Although the law clearly recognizes to some degree that the corporation charter is a contract,[76] critics of the economic perspective argue that the "set of contracts" model is a rhetorical device that overstates the amount of bargaining that is feasible among shareholders and managers.[77] They point out also that this view of the corporation as a purely private body ignores that a critical element in the corporate form—i.e., limited liability—comes from the state. True bargaining is also not feasible, they claim, because of high information costs and the difficulty of shareholder coordination.

The fundamental conceptual issue concerning the "series of bargains" approach is whether shareholders need to engage in actual bargaining for this perspective to have validity. Few would assert that actual explicit bargaining occurs or is generally feasible in the publicly held corporation, but proponents of this contractual model of the corporation argue that the market prices all the terms in the corporation's charter and that this pricing process is an adequate substitute for actual bargaining. Thus, in their view, shareholders should be deemed to have implicitly accepted all terms in the corporation's certificate, even when they buy into a management-controlled firm. Critics of this model reply that this view overstates the importance of the provisions in the certificate of incorporation and that shareholders actually rely more on the fiduciary duties imposed on management by the common law. They see standardized rules, embodied in statutory or common law, as being similar to the role played by consumer protection legislation in other areas where individual bargaining is infeasible and contracts of adhesion otherwise might result.[78]

This conflict in perspectives leads to an important theoretical issue for the future of corporate law: Should state corporation codes be interpreted as specifying mandatory elements to the corporate contract from which the parties are seldom free to deviate (for fear that shareholders will be overreached)? Or should state law be viewed as simply supplying a model form contract that simplifies the process of contracting between shareholders and management but whose provisions are largely optional and may be changed if there is a clear intent to do so? The prevailing economic view is that each state's corporation code simply provides an inventory of "off the rack" legal rules that the parties to the corporate contract select in order to avoid more costly contracting.[79] In this view, the parties are (or should be) free to "hand tailor" different and more individualized legal rules that deviate from, or even conflict with, the existing statutory or decisional law. Case law has seldom addressed these issues, but when it has, it has generally indicated that departures from the common law norms are permissible only where there is no potential for fraud or overreaching of shareholders.[80]

76. This was the holding, of course, in Dartmouth College v. Woodward, supra. Contract law scholars see all forms of business associations as a special kind of contract: a "relational" contract, as opposed to the standard "transactional" contract. See Ian Macneil, The Many Futures of Contracts, 47. S. Cal. L. Rev. 691, 720 (1974). A relational contract establishes a future continuing relationship under circumstances that cannot be fully understood or anticipated at the time of contracting.

77. See Victor Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. Rev. 1403 (1985).

78. See Allison Anderson, Conflicts of Interests: Efficiency, Fairness and Corporate Structure, 25 UCLA L. Rev. 738, 781-783 (1978).

79. For the view that state law simply provides an optional model form to reduce contracting costs, see Easterbrook & Fischel, footnote 74, at 401 supra.

80. See Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1957) (holding that shareholders may adopt a charter amendment that deviates from the common law, provided that it does not immunize corporate fiduciaries from liability for fraud, unfair self-dealing, or illegal acts). See also Irwin v. West

F. THE SOCIAL RESPONSIBILITY OF THE CORPORATION

1. TO WHOM DO FIDUCIARY DUTIES RUN?

A long-standing debate in American corporate law has centered on to whom the directors' fiduciary responsibility runs. The traditional assumption of American corporate law has been that managers and directors owe a fiduciary duty only to their shareholders. Thus, in Dodge v. Ford Motor Co.,[81] the Michigan Supreme Court sternly lectured Henry Ford when he had refused to pay dividends to his shareholders on the apparent grounds that they had already received sufficient profit: "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. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. . . ."[82]

But 13 years later, in a famous debate with Columbia Professor Adolf Berle, Harvard Professor E. Merrick Dodd argued that corporate powers were held in trust for the entire community. Compare Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932), with Berle, For Whom Corporate Managers are Trustees: A Note, 45 Harv. L. Rev. 1365 (1932). Dodd's view became the consensus position by mid-century, probably in part because professional managers welcomed the idea that they were not wholly responsible to shareholders and could balance the interests of other constituencies against shareholder interests. But with the birth of the "law and economics" movement in the 1960s, a sharp dissent was heard from economists and others who argued that this view converted managers into unelected civil servants. The following excerpts give the flavor of this continuing debate.

E. Merrick Dodd, For Whom Are Corporate Managers Trustees?

45 Harv. L. Rev. 1145, 1153-1157, 1162-1163 (1932)

If we may believe what some of our business leaders and students of business tell us, there is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfill those responsibilities. . . .

