The Legitimate Rights of Public Shareholders

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by

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In recent years there has been significant ongoing academic debate over the expansion of public shareholders’ participation rights in corporate governance. The debate has accompanied a dramatic increase in institutional shareholder and hedge fund activism attempting to influence the conduct of corporate affairs.

The legitimacy of shareholder participation rights depends upon the actual role public shareholders play in contributing to the corporation’s function of providing goods and services and, ultimately, to economic growth and social welfare. Nobody in the debate has stopped to examine this question. This paper presents original empirical evidence that demonstrates that public shareholders do not, on net, contribute capital to finance industrial production, and in fact are net consumers of corporate equity. Moreover, their investment incentives significantly distort the behavior of corporate managers who place strong emphasis on stock price at the expense of long-term business health, a fact that has played some role in the current global financial debacle. The logical conclusion is that public shareholders’ rights should, ideally, be eliminated, and certainly not expanded or enhanced.

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Introduction

For a decade or more before the American economy lay in its current shambles, our system of corporate governance had come under serious attack. Shareholders and their advocates had arisen from their slumber and begun to demand the right to participate in corporate decisionmaking. For over a decade, and accelerating during the pre-panic years, activist shareholders, typically institutional investors and hedge funds, had asserted their power to insist that the corporations in which they invested take the specific actions they desired. Among the institutional actions have been proposals to allow shareholders to advise boards on executive compensation, to require that directors be elected by majority vote of the shareholders (in contrast to the plurality rule that currently dominates), to remove takeover defenses like poison pills and staggered boards, to insist upon proxy access, and to eliminate broker voting. Activist hedge funds have been even more aggressive, often successfully demanding that corporations either sell themselves or divest themselves of portions of their businesses, that chief executives resign or be dismissed, or that their corporations undertake major restructurings to “return value” to shareholders while piling on corporate debt.

Their efforts have been aided by the work of prominent, and increasingly activist, scholars, led forcefully by Lucian Bebchuk, who have mounted an aggressive campaign to enhance shareholder voting rights. While their efforts have been controversial, they


3 See e.g. Iman Anabtawi and Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255, 1281-3 (2008). Antawabi and Stout also provide a nice description of the rise of the “activist shareholder.” Id. at 1274-1281.


have garnered significant attention and have created synergy with the actions of shareholders, acting principally through shareholder advisory services and by activist institutional investors, to put substantial pressure on businesses and lawmakers to expand shareholder rights.\(^7\)

The objective of the so-called reformers, and much of the defense, is centered on the question of which mode of corporate governance – a director primacy model or a shareholder-centric model – holds the greatest promise for enhancing firm value. While the meaning of the phrase “firm value” typically is left ambiguous, the underlying assumption in much of the debate appears to be that firm value equates to share price.\(^8\) A secondary objective, which I do not address because I believe that it serves principally as a rhetorical device and tends not to be taken very seriously, at least in the corporate and economics literature, is that the corporation is somehow a democratic institution and shareholders are its citizens.\(^9\)

Lost in the debate are three essential questions that necessarily drive it toward an appropriate resolution.\(^10\) Why do we have public corporations? What is it that...

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\(^7\) Lipton and Rowe do a nice job of summarizing the rise (and profitability) of shareholder advisory services. Martin Lipton and Paul K. Rowe, *The Inconvenient Truth About Corporate Governance: Some Thoughts on Vice-Chancellor Strine’s Essay*, 33 J. Corp. L. 63 (2007-2008). See also Leo E. Strine, Jr., *Toward Common Sense and Common Ground: Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. Corp. L. 1, 5-6 (to same effect).

\(^8\) One exception is Lynn Stout, who notes that academics may work on the assumption of this equivalence. Stout, *supra* note __ at 801. It is a point I have also made elsewhere, Lawrence E. Mitchell, *Corporate Irresponsibility: America’s Newest Export* (2001). It strikes me that the same equation typically is made by those who advocate a director primacy model as those who advocate a shareholder primacy model. This equation is not, of course, universally accepted. For one of the seminal statements of the fundamental value perspective see Benjamin Graham and David L. Dodd, *Security Analysis* (1934).

\(^9\) Tsuk Mitchell, *supra* note __.

\(^10\) It is not only striking that the debate offers no empirical evidence beyond the obvious fact that, as an historical matter, shareholders have exercised little participatory power in American corporate policy. While Bebchuk, in particular, cites a few articles that might suggest that shareholder participation has a positive effect on “firm value,” those few studies have been sufficiently debunked by Lynn Stout to obviate the need for me to repeat the analysis. Stout, *supra* note __ at 800.

Interestingly, Bebchuk himself has contributed to the development of an economic model that predicts potentially negative effects from short-term market pressures, and this at a time when, as I shall discuss, the stock market was considerably less volatile than it subsequently became. Lucian Arye Bebchuk and Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?*, 48 J. Fin. 719 (1993).

In Part II, I will refer to a much larger and more complete body of literature that has yet to find any positive effect of shareholder governance, or even corporate governance, on “firm value,” however measured.
shareholders contribute to them? How does this affect our view of shareholders’ legitimate rights? My answers are simple: (1) the principal purpose of corporations, public as well as private, is to make things and sell things, to provide services to customers, and in the process to employ people, all to the ends of wealth creation, economic growth, and social welfare. (2) Public shareholders contribute little or nothing to this process, not even, as the empirical evidence I present demonstrates, their capital. (It is worth noting that the evidence that any of the processes of corporate governance has a meaningful effect on economic growth is almost nonexistent.) The conclusion is that enhanced share price is at best a byproduct of corporate activity that, as I will argue, has distorted the productive incentives of corporate management to the potential long-term harm of American industry. (3) Therefore, public shareholders ought to have no rights beyond those of receiving information about the corporations in which they invest and selling their shares. The director primacy model ought to remain our paradigm of corporate governance.

The article proceeds as follows: Part I presents my empirical research demonstrating that public equity has had virtually no significant role in financing American industry, and indeed that the demands of public shareholders, manifested by the behavior of shareholder activists and the market, have resulted in an industrial base heavily overburdened by debt. To be more precise, while extensive evidence documents large numbers of common stock public offerings, on balance American public shareholders have been net consumers, rather than net providers, of corporate equity.

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12 Infra, Part I.


14 It may be that there is no practical alternative to shareholder election of directors. I take this up in Part III.

15 I am, for purposes of this article, indifferent as to which model of director primacy should be privileged, the Bainbridge model, Bainbridge, supra note __, or the Blair and Stout model, Margaret M. Blair and Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999), although it should be clear from my earlier work discussing the board’s mediating function that I favor the latter. Lawrence E. Mitchell, A Critical Look at Corporate Governance, 45 Vand. L. Rev. 1263 (1992).

16 See, e.g. the extensive database maintained by Jay Ritter at http://bear.cba.ufl.edu/ritter/ipodata.htm.

17 Eugene Fama and Kenneth French demonstrate that equity offerings are far more frequent and regular than had been supposed. Eugene F. Fama and Kenneth R. French, Financing Decisions: Who Issues Stock?, 76 J. Fin. Econ.549 (2005). While their findings are interesting, they are not necessarily inconsistent with my data. In the first place, they include within their study substantial amounts of
The real “owners” of the risk capital of American business are creditors, not shareholders, yet shareholders have the only legal rights of control. While it is possible these rights could serve industrial development in a positive way, it seems economically backward to allow those with the least real capital at risk to have power over those with the most.\(^\text{18}\)

privately issued-equity, including stock issued in private placements and for employee stock options and, indeed, attribute to the latter a substantial proportion of new equity issuances. The other large block of equity issued is in the context of mergers, in which the stock of the merging corporation disappears, so that the net effect on outstanding public equity is probably relatively minimal. In addition, much of the work that supports their conclusions relates to the ratio of equity to debt. But they use Compustat and Center for Research in Security Prices (CRSP) data, neither of which accounts fully for off-balance sheet financing which, as I will show in Part I, infra, comprises the bulk of recent debt financing. (Compustat does provide off-balance sheet rental payments for the first five years of operating leases on a company by company basis. Fama & French do not appear to have relied on this data, and if they had, it would nevertheless dramatically understate off-balance sheet financing. CSRP does include capitalized lease obligations but it is not clear how this affects their data.)


