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Theresa A. Gabaldon
tgabaldon@law.gwu.edu

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THE STORY OF PINOCCHIO: NOW I'M A *REAL* BOY

Theresa A. Gabaldon*

Abstract: Corporate responsibility has become a matter of great concern after the Enron and WorldCom scandals rocked corporate culture. This Article suggests that corporate irresponsibility stems from the failure of corporations to address the concerns of non-shareholders and the failure of shareholders and regulatory watchdogs to look beneath the corporate surface. Competing schools of thought, such as neoclassical economics, progressive corporate theory, and outsider corporate theory, offer divergent analyses of the corporate responsibility dilemma. Regulatory responses to the crisis of corporate conscience remain untested. This Article suggests that our failure to foresee corporate irresponsibility partly comes from over-reliance on traditional theories of shareholder primacy. Change is unlikely to come from within the corporation, so regulators must look beyond the board of directors to ensure responsible management. This Article proposes criminal liability for corporate indifference to the health and well-being of foreseeable victims of corporate irresponsibility.

> *Prove yourself brave, truthful, and unselfish, and someday you will be a real boy.*
>
> —Pinocchio (Walt Disney Studios 1940)

Introduction

The wind has changed. Recent years have seen a steady growth of concern, both in academia and otherwise, about corporate social responsibility.[1] Corporations either were to be tweaked or reengineered until their use of foreign and domestic labor became non-exploitative,

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* Professor of Law and Carville Dickinson Benson Research Professor of Law, George Washington University, B.S. 1975, University of Arizona, J.D. 1978, Harvard. The author would like to acknowledge, with thanks, the research assistance of Bryan Sillaman and Jason Wyrick, the inspiration of William T. Palmer, the insights and efforts of Robert L. Palmer, and the comments of Mitu Gulati and his class at Georgetown Law Center.

[1] For a discussion and summary of this trend, see, for example, Marianne M. Jennings & Jon Entine, *Business with a Soul: A Reexamination of What Counts in Business Ethics*, 20 Hamline J. Pub. L. & Pol'y 1, 3 (1998) and Colloquium, *Corporate Citizenship: A Conversation Among the Law, Business and Academia*, 84 Marq. L. Rev. 723, 724–25 (2001).

their use of test animals was eliminated, and their products became one hundred percent safe and effective.[2] These were years in which an aura of corporate plenty allowed the luxury of speculation about—if not a corporate soul—a corporate conscience.[3] We were fat and we were happy, and we were willing to entertain the thought of sharing our good fortune.

In a few short months, focus shifted from the prospect of creating a kinder, gentler corporation to something, how shall we say, more elemental. As some would have it, we are now concerned with matters of survival.[4] We now ask not how to share wealth, but how to prevent corporate managers from making it appear as a mirage in the desert.

The explanation for this change is obvious. We believe that conscience is a luxury afforded only after self-preservation is assured. The queasiness about financial well-being created when some of the air escaped from the overheated financial markets turned to outright nausea when Enron, WorldCom, and Qwest made their unhappy disclosures about the true state of their balance sheets and business affairs.[5] We are obsessed with counting the coins in the corporate pocketbook, saving for some later date the niceties of who might have been hurt to put them there.

This Article takes the position that this occasion for introspection can be put to multiple uses. As we contemplate the integrity of corporate accounting statements, we can continue to contemplate the fairness of corporate actions. As we do so, it may appear that strategies for assuring that corporate managers neither lie about nor steal corporate assets also are helpful in preserving the environment, improving the lives of workers, and enhancing product quality. In this Article, concerns such as these will be referred to as "matters of conscience."

When the perceived crisis in corporate integrity affected overall market levels, regulators leapt to respond. Since mid-2002, the New York Stock Exchange (the "NYSE") has implemented requirements that its listed companies have boards of directors with independent majorities;[6] have audit committees composed entirely of independent

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[2] *See* Jennings & Entine, *supra* note 1, at 5–7.

