THE UNEASY CASE FOR FAVORING LONG-TERM SHAREHOLDERS

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Abstract

Proposals to favor long-term shareholders of public firms are based on a widely-held belief: that long-term shareholders, unlike short-term shareholders, benefit from managers maximizing the long-term economic value generated by the firm. This belief, I show, is mistaken. Long-term shareholders, like short-term shareholders, can benefit from managers destroying economic value. My analysis suggests that the case for shifting power from short-term to long-term shareholders is substantially weaker than it might appear.

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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For decades, business executives and their advisors, along with a number of academics, have decried the influence of short-term shareholders in capital markets. The power of these shareholders, it is argued, leads to “short-termism”: managers of public companies feel pressured to boost the short-term stock price at the expense of creating long-term economic value. The recent financial crisis, which many blame on short-term shareholders, has renewed and intensified these concerns.

To reduce short-termism, academics and executives have proposed a variety of reforms. The oldest type of proposal, traceable back to John Maynard Keynes, is a tax on securities transactions. Such a tax, which would make short-term stock ownership less attractive, was put forward again by Joseph Stiglitz and Larry Summers in the late 1980s, and was recently endorsed by the Aspen Institute, a group of leading business figures and corporate advisors.

Other tax changes have been floated. To make long-term stock ownership relatively more attractive, the Aspen Institute has suggested a

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1 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-
2 See, e.g., ASPEN INSTITUTE, supra note x, at 2; Lipton and Rosenblum, supra note x, at 78 (arguing that many shareholders will push companies to take steps to boost the short-term stock price at the expense of economic value creation).

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


6 See ASPEN INSTITUTE, supra note x, at 2 (proposing a tax on securities transactions to discourage short-term trading).
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. 7 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. 8

Reformers are also eyeing modifications to corporate-governance arrangements. A number of prominent economists and business leaders have suggested that long-term shareholders receive additional dividend and voting rights. 9 Several European firms have voluntarily modified their corporate arrangements to give long-term shareholders more rights vis-à-vis short-term shareholders. 10 An American Bar Association corporate governance task force has chimed in with a report suggesting that similar arrangements be considered in the United States. 11

More informally, companies are being urged to give more weight to the views of long-term shareholders as a matter of “best practice.” For example, England’s 2012 Kay Commission report recommends that firms

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7 See id. at 2–3. The Aspen Institute also suggests increasing the deductibility of long-term capital losses. See id.


10 See Bolton and Samama, supra note x, at 9-10 (reporting that several British and French firms have already adopted loyalty-share arrangements to give long-term shareholders extra rights).

11 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 tax incentives and potentially enhanced voting rights). See also ASPEN INSTITUTE, supra note x, at 3 (recommending enhanced rights for long-term shareholders).
consult “major long-term investors” over board appointments. In the same spirit, the SEC’s (later-invalidated) 2010 proxy access rules required the nominating shareholder to have held the shares continuously for at least 3 years.

While different in their details, all of these proposals share the same objective: increasing the relative power of long-term shareholders in public firms. This objective reflects a long-standing and widely-held view: that long-term shareholders, unlike short-term shareholders, will want managers to maximize the long-term economic value created by the firm (“the economic pie”). Accordingly, managers should serve the interests of long-term shareholders. As Henry Hansmann and Reinier Kraakman famously put it, “there is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”


14 See Michael E. Porter, Capital Disadvantage: America's Failing Capital Investment System, 70 HARV. BUS. REV., 65, 79 (1992) (recommending that managers seek a smaller number of long-term or nearly permanent owners and give them a voice in corporate affairs, and calling for long-term shareholder value maximization to be identified as the explicit goal of the firm); Alfred Rappaport, The Economics of Short-Term Performance Obsession, 61 FIN. ANALYSTS J., 65, 69 (2005) (“The idea that management's primary responsibility is to maximize long-term shareholder value is widely accepted in principle but imperfectly implemented in practice.”)

15 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 shareholder value” (emphasis added) suggests that they believed that social welfare would be maximized if corporate law served long-term shareholders rather than short-term shareholders. Others have been more explicit. 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 the focus on long-term shareholders “maximizes . . . economic efficiency in the long run”).
The notion that long-term shareholders’ interests align with maximizing the economic pie, I show, is conceptually flawed. True, short-term shareholders may benefit when managers engage in actions that destroy value. But, I demonstrate, so may long-term shareholders. Thus, long-term shareholder interests are not necessarily better aligned with maximizing the economic pie than are short-term shareholder interests. Indeed, they could be less aligned. In short, we cannot count on shareholders to be better stewards of the firm simply because they hold their shares for a longer period of time.

One could easily show that neither short-term nor long-term shareholders’ interests align with maximizing the economic pie in a firm where the pie’s residual claimants include not only shareholders but also other stakeholders (such as employees, suppliers, and communities). In such a firm, short-term shareholders would want managers to increase their returns at the expense of reducing stakeholders’ payoffs by an even larger amount. But, of course, so would long-term shareholders. For example, long-term shareholders may want managers to engage in value-destroying actions (such as idling plants) to induce employees to accept lower wages if the value destroyed is less than the reduction in labor costs over time.

But the purpose of this paper is to show that long-term shareholders are not interested in maximizing the pie even in a firm where the only residual claimants are the firm’s own 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 particular, I demonstrate that long-term shareholders’ desire to maximize their own slice of the pie will cause them to push managers to take steps that reduce other investors’ share of the economic pie by an even larger amount.

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: long-term shareholders’ payoffs depend solely on the size of the economic pie. Accordingly, long-term shareholders will want managers to maximize that pie. Short-term shareholders, on the other hand, may benefit from managers engaging in what I call “costly price-boosting manipulation” – using earnings manipulation and distorted investment decisions that shrink the pie 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 market-wide. In 2007, U.S. firms conducted $1 trillion in share repurchases alone. 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 or sell $4 billion of its own shares over the next five years.

In a transacting firm, I show, long-term shareholders’ interests become decoupled from the goal of maximizing the economic pie. I first consider a transacting firm that repurchases its own shares before the long term. In a repurchasing firm, long-term shareholder payoffs depend not only on the size of the economic pie, but also on the amount the firm pays to short-term shareholders selling their shares to the firm. The lower is the repurchase price, the better off are long-term shareholders. Long-term shareholders benefit when managers conduct “bargain” repurchases—when they repurchase shares at a price below the stock’s actual below value. By contrast, they are hurt when managers repurchase shares at an “inflated price”—one above the stock’s actual value.

