible to escape the shareholder wealth paradigm. However, meeting projections is not the only way that companies can convince investors of their future prospects. Some companies can prosper without delivering smooth earnings increases every quarter. A New Managerialism may permit some companies to meaningfully commit to considering the interests of stakeholders.