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Margaret M. Blair, *Director's Duties in a Post-Enron World: Why Language Matters*, 38 Wake Forest Law Review. 885 (2003)
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Citation: 38 Wake Forest L. Rev. 885 2003

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This work was originally published as Margaret M. Blair, Directors' Duties in a Post-Enron World: Why Language Matters, 38 Wake Forest L. Rev. 885 2003.

DIRECTORS' DUTIES IN A POST-ENRON WORLD: WHY LANGUAGE MATTERS

*Margaret M. Blair**

This essay observes that, in the face of corporate scandals of the last few years, a number of prominent advocates for shareholder primacy have retreated to the position that directors and officers should attempt to maximize long-run *share value performance, rather than short-term value. But the mantra of share value maximization has no distinctive meaning and policy implications if it is not interpreted to mean maximization of short-term value. This is because the actions required to maximize share value in the long run are indistinguishable in practice from actions taken in pursuit of other more broadly-stated goals such as the maximization of wealth for all corporate stakeholders. Moreover, once advocates of shareholder primacy accept the goal of long run share value maximization, then they should consider discarding the language of shareholder primacy, and the associated emphasis on high-powered, equity-based incentive systems. Such language is unnecessarily divisive and provocative. It draws attention to conflicting interests in corporate enterprises and announces that, when faced with conflicts, directors should choose actions that benefit shareholders even if those actions harm other stakeholders. In so doing, it tends to reduce cooperation, send signals that other participants and other values are of secondary importance, and undermine the ethical climate inside corporations. This essay proposes that, by contrast, the language of "team production" supports cooperative behavior, sharing of burdens and rewards, and win-win solutions.*

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I. INTRODUCTION

What corporate governance ground rules are most likely to foster wealth creation by the corporate sector and economic growth more generally? For more than twenty years, a rhetorical and legal battle over this question has been waged among corporate managers, investors, shareholder rights advocates, and legal academics, both in the United States and abroad. Although the debate harkens back to a much older and more fundamental question about the nature and purpose of the corporation,[1] in the last two decades, the debate has focused, for the most part, on two questions. The first looks only at United States corporate law and asks how much discretion directors and officers of publicly-traded corporations should have to consider interests other than those of shareholders in general, especially in responding to hostile tender offers;[2] the other engages a much more complex and multi-layered question about the kinds of governance rules that should be adopted by emerging market and transition economy countries eager to gain the benefits of capitalism. This essay will focus mainly on the rhetoric used to discuss directors' duties in regard to the former question, but the discussion has broad implications for the lessons that United States policy specialists deliver about corporate governance around the world.

It is no exaggeration to say that, in respect to both of these questions, the dominant paradigm among United States legal scholars for the last twenty years has been "shareholder primacy"—the view that corporations should be run for the sole benefit of shareholders, that directors and officers of a corporation are, in fact,

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1. One famous round of this long-term debate took place in the 1930s between Professors Adolf Berle and Merrick Dodd. *See* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

2. Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1037-39 (2002) (providing a chronology of the main arguments of what he calls the "pro-takeover, anti-board-of-directors arguments" in that debate). Lipton, who argued early on that

> directors should be governed by the business judgment rule [in responding to hostile tender offers] and that in exercising their judgment they should be able to take into account the interests of employees, communities, and other constituents as well as the long-term (and not just the short-term) interests of the shareholders,

id. at 1040, invented what he called a "Warrant Dividend Plan" in 1982 as a tool for directors and managers to resist takeovers if they so chose. *Id.* at 1044. Lipton's plan and others like it were soon nicknamed the "poison pill" by investment bankers who were backing hostile bids. *Id.*

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the "agents" of the corporation's shareholders, and that, as such, their duties are to maximize share value.[3] It follows from this perspective, according to advocates, that directors and officers should be constrained from taking any actions that are clearly not in the immediate best interests of shareholders.[4] With respect to takeovers, for example, advocates of this perspective argue that directors' ability to resist a hostile takeover that offers shareholders an immediate higher price should be tightly constrained.[5] According

3. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253-54 & nn.15-16 (1999) (reviewing extensive literature asserting or assuming that directors should serve shareholders exclusively).

4. Despite the prominence of shareholder primacy rhetoric in legal and popular literature, however, state legislatures and courts that interpret corporate law have failed to adopt a strict shareholder primacy approach, and have continued to protect managers and directors who make decisions that benefit other corporate constituencies even at the apparent cost to shareholders. *See* discussion *infra* Part III.

5. *See* RONALD J. GILSON, *UNOCAL* FIFTEEN YEARS LATER (AND WHAT WE CAN DO ABOUT IT) (Colum. L. & Econ., Working Paper No. 177, 2000) (arguing that shareholder bylaws can restore to shareholders decision making power with respect to tender offers that had been denied them by poison pills); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 113 (2001) (proposing that shareholders should be entitled to opt into a body of federal takeover law that would require the board to remove a pill if a majority of outstanding shares vote in favor of a takeover bid); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1050 (1982) (arguing that directors should not be allowed to frustrate takeover bids but should advise shareholders as to fairness and seek competing bids) [hereinafter Bebchuk, *Case for Facilitating*]; John C. Coates, IV, & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-*Quickturn *Alternatives*, 56 BUS. LAW 1323, 1325-27 (2001) (arguing that even shareholder bylaws cannot effectively eliminate the takeover-chilling effect of poison pills); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981) (arguing that the decision about whether to accept a tender offer should rest with the shareholders alone, and that directors should be required to be passive in the face of a takeover bid); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 865-75 (1981) (arguing that management should not be able to block takeover bids, but should act to provide information to shareholders); Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 511 (1997) (arguing that shareholders should be able to adopt a bylaw that would allow them to control the use of poison pills in takeover battles); *see also* Lucian Arye Bebchuk, *The Case for Empowering Shareholders*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387940 (last modified April 2003) (arguing that shareholders should have the right not only to vote for or against any merger or acquisition

to some of the more adamant shareholder primacy advocates, directors should also be constrained from paying out corporate funds for charitable or social causes that are not directly connected to shareholder wealth,[6] and should be heavily incentivized to focus on share value with compensation packages tied to stock price performance.[7]

Academic and policy advisors from the United States, along with financial institutions interested in investing abroad, have carried this message to developed and developing countries as well.[8] Emboldened by the outstanding performance of the United States economy and stock market in the 1990s relative to European and Asian economies, they frequently preached to other countries that the shareholder-oriented model of corporate governance was the only one that could deliver sustained economic performance.[9]

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plan, but to initiate the sale of the firm or its assets).