The view that those who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders, is thus advanced today by persons whose position

End Dev. Co., 342 F. Supp. 687 (D. Colo. 1972) (refusing to give effect to charter provision approving self-dealing contracts without respect to their fairness); Cochran v. Penn-Beaver Oil Co., 143 A.2d 257 (Del. 1926) (invalidating restriction on shareholder inspection rights as contrary to state law and public policy).

81. 204 Mich. 459, 170 N.W. 668 (Mich. 1919).

82. Henry Ford had openly announced his view that "a sharing [of the profit] with the public, by reducing the price of the output of the company, ought to be undertaken." Id.

in the business world is such as to give them great power of influencing both business opinion and public opinion generally. Little or no attempt seems to have been made, however, to consider how far such an attitude on the part of corporate managers is compatible with the legal duties which they owe the stockholder-owners as the elected representatives of the latter.

. . . If the social responsibility of business means merely a more enlightened view as to the ultimate advantage of the stockholder-owners, then obviously corporate managers may accept such social responsibility without any departure from the traditional view that their function is to seek to obtain the maximum amount of profits for their stockholders.

And yet one need not be unduly credulous to feel that there is more to this talk of social responsibility on the part of corporation managers than merely a more intelligent appreciation of what tends to the ultimate benefit of their stockholders. Modern large-scale industry has given to the managers of our principal corporations enormous power over the welfare of wage earners and consumers, particularly the former. Power over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility. The managers, who along with the subordinate employees are part of the group which is contributing to the success of the enterprise by day-to-day efforts, may easily come to feel as strong a community of interest with their fellow workers as with a group of investors whose only connection with the enterprise is that they or their predecessors in title invested money in it, perhaps in the rather remote past.

Clear proof is not forthcoming. Despite many attempts to dissolve the corporation into an aggregate of stockholders, our legal tradition is rather in favor of treating it as an institution directed by persons who are primarily fiduciaries for the institution rather than for its members. That lawyers have commonly assumed that the managers must conduct the institution with single-minded devotion to stockholder profit is true; but the assumption is based upon a particular view of the nature of the institution which we call a business corporation, which concept is in turn based upon a particular view of the nature of business as a purely private enterprise. If we recognize that the attitude of law and public opinion toward business is changing, we may then properly modify our ideas as to the nature of such a business institution as the corporation and hence as to the considerations which may properly influence the conduct of those who direct its activities.

Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits

The New York Times, Sept. 13, 1970 (Magazine at 33)

In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. . . .

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hard-core" unemployed instead of better-qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct "social responsibility," rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.

But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public. . . .

The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes. He becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise. On grounds of political principle, it is intolerable that such civil servants—insofar as their actions in the name of social responsibility are real and not just window-dressing—should be selected as they are now. If they are to be civil servants, then they must be selected through a political process. If they are to impose taxes and make expenditures to foster "social" objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served. . . .

On the grounds of consequences, can the corporate executive in fact discharge his alleged "social responsibilities"? On the one hand, suppose he could get away with spending the stockholders' or customers' or employees' money. How is he to know how to spend it? He is told that he must contribute to fighting inflation. How is he to know what action of his will contribute to that end? He is presumably an expert in running his company—in producing a product or selling it or financing it. But nothing about his selection makes him an expert on inflation. Will his holding down the price of his product reduce inflationary pressure? Or, by leaving more spending power in the hands of his customers, simply divert it elsewhere? Or, by forcing him to produce less because of the lower price, will it simply contribute to shortages? Even if he could answer these questions, how much cost is he justified in imposing on his stockholders, customers, and employees for this social purpose? What is his appropriate share and what is the appropriate share of others? . . .

Many a reader who has followed the argument this far may be tempted to remonstrate that it is all well and good to speak of government's having the responsibility to impose taxes and determine expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed, but that the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems.

Aside from the question of fact—I share Adam Smith's skepticism about the benefits that can be expected from "those who affected to trade for the public good"—this argument must be rejected on grounds of principle. What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures.

American Law Institute, Principles of Corporate Governance (1994)

Sec. 2.01. *The objective and conduct of the corporation.* (a) . . . [A] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

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1. *ALI's middle course.* Under the ALI Principles of Corporate Governance, a Restatement-like effort to codify the common law of fiduciary duties, a corporation must always obey the law and may make "reasonable" charitable contributions even if there is no direct benefit to the corporation. Under the second clause of §2.01(b) above, ethical considerations are only permissive. The corporation may or may not take into account "ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business." Suppose a corporation with annual earnings in the $15 million range has a plant that is losing $4 million a year with no realistic hope of improvement. Deciding to sell the plant, the corporation receives only one bid—from a developer who will close down the plant and lay off all its employees. Can the corporation reject this bid because of the impact on employees? In an illustration using these facts, the ALI concludes that declining the bid "cannot be justified under §2.01(b)(2), because a corporation is not ethically obligated to continue indefinitely losing large amounts of money, equal to more than one fourth of the corporation's earnings, for the purpose of keeping workers employed." 1 ALI, Principles of Corporate Governance 68 (1994). The humanitarian justification under §2.01(b)(3) is also inapplicable, it finds, because the cost of declining the bid is excessive in relation to the corporation's earnings.

