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THE UNEASY CASE FOR FAVORING LONG-TERM SHAREHOLDERS

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Abstract

This paper critically re-examines a pervasive view in corporate governance: that firms should favor long-term shareholders over short-term shareholders. At the heart of this view is a strongly-held intuition that managers serving long-term shareholders will generate more economic value over time than managers serving short-term shareholders. But this intuition, I show, is faulty. Long-term shareholders, like short-term shareholders, can benefit from corporate decisions that destroy value. Indeed, long-term shareholders may well benefit more from value-destroying decisions than short-term shareholders. Favoring long-term shareholders could thus reduce, rather than increase, the value generated by a firm over time.

Key words: corporate governance, short-termism, short-term shareholders, long-term shareholders, agency costs, earnings manipulation, managerial myopia, share repurchases, open market repurchases, acquisitions, seasoned equity offerings, real earnings management

JEL Codes: G32, G34, G35, G38, K22

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INTRODUCTION

This paper challenges a persistent and pervasive view about proper corporate governance: that firms should favor long-term shareholders over short-term shareholders. This view is widely shared by academics, executives, corporate lawyers, and judges.[1] It has also motivated recent reform proposals—in the U.S., the U.K., and elsewhere—to give long-term shareholders more power in public companies.[2]

The persistence of this view derives from a strongly-held intuition: that a corporation that serves long-term shareholders will generate more economic value over time (a bigger "pie") than if it serves short-term shareholders. This intuition, I explain, is flawed. It assumes that a corporation does not transact heavily in its own shares in the short term. The typical U.S. corporation, however, trades heavily in its own shares, buying and selling over 40% of its market capitalization over a five-year period.[3] In such a transacting firm, long-term shareholders, like short-term shareholders, can benefit from managers pursuing value-destroying actions. In many cases, long-term shareholders may well benefit more from value destruction than short-term shareholders. Thus, favoring long-term shareholders in the typical firm could actually reduce the size of the pie.

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A corporation's directors are responsible for managing the firm, which includes hiring and replacing the chief executive officer (CEO). The directors, in turn, are elected (and can be replaced) by the firm's shareholders. Thus, a firm's directors and CEO (collectively, its "managers") will have at least some incentive to serve shareholders' interests.

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[1] See infra notes xx-yy.

[2] See infra notes xx-yy.

[3] See infra notes xx-yy.

How managers go about serving shareholders will depend, in part, on shareholders' time horizons. If most shareholders are short-term investors, managers can be expected to focus on increasing the short-term stock price. If long-term shareholders are more powerful than short-term shareholders, managers will focus less on the short-term stock price and more on increasing long-term shareholder returns.

Much attention has been focused on the potential problems that can arise when a firm's investor base consists largely of short-term shareholders.[4] In particular, managers seeking to serve short-term shareholders may engage in "short-termism": taking steps to boost the short-term stock that reduce the size of the pie. The cost of any short-termism is borne by other parties, including long-term shareholders (if any) and future shareholders—those buying shares in the short term.[5]

Short-termism has long been considered to be a major problem for publicly-traded U.S. firms. Indeed, the potentially perverse interests of short-term shareholders have been decried for decades by legal academics,[6] business school professors,[7] executives,[8] and corporate

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[4] See infra notes xx-yy.

[5] Managers serving short-term shareholders may also impose losses on (non-shareholder) stakeholders, such as employees and communities, that also have residual claims on the corporation. See infra note __.

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

[7] *See, e.g.,* Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, 70 HARV. BUS. REV., 65, 66–68 (1992) (criticizing the harmful influence of short-term shareholders in U.S. firms); Justin Fox and Jay Lorsch, *The Big Idea: What Good are Shareholders?*, 48 HARV. BUS. REV. 50 (2012) (similar).

[8] *See, e.g.,* ASPEN INSTITUTE, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT (Sept. 9, 2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/images/Overcoming%20Short-termism%20AspenCVSG%2015dec09.pdf (hereinafter, "ASPEN INSTITUTE") (report critical of short-term shareholders signed by Berkshire Hathaway CEO Warren Buffett as well as by other leading executives).

lawyers.[9] The recent financial crisis, which many blame on the influence of short-term shareholders, has renewed and intensified criticism of these investors.[10]

While the interests of short-term shareholders are denigrated, the interests of long-term shareholders are exalted. Managers are told to ignore the short-term stock price and focus on maximizing long-term shareholder value by legal academics,[11] business school professors,[12] and more importantly, Delaware judges, who have repeatedly emphasized the importance of serving long-term shareholders.[13] Indeed, Henry Hansmann and Reinier Kraakman went so far as to say a decade ago that "there is no longer any serious competitor to the view that corporate law should

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[9] *See, e.g.,* Martin Lipton and Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) (lamenting the power of short-term shareholders, which push companies to take steps at the expense of economic value creation).

[10] *See, e.g.*, Lynne Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 264 (2011).

[11] *See* John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law,* 78 MINN. L. REV. 1443, 1444, 1484 (1994) (arguing that managers should focus their efforts on maximizing value for long-term shareholders). *Cf.* Stephen Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 573 (2003) (arguing that directors should be "obliged to make decisions based solely on the basis of long-term shareholder gain").

[12] Porter, s*upra* note x, at 79 (calling for long-term shareholder value maximization to be identified as the explicit goal of the firm).

[13] *See* Gantler v. Stephens 965 A.2d 695, 706 (Del. 2009)(describing "enhancing the corporation's long term share value" as a "distinctively corporate concern."); Norman Veasey, *The Stockholder Franchise is not a Myth*, 93 VA. L. REV. 811, 815 (2007) (distinguishing between short-term and long-term shareholders, with the latter described as the firm's "underlying investors"). *Cf.* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. L. REV. 521 (2002) (concluding that the Delaware Supreme Court has "signaled . . . long-term shareholder primacy").

principally strive to increase long-term shareholder value."[14] As a result, managers have internalized the norm of maximizing long-term shareholder value.[15]

But when a firm's investor base consists largely of short-term shareholders, the long-term shareholder primacy norm may well have little impact. Managers, even those who believe they should serve long-term shareholders, may well feel considerable pressure to boost the short-term stock price. They may thus take steps to boost the short-term stock price at the expense of long-term shareholders.

As a result, policy makers are considering various types of proposals to increase the relative power of long-term shareholders in public companies and thereby decrease the relative power of short-term shareholders. One set of proposals focuses on voting rights. A number of prominent economists and business school professors in the U.S. and the U.K. have suggested that long-term shareholders receive more voting rights in the firm.[16] The Aspen Institute's Business and Society Program, a collection of leading executives and corporate governance specialists, has

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[14] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 439 (2001). While Hansmann and Kraakman were advancing the argument that social welfare would be maximized if corporate law served shareholder interests rather than those of other stakeholders, their use of the term "long-term*"* value suggests that they believed that social welfare would be maximized if corporate law served shareholders over the long-term rather than over the short-term. *Cf.* Matheson & Olson, *supra* note x at 1444, 1484 (arguing that the focus on long-term shareholders "maximizes . . . economic efficiency in the long run").

[15] *See, e.g.,* Business Roundtable, Principles of Corporate Governance 2005 (2005) at 31, *available at* http://www.ibm.com/ibm/governmentalprograms/pdf/BRTCorpGovPrinciples2005.pdf (describing "the paramount duty to optimize long-term shareholder value.").

[16] Andrew Haldane and Richard Davies, Bank of England, Speech: The Short Long (May 11, 2011), *available at* http://www.bis.org/review/r110511e.pdf (calling for enhanced shareholder rights for long-term investors); Colin Mayer, Firm Commitment: Why the corporation is failing us and how to restore trust in it 246-247 (Oxford University Press, 2012) (suggesting that long-term shareholders be given enhanced voting rights); Justin Fox and Jay Lorsch, *The Big Idea-What Good are Shareholders?*, 48 HARV. BUS. REV. 50, 56-57 (2012) (suggesting voting power increase with length of share ownership).

made a similar recommendation.[17] An American Bar Association corporate governance task force has expressed support for exploring the use of such arrangements.[18]

More informal and indirect approaches to increasing the influence of long-term shareholders have also been proposed. For example, the U.K.'s 2012 Kay Commission report recommends that firms consult "major long-term investors" regarding board appointments.[19] In the same spirit, the Securities and Exchange Commission's ("SEC") (later-invalidated) 2010 proxy access rules required the nominating shareholder to have held the shares continuously for at least 3 years.[20]

Another set of proposals seeks to increase the number of long-term shareholders by rewarding them with additional dividends or other cash-flow rights. For example, the economists Patrick Bolton and Frederic Samama have suggested that long-term shareholders receive "L-shares"—

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[17] *See* ASPEN INSTITUTE, *supra* note x, at 3 (recommending enhanced rights for long-term shareholders). Former Vice-President Al Gore has made a similar proposal. *See* Al Gore and David Blood, A Manifesto for Sustainable Capitalism (2011), *available at* http://www.generationim.com/media/pdf-wsj-manifesto-sustainable-capitalism-14-12-11.pdf (suggesting that firms provide loyalty shares to long-term investors).

[18] *See Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee Delineation of Governance Roles & Responsibilities*, 65 BUS. LAW. 107 (2009) (urging consideration of encouraging shareholder interest in long-term investment by rewarding long-term holding through enhanced voting rights). See also Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, *A Crisis Is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" is a Serious Mistake* (2009), available at http://amlawdaily.typepad.com/files/a-crisis-is-a-terrible-thing-to-waste---the-proposed-shareholder-bill-of-rights-act-of-2009-is-a-serious-mistake.pdf (proposing enhanced voting rights for long-term shareholders).

[19] *See, e.g.,* John Kay, The Kay Review of UK Equity Markets and Long-term Decision Making 63 (2012).

[20] 75 Fed. Reg. 56,668 (Sept. 16, 2010) (amending 17 C.F.R. 200, 232, 240, 249) (later invalidated).

shares entitling them to additional stock in the firm.[21] Several European firms have, of their own accord, modified their corporate arrangements to give long-term shareholders more cash-flow rights vis-à-vis short-term shareholders.[22]

Yet another set of proposals seeks to increase the number of long-term shareholders by revamping the income tax system to make long-term stock ownership relatively more attractive. For example, the Aspen Institute has proposed a graduated long-term capital gains tax rate, with the lowest rate available only to shareholders that own their stock for a considerable period of time.[23] It has also suggested increasing the deductibility of long-term capital losses.[24] Similarly, Vanguard's John Bogle has called for eliminating the tax deductibility of short-term capital losses and increasing the tax rate on ordinary income generated by stock trading.[25]

The Aspen Institute is also trying to rally support for a tax on transactions in the stock market.[26] Such a tax was first proposed by John Maynard Keynes in the 1930s[27] and later endorsed by the economists

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[21] *See* Patrick Bolton and Frederic Samama, *L-Shares: Rewarding Long-term Investors* (working paper, February 16, 2012) (suggesting that shareholders receive call options that are exercisable only if they hold their shares for a certain period of time).

[22] *See* Bolton and Samama, *supra* note x, at 9-10 (describing the British and French firms have already adopted arrangements to give long-term shareholders extra cash-flow rights).

[23] *See* ASPEN INSTITUTE, *supra* note x at 2–3.

[24] *See* ASPEN INSTITUTE, supra note x, at 3.

[25] *See* John C. Bogle, *The Clash of the Cultures*, 37 J. PORTFOLIO MGMT. 14, 25 (2010) (calling for elimination of tax deductibility for short-term capital losses and increased tax on income from stock trading).

[26] *See* ASPEN INSTITUTE, *supra* note x, at 2 (proposing a tax on securities transactions to discourage short-term trading).

[27] *See* J. M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST RATES AND MONEY 160 (New York: Harcourt Brace & World) (1936).

Joseph Stiglitz and Larry Summers in the late 1980s.[28] One of the main purposes of such a securities tax is to make short-term stock ownership less attractive, and therefore increase the number of long-term shareholders relative to the number of short-term shareholders.[29]

The norm of favoring long-term shareholders over short-term shareholders, as well as efforts to boost the number and power of long-term shareholders in public companies, are driven by a simple and appealing intuition: that managers serving long-term shareholders will generate more value over time than managers serving short-term stockholders. This intuition, I show, is faulty. It does not account for the possibility that a firm will buy and sell its own shares before the long term arrives. When a firm transacts heavily in its own shares, I show, managers serving long-term shareholders will not necessarily generate more value over time than managers serving short-term shareholders. Indeed, they may generate less. All of these efforts to favor long-term shareholders may thus, perversely, reduce the value generated by firms over time.

