4-1993

Implications of the Stakeholder Model

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Introduction

The corporate law paradigm that shareholders are the owners of a corporation who elect directors to manage the corporation on the shareholders' behalf is an old-fashioned legal fiction. Nevertheless, it has a powerful hold on the legal imagination, as various formulations in the American Law Institute's (ALI) *Principles of Corporate Governance* (*Principles*) demonstrate.[1] The *Principles* updated this paradigm to provide for a monitoring role for directors, who are not expected to manage the large public corporation, but rather to appoint officers to do so. Further, the *Principles* proposed the model of independent directors as a mechanism to make the corporation accountable to shareholders.[2]

Although the ALI Corporate Governance Project (Project) proceeded on the premise that something was wrong with the manner in which American corporate boards functioned, the reporters assumed the perspective of the equity holder seeking stock market gain. Such a holder may have a different perspective than that of the

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1. American Law Inst., Principles of Corporate Governance and Structure: Analysis and Recommendations (Proposed Final Draft 1992) [hereinafter Proposed Final Draft].

2. The author previously analyzed and commented upon this model in Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 Geo. Wash. L. Rev. 534, 544-56 (1984) (reviewing the history of independent director proposals and critiquing the ALI's tentative provisions and the underlying monitoring model).

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owner of a business enterprise, especially when the holder is an institutional investor that is a financial intermediary.[3] Many observers of the takeover frenzy and stock market gyrations of the 1980s decided that shareholders and financial intermediaries were the trouble with American business.[4]

As the convoluted controversies of the Project proceeded through the 1980s, state legislatures began to take a different perspective than that of shareholders seeking to cash out their shares at a premium in overheated stock markets. Starting with Pennsylvania in 1986, more than half of the states passed stakeholder statutes, which propose a corporate governance model rather different from either the classic corporate law paradigm of the director-manager acting for the shareholder-owner or the updated ALI version set forth in the *Principles*.[5] Although some comments in the *Principles* make passing reference to stakeholder statutes,[6] the black-letter law was not adjusted to address the stakeholder model of corporate governance, because the ALI Reporters shared the general disapproval of stakeholder statutes held by the legal establishment, which tended to dismiss them as mere antitakeover devices.

This Article argues that the stakeholder statutes were a fundamental reaction to the institutionalization of the markets and that they have realigned not only directorial duties but shareholder rights. Such rights have been limited by the claims of other corporate constituencies, specifically debtholders, employees, and communities. In this connection, it should be noted that pension funds, which are the largest and most influential of the institutional investors, hold debt as well as equity, represent employees, and often are political players. Accordingly, the popularly held view that the interests of institutional investors are synonymous with shareholder interests is basically flawed.

Under the stakeholder model, directors do not owe duties exclusively to stockholders. Rather, they play the role of mediators between different corporate constituencies. Many lawyers and law professors feel that this model is unsatisfactory, because it seems to get directors off the hook[7] by eliminating their accountability to a clearly defined group who can sue them if they are negligent or engage in self-dealing. The model of directors as mediators between

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3. *See* Ralph C. Ferrara & Harry Zirlin, *The Institutional Investor and Corporate Ownership*, 19 SEC. REG. L.J. 341, 342-43, 351 (1992) (exploring the distinction between "owning securities" and "owning companies").

4. *See infra* notes 25-30 and accompanying text.

5. *See infra* Part II.A.

6. *See infra* Part III.

7. *See* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 580-81 (1992) (outlining this pervasive criticism, but concluding that it is "flawed").

groups with competing claims on corporate assets and prospects is, however, more realistic and closer to most corporate cultures than a model in which shareholders are the exclusive beneficiaries of business success. In addition, the stakeholder model may provide a helpful framework for a renewed focus on jobs and competitiveness in a global marketplace where long-term strategic planning has a higher value than stock market prices.

Part I of this Article discusses the impact of institutional investors on corporate governance, their perceived role in the stock market crises of the 1980s, and more recent proposals by shareholder activists. Part II analyzes the stakeholder statutes and related court decisions. Part III discusses the way non-shareholder interests are treated in the *Principles.* Part IV suggests new roles for directors and new restraints on institutional investors created by the stakeholder statutes.

I. Institutions and Corporate Governance

Institutional investors now own more than 50% of all publicly traded U.S. stocks.[8] Nevertheless, they are not owners of corporations in the same way that the shareholders of classic capitalism were envisioned. Rather, institutional shareholders are themselves intermediaries.[9] They include banks acting as trustees, insurance companies, mutual funds, and public and private pension funds. Institutions are not monolithic, but their assets are concentrated. In 1990, pension funds accounted for 38.2% of institutional assets, and the top 20 pension funds accounted for 42.8% of the assets of the top 200 pension funds.[10]

Institutional investors do not behave like individual investors. They trade with greater frequency than individual shareholders—in part because of the tax advantages they enjoy in comparison to individual investors[11]—and thereby contribute to stock market volatility.[12] In addition, under modern portfolio theory, institutions are

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8. *See* Michael Siconolfi, *Individual Investors' Holdings of U.S. Stocks Fall Below 50% of Total Market for the First Time,* WALL ST. J., Nov. 13, 1992, at C1.

9. *See* Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises,* 94 HARV. L. REV. 561 (1981) (identifying and analyzing a "long-term pattern of changes in the institutional arrangements for aggregating and channeling capital" that has led to a "golden period" for financial intermediaries); *see also A Survey of Capitalism,* ECONOMIST, May 5, 1990, at 5, 8 (discussing the growth in institutional investment).

10. WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 28-29 (1992) (charting the distribution of assets of the top 20 pension funds); *see also* James A. White, *Giant Pension Funds' Explosive Growth Concentrates Economic Assets and Power,* WALL ST. J., June 28, 1990, at C1 (noting that while pension funds generally have experienced rapid growth, "the biggest of the big funds have expanded even more significantly").

11. *"Black Monday," The Stock Market Crash of October 19, 1987: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs,* 100th Cong., 2d Sess. 406 (1988) [hereinafter *Hearings*] (testimony of John J. Phelan, Jr., submitting report by Nicholas deB. Katzenbach).