The corporate obligation to obey the law has also been the source of debate and controversy. Suppose the management of a bus or trucking company instructs its drivers to drive five miles per hour above the speed limit and the corporation will pay for any resulting fines. Is this decision consistent with management's fiduciary responsibility to obey the law, even if the board concludes (after due deliberation and investigation) that such a practice will result in net savings (after fines and other legal costs) of $500,000 annually? Some economists have argued that the criminal law is only a pricing system and thus those willing to pay the fine can do the crime. On exactly these facts, however, the ALI Principles state that the corporate decisionmakers would be breaching their duty to the corporation. See §2.01, at 62. *Query:* What would be the damages on these facts?

2. *Charitable contributions.* Every state corporation statute authorizes the firm to make charitable contributions. The most common format (followed by 24 states and the District of Columbia) grants the corporation the "power to make donations for the public welfare or for charitable, scientific or educational purposes."[83] In another 19 states, the corporation statute first authorizes contributions "furthering the business and affairs of the corporation" and then also authorizes philanthropic donations for the same charitable, scientific, or educational purposes.[84] Finally, another seven states—including California, New York, and New Jersey—have gone further and enacted statutes authorizing charitable contributions "irrespective of corporate benefit."[85]

Judicial decisions on the propriety of charitable contributions have been rare, but the modern decisions have uniformly sustained such donations and suggested that the 10 percent ceiling on the deductibility of charitable contributions in §170(b)(2) of the Internal Revenue Code provides a "helpful guide" for determining their reasonableness.[86] Because corporate annual charitable contributions have averaged around 1.25 percent of pretax corporate profits,[87] this "guide" implies that few corporations will be subject to attack under such a "reasonableness" test. One area where potential liability may still exist, however, involves the problem of the "pet charity"—i.e., contributions motivated by the personal interests of a chief executive or director, rather than strategic interests of the firm or a general philanthropic policy.[88]

83. See Faith Stevelman Kahn, Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy, 44 UCLA L. Rev. 579, 602-603 (1997). Delaware follows this format. See Del. Gen. Corp. Law §122(9) (1998).

84. Id. See, e.g., Fla. Bus. Corp. Act §§607.0302(12), (14) (1997); Va. Stock Corp. Act §§627(A)(12), (13) (1995); Wis. Bus. Corp. Law §§302(13), (15) (1991).

85. Id. at 603. See, e.g., Cal. Gen. Corp. Law §207(e) (1978); N.J. Bus. Corp. Act §14A.3-4 (1998); N.Y. Bus. Corp. Law §202(12) (1978). New Jersey (and at least some other states) also require board of directors approval of charitable contributions.

86. See Kahn v. Sullivan, 594 A.2d 48, 61 (Del. 1991) (the test to be applied in examining the merits of a claim that a charitable contribution amounted to corporate waste "is that of reasonableness, a test in which the provisions of the Internal Revenue Code pertaining to charitable gifts by corporations furnish a helpful guide"). See also Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969). Perhaps the best known and most influential case in this field is A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953), which rejected the need for any corporate benefit or nexus requirement.

87. See American Association of Fund-Raising Counsel, Giving USA 1996: The Annual Report on Philanthropy for the Year 1996, at 90 (1996). Larger corporations typically donate between .5 percent and 2 percent of their annual profits.

88. See Jayne W. Barnard, Corporate Philanthropy, Executives' Pet Charities and the Agency Problem, 41 N.Y. L. Sch. L. Rev. 1147 (1997) (discussing numerous examples and concluding that the primary remedy should be greater board activism and a more detailed board policy toward charitable contributions).