My analysis initially focuses on a firm in which the only residual claimants on the value created by the firm are the firm's current and future shareholders: the investors who own (or will own) shares between now and "the long term"—the relevant end period, however that period is determined. In other words, I assume that all of the value generated by the firm is captured by the firm's current and future shareholders over time.

I begin by considering a "non-transacting" firm—one that does not repurchase its own shares or issue additional shares before the long term. In such a firm, I show, the conventional view is correct: managers serving long-term shareholders will generate more economic value over time than

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[28] *See* Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-term Trading*, 3 J. FIN. SERV. RES. 101, 109 (1989) (arguing that a transaction fee could lead to an increase in the relative number of long-term investors, causing managers to shift their focus to the long run); Lawrence H. Summers and Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERV. RES. 101, 261 (1989) (similar).

[29] *See* Stiglitz, *supra* note x.

managers serving short-term shareholders. In particular, long-term shareholders will want managers to maximize the economic pie. Short-term shareholders, on the other hand, may benefit when managers engage in what I call "costly price-boosting manipulation"—engaging in actions that boost the short-term stock price at the expense of the pie. Thus, in such a firm, it is better for managers to seek to maximize long-term shareholder value than to do whatever they can to boost the short-term stock price.

Most U.S. firms, however, are "transacting." They buy and sell large volumes of their shares each year: approximately $1 trillion worth market-wide.[30] In 2007, U.S. firms conducted $1 trillion in share repurchases alone.[31] The magnitude is staggering, not only in absolute terms, but also relative to firms' market capitalization. Over any given five-year period, U.S. firms buy and sell stock equivalent in value to approximately 40% of their aggregate market capitalization. Thus, for example, a company that has a market capitalization of $10 billion today can be expected to buy and sell $4 billion of its own shares over the next five years.

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

Bargain repurchases need not be value-destroying. In principle, they may merely redistribute a slice of the pie from short-term shareholders to long-term shareholders without shrinking the pie. If bargain repurchases are merely value-shifting and not value-destroying, it

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[30] *See infra* Parts III.A and V.A.

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

is still better for managers to serve long-term shareholders rather than short-term shareholders.

However, I show, managers seeking to boost long-term shareholder payoffs in a repurchasing firm may take two kinds of steps that do destroy value and reduce the economic pie. First, managers may engage in "costly contraction": undertaking economically excessive repurchases that divert funds from valuable projects inside the firm to buy back sharply discounted shares. From a long-term shareholder perspective, "investing" in very cheap shares may offer a higher return than using the cash to pursue valuable projects in the firm. But those higher returns, which translate into a higher long-term stock price, do not reflect the creation of more economic value; rather, they reflect a transfer of value from short-term shareholders to long-term shareholders that also comes at the expense of the economic value generated by the firm's activities over time. There is in fact evidence that firms engaging in share repurchases cut back on valuable activities inside the firm.

Second, managers serving long-term shareholders may engage in costly price-depressing manipulation around bargain repurchases. Once a firm decides to repurchase shares, long-term shareholders can benefit if managers engage in value-destroying manipulation to lower the price further before the repurchase occurs. Like costly contraction, such manipulation increases the amount of value transferred to long-term shareholders in the bargain repurchase, but shrinks the overall pie. Indeed, firms conducting repurchases engage in such manipulation to boost the long-term stock price.

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

Inflated-price issuances need not be value-destroying. In theory, they may merely redistribute value from future shareholders to long-term shareholders. But managers conducting inflated-price equity issuances for

the benefit of long-term shareholders can boost the long-term stock price by engaging in two types of actions that destroy value.

First, when the stock price is high, managers seeking to boost the long-term stock price may cause the firm to issue shares to acquire assets even if those assets lose value when they are absorbed into the firm. America Online's (AOL) acquisition of Time Warner in 2000, for $162 billion of stock, is a well-known example of long-term shareholders benefiting ex post from an issuance that destroyed economic value.[32] The acquisition destroyed so much value that AOL and Time Warner were forced to part ways nine years later. Nevertheless, from an ex post perspective, AOL's long-term shareholders undeniably benefited from the transaction; it enabled them to buy Time Warner's valuable assets at an extremely cheap price. In 2009, their combined stakes in AOL and Time Warner were worth approximately 400% more than the AOL stake they would have held absent AOL's acquisition of Time Warner.

Second, managers conducting inflated-price issuances can further benefit long-term shareholders by engaging in costly price-boosting manipulation (such as earnings manipulation). Such manipulation can transfer even more value to long-term shareholders. Thus, when a firm sells its own shares at an inflated price, the very same pie-reducing strategies that benefit short-term shareholders can also serve the interests of long-term shareholders. Indeed, AOL engaged in such value-destroying stock manipulation as it issued stock to Time Warner shareholders, to the benefit of AOL's long-term shareholders.[33] So do other firms issuing equity.[34]

Given the volume of repurchases and equity issuances, the amount of value that managers can transfer from other investors to long-term shareholders by exploiting mispricing in firms' securities and engaging in various types of value-destroying manipulations is likely to be substantial.

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[32] The AOL-Time Warner transaction is discussed in more detail in Part VI.A.2, *infra*.

[33] *See infra* Part VI.B.2.

[34] *See infra* Part __.

Indeed, a recent study by Richard Sloan and Haifeng You confirms that there already has been a large-scale transfer of value to long-term shareholders in publicly traded U.S. firms via equity transactions. The study finds that over the last 40 years, an aggregate of over $2.2 trillion has been transferred to long-term investors through bargain repurchases and inflated-price equity issuances.[35] Thus, managers have been annually transferring, on average, $50 billion of value to long-term shareholders through actions that reduce the size of the pie. This amount is likely to increase if, as is proposed, long-term shareholders are given even more power in widely-held firms.

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

The problem is that neither short-term shareholder payoffs nor long-term shareholder payoffs reflect the value flowing to all the firm's current and future shareholders. The short-term stock price does not reflect the value flowing to long-term shareholders and future shareholders. Long-term shareholder value does not reflect the value flowing to short-term shareholders and future shareholders. In sum, both short-term shareholder and long-term shareholder payoffs can be enhanced by inefficiently transferring value from other shareholders in the firm.

The desirability of favoring long-term shareholders depends not only on the type of analysis I offer but also on two additional considerations: (1) the potential existence of non-shareholder residual claimants on the value generated by the firm, whose residual claims may be affected by whether managers serve short-term and long-term

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[35] RICHARD G. SLOAN AND HAIFENG YOU, WEALTH TRANSFERS VIA EQUITY TRANSACTIONS 3 (working paper, 2013).

shareholders; and (2) the relative abilities of short-term and long-term shareholders to control managerial agency costs—the economic costs that arise when managers serve their own interests rather than those of shareholders (short-term or long-term).[36] Although a complete analysis of these two considerations is beyond the scope of this project, I address them briefly at the end of the paper.

Turning to the first consideration, advocates of a "stakeholder approach" to corporate governance, such as Professors Margaret Blair and Lynn Stout, have long pointed out – correctly, in my view -- that non-shareholder "stakeholders" also have residual claims on the corporation.[37] One might believe that such stakeholders are better off if managers run the firm for the benefit of long-term shareholders rather than short-term shareholders. But, I explain, as a matter of economic theory, the effect of managers' horizons on stakeholder welfare is indeterminate. Indeed, if markets are as inefficient as many believe, there is reason to believe that managers faithfully serving long-term shareholders may well seek to squeeze more value from other stakeholders than managers serving short-term shareholders. Thus, the potential existence of non-shareholder residual claimants may or may not strengthen the case for favoring long-term shareholders.

Turning to the second consideration, the desirability of favoring long-term shareholders will depend on whether long-term shareholders are better or worse at controlling managerial agency costs. Here, again, it is unclear whether long-term or short-term shareholders will provide better monitoring of managers. On the one hand, long-term shareholders have a greater interest in controlling managerial agency costs. But to the extent that short-term shareholders are willing to accumulate larger positions than long-term shareholders, they may have greater incentive and ability to discipline managers than long-term shareholders. If the latter effect

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[36] *See*, *e.g.*, Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 354-355 (1976).

[37] *See, e.g.*, Margaret M. Blair and Lynn A Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248,___ (1999) (explaining that non-shareholder constituencies are also residual claimants on the corporate pie).

dominates, favoring long-term shareholders by impeding short-term shareholders may lead to higher agency costs.

All in all, I explain long-term shareholders may have better or worse interests, and better or worse monitoring abilities, than short-term shareholders. Thus, my analysis suggests that the case for favoring long-term shareholders is much weaker than it might otherwise appear, and far from compelling.

Before concluding, a word about controlling shareholders. The purpose of my paper is to re-examine the desirability of favoring long-term shareholders in a widely-held firm where law, regulation, and private ordering could, in principle, be used to shift power away from short-term shareholders to long-term shareholders. But my analysis also has implications for the large number of firms where long-term shareholders already dominate: firms with controlling shareholders.[38] A controlling shareholder will often seek to engage in inefficient self-dealing transactions that directly transfer value from the corporation to itself via, among other things, asset sales and purchases.[39] My analysis suggests another problem with controlling shareholders: that controlling shareholders, *qua* long-term shareholders, will also have their firms engage in a variety of other value-reducing transactions to transfer value from other shareholders to themselves: costly contraction, costly expansion, and share-price manipulation around repurchases and equity issuances.[40] Thus, the economic costs associated with controlling shareholders may be even higher than is widely believed.

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[38] Average insider ownership in publicly-traded U.S firms is over 20%. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382 (2009). This figure suggests that controlling shareholders are more common in the U.S. than is widely believed. The frequency of controlling shareholders is much higher in non-US firms. *Id*., at ___.

[39] *See, e.g.,* Simon Johnson, Rafael La Porta, Florencio López-de-Silanes, and Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000).

[40] For evidence that these types of value diversion occur in controlled firms, s*ee* Borja Larrain and Francisco Urzua I., *Controlling Shareholders and Market Timing in Share Issuance*, forthcoming J. FIN. ECON. __ (examining equity issuances by controlling shareholders of Chilean firms between 1990 and 2009 and finding evidence consistent

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

I. BUILDING BLOCKS

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

A. Policy Goal: Maximizing Economic Value

I assume, consistent with most economic scholarship on corporate governance, that the regulation of public companies should be designed to

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with controlling shareholders timing issuances to transfer value from future shareholders); Jae-Seung Baek, Jun-Koo Kang, and Inmoo Lee, *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415 (2006) (finding evidence consistent with controlling shareholders of Korean firms using equity issuances to transfer value to themselves from public shareholders).

maximize the economic value created by the firm over time.[41] In particular, I assume that it is desirable to maximize the net economic output of the firm from today until "the long term"—the relevant end period, however that period is determined.[42] The net economic output of the firm is simply the value distributed by the firm less the value contributed to the firm. I call this maximand "economic value," or, more figuratively, "the pie."

To focus the analysis, I assume that the only residual claimants on the economic pie are the firm's current shareholders (who own shares now) and future shareholders (those who will buy its shares in the future, but before the long term arrives).[43] As a result, economic value is equivalent to the net amount of value flowing to current and future shareholders through the long term: cash they receive from the firm *less* cash (or other assets) they transfer to the firm.[44]

In effect, I treat current and future shareholders as if they collectively were a "sole owner" of the corporation. This sole owner wishes to maximize the net amount flowing to it over time—the amount withdrawn from the corporation (via dividends and repurchases) less the

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[41] *See*, *e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 28 (2d ed. 2009) (urging the use of Kaldor-Hicks efficiency as the criterion for evaluating corporate law and corporate governance arrangements).

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

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

[44] The assumption that current and future (common) shareholders are the firm's only residual claimants is, of course, a simplification. Other stakeholders, such as creditors, preferred shareholders, and employees, may also be affected by the firm's actions. And from an economic perspective, it would be desirable to maximize the total value flowing to all of these stakeholders. Thus, assessing whether it would be desirable to shift power from short-term shareholders to long-term shareholders would depend on how such a shift affected other residual claimants. I take up this issue in Part VIII.

amount invested in the firm (through the purchase of equity from the firm).