I want to be careful to point out that in this article I am only examining the question of the rights of public stockholders through the lens of their role in financing productivity. The role of the stock market, as an institution, in stimulating economic growth is a much larger and more complex question which I hope to address in a later paper as part of a larger project of which this article is a part. A substantial literature exists, drawing back to Joseph Schumpeter’s 1911, The THEORY OF ECONOMIC DEVELOPMENT, arguing that a nation’s economic growth is highly correlated with its development of sophisticated financial markets, a question of particular interest to development economists. For an excellent survey and analysis of this literature see Ross Levine, Financial Development and Economic Growth: Views and Agenda, 35 J. Econ. Lit. 688 (1997); Ross Levine, Finance and Growth: Theories and Evidence, 1A HANDBOOK OF ECONOMIC GROWTH (Philippe Aghion and Steven N. Durlauf, eds., 2005). For a sample of additional literature on the subject see Peter L. Rousseau, Share Liquidity and Industrial Growth in an Emerging Market: The Case of New England, 1854-1897, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=225069 (1999); Peter L. Rousseau and Richard Sylla, Emerging Financial Markets and Early U.S. Industrial Growth, NBER Working Paper W7448, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=191548 (1999); Raghuram G. Rajan and Luigi Zingales, Financial Dependence and Growth, 88 Amer. Econ. Rev. 559 (1998); Gerard Caprio, Jr. and Asli Demirguc-Kunt, The Role of Long-Term Finance: Theory and Evidence, 13 The World Bank Research Observer 171 (1998), note that “the effect of stock market development on firms’ financing decisions is theoretically inconclusive,” and little empirical evidence exists. Asli Demirguc-Kunt and Ross Levine, Stock Market Development and Financial Intermediaries: Stylized Facts, 10 World Bank Econ. Rev. 291,293-4 (1996); Peter Haas and Gerhard Fink, The Finance-Growth-Nexus Revisited: New Evidence and the Need for Broadening the Approach, EI Working Paper No. 73, http://fgr.wu-wien.ac.at/institut/el/publicat.html (2006). At the same time, more recent scholarship suggests that the data used in these studies provide only “fragile” support for the hypothesis that finance leads growth. Peter L. Rousseau and Paul Wachtel, Economic Growth and Financial Depth: Is the Relationship Extinct Already?, available at http://papers.ssrn.com/sol3/results.cfm?RequestTimeout=50000000 (2005); James B. Ang, A Survey of Recent Developments in the Literature of Finance and Growth, 22 J. Econ. Surveys 536, 543 (2008) (noting critiques of the finance-growth nexus argument) and 553 (specifically criticizing empirical studies noting among other critiques, for example, that country cross-sectional growth regressions tend to assume a positive correlation between financial development and growth, as well as critiquing specific cross-country regressions, time series studies, and panel studies); Felix Rioja and Neven Valev, Does One Size Fit All?: A Reexamination of the Finance and Growth Relationship, 74 J. Dev. Econ. 429 (suggesting the weakness and ambiguity of empirical studies of the finance-growth nexus); John
Two principal exceptions to the conclusion that public equity doesn’t provide corporate investment capital exist. First, in recent years the financial industry has been a net issuer of corporate equity. Regulatory requirements, and the need for an equity base to permit substantial leveraging, are the apparent reasons for this. The second is the role of private equity in financing risky new business and the incentives to invest that are provided by the possibility of exit through the public market. While these exceptions are important and may suggest a more layered corporate governance regime than we have at present, they are special cases that deserve extended analysis, and so I defer their discussion to another day.

Driffill, *Growth and Finance*, 71 The Manchester School 363 (2003) (arguing that the empirical evidence for the finance-growth nexus is insubstantial and that positive effects may well be due to regional differences including law and culture).

19 See infra, text at n. __.

20 The proportion of new business financing attributable to venture capital is quite small, although it may be important in terms of the nature of the industries that are its primary consumers. Allen N. Berger and Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. Banking & Fin. 613 (1998), and appears to be concentrated in discrete regions of the country and discrete business sectors, although the former conclusion may be due somewhat to limitations in available data. Paul A. Gompers, *Corporations and the Financing of Innovation: The Corporate Venturing Experience*, Fed. Res. Bank of Atlanta Econ. Rev., 4th Quarter 2002; Paul A. Gompers and Josh Lerner, *The Venture Capital Revolution*, 15 J. Econ. Persp. 145 (2001); Samuel Kortrum and Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 Rand J. Econ. 674 (2000). Kortrum and Lerner estimate that the ration of venture capital to research and development (which are close substitutes in innovation) was on average 3% between 1983 and 1992, venture capital can be attributed to 8% of innovation during that time frame. Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737, 765, noting that “[y]oung firms, and firms with intangible assets, may need to be equity financed simply because their assets have little or no liquidation value.” Raghuram G. Rajan and Luigi Zingales, *Financial Dependence and Growth*, 88 Amer. Econ. Rev. 559 (1998) (It almost goes without saying, but it is worth noting, that venture capital is highly concentrated in high technology industries, especially information technology and, to a lesser extent, biotechnology.”) Finally, as I will later discuss, venture capital tends to come in at a stage in small business development where the innovation has substantially been developed, although this observation says little about its utility in stimulating innovation in the first place.

21 There appear to be some other exceptions. In a study covering the period 1988 to 2004, Huang, Mayer, and Sussman find that firms typically rely upon internal sources of financing. In the face of severe cash flow shocks, financing turns to trade credit, inventory depletion, and cash depletion. Over time, their pre-shock leverage ratio is restored by the issuance of new equity. Zhangkai Huang, Colin Mayer, and Oren Sussman, *How Do Firms Finance Large Cash Flow Requirements?*, available on ssrn.com (2007). Gilchrist, Himmelberg, and Huberman find that equity issuances increase in response to stock price bubbles. Simon Gilchrist, Charles P. Himmelberg, and Gur Huberman, *Do Stock Price Bubbles Influence Corporate Investment?*, available on ssrn.com (2004). See also Malcolm Baker, Jeremy C. Stein, and Jeffrey Wurgler, *When Does the Market Matter? Stock Prices and the Investment of Equity-Dependent Firms*, 118 Q. J. Econ. 969 (2003)(arguing, among other things, that what they define as “equity-dependent firms” find investment constrained when stock prices are low due to non-fundamental causes). Gilchrist, *et. al.* discuss some of the other literature suggesting that the cost of external equity does have a meaningful influence on corporate investment. None of the literature I have examined, however, maintains that on balance, public equity financing provides a significant proportion of industrial investment capital.
I begin in Part II by accepting, for purposes of discussion, a strong argument in the development literature that holds that the stock market itself can, as an institution, indirectly contribute to economic growth regardless of whether shareholders provide the capital to finance production. I then argue that, in the United States, public shareholders, acting through that market, have increasingly (i) stripped American corporations of capital for productive investment by a shift from investing for dividends to capital gains, and (ii) distorted managerial incentives in favor of short-term stock price increases to the detriment of long-term productivity, such that increased shareholder rights would be dangerous to the real economy by aggravating already distorted incentives.22

Nonetheless, economists largely are in agreement that retained earnings and debt, not equity finance, have traditionally been the primary sources of funds for investment in productive capital. Levine, supra note __ at 720; Colin Mayer, New Issues in Corporate Finance, 32 Europ. Econ. Rev. 1167 (1988). Indeed Levine notes as a major weakness of much of the development literature referred to at n.__, supra, that “it focuses on equity markets.” Levine, supra at 714. See also Caprio and Demirguc-Kunt, supra at 182 (criticizing Rajan & Zingales for failing to distinguish between equity and credit markets, although noting that active, if not necessarily large, stock markets correlate with faster growth). My central focus in this essay is on the source of funds for productive capital, not such other growth-stimulating benefits that financial markets may provide.


My method is to critique two common arguments that, on close examination, suggest ways that the actions of public shareholders can damage the real economy. The first, perhaps the dominant argument in favor of shareholder voting, holds that shareholder voting is efficient because shareholders are specialists in risk bearing. I argue that the flaw in this argument is that the only risks in which shareholders are specialists are those that they themselves create. Thus shareholder voting cannot be efficient, at least as far as improved corporate productivity is concerned, because the interests of shareholders that are derived from these risks are largely irrelevant to corporate production.

This leads logically to the second and, perhaps, more interesting question of the manner in which dramatic changes in styles of investment have created a body of public shareholders whose profit expectations lead them effectively to pressure managers to steal from the corporate present in order to allow them to reap potentially illusory profits from the corporate future. Shareholder pressure creates incentives for managers to spend corporate cash now to create the illusion of future wealth and thus enhance stock prices rather than to invest in the long-term health of the corporation. A growing body of literature from the early 1990s on explores this question, with mixed results, but with most tending to find that the public stock market does have noticeable affects on managerial incentives. This gives rise to the further implication that significant restraints should be put on market behavior through the creation of incentives that favor long-term investing over short-term speculation.

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23 The very considerable difference between the expectation of profits from dividends and that from stock price increases, as I will discuss in Part II, seems very much to be the difference between investing and gambling. The difference would be erased in either the case of a perfectly efficient stock market, which is by no means any longer an article of faith, or if capital gains reflected only the accumulation of retained earnings. The behavior of the stock market over the last fifty years eliminates the latter possibility, as I will show.

24 See sources cited supra, note __.

25 History shows that attempts directly to regulate, or even to define, speculation typically fail. MITCHELL, THE SPECULATION ECONOMY, supra note __ at 188-91. My suggestions are more indirect and are aimed at building financial incentives into market decisionmaking for long-term holding. LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA’S NEWEST EXPORT (2001). I will not repeat these suggestions here. Rather, I believe that the limitation on shareholder rights that I advocate will help to relieve short-term pressures from management in a similar, indirect manner.
Part III concludes with a re-evaluation of the legitimate rights of public shareholders in light of their actual role in the American economy. They are few, indeed. At the very least, in the absence of any evidence that public shareholders serve American industry in a positive way, there is no credible case for the extension of shareholder rights.