[3] *See id.* at 9.

[4] *See* Simon Deakin, *Squaring the Circle? Shareholder Value and Corporate Social Responsibility in the U.K.*, 70 GEO. WASH. L. REV. 976, 986–87 (2002).

[5] *See, e.g.*, Dennis Hastert, *Bush Leading Us Back to Fiscal Recovery*, CHI. TRIB., Jan. 10, 2003, at N21; Mike Ivey, *No Doubt, Markets Need a Positive; Analyst Zempel Remains Bullish*, CAPITAL TIMES, Jan. 23, 2003, at 1E.

[6] *See* N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303(A)(1) (2003) [hereinafter NYSE MANUAL] (addressing corporate governance standards); Self-Regulatory Organiza-

directors with the sole power to hire and fire the corporation's outside auditor;[7] implement equity-based compensation plans, including those involving stock options, only after shareholder approval;[8] provide chief executive officer ("CEO") certification of financial statements;[9] and adopt corporate ethics codes, a feature of which must be protection for whistleblowers.[10] The Securities Exchange Commission (the "SEC"), acting under the auspices of its preexisting investigative authority, has required CEO certification of the financial statements of the largest companies with registered securities[11] and has imposed expedited schedules for filing various disclosure documents under the Securities Exchange Act of 1934 (the "'34 Act").[12] Congress has adopted a reform act enshrining a new regulatory scheme for corporate auditors,[13] requiring that corporations have specifically composed audit committees,[14] altering disclosure requirements for corporate attorneys,[15] providing protection and a remedy for whistleblowers,[16] heightening penalties for wire and mail fraud,[17] establishing a new crime of securities fraud,[18] and a new crime for destruction of evidence,[19] prohibiting loans to insiders,[20] requiring CEO certification of financial statements,[21] forbidding trading in company securities by insiders during periods in which rank-and-file employees are unable

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tions; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 34-47672, 68 Fed. Reg. 19,051, 19,052 (Apr. 17, 2003).

[7] *See* NYSE MANUAL, *supra* note 6, § 303(A)(7).

[8] *Id.* § 303(A)(8); Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change, by the New York Stock Exchange, Inc. Extending the Pilot Regarding Shareholder Approval of Stock Option Plans Through June 30, 2003, Exchange Act Release No. 34-47409, 68 Fed. Reg. 10,560, 10,560 (Mar. 5, 2003).

[9] *See* NYSE MANUAL, *supra* note 6, § 303(A)(12).

[10] *Id.* § 303(A)(10).

[11] Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, Exchange Act Order 4-460 (June 27, 2002).

[12] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 34-46084, 67 Fed. Reg. 42,914, 42,914 (June 25, 2002).

[13] *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

[14] *Id.* § 301.

[15] *Id.* § 307.

[16] *Id.* § 806.

[17] *Id.* § 903.

[18] Sarbanes-Oxley Act of 2002 § 807.

[19] *Id.* § 802.

[20] *Id.* § 402.

[21] *Id.* § 302.

to trade in such securities through their 401(k) plans,[22] extending the statutes of limitations for the exercise of private rights under the '34 Act,[23] forcing disclosure of the existence or absence of ethics codes,[24] and calling for real-time disclosure of developments that might affect a company's financial health.[25]

Such a flood of activity raises obvious questions. Are the ostensible changes long overdue? Are they individually well taken? Are they coherent overall? Do they amount to meaningful reform, or are they simply a matter of appearance? Is there really a difference? This Article addresses these questions only briefly and asks if one of these reforms could be utilized—in essence, piggybacked—for matters of conscience.