To be sure, the premise that it is desirable to maximize the net value flowing to all shareholders of the firm (both current and future), rather than *current-shareholder* value, might be questioned. In the U.S., directors are generally considered to owe a fiduciary duty to the firm and its current shareholders; future shareholders are not owed a fiduciary duty until after they have acquired stock in the firm.[45] Thus, one might believe that a firm should be run to maximize the value flowing solely to *current shareholders*.

From an economic perspective, however, a dollar flowing to a current shareholder is no more or less valuable than a dollar flowing to a future shareholder (adjusting, of course, for the time value of money). Thus, there is no economic reason for policymakers or analysts, in assessing policy proposals (including proposals designed to shift power to long-term shareholders), to weigh these dollars differently.[46] Accordingly, I assign the same weight to every dollar flowing to or from a firm's shareholders, whether the dollar flows to a current or future shareholder before the long term arrives.[47]

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[45] *See, e.g.*, Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1049 (2005) ("[d]irectors and management, at least in the United States, have a fiduciary duty only to investors holding an existing property right or equitable interest to support such a duty—i.e., current investors.")

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

[47] Perhaps recognizing the lack of an economic rationale for distinguishing between current and future shareholders, authorities in other common law systems, such as the U.K., have made explicit that directors owe a fiduciary duty to both current and future shareholders *See*, *e.g.*, Simon Goulding & Lilian Miles, *Regulating the approach of companies toward employees: the new statutory duties and reporting obligations of directors within the United Kingdom*, in RESEARCH HANDBOOK ON CORPORATE LEGAL RESPONSIBILITY 88, 89 (Stephen Tully, ed. 2005) (interpreting U.K. corporate law to require directors to advance the interests of "present and future" shareholders).

B. Shareholders' Objectives

My focus in this paper is on the *objectives* of short-term and long-term shareholders: that is, the outcomes they want the firm's managers to produce. I will assume that shareholders seek the highest possible financial return from their investment in the firm, given their holding period. Thus, they will want managers to maximize the stock price in the period when they will be selling their shares: short-term shareholders will seek a higher short-term stock price; long-term shareholders will seek a higher long-term stock price.[48]

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

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

The conventional view is that managers serving long-term shareholders will generate more value over time than managers serving short-term shareholders. This Part shows that the conventional view is correct, at least in a non-transacting firm (one that does not buy or sell its own shares) where shareholders are the only residual claimants.

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[48] In a firm that issues dividends, both short-term and long-term shareholders would care not just about stock price appreciation during the relevant period but about their total return, which would also include dividends. I assume, for simplicity, that the firms in this paper do not issue dividends. This assumption does not affect any of the analysis or conclusions.

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

A. Framework of Analysis

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

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

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

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

Long term: ABC's assets are sold for $V in cash, which reflects their actual value.[49] A total of $V is distributed to long-term shareholders and future shareholders. Because each type of shareholder holds one share, long-term shareholders receive $V/2 and future shareholders receive $V/2.

The sequence of events is illustrated in Figure 1 below.

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

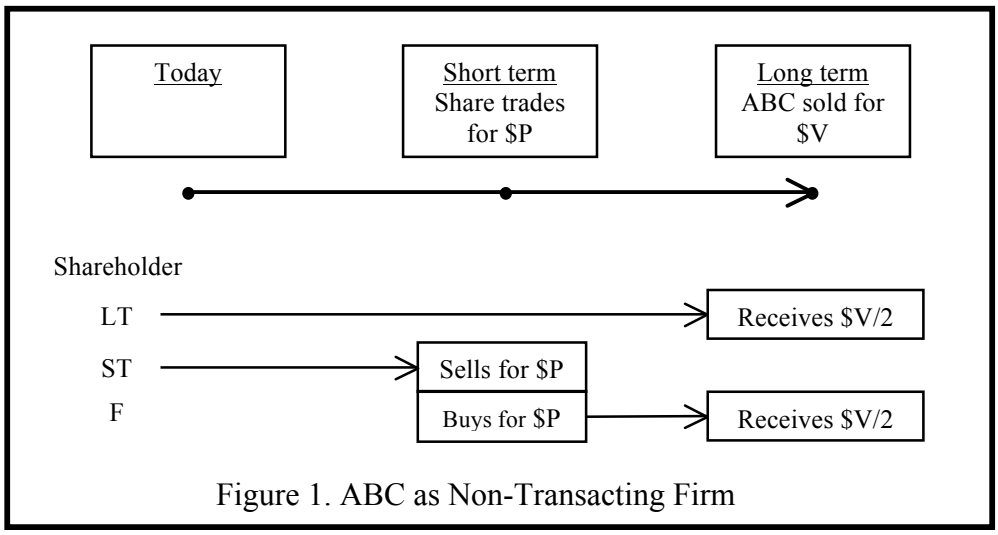

Figure 1. ABC as Non-Transacting Firm

The only cash flowing between ABC and its shareholders between today and the long term is the payment of $V made by ABC to long-term shareholders and future shareholders when ABC's assets are sold in the long term. Accordingly, economic value—the net amount of value flowing from ABC to ABC's shareholders over time—is $V.[50] Economic value (the pie), as well as the net amounts flowing to short-term shareholders and long-term shareholders, are all summarized in Table 1 below.

Table 1: Shareholder Payoffs and the Pie in a Non-Transacting Firm

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

[50] Throughout the examples in this paper, I ignore the time value of money (or alternatively, assume it is zero). This assumption, made purely for convenience, does not affect the analysis or conclusions.

B. Long-term Shareholders' "Better" Interests

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

1. Short-term Shareholders

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

But in the real world, future shareholders do not have full information about the value of a firm's stock.[51] Future shareholders must rely on information provided by managers, and managers can engage in "price-boosting manipulation"—providing information to make the firm appear more valuable than it really is, thereby boosting the price that future shareholders will pay for the stock. Indeed, short-term shareholders will want managers to engage in price-boosting manipulation because it will increase their returns.

If price-boosting manipulation were always economically costless—that is, it would not reduce the size of the pie—short-term shareholders' interests would be consistent with pie maximization. Short-term shareholders would want managers to boost the short-term stock

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

price through manipulation, and managers serving short-term shareholders would do so. But no value would be destroyed in the process. Instead, value would merely be transferred from one type of shareholder (future shareholders) to another (short-term shareholders) without any reduction in the size of the pie as a whole.[52]

However, short-term shareholders can also benefit from, and thus will want managers to engage in, "*costly* price-boosting manipulation" – manipulation that boosts the short-term stock price but destroys economic value.[53] Because short-term shareholders care only about the short-term stock price, any corporate action that boosts the short-term stock price serves their interest, even if it destroys value.

Managers already engage in a variety of practices that constitute costly price-boosting manipulation. One practice is earnings manipulation: reporting earnings different from the "correct" amount of earnings given the firm's actual business activity and cash flows.[54] Another practice is real earnings management: the postponing of desirable transactions or premature acceleration of transactions to boost short-term accounting results and the short-term stock price at the expense of long-term

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[52] If markets are rational, future shareholders will fully discount for the possibility of price-boosting manipulation. Ex ante, price-boosting manipulation will thus not transfer value from future shareholders to short-term shareholders.

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

[54] *See* Ilia Dichev, John Graham, Campbell R. Harvey, & Shiva Rajgopal, *Earnings Quality: Evidence From the Field* 3 (working paper, September 9, 2012) (reporting that CFOs believe that, in any given period, 20% of firms manage earnings to misrepresent economic performance, usually to influence the stock price, and for such firms 10% of earnings is typically managed). Such manipulation reduces economic value to the extent that the firm devotes resources to adjusting its earnings.

economic value.[55] Each of these strategies shrinks the economic pie but makes the short-term stock price higher than it would otherwise be.[56]

While managers certainly engage in costly price-boosting manipulation, they may do so to enrich themselves rather than short-term shareholders.[57] Indeed, only a few published studies have found evidence of a link between short-term shareholders and costly price-boosting manipulation.[58] Thus, many legal academics are skeptical that pressure

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[55] For evidence that managers engage in real earnings management, see, for example, Sugata Roychowdhury, *Earnings Management through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 336 (2006) (finding that managers overproduce goods so they can underreport the cost of goods sold and manipulate discretionary expenditures, which boosts reported earnings but can destroy economic value); John R. Graham, Campbell R. Harvey & Shiva Rajgopal, *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYST. J. 27, 33 (2006) (reporting results of survey of 400 CFOs, in which 78% reported that, to boost earnings and the short-term stock price, they would be willing to reduce discretionary spending on R&D, advertising, and maintenance, as well as delay starting projects to boost earnings, even if the actions reduced long-term cash flow).

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

[57] *See* Lucian Bebchuk and Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 183-185 (Harvard University Press, 2006).

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

from short-term shareholders *causes* managers to engage in value-destroying activities.[59] But whatever one's view on this empirical question, there is no doubt that short-term shareholder interests are not perfectly aligned with pie maximization.[60]

2. Long-Term Shareholders

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

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[59] *See, e.g.*, Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021, 1085 (2007) (concluding that the empirical evidence on the extent and magnitude of short-termism caused by short-term shareholders is "sketchy at best"); George Dent, *The Essential Unity of Shareholders and the Myth of Investor Short-termism*, 35 DEL. J. CORP. L. 99, 149-150 (2010) (noting that there is very little evidence of short-termism); MARK J. ROE, CORPORATE SHORT-TERMISM—IN THE BOARDROOM AND IN THE COURTROOM 20 (working paper, 2013) (arguing that there is not enough evidence of corporate short-termism to justify changes in corporate law); Lucian Arye Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value* (forthcoming, Colum. L. Rev. 2013) (arguing that there is little evidence that short-term shareholder influence undermines long-term value creation).

[60] If markets are rational, short-term shareholders cannot systematically benefit from costly price-boosting manipulation. But managers seeking to boost the short-term stock price still engage in costly price-boosting manipulation at the "moment of truth"—the point when they must decide whether or not to exploit an opportunity to do so. *See, e.g.,* Stein, *supra* note x (offering a model in which managers inflate current earnings to boost the current stock price and future shareholders rationally discount current earnings and the current stock price accordingly).

If markets are noisy rather than rational, the problem is much worse: short-term shareholders can benefit both ex post and ex ante from costly price-boosting manipulation. *See* Patrick Bolton, Jose Scheinkman, and Wei Xiong, *Executive Compensation and Short-termist Behavior in Speculative Markets*, 73 REV. ECON. STUD. 577 (2006) (presenting a model in which managers serving short-term shareholders in a speculative market will engage in costly price-boosting manipulation).

Accordingly, managers loyally serving long-term shareholders will seek to generate more value than managers loyally serving short-term shareholders. The conventional view and intuition about long-term shareholders is thus correct—for a non-transacting firm in which shareholders are the only residual claimants.

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Most firms, however, aggressively transact in their own shares. Indeed, publicly traded firms in the U.S. buy and sell, in aggregate, approximately $1 trillion of their own shares each year.[61] As we will see in the next four Parts, when firms buy and sell their own shares, long-term shareholder returns become decoupled from pie maximization and can be boosted by steps that actually destroy value. In such firms, neither short-term shareholder interests nor long-term shareholder interests align with pie maximization.

III. LONG-TERM SHAREHOLDER RETURNS IN A REPURCHASING FIRM

In this Part, I examine the interests of long-term shareholders in a repurchasing firm. Section A describes the widespread use of repurchases by U.S. firms. Section B modifies the analytical framework presented in Part II to explain how stock buybacks change the relationship between long-term shareholders' interests and economic value. Section C shows that long-term shareholders benefit when managers buy back stock at a cheap price; it also provides evidence that managers currently engage in such "bargain repurchases."[62]

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[61] *See infra* Parts III.A. and V.A.

[62] My goal in this Part is not to compare long-term and short-term shareholder interests within a repurchasing firm. Rather, my objective here is to show that repurchases decouple long-term shareholders' interests from economic value maximization. Thus, I focus here only on long-term shareholders' interests in a repurchasing firm.

A. The Widespread Use of Repurchases

Publicly-traded U.S. companies increasingly distribute cash through repurchases rather than through dividends.[63] Over 90% of U.S. public firms that distribute cash engage in share repurchases.[64] In 2007, S&P 500 firms distributed almost $600 billion through repurchases.[65] Market-wide, repurchases reportedly reached $1 trillion that year.[66]

In 2011, the market capitalization of publicly-traded U.S. firms was approximately $16 trillion.[67] If these firms repurchase (say) $600 billion of their shares per year, over 5 years they can be expected to distribute through share repurchases almost 20% of their terminal market capitalization. While many firms distribute more, and many less, the typical firm is likely to repurchase a substantial amount of its own stock.