6. *See, e.g.*, Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1199-1202 (1999) (using a contractarian analysis to link the question of how much discretion directors should have to use corporate resources for philanthropy to the takeover debate by arguing that directors and officers will be constrained from straying too far from share value maximization by the threat of takeover in the "market for corporate control"); Melvin Aron 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, 1 (1998) (considering the "problem of corporate philanthropy"); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 581 (1997) (also discussing the "problem of corporate philanthropy").

7. *See, e.g.*, Charles M. Elson, *Director Compensation and the Management—Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 130-31 (1996); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651-52 (1995); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives–It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

8. Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1234 (2002) (noting that "an interlocking set of institutions that constitute 'shareholder capitalism,' American style, 2001" has been "aggressively promot[ed] throughout the world" by United States advisors and corporate law scholars).

9. *See, e.g.*, THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE OF THE OECD, CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS (1998) (arguing that "most industrial societies" recognize that the "generation of long-term economic profit to enhance shareholder value" is the corporation's primary objective). The Business Sector Advisory Group was led by New York corporate lawyer Ira Millstein of Weil, Gotshal & Manges, who frequently represents and advises institutional investors in corporate governance disputes. *See also*

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But the collapse of the United States stock market, the flurry of accounting and insider trading scandals, and the surge in corporate bankruptcies of the past two years have pulled the rhetorical rug out from under shareholder primacy advocates. At Enron, WorldCom, Tyco, ImClone, and too many other companies, highly-incentivized executives who embraced shareholder primacy rhetoric looted their companies and lied about corporate profits and assets to keep the stock price up long enough for them to sell their shares. In the face of such abuses, the Anglo-American insistence that share value is the only right way to measure corporate performance and the only acceptable goal for corporate executives and directors, rings suddenly, pathetically, hollow. The goal of maximizing share value (to the exclusion of other corporate goals), it now seems obvious, is subject to gross manipulation for the benefit of insiders. Additionally, the current scrambling of legislators, regulators, and business people to clean up the mess and restore investor confidence in equity investments makes it clear that the debate about corporate governance is not over, and we have not yet seen the "End of History" for corporate law.[10]

Although few shareholder primacy advocates have conceded that the lessons of the last few years include the idea that corporate officers and directors must stop paying so much attention to share prices and focus instead on other measures of corporate performance, this paper suggests that this is exactly what should happen. I argue that officers and directors of corporations should, in fact, try to ignore short-term share value in most cases, and focus instead on the business of the corporation: developing sound corporate strategies; setting challenging but realistic goals for operating performance; making sure that the company invests in people, brands, ideas, and reputation; and, importantly, builds a corporate culture that supports integrity and fair play, as well as excellence in producing and delivering the company's product to its markets. I further suggest rethinking the language used in discussions of directors' duties. In attempting to build the business and improve the long-run performance of the company, the language and incentive structures of shareholder primacy have been distracting at best, and, at worst, unnecessarily divisive and,

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Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 443, 449 (2001) (claiming that a consensus had been reached around the world on the shareholder-oriented model due to "the failure of alternative models" of the corporation, and asserting that, "[t]he triumph of the share-holder oriented model of the corporation over its principal competitors is now assured" and its success represents, "The End of History for Corporate Law").

10. Hansmann & Kraakman, *supra* note 9, at 439.

perhaps, even conducive of unethical behavior. A language that is more holistic, more evocative of cooperation and of win-win solutions is now called for.

In Section II, I observe that the fall-back position of staunch shareholder primacy advocates in the face of the corporate disasters of the last few years is that corporate officers and directors should work to maximize share value in the long term, rather than in the short term.[11] Yet, the mantra of share value maximization has no distinctive meaning and policy implications if it is not interpreted to mean maximization of short-term value. The actions required to maximize share value in the long run are probably indistinguishable in practice from more broadly stated goals, such as the maximization of wealth for all corporate stakeholders.

In Section III, I briefly review an alternative model of corporate governance which starts from the premise that the purpose of the corporate form of organization is to solve the problem of contracting among multiple parties involved in "team production."[12] Under the team production approach to corporate law, directors are understood to be fiduciaries for the corporate entity, responsible for making the decisions necessary to keep the corporate team productive. As Professor Lynn Stout and I have argued elsewhere, many features of corporate law in the United States are more consistent with our team production model than they are with shareholder primacy, at least if shareholder primacy is interpreted to mean maximization of shareholder value in the short term.[13] The prescriptions for directors' duties under the team production model, however, turn out to be very similar, and perhaps even "observationally

11. *See, e.g.*, Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, BANK OF AM. J. APPLIED CORP. FIN., Fall 2001, at 8, 9 (arguing that the proper goal of corporate officers and directors should be maximization of long-term share value); *see also* discussion *infra* pp. 109-15. Among leaders in the business community, the idea that the proper goal of corporations should be measured in the long term, and not in terms of daily share price, or even quarterly earnings, is not controversial. *See, e.g.*, THE CONFERENCE BOARD COMMISSION INC., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 15 (2003), *available at* http://www.conference-board.org/knowledge/governcommission.cfm (last visited July 13, 2003) ("A view toward the long term serves the best interests not only of the company's shareowners, but also of the company's other constituencies, such as employees, customers, suppliers and communities.") [hereinafter THE CONFERENCE BOARD COMMISSION].

12. This section relies heavily on work done jointly with Professor Lynn Stout. In particular, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

13. *Id.* at 250.

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equivalent,"[14] in practice to the prescriptions that advocates of long-term share value maximization would make. The difference is primarily in the language used to describe the duties.

In Section IV, then, I argue that the language of shareholder primacy is unnecessarily divisive and provocative, especially if what its advocates really mean is maximization of long-term shareholder value. As most advocates of shareholder primacy are at pains to point out, long-term share value maximization requires that the interests of all other corporate constituencies be accommodated. But I argue that the language of shareholder primacy—by implying that only one set of corporate constituents matters—is more likely to evoke uncooperative, and even unethical behavior in the workplace than is the language of team production. I base this argument on evidence from empirical studies of the choices people make in "social dilemma" games,[15] as well as studies of factors that contribute—or detract from—establishing ethical norms and an ethical corporate climate.[16]

The final section expresses a cautionary note about how the language we use to describe the duties of corporate actors can have unintended consequences. Just as the language of share value maximization helped create a business climate which culminated in the abuses of the last few years, the language of team production can also lead to abuses. Both approaches to describing directors' duties rely, ultimately, on the individuals in the boardroom being people of strength and impeccable character who are knowledgeable about and engaged in the process of governing corporations to prevent abuses and to call forth the highest and best performance of all corporate team members.