However settled the law today may be, the rationale for corporate charitable contributions remains debatable. For example, what is the justification for a corporation that does not deal directly with the public (and so needs little institutional advertising) funding the cost of a public television program or a documentary unrelated to its business or concerns? Some argue that the corporation should instead pay a dividend and let those shareholders who wish to make individual contributions. Or, alternatively, they believe that a nonprofit maximizing act of corporate philanthropy should require shareholder approval.[89]

One possible answer to this argument focuses on the interests of shareholders in collective giving. Charities and similar eleemosynary institutions provide public goods that many in society benefit from and that few can be excluded from consuming (even if they do not contribute). Inevitably, such institutions face a "free rider" problem: Those who do not contribute can still watch the T.V. documentary, attend the museum, or listen to the subsidized concert. Also, many may not contribute because they feel their individual contribution will make little difference in the charity's overall budget and they may resent the fact that others who are similarly situated probably will not contribute. The standard answer to free rider problems is to find a mechanism that taxes the free rider. Charitable contributions by large corporations (AT&T, IBM, G.M.) having a million or more shareholders may be a partial answer to this problem. In effect, all shareholders are taxed proportionately. Moreover, there are tax advantages to the corporation making the payment, instead of paying a dividend (as the amount of the dividend would be taxable income both to the corporation and the shareholders receiving it). Finally, a large corporation may be better able than individual shareholders to negotiate with the charity about how its contribution will be used, thus introducing some monitoring controls over the charity's behavior.

3. *Problems of externalities.* Virtually everyone recognizes that corporate profit maximization can sometimes visit a greater harm on society than the gain it creates for shareholders. Pollution is an obvious example. Hard-boiled proponents of profit maximization argue that it is up to society to establish penalties and incentives that make such behavior truly contrary to the corporation's interests. Proponents of a broader definition of corporate social responsibility respond that external regulation of the corporation will always prove imperfect. See Elliott Weiss, Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse, 28 UCLA L. Rev. 343 (1981). Thus, they argue for an activist approach and would tolerate substantial inroads into the norm of profit maximization. The ALI Principles takes an intermediate position, tolerating (but never requiring) deviations that are "reasonably regarded as appropriate to the responsible conduct of business." This approach, which uses a societal consensus standard, can also be justified on the ground that the market expects such behavior (whatever the formal legal standard). Hence, there is little uncertainty created in the capital markets.

A similar perspective begins from the starting point that most shareholders own a portfolio of securities, not just stock in one company. Thus, even their narrow

89. For the provocative recent suggestion that shareholders should choose the recipients of corporate charity, see Victor Brudney & Allen Ferrell, Corporate Charitable Giving, 69 U. Chi. L. Rev. 1191 (2002). For a rebuttal, see Richard W. Painter, Corporate Speech and Citizenship: Commentary on Brudney and Ferrell, 69 U. Chi. L. Rev. 1219 (2002).

economic self-interest is broader than the fate of a single company and arguably is more closely linked with preserving a healthy, efficient capitalist system.

For an introduction to the extended literature on the topic of corporate social responsibility, see Melvin Eisenberg, Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct and Disclosure, 28 Stetson. L. Rev. 1 (1998); David Engle, An Approach to Corporate Social Responsibility, 32 Stan. L. Rev. 1 (1979); Edward Epstein, Societal, Managerial and Legal Perspectives on Corporate Social Responsibility—Product and Process, 30 Hastings L.J. 1287 (1979); Philip Blumberg, Corporate Responsibility in a Changing Society (1972).

2. THE RISE OF "CORPORATE CONSTITUENCY" STATUTES

Since the early 1980s, about 30 states have enacted statutes instructing directors that they either may or must take into account the interests of constituencies other than shareholders in exercising their powers.[90] Most of these statutes are merely discretionary, permitting but not requiring directors to consider the interests of employees, creditors, local communities, or other constituencies. A few statutes (including Connecticut's statute quoted below) appear to go further and mandate that directors must consider nonshareholder interests. Many of these statutes apply only to corporate control transactions (e.g., mergers, tender offers, buyouts, etc.). Others are generally applicable. Either way, it is clear that the driving force behind the adoption of these statutes was the heightened threat of hostile takeovers, which increased in frequency and scale during the 1980s. In response, managements of potential target companies sought state legislation that would expand their discretion to consider employee, creditor, and other interests in order to justify resistance to a hostile tender offer for their company's shares. Constituency statutes were also a response to the 1986 decision of the Delaware Supreme Court in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Casebook p.1025 infra, which seemed to require directors to consider only the interests of shareholders once a sale of the company had become "inevitable."

Although the passage of constituency statutes in 29 states is certainly a significant development, it is also noteworthy that 21 states (including Delaware) have not enacted such legislation (and Nebraska repealed its constituency statute in 1995). Even where enacted, it is often unclear what the impact will be on the preexisting common law on directors' duties. Set forth below are two constituency statutes illustrating some of the possible variations.

