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NEW PRINCIPLES FOR CORPORATE LAW

*Kent Greenfield**

The fundamental assumptions of corporate law have changed little in decades. Accepted as truth are the notions that corporations are voluntary, private, contractual entities, that they have broad powers to make money in whatever ways and in whichever locations they see fit. The primary obligation of management is to shareholders, and shareholders alone.¹ Corporations have broad powers but only a limited role: they exist to make money. Not much else is expected or required of them.

Those who maintain these principles – a group that includes most of the legal scholars who teach and write in the area – have derived the narrow role of corporations in one of two ways. A few traditionalists take it as an article of faith, developed from a rights-based view of the private nature of corporations.² Such view holds that shareholders are owners, and the corporation is their individual property. Their control is to be respected. Managers are shareholders' agents, and the correct law to apply is the law of property and trusts. Corporations are to serve their owners,

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1. See Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001).

2. Milton Friedman's articulation of the traditional view is the most popular. See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 33.

and the proper stance of government is one of deference, with a light regulator's hand if the hand asserts itself at all.

As more fully developed elsewhere,³ shareholders are not owners in any traditional sense of ownership. They are not owners in any other meaningful way either, if one means that there is something that distinguishes their contribution to the firm from that of other stakeholders. Historically, the corporation was a public institution with public purposes; shareholder primacy is a historically recent phenomenon.⁴ An argument that corporate governance operates in the realm of natural rights is a difficult, unpersuasive, and increasingly undefended contention: few of even the most vehement proponents of shareholder primacy make it anymore.

Instead, the best and most thoughtful argument for shareholder primacy is not a rights-based claim, but an instrumental one. Maintaining the narrow role of corporations and of corporate governance is the best way to benefit society as a whole.⁵ Requiring corporations to serve shareholders first and foremost results in a better society than if the rule were something else.

The problem with the instrumental claim is that it is largely unsupported by empirical data and untested by rigorous counterargument.⁶ Absent both, the instrumental claim for shareholder primacy reveals itself to be as founded on faith as the traditionalists' rights-based arguments. The instrumentalist justification is often merely a *post-hoc* explanation for the status quo rather than a serious examination of what society's "best interest" would require in corporate governance.

3. See Kent Greenfield, *Using Behavioral Economics To Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 591-601 (2002) [hereinafter Greenfield, *Using Behavioral Economics*]; Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998) [hereinafter Greenfield, *The Place of Workers*].

4. See generally MORTON HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 65-107 (1992) (describing the development of corporate theory in the latter half of the 19th century).

5. See Hansmann & Kraakman, *supra* note 1, at 441 (stating view that "all thoughtful people" agree that business should be organized to "serve the interests of society as a whole").

6. See Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409, 1422-26 (2002) (partial response to Hansmann & Kraakman's arguments).

This article takes a novel approach to developing a set of principles and policies for corporate law, starting with a focus on society's well being. With society's interest as the explicit foundational principle, other principles for the regulation of corporations emerge that are strikingly different from the status quo. The principles derived here, five in all, begin at a high level of generality and become more particular and presumably more controversial. Nevertheless, all of them are rational, practical, and rooted in the protection of the public good. If adopted, these new principles and proposals would provide the basis for significant change in the way we govern corporations in this country.

Of course, the foundational assumption that society's interest should be pursued will not satisfy those who see corporate law as governed by the realm of rights. Indeed, this article will not convince anyone who starts with the assumption that businesses can be run by their shareholder-owners as they see fit. For most people honestly wrestling with issues of corporate governance, however, shareholder primacy is not the foundational assumption but rather one of the potential conclusions. What this article makes clear is that other potential conclusions exist as well.

Let us start at the beginning.

PRINCIPLE ONE:
THE ULTIMATE PURPOSE OF CORPORATIONS SHOULD BE
TO SERVE THE INTERESTS OF SOCIETY AS A WHOLE

Imagine a situation in which a corporation is thriving. Its shareholders, workers, and various investors enjoy healthy returns on their contributions and are all content with the stability and quantity of their earnings. Also imagine that this corporation, while producing wealth for its investors and workers, spins off costs that, on balance, ultimately hurt society. These costs might arise for any number of reasons: perhaps the product itself is dangerous, the mechanism of production creates pollution, or the company perpetuates racial prejudice with its advertisements or hiring practices.

Such a situation would be untenable. No corporation, even one making money for its core constituents, should be allowed to continue unchallenged if its actions harm the rest of us. The corporation's prerogatives do not depend on any natural or human right. It is an instrument to serve the collective good, broadly defined. If it ceases to serve the collective good it does not deserve to continue, at least not in the

same way. If we knew that all corporations, corporations of a type, or even an individual corporation created more social harm than good, no society in its right mind would look the other way and no state would willingly grant their formation.

One would hope that this first principle were obvious. Unfortunately it is not, at least for one reading corporate law cases and books or sitting in on business courses in law or business schools. With the occasional exception, most judges and mainstream corporate law scholars take shareholder supremacy as the lodestar.⁷ The concerns and interests of the public are largely ignored.

Principle One therefore has meaningful doctrinal and theoretical implications. First, such an insight would mean that externalities do, in fact, matter. A company cannot be considered a success if the total social value it creates is less than the social costs it throws off. If the interests of society as a whole are what matters, then one cannot look just at the profit a company (or an industry or economy) makes in order to know if it is successful. One has to look at the cost side of the equation as well.

Of course both “social value” and “social cost” are elastic terms, and, as discussed below, it may be difficult to define them precisely. What is crucial to note here is the importance of defining both benefits and costs broadly. Benefits include not only profit to the shareholders but also workers’ earnings, the stability a company brings to communities in which it does business, the quality and importance of the company’s products or services, and more. Costs include pollution, over-use of scarce resources, harmful effects of the company’s products or services, mistreatment of employees, and even more abstract externalities such as the company’s reinforcement of harmful stereotypes. Ultimately, we cannot assess the social value a company creates simply by looking at its financial disclosures. One has to know about the company’s product or service, how it treats its workers, and whether it is a good citizen in the community. Even if their balance sheets were fiscally identical, a drug store that offers prescriptions at a fair price, treats its employees with dignity, and sponsors a local playground is more socially valuable than a strip club that waters down its drinks, exploits its employees, and sponsors amateur nights.

7. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”).

This leads to the second implication of Principle One, namely that we need to do a better job of measuring whether corporations in fact serve the interests of society as a whole. Because we signal what is important by what we measure, whether it be in a child's first grade class or in the world of business, it appears that what we believe to be truly important for businesses is their financial health. Public corporations are required to file various financial reports to the government and to shareholders.⁸ These reports are vital to ensuring that the shareholders and the public are well informed about the company's fiscal health. Untruthfulness can lead to both civil and criminal sanctions.⁹

Principle One means that the traditional fixation on financial reporting is under-inclusive. Even though a company's narrow-gauged financial reports are popularly cited as a measure of the company's worth, they do not come close to reporting a business's true value. Companies should be measured on more than their finances – if externalities count, we must try to count them. These reports do not disclose the value of the company to its workers or to the communities in which it does business. They do not report on the environmental costs of the company's products or services, except insofar as such costs are relevant to shareholders (such as the costs arising from lawsuits). They do not report whether the company has been complicit in human rights violations. Indeed, there is no general obligation on the part of companies to gather information about, much less publicly report on, the true costs and benefits of their activities.¹⁰ The absence of

8. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (“A fundamental purpose [of the Securities Act of 1933 and Securities Exchange Act of 1934] was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”); *see generally* Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a et seq. (2005)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a et seq. (2005)).