The overwhelming majority of share repurchases take the form of an "open market repurchase" ("OMR").[68] In an OMR, the firm repurchases its shares in the open market, through a broker. The transactions are

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

[64] *See* Skinner, *supra* note x, at 583 (explaining that in 2005 only 7% of firms paid dividends and did not distribute any cash through repurchases).

[65] *See* Press Release, Standard & Poor's, S&P 500 Buybacks Set Record of $589 Billion in 2007 (Apr. 7, 2008), *available at* http://www2.standardandpoors.com/spf/pdf/index/040708_SP500_BUYBACK_PR.pdf.

[66] *Supra* note x.

[67] *See* The World Bank, Market Capitalization of Listed Companies (current U.S. $), *available at* http://data.worldbank.org/indicator/CM.MKT.LCAP.CD.

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

anonymous: shareholders are unaware that the firm is buying shares as the repurchases are occurring. Investors learn about the transactions only after the end of the quarter, typically 3-5 months after the transactions occur, when the firm reports the prior quarter's monthly share repurchases.[69]

To be sure, investors are aware that an OMR *might* be occurring. A firm cannot conduct an OMR unless its board has previously announced that it has authorized an OMR.[70] However, such an authorization announcement does not actually commit the firm to buy back any shares. In fact, almost 30% of firms announcing OMRs do not buy back a single share within four years of the OMR announcement.[71] Thus, investors will not know with certainty that an OMR has occurred until 3-5 months after the company starts buying back shares.

OMRs can increase economic value: they provide a more flexible form of payout than dividends, as well as a means of easily acquiring shares for stock option plans.[72] But, as we will see below, managers may use OMRs to transfer value from short-term shareholders to long-term shareholders in ways that shrink the pie.

B. Analytical Framework: Decoupling Effect of Share Repurchases

To see how share repurchases decouple long-term shareholders' interests from economic value, we will modify the analytical framework introduced in Part II to consider the scenario in which ABC corporation

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[69] *See* Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Stock Repurchases*, 6 BERKELEY BUS. L. J. 96, 109 (2009).

[70] *See id.* at 96.

[71] *See* Utpal Bhattacharya & Amy Dittmar, *Costless vs. Costly Signaling: Theory and Evidence* 2 (working paper, December 2008). I will explain in Section C why managers may announce an OMR, but then not conduct it.

[72] Explanations for how repurchases can serve shareholders are explored and analyzed in Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323, 1336–40 (2005) [hereinafter "Fried, *Informed Trading*"].

repurchases its own equity in the short term for $P. For now, I assume that the repurchase does not increase or decrease the size of the pie.

The three periods are as follows:

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

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

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

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

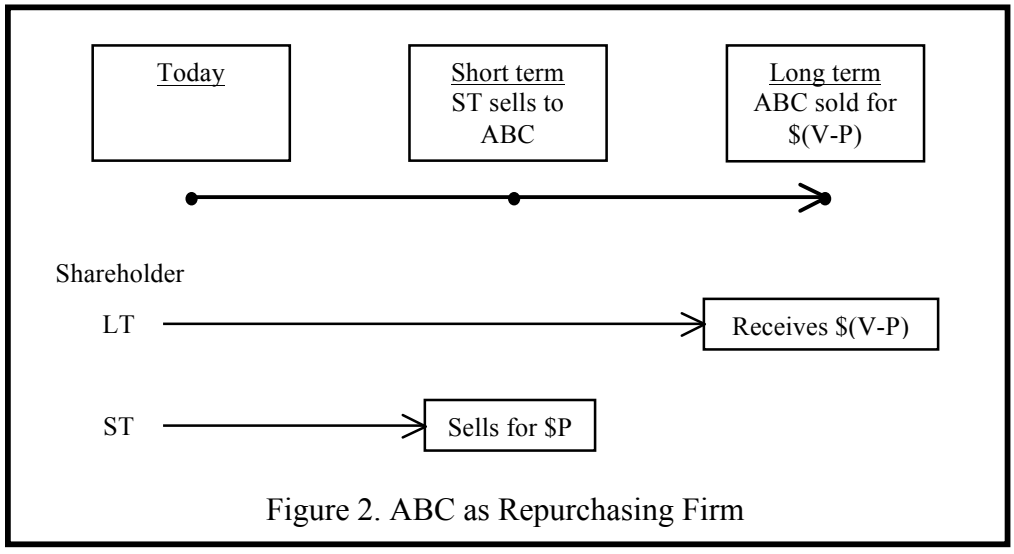

Figure 2. ABC as Repurchasing Firm

Although ABC's value in the long term is different from what it was in the non-transacting-firm scenario ($(V-P) instead of $V), the pie—the amount of value flowing to shareholders over time—is the same: $V.

The amount $(V-P) flows to long-term shareholders in the long term and the amount $P flows to short-term shareholders in the short term.[73]

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

Table 2: Shareholder Payoffs and the Pie in a Repurchasing Firm

Short-term Shareholders	Long-term Shareholders	Future Shareholders	The Pie
$P	$(V-P)	N/A	$V

Unlike in the non-transacting firm scenario, in a repurchasing firm there is now a disconnect between long-term shareholder returns and economic value. As $P falls, long-term shareholders' payoff increases even though the pie remains unchanged.

C. Bargain Repurchases

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

1. Economic Logic

As I have shown elsewhere, a share repurchase has the same distributional consequences as a transaction where the selling shareholders sell their stock to the remaining shareholders at the repurchase price.[74] Thus, a repurchase at a low price (i.e., a price lower than the no-

[73] Again, I ignore the time value of money.

[74] *See* Fried, *Informed Trading*, *supra* note x, at 1344–46.

transaction value of the stock) transfers value from selling shareholders to non-selling shareholders.[75]

We can see this in terms of our ABC example. In non-transacting ABC (where there is no repurchase), long-term shareholders will receive $V/2 for their equity. In the event of a repurchase, they will receive $V-P for their equity. Thus, if $P < $V/2, long-term shareholders will be better off if the repurchase occurs than if it does not.[76]

2. Evidence of Bargain Repurchases

Because managers own shares in their firms, many of which they expect to hold for several years or more, they have an incentive to repurchase shares at a low price. Evidence that managers engage in bargain repurchases includes (a) executives' own statements and behavior, and (b) post-repurchase stock returns.

a. Executives' Own Statements and Behavior

Executives report that they frequently use repurchases to buy cheap stock. According to economists who conducted a major 2005 survey of executives regarding firms' payout policies, "[t]he most popular response for all repurchase questions on the entire survey is that firms repurchase when their stock is a good value, relative to its true value:

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

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

86.4% of all firms agree or strongly agree with this supposition."[77] Importantly, the authors reported that "executives tell us that they accelerate (or initiate) share repurchases when their company's stock price is low."[78] And firms frequently describe repurchase programs as designed to buy shares at favorable prices for long-term shareholders.[79]

For those inclined to be skeptical of executives' accounts, a recent empirical study provides "hard" evidence that managers do, in fact, use inside information to time repurchases. The study finds that firms systematically buy stock at low prices within each quarter, often transferring large amounts of value to long-term shareholders.[80] In one firm, 7.76% of the firm's total market capitalization was shifted from selling shareholders to long-term shareholders in this manner.[81]

b. Post-Repurchase Stock Returns

The movement of stock prices following repurchases also suggests that many repurchases are driven by the desire to engage in indirect insider trading. Researchers have repeatedly found that companies announcing OMRs experience, on average, cumulative abnormal (market-adjusted) returns of approximately 25% over the next four years.[82] This suggests that

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

[78] *Id.*

[79] *See, e.g.*, UnitedHealth Group, "UnitedHealth Group Board Increases Shareholder Dividend 32%; Renews Share Repurchase Program" (June 5, 2013) *available at* http://www.unitedhealthgroup.com/Newsroom/Articles/Feed/UnitedHealth%20Group/2013/0605shareholderdividend.aspx?p=1& (reporting that the "renewed share repurchase program strengthens and extends our ability to repurchase shares at favorable prices for the benefit of long term shareholders").

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

[81] *Id.* at 1046.

[82] *See, e.g.*, Konan Chan et al., *Economic Sources of Gain in Stock Repurchases*, 39 J. FIN. & QUANT. ANALYSIS 461, 463 (2004) (finding that shares of firms announcing

firms announcing OMRs were, on average, 20% undervalued at the time of the OMR announcement.

However, as I noted earlier, many firms announcing OMRs do not actually buy back any stock.[83] We would thus expect firms that announce OMRs and then actually repurchase shares to be more undervalued, on average, than *all* firms announcing OMRs. Indeed, one study found that "value" firms (firms with a high book-to-market ratio) that had announced repurchases *and* subsequently repurchased more than 4% of their shares in the following year experienced average four-year post-announcement abnormal returns of 57%.[84] These post-repurchase returns provide further strong evidence that managers currently use repurchases to shift value from selling shareholders to long-term shareholders.[85]

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repurchases earn abnormal returns of 6.7% in the first year following the announcement and 23.6% over the subsequent four years); Urs Peyer & Theo Vermaelen, *The Nature and Persistence of Buyback Anomalies*, 22 REV. FIN. STUD. 1693, 1701 (2009) (finding, in a large sample of firms announcing OMRs, a 24.25% cumulative market-adjusted return over the 48 months following OMR announcements).

[83] *See supra* Part III.A.1. There are at least two reasons why managers announcing OMRs may not follow through with any repurchases. First, managers might announce a repurchase that they have no plan to conduct simply to boost the stock price so they can unload their own shares at a higher price. *See* Fried, *Informed Trading*, *supra* note x, at 1351–56 (developing the argument that executives can use repurchase announcements for false signaling and providing anecdotal accounts of such false signaling). Indeed, a recent paper finds evidence of such "false signaling." *See* Konan Chan et al., *Share Repurchases as a Potential Tool to Mislead Investors*, 16 J. CORP. FIN. 137, 139 (2010) (finding evidence consistent with executives of poorly performing firms making share repurchase announcements without an intention to repurchase shares). Second, managers may announce an OMR to give the firm an option to acquire stock at a cheap price—an option that they may decline to exercise if the stock price does not turn out to be low. *See* David L. Ikenberry & Theo Vermaelen, *The Option to Repurchase Stock,* 25 FIN. MGMT. 9, 10 (1996).

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

[85] For an explanation of why U.S. insider-trading law enables managers to use inside information in deciding when the firm should repurchase shares, see Jesse M. Fried, *Insider Trading via the Corporation* 14-16 (working paper, August 2, 2012) (hereinafter

Not surprisingly, managers' propensity to buy stock at a bargain price increases with their own equity ownership, that is, the extent to which their interests are aligned with those of long-term shareholders. One study found that abnormal returns following repurchase announcements, which are associated with pre-repurchase underpricing, are positively correlated with pre-buyback executive stock ownership.[86] Another found that relatively infrequent repurchase announcers—those firms that are more likely to be engaged in bargain repurchasing than repurchasing shares to acquire stock for employee-option programs—also tend to have higher levels of executive ownership.[87] Both of these studies indicate that executives are more likely to engage in bargain-price repurchases when their interests are more aligned with those of long-term shareholders.

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

Part III explained that managers can, and do, use bargain repurchases to shift value from selling shareholders to long-term shareholders. If these bargain repurchases were economically costless, they would merely shift value among different types of shareholders without reducing the size of the pie. Managers could thus boost long-term shareholder value without destroying value. Unfortunately, however, the use of bargain repurchases can give rise to economic costs that shrink the pie.

This Part describes two such costs. Section A explains that the use of bargain share repurchases to boost long-term shareholder returns can

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"Fried, *Insider Trading*") (explaining that much insider trading is legal under current law and that illegal insider trading is often difficult to detect and deter, especially given the lax reporting requirements imposed on firms trading in their own shares).

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

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

destroy economic value by inefficiently shrinking the firm. Section B explains that managers can, and do, benefit long-term shareholders by engaging in costly price-depressing manipulation around share repurchases.