New York Business Corporation Law (1992)

Sec. 717. *Duty of directors.* . . . (b) In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control

90. These states include Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Virginia, Wisconsin, and Wyoming. For good overviews, see Eric Orts, Beyond Shareholders: Interpreting Corporate Constituency Statutes, 61 Geo. Wash. L. Rev. 14 (1992), and Jonathan D. Springer, Corporate Constituency Statutes: Hollow Hopes and False Fears, 1999 Ann. Surv. Am. L. 85 (1999).

of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-term and the short-term interests of the corporation and its shareholders, and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

(i) the prospects for potential growth, development, productivity and profitability of the corporation;

(ii) the corporation's current employees;

(iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;

(iv) the corporation's customers and creditors; and

(v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.

For purposes of this paragraph, "control" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting stock, by contract, or otherwise.

New York's statute makes it clear that nonshareholder groups have no standing to sue the directors if their interests have not been adequately taken into account. Is this a conceptually defensible compromise? Or does the lack of any enforcement mechanism suggest that the real purpose and effect of the statute are simply to protect target managements? Alternatively, what would be the consequence if these groups were given standing to sue?

Connecticut Business Corporation Law (1997)

Sec. 33-756. *Board of directors*. . . . (d) . . . [A] director of a corporation which . . . [is publicly held] . . . shall consider, in determining what he reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located. A director may also in his discretion consider any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation.

Although the Connecticut statute states that a "director . . . shall consider" the interests of other nonshareholder constituencies, is it really a mandate? May creditors bring an action under this statute if a Connecticut corporation becomes insolvent after undertaking a risky business project? May employees claim that insufficient attention was given to their interests in the wake of layoffs? Are directors exposed to an excessive risk of litigation if they must be legally responsible to groups with typically conflicting interests?

3. OBJECTIONS TO CONSTITUENCY STATUTES

The appearance of constituency statutes has alarmed many commentators, including the Corporate Laws Committee of the American Bar Association. Typically four arguments have been raised against such statutes.

(1) Fiduciary duties should run only to the shareholders because they, as the firm's residual claimants who receive what is left over after creditors and other fixed interest claimants are paid, have the greatest incentive to maximize corporate value and thus to realize economic efficiency. In contrast, creditors have a more risk-averse attitude toward corporate decisionmaking because of the more limited payoff to which they are entitled. Hence, it is argued, if fiduciary duties are owed to creditors, the directors will be made responsible to a group that will predictably oppose efficient risk-taking.

(2) Corporate directors should not be made to serve "too many masters." Serving principals with conflicting interests may expose the agent to excessive liability. Conversely, if directors are made responsible to all groups having an economic interest in the corporation, they may become effectively responsible to none.

(3) Constituency statutes convert directors into "unelected civil servants," with a responsibility for determining the public interest. Arguably, they have neither the training, experience, diversity, or, perhaps, sensitivity to play this role effectively.

(4) Groups other than shareholders can negotiate contractual protections (and thus do not need fiduciary protections), but shareholders face severe contracting problems because of their need to protect their more amorphous residual right to everything that is left over; thus, they uniquely need a fiduciary duty running only to them.[91]

American Bar Association Committee on Corporate Laws, Report: Other Constituencies Statutes: Potential for Confusion

45 Bus. Law. 2253 (1990)

. . . [C]onstituency statutes have typically been adopted as one measure, among others, designed to assist directors in forestalling unwanted takeovers. However, they address a question that is of much broader significance in corporate law and to society in general: whose interests should a corporation serve? The issues posed by this question are:

91. These arguments are incisively made (and criticized) in Jonathan Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 Stetson L. Rev. 23 (1991).

(1) whether the corporation has some responsibility to employees, communities, and the others enumerated in other constituency statutes;

(2) if so, how these thus far legally unenforceable responsibilities (except when they are created by contract, e.g., employment agreements, or specific statute, e.g., laws imposing environmental obligations) are to be meshed with the legally enforceable obligations of directors to shareholders; and

(3) whether the board of directors should have the power or the duty to prefer the interests of those constituencies over the interests of shareholders in some circumstances. . . .

Historical Background. A recurring debate concerning corporations and their role in American life has centered on the persons to whom corporations owe a duty and have accountability, and whose interests the management and directors of a corporation may or must serve. In the early 1930s, Professor E. Merrick Dodd of Harvard Law School and Professor Adolf A. Berle of Columbia Law School engaged in a classic debate on this subject in the pages of the Harvard Law Review. Dodd asserted that public opinion increasingly viewed the corporation as an "economic institution which has a social service as well as a profit-making function."[1]

Professor Berle took strong exception to this viewpoint. While sympathizing with the idealism of Professor Dodd and suggesting that the law might be moving in the direction of recognizing the claims of groups other than shareholders, he repudiated the notion that the management of corporations should have responsibilities beyond the interests of the shareholders. He concluded:

> Unchecked by present legal balances, a social-economic absolutism of corporate administrators, even if benevolent might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require. . . .[2]

This view has prevailed to the present. With few exceptions, courts have consistently avowed the legal primacy of shareholder interests when management and directors make decisions. This conventional wisdom has not, of course, prevented courts from permitting on various grounds the limited use of corporate resources for eleemosynary and other non-profit oriented purposes; usually the conceptual justification has been the long-range interest of the corporation (and therefore the shareholders). . . .

