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Antitrust as Corporate Governance: Why a Firm's Mission Is to Earn No Profit

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By Ramsi Woodcock March 28, 2018

2 Comments

BlackRock, the vast asset manager, has been feted for demanding that the boards of its portfolio firms pursue a social purpose, which likely entails spreading corporate profits beyond shareholders to include labor and victims of environmental harm.[1] But despite being a shareholder in numerous firms, BlackRock should not actually have a say over what happens to corporate profits, because the law already requires that profits go to one group only, and not the group you might expect.

The consumer welfare standard in antitrust law requires that firms maximize the margin between price and product quality, a quantity called consumer welfare by economists.[2] This standard, adopted in the 1970s, resolves the long-running debate about which corporate constituency has a right to the profits of the firm, because profits and consumer welfare are a zero-sum game: Profits can be generated only by reducing the margin between price and quality, in effect redistributing wealth from consumers to firms.[3] The rule that consumer welfare must be maximized therefore means that profits must be minimized. The consumer welfare standard requires that firms pay their profits out in full to the one constituency that has hardly figured in debates over corporate mission: the consumer, by charging consumers the lowest possible prices in exchange for products of the highest possible quality.

Rules once thought to determine the distribution of corporate wealth, from the voting rights of shareholders, to the fiduciary duties of boards, to charitable contribution statutes, are all of no relevance, because federal antitrust law requires that firms earn no profits at all but work instead for the exclusive benefit of their customers. I argue in a recent paper that these other rules are preempted by federal antitrust laws that are supreme over all conflicting behavior authorized by state laws.[4] The only exception to supremacy is for behavior that is directly supervised by state regulators.[5] But state regulators do not directly supervise boards' exercise of their state-corporate-law-granted authority to maximize profits. The states do not even require, as they do of many rate regulated firms, that corporations notify regulators of the prices they charge to consumers, let alone meaningfully regulate those prices.

The notion that firms should generate no profits can inspire panic, because of confusion between the accounting and economic definitions of cost. The consumer welfare standard requires that firms charge prices equal to the cost of production, understood to include every last payment required to make the firm maximize the value that the firm creates, including not only payments to labor and management, but also sufficient payments to shareholders to make them willing to contribute capital to the firm. By contrast, the accounting definition of cost excludes payments required to compensate shareholders, which is why in the popular imagination profits are necessary for businesses to exist.

The wealth of the firm, in the economic sense, is what is left over after costs, including sufficient payment to shareholders to secure their participation, have been paid, a froth that can be ladled out to one group or another without crippling the ability of the firm to perform. Advocates of shareholder primacy have long argued that this froth should go to shareholders in the form of the profits generated by high prices; advocates of corporate social responsibility have said that boards should spread this froth fairly among all constituents of the firm, including workers and victims. Antitrust requires that it be paid out in full to consumers in the form of low prices. And antitrust controls.

The fundamental independence of the division of the froth from the problem of creating it – of distribution from efficiency – has long been obscured by the mistaken notion that the firm will perform well only if the party that gets the firm's wealth, sometimes called the residual claimant, also controls the management of the firm.[6] The shareholder rights movement has long argued, for example, that because shareholders have, at least by some accounts, the right to the residual, shareholders ought also have control over the board of directors.[7]

This misguided reading of agency theory, the science of bringing the incentives of managers into alignment with those of owners, establishes no connection between distribution and efficiency. Any share of firm wealth that must be paid to management to align incentives is not profit, but cost, a payment necessary for performance, making the agency problem a pure question of efficiency, not distribution. Moreover, the whole point of agency theory is that the entire wealth of the firm need not be paid out to shareholders, managers, the board, or whoever has control over the firm, in order to ensure performance. Otherwise, managers could never act as reliable agents.

So long as a constant fraction of the firm's wealth is paid out to the controller of the firm, the controller's wealth will grow in proportion to the wealth of the firm, and the right incentives will be created.[8] It is for precisely this reason that firms grant stock options, but not 100 percent ownership, to managers as a performance incentive: Whether a manager owns a share or the entire firm, the incentive to maximize wealth is the same.[9]

Who gets the wealth that remains once that the necessary share has been paid to managers is quite independent of performance, whether the remaining wealth goes to shareholders or consumers. Under the consumer welfare standard, the entire apparatus of agency theory, which has been devoted to determining the proper way to align incentives, but always under the assumption that shareholders are the principal, ultimately getting the firm's wealth, remains unchanged. But the consumer becomes the principal.