Because in a repurchasing firm long-term shareholders’ payoff depends in part on the price at which the firm repurchases its own shares, managers of a repurchasing firm can often benefit long-term shareholders by taking steps that reduce the pie. To begin, managers may distort capital-allocation decisions to maximize the value transferred to long-term shareholders through bargain repurchases. For example, they may engage in “costly contraction:” diverting funds from valuable projects inside the firm to buy back sharply discounted shares.

In addition, managers serving long-term shareholders can, and do, engage in costly price-depressing manipulation around repurchases. Once a firm decides to repurchase shares, long-term shareholders may benefit if managers expend corporate resources to lower the price around repurchases. Such manipulation either increases the amount of value transferred to long-term shareholders (if the post-manipulation price is lower than its actual value) or reduces the amount of value transferred from long-term shareholders (if the post-manipulation price is higher).

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16 See infra Parts III.A and IV.A.
I then turn to consider the case in which the transacting firm issues additional equity before the long term. Now, long-term shareholders’ payoffs depend not only on the economic pie but also on the amount received from future shareholders buying stock from the firm. The higher the issuance price, the better off are long-term shareholders. Long-term shareholders benefit when managers conduct inflated-price issuances. And they are hurt when managers issue shares at a bargain price.

Because the payoffs to long-term shareholders in an issuing firm depend in part on the price at which the firm issues equity, managers of an issuing firm can often benefit long-term shareholders by taking steps that are pie-reducing. For example, when the stock price is high, managers may cause the firm to issue shares to finance additional investments even if these investments reduce the amount of value to be shared among all those owning shares before the long-term arrives.

AOL’s 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.\(^\text{17}\) 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.

In addition, whether or not the pre-issuance stock price is high, managers conducting issuances can benefit long-term shareholders by engaging in costly price-boosting manipulation (such as earning manipulation). If the post-manipulation price is high, more value is transferred to long-term shareholders. If the post-manipulation price is low (but higher than it would otherwise be), less value is transferred from long-term shareholders. Thus, the very same pie-reducing strategies that benefit short-term shareholders can also serve the interests of long-term shareholders, at least when the firm sells its own shares.

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\(^{17}\) The AOL-Time Warner transaction is discussed in more detail in Part IV.D.2, \textit{infra}. 

My purpose in this paper is to show that long-term shareholder interests, like short-term shareholder interests, are not aligned with maximizing the long-term economic value created by the firm. My analysis, by itself, cannot resolve the question as to whether long-term shareholder interests are better aligned with maximizing the economic pie than are short-term shareholder interests. However, it does suggest that the case for favoring long-term shareholders – which is often based on a mistaken belief that long-term shareholders will seek to maximize the economic pie -- is much weaker than it might otherwise appear.

Before concluding, I describe how my analysis can be used to assist in resolving the question of whether long-term shareholders should be favored. Shifting power to long-term shareholders will be desirable, I argue, only if it increases the economic pie. And whether such a move is likely to increase the economic pie depends, I explain, on two considerations. The first is the extent to which long-term shareholder interests are closer to (or further from) pie maximization than short-term shareholder interests. My analysis can be used to help tackle this question. The second consideration is the relative abilities of short-term shareholders and long-term shareholders to reduce managerial agency costs—the loss of value suffered when a firm’s managers advance their own interests rather than increase the pie. I explain that long-term shareholders may have better or worse interests, and better or worse monitoring abilities, than short-term shareholders. Thus, at this point, the case for favoring long-term shareholders is far from compelling.

The remainder of the paper is organized as follows. Part I lays out my positive and normative assumptions for the analysis that follows. Part II shows that, in a non-transacting firm (a firm that does not repurchase or issue any shares), the conventional view about long-term shareholder interests is correct: long-term shareholders’ interests align with the goal of maximizing the economic pie, while short-term shareholders’ may not. Part III shows that, in a repurchasing firm, long-term shareholders can benefit from various types of value-destroying decisions. Part IV provides a similar analysis of long-term shareholder interests in an issuing firm.

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18 I use the term “managers” to refer to a firm’s directors and high-level officers.

Part V explains how analysts should go about determining the overall desirability of favoring long-term shareholders. A conclusion follows.

I. Building Blocks

This Part provides two building blocks for the analysis that follows. Section A describes what I take to be the policy objective of corporate-governance regulation: maximizing “long-term economic value”—the (net) economic value flowing from the firm between today and the long term. Section B describes my assumptions about short-term and long-term shareholders’ private objectives.

A. Policy Goal: Maximizing Long-Term Economic Value

I assume, consistent with most economic scholarship on corporate governance, that the regulation of public companies should be designed to maximize the economic value created by the firm over time. In particular, I assume that it 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. 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 “long-term economic value” or, more simply, “the economic 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). As a result, long-term economic value is equivalent to the net amount of value flowing to current and future

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21 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 point in time when the present value of future cash flows becomes immaterial. Alternatively, the long term might be the point in time when the firm exits the public markets.
shareholders through the long term: cash they receive from the firm less cash (or other assets) they transfer to the firm.22

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 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.23 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.24 Accordingly,

22 The assumption that current and future shareholders are the firm’s only residual claimants is, of course, a simplification. Other stakeholders, such as creditors, 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 V.

23 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.”)

24 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).
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.25

**B. Shareholders’ Private Goals**

My focus in this paper is on the objectives of short-term and long-term shareholders: that is, how they want the firm to be managed. I will assume that shareholders seek only to maximize the financial return from their investment in the firm based on their respective holding periods. Thus, they will want managers to maximize the stock price in the period where they will be selling their shares:26 Short-term shareholders will seek a higher short-term stock price; long-term shareholders will seek a higher long-term stock price.

In my analysis, I will abstract from short-term and long-term shareholders’ ability 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 V, I will consider the possibility that short-term and long-term shareholders may differ in their abilities to control managerial agency costs.27 For now, however, my focus is solely on the objectives of short-term shareholders and long-term shareholders.

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25 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).

26 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 include dividends plus stock price appreciation. 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.