A. Costly Contraction

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

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

From an economic perspective, a firm should distribute cash to shareholders via a repurchase (or dividend) if, and only if, the cash will generate more economic value outside the firm than inside the firm. If an outside project would yield a 15% return and an inside project would yield 10%, the cash should be distributed. But if the best outside project available to shareholders would yield a 10% return and an inside project would yield a 15% return, the cash should not be distributed.

Importantly, from an economic perspective, the firm's stock price is not a relevant consideration in determining whether the firm should distribute cash via a repurchase. The only relevant consideration is the economic return of the cash inside or outside the firm.

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

Suppose, for example, that $100 left in a firm (XYZ) would be used to fund a project generating a return of 15% ($15). Suppose that if the $100 were instead distributed to shareholders, the shareholders receiving the cash could generate returns of only 10% ($10) outside XYZ.

Distributing the $100 through a repurchase rather than funding the project would thus destroy $5 of economic value.[88]

Nevertheless, XYZ's long-term shareholders can benefit from such a value-reducing repurchase. In particular, they would profit if the price of the repurchased stock is sufficiently low that the return on the purchase of the stock exceeds the return from the desirable investment. Continuing with the above example, suppose that XYZ's shares are underpriced by 20% (relative to their value in the event of a $100 distribution from XYZ): shares trading for $100 are actually worth $125. By buying the shares for $100, XYZ can generate a return of 25% for long-term shareholders. The $25 return exceeds the $15 return on the desirable project, but does not represent the creation of economic value. Rather, the $25 reflects the transfer from one group of shareholders to another, with $5 of economic value lost in the process.

2. Must Economic Value be Sacrificed to Engage in Bargain Repurchases?

One might wonder why a firm repurchasing its stock cannot have its cake and eat it too: both pursue the valuable project *and* buy back stock when it trades at a low price. Indeed, in a world of perfect capital markets, there would be no need to sacrifice desirable projects to fund a bargain-price repurchase: firms could easily find enough cash both to buy their stock at a low price and to invest in high-value projects.[89]

However, in the real world, a firm may not be able to borrow enough money to fund the desirable project while also buying back stock at a low price. First, as economists have long understood, information

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[88] *Cf.* ONUR BAYAR, THOMAS J. CHEMMANUR & MARK H. LIU, PAYOUT POLICY UNDER HETEROGENOUS BELIEFS: A THEORY OF DIVIDENDS VERSUS STOCK REPURCHASES, PRICE IMPACT, AND LONG-RUN STOCK RETURNS 3 (working paper, 2013) (offering model in which the existence of heterogeneous beliefs about the value of a firm's project may cause managers to underinvest in the project in order to buy back shares at a low price).

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

asymmetry may prevent a firm from borrowing money on cost-effective terms.[90] While the managers may know that the firm's prospects are good, outside lenders asked to provide capital may lack sufficient information to reach the same conclusion. Outside lenders may thus demand terms that make the financing of the desirable project too costly, leading managers to forgo the project.

Second, even if a firm could borrow on reasonable terms from a lender, the borrowing may not be permitted by the firm's existing arrangements. For example, loan covenants with existing lenders might bar the firm from borrowing additional funds.[91] While renegotiation is possible in theory, it might be difficult in practice, particularly if the borrower must simultaneously renegotiate with multiple creditors to obtain the modifications needed to facilitate the new investment.

In short, firms cannot always be expected to have their cake and eat it too; they may need to choose between engaging in a bargain price repurchase and funding desirable projects. In fact, empirical evidence suggests that repurchases often divert cash that would otherwise be used for R&D and other productive investments in the firm.[92]

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[90] *See generally id.* at 187–220.

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

[92] *See* Alok Bhargava, *Executive compensation, share repurchases and investment expenditures: econometric evidence from U.S. firms*, REV. QUANTITATIVE FIN. & ACCT., Online First, Oct. 14, 2011, at 1 (concluding that repurchases, especially those that appear to be driven by executive stock ownership, appear to have a significantly negative effect on a firm's short-term investments and research and development, with a doubling of repurchases leading to an 8% reduction in R&D expenditures); Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises*, 40 J. ACCT. RES. 359, 359 (2002) (finding evidence that firms that repurchase shares to satisfy option exercises exhibit subsequent poor performance because the repurchases divert cash from productive investments).

B. Costly Price-Depressing Manipulation around Bargain Repurchases

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

As Part III explained, long-term shareholder returns in a repurchasing firm depend on the price at which the firm buys its own shares. Long-term shareholders benefit when the repurchase price is low (relative to the no-transaction value of the stock); the lower is the price, the better off are long-term shareholders. Thus, managers repurchasing cheap shares in the short term can benefit long-term shareholders by further depressing the short-term stock price.[93]

Importantly, managers can benefit long-term shareholders by manipulating the stock price around repurchases even if some economic value must be sacrificed to do so. In particular, as long as long-term shareholders' losses from value destruction are lower than their benefit from the reduced repurchase price, long-term shareholders will prefer that managers engage in costly price-depressing manipulation.[94]

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

[94] Consider again ABC Corporation. ABC initially has two shares outstanding (one held by long-term shareholders, and one held by short-term shareholders). It is liquidated in the long term. ABC will repurchase short-term shareholders' single share in the short term. There are two scenarios:

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

Costly-Manipulation Scenario: Now suppose that ABC can engage in price-depressing manipulation (say, earnings management) in the short term that reduces the

In fact, there is evidence that managers manipulate prices before and during repurchases, deliberately driving earnings and the stock price down to increase the amount of value transferred to long-term shareholders. One study examined 1720 OMR announcements during the period from 1984 to 2002 that were followed by actual repurchases during the quarter of the announcement or the following quarter.[95] The study found significant negative abnormal accruals among firms announcing and then actually conducting OMRs, but not among the firms that announced OMRs and then did not conduct them. Not surprisingly, such earnings manipulation was more aggressive among firms that repurchased more stock, and in firms where the equity ownership of the CEO was higher—that is, where the CEO's interests were more aligned with the interests of long-term shareholders.[96]

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short-term stock price by $2. Assume that the manipulation reduces economic value by $1. ABC can thus buy back a single share for $8, but must give up an additional $1 of value to do so. The repurchase, coupled with costly-price depressing manipulation, thus reduces the value of ABC in the long-term from $20 to $11. In the long term, the value of ABC's remaining share (held by long-term shareholders) is thus $11.

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

Table 1F. Long-term Shareholders and Costly Price-Depressing Manipulation

	The Pie	Long-term Shareholders
No Manipulation	$20	$10
Costly Manipulation	$19	$11

[95] *See* Guojin Gong, Henock Louis & Amy X. Sun, *Earnings Management and Firm Performance Following Open-Market Repurchases*, 63 J. FIN. 947, 983 (2008) (reporting that firms adjust accruals to decrease their reported earnings before stock repurchases). *Cf.* Dichev et al, *supra* note x, at 4 (reporting that 40% of earnings management is income-decreasing).

[96] *See* Gong, et al., *supra* note x, at 983.

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

V. LONG-TERM SHAREHOLDER RETURNS IN AN ISSUING FIRM

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

Section A describes the widespread use of equity issuances. Section B modifies the analytical framework presented in Part II to explain how equity issuances change the relationship between long-term shareholders' interests and economic value. Section C shows that long-term shareholders benefit when managers sell stock at an inflated price, and it provides evidence that managers currently engage in such "inflated-price" issuances.[97]

A. Widespread Use of Equity Issuances

The typical publicly-traded firm not only repurchases shares, but also issues a considerable amount of shares between the time it goes public and the time it ceases trading. Indeed, issuances typically exceed repurchases. For example, during each of the years in the period from

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[97] Just as my objective in Part III was not to compare the interests of short-term shareholders and long-term shareholders in repurchasing firms, my goal in this Part is not to compare the interests of long-term and short-term shareholders in issuing firms. Rather, my objective is to show that issuances decouple long-term shareholders' interests from value maximization. Thus, I focus here only on long-term shareholder interests.

1993 to 2002, an average of 66.5% of large firms made *net* stock issues (issuances less repurchases).[98] Strikingly, these net stock issues averaged 7.5% of assets, which is on the same order of magnitude as net debt issuances.[99] The fact that net issuances are so large suggests that the magnitude of issuances market-wide is similar to that of repurchases.

While almost all repurchases take the form of OMRs, equity issuances come in a variety of flavors. I will focus on two of the most important: (1) acquisition-related issuances and (2) seasoned equity offerings.[100]

1. Acquisition-Related Issuances

Acquirers often issue equity to provide currency for purchasing the shares of a target company, in part because the use of equity rather than cash can provide a tax benefit to the target shareholders.[101] An example of such an acquisition (and one to which we will return in Part VI.A.) is AOL's acquisition of Time Warner in 2000 for $162 billion in equity.

2. Seasoned Equity Offerings

Seasoned equity offerings ("SEOs") raise cash for operations and strategic investments, or to pay down debt.[102] Many firms engage in SEOs,

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[98] *See* Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549, 550 (2005).

[99] *Id.* at 551. The figure for smaller firms was 12.6%, about twice as much as their net debt issues. *Id*. at 563.

[100] A third important flavor is equity issuances made in connection with executive and employee compensation programs. For example, among the largest 200 firms in 2007, the range of shares allocated to equity compensation plans ranged from 0.92% of outstanding shares to 62.6% of outstanding shares, with the median around 10.5%. *See* Pearl Meyer & Partners, *2008 Equity Stake Study: Study of the Top 200 Corporations* 2 (2009).

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

[102] *See id*. at 573–75 (describing various purposes for stock issuances, including SEOs).

and the amount of stock sold is substantial.[103] SEOs come in two forms: "traditional" and "at-the-market" ("ATM").

a. Traditional SEOs

In a traditional SEO, shares are sold in a single pre-announced offering, with the number of shares to be sold announced in advance. Typically, the stock price falls when a traditional SEO is announced.[104]

b. ATMs

An ATM is a new form of equity offering that has become quite popular in the U.S. market.[105] In an ATM, shares are sold directly (and quietly) in the market through a sales agent.[106] A firm need not, and typically does not, announce these sales as they are occurring (much as firms do not announce OMR transactions as they are occurring). Indeed, ATMs are marketed as a way for firms to issue shares quickly when the

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[103] One study reported that SEOs increase outstanding shares by 26% on average. *See* Fangjian Fu, *Overinvestment and the Operating Performance of SEO Firms*, 39 FIN. MGMT. 249, 250 (2010) (reporting that, in a sample of 2873 SEOs during 1980-1999, outstanding shares increased by 26% on average).

[104] *See, e.g.*, Tim Loughran & Jay R. Ritter, *The New Issues Puzzle*, 50 J. FIN. 23, 30 (1995) (examining 3702 traditional SEOs between 1970 and 1980 and finding that the stock price drops when SEOs are announced).

[105] *See* Matthew T. Billett, Ionnis V. Floros, Jon A. Garfinkel, *A*t *The Market (ATM) Offerings* 2-3 (working paper, 2012) (describing regulatory changes in 2005 and 2008 that facilitated use of ATMs and the increasing use of ATMs by public companies); Sigitas Karpavicius & Jo-Ann Suchard, *Information Asymmetry and SEO Issue Method Choice: The Impact of Institutional Ownership, Analyst Coverage, and Earnings Management* 29 (working paper, 2010) (explaining that, from 1997 to 2007, the fraction of equity issued through traditional SEOs dropped from 82% to 19%).

[106] For a discussion of these offerings and their requirements, see James D. Small III et al., *The resurgence of United States at-the-market equity offerings to raise capital in volatile equity markets*, 4 CAP. MKTS. L. J. 290, 291 (2009) (describing requirements for ATM offerings).

price appears favorable without alerting the market to the issuance and causing the stock price to fall.[107]

To be sure, investors know that an ATM *might* be occurring. Before conducting an ATM, the firm must have an effective shelf registration statement and certain other disclosures on file with the SEC.[108] In these disclosures, the firm must indicate the maximum number of shares to be sold or the maximum aggregate gross proceeds from such sales, and the sales agent.[109] However, like an OMR announcement, the filing of these disclosures does not compel the firm to enter into any transactions. Thus, like an OMR announcement, an ATM filing gives a firm the option, but not the obligation, to trade in its shares on the open market.

B. Analytical Framework: Decoupling Effect of Equity Issuances

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

The periods are as follows:

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

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

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[107] *Id.*

[108] *See* Small et al., *supra* note x, at 295–96.