. . . The proponents of other constituencies statutes correctly recognize that many groups in addition to shareholders have a continuing and important economic stake in the welfare of corporations with which they have relationships. Often the shareholder's interest in the corporation is transitory, frequently a matter of days or weeks, while that of a manager or other employee may embrace a career and that of a community far longer. Similarly, a supplier may be almost wholly dependent upon one corporate customer for its economic viability, and a corporate customer may also have a measure of dependence upon its supplier. A community and its desirability as a corporate home and a residence for its citizens may depend upon one or a handful of corporations. A friendly or unfriendly change of control of a corporation can create severe hardships for many of these constituencies. . . .

1. Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1148 (1932).
2. Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365, 1372 (1932). . . .

The issue then becomes whether state corporation laws, and, in particular, a broadening of the interests that directors may consider, constitute an efficient and desirable way to provide protections for nonshareholder groups. The Committee has concluded that permitting—much less requiring—directors to consider these interests without relating such consideration in an appropriate fashion to shareholder welfare (as the Delaware courts have done) would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth.

The Committee believes that the better interpretation of these statutes, and one that avoids such consequences, is that they confirm what the common law has been: directors may take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation. While the Delaware courts have related the consideration directors may give other constituencies to the interests of shareholders by stating there must be "rationally related benefits to shareholders," it may well be that other courts may choose other words with which to express the nexus. . . .

While legislatures may not have intended it, adding other constituencies provisions to state corporation laws may have ramifications that go far beyond a simple enumeration of the other interests directors may recognize in discharging their duties. Directors might have a duty to oppose a transaction with whatever means are available because it would have a demonstrably adverse impact upon one or more of the constituencies (e.g., the acquirer plans to move the headquarters from the small town in which the company had been rooted for decades resulting in community disruption and loss of jobs). Or directors might be called upon to decide how much of the premium over market price being paid in an acceptable transaction should be allocated among the various constituencies (e.g., how much should accrue to communities in which plants might be closed; how much should be allocated to the terminated hourly employees; and how much should be allocated to a supplier who might lose his market).

The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.

If directors have, or may have, recognized legal duties to other constituencies, perhaps a new class or classes of plaintiffs will have access to the courts to redress perceived breaches of those duties or to challenge directors' failures to take various competing interests into account. An interpretation of these statutes to the effect that directors owe enforceable duties to constituencies other than shareholders would signal a major shift in the premises underlying traditional corporation law and might deter suitable candidates from undertaking board responsibilities.

Furthermore, an articulation of a director's duties that extended them to other constituencies without primacy being accorded shareholder interests would diminish the ability of shareholders to monitor appropriately the conduct of directors. Dean Robert C. Clark has said, "[a] single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. . . . Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable. They are more likely do to what they are supposed to do and do it efficiently.[58]. . ."

Finally, it is important to note that other constituencies legislation reinforces the contentions of those who would impose on corporations goals that transcend traditional business considerations and the profit motive. Those who argue for increased control of corporations at the federal level routinely point to the multiple interests that corporate activities affect as a basis for urging the exercise of increased corporate governance powers by agencies outside the corporation. Other constituencies provisions may lend support to this movement.

Conclusion. In conclusion, the Committee believes that other constituencies statutes are not an appropriate way to regulate corporate relationships or to respond to unwanted takeovers and that an expansive interpretation of the other constituencies statutes cast in the permissive mode is both unnecessary and unwise. Those statutes that merely empower directors to consider the interests of other constituencies are best taken as a legislative affirmation of what courts would be expected to hold, in the absence of a statute. . . .

4. THE CASE FOR CONSTITUENCY STATUTES

Although the ABA position paper argues that constituency statutes should be given a very thin reading that does not significantly change the prior common law, some scholars (although probably a minority) believe that constituency statutes represent a major, desirable, and overdue transition in the focus of corporate law. Professor Lawrence Mitchell argues that these statutes shift the focus of corporate law from shareholder wealth maximization to social wealth maximization. See Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579 (1991). Professor Mitchell doubts that shareholders necessarily deserve a priority in the directors' consideration, because, in his judgment, the cost of business decisions to communities, workers, and noteholders often outweighs the gains to the shareholders. Constituency statutes allow directors to focus more broadly on the overall impact of corporate action without exposing themselves to additional liability. Accountability to none will not be the result, he argues, because directors will still, as a practical matter, give greater attention to shareholder interests because of their voting power. Directors, however, will become more open about their concerns for the interests of other constituency groups.