**Part I: Financiers Who Do Not Finance: The Empirical Evidence**

In order to be legitimate, the rights of public shareholders must be grounded in reality, in some net social or private benefit conferred by public shareholders. The principal justification in the legal and financial economics literature for the existence of public shareholders is that they provide financing for risky enterprise. But it is clear that, on balance, the American public stock market rarely has been a significant factor in financing industrial enterprise. The only American business sector to rely upon public

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An additional justification for the market, beyond the scope of this article, is its role in providing exit for those who finance risky enterprise. Ross Levine, *Finance and Growth: Theories and Evidence*, 1A HANDBOOK OF ECONOMIC GROWTH (Philippe Aghion and Steven N. Durlauf, eds., 2005); Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 J. Econ. Lit. 688 (1997). Further justifications include that the market helps to ameliorate informational asymmetries, assists corporate monitoring, facilitates price discovery, and helps to encourage economic development. Most of the market’s identified functions either help to support, or are consequences of, the two principal functions noted in the text.

The private equity boom which, in one form or another, gained momentum from the 1980s until the recent market collapse, has raised a number of questions ranging from the efficiency of transactions to, most recently and dominantly, the financial success of private equity funds. It has also led to questions about the need for, and desirability of, public equity financing in the large, modern corporation, the touchstone being Michael Jensen’s now-famous 1989 *Harvard Business Review* article, “The Eclipse of the Public Corporation.” Michael Jensen, *The Eclipse of the Public Corporation*, Harv. Bus. Rev., Sept.-Oct. 1989, p.61.

Ron Gilson and Charles Whitehead have, over the past several years, been revisiting and revising Jensen’s argument. Ronald J. Gilson and Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 Colum. L. Rev. 231 (2008). Gilson and Whitehead argue that, while in substance correct, Jensen’s argument was premature. The implications of this article suggest that Jensen was more or less on time, just as Thorstein Veblen predicted the growth of a banker-dominated stock market economy in its earliest stages. MITCHELL, THE SPECULATION ECONOMY, supra note __ at 13-14 (2007).

In this article I disregard as irrelevant to the broader story the historic stock market crash that followed a Congressional bailout of the mortgage-backed securities industry during late September and early October of the Panic of 2008. Indeed while the consequences of the ongoing financial crisis might ultimately affect my (and others’) analysis, I believe it is too early to say anything meaningful about the future effects of the Panic. Consequently, my analysis (and data) run through early 2007, treating the beginning of the Panic as, at the latest, the summer of 2007.

27 Part of the explanation for the commonly-held view that external equity is an important source of funding, comes from the discipline’s reliance on financial economics which “has not emphasized real
stock issuances as an important source of financing productive activity, and that only relatively recently, is the financial industry itself. What are the legitimate rights of public shareholders if they don’t play a role in financing production?

In Part I (a), I explain the history of public equity financing in America, which is a relatively recent phenomenon. In Part I (b), I present the empirical evidence. That evidence, compiled from raw IRS corporate balance sheet data going back to 1955, Federal Flow of Funds data, compilations of earlier data where raw data were unavailable, and other secondary sources identified where relevant, clearly demonstrates that, on average, external equity has rarely been an important source of finance for American industry, and that American public shareholders have withdrawn more equity from corporations than they have contributed to their financing. Indeed, external equity financing for American industry only began to grow from the turn of the twentieth century on, and the lion’s share of external financing was in various forms of debt. The data show relatively flat or very slightly positive to net negative issuances of capital stock, even during such active trading periods as the 1960s Go-Go years and the capital” in contrast to stock market capital. Robert E. Hall, The Stock Market and Capital Accumulation, 91 Am. Econ. Rev. 1185 (2001).

This data was obtained as a result of my Freedom of Information Act request. Data from 1961 and 1977 were unavailable, but the effect of this absence is insignificant.

I am indebted to Bill Bratton for the observation that balance sheets prepared for tax purposes might show lower retained earnings than balance sheets prepared for GAAP purposes. While any difference should have no effect on the overall trends, it might affect the absolute numbers.

These data are drawn largely from records compiled by the United States Internal Revenue Service, the Bureau of Economic Analysis, the United States’ Bureau of the Census) as compiled in the various STATISTICAL ABSTRACTS OF THE UNITED STATES, and the historical abstracts of the United States, primarily as compiled and analyzed in the MILLENIAL EDITION OF THE HISTORICAL ABSTRACTS OF THE UNITED STATES.


With the exception of debt issued primarily by railroads, which grew in the late nineteenth century. See infra note __ and accompanying text.

See Figures 7 through 9, infra.
Internet bubble of the late 1990s. Capital stock is so relatively unimportant as a financing source for the formation of productive industrial capital that recent years have seen corporate stock repurchases outstrip almost all other forms of corporate investment, including, for the three years ended September 30, 2007, investment in capital for the production of goods and services.\(^{34}\)

\(\text{a. A (Very) Brief History of Equity Financing in America}\)

A significant public equity market, at least for industrial concerns, is just a bit over 100 years old, created at a point where industrialization had reached a stage of reasonable maturity.\(^{35}\) The railroads were financed largely with government subsidies and debt,\(^{36}\) and industrial corporations from Standard Oil to the companies that combined

\(^{34}\) See table at notes __-__ and accompanying text.

It is also important to emphasize the distinction between external equity, raised through the sale of publicly issued securities, and internal forms of equity, including retained earnings, depreciation and depletion allowances, and the use of current expenses to fund the creation of capital assets through, for example, research and development. Jules I. Bogen, \textit{The Importance of Equity Financing in the American Economy}, 5 J. Fin. 170, 171 (1950). While there is a superficially appealing argument that these internal forms of equity financing ought to be attributed to public stockholders who, after all, depend upon them for their ultimate return of capital, I shall be at pains to argue that, since equity financing is so minor a portion of corporate finance (Bogen notes it constituted 5\% of invested funds in the period 1946-1948), that one cannot attribute the creation of those funds to the investment of outside equity so much as to various forms of debt financing. The implication is that, while the law grants the residual of these funds to shareholders, it does so at the expense of other, far more important, sources of corporate finance.

\(^{35}\) Rousseau identifies 51 industrial companies listed on the Boston Stock Exchange in 1897, Rosseau, \textit{Share Liquidity}, supra note __, which was more or less the peak of that exchange’s leadership before becoming overshadowed by the New York Stock Exchange. Even the largest of these were small companies. Navin and Sears, supra note __ at 110. Noting that the Pullman Palace Car Company was the only industrial company trading on the New York Stock Exchange in the 1880s, Navin and Sears further note that in 1890 only 10 industrials had their prices quoted in financial journals, rising to 30 by 1893 and 170 by the beginning of the merger wave in 1897. \textit{Id.} at 110, 127.

\(^{36}\) GABRIEL KOLKO, RAILROADS AND REGULATION: 1877-1916, 15 (1965) ( . . . “the railroads during the 1870’s were the products, in large measure, of the financial efforts of the state and federal governments – about $350 million in state and federal funds, plus many millions of acres in land-grants, were pumped into the canal and railroad system until 1873.”); Alfred D. Chandler, Jr., \textit{Patterns of American Railroad Finance}, 28 Bus. Hist. Rev. 248 (1954); ARTHUR TWINING HADLEY, RAILROAD REGULATION: ITS HISTORY AND ITS LAWS, 51-52 and 53-62 (1907). It is interesting to note that Hadley uses “stock” to include debentures and bonds, \textit{id.} at 52, but it becomes clear from his discussion of railroad accounting (and attendant fraud) that debt was the primary instrument of railroad finance in the 19\textsuperscript{th} century. Ripley describes a detailed and nuanced evolution of railroad financing, noting that prior to the mid-1850s railroads principally capitalized with stock, but that following the Civil War bonds became the principal means of railroad finance. It is well-known that much of the private funding for railroad construction and expansion came from Europe, and “all European capital for railroad purposes came to this country in the form of mortgage loans.” WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION, 105-120, 106 (1923); ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS, 91-172 (1977); DAVID L. DODD, STOCK WATERING: THE JUDICIAL VALUATION OF PROPERTY FOR STOCK-ISSUE PURPOSES, 23 (1930). \textit{Cf.} Peter Tufano, \textit{Business Failure, Judicial Intervention, and
to create U.S. Steel were financed with retained earnings and debt. The public equity market simply wasn’t an important factor.\textsuperscript{37}

Thus American industrialization was accomplished with little significant external equity capital and, in the case of industrial corporations (in contrast to railroads, banks, and insurance companies), such external equity capital as was raised was almost always raised privately.\textsuperscript{38} Naomi Lamoreaux notes that equity capital was rarely a source of permanent finance before the 1930s.\textsuperscript{39} Railroads financed largely through debt, principally because limited disclosure discouraged outside shareholders and the more transparent integrity of some bond houses allowed lenders to rely upon the reputation of the selling bank for repayment. Significant trading in railroad stock typically signified a battle for control.\textsuperscript{40} While banks and utilities did finance with equity, it was typically confined to local holders.\textsuperscript{41} Virtually no industrial companies issued public equity and some, like Carnegie Steel, were organized as partnerships.