II. THE SHORT RUN VS. THE LONG RUN

In response to the scandals of the last few years, some shareholder primacy advocates have retreated to an older argument, made frequently prior to the takeover battles of the 1980s, that the

14. To an econometrician, two theories or explanations of patterns in data are "observationally equivalent" if they both predict the same pattern or set of relationships in the data.

15. This evidence is reviewed in detail in Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001).

16. *See, eg.*, Lynn L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Directors and Officers for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. (forthcoming Fall 2003), *available at* http://ssrn.com/abstractid=350341 (last visited July 10, 2003) (providing an excellent summary of the role of corporate climate in fostering ethical behavior).

proper goal of corporate managers and directors is the maximization of profit, or share value, in the *long run*.[17] The idea that there is a distinction between factors that might cause share prices to rise or fall in the short run and those that drive the long-run performance of share prices was, for many twentieth-century decades, the device that allowed courts and legislatures to sanction activities by corporations that were intended to benefit stakeholders other than shareholders without explicitly adopting a model of the corporation as a social entity with responsibilities to many stakeholders. Courts protected directors at companies that rejected a hostile takeover in part to protect employees,[18] that avoided risky undertakings that would benefit shareholders at creditors' expense,[19] that rejected profitable business opportunities that might be damaging to a local community,[20] or that gave money to charitable causes.[21] "The law

17. Harvard's Michael Jensen, one of the most prominent and adamant advocates of shareholder primacy, an unfettered market for corporate control, and compensation tied to stock price performance, has lately conceded, for example, that a myopic focus on short-term share value can be harmful. Jensen has observed that "an overvalued stock can be as damaging to a company as an undervalued stock." Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, J. APPLIED CORP. FIN., Winter 2002, at 41. Jensen now argues that the criterion managers should use in making decisions is "maximization of the long-run value of the firm." Jensen, *supra* note 11, at 9. Moreover, Jensen's notion of "firm value," is defined to mean "not just the value of the equity, but the sum of the values of all financial claims on the firm–debt, warrants, and preferred stock, as well as equity." *Id.* at 8. Jensen refers to this broader notion of value maximization as *"enlightened value maximization."* *Id.* at 9; *see also* Eric Talley, *On the Demise of Shareholder Primacy (Or, Murder on the James Trains Express)*, 75 S. CAL. L. REV. 1211, 1214 (2002) (dismissing attacks on the correctness of share value maximization as the primary corporate goal as "becoming a straw person among academics," and suggesting that all of the best minds in law and economics have abandoned any commitment to short-term share value maximization).

18. *See, e.g.*, Cheff v. Mathes, 199 A.2d 548, 556-57 (Del. 1964).

19. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. CIV.A. 12150, 1991 Del. Ch. LEXIS 215, at *107-09 (Del. Ch. Dec. 30, 1991).

20. *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 780-81 (Ill. App. Ct. 1968).

21. The Delaware courts made clear in *Theodora Holding Corp. v. Henderson*, that in its view, the loss of shareholders' profits from reasonable contributions to charities "is far out-weighed by the overall benefits flowing from the placing of such gift in channels where it serves to benefit those in need of philanthropic or educational support." 257 A.2d 398, 405 (Del. Ch. 1969). By the late 1970s, forty-eight states had passed laws "explicitly providing that chartered corporations could give to charities without specific charter provision[s]." EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 401 n.40 (1981).

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'papered over' the conflict in our conception of the corporation by invoking a murky distinction between long-term profit maximization and short-term profit maximization," wrote William T. Allen, former Chancellor of the Delaware Court, in explaining why the law permitted such activities while still using the language of what he called the "stock-holders oriented property theory" of the corporation.[22]

The problem with trying to make this distinction in the 1980s and 1990s, however, was that it represented a rejection of the Efficient Capital Markets Hypothesis ("ECMH"), one of the central tenets of finance theory.[23] According to the ECMH, the prices of securities that trade in active and liquid markets should, at all times, reflect "an unbiased forecast of future cash flows that fully reflects all publicly available information."[24] Today's price, according to finance theory, collapses the value of the expected future stream of dividend payments on the security into a single "present value." Thus, one of the supposed benefits of using share prices as the lodestar of performance for corporate officers and directors is that share prices are believed to be a forward-looking measure—the market's best guess about the value of investments undertaken so far as well as investments to be made in the future—while all accounting measures of performance are backward looking. Not only are share prices forward looking, according to the ECMH, but they are also the best crystal ball we have for evaluating the impact that decisions made today will have on corporate performance in the future.

Thus, the importance of the belief in short-term share price performance as the best measure of corporate performance, and hence, of the performance of directors and officers of the company, cannot be overstated. In the heat of the takeover wars of the 1980s and early 1990s, it was the fact that takeovers offered shareholders of target firms an *immediate* gain in the value of their shares that, to share value maximization and takeover advocates, required officers and directors to remain passive and not resist the takeover. Takeover advocates believed that allowing takeovers to go forward was necessary to maximize the total wealth created in the corporate

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22. *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 272-73 (1992).

23. *See* Gordon, *supra* note 8, at 1235, 1241 (noting that the Enron episode "provides another set of reasons to question the strength of the efficient market hypothesis" which, he adds, "has been one of the underpinnings of the argument for shareholder choice in the decision whether to accept a hostile takeover bid at a premium to the market price").

24. RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 136 (1993).

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sector because widespread evidence showed that target company share prices rose on the announcement of a bid for the shares.[25] Also, according to the ECMH, the rise in share prices of target company shares necessarily implied that takeovers were good for the economy overall. The fact that stock prices overall rose during the takeover era was taken as evidence of this claim.[26]

If one lesson of Enron and other corporate disasters in the last few years is that today's share price cannot be counted on to reflect the true underlying value of the equity of a corporation, then the rise in share prices in the short run after the announcement of a hostile tender offer cannot necessarily be interpreted as reflecting a true increase in value that would result from the takeover.[27] And if the rise in share prices is not uncontestable evidence that value will be created by a proposed takeover, then this undercuts a key contention of takeover advocates who had argued that the "market for corporate control" provides sufficient discipline to be sure that corporate officers and directors use their authority over corporate resources in ways that tend to maximize value creation by corporations.

Despite the critical importance of the belief that share prices at any point in time are the best estimate of the true underlying value of the stock, we find that, in the aftermath of the recent corporate scandals, formerly die-hard shareholder primacy advocates are now conceding that share prices can be manipulated in the short run. Harvard's Michael Jensen, a leading standard bearer for shareholder primacy, now says that corporate directors and officers

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25. *See, e.g.*, Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (summarizing evidence from "event studies" that target company share prices rise on the announcement of a tender offer, and arguing that this is evidence of social gains from takeovers).