Part I of this Article describes various perspectives from which these questions can be addressed.[26] Neoclassical economic and progressive corporate law approaches, including team production and behavioral economics, promise to provide divergent assessments of such issues as whether meddling in a corporation's "internal affairs" is an appropriate form of regulation, and what relationships exist between financial health, corporate fairness and/or social conscience, and corporate philanthropy.[27] Feminist and critical race (collectively referred to as "outsider") perspectives provide assessments that are more divergent still.[28]

Part II presents a brief explanation of how public perception of the relative importance of various corporate law issues has been skewed by recent market events.[29] It includes an inquiry into the role of public perception in motivating corporate agents to misrepresent the entity's financial status and in inspiring regulators to respond.[30] This inquiry leads to speculation about the validity of shareholder primacy as a goal of state corporate law and its relationship to shareholder protection as a goal of federal securities law.[31] Part II concludes that the collective role of shareholders of public corporations is a fiction—a construct,

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[22] *Id.* § 306.
[23] Sarbanes-Oxley Act of 2002 § 804.
[24] *Id.* § 406.
[25] *Id.* § 409.
[26] *See infra* notes 43–89 and accompanying text.
[27] *See infra* notes 43–69 and accompanying text.
[28] *See infra* notes 70–78 and accompanying text.
[29] *See infra* notes 90–139 and accompanying text.
[30] *See infra* notes 90–111 and accompanying text.
[31] *See infra* notes 112–139 and accompanying text.

and an unnecessary one at that—but one that is unlikely to change.[32] Recognizing both of these aspects can play a crucial role for the proponents of corporate conscience.[33] Among other things, it leads to the realization that if shareholder primacy is not the desired or necessary goal of corporate law, and if shareholders as traditionally conceived do not really exist, any reliance on shareholders for reform and/or enforcement probably is misdirected.[34]

Part III returns to the subject of recent regulatory responses to the perceived crisis in corporate integrity.[35] In evaluating these responses, this Part integrates a discussion of neoclassical, progressive, and outsider perspectives; the distinction between regulation of a corporation's "internal affairs" and regulation of its interfaces with the external world (sometimes referred to in this Article as the "internal/external" distinction); and shareholder primacy goals.[36] It also refers to the financial health/conscience/philanthropy continuum in speculating about whether integrity reforms may be useful in achieving broader conscience goals.[37]

Part IV describes an additional approach for adjusting and/or restructuring relevant laws in order to address matters of conscience.[38] It examines the proposition that regulation external to corporate law may be at least as good a tool for achieving desired results as is regulating a corporation's "internal affairs," and makes the point that the traditional internal/external distinction is, at this moment in time, very much up for grabs.[39] It develops, in particular, a proposal based on criminal law, discussing in detail the tailoring of suitable penalties and their anticipated effect on corporate constituents.[40] Finally, Part IV speculates about the broader market effects of this proposal.[41]

Detailed overview notwithstanding, the content of this Article can be described much more simply. It is, as its title suggests, about Pinocchio—an artificial being, one with occasional truth problems, one that occasionally is led astray.[42] It is about evil impresarios, loving fa-

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[32] *See infra* notes 120–139 and accompanying text.
[33] *See infra* notes 120–139 and accompanying text.
[34] *See infra* notes 137–139 and accompanying text.
[35] *See infra* notes 140–159 and accompanying text.
[36] *See infra* notes 140–159 and accompanying text.
[37] *See infra* notes 153–159 and accompanying text.
[38] *See infra* notes 160–201 and accompanying text.
[39] *See infra* notes 184–187 and accompanying text.
[40] *See infra* notes 191–193 and accompanying text.
[41] *See infra* notes 194–201 and accompanying text.
[42] PINOCCHIO (Walt Disney Studios 1940).

thers, and crickets. It is about puppets and real boys. It is about the quest for humanity, for which the intervention of conscience is necessary. And yes, it is about magic, of which belief is a necessary part.