The merger wave of 1897 to 1903 is generally identified as the period during which the giant modern public corporation was created.\textsuperscript{42} While there is little question that this is the time during which large numbers of industrial corporations went public, the function of public equity during this period was not especially related to financing. Although data is most unreliable before the passage of the Sixteenth Amendment and the enactment of the federal income tax in 1913, it seems clear that equity securities during this period were not so much used to raise corporate capital as to provide a currency for corporate acquisitions. Legal changes, most prominently in New Jersey, effectively licensed corporate promoters to print stock for the purpose of assembling competing companies into larger horizontal conglomerates.

\begin{itemize}
\item Navin & Sears, supra note __; MITCHELL, THE SPECULATION ECONOMY, supra note __.
\item Lamoreaux, supra note __ at 3-486.
\item Lamoreaux, supra note __ at 3-486; MITCHELL, supra note __. Railroad finance was also a significant source of financial fraud that principally affected shareholders. RIPLEY, supra note __ at 35(discussing the device of the railroad construction company and its use in siphoning railroad capital to controlling shareholders).
\item Lamoreaux, supra note __ at 3-486.
\end{itemize}
While stock offerings in the new combinations did raise some working capital, their primary purpose was to provide liquidity to industrialists and their families and profits to their investment bankers who took substantial portions of their fees in stock. This is not to say that securities offerings during the merger wave failed to fulfill a business purpose. To the extent that corporate combination rationalized business and eliminated destructive competition, common stock provided a cash-free way to ensure business survival and eliminate duplicative costs. The opportunity to use this method was provided by an unusually large cash surplus in the American economy and a paucity of investment opportunities available to the newly emerging middle class. So common stock may have played a useful role in corporate restructuring, but not in financing production, and it is hardly clear from the historical record that it was a role that could not have been played with equal success by debt. The success of the restructuring that did occur also remains a subject of lively debate among business historians.

The unavoidable conclusion appears to be that American corporations achieved high productivity without significant funding from public equity. This was certainly the case for most of the nineteenth century, when some of our largest (and still extant) corporations grew to maturity, and when American industrialization had completed its


44 Rousseau notes that share turnover of the largest manufacturers listed on the Boston exchange was very low, Rousseau, *Share Liquidity*, supra note __ at n.6.

45 The extent to which the combinations formed during the merger wave actually succeeded remains a subject of debate among business historians. It also bears noting that the new combinations did issue equity to raise some working capital during the merger wave.

46 J.P. Morgan began the practice of using common stock in railroad reorganizations instead of the more common debt in order to eliminate fixed charges from railroad balance sheets. Lamoreaux, *supra* note __ at __. Lamoreaux has also made the case that the elimination of high fixed charges in competitive industrial markets with low product differentiation were a principal financial motivator of the merger wave. *LAMOREAUX*, *supra* note __. This might suggest that debt financing would not have been a workable alternative to facilitate corporate combination. But the merger wave occurred during a time when, although dividend payments remained discretionary with boards of directors, they were expected by shareholders and only the desperate corporation could afford to pass a dividend, *MITCHELL, SPECULATION ECONOMY*, *supra* note __ at 95. During the first decade of the century (encompassing the last four years of the merger wave), Cowles Commission/S&P Composite stock dividend yields exceeded corporate bond yields by a mean of 30%, although with a standard deviation of 1.2 for stock yields compared with a standard deviation of .52 for bond yields. The median difference was 28%. (Data for stock yields was drawn from *MILLENIAL ABSTRACTS*, *supra* note __, Table Ch808-816, and for bond yields from *SIDNEY HOMER AND RICHARD SYLLA, A HISTORY OF INTEREST RATES*, Table 45 (3rd Ed. 1999)). Investors in the new stock issues clearly anticipated compensatory returns for their risk in the form of dividends. So while the flexibility to pass dividends might have made common stock appear more attractive to issuers, the financial reality was that it was little different from debt in terms of corporate obligation, and debt financing might have been a workable alternative. In addition, debt’s requirement of fixed charges might have prevented the overcapitalization that destabilized financial markets before the creation of the Federal Reserve Board (and for some time after, until it had gained real power), and limited corporate combinations to those that were more likely to be economically sustainable on the basis of real productivity.
As I will now demonstrate, it continued to be true for most of the twentieth century, most reliably (in terms of available data) at least from World War II onward.

b. The Empirical Evidence

The earliest data I present is drawn from work compiled for the Bureau of Economic Analysis by Simon Kuznets through 1956 and extended to 1962 by Arnold Sametz and presented in Table 1. These data show that, for the first half of the 20th century, overall external financing (including debt) was less important than internal sources of finance in general, and that its importance declined significantly in the post-World War II years. Using long-term cycles rather than individual years for a variety of methodological reasons, Kuznets shows that internal sources of finance were as follows through 1956, and Sametz, using different sources, shows this continuing until 1962:

Table 1: RATIOS OF INTERNAL TO TOTAL SOURCES OF FUNDS
NON-FINANCIAL CORPORATIONS, 1901-1956

<table>
<thead>
<tr>
<th>Years</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1901-1912</td>
<td>0.55</td>
</tr>
<tr>
<td>1913-1922</td>
<td>0.60</td>
</tr>
<tr>
<td>1923-1929</td>
<td>0.55</td>
</tr>
<tr>
<td>1930-1933</td>
<td></td>
</tr>
<tr>
<td>1934-1939</td>
<td>0.98</td>
</tr>
<tr>
<td>1940-1945</td>
<td>0.80</td>
</tr>
<tr>
<td>1946-1949</td>
<td>0.64</td>
</tr>
<tr>
<td>1946-1956</td>
<td>0.61</td>
</tr>
<tr>
<td>1957-1962</td>
<td>0.61</td>
</tr>
</tbody>
</table>

Sources: 1901-1956, Kuznets, Table 39, page 248; 1957-1962, Sametz, Table 4, page 455.

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47 Thomas McCraw identifies the founding periods of several of America’s largest corporations well before the merger wave (although a few, like General Electric, were the product of corporate combination), including Eastman Kodak, Chiquita Brands, Johnson & Johnson, Coca-Cola, Westinghouse Electric, Sears Roebuck, Avon Products, Hershey Foods (the 1880s), General Electric, Knight-Ridder, Ralston Purina, Reebok International, Harris Corp., Pepsico, and Goodyear (the 1890s). Thomas K. McCraw, American Capitalism, in Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions (Thomas K. McCraw, ed.), 303, 321. Of course many extremely large companies predated or were formed parallel to these, including Standard Oil, Carnegie Steel, Armour & Co., Proctor & Gamble, McCormick Reaper and John Deere (which would combine into International Harvester), and American Sugar Refining. McCraw is careful to emphasize that these periods don’t necessarily cover the corporations’ eras of greatest growth, but it is fair to say that, taken together, they illustrate the very substantial extent to which America had industrialized well before the advent of the public industrial corporation.

48 Bogen, supra note ___; KUZNETS, supra note __: Sametz, supra note__.

49 KUZNETS, supra note __: Sametz, supra note__.
The data original to this paper, presented in a time series running from 1955 through 2006, has been drawn and compiled from raw IRS balance sheet compilations. What those data demonstrate is that until the 1970s, American corporations financed their productive activities almost exclusively through retained earnings and various forms of debt. From the late 1970s on, retained earnings began rapidly to disappear, to be replaced almost entirely by debt. Public stock issuances were rarely a factor in industrial production.

Figures 1 through 5 show that the predominance of internal financing begins to decline in the 1970s, and rapidly thereafter from the 1980s into the 21st century. As I will soon clarify, its diminution has not been balanced by a net increase in external equity, but rather by a dramatic increase in off-balance sheet debt. (The data contained in these figures are also presented in tabular form in Appendix A.)

Figure 1 is the ratio of retained earnings to external financing. Retained earnings are, effectively, corporate savings, available either for investment in productive activity or, in some circumstance, payments to shareholders. Figure 1 shows a dramatic decline in the proportion of corporate assets attributable to retained earnings, and thus the amount of corporate savings.

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50 All the data has been drawn from the Corporation Income Tax Returns: Balance Sheet, Income Statement, and Tax Items section from various volumes of the Statistics of Income (SOI) Bulletin, issued quarterly, by the Statistics of Income Division of the Internal Revenue Service (IRS), and made available to us at the IRS library pursuant to a Freedom of Information Act request. Data between 1978 and 1990 has been compiled from the SOI Bulletins which are available at the IRS website. [http://www.irs.gov/taxstats/article/0,,id=117514,00.html](http://www.irs.gov/taxstats/article/0,,id=117514,00.html)


We have compiled our data from 1938 but do not here present the earlier results due to the fact that the IRS records separate paid-in or capital surplus only from 1955.