12. Ferrara & Zirlin, *supra* note 3, at 355; *see* Division of Market Regulation, SEC, THE OCTOBER 1987 MARKET BREAK 3-2 (1988).

encouraged to engage in diversification and index strategies.[13] Nevertheless, their holdings tend to be concentrated in major U.S. public corporations rather than smaller companies or foreign issuers.[14] Institutions are generally risk averse, seeking to avoid blame for investment losses.[15]

Institutions are highly regulated under statutory schemes designed to protect the beneficiaries who have entrusted them with the management of their retirement savings.[16] These statutory schemes, however, do not impose on institutional investors responsibilities to the corporations in which they invest, because corporate law is stuck in the paradigms of classical capitalism in which shareholder-owners owed no duties to either their corporations or other shareholders, unless perhaps they were controlling shareholders.[17] Institutions with only a small percentage of a corporation's capitalization, however, can exert the same leverage as a controlling shareholder, especially if several like-minded institutions act in concert or even in tandem.[18]

Commentators have criticized the passivity of institutional investors and sometimes have argued that the restrictive proxy rules of the SEC have inhibited institutions from taking a more active role in corporate governance.[19] Accordingly, some commentators argue that the SEC's recently adopted proxy rules, which now permit institutional investors to confer in order to speak to management with a common voice, will lead to beneficial institutional activism.[20]

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13. *Hearings, supra* note 11, at 414-19 (testimony of John J. Phelan, Jr., submitting report by Nicholas deB. Katzenbach).

14. *See* White, *supra* note 10, at C1. The investment practices of institutions are to some extent a function of the sheer size of their portfolios. Indexing also discourages seeking out small businesses in which to invest.

15. *See* O'BARR & CONLEY, *supra* note 10, at 85-89.

16. *Id.* at 95-100. These restraints include the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001-1461 (1988 & Supp. II 1990), the Investment Company Act of 1940, 15 U.S.C. § 80a-1 to 80b-2 (1988 & Supp. III 1991), state regulation of insurance companies, and banking regulation. For a description of the fiduciary responsibility provisions of ERISA, see RUSSELL K. OSGOOD, THE LAW OF PENSIONS AND PROFIT-SHARING 347-71 (1984). *See also* 1 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS 21-88 (1978) (surveying the regulation of different types of investment managers).

17. *See* Swinney v. Keebler Co., 480 F.2d 573, 577 (4th Cir. 1973) (noting that a "dominant or majority stockholder does not become a fiduciary for other stockholders *merely* by owning stock"); McDaniel v. Painter, 418 F.2d 545, 547 (10th Cir. 1969) (finding no fiduciary duty generally except by a "managing majority").

18. *See* EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 63 (1981); O'BARR & CONLEY, *supra* note 10, at 35.

19. *E.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

20. *See* Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1991) (concluding that "institutional oversight *might* help to correct" many "shortfalls in American corporate performance"); Nell Minnow, *Proxy Reform: The Case*

Others, however, have argued that the new rules likely will lead to an unhealthy control over corporate governance by a few influential institutions to the detriment of small shareholders and other corporate constituencies.[21]

It would appear, however, that institutional passivity is unlikely to be overcome easily and that the institutions most interested in shareholder activism are public pension funds with political agendas.[22] Moreover, shareholder activists are more likely to destabilize corporate capitalizations than to compel corporations to engage in long-term capital planning that will assure financial stability.[23] In part, the fallacy of relying on institutions to behave like owners in monitoring corporate managers is that they have delegated their investment decisionmaking to money managers, whose interests frequently diverge from those of the institutions and their beneficiaries.[24]

Corporate managers and the public are deeply suspicious of institutions for at least three reasons. First, institutions were major players in the takeover battles of the 1980s.[25] In these battles, the notion of equity investment as a participation in the long-term business success of the corporation was devalued, if not lost.[26] An environment of confrontation and distrust between shareholders and corporate managers developed in which investors and their champions focused on disciplining managers instead of making them more effective.[27]

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for Increased Shareholder Communication, 17 J. CORP. L. 149 (1991) (advocating greater shareholder involvement in oversight).

21. *See* Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes,* 17 J. CORP. L. 163, 173-74, 176-77 (1991) (noting "the potential for conflicts between the interests of fund managers and the interests of the beneficial owners of the shares"); Norman Feit, *SEC Proxy Reforms: Boon for Free Expression or Back Room Deals?,* N.Y. L.J., Oct. 13, 1992, at 11 (stating that opponents "fear that shareholder voting blocs will form as a result of 'back-room' dealmaking and that institutional leverage, already substantial but often fragmented, will become all but monolithic").

22. *See* Helen Garten, *Institutional Investors and the New Financial Order,* 44 RUTGERS L. REV. 585, 636-40 (1992) ("The most visible institutional investors today are the huge public pension funds. Their visibility subjects them to significant political pressures . . . that . . . may ultimately make institutions very cautious in proposing solutions to firm-specific problems that may prove controversial."); Rosenbaum, *supra* note 21, at 176-79 (noting that political leaders acting as pension fund trustees may "be inclined to use their enormous voting power to further what they perceive to be popular political agendas").

23. Garten, *supra* note 22, at 662-72; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism,* 79 GEO. L.J. 445, 479-81 (1991).

24. Rock, supra note 23, at 469-78; *see also* ERNEST BLOCH, INSIDE INVESTMENT BANKING 352-56 (1989) (noting that "the management of wealth has undergone a split between ownership and management," and that "[d]ecisions regarding institutional portfolios are made by managers of wealth with minimal participation by the owners of wealth").

25. *See* Garten, *supra* note 22, at 632-36; Rock, *supra* note 23, at 447-53.

26. *See* Steven A. Rosenblum, *Proxy Reform, Takeovers, and Corporate Control: The Need for a New Orientation,* 17 J. CORP. L. 185, 202 (1991) (explaining that the takeover activity of the 1980s was unhealthy because long-term success was sacrificed for short-term profits).

27. *Id.* at 207-11. There has also been at least a perception that this environment

Second, institutions were fingered as the culprits in the stock market crash of October, 1987.[28] Institutional trading strategies created conditions of extreme volatility and instability.[29] Although speculative bubbles and their collapse have always plagued stock market activity, the speed and severity of the October 19, 1987 market break seemed to signify that institutional investors are a new threat to the stability of capital markets.

Third, institutional investors are powerful, monied interests, modern counterparts of the Vanderbilts, Morgans, and Rockefellers who provided capital to industry in past times.[30] Capital cartels were rampant in the 1920s, but they were outlawed by the federal securities laws in the 1930s. Although there are significant differences between the financial powers of the past and the institutional investors of today, there also are similarities, and Americans have never been wholly comfortable with the potential political power of those who control huge aggregations of capital.