27 I also consider the possibility that shareholders may have interests other than maximizing the stock price in the period where they will sell their shares.
II. Long-Term Shareholders in a Non-Transacting Firm

The conventional view is that long-term shareholders are interested in maximizing the economic pie created by the firm, while short-term shareholders are not. This Part shows that the conventional view is correct in a non-transacting firm (one that does not buy or sell its own shares). In such a firm, long-term shareholder payoffs are purely a function of the size of the economic pie. In contrast, short-term shareholder payoffs are not. Section A introduces a simple analytical framework for examining the relationship between shareholders’ interests and long-term economic value in a non-transacting firm. Section B describes long-term and short-term shareholders’ interests in the non-transacting firm.

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.

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 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 economic (social) value.28 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.

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28 Throughout, I assume that ABC’s assets are correctly valued in the long term. In other words, ABC’s long-term stock price (unlike the short-term stock price) always 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.
The sequence of events is illustrated in Figure 1 below.

![Figure 1. ABC as Non-Transacting Firm](image)

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.\(^29\) Accordingly, ABC’s long-term economic value—the net amount of value flowing from ABC to ABC’s shareholders over time—is $V.\(^30\) Long-term economic value (the economic pie) and the net amounts flowing to short-term shareholders, as well as long-term shareholders, are all summarized in Table 1 below.

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

<table>
<thead>
<tr>
<th>Short-term Shareholders</th>
<th>Long-term Shareholders</th>
<th>Future Shareholders</th>
<th>The Economic Pie</th>
</tr>
</thead>
<tbody>
<tr>
<td>$P</td>
<td>$V/2</td>
<td>$(V/2 - P)</td>
<td>$V</td>
</tr>
</tbody>
</table>

\(^29\) Throughout the paper, I assume that ABC does not issue dividends. This assumption, made purely for convenience, does not affect the analysis.

\(^30\) 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.

B. The Interests of Long-term and Short-term Shareholders

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

1. Long-Term Shareholders

Long-term shareholders’ interests are straightforward. As Table 1 makes clear, long-term shareholders’ payoff ($V/2), rises and falls with long-term economic value ($V). Thus, in a non-transacting firm, long-term shareholders’ interests are aligned with maximizing the economic pie. Accordingly, managers loyally serving long-term shareholders will seek to maximize long-term economic value.

2. Short-term Shareholders

Short-term shareholders’ interests are in maximizing the short-term stock price ($P). 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, managers would maximize $P by maximizing $V, the long-term economic value created by the firm. Thus, in such a market, short-term shareholders’ interests would, like long-term shareholders’ interests, be aligned with pie maximization.

But in the real world, markets do not have full information about the value of a firm’s stock. They must rely on the 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. Short-term shareholders will want managers to engage in price-boosting manipulation because it will increase their returns.

31 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. Indeed, long-term shareholders’ interests are likely to diverge even more from pie maximization if markets are noisy.
If price-boosting manipulation were always economically costless, short-term shareholders’ interests would not be inconsistent with pie maximization. Short-term shareholders would want managers to boost the short-term stock 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.\(^{32}\)

However, short-term shareholders can also benefit from, and will thus want managers to engage in, “costly price-boosting manipulation” – manipulation that destroys long-term economic value.\(^{32}\) Managers already engage in a variety of practices that constitute costly price-boosting manipulation. One is earnings manipulation: reporting earnings different from the “correct” amount of earnings given the firm’s actual business activity and cash flows.\(^{34}\) Another is real earnings management: the

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\(^{32}\) 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.

\(^{33}\) One might wonder why I use the term “costly price-boosting manipulation” rather than more compact and well-known terms such as “short-termism” or “managerial myopia.” I do so because, as I explain in Part IV.E., actions that increase the short-term stock price but reduce the economic pie can also increase 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.

\(^{34}\) Legal earnings manipulation, earnings manipulation that does not violate Generally Accepted Accounting Principles (GAAP), is quite common. 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 long-term economic value to the extent that the firm devotes resources to adjusting its earnings.

Illegal earnings manipulation, earnings manipulation that does violate GAAP, may also be common given the frequency of restatements. See Mark Cheffers et al., *Audit Analytics Trend Rep., 2009 Financial Restatements: A Nine Year Comparison* (2010) (reporting that there were 4609 financial restatements during the years 2006–2009 among the approximately 10,000 publicly-traded firms.) Illegal earnings manipulation is more economically destructive than legal earnings manipulation because firms incur substantial accounting “cleanup” costs when required to restate their
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 economic value. Each of these strategies shrinks the economic pie but makes the short-term stock price higher than it would otherwise be.

35 For evidence that managers engage in real earnings management, see, e.g., 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 does not contribute to long-term 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).

Relatedly, managers may undertake value-wasting investments or transactions to make the firm appear (other than through its short-term earnings) more valuable than it is. See, e.g., Donald J. Smith, *Perspectives: Hidden Debt from Enron’s Commodity Prepays to Lehman’s Repo 105s*, 67 FIN. ANALYST. J. 15, 15–21 (2011) (describing costly transactions used to hide the extent of a firm’s debt from investors); Simia Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2195 (2009) (reporting evidence that firms engaged in accounting manipulation to boost the short-term stock price also engage in economically inefficient over-investment to create the impression that they are successful firms); cf. Lucian Arye Bebchuk & Lars A. Stole, *Do Short-term Objectives Lead to Under- or Overinvestment in Long-Term Projects?* 48 J. FIN. 719 (1993) (presenting a model in which managers over-invest in long-term projects to boost the short-term stock price). Similarly, managers might fail to undertake efficient investments that the market has difficulty valuing. See Christopher Polk & Pablo Sapienza, *The Stock Market and Corporate Investment: A Test of Catering Theory*, 22 REV. FIN. STUD. 187, 187 (2009) (arguing that managers with a short-term horizon have an incentive to waste resources and to forgo positive investment opportunities).

36 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 less than the stock’s actual 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*, 15
While managers already engage in costly price-boosting manipulation, they may do so to enrich themselves rather than short-term shareholders. Indeed, only a few published studies have found evidence of a link between short-term shareholders and costly price-boosting manipulation. Thus, many commentators are skeptical that pressure from short-term shareholders causes managers to engage in value-destroying activities.

But whatever one’s view on this empirical question, there is no doubt that, in a non-transacting firm, short-term shareholder interests are not as well aligned with pie maximization as long-term shareholder interests. If managers serve long-term shareholders, they will seek to increase the size of the pie. If managers serve short-term shareholders, they might engage in costly price-boosting manipulation that reduces the size of the economic pie.

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).