[109] *See id.* at 296.

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

The sequence of events is illustrated in Figure 3 below.

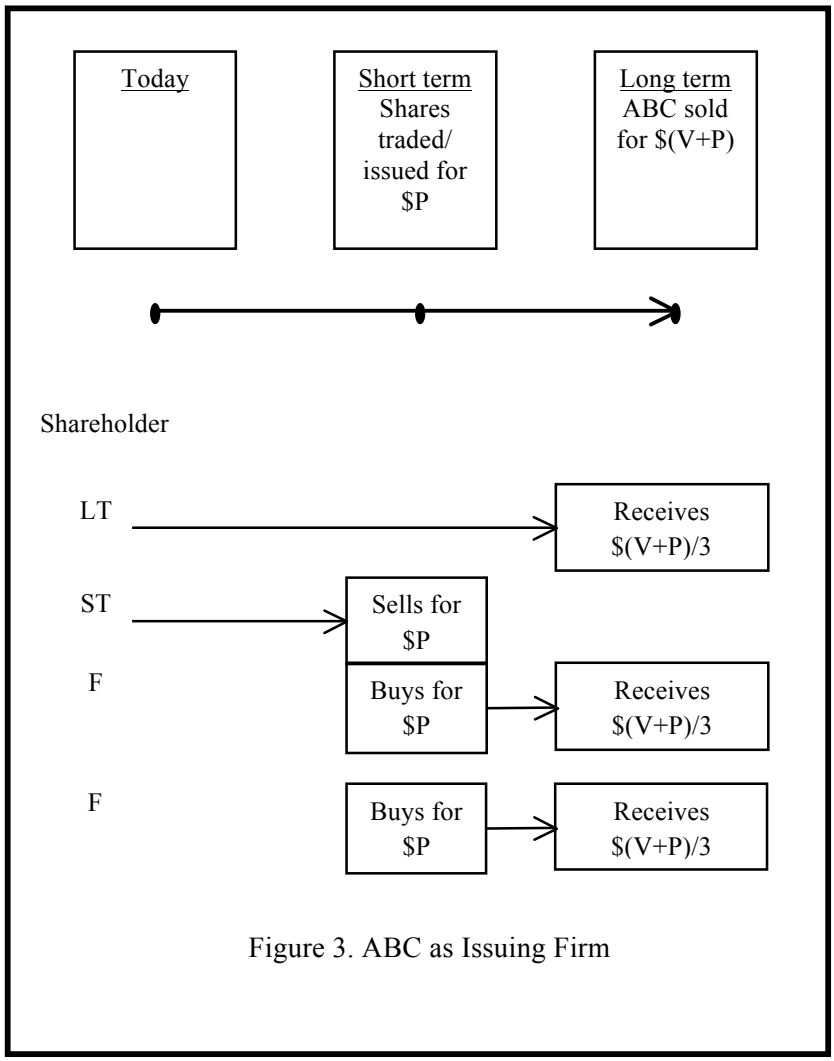

Figure 3. ABC as Issuing Firm

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

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

Table 3: Shareholder Payoffs and the Pie in an Issuing Firm

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

Unlike in the non-transacting case, but as in the repurchasing case, there is a disconnect between long-term shareholder returns and the pie. As $P increases, long-term shareholders' payoff rises, but the pie remains the same. Another way to put it is that the equity issuance converts a long-term shareholder into a partial short-term shareholder (one whose payoff is linked to $P, the short-term stock price).

C. Inflated-Price Issuances

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

1. Economic Logic

An equity issuance has analogous distributional effects to a share repurchase. A share repurchase transfers value from short-term shareholders to long-term shareholders when the stock price is lower than its actual value. A stock issuance transfers value from future shareholders to long-term shareholders when the stock price is higher than its actual

value. Hence, managers can benefit long-term shareholders by selling stock at an inflated price.[110]

We can see this in terms of our ABC example. In non-transacting ABC (where there is no equity issuance), long-term shareholders will receive $V/2 for their equity. In the event of an issuance of one share for $P, they will receive $(V+P)/3 for their equity. Thus, if $P > $V/2, long-term shareholders are better off.

2. Evidence of Inflated-Price Issuances

We saw in Part III that managers acknowledge that they have their firms repurchase shares when the price is low.[111] Similarly, and not surprisingly, managers acknowledge that they issue shares when they believe the stock price is "high."[112] Thus, managers report that they boost the long-term stock price both by buying low and selling high. And just as empirical studies repeatedly find that managers conduct repurchases at low prices, there is considerable evidence that managers conduct equity issuances—either to acquire other firms or to raise cash—when the stock is overpriced.

Turning first to acquisition-related issuances, firms tend to use overpriced stock as currency in acquisitions.[113] Such acquisitions benefit

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

[111] *See* Brav et al., *supra* note x, at 514.

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

[113] *See, e.g.*, Ming Dong et al., *Does Investor Misvaluation Drive the Takeover Market?*, 61 J. FIN. 725, 757 (2006) (finding that overpriced firms are more likely to try to acquire other firms that are less overpriced); Matthew Rhodes-Kropf et al., *Valuation Waves and Merger Activity: The Empirical Evidence*, 77 J. FIN. ECON. 561, 600–01 (2005) (concluding that the "vast majority" of mergers involve "highly overvalued bidders");

the long-term shareholders of the acquiring firms by enabling the acquiring firms to purchase assets cheaply.[114]

Equity issuances for cash show a similar pattern. There is evidence, going back decades and from around the world, that traditional SEOs are, on average, overpriced.[115] A recent paper examining 2600 SEOs between 1992 and 2010 suggests the magnitude of this benefit. It finds that firms timing traditional SEOs boost average returns to long-term shareholders by approximately 3% over the following three years.[116]

To my knowledge, there has not yet been an academic study of ATMs, which have become popular only recently. But ATMs are

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Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?*, 52 J. FIN. 1765, 1775 (1997) (finding that managers of acquiring firms use stock to pay for the acquisitions when their firms' stock is likely to be overvalued and cash when their firms' stock is likely to be undervalued).

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

[115] *See, e.g.,* Loughran & Ritter, *supra* note x, at 25, 47 (examining 3702 SEOs between 1970 and 1980 and finding evidence consistent with firms announcing stock issues when the stock is grossly overvalued, the market failing to revalue the stock appropriately, and the stock remaining overvalued when the issue occurs); Malcolm Baker & Jeffrey Wurgler, *Market Timing and Capital Structure*, 57 J. FIN. 1, 2 (2002) (reporting that equity market timing—having the firm buy shares at a low price and issue shares at a high price—is an important aspect of actual corporate finance practice); Jeffrey Pontiff & Artemiza Woodgate, *Share Issuance and Cross-Sectional Returns*, 63 J. FIN. 921, 943–44 (2008) (finding evidence of post-SEO stock underperformance in a recent sample of U.S. SEOs). Equity issuances outside the U.S. also tend to be overpriced. Brian J. Henderson et al., *World Markets for Raising New Capital*, 82 J. FIN. ECON. 63, 66 (2006) (examining equity issuances around the world and concluding that "firms are more likely to issue equity when the stock market appears to be overvalued").

[116] *See* Ilona Babenko *et al*., *Agency Implications of Equity Market Timing* 5 (working paper, May 9, 2012) (reporting that for firms timing SEOs, the average additional three-year return created for long-term shareholders was 3.21%).

marketed to firms as a method of enabling managers to issue shares quickly when the price appears favorable without alerting the market of the issuance and causing the stock price to fall.[117] We can thus expect ATMs, like traditional SEOs, to be used to transfer value from future shareholders to long-term shareholders.[118]

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

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

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

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[117] As one practitioner article candidly described the benefits of an at-the-market SEO, "the issuer can opportunistically take advantage of stock price movements." James D. Small III, W. Clayton Johnson, & Leslie Silverman, *The Resurgence of United States at-the-market equity offerings to raise capital in volatile equity markets*, 4 CAP. MKTS. L. J., 290, 291 (2009).

[118] For an explanation of why U.S. insider-trading law enables managers to use inside information in deciding when the firm should issue shares, see Fried, *Insider Trading, supra* note x, at 14–16 *(*explaining that much insider trading is legal under current law and that illegal insider trading is often difficult to detect and deter, especially given the lax trade-reporting requirements imposed on firms conducting ATMs).

A. Costly Expansion

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

1. Economic Logic

We saw in Part III that a repurchase can reduce economic value by distributing cash that, from the perspective of all the firm's current and future shareholders, could generate higher returns if invested in the firm's own projects. Analogously, an equity issuance can reduce economic value if the equity issuance causes the firm to absorb assets that would generate more value outside the firm. And, just as long-term shareholders can benefit from managers sacrificing valuable in-firm projects to buy back stock at a low price, they can benefit from managers acquiring assets at a discount through the use of overpriced stock that would generate more economic value outside the firm.[119]

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[119] A numerical example involving ABC Corporation may help clarify. As before, ABC initially has two shares outstanding and is liquidated in the long term. One share is held by long-term shareholders, another by short-term shareholders. Consider two scenarios:

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

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

Managers serving long-term shareholders will expand the firm, because it increases long-term shareholders' payout from $10 to $11. However, the expansion reduces economic value. In the No-Expansion Scenario, the pie is $20; in the Costly-Expansion Scenario, the pie is $19 ($33 distributed in the long term less $14 received from shareholders in the short term). The effect of the expansion on the pie and long-term shareholders' payoff is summarized in Table 2F:

2. AOL-Time Warner Transaction

Can long-term shareholders actually benefit from the sale of overpriced equity to finance a value-destroying acquisition? From an ex post perspective, one can certainly find many examples where long-term shareholders of acquirers benefit from value-wasting acquisitions financed with inflated stock. But if there were a "poster child" for such a transaction, it would likely be AOL's acquisition of Time Warner in 2000.[120]

AOL, with a market capitalization of over $200 billion, used $162 billion of stock to acquire Time Warner.[121] The companies thus had roughly equivalent market capitalizations before the merger. A hypothetical AOL shareholder owning 2% of AOL before the merger thus would have ended up with approximately 1% of the combined firm.

There is little doubt, from an ex post perspective, that the acquisition destroyed economic value. The expected synergy benefits failed to materialize. In fact, AOL and Time Warner parted ways nine years later,[122] suggesting that synergy effects were actually *negative*. The

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Table 2F. Long-term Shareholders and Costly Expansion

	The Pie	Long-term Shareholders
No Expansion	$20	$10
Costly Expansion	$19	$11

[120] *See* Tim Arango, *How the AOL–Time Warner Merger Went So Wrong*, N.Y. TIMES (Jan. 11, 2010), *available at* http://www.nytimes.com/2010/01/11/business/media/11merger.html?_r=1 (reporting that the 2000 deal valued the combined firm at $350 billion and that ten years later the combined value of the companies, which have since separated, was about one-seventh of their combined value on the day of the merger).

[121] *See* Daniel Okrent, *Happily Ever After?*, TIME, Jan. 24, 2000, at 39 (reporting that the transaction was an all-stock acquisition for about $162 billion of AOL stock).

[122] *See* W. David Garnder, *AOL Completes Spin-Off From Time Warner*, INFORMATION WEEK (Dec. 10, 2009), *available at* http://www.informationweek.com/news/internet/ebusiness/showArticle.jhtml? articleID=222001597.

economic costs of this failed marriage included the transaction costs associated with combining and then splitting the businesses, as well as the negative synergy costs incurred while keeping the two firms stapled together.

Nevertheless, AOL's long-term shareholders appear to have benefited from the transaction. When AOL and Time Warner were separated in 2009, AOL was worth $3.5 billion while Time Warner was valued at about $36 billion,[123] for a combined value of about $40 billion. Assuming AOL would have been worth the same ($3.5 billion) in 2009 had it not acquired Time Warner, our hypothetical 2% AOL shareholder would (absent the merger) have owned shares worth $70 million. Instead, as a result of the merger, that shareholder would have owned 1% of AOL (worth $35 million) and 1% of Time Warner (worth $360 million), for a total value of approximately $400 million—more than five times the value of her hypothetical no-transaction stake in AOL.

To be clear, I am not claiming that the AOL-Time Warner deal was driven by AOL managers seeking to serve long-term shareholders through costly expansion. AOL's managers may or may not have believed that AOL was overpriced, and they may or may not have believed that the merger would destroy economic value. I describe AOL's acquisition of Time Warner simply to offer a concrete example of how long-term shareholders *can benefit* ex post from a transaction that destroyed economic value.