9. *E.g.*, Securities Act of 1933 § 24, 15 U.S.C. § 77(x) (penalty of up to \$10,000 or imprisonment for up to five years for violation of the provisions of this title).

10. To be fair, businesses are indeed required to measure and report on a few specific matters that are important to society's interests: for example, certain employment statistics relevant to the company's obligation not to discriminate. *See* 42 U.S.C. § 2000e-8(c) (2005) (requiring employers to keep records relevant to legality of employment practices and submit reports to EEOC). Also, companies report on the presence of certain dangerous chemicals in the workplace, relevant to their responsibility to maintain healthy work environments. *See* Occupational Safety and Health Act of 1970 (OSHA), Pub. L. No. 91-596, 84 Stat. 1590 (codified as 29 U.S.C. §§ 651 et seq. (2005)); 29 C.F.R. § 1910.1200 App. E (2005) (providing that “employees have both a need and a right to know the hazards

this information is remarkable. If what is important is the company's contribution to the society as a whole, it is odd indeed that even the largest companies are not required or even encouraged to account for their social impact.

This information is important not only to citizens interested in knowing the true impact of a company, but also to the decision-makers within the company itself. Just as we measure what is important, we pay attention to what we measure. When public policy requires corporations to report only on finances, corporate decision-makers will, accordingly, make decisions as if that is their only concern. If public policy required corporations to make a more robust accounting of their activities, corporate decision-makers would take a broader view of their responsibilities. Corporate decision-makers urged to focus only on shareholder return inevitably will make decisions differently than those who are urged to take account of broader goals and measures.

It is unnecessary here to articulate precisely the details of any new reporting scheme for corporations. Sufficient now is to note that a number of scholars have proposed broader social accounting measures for corporations¹¹ and that the general idea makes sense. At the very least, and I do mean the *very* least, corporations should be required to tell the truth to their core constituents as they are required to do with their shareholders. Currently, companies do not even have an enforceable obligation to be truthful to their employees.¹²

A final implication of Principle One is worth highlighting. A common notion in corporate law doctrine, business training, and even government regulation is the importance of sustainability: the ability of businesses to survive over time. In this view, the worst thing a company can do is fail. Judges in corporate law cases guard against it; business students learn how to avoid it. Government regulators craft regulations on everything from pollution to worker safety using business sustainability as a key constraint. One example is regulations enforcing the Occupational Safety and Health Act.¹³ Businesses are required to maintain safe and healthful work

and identities of the chemicals they are exposed to when working.”). Even these additional requirements, however, are spotty and haphazard.

11. See, e.g., Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1300-05 (1999).

12. See generally Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 Yale L.J. 715 (1997).

13. 29 U.S.C. §§ 651 et seq.

environments, but only to the extent that the requirement to do so is consistent with the need of the businesses to survive over time.¹⁴ Even corporate law scholars identified as more progressive often use the touchstone of sustainability as a guide.¹⁵

Of course this attention to sustainability is important. A corporation creating wealth for society must sustain itself over time in order to maximize its value to the society it serves. But note the condition on that statement: a corporation *creating wealth for society* must sustain itself. Not all corporations do that. For those that do not, sustainability is either beside the point or affirmatively harmful. Sustainability is only crucial if a corporation satisfies the obligation inherent in Principle One. If a corporation sustains itself by extracting net wealth from society and transferring that wealth to its shareholders, managers or others, then it should be stopped. In other words, some companies *should* fail.

I am not suggesting that it will be obvious which companies should fail and which should not. Nor am I advising that some government official be given the power to make such a choice. However, as a matter of doctrine, theory, and law, the fixation on sustainability is both distracting and at times detrimental to the public good. What is crucial is the question of how we construct a legal framework for corporations that maximizes the probability that businesses serve the interests of society as a whole.

PRINCIPLE TWO:
CORPORATIONS ARE DISTINCTIVELY ABLE TO CONTRIBUTE
TO THE SOCIETAL GOOD BY CREATING FINANCIAL PROSPERITY

One cannot go very far in a discussion about guiding principles for the regulation of corporations without noting what is special about them: they are especially able to create wealth. Modern public corporations bring together a number of characteristics that distinguish them from other kinds of businesses and that make them particularly successful in making money.

14. *See Indus. Union Dep't v. Amer. Petroleum Inst.*, 448 U.S. 607 (1980) (suggesting that exposure limits for carcinogenic material must be regulated to the point of economic feasibility).

15. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 280-81 (1999) (arguing that the responsibility of a board of directors of a public corporation is to keep "everyone happy enough that the productive coalition stays together").

These traits include easy transferability of shares, limited liability, specialized and centralized management, and a perpetual existence separate from their shareholders.¹⁶ The easy transferability of shares allows thousands or even millions of small investors to finance the equity portion of a company; companies that would not exist if they had to be funded with a small number of large investments are able to have a go at it. With more investors, companies can grow larger and take advantage of efficiencies from economies of scale. Limited liability reassures investors that they will not suffer personal liability if the company fails or is unable to pay its debts. Shareholders can buy small numbers of shares and are protected from personal liability for the acts of the company; they can delegate managerial duties to hired specialists who owe their jobs to their ability to make the company successful. The separate legal existence of corporations makes it possible to sustain them over time, even as shareholders and management change.

These and other characteristics make for a very powerful money-making institution. Other business forms – whether partnerships, sole proprietorships, privately-held corporations, or newer forms such as limited liability companies – have their place and have made people rich. But none of them is as broadly successful as the public corporation in providing the framework for large business enterprises.

These unique characteristics are creations of law. None of them would be available without sanction by the state. This is obviously true with regard to limited liability and the perpetual life of corporations, but it is also true with the other characteristics, if only in a less direct way. Even specialized management, for example, is encouraged and protected by law.¹⁷ The corporate laws of most states protect the management prerogative of the board of directors and thereby limit the power of shareholders to make managerial decisions for the company.¹⁸ The very framework of corporate law is rightly considered a subsidy for business: an explicit encouragement and facilitation of wealth creation through the corporate form.

16. Kim Brooks, *Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax*, 36 U. B.C. L. REV. 621, 645-46 (2003).

17. Wilson McLeod, *Shareholders' Liability and Workers' Rights: Piercing the Corporate Veil under Federal Labor Law*, 9 HOFSTRA LAB. & EMP. L.J. 115, 193-94 n.341 (1991).

18. See, e.g., 8 Del. Code § 141 (2005).

Seen in this way, society establishes the framework of corporate law in order to create the space in which large public corporations can be one of the crucial engines of wealth creation in the economy. Corporations are not the only engine of wealth creation, as governments, universities, small businesses, individual entrepreneurs, inventors and even stay-at-home parents contribute to the creation of surplus. Public corporations do, however, occupy a special place. They are specially constructed so that making money is their comparative advantage. It is a mistake, therefore, to assume that corporations should act altruistically in the same way as churches, families, schools, or social service organizations. Corporations are institutions with a distinctive purpose: to create wealth. If they stop creating wealth, they are failures.

It follows, then, that a corporation that does nothing more than create wealth for its shareholders, employees, and communities is providing an important social service. Even if the corporation does nothing else to advance social welfare (and, importantly, assuming Principle One is otherwise met), the corporation has satisfied its purpose for existence. Here I differ from some other critics of the corporation.¹⁹ It may be a good thing if a business provides meaning for people who work there, finds a cure for cancer, or funds the local symphony. All these things add to the positive side of the social benefit “ledger,” but they are extras. A company that is otherwise a neutral, lukewarm actor in society can still be counted as a success, *if* it creates wealth for society. Indeed, care should be taken that over-regulation of corporations does not destroy their ability to contribute to society by building wealth for it.