Thus far, institutional investors have led a charmed life in the academic literature. The law and economics gurus of the past decade laud shareholders as engines of economic efficiency, destined to discipline inept managers through tender offers and other free-market mechanisms.[31] Others view institutional investors as potential agents for the greening of corporate America, because they can act as surrogates for labor and the public interest.[32] As the Reagan-Bush era was drawing to a close, the Chairman of the SEC became an upscale populist, championing the cause of institutional activists in the name of corporate accountability.[33]

The only real counterpoint to the view that institutional investors should be encouraged to act like owners and monitor corporate

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caused massive job loss. *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes,* 19 PEPP. L. REV. 971, 1002-04 (1992).

28. *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET 56-87 (1988); Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis,* 57 FORDHAM L. REV. 191, 226-28, 241-46 (1988).

29. *See* Solomon & Dicker, *supra* note 28, at 226-28, 241-46.

30. *See* O'BARR & CONLEY, *supra* note 10, at 11.

31. *See* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game,* 78 GEO. L.J. 1495 (1990); 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 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Takeovers,* 33 STAN. L. REV. 819 (1981).

32. *See* Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective,* 57 BROOK. L. REV. 1 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?* 22 U. MICH. J.L. REFORM 117, 135-40, 172-74 (1988).

33. The President of Institutional Shareholder Services, in November 1992, praised SEC Chairman Richard Breeden for his "singleminded determination" as the "principal advocate for proxy reform." James E. Heard, *How New SEC Rules Impact '93 Proxy Season,* ISSUE ALERT, Nov. 1992, at 1.

managers has been the view, embedded in the *Principles*, that independent directors are the key to corporate accountability. Recently, as public and political opinion has been shifting from advocating free-market forces to advocating government intervention, institutional activists also have been pursuing director independence as an alternative to tender offers and other market mechanisms that serve as accountability devices.[34] In addition to pursuing the goal that boards be composed of a majority of independent directors, institutional investors have been pressing for nominating and compensation committees composed of independent directors, for a chairman of the board who is separate and independent from the CEO, and for direct communications between directors and institutional investors.[35]

All of these devices are intended to diminish the power of the CEO and inside corporate management.[36] Whether these measures will strengthen U.S. business and make it more effective and competitive in the global marketplace is another question. As one skeptic has stated, the independent outside director conceived by the ALI "is at best independent of both shareholders and management and often has no individual economic stake in effectively disciplining management."[37] On the other hand, reliance on independent directors probably represents a consensus that major U.S. corporations are too important to the national economy to be controlled exclusively by either unaccountable, self-appointed managers or amoral free market forces that elevate efficiency over all humanistic values, including the very important political value of jobs.

Because corporate governance debates are inherently political, it can be anticipated that the change in direction the 1992 presidential election signalled will change academic dialogues about the value and role of institutional investors. Efficient market theses may no longer be so fashionable. Articles about ethics and reinterpretations of fiduciary duty concepts may become more common.[38]

II. *Legislative and Judicial Responses to Institutional Activity*

A. *The Stakeholder Statutes*

The most important check on the power of institutional investors in the public securities markets has been the stakeholder statutes

34. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

35. *See* Gilbert Fuchsberg, *New York City Pension Funds Target Firms for Corporate Governance Reform*, WALL ST. J., Nov. 6, 1992, at A4; Joann S. Lublin, *Other Concerns Are Likely to Follow GM in Splitting Posts of Chairman and CEO*, WALL ST. J., Nov. 4, 1992, at B1; *see also* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 184-85 (1989) (suggesting that "the CEO's power as leader of the board" should be diminished "by law and by custom").

36. *See* LORSCH, *supra* note 35, at 186.

37. Rock, *supra* note 23, at 449.

38. William W. Bratton, Jr., *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180 (1992), may run counter to the anticipated change.

that well over one-half of the states have passed. Pennsylvania enacted the first stakeholder statute in 1986.[39] The statute provides that directors, in considering the best interests of the corporation in discharging their duties, are permitted to consider the effects of any action upon all groups affected by such action, including shareholders, employees, suppliers, customers, creditors of the corporation, and communities in which offices or other establishments of the corporation are located.[40] Furthermore, directors may consider the short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.[41]

Statutes passed in other states vary, but they all permit directors to consider corporate constituencies other than investors when ascertaining the best interests of the corporation.[42] States like California that have not adopted stakeholder statutes adhere to the traditional principle that a director shall act in good faith in a manner which the director believes to be in the best interests of the corporation and its shareholders.[43]

An even more significant change from traditional corporate law principles is represented by the Connecticut statute that requires directors to consider the long-term as well as the short-term interests of the corporation and the shareholders. These interests could be served best by the continued independence of the corporation and by consideration of the interests of the corporation's employees,

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39. *Cf.* Arthur R. Pinto, *Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*, 41 U. MIAMI L. REV., 473, 480 (1987).

40. 15 PA. CONS. STAT. ANN. §§ 1715-1716 (Supp. 1992).

41. *Id.* Another Pennsylvania statute contained other strong antitakeover features, such as a loss of voting rights by acquirers of control blocks and was so controversial that many *Fortune* 500 companies were pressured to opt out of the statute. *See* Justin P. Klein & Jeffrey P. Greenbaum, *Many Pa. Companies Opt Out,* NAT'L L.J., Sept. 10, 1990, at 1.

42. At least 28 jurisdictions in addition to Pennsylvania have stakeholder statutes. *E.g.*, ARIZ. REV. STAT. ANN. § 10-1202 (1990 & Supp. 1992); CONN. GEN. STAT. ANN. § 33-313 (West 1987 & Supp. 1992); FLA. STAT. ANN. ch. 607.0830 (Harrison 1993); GA. CODE ANN. § 14-2-202(b)(5) (Michie 1989); HAW. REV. STAT. § 415-35 (Supp. 1992); IDAHO CODE § 30-1602 (Supp. 1992); ILL. REV. STAT. ch. 32, para. 8.85 (Supp. 1992); IND. CODE ANN. § 23-1-35-1 (Burns Supp. 1991); IOWA CODE § 490.1108 (1991); KY. REV. STAT. ANN. § 271B.12-210 (Baldwin 1992); LA. REV. STAT. ANN. § 12:92 (West 1969 & Supp. 1993); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1992); MASS. ANN. LAWS ch. 156B, § 65 (Law. Co-op. 1992); MINN. STAT. ANN. § 302A.251 (West 1985 & Supp. 1993); MISS. CODE ANN. § 79-4-8.30 (Supp. 1992); MO. REV. STAT. § 351.347 (1991); NEB. REV. STAT. § 21-2035 (1987); NEV. REV. STAT. ANN. § 78.138 (Michie Supp. 1991); N.J. STAT. ANN. § 14A:6-1 (West Supp. 1992); N.M. STAT. ANN. § 53-11-35 (Michie 1992); N.Y. BUS. CORP. LAW § 717 (Consol. 1992); OHIO REV. CODE ANN. § 1701.59 (Anderson 1992); OR. REV. STAT. § 60.357 (1991); R.I. GEN. LAWS § 7-5.2-8 (1992); S.D. CODIFIED LAWS ANN. § 47-33-4 (1991); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. § 180.0827 (1992); WYO. STAT. § 17-16-830 (1989).