I. The View Is Different from over Here

A. *The Players*

1. The Traditionalists

As a matter of tradition, corporations have been regarded as fictional entities—at worst, as Frankenstein's monster, and, at best, as the initial animation of Pinocchio.[43] It has proven eye-catching and convenient to regulate corporations pursuant to the assumption that if their internal workings are set in motion by human beings complying with the corporate laws regulating "internal affairs," then they may be treated as if they were real human beings as a matter of "external" law.[44] Although decades of academic commentary have treated this view more as something to react to than to endorse,[45] it unarguably has had tremendous impact in actual law making[46] and in shaping approaches to the question of what comprises "internal" corporate law.[47]

In contemplating the traditionally viewed "internal" structure of the corporate entity, it is useful to note that different groups play

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[43] *See* Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 Vand. L. Rev. 1387, 1391–92 (1992); *see also* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 567 (1933) (Brandeis, J., dissenting).

[44] *See* David Millon, *Theories of the Corporation*, 1990 Duke L.J. 201, 206; Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 Sup. Ct. Econ. Rev. 95, 97–100 (1995); *see also* Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (44 Wheat.) 518, 636 (1819) (describing the corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law").

[45] *See* William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 Stan. L. Rev. 1471, 1475, 1480–81 (1989); Michael Jensen & William Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Principles*, 3 J. Fin. Econ. 305, 311 (1976) (stating that the corporation is a "nexus of contracts"); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* Progressive Corporate Law 3–4 (Lawrence E. Mitchell ed., 1995) (rejecting the "nexus of contracts" approach in favor of a "communitarian" approach).

[46] *See* Millon, *supra* note 44, at 206 (noting that courts frequently have interpreted statutes containing the word "persons" to include corporations); *see, e.g.*, Loudon v. Coleman, 59 Ga. 653, 655 (1877); People *ex rel.* Bank of Watertown v. Assessors of Watertown, 1 Hill 616, 620–21 (N.Y. Sup. Ct. 1841); Fisher v. Horicon Iron & Mfg. Co., 10 Wis. 351, 355 (1860).

[47] *See* Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1461 (1989); Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 Vand. L. Rev. 1263, 1263 (1992).

roles that are understood easily by analogy to the human body. Thus, it is clear that the brain of the corporation, responsible for making or supervising the decisions necessary for the management of its affairs, is the board of directors.[48] The functioning limbs of the corporation are its agents, including its officers. There has been, however, some tug-of-war in the understanding of the role of shareholders, who most often appear to be the stomach, or appetite, of the entity, less frequently moderating their own appetites with an appearance as the corporate conscience.

2. The Contractarians

Contractarians have tended to reject the traditional "corporation as fictional human" imagery and have characterized the corporation as a "nexus of contracts" among self-interested capital providers, managers, employees, and others.[49] Contractarians frequently characterize the "best," or "most efficient," corporate law as providing the "best," or "most efficient," set of default contract rules—those that the parties would negotiate for themselves most frequently, but which still may be negotiated around.[50] These rules, which may be characterized as comprising "internal" corporate law,[51] accept the assumption that managers are agents for shareholders and thus, are responsible for maximizing the residual value of the firm remaining after other claimants have been satisfied.[52] This assumption generally leads to the conclusion that the interests of shareholders are preferred over those of others with interests in the firm—a conclusion often referred to as the "shareholder primacy" model.[53] Notwithstanding shareholder primacy, contractarian analyses of corporate functioning typically, but not inevitably,

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[48] Lawrence E. Mitchell & Theresa A. Gabaldon, *If I Only Had a Heart: Or, How Can We Identify a Corporate Morality*, 76 TUL. L. REV. 1645, 1657 (2002).

[49] Jensen & Meckling, *supra* note 45, at 310–11; *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (1991); Henry W. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 99, 100 (1989).

[50] *See* EASTERBROOK & FISCHEL, *supra* note 49, at 34; Jensen & Meckling, *supra* note 45, at 311.

[51] *See* Bratton, *supra* note 45, at 1480 (stating that the contractual model implies a limited role for corporate law). Note, however, that these arrangements include the hypothetical bargain between consumer and shareholders conferring limited liability on shareholders.

[52] *See* EASTERBROOK & FISCHEL, *supra* note 49, at 35–39.