Also, Principle Two means that there are some social goods that we should not expect corporations to produce on their own.²⁰ We have created an entity with a drive to make money; we should not expect it to act altruistically. Other social institutions – government or non-corporate private groups – must step in to provide goods and services that the market cannot profitably provide.

19. See Douglas Litowitz, *Are Corporations Evil?*, 58 U. MIAMI L. REV. 811 (2004); C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective For the Twenty-first Century*, 51 U. KAN. L. REV. 77 (2002).

20. See generally Greenfield, *supra* note 6, at 1411-14 (arguing that the public mistakenly trusted for-profit airlines to provide for safety and security before the September 11, 2001 attacks).

The obvious question here is how Principle Two differs from the mainstream view. There are a number of distinctions. First of all, creation of wealth includes more than just shareholder gain. This follows from Principle One. We must also include the value to employees of their jobs and the social worth of the goods or services sold, as well as the multiplier effect on other businesses that provide raw materials, transport the end product to market, or sell sandwiches to the employees at lunchtime. Also, the “extras” discussed above – whether corporate philanthropy or a cure for cancer – certainly factor into the social accounting.

Second, as social values go, the creation of wealth is not at the top of the hierarchy. Other values are more important than wealth. Here we must only consider how we act individually. Sure, as individuals we need money to survive and we each strive to earn at least enough to provide for ourselves and our loved ones. Very few of us, however, act as if earning money is the most important thing in our lives. Those who do, in fact, seem odd and out of place, even in a society as competitive and consumer-oriented as our own. As individuals we value other things more than our money – time with our families, our health, whether the Red Sox will win a World Series again. This is not to say that money is unimportant, but there are many things we cherish that have little or nothing to do with how monetarily valuable they are. Wealth is an instrumental value, not an end in itself.

Even collectively we often make decisions to put other values ahead of wealth. We strive to end racial injustice, even if such efforts “cost” us in terms of financial wealth. We protect pristine wilderness areas not because of their financial value but because we enjoy walking in deep forests or – more profoundly – we value the idea that deep forests exist, even if we never get to walk in them. We prohibit companies from discriminating against potential employees on the basis of their disability, even if such disability is costly to accommodate. We collectively value justice, fairness, equality, and human rights even though it “costs” money and resources to protect them.

What this means is that the corporation should be considered warily. While it is especially capable of creating wealth, it is not (absent some regulation) adept at taking care of other values, many of which are even more important than wealth. Justice Brandeis said it best, in explaining the historical basis for greater regulation of the corporation:

The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in

corporate form were inherent in the citizen; and has led them to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life and, hence, to be borne with resignation. Throughout the greater part of our history a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations.²¹

A wariness of corporations is healthy, given the form and powers we have bestowed upon them.

This wariness leads to the third difference between these Principles and the mainstream view of corporate law. Corporations are good at making money, but they can create massive social costs as well. Our collective attitude of wariness should thus translate into a willingness to regulate the corporation to ensure it uses its ability to make money (Principle Two) to further the collective good rather than just its shareholders (Principle One). The necessary regulation can come as external pressures on the corporation or can come internally, as changes in corporate governance rules themselves. As an example of an external regulation, we could tax corporations an amount roughly equivalent to the net negative externalities they impose on society. If we wanted to act internally, we could change corporate governance to make firms more attuned to social good or to cause the firm's surplus to be shared more equitably.

The ability to create wealth is a very important power of corporations. As any powerful force, it needs to be constrained and regulated to ensure it does not careen out of control. The guiding standards for this regulation are the focus of Principle Three.

21. *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548-49 (1933) (Brandeis, J., dissenting).

PRINCIPLE THREE:
CORPORATE LAW SHOULD FURTHER PRINCIPLES ONE AND TWO

This Principle is simply the concept that *law* is necessary to ensure the first two principles are satisfied. If corporations are to serve the interests of society (Principle One) and do so primarily by creating wealth (Principle Two), we need law to make sure those principles are met. Corporations will not, through their own generosity, internalize the external costs of their decisions or keep an eye on the social benefits they produce. Perhaps ironically, because the legal characteristics we give to corporations make them so capable of making money, we need to constrain them with other laws and regulations. Otherwise, a small group of managerial or shareholder elites is likely to gain at the expense of the rest of society.

This principle – that we need law to ensure the first two principles are satisfied – borders on the obvious. Few would contest the claim that corporations need to be regulated to keep them focused on their primary responsibility and to ensure they do not create undue social costs. Examples of the former kind of regulation are the corporate law duties of care and loyalty, which require managers to perform their tasks diligently and without acting on the basis of self interest,²² and a company's obligation to report its financial performance publicly.²³ An example of the kind of corporate regulation to protect against social costs is the requirement that companies provide a safe and healthful workplace for their employees.²⁴ These examples are straightforward.

Often ignored, however, is the fact that existing corporate law routinely makes the satisfaction of Principles One and Two *less* likely. The most obvious example is the requirement in corporate law that directors look after the interests of shareholders first and foremost.²⁵ Consider the situation in which a board of directors of a public company makes a decision that benefits its employees financially but imposes long-term costs on shareholders. Also assume that the board makes the decision because they have determined that benefits to the employees would far outweigh the costs to shareholders. Such a decision would violate the board's duties

22. See, e.g., Cal. Corp. Code § 309 (2005); 8 Del. Code § 144 (2005).

23. See generally Securities Act of 1933, 15 U.S.C. §§ 77a et seq.; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq.

24. See generally OSHA, 29 U.S.C. §§ 651 et seq.

25. Dodge, 170 N.W. at 684.

under existing law.²⁶ The directors might be able to protect themselves from suit, but only if they lie about their real reasons for doing what they did.²⁷

This is why it is necessary to articulate what should also be obvious – law should not prohibit corporate decision-makers from taking into account the very societal interests in whose name the corporation was created in the first place. What is needed instead is a rule of corporate governance that would require corporate directors to take a broader view of their responsibilities and of the responsibilities of the corporation itself. If we mean to create institutions that create financial wealth for an expansive range of stakeholders, the rules governing those institutions should align with that purpose rather than work against it.

There is another way in which existing corporate law is directly contrary to Principles One and Two: the dominance of Delaware. Under Principle One, because externalities must count in the social calculus, it follows logically that corporate governance rules should make it easier for corporations to know about such externalities and to take them into account. Also, under Principle Two, the interests of *all* stakeholders count when we measure the corporation's ability to create wealth. One would therefore expect that the best corporate governance rules would encourage such a sharing of the corporate surplus.

Unfortunately, Delaware's dominance in providing corporate governance rules makes both of these progressive policies impossible to implement. As I have argued elsewhere, Delaware externalizes the true costs of its corporate rules onto other states and non-shareholder stakeholders.²⁸ It constructs rules that benefit shareholders and managers at the expense of everyone else, and does so with impunity.²⁹ In other words, regardless of whether Delaware's dominance is a "race to the top" or a

26. *Id.*

27. The business judgment rule would likely protect the directors' decision if they said that what they were doing was serving the corporation in the long term even if it was not in fact the case. *See Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968). On the other hand, the business judgment rule would not protect the directors if what they were doing was in fact in the long term interests of the corporation but they said that they were acting in order to serve society. *See Dodge*, 170 N.W. at 684.

28. Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135, 137 (2004).

29. *Id.* at 136-38.

“race to the bottom” from the standpoint of shareholders, it is only a race to the bottom from the public’s perspective.