26. *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 837 (1993) (noting that from 1976 to 1990, total merger and acquisition transactions generated $750 billion in gains to target company shareholders (measured in 1992 dollars)).

27. Professor Lynn Stout challenged the notion that the premium offered for the shares of takeover targets should be interpreted as evidence of the additional value that would be created by the acquisition of the target bidder. *See* Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 Yale L.J. 1235, 1259-75 (1990); *see also* SARA B. MOELLER ET AL., DO SHAREHOLDERS OF ACQUIRING FIRMS GAIN FROM ACQUISITIONS? (Dice Center, Working Paper No. 2003-4), *available at* http://papers.ssrn.com/paper.taf?abstract id=383560 (2003) (last modified Feb. 2003) (noting that in 12,023 acquisitions by public firms from 1980 to 2001, acquiring firms lost a total of $218 billion when the acquisitions were announced).

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should "Just Say No to Wall Street" pressure for short-term earnings performance, at least if it requires so-called "earnings guidance" to live up to Wall Street's expectations.[28] Instead, he advises corporate directors and officers to practice what he calls "*enlightened value maximization*," instead of focusing too narrowly on short-run share prices.[29] "Enlightened value maximization," he says, requires maximizing the aggregate value of all financial securities (debt plus equity) issued by the firm, not just maximizing the value of equity shares.[30]

It is instructive, however, to see what Jensen says directors and officers must do to maximize financial value: "In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders—customers, employees, managers, suppliers, and local communities. Top management plays a critical role in this function through its leadership and effectiveness in creating, projecting, and sustaining the company's strategic vision."[31] "Enlightened value maximization," he continues, "uses much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders."[32]

Thus, it turns out that as shareholder primacy advocates have become "enlightened," they have discovered that value creation involves vision, risk-taking, and complex trade-offs among a variety of different participants in the business enterprise of the firm. The implicit prescription for director behavior under a rule of enlightened value maximization is not very well specified, however. As long as directors are not rapaciously self-interested or grossly negligent, it is difficult to see how a court could use an "enlightened value maximization" standard to determine whether directors are carrying out their fiduciary duties.

III. THE "TEAM PRODUCTION" ALTERNATIVE

In earlier work I have done jointly with Professor Lynn Stout, we have argued that corporate law should be understood as an important solution to the problem of organizing production in teams.[33] We use the phrase "team production" to refer to productive

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28. Fuller & Jensen, *supra* note 17, at 41.
29. Jensen, *supra* note 11, at 9.
30. *Id.* at 8.
31. *Id.* at 9.
32. *Id.*
33. Blair & Stout, *supra* note 3, at 250. Corporate law is not the only solution to this problem, to be sure, but one more likely to be used the larger the number of individual contributors to the corporate team, and the more complex and enterprise specific the contributions must be.

activity that requires multiple parties to make contributions that are complex, at least somewhat specific to the enterprise the team is undertaking, difficult to verify, and non-separable, meaning that it is impossible to determine ex post which team member is responsible for what part of the output.[34] Economists who have studied the problem of team production have observed that it is extremely difficult, if not impossible, to write complete contracts that would govern the relationships among team members.[35]

Building on that prior body of work, Professor Stout and I constructed a theoretical solution to the team production problem which works by allocating control rights to certain parties who are not members of the team. In particular, we suggest that corporate law provides one possible solution by offering a legal structure in which all of the assets used in production by the team, as well as the output from the efforts of the team, are the property of a separate legal entity, the corporation, and decision rights over these assets are relegated to a board of directors that is independent of the team.[36] Directors, then, have fiduciary duties that run to the corporation—the legal entity that represents the aggregate interests of all of the "team members"—and only through the corporation to shareholders.[37]

Professor Stout and I further argue that many features of corporate law in the United States are more consistent with our team production model than they are with shareholder primacy.[38] For example, although it has become common in legal scholarship in

34. *Id.* at 249-50.

35. *Id.* at 265-71 (reviewing theoretical literature about the difficulty of solving the team production problem, especially work by economists Armen Alchian and Harold Demsetz, Bengt Holmstrom, Oliver Hart, Raghurum Rajan and Luigi Zingales); *see, e.g.*, Armen A. Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779-83 (1972) (defining team production problems); Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 J.L. ECON. & ORG. 119, 121-25 (1988) (noting that property rights, which give the "owner" residual control rights, help to close the gaps in incomplete contracts); Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324, 325 (1982) (noting the impossibility of writing complete contracts governing the relationships among team members who make team-specific investment without introducing distorting incentives); Raghurum G. Rajan & Luigi Zingales, *Power in the Theory of the Firm*, 113 Q.J. ECON. 387 (1998) (noting that one solution to the team production problem requires team members to yield certain control rights to someone outside the team).

36. Blair & Stout, *supra* note 3, at 271-79.

37. *See* RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a (1958) (stating that directors' duties are owed to "the corporation itself rather than to the shareholder individually or collectively").

38. Blair & Stout, *supra* note 3, at 249-50.

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the last two decades to refer to corporate directors and managers as "agents" of shareholders,[39] corporate law in fact makes a sharp distinction between the role of managers and the role of directors. Dean Robert Clark makes this point succinctly:

> (1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with "the corporation"); (3) directors are not agents of the corporation but are *sui generis*; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are "fiduciaries" with respect to the corporation and its stockholders.[40]

As noted above,[41] corporate law also provides enormous discretion to directors who make decisions in good faith about the allocation of corporate resources, even in cases where it is hard to show how such allocations benefit shareholders. Courts have also explicitly recognized that in situations in which share value is not a good proxy for the overall wealth creating capacity of the corporation, directors' duties may run to other stakeholders, especially creditors.[42]

Furthermore, the rules of derivative actions are much more consistent with a team production interpretation of corporate law than with a shareholder primacy interpretation. Although ordinarily only common shareholders have standing to file a derivative action,[43] several procedural hurdles make it difficult for

39. An example of the persistent reliance on this construct can be found in Lucian A. Bebchuck's work. *See* Bebchuck, *Case for Facilitating*, *supra* note 5. Bebchuck uses the words "management," "boards," "directors," and "boards of directors" completely interchangeably throughout the article, which is devoted in its entirety to examining proposed solutions to the "principal-agent" problem between shareholders and management/directors.

40. Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 56 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (emphasis added).

41. *See supra* notes 17-21 and accompanying text.

42. *See, e.g.*, *Credit Lyonnais Bank*, 1991 Del. Ch. LEXIS 215, at *108 (noting that when a corporation is "in the vicinity of insolvency" director duties run to "the community of interests" that make up the corporation).