Similarly, Professor Marleen O'Connor has argued that other constituencies should have standing to enforce their rights under these statutes and would read them "as a foundation for judicial intervention to ameliorate the impact corporate

58. Robert C. Clark, Corporate Law 20 (1986).

restructuring, plant closings and layoffs have on employees." See O'Connor, Restructuring the Corporation's Nexus on Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers, 69 N.C. L. Rev. 1189, 1190 (1991).[92] *Query:* If a corporate constituency statute makes directors less responsive to the interests of shareholders and reduces the economic return on the shareholders' investment in the corporation, should this be seen as a "taking" for which shareholders are entitled to just compensation under the Fifth Amendment?[93] Or can such a change in legal standards be justified under the "reserved power" clause that the *Dartmouth College* case, p.19 supra, caused states to insert into their corporation statutes?

Whatever the theoretical arguments about their merit, the actual impact of constituency statutes has been modest to date in the judgment of virtually all commentators. Relatively few cases have litigated their meaning, and even fewer have sought to apply them outside the context of takeover defenses.[94]

5. THE JUDICIAL DEVELOPMENT OF NON-SHAREHOLDER FIDUCIARY DUTIES

Although the Delaware legislature has not adopted a constituency statute, the Delaware courts have recently indicated that under some limited circumstances directors may have to consider creditor interests on at least an equal footing with those of shareholders. Outside of Delaware, other courts have also reached similar results during the last decade. See, e.g., Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506 (2d Cir. 1981); Federal Deposit Insurance Corp. v. Sea Pines Co., 692 F.2d 973 (4th Cir. 1982). These cases are an extension of the "trust fund" doctrine that originated in Wood v. Drummer, pp.20-21 supra, and under them a fiduciary duty extending to creditors arises at some point when the corporation nears insolvency.

Many of these cases have involved egregious facts in which the dominant shareholder simply distributes the firm's assets to itself on the eve of insolvency; in these cases, the creditors are simply suing for recovery of the fraudulently converted assets. However, in the best known recent decision, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 Del. Ch. LEXIS 215, 1991 W.L. 277613 (Del. Ch. Ct. 1991), the issue was the level of business risk that a nearly insolvent firm should be permitted to accept. The 98 percent shareholder

92. For similar arguments, see Timothy L. Fort, Corporate Constituency Statutes: A Dialectical Interpretation, 15 J.L. & Com. 257, 292 (1995) ("Stakeholder/corporate constituency analysis asks the right question of what duties corporations owe to non-shareholder constituencies. As creatures obtaining social benefits in the form of limited liability and other corporate features, corporations have duties to members of society.").

93. For an affirmative answer to this question, see Lynda J. Oswald, Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause, 24 J. Corp. L. 1 (1998).

94. In Basswood Partners v. NSS Bancorp, Inc., 1998 Conn. Super. LEXIS 317 (Feb. 6, 1998), a minority shareholder in NSS Bancorp sought access to that corporation's shareholders list in order to communicate with other shareholders regarding the company's poor financial record. Defendant NSS claimed that it need not grant access to the shareholder list and invoked Connecticut's above quoted constituency statute to justify its refusal, because it sensed a hostile bid might be forthcoming. Nonetheless, the court held for plaintiff Basswood Partners, finding that "the obligations imposed on a director by [the Connecticut constituency statute] do not restrict the rights of a shareholder under [state laws granting shareholder access to corporate books and records]." Id. at *7. Virtually every other reported citing these statutes has involved a clear takeover defense. See, e.g., Baron v. Strawbridge, 646 F. Supp. 690 (E.D. Pa. 1986); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis. 1989), aff'd on other grounds, 877 F.2d 496 (7th Cir. 1989).

of a nearly insolvent corporation (MGM, the movie studio) alleged that the firm's management and its chief creditor had injured the shareholder by refusing to allow the company to undertake a high-risk strategy that the shareholder favored. In whose interests did the corporation's officers have to manage the firm: the creditors or the shareholder? In *Credit Lyonnais*, Chancellor Allen explained that the directors had behaved properly in rejecting the riskier (but legal) course of action favored by the shareholders, holding that: "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearer, but owes a duty to the corporate enterprise." Then, in a much discussed footnote, Allen analyzed the potentially perverse incentives of shareholders to accept extreme risk as the company nears insolvency (this example is set forth and analyzed in Chapter III infra at pp.233-235).