One possible response to the arguments so far in favor of Principle Three is that, even if Principles One and Two are correct, it is unnecessary and even counter-productive to have corporate law mandate that corporate managers do anything but look after shareholder interests. Corporations make money, and if we want them to act in a certain way then we should impose external costs, such as taxes, fines, and other penalties. Easterbrook and Fischel make this point, arguing that society is better off when it “conscript[s] the firm’s strength (its tendency to maximize wealth) by changing the prices it confronts.”³⁰ A change in corporate structure to make the firm “less apt to maximize wealth” will yield less in both wealth and social goals.³¹ A similar argument could be made about Delaware. The argument would be that Delaware’s dominance derives from its ability to provide a set of corporate laws that best maximizes the firm’s ability to maximize wealth. To weaken its preeminence would gain society little in non-monetary goods but weaken firms’ ability to build wealth.

A rejoinder to this counter-argument would start with pointing out how truly awkward it is to assert that corporate managers best advance societal well-being by ignoring it. Not even Adam Smith’s invisible hand was assumed to be so powerful that people should be *prohibited* from taking the interests of others, or society in general, into account.³² Yet that is exactly what corporate law claims to do and what most corporate law scholars assert that it *should* do. It is a tough argument to make, however, and few take the trouble to articulate it fully.

From what I can make out, however, the mainstream view contains three separate claims. First, advancing shareholder wealth advances societal wealth.³³ Second, broadening managers’ responsibilities to include other stakeholders in fact releases them from any real responsibility.³⁴ Third, it is more efficient to regulate corporations from the outside than from the inside.³⁵ These claims can be answered.

30. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 38 (1991).

31. *Id.*

32. 2 ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 687-88 (R.H. Campbell & A.S. Skinner eds., Liberty Fund Press 1981) (1776).

33. Easterbrook & Fischel, *supra* note 30, at 38.

34. Sol Picciotto, *Rights, Responsibilities and Regulation of International Business*, 42 *COLUM. J. TRANSNAT’L L.* 131, 135 (2003).

35. Hansmann & Kraakman, *supra* note 1, at 442.

The first claim is that we need not worry about non-shareholder interests, since looking after shareholders will inevitably help other stakeholders as well.³⁶ At one level this claim is true; a company that is losing money is not much good to anyone. Once the argument gets beyond that, however, the claim becomes much more tenuous. A firm that makes money for shareholders does not necessarily create wealth for others or for society. Without a mechanism to internalize externalities or to share profits there is no inevitable gain on the part of workers or society. The “trickle-down” is not inevitable. Indeed, shareholder profit could result from a transfer of wealth *from* the company’s employees or from society generally. For example, by some accounts Wal-Mart’s employee wages are so low that its workers must subsist on a range of government assistance programs.³⁷ In effect, therefore, government programs are subsidizing the profits of Wal-Mart shareholders. According to one Congressional study, the federal taxpayers subsidize Wal-Mart over \$2,000 per employee per year.³⁸

Moreover, a fixation on shareholder interests will result at times in managerial decisions that are overly risky from society’s perspective. Because shareholders are protected by limited liability, and thus suffer only a portion of the costs of bad decisions, they tend to prefer decisions that may have a high risk of failure but also a high possible payout. But society’s cost/benefit analysis is different, since all costs have to be accounted for.

Even at its strongest, this first mainstream claim is not an assertion that a broader view of corporate obligations is a bad idea. It is a claim that a broader view is *unnecessary* because the existing scope of duties is good enough not only for shareholders but for society as well. There is little reason to believe this, however, other than as an expression of faith. On the contrary, there is reason to believe that adding to managers’ fiduciary

36. Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 47 (2004) (quoting Milton Friedman’s invisible hand theory that “all stakeholders are automatically protected, . . . if we allow corporations to do what they do best: maximize profits”).

37. DEMOCRATIC STAFF OF HOUSE COMM. ON EDUCATION AND THE WORKFORCE, EVERYDAY LOW WAGES: THE HIDDEN PRICE WE PAY FOR WAL-MART 8 (Feb. 16, 2004) (report by Rep. George Miller), available at <http://edworkforce.house.gov/democrats/WALMARTREPORT.pdf> (last accessed Mar. 21, 2005).

38. *Id.* at 9.

duties to require them to consider other stakeholders will in fact make companies *better* able to make money. This is discussed more below.³⁹

The second claim made by mainstream scholars is that a broadening of corporate responsibilities actually makes it easier for managers to avoid responsibility.⁴⁰ This argument differs from the first in that it *does* include the ironic allegation that society will be made worse off by a rule requiring its interests to be considered.⁴¹ The argument goes like this: if corporate managers have more than one “master,” they can play masters off of one another, much like a child might play parents off of one another.⁴² Instead of the child (the manager) owing a duty to obey both parents (shareholders, other direct stakeholders, and the public at large), the child (manager) will be loosed from obligation to either. This is the economists’ “agency costs” argument: enlarging the duties of management will increase the agency costs inherent in managing the firm, since it will be more difficult to monitor whether the managers are in fact doing their jobs carefully and in good faith.⁴³

I think this is the Emperor’s New Clothes of corporate law scholarship – an assertion that is made so often and so loudly that few question it anymore. But the argument is overblown and dubious; it is rarely used outside the setting of corporate law. It is worth remarking, initially, that this claim is in conflict with the first assertion of mainstream scholars. If the interests of shareholders and other stakeholders are not in conflict then agency costs will not rise much if the law requires managers to take into account the interests of other stakeholders. The mainstream theorists cannot have it both ways: claiming on one hand that we do not need to take care of non-shareholder stakeholders because their interests coincide with shareholders, and on the other hand saying that the sky will fall once their interests are taken into account.

39. See Greenfield, *Using Behavioral Economics*, *supra* note 3; Kent Greenfield & Peter C. Kostant, *An Experimental Test of Fairness under Agency and Profit-Maximization Constraints (With Notes on Implications for Corporate Governance)*, 71 GEO. WASH. L. REV. 983 (2003).

40. JOE BAKAN, *THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER* 34 (2004).

41. *Id.* at 33 (quoting from an interview with Milton Friedman that moral virtue is immoral when it does not serve the bottom line).

42. EASTERBROOK & FISCHEL, *supra* note 30, at 38. The seminal case is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (outlining obligations inherent in duty of care).

43. THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE, *The Rise of Regulatory Capitalism: The Global Diffusion of a New Order: The Global Diffusion of Regulatory Capitalism*, in 598 ANNALS 12, 21 (David Levi-Faur, Jacint Jordana eds., 2005).

My view is that there is indeed a conflict between the interests of shareholders and other stakeholders in a range of cases. I do not believe, however, that such conflict is a reason to fear that managers cannot handle such responsibility or that it would be impossible to know whether managers are doing their jobs well. Of course it is true, in a mundane way, that someone who has two responsibilities may have more difficulty meeting both than if she had only one. But people routinely have more than one responsibility, some of them even conflicting, and we do not helplessly throw up our hands. For example, Boston College pays me to be both a scholar and a teacher. It is not impossible to tell if I am a good scholar even though I am a teacher as well. What's more, one could still judge whether I am a good parent or neighbor even though I am dedicated to my professional endeavors. Humans are quite accustomed to having a range of obligations.

This is true even in business institutions. Corporate directors and managers, in actual practice, routinely balance a number of obligations, some arising from corporate law, some from other areas of law, and some from the market itself. Corporations, for example, regularly issue different classes of stock that afford different rights.⁴⁴ Directors owe fiduciary duties to holders of all classes of stock even when the interests of the various classes are in conflict.⁴⁵ The fact that these interests might conflict in some cases does not mean that corporations should not issue different classes of stock.