43. FED. R. CIV. P. 23.1; DEL. CODE ANN. tit. 8 § 327 (2002). The court in *Hoff v. Sprayregan* also granted standing to file a derivative action to convertible debenture holders who had converted their holdings into common stock during the time in which the alleged breaches of fiduciary duty had occurred, but this approach has not been widely followed. 52 F.R.D. 243, 247-48 (S.D.N.Y. 1971).

shareholders to take such action.[44] Moreover, if, despite the obstacles, the derivative action is successful, any damages recovered must be paid not to the shareholders who pursued the action, but to the corporation. Finally, shareholders can only win a derivative action if directors are found to have blatantly violated their duty of loyalty by appropriating to themselves resources that belong to the corporation, or have so negligently violated their duty of care that their actions were judged to have wasted corporate resources. In these situations, the harm done is to the interests of the corporation as a whole, rather than directly to the suing shareholders, or even to shareholders as a group. Meanwhile, shareholder actions have not been successful where they allege that directors have made decisions or allocated resources in ways that may benefit other corporate stakeholders, even at the (short-run) expense of profits.[45]

The team production model helps explain the broad discretion granted directors under corporate law, as well as the limits placed on shareholders' ability to intervene in the decision-making process.[46] But so far the team production model has not been used to develop detailed prescriptions regarding positive duties that directors should have. In earlier work, I have argued that the job of boards of directors should be to maximize "the total wealth-creating potential of the enterprises they direct."[47] In doing this, directors must understand that business enterprises generate wealth in at least three different ways: they "provide products and services that are worth more to the customer than the customer pays for them"

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44. Shareholders must first make a "demand" on the board of directors that it take the desired action on behalf of the firm against managers or directors who are alleged to have violated their fiduciary duties, or they must demonstrate that the board is so tainted by conflict of interest that demand should be excused. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 810-15 (Del. 1984), *rev'd on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (discussing demand requirement). Even if demand is excused, directors may form an investigative committee of independent directors who may take control of the lawsuit and have it dismissed. *See* ROBERT C. CLARK, CORPORATE LAW 640-43 (Francis A. Allen et al. eds., 1986); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 782-84 (Del. 1981) (discussing situations in which derivative action can be terminated by a committee of the board).

45. *See* Blair & Stout, *supra* note 3, at 302-04 (reviewing the various ways that courts "have allowed directors to sacrifice shareholders' profits to stakeholders' interests when necessary for the best interest of 'the corporation'").

46. *See* Bebchuck & Ferrell, *supra* note 5, at 113-15 (discussing at length the constraints on shareholders' initiatives, and a set of "reform" proposals that would grant shareholders much more power relative to managers and directors in publicly-traded corporations).

47. MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 239 (1995).

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(this results in "consumer surplus");[48] they "provide opportunities for workers to be more productive at their jobs than they could be in other available employment" (to the extent that the workers are paid more than they would earn at alternative employment, they capture some of this wealth as "labor surplus");[49] and they can "provide a flow of profits to its investors that is greater than those investors could get by investing in alternative activities" (such wealth captured by financiers is "capital surplus").[50] Finally, the sum of consumer surplus, labor surplus, and capital surplus must exceed any costs imposed on the surrounding community, or on others who are not direct participants in the enterprise.[51]

It seems clear that for directors to do this they must take into account not only the investment interest of shareholders, but also the interests of all of the stakeholders who have made specific investments that are at risk in the enterprise. Beyond that, however, the prescriptions that come out of a team production approach to corporate law are not, so far, very specific, and in practice may be indistinguishable from the prescriptions that advocates of long-term share value maximization would make. The difference is primarily in the language used to describe the duties.

IV. WHY CHOICE OF LANGUAGE MATTERS

The team production model of corporate law, we have seen, suggests that the role of corporate directors is to mediate among members of the corporate team, making decisions in the interest of the corporate entity, which serves as a proxy for the combined interest of all the team members. Meanwhile, leading business people (as well as a few prominent shareholder primacy advocates), have claimed that the "long-run" version of the shareholder primacy model implies that corporate directors should make decisions that accommodate the interests of important stakeholders in an effort to maximize the long-run wealth creation by the corporation. For example, investment banker Peter G. Peterson, who co-chaired the Conference Board Commission on Public Trust and Private Enterprise,[52] observes,

48. *Id.* at 240.

49. *Id.* at 241.

50. *Id.* at 240-41.

51. *Id.* at 241. *See also* Gregory Scott Crespi, *Redefining the Fiduciary Duties of Corporate Directors in Accordance with the Team Production Model of Corporate Governance*, 36 CREIGHTON L. REV. 623, 636-39 (analyzing in detail the complete calculations judges would have to make to determine whether corporate officers or directors were maximizing total wealth creation).

52. THE CONFERENCE BOARD COMMISSION, *supra* note 11, at 3.

> [W]hereas managing for stock price gains too often means managing for the short term, managing with an eye towards long-term operating performance is in the best long-term interests of the corporation and its shareholders, as well as its other constituencies, such as employees, communities and customers–all of whom have a decided interest in the long-term success of the corporation.[53]

Thus, in practice, it seems clear that it will be difficult, if not impossible, to distinguish between the goal of overall wealth maximization, and the goal of long-term share value maximization: Is a decision to award stock options to all employees made because it is good for shareholders in the long run? Or is it made to share the benefits of wealth creation with employees, and thereby encourage them to stay motivated and productive? Is a decision to aggressively reduce carbon emissions from a company's plants made because it is the socially responsible thing to do, or is it made because, in the long run, it will be good for shareholders if the company plays a leadership role in developing environmentally sustainable ways to operate?

Neither a mandate to engage in long-run share value maximization, nor a mandate to enhance the performance of the corporation as a whole by carefully balancing competing interests so that the team stays productive provide courts with a way to tell whether directors are doing their job in an optimal way. Because of this indeterminacy, courts have, wisely, avoided trying to second-guess the decisions of directors when faced with a challenge from shareholders (or occasionally from other constituents such as creditors).[54] Instead, unless the directors are so badly tainted by self interest that they could not be expected to be able to make a decision that fulfilled either mandate, courts have relied on the "business judgment rule" which is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[55] The business judgment rule

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53. *Id.* at 9.

54. As discussed above, the rules of derivative suits normally permit only shareholders to act for the corporation in bringing a derivative action against directors for breach of their fiduciary duties, but corporate law occasionally allows bondholders and other creditors to bring claims of breach of fiduciary duty against the board once a corporation becomes insolvent. *See supra* notes 44-45; Geyer v. Ingersoll Publ'n Co., 621 A.2d 784, 787-88 (Del. Ch. 1992) (holding that a board of directors owes fiduciary duties to creditors no later than when the corporation becomes insolvent).

55. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *rev'd on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

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protects directors from liability for honest errors and mistakes of judgment by declaring that "[t]he law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than welfare of the corporation."[56]

If judges cannot constrain director behavior to conform to either mandate, why should it matter what metaphor or what language we use to describe the duties of directors? The reason is that language itself influences behavior because it is an extremely important part of the social signals that people send each other to help establish the norms and expectations that people have for each other.[57] Although scholars steeped in the jurisprudence of law and economics tend to consider only the ways that economic incentives and legal constraints influence behavior, there is strong evidence from other social sciences that a variety of social signals also influence behavior.[58]

A. *Language and Cooperation*

Professor Stout and I, for example, have reviewed the empirical evidence of studies by social psychologists, sociologists, and economists on the factors that cause people to cooperate in social dilemma games, rather than to "defect," which, in the context of social dilemma games means to choose the myopically self-interested, but socially sub-optimal action.[59] This evidence suggests that cooperation rates in social dilemma games can be induced to range, predictably, from as low as 5% to as high as 95%, depending on the social context in which the game is played.[60] The social signals that seem to matter most include instructions from authority figures,[61] perceptions about whether the other players in the game

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56. Bayer v. Beran, 49 N.Y.S.2d 2, 5 (N.Y. App. Div. 1944).

57. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997) (providing an interesting discussion of how the language used by judges in the Delaware courts help to establish norms and expectations that directors should be responsible and ethical, even as the substance of the actual decisions gives directors enormous discretion).

58. *See* Blair & Stout, *supra* note 15.

59. *Id.* at 1760; *see also* David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58, 77-85 (1995) (reviewing the findings from dozens of social dilemma experiments over the years).

60. Blair & Stout, *supra* note 15, at 1768.

61. *Id.* at 1769. In the stylized world of social dilemma games, instructions from authority figures usually mean whatever those who are running the experiment tell or ask the players to do.

are members of one's own group, however such groupings might be defined,[62] and the expectations that players have about how likely their fellow players are to cooperate.[63]

A consistent finding in social dilemma games is that cooperation rates can be dramatically increased (by as much as 40 percentage points) if the experimenter simply tells the players they are supposed to cooperate.[64] Likewise, cooperation rates fall by as much as thirty-three percentage points if players are instructed to compete.[65] By analogy, if corporate executives and directors announce to corporate participants that the venture they are participating in is a competitive enterprise in which employees must get what they can for themselves because officers and directors are working for the sole benefit of shareholders, it seems unlikely that they will elicit as much eager cooperation and self-sacrifice for the good of the enterprise than if they announce that all of the participants, regardless of what kind of contribution they bring to the enterprise, are part of the same team, and all will share in the success of the enterprise.

The language of team production is also a language that suggests to corporate participants that they are all part of the same in-group. In contrast, the language of shareholder primacy suggests that shareholders are a privileged in-group, while all others are outsiders, and not part of the in-group. Social scientists have shown, however, that when group identity is brought into play as a factor in social dilemmas, individuals who perceive themselves to be a part of the same in-group with their fellow players are far more likely to cooperate than individuals who perceive themselves to be playing against another group.[66]

Finally, social scientists have found that individuals are much more likely to cooperate if they expect their fellow players to cooperate.[67] It seems unlikely on its face that employees, suppliers, creditors, customers, and communities will be eager to cooperate to produce a successful outcome in an enterprise if directors and managers repeatedly assert that the enterprise is all about profits for shareholders, period. Admittedly, there may be circumstances in which old implicit and explicit understandings about how economic gains from an enterprise are to be shared must be broken, and new

62. *Id.* Group membership can be defined in such games by factors as otherwise meaningless as colored markers drawn randomly from a jar.

63. *Id.* at 1772.

64. *Id.* at 1769-70.

65. *Id.* at 1770.

66. *Id.* at 1171; *see also* Sally, *supra* note 59, at 68.

67. Blair & Stout, *supra* note 15, at 1772.

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contracts (explicit and implicit) must be written. The major commercial airlines, for example, are all in the process of trying to slash costs by rewriting their contracts with suppliers, creditors, and labor.[68] But it seems self-evident that those negotiations would be much less likely to yield sacrifices by other corporate participants if profits were still strong, and if the stated purpose of the sacrifices was to make shareholders even better off. The language of shareholder primacy is a language that draws attention to conflicting interests and announces that, when faced with conflicts, directors will choose to benefit shareholders over all others. By contrast, the language of team production is a language of shared sacrifices and shared benefits.

B. Language and Incentive Systems

As if the language of shareholder primacy was not divisive enough by itself, shareholder primacy advocates also have frequently advocated that executives and directors should be compensated in ways that are tied to share price performance. Behind this desire to link executive pay to share price is a firmly-held belief by individuals trained in the logic of law and economics that corporate executives are fundamentally untrustworthy, and will abuse their positions of power and authority by redirecting corporate assets to their own benefit at the expense of the corporation unless they are given powerful economic incentives to focus solely on those activities that enhance share price. The whole idea of incentive compensation, then, became part of a set of social signals sent by investors, academics, consultants, and the media in the 1980s and 1990s that corporate managers were expected to play a competitive game, not a cooperative one. It was expected that they would be in the game for themselves, rather than for some larger vision, so that directors would have to make it attractive for the executive not to cheat the company, but rather to work for higher share value.[69]

68. *See, e.g.*, Margaret M. Blair, *The Economics of Post-September 11 Financial Aid to Airlines*, 36 IND. L. REV. 2 (2003) (describing the wrenching effect on the airlines of reductions in air travel since September 11, 2001).