[53] *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1193 (2002).

concede that corporations should comply with external law, and that this external law properly may take account of public goals.[54]

3. The Progressives

If one is inclined to question neoclassical economic analysis, which attempts to explain the utilitarianism of corporate culture and its enabling structures, then the management/shareholder relationship is a good place to start. Shareholder primacy is, perhaps, the most obvious point on which neoclassical economic and progressive corporate analysts tend to diverge.[55] Corporate progressives generally attempt to devise methods of setting more places at the table—for expanding the goals of the corporation and the duties of management (most notably the board of directors) to encompass notions of responsibility to other constituents, including broad-based society.[56] It is, however, the corporation's routine interactions with workers, the environment, and so forth that most typically are raised by those with corporate conscience concerns.[57] The inside/outside paradigm usually is not questioned; rather, the progressive focus is on expanding the internal coverage of corporate law.[58] Thus, progressives often argue for the recognition of fiduciary duties running from directors to groups such as creditors and employees, with, of course, corresponding private enforcement rights to police these duties.[59]

It is easy to understand, from the progressive perspective, why little attention needs to be devoted to "external" law. This is because only those who have no interactions with a corporation or its products are likely to be regarded as non-stakeholders. It should be noted, moreover, that because those presently or prospectively affected by

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[54] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 49, at 37–39.

[55] For arguments in support of shareholder primacy, see Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32; Jensen & Meckling, *supra* note 45, at 306. For arguments against shareholder primacy, see Lyman Johnson, *New Approaches to Corporate Law*, 50 WASH. & LEE L. REV. 1713, 1714 (1993); Millon, *supra* note 45, at 1–2.

[56] *See, e.g.*, Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime That Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587, 591 (1997); Millon, *supra* note 44, at 238.

[57] *See, e.g.*, Marlene O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1246 (1991).

[58] *See* Mitchell, *supra* note 47, at 1263.

[59] *See* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1168–70 (1990) (arguing that fiduciary rights should be extended to corporate bondholders); O'Connor, *supra* note 57, at 1194 (arguing that fiduciary duties should extend to displaced workers).

the environmental and social impacts of decisions made by corporations could be within the group of those defined as having corporate interactions, this group of non-stakeholders actually would be quite small. This is true even if a corporation's failure to act in some regards—such as failure to give to unrelated charities—could be preserved conceptually as an area without an effect on others. As this example suggests, however, the group of those with no other interaction with a particular corporation nonetheless might have some interest in reforming it or otherwise extracting something from it as a matter of corporate philanthropy.

Two cutting-edge schools of corporate analysis sometimes are identified with the progressive movement. The first is the team production approach.[60] The second is behavioral economics.[61] Both share an interest in speaking the language of neoclassical economics; although they divergently realign some of its basic assumptions, they derive similar, "progressive" conclusions.[62]

Team production scholars contend that the board of directors should be understood as an independent "mediating hierarchy" vis-à-vis the various constituents of a corporation. In their view, the constituents are those with team specific inputs.[63] The board should be charged with employing the inputs of financiers, workers, communities, and other constituents to maximize the value of the firm, and with allocating resulting profits fairly among the inputting groups.[64] In this model, the interests of shareholders are not to be preferred, except in somewhat minor, process-based ways attributable to historic happenstance and/or continuing convenience, such as the ability to elect directors and to bring derivative actions on behalf of the corporation.[65] The long-standing acceptance of corporate philanthropy is taken as some evidence of the model's viability.[66]

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[60] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249 (1999). Note, however, that the adherents of this model specifically disavow identification as progressives. *Id.* at 253–54.

[61] *See, e.g.*, Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 583 (2002); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1473 (1998).

[62] *See supra* notes 60–61 and accompanying text.

[63] Blair & Stout, *supra* note 60, at 250.

[64] *Id.* at 250–51.

[65] *Id.* at 313–15.