The only way that more and broader responsibilities would make it easier for managers to avoid responsibility is that they could use one obligation as a defense to a claim that they failed in meeting another. This, however, is more of a function of how responsibilities are *enforced* than of the responsibilities themselves, and corporate law duties are simply not enforced in that way. Consider the duty of care, for instance. When courts enforce that duty, they reduce it essentially to a procedural duty – to investigate various alternatives, to look at the various possible outcomes, and to take the time necessary to make a good decision.⁴⁶ If managers were required to take account of, for example, workers' interests, the duty of care would be enforced in the same way it is now. No manager would be able to erect a defense to a shareholder claim by saying she was unable to

44. MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 161 (1995).

45. *Id.*

46. EASTERBROOK & FISCHER, *supra* note 30, at 98-99.

pay attention to the impact of the decision on shareholders because she was thinking at the time about workers. The managers would have to do *both*.

Similarly, the duty of loyalty would not be loosened if managers were required to look after non-shareholder stakeholders. In corporate law, loyalty requires managers to not engage in self-dealing.⁴⁷ Such an obligation would not be weakened by including workers among the beneficiaries of managers' fiduciary duties. Rather, adding to the number of people who benefit from managers' fiduciary duties will make it *more* difficult for managers to self-deal as more corporate stakeholders will have an interest in monitoring managerial conflicts of interests. A manager will not be able to defend a duty of loyalty claim brought by a shareholder by saying that she was actually working for the workers. That would be nonsense. A loyalty suit is essentially about theft – and theft from both shareholders and workers is no more defensible than stealing from shareholders alone.

Looking behind the curtain of the agency cost argument, we find the *real* worry of the mainstream theorists is that adding to the responsibilities of management will make it less likely that management will act as agents of the shareholders. I agree, but that begs the question. It makes no sense to argue that shareholders should be supreme because any other rule makes it harder for them to be supreme. Other stakeholders make important contributions to the firm and all of them depend on management to use those contributions to create wealth. All stakeholders depend on managers and must therefore monitor them. A shareholder primacy rule makes it more difficult for these other stakeholders to depend on management, raising their agency costs. A relaxation of the shareholder primacy model might increase the agency costs of shareholders, but it will *decrease* the agency costs of non-shareholder stakeholders, and their agency costs are just as important as shareholders'. To say that only shareholders should have a rule that lowers their agency costs assumes shareholder primacy. In other words, we cannot justify the rule of shareholder supremacy by pointing to shareholder agency costs unless the agency costs of other stakeholders are discounted and non-shareholder agency costs can only be discounted if shareholders are supreme.

So, the mainstream contention that corporate law should focus on shareholders alone reduces to the third and final claim that it is more efficient to regulate corporations from the "outside" than from the "inside."

47. See Cal. Corp. Code § 5233 (2005).

Sometimes, this argument depends on the mistaken assumption that corporate law is private law and that corporate governance should be insulated from regulation because of the “rights” of shareholders or of the corporation itself.⁴⁸ I have, I hope, dealt sufficiently with this argument elsewhere.⁴⁹ Here, the only point that remains is an empirical one. If we want to regulate corporations to serve Principles One and Two, are we better off using corporate law along with other regulatory mechanisms or just those other mechanisms alone?

Even progressive corporate scholars disagree on this point.⁵⁰ My own belief is that corporate law is a significant untapped resource and that we would be better off if corporate law reinforced other regulatory initiatives rather than stood alone. I and others have gone into more detail elsewhere,⁵¹ but consider here why corporate law could be a powerful regulatory tool.

Allow me to begin with an analogy. Imagine that we have a goal of reducing water pollution and that we are considering two possible regulatory choices. The first allows companies to pollute but then taxes them in order to pay for cleaning any pollution they caused. The other requires corporations to change their internal practices to reduce the amount of pollution. The second one will likely be much more efficient in reducing pollution at low cost, and the reasons are fairly obvious. It is often cheaper to avoid a problem than to rectify it later, and it is often better to give the responsibility to avoid a problem to the person who knows most about it and can avoid it most cheaply.

The same would be true about a range of public policy issues related to businesses and the economy. Indeed, corporate law has comparative advantages over other kinds of law in addressing certain kinds of concerns. For example, because the principal measure of whether corporations meet their obligations is whether they create wealth for a broad range of stakeholders (Principle Two), it is likely to be more efficient to have that goal be included among the corporation’s own objectives rather than having government redistribute the wealth after the fact. Redistribution is

48. Greenfield, *Using Behavioral Economics*, *supra* note 3, at 591-601.

49. *Id.*

50. See Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 *LAW & CONTEMP. PROBS.* 109 (2004).

51. Greenfield, *Using Behavioral Economics*, *supra* note 3, at 581; Greenfield & Kostant, *supra* note 39, at 983.

important, to be sure, but it would be more efficient to distribute the corporate surplus more fairly to begin with. Indeed, a fair distribution of corporate profits to employees will likely have significantly positive multiplier effects (such as workers being more productive because they feel they are being fairly treated) that would not likely occur with bare redistribution initiatives.

Another reason why it would likely be better to have corporate law reinforce Principles One and Two rather than work against them is that corporate managers may have expertise in areas that government bureaucrats do not. Moreover, there may be efficiencies in a corporate setting that do not exist in a governmental setting. A broadening of corporate responsibilities may allow corporations and their management to be proactive in addressing issues of social concern which, in turn, might be more efficient than relying on the mostly reactive power of government regulation. Finally, progressive changes in corporate governance would affect the corporation wherever it does business whereas regulatory reforms largely stop at the border.

More could be said, but for now note that there seems to be no good reason to insulate corporate law from the same obligations of other areas of law – that is, to serve as a mechanism to move our society closer to what we want it to be. The mainstream claim that corporate law should serve only the interests of the shareholder and managerial elite is highly suspect, especially if we believe that the purpose of corporations is to serve society as a whole rather than a small wealthy minority.

Once we agree that corporations should be measured by how they advance the interests of society as a whole, that corporations have a comparative advantage in building wealth for all of its stakeholders, and that corporate law should reinforce these principles, the question becomes how specifically corporate governance might advance these goals. Principles Four and Five focus on this question.

PRINCIPLE FOUR:
A CORPORATION'S WEALTH SHOULD BE SHARED FAIRLY
AMONG THOSE WHO CONTRIBUTE TO ITS CREATION

To explain Principle Four, one must start with the non-controversial idea that corporations are distinctively collective enterprises. Corporations require a multitude of inputs, all of which are essential. The firm needs financial capital, which they get from equity investors, debt creditors,

consumers who pay money for the firm's goods and services, and sometimes from government. The firm depends on labor, which they get from salaried employees, hourly-wage workers, and independent contractors. The firm depends on infrastructure, which comes from governments of various stripes. Finally, the firm depends on a social fabric of laws and norms that create and sustain the marketplace and enable a stable society in which the company can operate. The notion that corporations depend on multiple stakeholders is implicit in most theories of the firm and is not particularly contentious. The difficulty, of course, is what to do with that insight.