39 If markets are rational, short-term shareholders cannot systematically benefit from costly price-boosting manipulation. But managers serving short-term shareholders will 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. Because this manipulation is not observable as it is happening, future shareholders will discount the short-term stock price whether or not managers actually engage in manipulation. Thus, managers cannot make short-term shareholders better off by refraining from manipulation
III. Long-term Shareholders in A Repurchasing Firm

In Part II, we saw that long-term shareholders’ interests align with economic-pie maximization in a non-transacting firm (a firm that does not repurchase or issue any shares), while short-term shareholders’ interests may not. However, most firms 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. As we will see, when firms buy and sell their own shares, long-term shareholders’ payoffs become decoupled from value maximization.

In this Part, I explain that long-term shareholders in a repurchasing firm will want managers to take steps that reduce the economic pie. 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 long-term 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.” Section D explains that share repurchases can reduce long-term economic value, and that managers can benefit long-term shareholders by engaging in bargain repurchases that destroy value. Section E explains that managers can, and do, benefit long-term

at the moment of truth. Indeed, the short-term stock price will be lower (and short-term shareholders will be worse off) if managers fail to manipulate the short-term stock price. The only rational equilibrium is one in which managers manipulate the short-term stock price whenever they can and future shareholders fully discount the stock price to reflect the possibility of such manipulation. 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 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).

40 See infra Parts III.A. and IV.A.
shareholders by engaging in costly price-depressing manipulation around share repurchases.

Before proceeding, I wish to note that my goal in this Part is not to compare long-term shareholders’ interests in a repurchasing firm to those of short-term shareholders. Rather, my objective here is to show that repurchases decouple long-term shareholders’ interests from value maximization. Thus, I focus here only on long-term shareholders’ interests in a repurchasing firm.

A. The Widespread Use of Repurchases


In 2011, the market capitalization of publicly-traded U.S. firms was approximately $16 trillion. 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.

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42 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).


The overwhelming majority of share repurchases take the form of an “open market repurchase” (“OMR”).\(^{46}\) In an OMR, the firm repurchases its shares in the open market, through a broker. The transactions are 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.\(^{47}\)

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.\(^{48}\) 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.\(^{49}\) (I will explain in Section B why managers may announce an OMR, but then not conduct it.) Thus, investors will not know with certainty until 3-5 months after the company starts buying back shares.

OMRs can increase long-term economic value: they provide a more flexible and tax-efficient form of payout than dividends, as well as a means of acquiring shares for stock option plans.\(^{50}\) But, as we will see below, managers may use OMRs to transfer value from short-term shareholders to long-term shareholders in ways that decrease long-term economic value.

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\(^{46}\) 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).


\(^{48}\) See id. at 96.


\(^{50}\) Reasons for the popularity of repurchases 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”].
B. Analytical Framework: Decoupling Effect of Share Repurchases

To see how share repurchases decouple long-term shareholders’ interests from long-term economic value, we will modify the analytical framework introduced in Part II to consider the scenario in which ABC corporation 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 economic (social) 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 long-term stock price is different from what it was in the non-transacting-firm scenario ($V-P$ instead of $V$), ABC’s long-term economic value—the amount of value flowing to shareholders over time—is the same: $V$. $$(V-P)$$ flows to long-term shareholders in the long term and $$P$$ flows to short-term shareholders in the short term.\(^{51}\)

The payoffs to shareholders and long-term economic value are summarized in Table 2 below.

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

<table>
<thead>
<tr>
<th>Short-term Shareholders</th>
<th>Long-term Shareholders</th>
<th>Future Shareholders</th>
<th>The Economic Pie</th>
</tr>
</thead>
<tbody>
<tr>
<td>$P$</td>
<td>$(V-P)$</td>
<td>N/A</td>
<td>$V$</td>
</tr>
</tbody>
</table>

Unlike in the non-transacting firm, there is now a disconnect between long-term shareholder returns and long-term economic value. As $P$ falls, long-term shareholders’ payoff increases even though the size of the pie remains unchanged. As we will see shortly, this disconnect can give managers serving long-term shareholders an incentive to take various steps that reduce the size of the pie.

### C. Bargain Repurchases

Managers can and do conduct “bargain repurchases”—OMRs at a cheap price—to transfer value from short-term shareholders to long-term shareholders.

#### 1. Economic Logic

A corporation’s 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.\(^{52}\) Thus, a repurchase at a low price (i.e., a price lower than the no-transaction value

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\(^{51}\) Again, I ignore the time value of money (or assume it is zero).

\(^{52}\) See Fried, *Informed Trading*, supra note x, at 1344–46.
of the stock) transfers value from selling shareholders to non-selling shareholders.\(^53\)

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. (And if $P > $V/2, long-term shareholders would be worse off).

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. And they do just that. Evidence includes (a) executives’ own statements and behavior, and (b) the movement of stock prices following repurchases.

a. Executives’ Own Statements and Behavior

Executives admit (in confidential surveys) 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: 86.4% of all firms agree or strongly agree with this supposition.”\(^54\) Importantly, the authors reported that “executives tell us that they accelerate (or initiate) share repurchases when their company’s stock price is low.”\(^55\)

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\(^{53}\) 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.


\(^{55}\) Id.
For those inclined to be skeptical of executives’ accounts, a recent empirical study provides “hard” evidence that managers 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. In one firm, 7.76% of the firm’s total market capitalization was shifted from selling to long-term shareholders in this manner.

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. This suggests that 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. 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

56 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).

57 Id. at 1046.

58 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 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).

59 See supra Part II.A.1.
own shares at a higher price. Indeed, a recent paper finds evidence of such “false signaling.” 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.

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%. These post-repurchase returns provide further strong evidence that managers currently use repurchases to shift value from selling shareholders to long-term shareholders.

Indeed, managers’ propensity to buy stock at a bargain price increases with their own equity ownership. One study found that

60 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).


63 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).

64 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 “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 trade-reporting requirements imposed on firms). For a proposal that would reduce managers’ ability to use inside information in conducting OMRs, see Fried, Insider Trading, supra, at 39-41 (proposing that firms, like their insiders, be required to disclose trades within two business days).
abnormal returns following repurchase announcements, which are associated with pre-repurchase underpricing, are positively correlated with pre-buyback executive stock ownership. 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. 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.

D. Costly Contraction

Section C 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. Unfortunately, however, the use of bargain repurchases can give rise to economic costs.

To understand these costs, it will be helpful to describe the optimal repurchase policy for a firm. From an economic perspective, a firm should distribute cash to shareholders via a repurchase 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.