3. Must Value be Destroyed to Issue Overpriced Equity?

We have seen that long-term shareholders can be made better off if their firm issues overpriced equity for value-wasting acquisitions (rather than refrains from doing so). But long-term shareholders would be even better off if the firm could use inflated-price issuances to acquire assets that do not decrease in value when brought into the firm. In particular, long-term shareholders would prefer managers of firms with overpriced

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[123] *Id.*

stock to either (a) acquire hard assets, via an acquisition-related issuance, that do not decrease in value when brought into the firm; or (b) engage in an SEO and invest the cash in a way that enhanced (or at least did not waste) economic value.

However, in many situations, these two alternatives might either be unavailable or deliver less value to long-term shareholders than costly expansion. Consider first the possibility of conducting an acquisition-related issuance aimed at bringing "good" assets (assets that do not lose value when acquired) into the firm. To begin, the firm may be at its optimal scale and scope, so that expanding the firm can only reduce the economic pie. In addition, even if the firm could be expanded in ways that did not reduce long-term economic value, it may not always be possible to find and acquire good assets during the window when the acquirer's stock is overpriced. If good assets are unavailable during this window, long-term shareholders might be better off if managers engage in a value-destroying acquisition rather than no acquisition at all.[124]

Next, consider the possibility of conducting an SEO (and not mis-investing the cash). In theory, long-term shareholders would be better off if managers did not engage in a value-wasting acquisition, but instead sold overpriced equity for cash, and then either kept or distributed the cash to shareholders, avoiding any shrinkage of the pie. But a firm conducting an SEO, whether traditional or ATM, must inform its old and new investors of the purpose of the financing.[125] If the firm announces that it will take all of the funds raised and hold them in cash or distribute them to shareholders, investors are likely to infer that the firm is issuing stock

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

[125] *See, e.g.*, SEC, Registration Statement Under the Securities Act of 1933, at 10 (Form S-3), *available at* www.sec.gov/about/forms/forms-3.pdf (requiring a stock issuer to furnish the information required by Item 504 of Regulation S-K, namely the "principal purposes for the which the proceeds are to be used").

merely to exploit the fact that it is overpriced.[126] Investors might then lower their valuations of the firm, making it more difficult for the firm to sell overpriced equity through the SEO. Thus, managers will typically indicate that the money raised will be used for investment.

Not surprisingly, managers conducting SEOs to sell overpriced stock normally accumulate excessive capital rather than distributing the cash to shareholders.[127] One study of firms undertaking SEOs between 1980 and 1999 found that these firms dramatically increased investment rather than retiring debt or increasing working capital, and that this spike in investment tended to reduce returns on assets by an economically and statistically significant amount.[128] In sum, long-term shareholders may be best off if a firm with overpriced stock engages in costly expansion rather than refrains from it.

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

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

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

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

[128] *See* Fu, *supra* note x, at 250.

1. Economic Logic

We saw in Part V that long-term shareholder payoffs depend on the price at which the firm issues additional shares. Long-term shareholders benefit when the issuance price is high (relative to the no-transaction value of the stock). The higher the stock price, the greater the benefit. Thus, managers issuing shares at an inflated price can boost long-term shareholders' returns by pushing up the issuance price further.[129]

Importantly, managers can benefit long-term shareholders by manipulating the stock price around issuances even if some economic value must be sacrificed to do so. In particular, as long as long-term shareholders' losses from the value destruction are lower than their benefit from an issuance at a higher price, long-term shareholders will prefer that managers engage in costly price-boosting manipulation.[130]

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

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

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

Costly-Manipulation scenario: Now suppose that, by destroying $1 of value, ABC's managers can boost the short-term stock price by $4. Instead of having $30 to distribute to the holders of three shares in the long term, there will be $33 ($4 extra received from future shareholders, less $1 value destroyed). In the long term, each of ABC's shares will be worth $11.

Managers serving long-term shareholders will engage in costly price-boosting manipulation because it will boost long-term shareholder payoffs from $10 to $11. But such manipulation would reduce economic value. In the No-Manipulation Scenario, the pie is $20: $30 is distributed to shareholders in the long term, and $10 is received from shareholders in the short-term. In the Costly-Manipulation Scenario, the pie is $19: $33 is distributed to shareholders in the long term, and $14 is received from shareholders in the short-term. The results are summarized in Table 3F below.

To be sure, long-term shareholders will not always benefit from costly price manipulation. If costly price manipulation destroys too much economic value, long-term shareholders will be made worse off. But the critical point is that even long-term shareholders, just like short-term shareholders, may benefit from costly price-boosting manipulation.[131]

2. Evidence of Costly Price-Boosting Manipulation around Equity Issuances

Managers already engage in costly price-boosting manipulation around equity offerings—both acquisition-related issuances and SEOs. Turning first to acquisition-related issuances, managers engage in earnings manipulation when issuing stock to acquire another company.[132] One study

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Table 3F. Costly Price-Boosting Manipulation and Long-term Shareholders

	The Pie	Long-term Shareholders
No Manipulation	$20	$10
Costly Manipulation	$19	$11

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

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

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

looks at mergers announced between January 1992 and December 2000.[133] It finds that, in acquisitions where acquirer-firm stock is used as consideration, acquiring firms show significant positive accruals in the quarter before the announcement.

AOL again offers a useful illustration. During the period in which AOL acquired Time Warner, AOL's managers engaged in aggressive costly price-boosting manipulation: they massively inflated advertising revenues.[134] The combined entity was later sued by the SEC, the Justice Department, and plaintiffs' lawyers, and forced to pay almost $3 billion to investors and the government.[135] (The settlement somewhat reduced the gains accruing to AOL's long-term shareholders from the costly price-boosting manipulation that occurred before and during the acquisition.[136])

Next, consider SEOs. Firms conducting traditional SEOs may attempt to boost their stock prices by engaging in real earnings management,[137] earnings manipulation,[138] or a combination of the two. One

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

[134] *See* David A. Vise, *Time Warner Agrees to Pay $500 Million to Settle AOL Charges* (Washington Post, December 15, 2004), 2004 WLNR 18273277 (reporting that AOL agreed to pay the government $500 million to settle criminal and civil allegations that AOL manipulated its revenue before the acquisition).

[135] *See* Vise, *supra* note x; CNN Money, Time Warner in $2.5B Fraud Settlement (August 3, 2005), available at http://money.cnn.com/2005/08/03/news/fortune500/timewarner_settlement/index.htm (reporting that Time Warner will pay $2.4 billion to shareholders who acquired America Online or Time Warner stock during the inflation period).

[136] AOL's example suggests that the imposition of Rule 10b-5 liability on the corporation can be used to deter securities fraud when there are long-term shareholders. *Cf.* James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong about 10b-5*? 13 AM. L. & ECON. REV. 259 (2011) (presenting a model in which Rule 10b-5 improves corporate governance by forcing long-term shareholders to bear part of the cost of misreporting in the short term).

[137] *See, e.g.,* Natalie Mizik & Robert Jacobson, *Earnings Inflation through Accruals and Real Activity Manipulation: Its Prevalence at the Time of an SEO and the Financial*

study, examining 1511 completed traditional SEOs during the period from 1987 to 2006, found that firms conducting these SEOs engage in both accruals management and real earnings management.[139]

Given that long-term shareholders are the investors most likely to benefit from costly price-boosting manipulation around equity issuances, it is not surprising that firms with large blockholders (which are more likely to be long-term shareholders) are more likely to engage in earnings manipulation around equity offerings than firms without such blockholders.[140] An examination of 1372 traditional SEOs between 1996 and 2002 found that accruals increase by about 2% of assets around equity offerings in the presence of large outsider blockholders owning more than 5% of the stock, with no increase in the absence of such blockholders. This study suggests that costly price-boosting manipulation around equity issuances may, in fact, be designed to serve the interests of long-term shareholders.

Market Consequences (working paper, 2007) (finding that firms conducting SEOs engage in real-earnings management leading to overvaluation of the firm by the market).

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

[139] *See* Daniel A. Cohen & Paul Zarowin, *Accrual-Based and Real Earnings Management Activities Around Seasoned Equity Offerings*, 50 J. ACCT. & ECON. 2, 11 (2010) (finding use of both accrual-based and real earnings management in a sample of 1,511 SEOs between 1987 and 2006). *See also* S.P. Kothari, Natalie Mizik, and Sugata Roychowdhury, *Managing for the Moment: The Role of Real Activity versus Accruals Earnings Management in SEO Valuation* 26–27 (working paper, January 10, 2012) (finding, in a sample of pre-Sarbanes Oxley SEOs, that real earnings management is likely to be a bigger driver of overvaluation than earnings manipulation).

[140] *See* Katherine Guthrie & Jan Sokolowsky, *Large Shareholders and the Pressure to Manage Earnings* 16 J. CORP. FIN. 302, 318 (2010*)* (examining 1372 seasoned equity offerings between 1996 and 2002 and finding that accruals increase by about 2% of assets around equity offerings in the presence of large outsider blockholders owning in excess of 5% of the stock, with no increase in the absence of such a blockholder).

VII. WHEN IS FAVORING LONG-TERM SHAREHOLDERS UNDESIRABLE?

Parts III-VI have demonstrated that, when a firm buys or sells its own shares (a transacting firm), managers seeking to boost long-term shareholder returns may well take steps that destroy value. Neither short-term shareholder interests nor long-term shareholder interests align fully with those of shareholders as a collective. Rather, each type of shareholder will want managers to maximize its own payout, even if those steps may reduce the size of the pie.

One cannot be confident, a priori, that long-term shareholder interests are necessarily better or worse aligned with pie-maximization. Short-term shareholders benefit from costly price-boosting manipulation. Long-term shareholders benefit from costly contraction, costly expansion, and costly price manipulation (price-boosting around equity issuances, price-depressing around repurchases). Each type of shareholder, therefore, is characterized by its own set of "vices."[141]

While it is difficult to make sweeping statements about whose interests are better aligned with all the firm's shareholders over time, it is possible to identify factors that may, in fact, make long-term shareholders *worse* representatives than short-term shareholders.

A. Volume of Repurchases and Equity Issuances

As we saw in Part II, managers serving long-term shareholder interests in a non-transacting firm will seek to maximize the pie. However, as we saw in Parts III-VI, share repurchases and equity transactions decouple long-term shareholder interests from pie maximization and may

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[141] In considering the "vices" of each type of shareholders, it would of course be necessary to consider whether short-term shareholders might benefit from (and therefore push for) certain types of value-reducing actions that I have identified as benefiting long-term shareholders, such as costly contraction and costly expansion. Because it seems unlikely that short-term shareholders will systematically benefit from costly contraction and costly expansion, I assume here that they do not.

well encourage managers serving long-term shareholders to destroy value (that is, pursue long-term shareholder interests at the expense of the pie).

In the U.S., publicly traded firms buy and sell approximately $1 trillion of their own shares each year.[142] A typical U.S. firm buys and sells 40% of its market capitalization over a 5-year period.[143] Obviously, some firms buy and sell more than 40%; others less. The higher the volume of repurchases and equity issuances, the more likely it is that long-term shareholder interests will be less aligned with pie-maximization than short-term shareholder interests.

By contrast, the lower the volume of repurchases and equity issuances, the more likely it is that long-term shareholder interests will be better (i.e., more closely aligned with pie-maximization) than short-term shareholder interests. Consider, for example, a firm that rarely transacts in its own shares—that is, an essentially (but not completely) non-transacting firm. In such a firm, long-term shareholder interests will almost inevitably be better aligned with pie maximization than short-term shareholder interests.

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

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[142] *See supra* note x.

[143] See supra note x.

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

In short, we can confidently conclude that in a rarely transacting firm, managers serving long-term shareholder interests are likely to generate more value than managers serving short-term shareholder interests. But we may not be able to confidently ascertain which firms will be rarely transacting in the future.

B. Managers' Ability to Exploit Information Asymmetry Via the Firm

The desirability of having managers pursue long-term shareholder interests will depend, in part, on managers' ability to buy shares at a cheap price and sell shares at an inflated price. This ability, in turn, will depend on the degree of mispricing in markets, the efficiency of markets in absorbing information about repurchases and equity issuances, and the degree to which managers can hide from investors information from the firm's ongoing share repurchases and equity issuances. The greater the degree of mispricing and inefficiency, and the looser are disclosure regulations relating to repurchases and equity issuances, the more likely it is that managers serving long-term shareholders will destroy more value than managers serving short-term shareholders.