The mainstream view of what to do with the insight is nothing; the shareholder is supreme and should be the sole beneficiary of the management's fiduciary duties.⁵² The management's sole obligation within corporate law is to serve the shareholder, usually by maximizing the share price.⁵³ The others that contribute to the firm protect themselves through contract or government regulation. The management has no obligations to these additional stakeholders other than those that arise from their market power, from contractual commitments, or from some non-corporate source of law.⁵⁴

Once we take Principle One to heart, however, this fixation on shareholder gain is revealed as a mistake. It is not based on a shareholder "right" to the exclusive attention of the management, and it is unlikely to further the interests of society as whole. Rather, the real reason for shareholder primacy in corporate *law* has to do with the primacy of shareholders in the *market*. Capital is much more mobile than labor or infrastructure, so it can extract in the corporate "contract" the right to be the sole beneficiary of management's fiduciary duties. This does not settle, of course, the normative argument. The market is a creature of law, and law can certainly constrain it. The law need not mimic the market's power hierarchy. Indeed, if the purpose of corporate law is to serve society as a whole, the law emphatically should not mimic the market.⁵⁵

52. Friedman, *supra* note 2.

53. *Id.*

54. *Id.*

55. See DANIEL J.H. GREENWOOD, DEMOCRACY AND DELAWARE: THE PUZZLE OF CORPORATE LAW (George Washington Univ. Law School, Public Law & Research Paper Series No. 55, 2003) (discussing the difference between market allocation of goods and a democratic allocation of goods), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=363480.

An alternative to the market arrangement for corporate law is one in which the collective nature of the firm is recognized by equitable sharing of the corporate surplus. Let us set aside for the moment the issue of how to enforce such a sharing. For now, let us focus only on the question of whether a fair sharing of the corporate surplus would be a beneficial component of a corporate law that takes society's collective interests as its lodestar.

There are two related arguments for such an arrangement. First, a norm of fair allocation of the corporate surplus would be better for firms themselves over time. Many of the stakeholders in the firm make firm-specific "investments" – whether of capital or labor or infrastructure – meaning that their contributions are much more valuable in the particular firm than they would be generally.⁵⁶ This is great for the firm because the firm can then take advantage of and build on the knowledge and expertise of its investors, suppliers, communities and employees over time. The problem that has bedeviled corporate economists, however, is that the more firm-specific investments a stakeholder makes, the greater the risk. The firm may collapse, violate some implicit or explicit contract with the stakeholder, or extort concessions from the stakeholder. As the stakeholder becomes more valuable to the company, she also becomes more vulnerable. In concrete terms, imagine that a worker has developed an ability to run a particular machine that is especially complex and that the machine is not used by her company's competitors. The problem is that if her company fails or requires her to take a pay cut, the employee's ability to use her knowledge elsewhere is severely limited. This risk makes the employee less willing to dedicate herself to developing the firm-specific ability in the first place. Lynn Stout and Margaret Blair call this the "team production problem" – how do firms encourage their stakeholders to make firm-specific investments even though such investments make them more vulnerable?⁵⁷

My answer to this question is that a fair allocation of the profit created by the firm will help ensure that all stakeholders will be willing to make firm-specific investments. Because corporations are a collective effort, the key to sustainability is for those who contribute to the firm to receive the benefits (or suffer the costs) of the firm in rough proportion to their contributions. For example, if you are an employee who needs to spend

56. See generally Greenfield, *The Place of Workers*, *supra* note 3 (examining other implications of this economic fact).

57. See generally Blair & Stout, *supra* note 15.

evenings learning a specific skill that is particularly useful to your employer, you will be more willing to do so if you know you will gain a fair allocation of the profit created from your work. How to decide what is fair is a question discussed later in this article. For now, it is clear that stakeholders who believe they receive a fair allocation of the corporate surplus will be more willing to “invest” in the firm. Over time the firm will be more successful if the various stakeholders are willing to make such investments.

There is an additional reason why fair allocation of the corporate surplus will inure to the benefit of the firm over time. Numerous studies have shown the truth of what we intuit from our everyday interactions, namely that human beings are “reciprocators” – that human beings tend to treat others the way that others treat them.⁵⁸ Road rage is the negative example; the norm of giving gifts during the holidays is a positive example. People are reciprocators in the working world as well. For example, workers who believe they are treated fairly tend to work harder, be more productive, obey firm rules more often, and be more loyal to their employers. This in turn likely makes those firms more profitable than they would have been absent such fair treatment.⁵⁹

A rejoinder to my argument thus far is if fairness would help firms be more profitable, why do they not already do it? One answer is that some firms already try to share wealth created by the collective action of their stakeholders and some firms even recognize that they owe an obligation to treat all their stakeholders fairly. The more general answer, however, is that, in all likelihood, firms simply do not see the potential long-term profitability of fairness. Boards are elected by shareholders and the law makes shareholders supreme. Few directors or managers have the incentive to push their firms to take what must seem like a huge short-term risk – re-allocating a greater portion of the corporate surplus to non-shareholder stakeholders – for gains that seem abstract. No one wants to make the first move. The law is needed to overcome this “stickiness” of the status quo.

Even if one is not convinced that fairness is better for firms themselves, there is an additional reason to push for a fair allocation of the corporate surplus. When we take society’s interest as our ultimate guidepost, society

58. See Greenfield, *Using Behavioral Economics*, *supra* note 3, at 633.

59. See generally *id.*

is not concerned exclusively with the maximization of aggregate wealth. Rather, the fairness of the allocation of society's wealth is an important principle for the United States as well as other democracies. As a society, we look not only at the total social wealth, but also at the equality of its distribution.⁶⁰

One illustration of this point: at the beginning of every corporate law course I teach I offer the students in my class a series of three choices. They are to pick one choice in each pair.⁶¹ The first choice is between the present economy and its distribution of wealth and income, or an economy in which the top fifth of income earners get a 25 percent raise and the bottom fifth a 15% raise. This choice typically splits the class roughly in half. Even though the second choice adds to the economy in the aggregate and even though the poorest get more than they have now, about half of my students would rather keep the present economy than allow the richest to gain even a little advantage on the poorest among us.

The second choice I offer is between the present economy and an economy in which the top fifth receive a 25 percent gain but the poorest receive nothing. This choice typically results in the vast majority picking the present economy even though, as I make sure to point out, the aggregate wealth of the economy is increased. There are a few that pick the second option, noting that the poor are not *worse* off, but most law students (even those who are in a class about business law) are uncomfortable with such inequality.

The third choice ups the ante. I again offer the existing economy as the first choice. The second choice, however, is to give the richest fifth a 25 percent raise and the bottom fifth a 15 percent pay cut. I point out that this choice increases the aggregate wealth of the nation. Nevertheless, in all the years I have offered these choices, not a single one of the hundreds of law students who have weighed in has taken this last "deal." Once we get to the point where no one would accept such a deal, I point out that, while the aggregate numbers vary from year to year, this last deal is not far from what has indeed occurred in America over the last few decades.⁶²

60. JOSEPH M. ANDERSON, U.S. DEP'T OF COMMERCE, THE WEALTH OF U.S. FAMILIES: ANALYSIS OF RECENT CENSUS DATA (1999), available at <http://www.census.gov/dusd/MAB/wp233.pdf>.

61. I owe this teaching idea to Robert Reich, who used the same technique in a speech he gave here in Boston a number of years ago. I have used it ever since, and I owe him thanks for such a great teaching tool.

62. See KEVIN P. PHILLIPS, WEALTH AND DEMOCRACY: A POLITICAL HISTORY OF THE

I understand that my surveys of my students are not scientific and that there might have been some students over the years who have not been willing to admit publicly to preferring a gain in the aggregate wealth at the cost of more inequality. Nevertheless, my students likely represent the majority view in our country. I think that, if asked, most Americans would give up potential gains in aggregate wealth for a fairer distribution of a lesser amount. In other words, Americans care about economic justice.⁶³ When we measure whether corporate law serves society, we have to ask whether corporate law makes economic justice more or less likely.