69. *See, e.g.*, MARGIT OSTERLOH & BRUNO S. FREY, CORPORATE GOVERNANCE FOR CROOKS? THE CASE FOR CORPORATE VIRTUE (Institute for Empirical Research in Economics, Working Paper No. 164, 2002) (arguing that extrinsic motivation through incentive contracts and intensive monitoring crowds out intrinsic motivation, resulting in a "governance structure for crooks"); *see also* Ernst Fehr and Simon Gachter, *Do Incentive Contracts Crowd Out Voluntary Cooperation?*, 1 (USC Center for Law, Economics & Organization, Research Paper No. C01-3, 2001), *available at* http://papers.ssrn.com/abstract_id=229047 (reviewing the empirical evidence that incentive contracts "crowd out" intrinsic

The result was an orgy of stock option grants,[70] compensation levels that rose by orders of magnitude to heights (relative to the wages of average workers) not seen since the Robber Baron days,[71] and huge incentives to manipulate stock prices with misleading information. "Unfortunately, institutional investors, corporate governance activists, and even SEC regulations have led many corporations to define performance simply as stock performance–to disregard a corporation's vision and . . . its value system," observed consultant Pearl Meyer during a recent Harvard Business School roundtable.[72] "As a result of all this emphasis on stock price, 60% of CEO compensation today is in stock options. [Including] other elements of pay, 70% in all is stock-based. . . ."[73]

Although options were often sold as a form of compensation that would align the interests of directors and officers with those of shareholders, they actually have the effect of creating further divisions within the organization. This is because option holders can make themselves better off at the expense of shareholders, as well as all other stakeholders, by causing the firm to engage in highly risky strategies (not to mention by lying about accounting performance in the hopes of manipulating stock prices). Nevertheless, most shareholder primacy advocates saw only the incentives that stock options created for increasing share prices. "Weren't we saying in the 1980s that we should tie CEOs to the

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motivation, and providing new experimental evidence that the crowding out effect is strong enough that incentive contracts "are on average less efficient and elicit less effort from agents, than contracts that do not provide any incentives at all").

70. The compensation mechanism of choice to provide executives with incentives to focus on share value has usually been stock options, although the reasons were primarily tax and accounting factors rather than economic incentive reasons. Corporations have not been required to treat stock option grants as a cost, to be charged against earnings in the current period, an accounting treatment that made it easier for directors to think of options as "free" and to award them in very large quantities. For tax purposes, options are attractive to the recipients because they are not treated as income to the recipient until she exercises the options (at which point, the difference between the price the recipient pays to exercise the option and the trading price of the stock will be treated as a cost to the company for tax purposes, and as income to the recipient).

71. *See* Paul Krugman, *For Richer: How the Permissive Capitalism of the Boom Destroyed American Equality*, N.Y. TIMES MAGAZINE, Oct. 20, 2002, at 62, 64 (citing data on income distribution and arguing that we are now living in a "New Guilded Age").

72. *What's Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 69, 72.

73. *Id.* Meyer said that her data are based on compensation for CEOs at the largest 200 corporations in the United States. *Id.*

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market in order to identify them with shareholder value?" asked Joe Bachelder, a leading compensation lawyer and consultant participating in the same roundtable.[74] "We got what we asked for," he added in response to his own rhetorical query.[75]

C. *Language and Ethical Behavior*

The language we use to describe the job of corporate officers and directors also helps to create the climate within which ethical decisions are made. As Professor Lynne Dallas has observed,[76] the United States Sentencing Commission's Organizational Sentencing Guidelines, supported by case law,[77] suggest that one of the important duties of directors and officers of corporations is to put in place information and control systems that will help to prevent unethical or illegal behavior by employees. The Sarbanes-Oxley Act of 2002 (the "Act") further directs the Sentencing Commission to reevaluate its sentencing guidelines to be sure that they are "sufficient to deter and punish organizational criminal activity."[78] The Act also directs the Securities and Exchange Commission (the "Commission") to require public corporations to disclose whether or not they have adequate internal controls,[79] and whether or not they have a code of ethics for senior officials and, if not, to disclose the reason why not.[80] And it directs the Commission to require companies to disclose situations in which directors waive an ethics requirement for some employee, or for some transaction, and explain why.[81] The New York Stock Exchange has also proposed similar rules, plus a requirement that goes even further by requiring that listed corporations "proactively promote ethical behavior."[82] The Conference Board Commission on Public Trust and Private Enterprise further espouses (among other recommendations) the principle that "ethical standards and the skills required to foster

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74. *Id.* at 73.

75. *Id.*

76. Dallas, *supra* note 16, at 7-12.

77. *See, e.g.,* In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968-70 (Del. Ch. 1996) (suggesting that directors have a duty to become informed about legal compliance matters in their organizations).

78. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 805(a)(5), 116 Stat. 745 (2002).

79. Sarbanes-Oxley Act §404.

80. Sarbanes-Oxley Act § 406(a).

81. Sarbanes-Oxley Act § 406(b).

82. *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate, Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors, available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf, at § 10 (last modified Aug. 1, 2002).

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ethical practice throughout the organization should be among the core qualifications for the CEO and other senior management positions," that a board committee should be designated to oversee ethics issues, and that "ethics-related criteria" should be included in employees' annual performance reviews and in the evaluation and compensation of management.[83]

How does a corporation "proactively promote ethical behavior," and how do directors evaluate management on the basis of "ethics-related criteria"? Related questions have been studied in some detail by business ethicists and social scientists who have inquired into the problem of creating an ethical corporate climate.[84] Dallas summarizes a growing literature on the subject, which, consistent with the findings on trust and trustworthy behavior in the previous section, finds that ethical behavior is more strongly influenced by situational factors than by the personal belief systems of individuals.[85]

Dallas' summary suggests a number of ways that shareholder primacy language, as well as incentive compensation systems tied to stock price performance, might undermine any attempt to create or maintain an ethical climate within an organization. For example, she finds several different contextual factors that encourage or discourage employees from giving priority to moral decision-making and actions.[86] One of these is the "role expectations" within the business environment. Because most employees segregate the values that influence their choices at home from the values that influence their choices at work, "managerial decisions will correspond more closely to the humanistic, religious, cultural and societal values of society-at-large only when these values are made part of the job environment."[87] The rhetoric of shareholder primacy, however, serves to suppress values of empathy toward others to focus attention solely on the bottom line financial impact of corporate decisions.

Dallas argues that the "ethical climate of a corporation consists

83. THE CONFERENCE BOARD COMMISSION, *supra* note 11, at 32.

84. *See, e.g.*, Woodstock Theological Center Seminar in Business Ethics, *Creating and Maintaining an Ethical Corporate Climate*, *available at* http://www.georgetown.edu/centers/woodstock/business_ethics/ecct.htm (last visited July 13, 2003) [hereinafter Woodstock Theological Center]; *see also* Dallas, *supra* note 16, at 13 n.38.

85. *See, e.g.*, O.C. Ferrell & Larry G. Gresham, *A Contingency Framework for Understanding Ethical Decision Making in Marketing*, 49 J. MKT. 87, 92-93 (1985).

86. Dallas, *supra* note 16, at 26.

87. *Id.* (quoting Michael Bommer et al., *A Behavioral Model of Ethical and Unethical Decision Making*, 6 J. BUS. ETHICS 265, 268 (1987)).