51 The ratios of external to internal financing are based on the following equation: External Financing = (Capital Stock) + (Paid in Capital or Capital Surplus) + (Accounts Payable) + (Short Term Debt) + (Long Term Debt).

52 Infra, notes __-__ and accompanying text.

53 Retained earnings do not, of course, necessarily represent cash, but rather the net value of corporate assets not represented by the capital balance sheet entries shown in Figure 2. Retained earnings can be distributed to shareholders as returns of equity in the form of stock buybacks, which I discuss infra at notes __-__ and accompanying text.
Figure 2 captures the ratio of capital plus paid-in capital or capital surplus to external financing. This data serves as a proxy for both public and private equity issuances in general. (I present a set of equity data based on net issuance values in Figures 7 through 9). These balance sheet items, together with the retained earnings shown in Figure 1, constitute the equity portion of the corporate balance sheet. While the data show a steady rise in capital as a proportion of external financing from 1979 to 2002, the aggregate data presented in this paper suggest that the uptrend is at least in part attributable to an apparent decline of all other forms of financing rather than an actual increase in equity itself.\footnote{In other words, if one were to hold capital relatively constant and decrease all other forms of external financing, one would expect to see the ratio of capital to external financing rise simply as a mathematical matter. As I show \emph{infra} at notes \_\_\_\_\_ and accompanying text, the likely growth in external financing comes in the form of off-balance sheet debt.}

Another contributory explanation may be the privately-placed sources of equity described by Fama and French. Fama and French, \emph{supra} note \_\_. Finally, as I show in Figure 9, financial corporations have been net issuers of equity in recent years and some of the uptrend is undoubtedly attributable to their financing. Financial corporations are included in my IRS data.
Figures 2 through 5 capture the ratios of the various components of debt (accounts payable, short-term debt, and long-term debt) to external financing. Accounts payable increase rather significantly, but both short-term and long-term debt show substantial declines after initially rising through the late 1980s (short-term debt) and the early 1970s (long-term debt).
Mapped together, the trends appear in Figure 6 as follows:
In place of the Kuznets-Sametz first half century range of retained earnings of 55% to 71% (leaving aside the extraordinary 98% during the period when America was emerging from the Great Depression), we see 37% in 1978, dropping as low as 3% in 2002 (which can partially be explained by the consequences of 9/11), but still well below 20% from 1986 on. Clearly, the importance of retained earnings in relation to overall external financing has evaporated and, as the graphs show, this also appears to be true of the various forms of debt, although accounts payable show some degree of relative stability.

Perhaps the most striking thing about these data, besides their departure from historical trends, is that they are entirely counterintuitive. For what we see is that, almost precisely when the going-private movement began in the late ‘70s, in the form of leveraged transactions in which it has principally continued, the relative importance of retained earnings and all forms of debt plummet and equity appears to rise.\footnote{But see the probable explanations for the apparent increase in equity, supra note __.} In light of the fact that, by definition, going private transactions remove equity from the public market, and the common understanding that debt financing was the principal means of accomplishing this, we would expect to see exactly the opposite result, even accounting for the dot.com boom of the late ‘90s. The diminution in the ratio of retained earnings to external financing by itself isn’t especially surprising, although the magnitude is, since one characteristic of attractive takeover targets is large amounts of cash with which to pay debt service, and one might conclude that leveraged going private transactions eat internal equity and continue to eat cash flows that might add to that equity. But the debt numbers in light of what we think we know about financing during the period are
The probable answer is that some very significant portion of this diminution in debt is accounted for by off-balance sheet financing transactions, although for obvious reasons data on off-balance sheet financing are notoriously difficult to compile. Although perhaps an extreme case, had Enron reported its off-balance sheet financing as balance sheet debt in 2000, its reported debt would have been $22.1 billion instead of its


*But see* Thomas W. Bates, Kathleen M. Kahle, and Rene M. Stultz, *Why Do U.S. Firms Hold So Much More Cash Than They Used To?*, NBER Working Paper 12534 (2006), available at [http://www.nber.org/papers/w12534](http://www.nber.org/papers/w12534), who note a doubling in the average cash to assets ratio of U.S. industrials between 1980 and 2006 such that the additional cash accumulation on average wipes out the firms’ debt obligations resulting in a net no-leverage position. They explain the phenomenon as characterizing firms with relatively risky cash flows (including firms with more recent IPOs) and which do not pay dividends, have decreased inventories and capital expenditure, and increased research and development budgets. This explanation is an interesting and plausible explanation for the data reported in the text. One potential flaw in their research is their use of COMPUSTAT data which does not reflect off-balance sheet financing. Although some effects of off-balance sheet financing may be reflected in this data in the form of market value of assets, which they use as one variable, it is unlikely to capture anything close to the magnitude of off-balance sheet financing.
actual reported balance sheet debt of $10.2 billion. Perhaps more strikingly, one estimate notes that in 2003, $208 billion, or 31% of a total of $668 billion of productive business assets, were acquired by off-balance sheet leasing. It seems reasonable to conclude that off-balance sheet financing arrangements account for a substantial proportion of the apparent diminution in long-term debt, a practice which, intentionally or not, distorts corporate balance sheets and drives stock prices higher.

An examination of Federal Flow of Funds data makes the trend even more puzzling. As shown in Figure 7, from 1945, except for two brief periods between 1991 and 1993 and between 2000 and 2003, net equity issuances by all corporations have been flat or negative, and in fact a significant dip occurred between 1996 and 1998 during the dot.com boom.

58 UNITED STATES SECURITIES AND EXCHANGE COMMISSION, OFFICE OF THE CHIEF ACCOUNTANT, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILING BY ISSUERS 16 (2005).

59 CHIEF ACCOUNTANT’S REPORT, supra note ___ at 60, n.154 (citing a report by the Equipment Leasing Association). Corporate obligations under finance leases are, for all relevant purposes, the functional equivalent of debt payments.

60 See Miller and Bahnson, supra note __, who, while calling the practice fraudulent, note that it winds up being more damaging than helpful to the corporation engaging in extensive off-balance sheet financing.

61 See also the chart provided in Table Cj817-830 of the MILLENIAL EDITION, compiled by Peter L. Rousseau, for specific numbers. Rousseau shows slightly positive issuances from 1946 through 1977 with variance increasing thereafter but trending significantly negatively.

Hall, supra note ___ at 16, although without addressing this particular data set, notes that equity figures tend to be overstated, although not grossly, because “Corporations frequently barter their equity for the services of employees,” both because corporate founders tend to retain significant portions of their equity and because employees often receive stock as a portion of their compensation. While founders can almost certainly be said to have put up some portion of the corporation’s risk capital, stock compensation to employees, while offering them a participation in profits, in no way can be said to raise external equity for the purpose of financing production. See also supra note ___ (discussing the Fama and French results).

During the three year period ended September 30, 2007, non-financial corporations included in the S&P 500 increased their long-term debt only 6%, compared with an overall debt increase (including financial corporations) of 76.1%.

http://www2.standardandpoors.com/spf/pdf/index/121307_SP500_BUYBACK_PR.pdf?vregion=us&vlang=en
Resolution of the puzzle begins to clarify when we separate out non-financial corporations from financial corporations. Figure 8 shows an immaterial positive blip here and there but tending around zero to deeply negative, largely following the overall story for all corporations:

Mapping the same data for financial corporations, as shown in Figure 9, completes the explanation. Note that the first major uptrend begins almost precisely at the time of the beginning of the going-private movement, when overall equity issuances were
down, and that the most recent and significant up-trend begins in 1997, just a year after the big dip for all corporations started during the dot.com boom.

Figure 9: Corporate Equity – Financial Corporations (Billions of Dollars)

The implications for the structure of the American economy are significant. The data suggest that America’s economy is increasingly based on finance, and that our public financial markets principally are financing finance. At a minimum, it appears clear that industrial corporations are not obtaining their net financing from publicly issued equity.

A relatively recent explanation for the increasing disappearance of industrial equity is the boom in stock-buybacks. The numbers from 1988 through 2008 are presented as Figure 10 and in tabular form in Appendix B. The decrease in net equity issuances by financial corporations beginning in 2004 can be accounted for at least in part by stock buybacks, but this activity began to diminish. Financial corporations accounted for only 13.4% of buybacks in the fourth quarter of 2007 in contrast to 22.3% for the fourth quarter of 2006, most likely reflecting their growing liquidity problems.

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62 As I will explore in a future article in this series, this, within limits, isn’t necessarily a bad thing and may in fact hold the key to explaining the as-yet unexplained nexus between stock market development and real economic growth. On the other hand, and as I suggest elsewhere, such an economic structure creates significant distorting effects on the real economy. Lawrence E. Mitchell, The Morals of the Marketplace, 20 Stan. Law & Policy Rev. ___ (forthcoming 2009).