Economic justice is ignored in mainstream corporate law. In fact, a theory of corporate law that is based on unconstrained ability to contract – the mainstream view – virtually insures that inequality will be worsened. The reason for this is straightforward.⁶⁴ When people use bargained-for exchange to distribute goods, the weaker bargainer will be less able to extract concessions from the other. Even if a contract will make the less-well-off party marginally better off, the more powerful party will tend to be much better off. So unless there is some explicit constraint on the ability of corporations to pass along the lion's share of profit to shareholders, the nation's inequality will worsen over time. A concern for economic fairness is a component of society's interests, and public policy needs to (and does, in a variety of ways) take that value into account.

The question, then, is why *corporate* law should be used to further the interests of fairness rather than other areas of regulation. The answer to this query harkens back to Principle Three. It may simply be more efficient, as a matter of regulatory policy, to use corporate law to redistribute wealth and income than to use other mechanisms. I have discussed this more elsewhere.⁶⁵ For now, all that demands comment is that public policy tools that redistribute wealth and income tend to either work after the initial distribution of financial wealth (e.g., taxes, welfare

AMERICAN RICH 137 (2002) (chart showing that from 1977-1994, the lowest quintile of income earners had their after-tax income fall 16%. The top income earners had their after-tax income increase by at least 9% (for those in the 81-90% group) to as much as 72% (for the top 1% of income earners)).

63. Humphrey Taylor, *The Enron Effect: The American Public's Hostile Attitudes Toward Top Business Managers* (The Harris Poll No. 55, Oct. 18, 2002), at http://www.harrisinteractive.com/harris_poll/index.asp?PID=334 (last accessed Mar. 31, 2005).

64. See GREENWOOD, *supra* note 55, at 22.

65. See generally Greenfield, *Using Behavioral Economics*, *supra* note 3.

policy) or to benefit only those at the lowest rung of the economic ladder (e.g., the minimum wage). A stakeholder-oriented corporate law would work at the initial distribution of the corporate surplus and would benefit stakeholders up and down the economic hierarchy. Certainly, once we take economic fairness seriously as a value, we should not blindly accept a corporate law framework that makes fairness less rather than more likely.

The remaining question, then, is how we implement the requirement (or even an encouragement) of a fair allocation of the corporate surplus. This is the subject of the final Principle.

PRINCIPLE FIVE:
PARTICIPATORY, DEMOCRATIC CORPORATE GOVERNANCE IS
THE BEST WAY TO ENSURE THE SUSTAINABLE CREATION
AND EQUITABLE DISTRIBUTION OF CORPORATE WEALTH

Once we recognize that corporate law should seek to create the legal framework that allows wealth to be both created and distributed fairly, the crucial question is not difficult to see. It is the question of corporate governance itself: how do we create a set of rules for corporations to maximize the chances that the organizational principles are satisfied? At this level of generality, this is the same question that occupies any corporate governance scholar or any judge hearing a corporate law case. The difference, of course, comes from the different principles that underlie the question. For mainstream corporate scholars, the question is essentially how corporate governance can best mimic what a hypothetical perfect market would provide. In my view, imitating the market is exactly the wrong idea in many aspects of corporate law since the market will tend to contradict a number of principles outlined above.

Because in mainstream corporate law the shareholders are the most powerful party in the marketplace, they should receive the supreme position in corporate governance. They are the only beneficiary of management's fiduciary duties, they are the only stakeholder that can bring a derivative suit on behalf of the firm against corporate directors, and they are the only voters in elections for corporate directors.⁶⁶ Once we understand, however, that corporations are to serve *all* their stakeholders by equitably sharing the corporate surplus, it becomes clear that the

66. See Easterbrook & Fischel, *supra* note 30, at 2, 63, 91, 101.

dominance of shareholders within corporate management is a mistake as well.

In place of the mainstream view, I suggest that the key problem for corporations is how to make the fair allocation outlined in Principle Four. A fair allocation of the corporate surplus is essential to sustaining socially-beneficial corporations over time, but allocative decisions are extremely difficult, especially *ex ante*. Instead of trying to reach agreements *ex ante* about substantive fairness, corporate governance should instead focus on procedural fairness. Because the stakeholders cannot be expected to decide ahead of time who should get what, they need to decide instead *how* to decide who gets what. The crucial objective of corporate governance, then, is to create methods of decision-making that offers procedural fairness among the various stakeholders.

Let us pause here and reference again the work of Lynn Stout and Margaret Blair, who urge that the main problem faced by corporate governance is that of team production.⁶⁷ In their view, the sustainability of the firm depends on maintaining the “team” of stakeholders over time.⁶⁸ They argue that contemporary corporate law achieves this goal by giving the real power to run the company to the board of directors.⁶⁹ The board is given the obligation to balance the various goals and interests of the firm’s stakeholders so that each of them has the incentive to maintain their own investment in the firm over time.⁷⁰ The reason behind the board having this power is to address the problem mentioned above – that it is impossible to decide who should get what ahead of time. The answer to *how* to decide after the fact is to give the power to the board.⁷¹ The board makes the allocative decisions, and so long as they do a good enough job the various stakeholders will stay over time and the corporation will succeed over time.⁷²

Blair and Stout also argue that not only *should* boards act this way, but that boards *already* act this way.⁷³ They assert that current corporate law allows the board the authority to balance the needs of the various

67. See Blair & Stout, *supra* note 15, at 305.

68. *Id.*

69. See *id.* at 263–64.

70. See *id.* at 281.

71. See *id.* at 282.

72. See generally *id.* at 304–05.

73. See generally *id.* at 287–88.

stakeholders by way of the business judgment rule, which protects management from derivative lawsuits except in the most egregious situations.⁷⁴

There is much to praise in Blair and Stout's work, especially as a normative matter. I, too, believe that it is essential for the board of directors to consider the interests of all the firm's stakeholders in making key decisions. Also, I agree that the placing of one stakeholder in a supreme position in every case will result in the other stakeholders withdrawing or reducing their investment over time.

I am skeptical, however, of Blair and Stout's descriptive claim that the board currently occupies the role of an impartial arbiter among the firm's stakeholders.⁷⁵ Even though the business judgment rule does give them much leeway, the ultimate goal of shareholder gain is hardly in dispute. Moreover, the directors are elected by a vote of the shareholders only, and only shareholders may bring derivative actions against them for violations of fiduciary duties. I do not believe that it is correct to say that company boards are in fact representatives of all key firm stakeholders when they owe duties to only one stakeholder, only one stakeholder can sue to enforce those duties, and only one stakeholder can vote them out of office.

To make the important normative arguments of team production a genuine possibility, the reality of corporate law needs to be changed. In other words, in order to make it a real possibility that a corporation will serve its stakeholders by creating wealth in a sustainable way and then equitably sharing that wealth, the management of the firm needs to be subject to different constraints than at the present. These changes are simple, yet profound.

First, directors need to be held to a fiduciary obligation to all the firm's stakeholders, one that varies according to the contributions of the stakeholders to the success of the firm. One way to conceptualize this is that the directors and management should be seen as owing a duty to the firm as a whole, rather than a specific subset of it. Some corporate law scholars – including Blair and Stout – believe that this is the best description of current corporate law, and some cases would appear to stand for that proposition.⁷⁶ In that respect, such a change in doctrine would not represent a huge transformation.

74. *See id.* at 298–300, 320–321.

75. *See id.* at 279.