43. *E.g.*, CAL. CORP. CODE § 309 (Deering Supp. 1993).

customers, creditors, suppliers, community, and societal considerations.[44] The Arizona and Idaho statutes require directors to consider the long-term as well as the short-term interests of the corporation and its shareholders, including the possibility that these interests would be best served by the continued independence of the corporation.[45] Although the difference between long-term shareholder interests and non-shareholder interests is unclear, these statutes would appear to require directors to prefer preservation of the corporate entity to a premium bid cashing out shareholders.

Stakeholder statutes were passed as a result of pressure from managers, employees, and municipalities to counter hostile takeovers, which these groups perceived to be inimical to the public welfare.[46] A few of the statutes therefore are limited to decisionmaking regarding takeovers,[47] but most of the statutes apply to all contexts of director decisionmaking. The stakeholder statutes generally were passed subsequent to the control-share statutes, which require a shareholder vote or director consent before a change-of-control transaction can proceed.[48] The stakeholder statutes arguably address more general corporate governance concerns than the role of directors in confronting a hostile takeover.

Academics and private practitioners have criticized the stakeholder statutes as contrary to the teachings of economic efficiency and traditional legal standards for directorial behavior.[49] In the light of such criticisms, Delaware has declined to pass a stakeholder statute.[50] The Delaware courts, however, have responded to the

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44. CONN. GEN. STAT. ANN. § 33-313 (West 1987 & Supp. 1992).

45. ARIZ. REV. STAT. ANN. § 10-1202 (1990 & Supp. 1992); IDAHO CODE § 30-1602 (Supp. 1992).

46. *See* Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes,* 87 MICH. L. REV. 846 (1989) (arguing that the purpose of state antitakeover laws "is to protect *non*shareholders from the disruptive impact of . . . corporate restructuring"); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism,* 136 U. PA. L. REV. 1, 35-43 (1987) (noting that a "shareholders-only view ignores the reality that other constituencies both share the risk and are vital to the success of corporate activity"); Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111, 120-22 (1987) (arguing that "managers are better positioned to secure the enactment of legislation that shareholders do not desire when management can align themselves with interest groups outside the shareholder-manager nexus").

47. These include the statutes of Connecticut, Iowa, Kentucky, Louisiana, Missouri, Oregon, Rhode Island, and Tennessee, cited *supra* note 42.

48. N.Y. BUS. CORP. LAW § 912(b) (Consol. 1992) is typical. A discussion of control-share statutes is beyond the scope of this Article.

49. *ABA Model Act Panel Rejects Other-Constituencies Measures,* 22 Sec. Reg. & L. Rep. (BNA) 1217 (Aug. 17, 1990); *see also* William J. Carney, *Does Defining Constituencies Matter?,* 59 U. CIN. L. REV. 385, 424 (1990); Comm. on Corporate Laws, ABA, *Other Constituency Statutes: Potential for Confusion,* 45 BUS. LAW. 2253 (1990); James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s,* 21 STETSON L. REV. 97, 118 (1991); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties,* 21 STETSON L. REV. 23, 43-44 (1991).

50. Instead, after considerable controversy, Delaware adopted a control-share statute. DEL. CODE ANN. tit. 8, § 203 (repl. Vol. 1991 & Supp. 1992); *see* Lewis S. Black, Jr., *Why Delaware Is Wary of Anti-Takeover Law,* WALL ST. J., July 10, 1987, at 18.

political pressures that caused other states to pass stakeholder statutes by adjusting the law governing the duty of directors confronted by hostile takeovers.

B. *Judicial Recognition of Non-Shareholder Interests*

The business judgment rule shields directors from liability for disinterested business decisions made with due care, in good faith, and without an abuse of discretion.[51] The business judgment rule grants the same protection to directors in the takeover context as in any other context. When a board fights a takeover, however, there is a danger that it is "acting primarily in its own interests, rather than those of the corporation and its shareholders."[52] Faced with this danger, the Delaware Supreme Court, in *Unocal Corp. v. Mesa Petroleum Co.*,[53] developed two prerequisites for the application of the business judgment rule to antitakeover measures. First, the board must demonstrate good faith and make a reasonable investigation to prove that protection of the corporate enterprise and shareholders is necessary.[54] Second, defensive measures must be reasonable in the face of the threat posed.[55] This inquiry requires the board to analyze the takeover bid and its effect on the corporate enterprise, including a concern for non-shareholder constituencies.[56]

In *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc.*,[57] the Delaware Supreme Court articulated a duty for directors to sell the corporation to the highest bidder when a sale is inevitable.[58] Directors have no general duty to auction off the firm,[59] however, and thus may work for preservation of the firm and prefer long-term value over short-term shareholder gain. Directors can therefore look to non-shareholder, and perhaps even non-economic, interests in considering whether to capitulate to a hostile takeover.