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of the ethical meaning attached by employees to organizational standards, practices and procedures, including managerial behavior and reward systems, that reflect the corporate norms and values."[88] While I would imagine that most shareholder primacy advocates believe themselves to be highly ethical people, with a low tolerance for unethical behavior,[89] the language of shareholder primacy states outright that the norms and values of the corporation should be about enhancing shareholder value, and any consideration of the impact of corporate actions on other stakeholders is only instrumental. Moreover, the incentive systems promoted by shareholder primacy advocates reinforces the message by emphasizing self-interest as a motivation, and rewarding choices that emphasize the financial bottom line over other goals. Such practices and procedures can easily undermine verbal messages that seem to place a value on ethics.[90] Dallas concludes, for example, that performance evaluations that increase the competitiveness of the work environment, and "unduly focus on the bottom line can lead to pressures to engage in unethical conduct."[91] Other scholars and commentators have made similar points. "It was the laser focus on stock price gain that encouraged executives to drive their beasts so hard they collapsed. CEOs were the visible villains, but there were whips wielded to keep them driving toward maximum share

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88. *Id.* at 32.

89. *See* Michael C. Jensen & Joe Fuller, *What's a Director to Do?, in* BEST PRACTICE 243 (Perseus Publishing ed., 2003) (devoting an entire section of their article on reforming corporate boards to the problem of restoring honesty and integrity to corporate decision-making).

90. "Enron rang all the bells of CSR [Corporate Social Responsibility]," noted Marjorie Kelly, editor of Business Ethics in the magazine's first post-scandal editorial.

> It won a spot for three years on the list of the 100 Best Companies to Work for in America. In 2000, it received six environmental awards. It issued a triple bottom line report. It had great policies on climate change, human rights, and (yes indeed) anti-corruption. Its CEO gave speeches at ethics conferences and put together a statement of values emphasizing 'communication, respect, and integrity.' The company's stock was in many social investing mutual funds when it went down.

Marjorie Kelly, *The Next Step for CSR: Economic Democracy*, 16 BUS. ETHICS, May/June/July/August 2002, at 3-4 (1990). But at the same time that it was giving lip service to the importance of ethics, Enron was providing outsized financial rewards to employees who met or exceeded aggressive financial targets, and conducting annual performance reviews of employees based solely on how they did relative to financial targets, laying off those employees in the lower tail of the distribution. *See* Wendy Zellner et al., *Fall of Enron*, BUS. WEEK, Dec. 17, 2001, at 30, 33-36.

91. Dallas, *supra* note 16, at 48.

price: whips of firing, stock options, and hostile takeovers," observes Marjorie Kelley, editor of *Business Ethics* magazine.[92]

To be fair, the rhetoric of team production can also be used to promote unethical practices by supporting a "win at any cost" mentality among corporate "team members." But it seems inherently less likely to promote cutthroat competition among team members, and also more conducive to assessing corporate actions and choices in terms of their impact on all of the corporation's stakeholders, and not just the impact on one subset of stakeholders.

Directors who start from the premise that their job is to oversee the work of a team and to mediate among team members to encourage them to work together to achieve value creating corporate goals are more likely to consider each decision in terms of its impact on each of the relevant and important stakeholders, as well as on the overall goals of the corporation. In the long run, making decisions in this way seems more likely to produce sustainable, long-run value creation than allowing decision-making to be driven by when management's stock options expire, or by what management thinks market analysts want to hear at the next analysts' meeting to justify their "buy" recommendations.

V. CONCLUDING THOUGHTS

The problem with shareholder primacy rhetoric is not that profits and share price are not important measures of overall corporate performance. Rather, it is that when coupled with a religious devotion to the efficient capital markets hypothesis (which teaches that today's share price is a better forecast of performance than any innovative, carefully articulated, holistic, and nuanced strategic plan or forecast by management could be), shareholder primacy becomes a mantra that can justify actions taken in the business context that most business people would not contemplate in other contexts. As Harvard Business School professor Thomas R. Piper puts it,

> The idea of emphasizing shareholder wealth was not a bad message. It was shorthand for "Let's focus on becoming more efficient in competitive terms." And it worked in accomplishing that objective. But it fails to connect to all the constituencies–other than the shareholders–whose energies and commitment you need. They heard it as, "Let's make rich people richer." And it did not address the matter of *how* the

92. Kelly, *supra* note 90.

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maximization was to be accomplished.[93]

Business organizations, like any goal-oriented organizations, need shorthand language or "code" to share relevant information among the participants in the organization, to convey to all team members what the collective goals are, and to measure progress toward those goals.[94] But any shorthand phrase that is used to define corporate goals can be manipulated and corrupted. Lynn Stout and I have suggested elsewhere that corporate law and governance problems should be understood and analyzed as "*team production*" problems.[95] And I have argued here that the language of team production evokes concepts such as cooperation, mutual support, sharing of burdens and rewards, and win-win solutions. Such concepts are surely more likely than the concepts and images associated with shareholder primacy to elicit behavior from corporate participants that builds and sustains the enterprise rather than undermines and corrupts it.

But the language of team production could also be corrosive if used to justify free riding, blame sharing, or vaguely worded corporate goals that do not provide a means to measure performance and hold managers and boards accountable. Words are important, but even more important is the context in which they are used, who uses them, and how the individuals who use those words exercise leadership. The single most important factor in creating a corporate culture that promotes ethical conduct on the part of the organization and its employees is the "quality of corporate leadership, especially the 'tone at the top' set by boards," according to the Conference Board report.[96]

If the people invoking them behave honorably, poorly chosen metaphors and symbols are unlikely by themselves to corrode trust, cooperation, and ethical behavior. But if the people invoking them are behaving badly, even the most well chosen language and symbolic acts cannot promote trust, cooperation, and ethical behavior. Nonetheless, for corporate leaders who want to build a climate that supports trust, cooperation, and ethical behavior, the language of team production surely provides a better starting place

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93. Thomas R. Piper, *What Leaders Need to Do to Restore Investor Confidence*, *available at* http://hbswk.hbs.edu/pubitem.jhtml?id=3126&sid=0&pid=0&t=leadership (last modified Oct. 7, 2002).

94. *See, e.g.*, BIRGER WERNERFELT, ORGANIZATIONAL LANGUAGES (MIT Sloan School of Management, Working Paper No. 4278-03, 2003) *available at* http://papers.ssrn.com/paper.taf?abstract_id=372640 (last visited July 14, 2003).

95. *See* Blair & Stout, *supra* note 15, at 247-50.

96. THE CONFERENCE BOARD COMMISSION, *supra* note 11, at 22.

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than the language of share value maximization.

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