From an economic perspective, the price at which the firm repurchases its stock when distributing the cash is irrelevant. However, as we saw in Section C, 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. In particular, it can


lead to “costly contraction”: managers giving up economically desirable projects to buy back stock at a low price.

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.

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.67

67 A numerical example involving our ABC Corporation might be helpful. As before, ABC initially has two shares outstanding and is liquidated in the long term. One share is held by long-term shareholders and one share is held by short-term shareholders.

Consider two scenarios:

No-Contraction Scenario: Suppose that if ABC does not repurchase any of its equity in the short term, ABC’s short-term shareholders will sell their share to future shareholders and ABC will distribute $20 to the holders of its two shares (long-term shareholders and future shareholders) in the long term. The no-transaction value of each of ABC’s two shares in the long term is thus $10.

Costly-Contraction Scenario: Now suppose that ABC can conduct a repurchase in the short term when the stock trades at $8 ($2 less than its actual value of $10), buying back short-term shareholders’ share at that price. Assume that the $8 spent on the repurchase reduces ABC’s long-term value by $9, from $20 to $11, because ABC must give up a valuable project. 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 inefficiently contract the firm to buy back stock at a low price. The repurchase boosts long-term shareholders’ payout from $10 to $11. This contraction, however, reduces long-term economic value. In the No-Contraction scenario, ABC’s long-term economic value is $20; in the Costly Contraction Scenario, ABC’s long-term economic value is $19 ($8 flowing to short-term shareholders and $11 flowing to long-term shareholders). The effect of the repurchase on
Now, 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.\footnote{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).}

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 asymmetry may prevent a firm from borrowing money on cost-effective terms.\footnote{See generally, id. at 187–220.} 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.\footnote{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).}

While renegotiation is theoretically possible, it might be difficult in practice, particularly if the long-term economic value and long-term shareholders’ payoff is summarized in Table 1F.

**Table 1F. Long-Term Shareholders and Costly Contraction**

<table>
<thead>
<tr>
<th></th>
<th>The Economic Pie</th>
<th>Long-term Shareholders</th>
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<tbody>
<tr>
<td>No Contraction</td>
<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>Costly Contraction</td>
<td>$19</td>
<td>$11</td>
</tr>
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</table>
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.\(^7\)

**E. Costly Price-Depressing Manipulation around 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 will engage in costly price-depressing manipulation to reduce the short-term stock price around share repurchases; indeed, there is evidence that such costly price manipulation already occurs.

In Section B, we saw that 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); conversely, long-term shareholders suffer when the repurchase price is high. Thus, managers repurchasing shares in the short term can benefit long-term shareholders by depressing the short-term stock price.

Note that long-term shareholders benefit from such manipulation whether the pre-manipulation stock price is high or low relative to its actual value. If the pre-manipulation stock price is already low, reducing the stock price further will transfer more value to long-term shareholders.

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\(^7\) See Alok Bhargava, *Executive compensation, share repurchases and investment expenditures: econometric evidence from US 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).
On the other hand, 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.

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 the 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.\(^\text{72}\)

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. 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 short-term stock price by $2. Assume that the manipulation reduces ABC’s long-term 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 ABC’s long-term value 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 shareholders’ payouts from $10 to $11. But $1 of long-term economic value is lost: in the No-Manipulation Scenario, long-term economic value is $20 ($10 distributed in the long term and $10 distributed in the short term); in the Costly-Manipulation Scenario, long-term economic value is $19 ($11 distributed in the long term, and $8 distributed in the short term). The results are summarized in Table 2F below.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>The Economic Pie</th>
<th>Long-term Shareholders</th>
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</thead>
<tbody>
<tr>
<td>No Manipulation</td>
<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>Costly Manipulation</td>
<td>$19</td>
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**Costly-Manipulation Scenario:** Now suppose that ABC can engage in price-depressing manipulation (say, earnings management) in the short term that reduces the short-term stock price by $2. Assume that the manipulation reduces ABC’s long-term 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 ABC’s long-term value 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 shareholders’ payouts from $10 to $11. But $1 of long-term economic value is lost: in the No-Manipulation Scenario, long-term economic value is $20 ($10 distributed in the long term and $10 distributed in the short term); in the Costly-Manipulation Scenario, long-term economic value is $19 ($11 distributed in the long term, and $8 distributed in the short term). The results are summarized in Table 2F below.
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.\textsuperscript{73} 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.\textsuperscript{74}

To be sure, long-term shareholders will not always benefit from costly price manipulation. If costly price manipulation destroys too much long-term economic value, 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.

**IV. Long-term Shareholders 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 long-term economic value maximization. And like long-term shareholders in a repurchasing firm, long-term shareholders in an issuing firm will want managers to take 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

\textit{Cf.} Dichev et al, *supra* note x, at 4 (reporting that 40% of earnings management is income-decreasing).

\textsuperscript{74} See Gong, et. al., *supra* note x, at 983.

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shareholders’ interests and long-term 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. Section D explains that equity issuances can reduce long-term economic value, and that managers can benefit long-term shareholders by engaging in inflated-price issuances that reduce the economic pie. Section E explains that managers can, and do, benefit long-term shareholders by engaging in costly price-boosting manipulation around equity issuances.

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 shareholders’ interests.

A. Widespread Use of Equity Issuances

The typical publicly-traded firm not only repurchases shares, but also issues considerable amounts 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 1993 to 2002, an average of 66.5% of large firms made net stock issues (issuances less repurchases).\(^{75}\) Strikingly, these net stock issues averaged 7.5% of assets, which is on the same order of magnitude as net debt issuances.\(^{76}\) 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.\(^{77}\)

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\(^{76}\) *Id.* at 551. The figure for smaller firms was 12.6%, about twice as much as their net debt issues. *Id.* at 563.

\(^{77}\) 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 31
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. An example of such an acquisition (and one to which we will return in Section E) is AOL’s acquisition of Time Warner in 2000 for $162 billion in equity.

2. Seasoned Equity Offerings (SEOs)

Seasoned equity offerings (SEOs) raise cash for operations and strategic investments, or to pay down debt. Many firms engage in SEOs, and the amount of stock sold is substantial. 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.

b. ATMs

An ATM is a new form of equity offering that is becoming very widely used in the U.S. market. In an ATM, shares are sold directly (and 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).

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

79 See id. at 573–75 (describing various purposes for stock issuances, including SEOs).

80 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).