[66] *See* Margaret M. Blair, *A Contractarian Defense of Corporate Philanthropy*, 28 STETSON L. REV. 27, 33 (1998) (defending director's contributions to corporate charities through the team production model).

The second recently popularized approach to corporate law, behavioral economics, involves utilization of empirical studies of human behavior in order to reassess and revamp some of the assumptions of neoclassical economic analysis.[67] For purposes of this Article, some of the most important insights of this method have to do with the role of altruism in economic behavior. Numerous studies document that, in many situations, human beings act in a manner that is moderately altruistic rather than classically self-interested.[68] This means that the outcomes hypothetically bargained for by those involved in the behavioral economist's corporate nexus of contracts could be quite different from those hypothetically achieved as a matter of neoclassical economic analysis. Notably, shareholders might prefer, and thus concede, that directors should have discretion to compromise the strict financial interests of the shareholders in some circumstances.[69]

4. The Outsiders

The term "outsider" potentially encompasses the large number of women, minorities, economically disadvantaged individuals, and others who have been outside traditional power structures, including the upper echelons of both political and corporate hierarchies. Outsiders often are skeptical of the analyses and actual laws produced by the traditionally empowered.[70]

Outsider skepticism can and does extend both to established doctrines and to ostensible progressive reforms that are board-centered—that is, based on directorial power and discretion.[71] Corporate law and corporate culture tend to concentrate power over the many

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[67] Greenfield, *supra* note 61, at 588 (indicating that behavioral law and economics "insights may prove to weaken conventional corporate law theory sufficiently so that much of it will have to be reconsidered and replaced"); *see, e.g.*, Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 73; Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 137 (2002). Although it is the author's belief that at least some of these studies could be interpreted as easily as evidence of the subjects' preference for gambling as for altruism, that is not the subject of this Article.

[68] Greenfield, *supra* note 61, at 628.

[69] *Cf. id.* at 633–40 (discussing significance of behavioral incentives to share and cooperate for the conduct of directors, without addressing shareholder preference).

[70] *See* Ann C. Scales, *The Emergence of Feminist Jurisprudence*, 95 YALE L.J. 1373, 1376–79 (1986); Jeffrey J. Pyle, Note, *Race, Equality and the Rule of Law: Critical Race Theory's Attack on the Promises of Liberalism*, 40 B.C. L. REV. 787, 797 (1999).

[71] *See* Theresa A. Gabaldon, *Corporate Conscience and the White Man's Burden*, 70 GEO. WASH. L. REV. 944, 952 (2002).

in the hands of the few.[72] Proposals for corporate overhaul tend to further concentrate this power in the hands of those who already have it and arguably have misused it.[73] Thus, progressive—including team production—appeals to a board that has the discretion and/or duty to consider non-shareholder interests still are appeals to (predominantly) privileged, middle-aged white males.[74] This is the group that, even before the advent of neoclassical shareholder primacy,[75] gave us sweatshops, as well as laws and policies excluding women and minorities from the workforce and otherwise limiting their opportunities.[76] Even with the (arguably) best of reformed intentions, it is extremely unlikely that such a group can, of its own accord, perceive the issues of concern to the disadvantaged, much less respond to them.

Token representations of women, minorities, workers, and others on boards are, in a sense, incursions by outsiders.[77] These representations are, however, unlikely to result in meaningful reform. The token representatives elected to boards, unless responsible in some legal or emotional way to those they ostensibly represent, are likely to assume—indeed, are likely already to have assumed—the attitudes of

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[72] *See* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 8 (2002) (describing the board of directors as "[p]latonic guardian[s]," those wise few who make decisions in the best interest of the community); Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 923 (1996) (citing the shift to majority voting rules as the reason for the transfer of power to boards of directors).

[73] *See, e.g.*, LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY 129–34, 157–61 (2001) (calling for lengthening the term of board members and lengthening the time between mandated disclosure of financial reports as methods of alleviating pressure on boards to focus on short-term results).