63 http://www2.standardandpoors.com/spf/pdf/index/040708_SP500_BUYBACK_PR.pdf?vregion=us&vlang=en
Buybacks, with just a few exceptions, trailed dividends until the fourth quarter of 2004. Then buybacks soared, both absolutely and in relationship to dividends. In the three year period ended December 31, 2007, the corporations comprising the S&P 500 spent $1.44 trillion in buybacks, compared to $1.56 trillion on capital expenditures and $721 billion on dividends. And while aggregate data can be misleading, for the three years ending with the third quarter of 2007, 279 of the S&P 500 companies had spent more on buybacks than capital investment. During this period, 12.5% of the outstanding shares on the market were removed due to buybacks alone, just under a majority of which went into treasury stock with the balance used for M&A and options. While there are legitimate business reasons for corporations to engage in buybacks, the result has been a significant distortion in earnings per share, and an artificial increase in stock prices.

64 http://www2.standardandpoors.com/spf/pdf/index/040708_SP500_BUYBACK_PR.pdf?vregion=us&vlang=en. At the end of the third quarter, 2007, these companies had spent more on buybacks during a three year period than on capital expenditures.

Figure 11 breaks out total dividend payouts and share repurchases by S&P 500 corporations, showing their levels relative to one another and to the S&P 500 index since 1998, completing the picture of the substantial degree to which these corporations have been returning wealth to shareholders.  

**Figure 11: S&P 500 Payouts, 1998-2007**

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**c. Summary Conclusion: Creditors Make, Shareholders Take**


The data are clear. Creditors own American business. Public shareholders have made little contribution to the core functions of American industrial corporations, the financing of productive activity. Indeed, as the data from the last quarter of the 20th century suggest, public shareholders have been net consumers rather than providers of corporate equity capital. The argument for expanded shareholder rights can not be supported by the idea that shareholders contribute value to American industrial production and thus financial growth. In order to support the legitimate expansion of shareholder rights, its supporters must make a case that public shareholders make some other kind of contribution to the American economy.}\(^{67}\)

Moreover, the withdrawn equity has been replaced by debt. It is clear that as early as the middle of the 20th century, the profits of public shareholders piggybacked on the risk capital contributed by debtholders or, to put it differently, that creditors were providing the bulk of the risk capital that had not been generated from the early investments of entrepreneurs. Now one could argue that the legal claims of equity and debt have long been settled such that this observation, while interesting, is not problematic. But the overlay of legal form on economic reality shows that those who control the risk capital, that is, the shareholders, do not provide that risk capital. The mismatch permits managers, who are put in place indirectly by the shareholders, to engage in risk-taking with potentially large benefit to the shareholders but with potentially significant adverse consequences to the debtholders. Again, the established existence of legal forms, along with the ability of creditors to self-protect through contract, may not make this a problem of fairness as between the different financial claimants.\(^{68}\) But it does present a problem of incentives that have potentially significant negative effects on the productive economy.

Managerial incentives can be significantly distorted by the existing regime of shareholder participation rights, and the problem obviously would be exaggerated by an expansion of shareholder rights. But shareholders are seen to be risk-bearers of sorts. Perhaps this would justify a regime of expanded rights, even if those rights posed some macroeconomic risks. It is to this question that I now turn.

**Part II – Equity Without Risk**

In this section I put aside the data I presented in Part I and the conclusions to be drawn from them -- public shareholders have no legitimate corporate participation rights because they make no positive contribution to American industry -- to address two additional important points. The first is the argument that shareholders should have corporate participation rights because they take on the risk-bearing function of American

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\(^{67}\) As I noted supra note __, there is a growing literature debating the question of whether the stock market as an institution stimulates economic growth. That is a question I will examine in a future paper.

industry. My conclusion is that, even assuming my data is wrong, a close look at modern finance theory leads to the conclusion that the only risks public shareholders take are those that they create themselves. This lends no support at all to an argument in favor of expanded shareholder rights, and probably undercuts it.

The second point is to question the frequently-asserted equivalence of dividends and capital gains, because it is here that the greatest potential damage to the real economy from expanded shareholder rights is demonstrated. From the perspective of the corporation’s long-term business health, the two are rather dramatically different. But the history of investment in America shows a marked shift from the expectation of dividends to that of capital gains, which has distorted managerial incentives in a way that encourages managers to harm the long-term health of their corporations’ businesses in order to satisfy current shareholder demands. Again, the conclusion to be drawn is that shareholder rights exacerbate the problem and thus should be quite limited.

a. Shareholders as Risk-Bearers

The development literature I referred to earlier in this article gives significant pride of place to the role of financial institutions like the stock market in overcoming information asymmetries and facilitating liquid markets. The macroeconomic literature connects this function with economic growth by arguing that financial institutions thus overcome barriers to investment, opening the investment markets to large numbers of participants over whom the risk of loss is broadly distributed. In the absence of the evidence I provided in Part I, the legal literature has justified shareholder participation rights at least in part on this perceived risk of loss. The argument, in brief, is that since shareholders are the corporation’s residual risk bearers, they have the greatest incentives of all corporate stakeholders to monitor corporate management and it is therefore efficient to assign this role to them through the medium of voting rights.

Thus I will turn, in this part, to one of the principal perceived benefits of these market functions, the facilitation of risk sharing among a broad group of investors. For regardless of what I have thus far demonstrated, it is taken almost as an article of faith in the finance and corporate literature that shareholders do indeed assume the risk-bearing function of corporate productivity and this in a meaningful sense justifies their participation rights. While I have already demonstrated that public shareholders do not own the risk capital of American industry, it would be idle to deny that in fact they bear some risk; they can and do lose money from investing in poorly performing corporations. Moreover, the argument is sufficiently embedded that it justifies discussion. Thus I will turn briefly to the microeconomic literature to evaluate precisely what risks are actually born by public shareholders.

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69 This standard argument is described in STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS, 10.3(C) (2002).
Assume that shareholders do, in a meaningful way, take the risk of failure resulting from poor corporate production and innovation, and that they are motivated to do so in part because they have access to information that permits intelligent decisionmaking. This information also facilitates the transfer of shares among investors. The question is how shareholders assume this risk. They do so by purchasing stock, but well before the seminal work of Graham and Dodd, it was widely acknowledged that the purchase of stock in a single public company was a poor investment strategy. That argument has been refined over time into what is generally known as modern finance theory. One aspect of that theory, portfolio theory, first developed by Harry Markowitz in 1952, addressed the question of how an investor should maximize the value of his investment. The answer was to achieve a balance between moderating variance and return on his investment by creating an efficient portfolio, that is, one that either provided the highest return for a given level of variance or the lowest risk for a given return. By so doing, that is to say, by diversifying his investments, each shareholder could achieve the maximum return for a given level of risk. The wisdom of investing in this manner followed as a matter of course.

But what are the risks involved? The microeconomic literature is careful in categorizing risk, which is refined in the capital asset pricing model. The capital asset pricing model followed relatively quickly on the heels of Markowitz’s work. As William Sharpe observed in his famous contribution to the creation of CAPM, if stockholders can eliminate the risk of loss from any particular corporation by diversifying, a corporation must only compensate its shareholders – its risk-bearing specialists – for taking nondiversifiable risks. What risks are nondiversifiable? Those that exist in the market itself, like risks of inflation, market bubbles, major political events, the impact of economic cycles, the unavailability of credit, and the like. So far, so good.

But notice the paradox. If the only risk for which corporations must (and therefore will) compensate shareholders is the risk inherent in the market, then the only risks in which shareholders are specialists are market risks. In the absence of a stock market or, to put it differently, in an economy based largely on the provision of external financing by specialized institutions, those institutions would, as they do, demand compensation for the risk of loss inherent in specific corporate investments. While systematic risk would still exist, it would be tempered by significant alpha, that is, corporate-specific returns, and it is likely that much systematic risk would be diminished by eliminating the market. There would, in other words, be no need for the risk specialization services provided by shareholders, which is to assume systematic risk.

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71 William Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. Finance 425 (1964). It is commonly said that diversification “eliminates” the risk of holding stock in a particular corporation. This is obviously incorrect. If you own the stock of corporation A in your portfolio and A goes bankrupt, you have lost your investment in A. It is more accurate to say that the impact of that loss on your overall portfolio is balanced by potential gains in the stock of other corporations you own.

72 See sources cited *supra* note ___ for discussions of market irrationalities.
Put yet another way, the logic of finance theory seems to lead to the conclusion that the only risks in which shareholders specialize are the risks that they themselves, aggregated in the institution of the market, create, since it is they, and not banks or public debtholders, who are uniquely dependent upon beta for their returns. Consequently, it seems as if the risk-specialization argument for the presence of public shareholders, and thus the stock market, becomes weaker. The logic of risk-specialization is a consequence of the existence of the market, not a justification for it.

Now I confess that this reasoning moves a bit too quickly. Despite the claims of portfolio theory, or at least those made on behalf of portfolio theory, stockholders still buy stock in specific companies, and still take the risk of holding stock in specific companies, no matter the facility with which they can diversify in order to minimize that risk. In the absence of a market that allowed such diversification, shareholders would, so the argument continues, refuse to invest in specific companies and would therefore fail to provide the capital necessary to finance industry.