Chancellor Allen articulated this important principle at length in *Paramount Communications, Inc. v. Time, Inc.*[60] *Paramount* involved an unsuccessful effort by a tender offeror to upset previously laid merger plans. In July, 1988, the board of directors of Time Inc. (Time) authorized its management to negotiate a merger agreement

51. DENNIS BLOCK ET AL., THE BUSINESS JUDGMENT RULE 12 (3d ed. 1989).
52. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).
53. *Id.*
54. *Id.* at 955.
55. *Id.*
56. *Id.*
57. 506 A.2d 173 (Del. 1986).
58. *Id.* at 182, 184-85.
59. *See* Barry Reder, *The Obligation of a Director of a Delaware Corporation to Act as an Auctioneer*, 44 BUS. LAW. 275, 278-80 (1989).
60. *In re* Time Inc. Shareholders Litig. (Paramount Communications, Inc. v. Time, Inc.), [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

with Warner Communications Inc. (Warner).[61] From the outset, the merger was conditioned on a desire to maintain an independent Time culture, including succession of Time management to senior positions in the merged entity.[62] Of serious importance was the continued editorial independence of *Time* magazine.[63] On March 3, 1989, the directors of Warner and Time, both Delaware corporations, agreed to a merger whereby Warner shareholders would own approximately 62% of the outstanding shares of the new, combined entity.[64] The new entity would not have been highly leveraged. Because the merger agreement provided that only Warner shares would be converted, Delaware law required a vote by only Warner shareholders.[65] The rules of the New York Stock Exchange (NYSE), however, required a vote by Time shareholders as well,[66] so the merger agreement provided for a vote by the shareholders of both companies. Time's shareholders were scheduled to vote on June 23, 1989.[67]

On June 7, 1989, Paramount Communications, Inc. (Paramount) made a cash tender offer for all outstanding Time common stock at $175 a share.[68] At a June 16, 1989 meeting, Time's board concluded that the Paramount offer was inadequate.[69] The board also concluded that it was not in the long-term interest of Time or its shareholders to sell the corporation at that time.[70] Accordingly, Time's board restructured the merger as a tender offer by Time for Warner stock at $70 a share.[71] The tender made shareholder approval unnecessary and also resulted in a significant leveraging of Time.[72] Paramount, joined by both substantial individual Time shareholders and a purported shareholder class, sued to enjoin the Time tender offer for Warner.[73]

Chancellor Allen was confronted with two issues: first, whether Time's directors were under an obligation to seek, in good faith, only to maximize current share value on June 16;[74] and second, whether the circumstances imposed upon the Time board a fiduciary obligation to afford shareholders a choice with respect to whether the corporation should be sold or managed for the long term.[75] Both questions were answered in the negative.[76] The court

61. *Id.* at 93,267-73.
62. *Id.* at 93,268-69.
63. *Id.* at 93,268.
64. *Id.* at 93,270.
65. DEL. CODE ANN. tit. 8, § 251(f) (repl. vol. 1991 & Supp. 1992).
66. NEW YORK STOCK EXCHANGE, INC., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 312.00 (1990).
67. *Paramount,* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,271.
68. *Id.*
69. *Id.* at 93,272.
70. *Id.*
71. *Id.* at 93,274.
72. *See* Dennis Kneale, *Time Warner Offers a Cashless Package of Stock for Remaining Warner Shares,* WALL ST. J., Aug. 24, 1989, at A2.
73. *Paramount,* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,265.
74. *Id.* at 93,278-81.
75. *Id.* at 93,281-82.
76. *Id.* at 93,278-82.

held that the original merger agreement was not a change-of-control transaction because the shares of Time and Warner were so widely held that neither corporation could be said to be acquiring the other: "Control of both remained in a large, fluid, changeable and changing market."[77] Moreover, Chancellor Allen held that the Time board was under no duty to let the Time shareholders decide whether the Paramount offer was better than the Time tender offer.[78] Chancellor Allen also concluded that the Time board's restructuring was a reasonable response to the threat that its long term strategic plan would be thwarted.[79]

The interesting question in *Paramount* is just what was the long-term value the directors were allowed to protect against the wishes of their shareholders. Although Chancellor Allen found that the Time directors were concerned "for the larger role of the enterprise in society," he decided that there was an "insufficient basis to suppose . . . that such concerns have caused the directors to sacrifice or ignore their duty to seek to maximize in the long run financial returns to the corporation and its stockholders."[80] Yet the Chancellor acknowledged that in an efficient, well-developed stock market there should be "no discount for long-term profit maximizing behavior except that reflected in the discount for the time value of money."[81] Further, he recognized that the concept of long-term management includes charitable giving and similar endeavors.[82]

Before the court decided *Paramount,* courts had upheld the validity of defensive recapitalizations in prior cases.[83] Further, the Delaware Court of Chancery also had articulated the principle that directors need not pursue immediate maximization of share value at the expense of long-term strategic plans.[84] Indeed, in a prior case Chancellor Allen refused to compel a board of directors to redeem a shareholder rights or poison pill plan in the face of a tender offer

77. *Id.* at 93,280. The court recognized that Time shareholders would have suffered dilution. This dilution is the basis of the NYSE rule requiring a shareholder vote in such situations. *See supra* note 66. The significance of this ruling to the case is that if there is no sale of control, there is no *Revlon* duty to maximize a sale price. *See supra* notes 57-59 and accompanying text.

78. *Paramount,* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,282-83.

79. *Id.* at 93,283-84.

80. *Id.* at 93,269.

81. *Id.* at 93,277. In his view, directors may reject efficient market theory and "operate on the theory that stock market valuation is 'wrong.' " *Id.*

82. *Id.* at 93,277 n.15.

83. *E.g.,* City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988) (holding that good faith use of recapitalization by directors should defeat motion for injunction by entity seeking to acquire corporation), *aff'd,* 556 A.2d 1070 (Del. 1988); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y. 1985) (same).

84. *See* TW Servs. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. Mar. 2, 1989) (denying an injunction sought by an acquiring corporation against directors of the target corporation to require redemption of previously granted stock rights).

conditioned on such redemption. In so doing, the Chancellor recognized that the proposition that directors owe a duty "to the corporation and its shareholders"[85] masks the fundamental issue: whether the board represents long-term shareholder interests, corporate entity interests, or multi-constituency interests, or whether it represents short-term shareholder interests or current share value interests. Further, permitting directors to consider long-term interests allows them to support "research and product development; personnel training and compensation; and charitable and community financial support."[86] Nevertheless, Chancellor Allen's decision in *Paramount* went somewhat further than prior cases in permitting directors to consider constituencies other than current shareholders.[87]

Although the Delaware Supreme Court affirmed Chancellor Allen's decision, it did so on narrower grounds, holding that Time was not for sale within the meaning of the *Revlon* case and that therefore the two-pronged *Unocal* test applied to the Time-Warner merger.[88] Nevertheless, in applying that test and holding that the directors of Time were entitled to the protection of the business judgment rule, the court noted that in evaluating the threat posed by a takeover bid, one appropriate consideration is "the impact on 'constituencies' other than shareholders."[89]

III. Stakeholders in the Principles

There are three sections of the *Principles* in which the drafters implicate the stakeholder concept and mention it in the commentary. These are section 2.01, discussing the objectives and conduct of the corporation; section 4.01, discussing the business judgment rule; and section 6.02, discussing the actions of directors in blocking an unsolicited tender offer.[90] All of these provisions generally relegate directors' concern for the interests of non-shareholder constituencies to the realm of ethics and take the view that the economic interests of shareholders are superior to the interests of all other constituencies.[91] The stakeholder statutes are rationalized away as consistent with case law and standing for the proposition that concern by directors for non-shareholder constituencies is in the long-term interests of shareholders.[92]

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85. *Id.* at 92,178.