For example, under current U.S. securities laws, U.S. firms can purchase shares secretly through open market repurchases (OMRs) and sell shares secretly through at-the-market offerings (ATMs), which enables firms to more easily exploit differences between the share price and share value. Elsewhere, I have argued that firms trading in their own shares should be subject to the same disclosure requirements as are the

firms' insiders trading in those same shares.[144] Imposing such disclosure requirements would make it more difficult for managers to use inside information in share repurchases and equity issuances, and therefore better align long-term shareholder interests with the creation of economic value.

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

C. The Difficulty of Engaging in Costly Price Manipulation

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

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

Second, long-term shareholders, because they have continuing interests in the firm, are hurt ex post by costly price manipulation that destroys too much economic value; by contrast, short-term shareholders are not. Thus, when managers engage in costly price manipulation for long-term shareholders, it is likely to be less destructive than when managers engage in costly price manipulation for short-term shareholders.

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[144] See Fried, *Insider Trading, supra*, at 39–41 (proposing that firms, like their insiders, be required to disclose trades within two business days).

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

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

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

My analysis has focused on a highly stylized setting. I have assumed that shareholders are the only residual claimants on the value generated by the firm. I have also assumed that managers seek to advance the interests of either short-term or long-term shareholders rather than to benefit themselves at shareholders' expense; in other words, I have abstracted from managerial agency costs. In most firms, however, there are likely to be non-shareholder residual claimants and, more importantly, managerial agency costs. Ultimately, the desirability of favoring long-term shareholders will depend, at least in part, on how it affects non-shareholder residual claimants and managerial agency costs.

In this Part, I briefly touch on these two issues. Section A discusses the degree to which favoring long-term shareholders is likely to benefit or hurt non-shareholder residual claimants. Section B addresses the degree to which favoring long-term shareholders is likely to increase or decrease managerial agency costs. My goal here is not to provide a complete analysis. Rather, it is to explain why it is far from clear that either of these considerations strengthen the case for favoring long-term shareholders. Section C wraps up.

A. Non-Shareholders as Residual Claimants

My analysis thus far has considered a firm in which the only residual claimants on the value generated by the firm are its current and future shareholders. While shareholders might be the most important residual claimants on the economic pie created by the firm, they may not be the *only* residual claimants. Other parties, such as employees and creditors, may also be affected by managers' decision-making. Indeed, the existence of such non-shareholder residual claimants has led some prominent legal commentators to argue for a "stakeholder approach" to corporate governance: corporations should be run for the benefit of all stakeholders with residual claims on the corporation, not just shareholders.[145]

How would the presence of non-shareholder residual claimants affect the desirability of favoring long-term shareholders? One's intuition might suggest that non-shareholder constituencies are better off when managers serve long-term shareholders rather than short-term shareholders. Indeed, it is often claimed that managers seeking to benefit long-term shareholders will directly serve these constituencies as a means to that end (while managers serving short-term shareholders may not).[146]

However, intuition can lead one astray. Neither short-term shareholders nor long-term shareholder interests are likely to be well aligned with those of non-shareholder residual claimants. Thus, managers serving either short-term shareholders or long-term shareholders may act

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[145] *See, e.g.,* Margaret M. Blair and Lynn A Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 248,___ (1999) (explaining that non-shareholder constituencies are also residual claimants on the corporate pie).

[146] *Cf.* Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 702 (2006) (stating that "proponents of the long-term view of shareholder primacy would contend that such a view accommodates non-shareholder interests . . . because "stakeholder" concerns, such as giving money to charity or behaving responsibly towards employees and customers, inure to the benefit of shareholders in the long-term.")

in ways that hurt these stakeholders.[147] For example, both long-term shareholders and short-term shareholders have an incentive to transfer value to themselves, away from long-term creditors and stakeholders.

Indeed, one of the very problems associated with "short-termism" may lead managers serving long-term shareholders to squeeze more value from these non-shareholder stakeholders than managers serving short-term shareholders. Critics of short-termism typically argue that the stock market cannot properly value investments with a long-term payoff.[148] The market sees only the short-term costs associated with these investments, not the long-term benefits. As a result, managers serving short-term shareholders will not undertake such investments.

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

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

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[147] See ROE, supra note x, at 20 (noting that corporate bad behavior could be long-term or short-term).

[148] See Bratton and Wachter, supra note x, at ___

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

The example of Wal-Mart is instructive. The firm is well-known for keeping employee wages extremely low, even as compared to other large discount retailers.[149] Indeed, its workers are paid so little that they make much greater use of public health and welfare programs than the employees of similar firms,[150] costing taxpayers upwards of $3000 per employee annually in public benefit programs.[151] These low wages are maintained via aggressive anti-union tactics.[152] All of this is done to serve

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[149] Controlling for differences in geographic location, Wal-Mart workers in the United States earn an estimated 12.4 percent less than retail workers as a whole, and 14.5 percent less than workers in large retail in general. *See* Ken Jacobs et al., LIVING WAGE POLICIES AND BIG-BOX RETAIL: HOW A HIGHER WAGE STANDARD WOULD IMPACT WALMART WORKERS AND SHOPPERS, RESEARCH BRIEF, UNIVERSITY OF CALIFORNIA BERKELEY CENTER FOR LABOR RESEARCH AND EDUCATION (2011), *available at* http://laborcenter.berkeley.edu/retail/bigbox_livingwage_policies11.pdf.

[150] *See* ARINDRAJIT DUBE, T. WILLIAM LESTER, AND BARRY EIDLIN, FIRM ENTRY AND WAGES: IMPACT OF WAL-MART GROWTH ON EARNINGS THROUGHOUT THE RETAIL SECTOR, UNIVERSITY OF CALIFORNIA BERKELEY INSTITUTE FOR RESEARCH ON LABOR AND EMPLOYMENT (2007), available at http://www.escholarship.org/uc/item/22s5k4pv.

[151] *See* DEMOCRATIC STAFF OF THE U.S. HOUSE COMMITTEE ON EDUCATION AND THE WORKFORCE DEMOCRATIC, THE LOW-WAGE DRAG ON OUR ECONOMY: WAL-MART'S LOW WAGES AND THEIR EFFECT ON TAXPAYERS AND ECONOMIC GROWTH (2013), available at http://democrats.edworkforce.house.gov/sites/democrats.edworkforce.house.gov/files/documents/WalMartReport-May2013.pdf

[152] These tactics include sending managers to eavesdrop on employees, warning employees they will lose benefits if they organize, and even firing workers for their union activity. *See* Human Rights Watch, DISCOUNTING RIGHTS: WAL-MART'S VIOLATION OF

the interests of long-term shareholders who control the firm: members of the Walton family.[153] It is not done for the benefit of short-term shareholders.

I don't bring up Wal-mart to criticize or defend the firm's labor practices. Rather, I use the Wal-mart example to make the simple point that managers serving long-term shareholders will not necessarily treat non-shareholder constituencies more favorably than when they serve short-term shareholders. To the extent that markets are not efficient, they might treat them even worse.

Of course, even if managers serving long-term shareholders treat non-shareholder residual claimants better than managers serving short-term shareholders, this would not dispose of the question of whether managers loyally serving long-term shareholders will generate a bigger pie than managers loyally serving short-term shareholders. Even if long-term shareholder interests are better aligned with those of stakeholders, they could still be less aligned with *overall* pie maximization.

B. Managerial Agency Costs

My analysis has considered a firm in which managers loyally serve either short-term shareholders or long-term shareholders. In the real world, there are managerial agency costs: managers will tend to act in ways that benefit themselves at the expense of shareholders.[154] Indeed, shareholders'

US WORKERS' RIGHT TO FREEDOM OF ASSOCIATION (2007), *available at* http://www.hrw.org/reports/2007/04/30/discounting-rights-0. *See also* Gary Gereffi and Michelle Christian, The Impacts of Wal-Mart: The Rise and Consequences of the World's Dominant Retailer, 25 ANN. REV. SOC. 573, 581–82 (2009), *available at* http://www.annualreviews.org.ezp-prod1.hul.harvard.edu/doi/pdf/10.1146/annurev-soc-070308-115947.

[153] Renee Dudley, *Wal-Mart Board Seen at Risk of Losing Independent Voices*, BLOOMBERG NEWS, June 6, 2013, http://www.bloomberg.com/news/2013-06-06/wal-mart-board-seen-at-risk-of-losing-independent-voices.html

[154] *See*, *e.g.*, Jensen & Meckling, *supra* note x, at 309. For example, managers may entrench themselves, engage in value-destroying manipulation to boost their

ability to minimize managerial agency costs is one of the most important challenges in the corporate governance of widely-held firms. Thus, the desirability of steps to favor long-term shareholders will depend in large part on how these steps affect shareholders' ability to reduce managerial agency costs.

On the one hand, managerial agency costs might be lower if long-term shareholders have more power. Long-term shareholders will have a greater interest in reducing managerial agency costs than short-term shareholders because they hold their shares for a longer period of time. Long-term shareholders may find it easier to evaluate managerial performance because they have more familiarity with it. And managers may be more willing to bend to the demands of long-term shareholders than short-term shareholders, knowing that the long-term shareholders are there to stay.

On the other hand, favoring long-term shareholders at short-term shareholders' expense could *increase* managerial agency costs. Long-term shareholders might (everything else equal) not be willing to hold as concentrated a position in the stock as short-term shareholders, reducing their incentive to monitor managers. There may also be certain types of shareholders, such as activist investors and hedge funds, that are particularly capable of monitoring managers but cannot or will not commit to holding stock for the very long term.[155] Their ability to induce desirable change in firms will decline as long-term shareholders get more power. Thus, shifting power away from short-term shareholders to long-term shareholders could lead to lower or higher managerial agency costs.

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compensation, build inefficient empires, or fail to downsize when appropriate—all of which reduce the pie.

[155] *See generally* Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021 (2007) (describing the monitoring benefits generated by the presence of short-term hedge funds); Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, __ (2013). For evidence that these short-term hedge funds benefit long-term shareholders, see LUCIAN BEBCHUK, ALON P. BRAV, AND WEI JIANG, THE LONG-TERM EFFECTS OF HEDGE FUND ACTIVISM (working paper, 2013);

C. It's Still an Uneasy Case

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

In this Part, I have briefly described two other considerations: (1) the possibility that non-shareholder constituencies are also residual claimants to the pie; and (2) managerial agency costs. We have seen that favoring long-term shareholders may benefit or hurt non-shareholder stakeholders, and may reduce or increase managerial agency costs. Thus, adding these two considerations to the mix could either weaken or strengthen the case for favoring long-term shareholders. In short, the case for favoring long-term shareholders is, at this point, still uneasy.

CONCLUSION

The power of short-term shareholders, it is argued, leads to "short-termism": managers feel pressured to boost the short-term stock price at the expense of maximizing the size of the economic pie created by the firm over time. To counter short-termism, commentators have proposed various reforms aimed at increasing both the number and power of long-term shareholders relative to short-term shareholders. These proposals appear to reflect the strongly-held intuition that managers serving long-term shareholders are likely to generate more value over time than managers serving short-term shareholders.

In this paper, I have shown that this intuition is generally flawed. Although it is correct when a corporation does not transact heavily in its own shares in the short term, most corporations do just that. Indeed, the typical U.S. corporation buys and sells over 40% of its market capitalization over a five-year period. In such a transacting firm, long-term shareholders, like short-term shareholders, can benefit from firms destroying value. In many cases, long-term shareholders may well benefit

more from value destruction than short-term shareholders. Thus, favoring long-term shareholders in the typical firm could actually reduce the pie.

My analysis indicates that it is ultimately an empirical question as to which shareholders—short-term or long-term—have interests that are better aligned with a firm's creation of economic value. One of my purposes in writing this paper is to encourage academics to take up this question. Determining whether managers serving long-term shareholders are likely to generate more value is crucial for properly evaluating proposals for regulatory intervention and new private ordering arrangements. It is not enough to assume, as many do, that it will be desirable to strengthen the hand of long-term shareholders in public companies simply because they hold their shares for a longer period of time than short-term shareholders.