In the market through a sales agent. 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 price appears favorable without alerting the market to the issuance and causing the stock price to fall.

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. 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. 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 long-term economic value, 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 long-term economic value.

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82 See Matthew T. Billett, Ionnis V. Floros, Jon A. Garfinkel, At 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%).

83 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).

84 Id.

85 See Small et al., supra note x, at 295–96.

86 See id. at 296.
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.

*Long term:* ABC’s assets are sold for $(V+P) in cash, which reflects their economic (social) 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](image)

Although ABC’s long-term stock price is different from what it was in the non-transacting case (it is $(V+P)/3 instead of $V/2), ABC’s long-term economic value—the amount of value flowing to shareholders over time—is the same: $V. $(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 run.
The payoffs to the different types of shareholders and long-term economic value are summarized in Table 3 below.

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

<table>
<thead>
<tr>
<th>Short-term Shareholders</th>
<th>Long-term Shareholders</th>
<th>Future Shareholders</th>
<th>The Economic Pie</th>
</tr>
</thead>
<tbody>
<tr>
<td>$P$</td>
<td>$(V+P)/3$</td>
<td>$2[-P+(V+P)/3]$</td>
<td>$V$</td>
</tr>
</tbody>
</table>

Unlike in the non-transacting case, but as in the repurchasing case, there is a disconnect between long-term shareholder returns and long-term economic value. As $P$ falls, long-term shareholders’ payoff decreases, but long-term economic value remains the same. As we will see, this disconnect can lead managers serving long-term shareholders to take steps that are value-reducing.

**C. Inflated-Price Issuances**

Managers can and do 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.

**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.\(^{87}\)

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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. (And if $P < V/2$, long-term shareholders are worse 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.\textsuperscript{88} Similarly, and not surprisingly, managers acknowledge that they issue shares when they believe the stock price is “high.”\textsuperscript{89} 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.\textsuperscript{90} Recent work has shown that such acquisitions benefit the long-term shareholders of the acquiring firms’ shares by enabling the acquiring firms to purchase assets cheaply.\textsuperscript{91}

\textsuperscript{88} See Brav et al., supra note x, at 514.

\textsuperscript{89} 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 survey of 392 CFO about their decision-making around capital structure).

\textsuperscript{90} 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”); 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).

\textsuperscript{91} 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
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.\textsuperscript{92} 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.\textsuperscript{93}

To my knowledge, there has not yet been an academic study of ATMs, which only recently have become popular. But ATMs are 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.\textsuperscript{94} We can thus expect ATMs, like traditional SEOs, to be used to transfer value from future shareholders to long-term shareholders.\textsuperscript{95}

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).

\textsuperscript{92} See, e.g., Loughran & Ritter, supra note x, at 25, 47 (examining 3702 seasoned equity offerings 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”).

\textsuperscript{93} 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%).

\textsuperscript{94} 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).

\textsuperscript{95} 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, 37
D. Costly Expansion

Section C 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 engage in costly inflated-price issuances: issuances that generate costs that reduce the economic pie.

This Section focuses on one type of costly inflated-price issuance: “costly expansion.” In particular, managers serving long-term shareholders will increase the size or scope of the firm through the sale of overpriced equity, even though the expansion destroys long-term economic value.

1. Economic Logic

We saw in Part III that a repurchase can reduce long-term 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 long-term 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.96

96 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, 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.
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 America Online’s (“AOL’s”) acquisition of Time Warner in 2000.97

AOL, with a market capitalization of over $200 billion, used $162 billion of stock to acquire Time Warner.98 The companies thus had roughly equivalent market capitalizations before the merger. A

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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 long-term economic value. In the No-Expansion Scenario, ABC’s long-term economic value is $20; in the Costly-Expansion Scenario, it is $19 ($33 distributed in the long term less $14 received from shareholders in the short term). The effect of the expansion on long-term economic value and long-term shareholders’ payoff is summarized in Table 3F:

<table>
<thead>
<tr>
<th>The Economic Pie</th>
<th>Long-term Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Expansion</td>
<td>$20</td>
</tr>
<tr>
<td>Costly Expansion</td>
<td>$19</td>
</tr>
</tbody>
</table>

97 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).

98 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).
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 long-term economic value. The expected synergy benefits failed to materialize. In fact, AOL and Time Warner parted ways nine years later,\(^99\) suggesting that synergy effects were actually negative. The 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,\(^{100}\) 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 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.


\(^{100}\) Id.
3. Must Value be Destroyed to Issue Overpriced Equity?

We have seen that long-term shareholders can be made better off if their firm, rather than refraining from issuing equity, issues overpriced equity for value-wasting acquisitions. But long-term shareholders would be even better off if the firm could use inflated-price issuance 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 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 than in no acquisition at all.101

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.102 If the firm announces that it will take

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101 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.

102 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
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 merely to exploit the fact that it is overpriced.\textsuperscript{103} 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 distribute the cash to shareholders.\textsuperscript{104} One study of firms undertaking SEOs between 1980 and 1999 finds 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.\textsuperscript{105} In sum, long-term shareholders may be best off if a firm with overpriced stock engages in costly expansion.

**E. Costly Price-Boosting Manipulation around Equity Issuances**

Just as managers serving long-term shareholders may engage in costly \textit{price-depressing} manipulation around repurchases, they may engage in costly \textit{price-boosting} manipulation when the firm issues shares. Indeed, there is evidence that managers routinely manipulate the stock price around these transactions.

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\textsuperscript{103} See, \textit{e.g.}, Merritt B. Fox, \textit{Civil Liability and Mandatory Disclosure}, 109 COLUM. L. REV. 237, 262 \& n.65 (2009).

\textsuperscript{104} See Robert S. Chirinko and Huntley Schaller, \textit{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). \textit{See also} Ming Dong et al., \textit{Stock Market Misvaluation and Corporate Investment} 4 (Munich Personal RePEc Archive, Paper No. 3109, 2007), \textit{available at} http://mpra.ub.uni-muenchen.de/3109 (finding that cash raised by overpriced firms issuing equity is used to increase investment).

\textsuperscript{105} See Fu, \textit{supra} note x, at 250.
1. Economic Logic

We saw in Section B 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). Conversely, long-term shareholders would suffer, everything else equal, if managers were required to issue stock when the issuance price is low (say, to raise capital when cheaper sources of capital are unavailable). Thus, managers issuing shares can boost long-term shareholders’ returns by pushing up the issuance price, whether the pre-manipulation price is high or low relative to its actual value.