86. *Id.* at 92,178 n.6.

87. "The mission of the firm is not seen by those involved with it as wholly economic, nor the continued existence of its distinctive identity as a matter of indifference." *In re* Time Inc. Shareholders Litig. (Paramount Communications, Inc. v. Time, Inc.), [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

88. Paramount Communications, Inc. v. Time Inc. (*In re* Time Inc. Shareholder Litig.), 571 A.2d 1140, 1142 (Del. 1990).

89. *Id.* at 1153.

90. Proposed Final Draft, *supra* note 1, §§ 2.01, 4.01, 6.02.

91. *See id.*

92. *See id.*

According to section 2.01 of the *Principles*, the objective of a corporation is "the conduct of business activities with a view to enhancing corporate profit and shareholder gain."[93] There are only limited exceptions to this general rule. A corporation "[m]ay take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business."[94] In addition, a corporation may devote "reasonable . . . resources" to philanthropy.[95] This black letter law states the rule of some venerable cases.[96] The stakeholder statutes are not specifically mentioned anywhere in the commentary to this section.[97] Indeed, in discussing implementation of the section, the *Principles* expresses a preference for case law, rather than statutory development.[98]

Concepts set forth in the stakeholder statutes, however, are discussed in the comments. In describing the economic objective of the corporation, the comments state that:

> The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities in which the corporation operates. The long-term profitability of the corporation generally depends on meeting the fair expectations of such groups. Short-term profits may properly be subordinated to recognition that responsible maintenance of these interdependencies is likely to contribute to long-term profitability and shareholder gain. The corporation's business may be conducted accordingly.[99]

Later in the commentary, concerns for employees, customers, suppliers, and communities are relegated to ethical considerations or to public welfare, humanitarian, educational, and philanthropic purposes.[100] The *Principles* does not admit the possibility that directors might be legally required to consider such constituencies and to balance those interests against shareholder interests.[101] Furthermore, the *Principles* does not mention considering the interests of creditors.[102]

As Professor Lawrence Mitchell has argued persuasively, the cases

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93. *Id.* § 2.01(a).

94. *Id.* § 2.01(b)(2).

95. *Id.* § 2.01(b)(3).

96. *See* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919); A.P. Smith Mfg. v. Barlow, 98 A.2d 581 (N.J. 1953).

97. *See* Proposed Final Draft, *supra* note 1, § 2.01 cmts. a-i, at 69-89.

98. *Id.* § 2.01 cmt. b, at 70.

99. *Id.* § 2.01 cmt. f, at 72-76, 72-73.

100. *Id.* § 2.01 cmts. h-i, at 80-89.

101. *See id.* § 2.01 cmts. a-i, at 69-89.

102. *See id.*

obliging directors to consider the interests of shareholders developed in situations where director self-interest conflicted with shareholder interests.[103] In some situations, the Supreme Court has imposed a fiduciary duty to another constituency—creditors—for the purpose of limiting director self-interest.[104] In recent years, bondholders have tried to impose a duty on directors to consider their interests in tender offers and restructurings.[105] These efforts thus far have failed in the courts,[106] but some of the stakeholder statutes permit or require directors to consider creditor interests.[107]

In articulating the duty of care imposed upon directors, the *Principles* generally exhorts directors to consider "the best interests of the corporation,"[108] and refers back to section 2.01.[109] In discussing the duty of directors in tender offers, however, the *Principles* refers indirectly to the stakeholder statutes.[110] Under section 6.02, directors generally may act to block a takeover only if their actions are "a reasonable response to the offer."[111] In determining whether action is reasonable, directors may consider threats to the corporation's "essential economic prospects."[112] The board may have regard for the interests of non-shareholder groups "with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders."[113] Although the stakeholder statutes are mentioned in the commentary, they are not given their due either in the black letter law quoted above, or in the comments.[114] Rather, the commentary states that the statutes "can be construed in a manner consistent

103. Mitchell, *supra* note 7, at 585.

104. *See* Pepper v. Litton, 308 U.S. 295, 306-10 (1939) (disallowing a secured claim of a controlling shareholder in a bankruptcy proceeding).

105. *See Leveraged Buyouts and Corporate Debt: Hearings Before the Senate Finance Comm.*, 101st Cong., 1st Sess. 26-32 (1989) (testimony of John J. Creedon, Jr.); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990).

106. *See* Hartford Fire Ins. Co. v. Federated Dep't Stores, Inc., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,744 (S.D.N.Y. Oct. 13, 1989); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Simons v. Cogan, 542 A.2d 785 (Del. Ch. 1987); *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (noting that "the rights of the noteholders were fixed by agreement" and that nothing short of a breach of those terms would be actionable).

107. CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1992); GA. CODE ANN. § 14-2-202(b)(5) (Michie 1989); HAW. REV. STAT. § 415-35(b)(1) (Supp. 1992); IOWA CODE § 490.1108(1)(a) (1991); KY. REV. STAT. ANN. § 271B.12-210(4)(a) (Baldwin 1992); LA. REV. STAT. ANN. § 12:92(G)(2) (West Supp. 1993); MASS. ANN. LAWS ch. 156B, § 65 (Law. Co-op. 1992); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1993); MISS. CODE ANN. § 79-4-8.30(d)(1) (Supp. 1992); NEV. REV. STAT. ANN. § 78.138(3)(a) (Michie Supp. 1991); N.M. STAT. ANN. § 53-11-35(D)(1) (Michie 1992); OHIO REV. CODE ANN. § 1701.59(E)(1) (Anderson 1992); R.I. GEN. LAWS § 7-5.2-8(a)(1) (1992); S.D. CODIFIED LAWS ANN. § 47-33-4(1)(b) (1991); WYO. STAT. § 17-16-830(e)(i) (1989).