But the logical end of the specialization argument returns us to the premise that stockholders provide financing for industrial production. And that is precisely the question at issue, the answer to which is suggested by the data. For those data demonstrate that stockholders do not importantly provide financing for industrial production, both as an historical and as a contemporary matter. That financing historically has come principally from retained earnings and debt. While the argument from finance theory is elegant and is logical within its assumptions, the assumptions fall on the facts.

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73 I don’t mean to suggest that systematic risk would be entirely eliminated or that financial institutions would not suffer in their investments from systematic risk. What I do mean to suggest is that the return demanded by financial institutions, whose profits would come not from trading but from dividends and interest, would likely be more finely calibrated to the risks inherent in individual corporate investments rather than exogenous factors. A closer correlation between actual corporate performance and returns on investments would likely result. I do think it is fair to note that the same result could be accomplished in the stock market if each market participant (or the overwhelming majority of market participants) invested on the basis of fundamentals and focused more on returns from corporate cash flow than from trading profits.

74 As I discuss, infra, this was historically true during the greatest period of American industrialization before the emergence of the modern stock market. And while the failed conglomeration movement of the 1960s suggests the perils of overdiversified corporations, at least some of the great 19th century industrialists did at least vertically integrate their businesses as a protection against volatility in various supply markets.

75 Since the data demonstrate a dramatic recent decrease in retained earnings, it is fair to ask whether the historic reliance on internal financing can continue. In light of current economic conditions, I think it is reasonable to suspect that many corporations will begin again to retain earnings to support their stock prices, much as they did in the early part of the 20th century. See infra at __ for a discussion of the earlier era.
The conclusion remains that stockholders can be seen as specialists in risk bearing only because of the existence of a public market, and the market exists primarily as an historically contingent fact, largely unrelated to the financing of productive enterprise. If this is true, then the market exists for the sake of the market, and investment in equities very much resembles the gambling it is often accused of being. Modern finance theory nicely illustrates the gap between the real economy and the finance economy, and raises significant questions about public shareholders’ real contribution to economic growth. The argument from risk-bearing proves too much.

b. The Unbearable Lightness of Capital Gains

Our state and federal regulatory models treat public shareholders as investors in American corporations. But I will show that the historical trend demonstrates that the market is more properly described as a speculative arena, and those who buy and sell stocks have come far less to resemble investors than traders for short-term profit. Stock market volatility has increased dramatically since 1980, during the same period in which a precipitous drop in internal resources was matched with a run-up in borrowed funds. Empirical evidence increasingly points to a managerial focus on short-term stock prices during this period, even at the expense of business development, culminating in the dramatic increase in stock buybacks from 2004 to 2007, a period during which the S&P 500 spent more (in the aggregate, and more as a simple majority of corporations) on stock buybacks than on productive capital, and dramatically more than on research and development.

The historical record demonstrates a significant shift in investment style. Through the 1950s, those who invested in public equity did so primarily for dividends. Indeed the New York Stock Exchange emphasized dividends in its “Own Your Share of American Business” campaign to induce larger numbers of Americans to invest in the stock market.


77 I again defer a question, that is, whether the stock market helps financial institutions more broadly to allocate capital, and especially debt capital. While important to analyzing the appropriate design and regulation of markets, it is beyond the scope of the issue of shareholder rights.

78 Kenneth A. Froot, Andre Perold, and Jeremy C. Stein, Shareholder Trading Practices and Corporate Investment Horizons, 5 J. App. Corp. Fin. 42 (1992), make a careful argument that distinguishes mere turnover from real volatility, arguing that while turnover has significantly increase, volatility has not as a result of increased market capacity. They do, however, note the possibility that informational asymmetries between management and the market might well induce short-term managerial incentives. While their argument is powerful, it is somewhat limited by the fact that it was made in 1992 before the very dramatic turnover increases in the early 21st century. It would be interesting to apply their methodology to that period to see if their conclusions hold.

as well as to establish a broader base with which to lobby against double taxation. But matters changed in the 1960s and have continued along the path then set. The desire for dividends gave way to the demand for capital appreciation.

To some extent, this shift was planned and encouraged by the New York Stock Exchange, suffering from a lack of business in the 1950s. The NYSE clearly contemplated that increasing shareownership would enhance the speculative character of the market (as eventually it did). For example, in its 1955 Annual Report, it noted the low annual turnover of 19%, stating that “[t]his is to be expected, of course, in a cash market of an investment character.” Low turnover meant low commissions and low profits for the specialists that controlled the NYSE, and it went on to complain that the Federal Reserve Board, through a lack of understanding of the importance of securities credit, had raised margin requirements twice that year. The annual report describes that the Exchange “devoted increasing effort to research and education in this area . . . . [I]t should be made clear that an excessively high level of initial margin requirements, at a time when there is only a modest amount of credit employed by the securities industry, can be harmful to the nation’s entire economy by adversely affecting the liquidity of our marketplace.” While buying stock on margin could in fact be consistent with the desire for dividends, it is significantly more related to investing for capital appreciation. Explosive market development in the succeeding years, with a marked turn to investing for capital gains, demonstrates the success of the NYSE’s programs, despite the failure of the Fed significantly to reduce (and even sometimes to increase) margin rates.

This shift to capital gains investing has significant implications for the appropriate role of public shareholders. The famous Miller-Modigliani irrelevance theory which, although debated, has wide adherence, holds that, transactions costs and taxation left aside, investors should be rationally indifferent between receiving dividends and capital gains. If the market is efficient, an increasingly dubious proposition, public stock

80 As recently as the late 1950s, investing for dividends was the dominant style. See e.g., New York Stock Exchange and Affiliated Companies, Annual Report for 1955 (available at the New York Stock Exchange Archives).

81 One exception to the drive toward speculation appears to have been perhaps the greatest popularizer of post-Depression common stock investment and a creator of the NYSE’s Monthly Investment Plan, Charles Merrill and the firm he founded. Merrill appears to have been concerned with ensuring that new investors were careful in assessing the risks they took and prudent in their investments. EDWIN J. PERKINS, FROM WALL STREET TO MAIN STREET: CHARLES MERRILL AND MIDDLE CLASS INVESTORS (1999). The biography, apparently the first on Merrill, is a bit hagiographic but does provide some support for the idea that Merrill popularized common stock investing in a fairly conservative way.

82 NYSE Annual Report for 1955, supra note __.


84 Merton Miller and Franco Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411 (1961); Franco Modigliani and Merton Miller, The Cost of Capital, Corporation Finance, and the
prices in a broad and efficient market should discount all future cash flows to present value and incorporate them in the stock price. Thus one could receive dividends over the long term by holding onto the stock, or receive them now by selling the stock and receiving future dividends in the form of capital gains, as well as the proportion of the selling price that captures the seller’s share of retained earnings. Whether or not the market is speculative in character doesn’t matter, as long as it’s efficient.

But this argument ignores one very important fact. With certain rare exceptions, dividends must be paid out of cash earned currently, or at least cash that is owned by the corporation and therefore certain. Discounted future dividends, even if the market is efficient, are a risky proposition. Because they will only come in the future, they do not exist at the time that a stockholder sells his shares for capital appreciation. And, as a matter of financial reality, they are only as good as the assumptions one makes in applying various valuation models to the corporation’s earnings and cash flows.86 So in one very real sense, the capital gains seller is shorting future dividends, and the capital gains buyer is gambling that the rather significant assumptions upon which valuation models are built turn out to be correct, or at least that he can find someone else to buy the stock who believes them to be correct. Moreover, as the data show, retained earnings have more or less disappeared from the books of industrial corporations, so the capital gains trader is effectively buying or selling what used to be referred to as “water.” While financial theory might establish equivalence, in real economic terms, taking one’s profits in capital gains (taken as discounted future cash flows rather than as accumulated retained earnings) is a very different proposition from receiving a check from a corporation with money in the bank.

The disappearance of retained earnings might well have significant implications for the continuing legitimacy of the Modigliani-Miller theory. Miller and Modigliani published their papers in 1958 and 1961. As the data presented in Part II show, in 1961 retained earnings constituted between 40% (my data) and 61% (Sametz’s data) of corporate balance sheets. In a very real sense at that time, capital gains appear to have been supported by real deferred dividends, held as retained earnings, and while one assumes that market movements also affected stockholder profits, there were balance sheet assets to support stock prices.87 The situation is dramatically different where, as we

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85 See, e.g., Antawbi, supra note __; sources cited supra at n. __.

86 Marco Pagano, Fabiano Panetta, and Luigi Zingales, Why Do Companies Go Public? An Empirical Analysis, 53 J. Fin. 27, 28 (1998), studying a sample of Italian corporations, conclude that investment and profitability tend to diminish following an IPO, and that the greatest single predictor of whether a firm will undertake an IPO is a high market to book ratio.