[74] A 2001 Canadian survey found that only 9.8% of board seats in Canada, and only 12.4% of Fortune 500 board seats in the United States, were held by women. Janis Sarra, *The Gender Implications of Corporate Governance Change*, 1 SEATTLE J. SOC. JUST. 457, 487 (2002); *see* FED. GLASS CEILING COMM'N, U.S. DEP'T OF LABOR, GOOD FOR BUSINESS: MAKING FULL USE OF THE NATION'S HUMAN CAPITAL, 9 (1995), *available at* http://www.dol.gov/asp/programs/history/reich/reports/ceiling.pdf (stating that only 0.60% of senior level managers in major companies were African-American when the report was published).

[75] *See* sources cited *supra* notes 49–53 and accompanying text.

[76] *See generally* Gabaldon, *supra* note 71, at 952–53 (describing feminist and other reactions to director-centered proposals).

[77] *See* Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1385–87 (2002) (relating increased representation of women, minorities, and non-nationals on corporate boards to new managerial attitudes); Steven A. Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. & FIN. 85, 90 (2000) (citing demographics and globalization as creating a business need for diversity among boards).

the majority board members.[78] Their presence on the board thus may be a placebo interfering with more meaningful change.

Given the dominance of the board of directors both in traditional structure and reform proposals, there are two obvious ways for outsiders to react. One reaction is that they must do the best they can with what they have, perhaps resigning themselves to the notion that if capital is to agglomerate, it must be managed centrally. This is, in effect, a "necessary evil" view of board-based structures, calling, however, for intense and continuing scrutiny of board composition and function. The other reaction is to begin to color outside the lines. This approach calls for rethinking—if not changing—some of the basic assumptions of corporate law and may call on the tools of "external" law to make necessary adjustments.

B. *The Internal/External Dichotomy*

The traditional distinction between internal corporate law and law external to the corporation is by no means mysterious to those inclined to accept it. The "internal affairs" doctrine is an excellent starting place and, indeed, the most consequential aspect of the distinction. It is a well-established tenet of conflicts law that the laws of a corporation's state of incorporation govern its "internal affairs."[79] These are the laws that govern the relationships between the corporation and its shareholders, officers, and directors.[80] They do not encompass the laws addressing the relationships between the corporation and its non-officer agents, including its non-officer employees, presumably because these relationships are thought to be no different than those of individuals and their employees or other agents. In a sense, the original notion of "internal" corporate law relied on traditionalist imagery in addressing the matters necessary to animate the inhuman corporate creature.[81]

The contents of a corporations casebook may confuse this issue slightly, beginning, as they often do, with coverage of agency and part-

[78] For discussion of the co-option process, see, for example, John M. Darley, *How Organizations Socialize Individuals into Evildoing*, *in* CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 13 (David M. Messick & Ann E. Tenbrunsel eds., 1996).

[79] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).

[80] It is thought by some that the "internal affairs" doctrine also encompasses the doctrine of limited liability as a question of the "relationship of shareholders to their corporation." ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 334 (7th ed. 2001).

[81] *See* sources cited *supra* notes 44–48 and accompanying text.

nership law, and including some scattered coverage of federal securities laws.[82] Both are practically useful to those contemplating practice in the business world, and the former is helpful in understanding both the derivation and operation of many "internal" corporate law doctrines. The latter may be understood as regulating the formation of the relationship between shareholders and the corporation and has reflected an established, albeit hesitant, federal intrusion on,[83] and uneasy interaction with,[84] state laws governing corporate internal affairs. As will be expanded upon below, recent events have overcome some, but far from all, of this established federal hesitance and unease.[85]

To non-traditionalists, the internal/external line would seem to be more puzzling, or, at any rate, less natural. Neoclassical economists, however, find value in permitting states to signal the "package" of bargains they offer, something that would not be possible without the "internal affairs" doctrine and thus some notion of what "internal affairs" are.[86] Neoclassical economists and progressives alike might concede that the internal/external line has descriptive power and is largely a question of acknowledging who has enforcement power. If it is the shareholders vis-à-vis the corporation, its officers, or its directors, it is corporate law. If it is creditors or employees, it is something

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[82] *See, e.g.*, William A. Klein et al., Business Associations: Agency, Partnerships, and Corporations 1–203, 390–490 (4th ed. 2000) (dealing with agency and partnerships in chapters 1 and 2, and briefly discussing securities and disclosure laws in chapter 4, sections 3 and 4).