Recognizing that antitrust preempts state corporate law rules regarding the distribution of corporate wealth resolves a contradiction in the structure of our economic system: the assumption that the invisible hand visits corporate law, but not antitrust law. Corporate law has long assumed that profit maximization should be the goal of the firm, because private self-interested behavior ultimately benefits society as a whole, competition ensuring that the best firms rise to the top and earn rewards consistent with the value they deliver to consumers.[10]

Antitrust once embraced the invisible hand too, seeing its role as promoting the competition that is an essential requirement for the invisible hand to do its work.[11] Antitrust later embraced the consumer welfare standard, however, because antitrust came to believe that competition is not always good for consumers, eroding the production scales sometimes needed to minimize costs or fund research on improving products.[12] Under the consumer welfare standard, antitrust now tolerates monopoly whenever it appears best for consumers. The assumption in corporate law that beyond the walls of the firm there is always a perfectly competitive market turning greed into good is now dated, abandoned long ago, at any rate, by antitrust.

If monopoly's Cerberus has abandoned its post, then firms must no longer be allowed to maximize profit, because often no market discipline will prevent them from using that authority to raise prices. The corporation must instead internalize the goals that the market once imposed upon the corporation from without. Reading the consumer welfare standard to require firms to minimize profit accomplishes that task.

There is much work to be done. For one thing, the phenomenon of the firm that has more cash than it knows how to invest must come to an end. Apple must rebate the $268 billion that it currently carries on its books to consumers.[13] Firms receiving tax windfalls must pass them on as well.[14]

Of potentially greater long-term importance, firms must cease a whole range of technology-driven pricing practices that are oriented toward extracting maximum value from consumers, rather than merely covering costs. These practices, known as yield management in the airline industry, revenue management in the hospitality industry, dynamic, personalized, or surge pricing to consumers, and price discrimination to economists, seek to maximize profits by charging different groups prices that are different but always targeted at extracting the greatest possible wealth.[15] Airlines must stop charging last minute travelers more; Uber must stop pricing the surge; and "Hamilton" tickets must sell for one low price, not because antitrust has created competition in the market – what show can compete with "Hamilton?" – but because corporate boards have a duty, at pain of law, to charge the lowest possible prices consistent with covering costs.[16]

Corporate law has ignored the arrival of the consumer welfare standard for decades, perhaps because the standard is a meta rule, governing which rules antitrust may apply, rather than speaking directly to defendants about what they should or should not do. Courts have used the standard, for example, to limit the longstanding antitrust ban on collusive behavior.[17] But meta does not mean any less the law. If the consumer welfare standard could be used to limit the scope of the antitrust laws, it can be used to limit the scope of state corporate laws.

In the 1960s, when the Chicago School embarked on a program of restoring laissez faire to American business life, the movement sought two things. First, it sought to replace the prevailing socially-oriented managerialist view of corporate law, which saw the board as responsible for spreading the firm's wealth, with the doctrine of shareholder primacy, which gave pride of place to narrow pecuniary interests.[18] Second, the movement sought to use the consumer welfare standard, which allowed firms to undermine competition in the name of helping consumers, to roll back antitrust.[19] The Chicago Schoolers did not realize that these are fundamentally inconsistent ends. It is time for the law to reconcile them.

Allocating the wealth of the firm to consumers leaves the longstanding problem of oppression of non-controlling constituencies unresolved, because it perpetuates the practice of centralizing corporate wealth in the hands of a single group, now consumers instead of shareholders.[20] Whether management does the bidding of shareholders or consumers, the favored group has an incentive to pressure the board to drive a hard bargain with workers, the supply chain, environmental victims, and other constituencies in order to minimize costs. After all, bargaining determines the size of the payments that are necessary for production to take place, and therefore the size of costs.

Of course, the oppression is tempered if other legal regimes, such as labor law for workers, allows non-controlling constituencies to bring power of their own to the bargaining table.[21] But it is precisely in the uncompetitive markets allowed by antitrust enforcers applying the consumer welfare standard that the bargaining power of these other groups is at its lowest. When the firm is a monopoly, the firm dictates terms. A federal corporate law mandating a more equal division of corporate wealth, or a more progressive tax system, may be needed to address this problem more fully.[22]

In the meantime, throwing off corporate wealth to consumers will surely spread wealth more broadly than it is spread today. The only economic group to which all Americans belong is that of the consumer. Only some Americans own, and many do not work, but all consume, if nothing else than the occasional bite of food. When firms pay their wealth to consumers, they do not pay it all to the poor, but they do pay it to all.