87 As to stock price movements, it is worth noting that volatility, expressed as turnover, was very low. See the historical table from 1900 to the present at http://www.nyndata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=22.
see in 2005, retained earnings constitute 11% of corporate balance sheets equity. Capital gains are no longer supported by balance sheet assets. Market movements constitute virtually the entire amount of shareholder capital gains. Whatever power the irrelevance theory had at mid-century, the disappearance of retained earnings would seem to cast it in an entirely different, and far less persuasive, light.

The contemporary capital gains situation has historical precedent. During the great merger wave, which took place in the U.S. between 1897 and 1903, $20 billion of new capitalization entered the American economy in the form of newly created common and preferred stock. Changes in New Jersey law permitted trust promoters to create holding companies, issue as much stock as they like, and use it to buy up existing industrial enterprises, combing them (typically) into huge horizontally integrated companies. The promoters and sellers then dumped their stock on the market before the new combinations had to show much profit or justify their stock prices, and an eager middle class was ready to buy. Not surprisingly, stock prices collapsed in 1903, leaving much of the newly-issued stock well below its issuance price (although quite likely more realistically in line with its value). The consequences for corporate finance were significant. U.S. Steel, for example, spent most of the first thirty years of its existence building its retained earnings in order to support its initial (and rapidly demolished) public stock price.

We don’t believe in watered stock anymore. Much work in finance theory has been directed to showing how public markets correct mispricing. And in fact, even during the merger wave (which raised issues of overcapitalization that concerned policymakers for decades), many of the new combinations found that they had to adjust either their stock prices or the quantities issued in order to sell their offerings. Nonetheless, the grain of truth that lay in the overcapitalization argument, whether or not it should have been troubling, was that corporations could not in fact be liquidated for their stock prices; that profit was pretty exclusively on the come. The demand for dividends disciplined corporate managers to concentrate on generating real earnings and cash flow out of which to pay them. The shift to capital gains investing removed that discipline. In an environment dominated by the desire for capital gains, profits are provided by the market, not by the profits of production. Thus CAPM links up with history, and, as I noted earlier, a principal reason that traders make money in the stock market is from the existence of the market itself. The effort shifts from achieving gains from production to using the corporate machinery to manipulate stock price. We may not believe in watered stock anymore, but the evidence of its effects are now painfully clear. Increasing the rights of shareholder will merely exacerbate the problem.

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88 Mitchell, Speculation Economy, supra note ___ at Chapter Three; David L. Dodd, Stock Watering: The Judicial Valuation of Property for Stock Issue Purposes 1930).

89 For both support for, and some skepticism about, this view see sources cited supra note ___.

Part III. The Legitimate Rights of Public Shareholders

a. State Law

The existing legal rights of shareholders is a subject so well-known as to merit relatively brief mention here. Simply put, and as a general matter, shareholders vote to elect directors, approve certain fundamental decisions made by directors, like amending the corporate charter, engaging in mergers and sales of substantially all of a corporation’s assets, and, with qualification, adopt and amend by-laws, remove directors for cause, obtain access to certain corporate books and records, and receive material information with respect to their voting. The federal securities laws overlay these state-given rights with basic disclosure requirements. Whether or not these rights have been meaningfully exercised, it is fair to say that shareholders already have the right to be heard on some of the most essential aspects of corporate governance and finance.

As both the empirical data and theoretical arguments I have presented make clear, debt and retained earnings are by far the primary sources from which at least reasonably mature businesses finance their production. I have also argued that, to the extent that public shareholders are said to be specialists in risk bearing, the only risks they bear are those they create through the mechanism of the market. While it remains true that a shareholder can see her equity investment disappear in bankruptcy, both finance theory and the law presume that shareholders will diversify so as significantly to mitigate, if not eliminate, any such losses.\(^\text{90}\) As I have further shown, over the past 30 years debt has increasingly replaced retained earnings as the primary source of risk capital in American industrial corporations, thus leaving the public equity holders, whose corporate capital at risk is negligible, in legal control while managing the money put up by creditors who, while they have the ability to negotiate some degree of almost entirely negative contractual control through covenants, have no significant ongoing participatory role in corporate conduct.

This analysis leads to some conclusions about the appropriate place of public equity holders in American industrial corporations, and some questions about our current mode of regulation. If, as the development literature holds, information rights and exit are the principal mechanisms through which the public market makes itself of use in stimulating production, then it would seem logical to limit the rights of public equity holders precisely to the receipt of information, as is currently required under the federal securities laws, and of course the right to sell their shares which follows both as a matter of corporate law and simple concepts of property. The right to participate in ongoing corporate affairs, such as by voting, appears to offer no benefit to corporate production and may, as I have been at pains to suggest throughout, create potentially dangerous distortions in managerial incentives. Thus, ideally (although most likely improbably), the

\(^{90}\) Indeed one famous justification for the director-protective business judgment rule is that shareholders do, or ought to, diversify and that if they fail to do so, they should receive no legal protection from even significant business mistakes. See, e.g., Joy v. North, 692 F. 2d 880 (2nd Cir. 1982)(justifying the scope of the business judgment rule on this ground).
right of public shareholders to vote should be eliminated.\textsuperscript{91} At a minimum, their rights should not be expanded or enhanced.

This is not to say that corporate governance should entirely be revamped. In the first place, the market for corporate control will still create a powerful incentive for managers to be attentive to shareholder returns.\textsuperscript{92} It may be that managers choose to avail themselves of takeover protections which activist shareholders abhor, which would of course diminish the effect of that market, but if this is a suboptimal practice we can assume, or at least postulate, that the market will discount for it and such managers will be punished through diminished share prices and perhaps a higher cost of capital. Whether or not the practice is suboptimal is, of course, a subject of lively debate. But it will allow the managers to make a determination as to whether they think that their ability to provide long-term value through the profitable production of goods and services is greater than whatever benefit might result from market pressures to maintain high stock prices.

There is another aspect of state corporate governance law that should be maintained, and that is the law of fiduciary obligation. This is probably even more significant in the absence of voting rights. Despite their insignificant role in financing corporate productivity, public shareholders do put their money at risk through a legally and socially sanctioned mechanism whereby they are vulnerable to the actions of others.\textsuperscript{93} Thus the traditional duties of care and loyalty, to the extent that they are effective, serve to limit the ability of managers to steal or shirk, while their freedom from voting pressure would permit them to manage the corporation as they see fit.

\textit{b. Information and Exit: Federal Securities Regulation}

The federal securities laws perform different tasks than state corporate laws, and to the extent that difference is more or less complete, serve a salutary function. Since, as the development literature holds, the dissemination of information is one of the principal benefits of a public stock market, the mandatory disclosure system should naturally be maintained, as should anti-fraud and anti-manipulation laws that keep the markets honest (and these latter for much the same reasons that I argued for maintaining fiduciary

\textsuperscript{91}I do not address, as beyond the scope of my task here, how directors and managers would be appointed in the absence of shareholder elections. One possible suggestion is that shareholders and creditors vote, perhaps as one class or several, solely for the election of directors and nothing more. Another is to permit shareholders to vote for directors but to stretch their terms to, say, five years, as Martin Lipton has suggested, in order to diminish the effects of short-term market and shareholder pressure on management. Martin Lipton and Steven A. Rosenblum, \textit{A New System of Corporate Governance: The Quinquennial Election of Directors}, 58 U. Chi. L. Rev. 187 (1991); Mitchell, \textit{Corporate Irresponsibility, supra} note 2 at 129-32.

\textsuperscript{92}In Lawrence E. Mitchell, \textit{Corporate Irresponsibility: America’s Newest Export} (2001) I demonstrate the pressure that market forces place on directors to be attentive to shareholder interests.

Those aspects of federal law designed to enhance the practice of shareholder democracy, in particular the shareholder proposal rule, Rule 14a-8 and, depending upon the method chosen to select directors, the proxy rules of Section 14, would obviously serve no purpose in a regime of state corporate law in which shareholders were prohibited from voting. Thus these aspects of federal regulation, those that mesh with the state law model of shareholder “ownership” of the corporation, as well as the considerable direct and indirect costs of maintaining them, would disappear.

c. Conclusion

Based on both theory and evidence, it seems reasonable to conclude that the public shareholders serve only a very limited function in stimulating industrial production and economic growth in the United States and are potentially detrimental to the achievement of those goals. While the financial implications are highly nuanced, the legal implications are rather simple. We have little use for the congeries of rights that have developed to allow public shareholders to participate in the governance of those corporations as if they in any meaningful way made a contribution to improved economic performance. The case for empowering shareholders falls on the facts.

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94 These disclosure obligations principally are set out in the Securities Act of 1933 and the Securities and Exchange Act of 1934.

95 Securities and Exchange Commission Rule 14a-8.

96 Securities and Exchange Act, Section 14(a).
### Appendix A

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio of Retained Earnings to External Financing</th>
<th>Ratio of Capital plus Paid-in Capital or Capital Surplus to External Financing</th>
<th>Ratio of Accounts Payable to External Financing</th>
<th>Ratio of Long Term Debt to External Financing</th>
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Source: S&P 2008