76. *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004)

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The real change would come when it is acknowledged that a duty to a range of stakeholders is largely meaningless unless stakeholders have some way to enforce the duty. The way for that to occur includes allowing non-shareholder stakeholders to bring suits in court for violations of the duties of care and loyalty, and providing some mechanism for non-shareholder stakeholders to elect their own representatives to the board. While the former idea is better than current law, I believe the latter has more potential for success over time. Let me explain why.

While the duties of care and loyalty are crucial, they have little connection to the problem of fair allocation of the corporate surplus. The best way to have the board make such decisions is to have the important stakeholders represented there. Certainly the team production model advances the ball by making clear that directors have an obligation to the firm as a whole, but there is no way to enforce such a broad obligation. If, however, the board was more of a pluralistic body, with all perspectives represented, the ball could be moved even further.

What I am imagining here is, in an ironic sense, a genuine realization of a nexus-of-contracts view of the firm. If the firm is best seen as a microcosm of the market, then let us make that real by putting the most important market participants in a position where they can be heard at the decision-making level of the firm. The specifics will be difficult, though not impossible. Employees could elect a proportion of the board; communities in which the company employs a significant percentage of the workforce could be asked to propose a representative for the board; long-term business partners and creditors could be represented as well.

Again, at this stage of the discussion, the specifics do not matter as much as the notion that the board itself should be a place where more than just a shareholder perspective will be heard. As they participate on the board, each stakeholder representative will have the incentive to build and maintain profitability in order to sustain the company over time. Moreover, the board will be the locus of the real negotiations among the various stakeholders about the allocation of the corporate surplus. Even though

(noting that “directors are not required to put aside any consideration of other constituencies . . . when deciding how to manage the firm”); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1148 (Del. 1989) (discussing directors’ concern over Paramount’s premium purchase offer because it threatened “Time culture.”); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (regarding directors’ defense against hostile takeover that would be harmful to employees).

board members might be selected for their positions in different ways and from different constituencies, each would be held to fiduciary duties to the firm as a whole. Decisions that affect major stakeholders would no longer be made cavalierly, without someone on the board being able to anticipate and articulate the likely impact such a decision would have on the stakeholders.

The fact that the board would have members that could speak from the perspectives of the company's various constituencies would not mean that members would have responsibilities to only one constituency. A board member elected by workers would not avoid fiduciary duty obligations to look after the interests of the firm as a whole merely because she owes her position to the workers. There would be no duty of loyalty problem for a worker-elected board member to weigh in on a decision that affected workers any more than it is currently a violation of the duty of loyalty for a shareholder-elected director to vote on matters that affect shareholders.

This proposal for board pluralism will strike most mainstream corporate law scholars as lunacy. Remember, however, that in Germany, half of the supervising board of major companies consists of worker representatives.⁷⁷ Mainstream corporate law scholars decry this "co-determination" as inefficient and unnecessary,⁷⁸ and my proposal is in some ways even more of a change than co-determination would be.

Let me answer these concerns in a couple of ways. First, in most cases no constituency would have an incentive to hurt the company in order to gain a larger piece of the pie. Even if this incentive were present, the constituency would be violating its fiduciary duties to the firm as a whole and could be held to account for its behavior. Second, the possibility of strategic, "rent-seeking" behavior *already* exists in the firm; directors now are elected by shareholders only and shareholders already have incentives in certain circumstances to put their interests ahead of the interests of the firm as a whole. A pluralistic board could actually retard those selfish impulses because any behavior that benefits one stakeholder at the expense of the firm must be done in full view of the others.

Consider the federal government as analogy. As Madison argued in the Federalist Papers, a pluralistic federal government where power is balanced among many different groups actually *weakens* factions.⁷⁹ To make

77. Greenfield, *supra* note 6, at 1423-24.

78. *Id.* at 1424.

79. THE FEDERALIST NO. 10, at 48 (James Madison) (George W. Casey & James

important decisions, one must build coalitions; individual factions cannot act on their own.⁸⁰ The same is likely true in corporate governance. The probable effect of a broadening of the board to include those who can speak for non-shareholder stakeholders is that such stakeholders will gain a larger share of the pie than they now get. That, remember, is the goal.

Of course there will be disagreement, sometimes heated, but this is hardly a reason to shy away from pluralistic corporate democracy. As a matter of group and institutional dynamics, good decision-making requires a diversity of viewpoints. As Cass Sunstein has detailed in his recent book, *Why Societies Need Dissent*, conformity among people in a decision-making group breeds error.⁸¹ Dissent is essential and “social bonds and affection” can suppress dissent.⁸² “If strong bonds make even a single dissent less likely, the performance of groups and institutions will be impaired.”⁸³ He extends the points to corporate boards: “[t]he highest performing companies tend to have extremely contentious boards that regard dissent as a duty and that ‘have a good fight now and then.’”⁸⁴

Making the board less insulated and homogeneous will make decisions more difficult simply because more views will have to be taken into account and the board will have to come to terms with the effects of its decisions more often. The fact that decisions will be more difficult, however, is not in itself a reason to refuse to improve boards by adding a range of views and perspectives. The real question is whether additional diversity results in decisions worth the extra effort, and here there is reason to be hopeful. Numerous studies have shown what one’s intuition would suggest – that “defective decision-making” is “strongly correlated” with structural flaws such as “insulation and homogeneity.”⁸⁵

This is a common idea, widely accepted in other institutions. We recognize in legislative bodies, administrative agencies, school faculties, and non-profit boards that diversity of viewpoints and people increases the likelihood that dissent will be welcomed, important perspectives will be

McClellan eds., Liberty Fund Press 2001) (1788).

80. *Id.*

81. CASS R. SUNSTEIN, *WHY SOCIETIES NEED DISSENT* 1-5 (2003).

82. *Id.* at 27.

83. *Id.*

84. *Id.* at 28 (quoting Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, 80 *HARV. BUS. REV.* 106, 111 (2002)).

85. *Id.* at 143.

heard, and decisions will be more fully vetted. “[I]nstitutions perform better when challenges are frequent, when people do not stifle themselves, and when information flows freely.”⁸⁶ John Rawls would appear to agree:

In everyday life the exchange of opinion with others checks our partiality and widens our perspective; we are made to see things from their standpoint and the limits of our vision are brought home to us . . . The benefits from discussion lie in the fact that even representative legislators are limited in knowledge and the ability to reason. No one of them knows everything the others know, or can make all the same inferences that they can draw in concert. Discussion is a way of combining information and enlarging the range of arguments.⁸⁷

These principles of good decision-making are thus nothing new or earth-shaking, they are just systematically ignored in corporate governance. At base, all I am suggesting is that corporate boards – now among the most homogeneous decision-making groups in society⁸⁸ – would stand to benefit from a greater openness and diversity. Such openness would not only make for better decision-making but likely *fairer* decision-making as well.

86. *Id.* at 148 (citing LUTHER GULICK, ADMINISTRATIVE REFLECTIONS FROM WORLD WAR II 120–125 (1948)).

87. JOHN RAWLS, A THEORY OF JUSTICE 358-59 (1971).

88. A 2002 survey found that 82% of the director positions on Fortune 1000 companies were held by white men, 11% by white women, 3% by African-Americans, 2% by Asian-Americans, and 2% by Hispanics. Gary Strauss, *Good Old Boys' Network Still Rules Corporate Boards*, USA TODAY, Nov. 1, 2002, at 1B (data provided by Microquest Corporation). Only 8% of public companies have three or more female directors, and only 6% of public companies have three or more directors who are ethnic minorities. *See also* Taylor, *supra* note 63.