108. Proposed Final Draft, *supra* note 1, § 4.01(a).

109. *Id.* § 4.01 cmt. d, at 184-86.

110. *Id.* § 6.02(a).

111. *Id.*

112. *Id.* § 6.02(b)(1).

113. *Id.* § 6.02(b)(2).

114. *See id.* § 6.02 cmts. a-f, at 548-77.

with §§ 2.01 and 6.02."[115] Although this construction may be correct, the statutes also could be construed much more liberally to prefer non-shareholder interests to shareholder interests in appropriate circumstances. The long-term interests of shareholders are not necessarily the same as the short-term or long-term interests of creditors or employees.

IV. Rights and Duties Under the Stakeholder Model

A. Contributions to Capital

The stakeholder model is premised on the theory that groups in addition to shareholders have claims on a corporation's assets and earnings because those groups contribute to a corporation's capital. Like shareholders, bondholders provide corporations with capital and expect to be dealt with fairly and to receive a return on that capital. Bondholders receive their return in the form of interest and a redemption or sale of their bonds, and shareholders receive their return in the form of dividends and a liquidation of their investment by the sale of their stock. Accordingly, price fluctuations in the trading markets materially affect bondholders as well as stockholders. Further, because of the blurring of debt and equity in the many new financial products designed to accommodate institutional investors and the trading patterns of institutions, the distinctions between debt and equity from a financial perspective are no longer as meaningful as they used to be.[116] Legal theory has lagged behind the developments in the marketplace, where equity capital is provided to corporations for a period of time that may well be shorter than an investment in the form of debt.[117] Holders of junk bonds may resemble old-fashioned equity investors more than holders of nonvoting common stock with a guaranteed dividend rate higher than that of other stockholders.[118]

Employees have a different claim on a corporation's assets than investors. Their financial contribution to the corporation is in the form of human capital. Although Anglo-American legal traditions have treated the relationship between labor and management as an

115. *Id.* § 6.02 cmt. a, at 548-55. As one commentator responded, "[I]f the statutes do nothing more than codify current law, with no changes at all, why did the legislatures of well over half the states bother adopting them?" Bainbridge, *supra* note 27, at 971.

116. *See High-Fashion Hybrids,* ECONOMIST, Jan. 11, 1992, at 75 (discussing the emergence of preference equity redemption cumulative stock).

117. *See* Ferrara & Zirlin, *supra* note 3, at 351, 353-57.

118. *See* BLOCH, *supra* note 24, at 95-104; *see also* Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems,* 71 N.C. L. REV. 1, 32-37 (1992) (noting that "the groups that emerge as dominant determine the institution's behavior" and that "[t]he dominance of a group depends not on its stake or the nature of the group's interest in the firm, but rather on the firm's perceived dependence on the group and the resources it provides").

adversarial encounter, in which bargaining and contract are the regulating mechanisms, there is a growing unease about this model. A dismantling of hierarchical management structures, made possible by computerization and made necessary by global competition, has led to greater employee participation in decisionmaking and more cooperative relations between labor and management.[119] Corporations now emphasize quality rather than standardization in manufacturing.[120] Also, service jobs are replacing many manufacturing jobs.[121] Governance structures such as the German two-tier board model, in which labor is represented on the board of directors, have been suggested by some as a means for improving the effectiveness of American business and as possibly more appropriate to modern business organizations.[122]

Communities contribute to a corporation's capital more indirectly. The community in which a plant or office is located provides governmental services to the business and its employees. It may, in addition, provide tax incentives to that business. Finally, stakeholder statutes frequently recognize customers or suppliers as corporate constituents, but it is difficult to weave any theory as to how they supply a corporation with capital unless they are providers of trade credit. Generally, customers, suppliers, and a business corporation are mutually dependent upon one another for profit.

When the capital contributions of different corporate constituencies are examined in the context of the stakeholder statutes, it can be argued that shareholders are not entitled to a control premium that is excessive when analyzed from the perspective of creditors, employees, or others.[123] Although case law has established that shareholders may be paid a control premium,[124] the stakeholder statutes could be utilized to limit that premium to an amount that does not damage other constituencies.[125] In the *Paramount* case, Chancellor Allen held that the Time board could follow a long-term strategy that, in effect, deprived public shareholders of their control premium.[126] In some situations, bondholders have complained that the size of a takeover premium reflected a portion of their capital.[127] Similarly, if a takeover leads to plant closings and layoffs, employees could complain that they have been deprived of their human capital contributions to a corporation. Further, if a state or municipality

119. *See* PETER F. DRUCKER, THE NEW REALITIES 207-20 (1989); ROBERT B. REICH, TALES OF A NEW AMERICA 118-26 (1987).
120. REICH, *supra* note 119, at 123-26.
121. *Id.* at 120-23.
122. *See* Buxbaum, *supra* note 32, at 29-45.
123. In most takeovers, the bidder offers a premium over the market price that represents all or part of a control premium.
124. *E.g.*, Clagett v. Hutchison, 583 F.2d 1259, 1262-63 (4th Cir. 1978); McDaniel v. Painter, 418 F.2d 545, 548 (10th Cir. 1969); Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387, 388 (N.Y. 1979).
125. *Cf.* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.) (holding that majority stockholder may have to account to minority holder for gains), *cert. denied*, 349 U.S. 952 (1955).
126. *See supra* text accompanying notes 60-82.
127. *See* McDaniel, *supra* note 105, at 206-09.

afforded the corporation tax breaks, the community could complain that it has been deprived of the long-term value of such tax incentives. The stakeholder statutes appear to be an effort to prevent such damage in the future.

B. Director Duties

If boards of directors are permitted or required to take different constituencies into account, they need to develop standards for balancing these interests. The only situation in which directors, under current case law, are required to balance shareholder and creditor interests is as a corporation approaches insolvency. In this situation, creditors have preference over shareholders.[128] If such balancing becomes the norm in other situations, the law needs to develop mechanisms for continuing to hold directors accountable for due care and fair dealing. One appeal of the traditional view, that directors work for the economic benefit of shareholders, is that this is a simple standard that has been made legally enforceable through derivative and shareholder class actions. In theory, bondholders could be given the right to bring derivative actions, especially in cases involving self-dealing or abuse of corporate privileges.[129] When directors are negligent or engage in self-dealing, there is no intuitive reason why only shareholders should be entitled to hold directors to account, because these transgressions also harm other corporate stakeholders.