Importantly, managers can benefit long-term shareholders by manipulating the stock price around issuances even if some long-term 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-depressing manipulation.106

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106 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 shareholders from $10 to $11. But such manipulation would reduce ABC’s long-term economic value. In the No-Manipulation Scenario, ABC’s long-term economic value 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, long-term economic value 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 4F below.

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**Table 4F. Costly Price-Boosting Manipulation and Long-term Shareholders**

<table>
<thead>
<tr>
<th></th>
<th>The Economic Pie</th>
<th>Long-term Shareholders</th>
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<tbody>
<tr>
<td>No Manipulation</td>
<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>Costly Manipulation</td>
<td>$19</td>
<td>$11</td>
</tr>
</tbody>
</table>

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To be sure, long-term shareholders will not always benefit from costly price manipulation. If costly price manipulation destroys too much long-term economic value, long-term shareholders will be made worse off. But the critical point is that even long-term shareholders may benefit from costly price-boosting manipulation, just like short-term shareholders. 107

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. 108 One study looks at mergers announced between January 1992 and December 2000. 109 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.

107 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.


AOL again serves as a useful anecdote. During the period in which AOL acquired Time Warner, AOL’s managers engaged in aggressive costly price-boosting manipulation: they massively inflated advertising revenues. The combined entity was later sued by the Securities and Exchange Commission, the Justice Department, and plaintiff lawyers, and forced to pay almost $3 billion to investors and the government. The settlement obviously reduced the gains accruing to AOL’s long-term shareholders from the costly price-boosting manipulation that occurred before and during the acquisition.

Next, consider SEOs. Firms conducting traditional SEOs may attempt to boost their stock prices by engaging in real earnings management, earnings manipulation, or a combination of the two. One study, examining 1511 completed traditional SEOs during the period

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110 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).

111 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).

112 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).


114 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).
from 1987 to 2006, found that firms conducting these SEOs engage in both accruals management and real earnings management.\footnote{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-SOX SEOs, that real earnings management is likely to be a bigger driver of overvaluation than earnings manipulation).}

Intriguingly, one study reports 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.\footnote{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).} The paper examines 1372 traditional SEOs equity offerings between 1996 and 2002 and finds 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. This study suggests that costly price-boosting manipulation around equity issuances may, in fact, be designed to serve the interests of long-term shareholders.

V. Should Long-term Shareholders Be Favored?

My purpose in this paper has been to show that long-term shareholder interests, like short-term shareholder interests, are not aligned with maximizing the long-term economic value created by the firm. Both short-term shareholders and long-term shareholders can benefit from managers taking steps that shrink the economic pie.

Ultimately, however, the critical question for analysts, policymakers, and investors is whether the power of long-term shareholders should be increased through tax reforms or changes to corporate-governance arrangements. In other words, are long-term shareholders,
even if imperfect, likely to be better stewards of the firm than short-term shareholders?

In this Part, I explain how the analysis I have offered in this paper can be used to help address this question. In my view, shifting more power to long-term shareholders will be desirable if and only if it increases the long-term economic value generated by firms. And whether such a move is likely to increase the economic pie, I explain, depends on how long-term shareholders compare to short-term shareholders along two dimensions. The first dimension is the respective interests of short-term shareholders and long-term shareholders relative to pie-maximization (taking into account the possibility, which I have abstracted from so far, that non-shareholder constituencies are also residual claimants to the pie). The second dimension is the relative abilities of short-term shareholders and long-term shareholders to reduce managerial agency costs—the value that is lost when managers selfishly serve their own interests at the expense of the pie. The analysis I have offered in this paper can be used in the first dimension of the analysis: the respective interests of short-term and long-term shareholders.

If long-term shareholders have better interests and better monitoring abilities than short-term shareholders, favoring long-term shareholders will be desirable. But if long-term shareholders have either worse interests or worse monitoring abilities, it might not be desirable to favor them. And if long-term shareholders have both worse interests and worse abilities (a possibility that, at this point, cannot be ruled out), it will be undesirable to favor them.

Section A uses the analysis provided in this paper to explain that long-term shareholder interests may deviate more or less from pie-maximization than short-term shareholder interests. Section B explains that long-term shareholders may have more or less ability to control managerial agency costs than short-term shareholders. Section C concludes that there is no reason to be confident that long-term shareholders will be better stewards of the firm than short-term shareholders.
A. Interests: Long-term vs. Short-term Shareholders

Building on the analysis offered earlier in the paper, I show that long-term shareholders may have better or worse interests than short-term shareholders. This is so even after considering the possibility that non-shareholder constituencies, such as employees, are residual claimants on the long-term economic value generated by the firm.

1. When Shareholders Are the Only Residual Claimants

We have seen that, in a world where current and future shareholders are the only residual claimants on the long-term economic value created by the firm, neither short-term shareholders nor long-term shareholders want managers to maximize the economic pie. Rather, each type of shareholder wants managers to maximize the stock price during the period that it cashes out, even at the expense of the pie.

In such a world, there is no reason to believe, a priori, that long-term shareholder interests are 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 has its own set of “vices.”

To be sure, 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 benefits short-term shareholders whether or not the firm is transacting in its own shares. Second, long-term shareholders, because they have continuing interests in the firm, are hurt ex post by costly price manipulation that destroys too much value; by contrast, short-term shareholders are not. Thus, if costly price manipulation were the only type

117 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. In this Part, I assume that short-term shareholders do not systematically benefit from costly contraction and costly expansion.
of pie-reducing activity that benefitted short-term shareholders and/or long-term shareholders, long-term shareholder interests would undoubtedly align better with pie maximization.

However, long-term shareholders also benefit from costly contraction and costly expansion. If the amount of value destroyed by costly contraction and costly expansion is large relative to the value destroyed by costly price-boosting manipulation, long-term shareholder interests will be less aligned with pie maximization than short-term shareholder interests. Given that costly contraction and costly expansion always distort the firm’s investment decisions, while costly price-boosting manipulation may involve mere earnings manipulation, this possibility cannot be ruled out.  

2. When Non-Shareholders Are Also Residual Claimants

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. Thus, these parties may be affected whether short-term shareholders or long-term shareholders have more influence in the firm. How would adding non-shareholders to the mix of residual claimants likely affect the comparison of long-term shareholder interests with short-term shareholder interests?