ENDNOTES

[1] *See Larry Fink's letter to CEOs*, BlackRock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[2] *See* Steven C. Salop, *Question: What is the Real and Proper Antitrust Welfare Standard? Answer: The True Consumer Welfare Standard*, 22 Loy. Consumer L. Rev. 336, 336 (2010); John B. Kirkwood & Robert H. Lande, *The Fundamental Goal of Antitrust: Protecting Consumers, Not Increasing Efficiency*, 84 Notre Dame L. Rev. 191, 198 (2008).

[3] For the history of the consumer welfare standard, see Sandeep Vaheesan, *The Evolving Populisms of Antitrust*, 93 Neb. L. Rev. 370, 395–403 (2014).

[4] Ramsi A. Woodcock, *Antitrust as Corporate Governance* (2018), https://papers.ssrn.com/abstract=2246564.

[5] For antitrust preemption and the state action doctrine, see California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc., 445 U.S. 97, 102–5 (1980).

[6] *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 312 (1976).

[7] *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 850 (2005).

[8] Things get more complicated when risk is taken into account, but the principle is the same.

[9] The share must of course be large enough to make the manager better off than the manager would be doing some other job.

[10] *See* Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 22 J. Applied Corp. Fin. 32, 11–12 (2001).

[11] *See* Northern Pacific R.R. Co. v. United States, 356 U.S. 1, 4 (1958).

[12] *See* Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407–8 (2004).

[13] *See* Apple Inc., Annual Report (Form 10-K) 21 (Sept. 30, 2017).

[14] *See What Companies Are Really Doing With Their Tax Windfall (So Far)*, Bloomberg, Jan. 415, 2018, https://www.bloomberg.com/news/articles/2018-01-26/what-companies-are-really-doing-with-their-tax-windfall-so-far.

[15] For a history of these practices, see Robert G. Cross et al., *Milestones in the Application of Analytical Pricing and Revenue Management*, 10 J. Revenue & Pricing Mgmt. 8 (2011).

[16] *See* Christopher Elliott, *Why Can't Airline Tickets Be Transferable?*, USA Today, Dec. 23, 2013, http://www.usatoday.com/story/travel/flights/2013/12/23/airline-ticket-transfer-name-change/4174145/; Ben Popper, *Uber Surge Pricing: Sound Economic Theory, Bad Business Practice*, The Verge, Dec. 18, 2013, https://www.theverge.com/2013/12/18/5221428/uber-surge-pricing-vs-price-gouging-law; Gordon Cox, *'Hamilton' Ticket Prices Hit New High With $1,150 Premium*, Variety, Dec. 26, 2017, http://variety.com/2017/legit/news/hamilton-ticket-prices-1202648756/. Supply is obviously fixed in the case of Broadway and airline seats, and not nearly so variable as price in the case of ride-share seats, making these pricing practices largely about distribution, not efficiency.

[17] *See* Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1, 19–20 (1979).

[18] *See* Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, The New York Times Magazine, Sept. 13, 1970.

[19] *See* George L. Priest, *Bork's Strategy and the Influence of the Chicago School on Modern Antitrust Law*, 57 J. L. & Econ. S1 (2014).

[20] *See* Lynn A. Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (2013).

[21] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439, 442 (2000).

[22] *See* Thomas Piketty, Capital in the Twenty-First Century (Arthur Goldhammer trans., 2017).

This post comes to us from Professor Ramsi Woodcock at Georgia State University. It is based on his recent article, "Antitrust as Corporate Governance," available here.

2 Comments

Comments are closed.

Georgia Dog

This is one of the many examples of the novel but baseless argumentation the academe is famous for. Where is the author's doctrinal support for the proposition that "[t]he corporation must instead internalize the goals that the market once imposed upon the corporation from without"? And where is the empirical support for the proposition that in bygone days, market forces maximized consumer welfare? Misinformation has costs, and we would live in a better world if professors remained silent rather than publish nonsense.

March 28, 2018 at 10:46 am

Chris Bonner

I am stumbling over the concept that contemporary antitrust law has a huge hole in it where the law allows monopolies which benefit consumers. Let's see what the underlying article by Professor Woodcock actually says about that.

March 30, 2018 at 4:47 pm