If, however, shareholders, creditors, employees, and others were all given legal remedies to enforce director duties owed to them, the courts rather than directors would be forced to decide the relative merits of the claims of competing constituencies. A litigation explosion could follow, with no assurance of greater director accountability or effectiveness or profit to the business corporation. It does not appear that the legislatures that passed the stakeholder statutes intended to impose new duties on directors that creditors, employees, and other constituencies could legally enforce directly.[130] Rather, the import of these laws was to establish that directors should work for the survival of the corporation and the continuation of its business for the benefit of its various constituencies. In practical terms, this interpretation means not only fending off an unwelcome or disreputable bidder who threatens to undermine the capital base or liquidate the corporation, but also preserving a sound corporate

128. *See In re* STN Enters., 779 F.2d 901, 904 (2d Cir. 1985); Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983); Bank Leumi-Le-Israel v. Sunbelt Indus., Inc., 485 F. Supp. 556, 559 (S.D. Ga. 1980).

129. *See* Mitchell, *supra* note 105, at 1189-212.

130. *E.g.*, N.Y. Bus. Corp. Law § 717(b) (Consol. 1992).

capital structure that is fair to all constituencies.[131]

C. *Shareholder Duties*

A very interesting question is whether, under the stakeholder model, duties to other constituencies can be imposed upon major shareholders. Under traditional legal standards, only controlling shareholders are viewed as fiduciaries, and the duties imposed upon them run to minority shareholders, not to creditors, employees, or others. In a few cases where shareholders have negligently permitted a corporation to be looted, courts have held them liable for the benefit of non-shareholder constituencies.[132] In the closed corporation context, courts have been enlarging the concept of fiduciary duty owed by shareholders by analogizing to partnership law.[133] Although partners owe a duty of loyalty to one another, they generally do not owe duties to creditors or employees. Because they are personally liable to creditors, however, they may have a heightened sense of responsibility concerning debts incurred by the partnership. Consideration of whether shareholders owning far less than the traditional twenty-five percent thought necessary to exercise control should shoulder fiduciary duties seems appropriate in an institutional marketplace.[134] The stakeholder statutes implicitly raise the question of whether some shareholders should bear responsibilities to non-shareholder constituencies, but the imposition of such duties could radically change the principle of limited shareholder liability. This liability could arise because shareholders who improperly usurp the control premium would become liable to creditors and possibly even employees, in the type of situations where they are now liable, if at all, only to minority shareholders.[135]

Any such responsibilities to one another imposed on stakeholders should be limited to maintaining the viability of the corporation's capitalization. In some bankruptcy proceedings of corporations which became insolvent as the result of junk bond recapitalizations, actions against shareholders have been brought on a theory that shareholders should be liable to creditors if distributions to them caused the corporation's insolvency.[136] Cases against shareholders

131. State Blue Sky statutes that have a fair, just, and equitable standard require that a capitalization be fair to public stockholders when a corporation becomes a public company. There is no comparable merit standard under the federal securities laws. *See* JOSEPH C. LONG, BLUE SKY LAW § 1.03 (1992).

132. *See* Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

133. Zimmerman v. Bogoff, 524 N.E.2d 849, 853-54 (Mass. 1988); Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass. 1981); Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505, 515 (Mass. 1975).

134. The author made this argument in Roberta S. Karmel, *Greenmail, the Control Premium and Shareholder Duty*, 48 WASH. & LEE L. REV. 937 (1991).

135. *See* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Jones v. H.F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969).

136. *See* Robert J. White, *LBOs and Fraudulent Conveyances*, 22 REV. SEC. & COMMODITIES REG. 133 (1990); Amy D. Marcus, *Revco Examiner Appears to Find Some Basis for Suits by Creditors*, WALL ST. J., July 17, 1990, at B6. These cases have been based on bankruptcy law principles, which treat these conveyances as fraudulent conveyances.

for liability to creditors, when the shareholders looted a corporation in connection with a sale of control, however, have on occasion been successful.[137] It seems anomalous that shareholders should be able to deplete corporate assets to the detriment of other constituencies—especially creditors—with impunity.

The central issue in this debate is the soundness of a corporation's capitalization for the benefit of all of its constituencies. If distributions to shareholders are so excessive that they impair a corporation financially, bondholders and employees ought to have some mechanism for preventing such distributions.[138] On the other hand, if employee compensation is so excessive as to diminish the capital available for dividends, shareholders and bondholders ought to have some recourse, not only against directors, but against a corporation's employees.[139] The essential problem is appropriately adjusting the claims of these diverse corporate constituencies so that the corporation remains a solvent and ongoing business enterprise.

The stakeholder statutes were based on a recognition that some leveraged takeovers and recapitalizations were killing the corporate goose whose golden eggs had been feeding not only shareholders, but also creditors, employees, and others. Future interpretations of these statutes should motivate directors to prevent any single constituency from usurping a corporation's capitalization for its own use in such a manner that other valid constituencies are significantly harmed. Further, mechanisms should be developed to enable lenders and employees as well as shareholders to monitor directorial activity to insure that the business enterprise remains viable. Ironically, it is institutional investors who are in the best position to develop such mechanisms and use their power to make corporations more effective and viable in the long term, because they own debt as well as equity and also represent employee interests. Thus, these institutions may act to protect the interests of diverse stakeholders in the corporation.

Conclusion

The *Principles* treats the enactment of stakeholder statutes as a nonevent. Stakeholder statutes are, however, part of a powerful

137. *See* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); Bailes v. Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971).

138. At one time, regulation of dividend payments protected creditors from excessive distributions to shareholders that would impair a corporation's capital. *See* MODEL BUSINESS CORP. ACT § 6.40 (1979). The protection that such statutes provide to bondholders of public companies is problematic because restraints against paying excessive dividends come into play only when a corporation is on the verge of insolvency.

139. This theory is the essence of an action for waste. *See* Rogers v. Hill, 289 U.S. 582 (1933).

political revulsion against hostile takeovers and leveraged recapitalizations. These statutes favor director control and discretion over shareholder prerogatives. Stakeholder statutes present a new corporate governance model that needs to be taken seriously in order for directors to be held accountable for the success or failure of business enterprises. In addition, these statutes suggest that the rights of shareholders will be limited by the claims of non-shareholder constituencies. Directors of corporations of the future will be challenged to balance and mediate the claims of many constituencies for the benefit of all concerned. After directors decide how to balance the varied interests, courts will undoubtedly look to the stakeholder statutes for guidance in assessing the business judgments the directors have made.