One’s intuition might suggest that non-shareholder constituencies are better off if long-term shareholders are in control. Indeed, it is often claimed that serving these constituencies actually benefits long-term (but not necessarily short-term) shareholders. If this were indeed correct, the

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118 In today’s firms, where long-term shareholders lack sufficient power, managers are likely to engage in less costly contraction and costly expansion than they would in firms where long-term shareholders have more power. Thus, in determining the costs associated with costly contraction and costly expansion in a world where long-term shareholders have more influence, one could not rely on measurements of the value lost from costly contraction and costly expansion in today’s firms.

119 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.”)
likelihood that long-term shareholder interests align better with pie maximization would be higher. But it would not dispose of the question of whether long-term shareholder interests are more aligned with pie maximization than short-term shareholder interests. Long-term shareholders’ interests could still be less aligned with overall pie maximization, even if they are better aligned with the interests of non-shareholder constituencies.

Suppose, for example, that if managers sought to maximize value for long-term shareholders, they would generate $20 of residual value for shareholders and $10 of residual value for non-shareholders. And suppose that if managers sought to maximize value for short-term shareholders, they would generate $30 of residual value for shareholders and $5 of residual value for non-shareholders. Compared to short-term shareholder interests, long-term shareholders’ interests would align more with non-shareholders ($10 vs. $5) but less with maximizing the total pie ($30 vs. $35).

However, it is far from obvious that long-term shareholder interests better align with those of non-shareholder constituencies. Managers serving long-term shareholders will engage in costly contraction when the stock is underpriced; the diversion of cash from profitable investments in the firm is unlikely to benefit (and likely to hurt) non-shareholder claimants on the residual value generated by the firm. Costly expansion might also hurt non-shareholders if wasteful acquisitions lead to layoffs of “redundant” employees. In short, the damage caused by pie-reducing decisions designed to increase the long-term stock price might not be limited to shareholders. Thus, the possibility that non-shareholder constituencies are residual claimants may or may not make long-term shareholder interests relatively more aligned with pie maximization.

**B. Monitoring Abilities: Long-term vs. Short-term Shareholders**

As I indicated earlier, whether long-term shareholders should be favored depends not only on their interests (relative to short-term shareholders) but also on their ability (again, relative to short-term shareholders) to reduce managerial agency costs. After all, shareholders do not actually make decisions for the firm: its managers do. And it is widely understood that a firm’s managers may deliberately sacrifice some of the value that could be generated by the firm to make themselves better
Thus, whether it is desirable to shift power from short-term shareholders to long-term shareholders would depend, in part, on which type of shareholder is better able to control managerial agency costs.

As a matter of theory, long-term shareholders may do a better or worse job monitoring managers and reducing managerial agency costs. On the plus side of the ledger: Long-term shareholders may have more familiarity with the firm and its performance, making it easier for them to evaluate managers. And long-term managers may be more willing to bend to the demands of long-term shareholders, knowing that they will have to continue to deal with long-term shareholders into the indefinite future.

But it is also easy to imagine that long-term shareholders will be worse monitors. 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 hedge funds, that are particularly capable of monitoring managers but for various reasons will not commit to holding stock for the long term. Their ability to induce desirable change in firms will decline as long-term shareholders get more power. Thus, shifting power from short-term shareholders might lead to lower or higher managerial agency costs.

C. The Still Uneasy Case

From an economic perspective, shifting power to long-term shareholders will be desirable if and only if the pie gets bigger as a result. Whether the pie gets bigger will depend on long-term shareholders’ interests and monitoring abilities relative to short-term shareholders. Both are important.

Consider the scenario in which long-term shareholders have better interests and better monitoring abilities than short-term shareholders.

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120 See, e.g., Jensen & Meckling, supra note x, at 309. For example, managers may entrench themselves, engage in value-destroying manipulation to boost their compensation, build inefficient empires, or fail to downsize when appropriate—all of which reduce long-term economic value.

Favoring long-term shareholders is likely to lead to a larger pie. Long-term shareholders will want managers to act in a more value-generating manner than would short-term shareholders. And managerial agency costs will be lower, so that relative to long-term shareholders’ “ideal” pie there will be less value lost.

If long-term shareholders are better along one dimension (say, interests) but worse along the other (monitoring abilities), favoring them may lead to a larger or smaller pie. It would lead to a smaller pie, for example, if long-term shareholders enable managers to engage in considerable value-destroying behavior that would be prevented if short-term shareholders had more influence.

Suppose, for example, that the “ideal” pies for long-term shareholders and short-term shareholders are $10 and $18 respectively. Suppose further that the reduction in value due to managerial agency costs will be $8 if long-term shareholders are in control and $5 if short-term shareholders are in control. Even though long-term shareholders have better interests than short-term shareholders, under their control the pie ends up being worth $1 less ($12 rather than $13). Paradoxically, it might be desirable for short-term shareholders to have the most influence in the firm, even though they are more likely to benefit from managers engaging in activities that reduce the economic pie.

At this point, we do not know whether long-term shareholders have better or worse interests than short-term shareholders (Section A). We also do not know whether long-term shareholders have better or worse monitoring abilities than short-term shareholders (Section B). Indeed, long-term shareholders may well be worse along both dimensions. Thus, taking into account the possibility of non-shareholder residual claimants and the problem of managerial agency costs (both of which I abstracted from earlier in the paper) may or may not make the case for favoring long-term shareholders easier. 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 long-term economic value creation by the firm. 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 a view—widely held by those putting forward these reform proposals as well as by other commentators—that long-term shareholders, unlike short-term shareholders, have an interest in maximizing the economic value created by the firm.

In this paper, I have shown that long-term shareholders’ interests in fact do not align with economic-value maximization for the typical firm—a firm that buys and sells a large portion of its own shares in the market. In such a firm, long-term shareholders’ payoffs depend not only the economic value generated by the firm over time but also the amount of value diverted from short-term shareholders selling shares to the firm and future shareholders buying shares from the firm. Thus, long-term shareholders can benefit when managers reduce the economic value created by the firm to increase the amount of value transferred from these other “factions” of shareholders. Indeed, many of the corporate pathologies attributed to short-term shareholders, such as earnings manipulation and distorted investment decisions, can also serve the interests of long-term shareholders when the firm is buying or selling shares.

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, which has important implications for corporate governance and the desirability of various regulatory interventions and private ordering arrangements being considered which, if put into effect, will strengthen the hand of long-term shareholders in public companies.