The basic idea underlying Chancellor Allen's analysis is that shareholders who have nothing to lose will take high-risk gambles with the firm's assets that may be economically inefficient. In such a context, shareholders could rationally decide to accept a negative net present value investment, because most of the risk will fall on creditors. Thus, they might expend the corporation's last $1 million on an investment that had a total expected value of only $500,000, because it included a 1 percent chance of a payoff of $10 million (which would keep the firm solvent and preserve their investment). Although the *Credit Lyonnais* decision actually shielded directors from liability, its clear implication was that investment decisions appropriate for a solvent firm could constitute a breach of the directors' duties once the firm entered the vaguely defined "vicinity of insolvency." But what happens when a firm in this context makes a very risky investment that does have a positive net present value (e.g., suppose the $1 million investment has a 10 percent chance of yielding an $11 million return and a 90 percent chance of a $0 return)? Should the board's decision to accept this (barely) positive net present value investment be beyond judicial cognizance? What criteria can courts feasibly use to decide whether an investment is too risky?

The *Credit Lyonnais* decision (and the increased rate of corporate insolvencies after the highly leveraged financing of the 1980s) produced an outpouring of academic writing, which divided sharply over both the feasibility and desirability of Chancellor Allen's view that the board owed a "duty to the corporate enterprise" once into the "vicinity of insolvency."[95] Although Chancellor Allen did not suggest that a duty was owed directly to creditors, a later Delaware decision has imposed such a duty to creditors, based on the familiar trust fund concept, once the firm becomes insolvent. In Geyer v. Ingersoll Publications Co.,[96] the narrow issue was when this duty to creditors arose: as of the moment of insolvency or later when bankruptcy ensued? Defendants claimed that a duty owed directly to creditors arose only once a petition in bankruptcy was filed. No other bright lines were available, they argued, to "give directors a clear and objective indication as to when their duties to creditors arise. . . ." Refusing to limit the legal definition of insolvency in this way, Vice Chancellor Chandler found that the duty to creditors arose as of the actual moment of insolvency. Policy reasons, he said, inclined

95. Compare Lynn LoPucki & William Witford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669 (1993), with C. Robert Morris, Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais, 19 J. Corp. L. 61 (1992).
96. 621 A. 2d 784 (Del. Ch. 1992).

him to this result: "[T]here are other policy concerns which suggest that I interpret the insolvency exception to arise when insolvency exists in fact. That is, it is efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings. See Credit Lyonnais Nederland, N.V. v. Pathe Communications Corp. . . . The existence of the fiduciary duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interests."

Other jurisdictions have divided over this same issue of when a fiduciary duty to creditors arises. In In re Mortgage America Corp., 714 F.2d 1266, 1271 (5th Cir. 1983), such a duty was said to arise when the corporation could "no longer be considered a true going concern"—a point well after insolvency in the usual sense. But see Saracco Tank & Welding Co. v. Platz, 65 Cal. App. 2d 306, 150 P.2d 918 (1944) (duty arises as of moment of insolvency).

Read together, *Credit Lyonnais* and *Ingersoll Publications* seemingly subject directors to three stages of shifting obligations: At stage one, when the company is clearly solvent, their duty runs to the shareholders; at stage two, as the "vicinity of insolvency" is reached, their duty is to the "corporate enterprise" as a whole; and, at stage three, once the firm is insolvent in fact, it runs to creditors. Given that the existence of insolvency often involves complex issues of valuation, what will be the impact on these new duties on directors? Some believe that it may cause directors to file for corporate bankruptcy at an earlier point; others, that it will reduce risk-taking by nearly insolvent companies. But clearly, it adds a new dimension to the board's inquiry.

G. THE GLOBAL PERSPECTIVE

The key features in American corporate governance—fragmented share ownership, a resulting separation of ownership and control, and the substantial reliance on independent directors as monitoring agents—are not necessarily standard in other developed economies. Nor are other corporate systems necessarily evolving in the direction of the United States. Indeed, both Japan and Germany (the two leading national economies after the United States) provide striking contrasts. Among the leading differences there are the following.

1. *Concentrated ownership and bank-centered monitoring systems.* Concentrated ownership remains very much the norm in Europe. For example, more than 50 percent of the publicly traded, nonfinancial corporations in Austria, Belgium, Germany, and Italy have a single control block that holds a majority of the voting rights in the company. This contrasts with the United States and the United Kingdom where only about 3 percent of the publicly traded companies have such single control blocks.[97] Often, control over the voting rights results from the use

97. For these statistics, see Marco Brecht & Colin Mayer, "The Control of Corporate Europe" in The Control of Corporate Europe (Fabrizio Barco & Marco Brecht eds. 2001). They similarly report that in more than 50 percent of the nonfinancial, listed companies in the Netherlands, France, Spain, and Sweden a single control block holds 43.5 percent, 20 percent, 34.5 percent, and 34.9 percent of the