[83] Proxy rules governing communications in the course of shareholder vote-taking, including the election of directors, are a prime example. Section 14(a) of the '34 Act governs the solicitation of proxies in connection with shareholders' meetings, at which the business conducted is a matter of state law. 15 U.S.C. § 78n(a) (2004).

[84] For cases illustrating the conflict between federal tender offer legislation and state takeover statutes, see CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 74 (1987); Edgar v. MITE Corp., 457 U.S. 624, 626 (1982); Amanda Acquisition Corp. v. Universal Food Corp., 877 F.2d 496, 499 (7th Cir. 1989) and see also Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 Brook. J. Int'l L. 495, 503–05 (2003) (discussing the U.S. Supreme Court's attempts at reconciling federal securities laws with notions of internal corporate governance).

[85] *See infra* notes 149–152 and accompanying text.

[86] *See* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913, 913–14 (1982) (arguing against a federal corporate law scheme to replace the various state schemes); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679, 682 (2002) (stating that "[w]ith market capitalization of public corporations in the United States in the range of $16 trillion, the dynamics that shape the laws states offer to govern the internal affairs of companies are of substantial importance").

else, but is still a matter of private law. If it is the state, it is public law, and something else yet again.[87]

This said, it is worth emphasizing that critical to the progressive corporate law movement is the notion that non-shareholders should be regarded as within the corporate tent and presumably given some interest in enforcement.[88] Thus, to progressives, the descriptive line separating shareholder-enforceable matters from other issues seems arbitrary. Why, outside of traditional imagery and political power, are shareholders any more crucial to corporate operation than consumers or employees?[89] It also is worth emphasizing that to the extent shareholder privilege (including shareholder enforcement of duties owed by the board of directors) is central to "internal" corporate law, outsiders are apt to be extremely unimpressed with the internal/external distinction.

In summary, apart from the choice-of-law consequences of identifying an issue or relationship as "internal" to the affairs of the corporation, the only reality that appears to inhere in the internal/external dichotomy involves recognition of stakeholder status, or lack thereof. If one is recognized by economists, progressives, and/or policymakers as a stakeholder with respect to corporate governance, one's interests are more apt to be considered when issues labeled "corporate governance" arise and one is more apt to be assigned some sort of remedy. This presents outsiders with a choice of strategies—seeking recognition as stakeholders or seeking to minimize the overall importance of corporate law.

C. *The Continuum*

Somewhat related to consideration of the internal/external distinction is contemplation of a continuum of possible values to be fur-

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[87] *See* Greenfield, *supra* note 61, at 591. Note, however, that the usual ability of a state to bring *quo warranto* proceedings has the theoretical effect of blurring these distinctions. *See id.* at 591–601 (describing corporate law as public law).

[88] Millon, *supra* note 45, at 13 (stating that "[t]he multifiduciary label conveniently captures the idea that nonshareholders as well as shareholders ought to be the beneficiaries of managerial decisionmaking"); Mitchell, *supra* note 59, at 1168–70 (arguing that fiduciary rights should be extended to corporate bondholders); O'Connor, *supra* note 57, at 1194 (arguing that fiduciary duties should be extended to displaced workers).

[89] Giving outside regulators such authority is something different. Although outside regulation is not a particular focus of progressives, it is conceded even by neoclassical economic analysis to be appropriate in those circumstances in which public policy dictates an outcome not covered by the bargains of those with recognized stakes in the corporation and its activities. *See* sources cited *supra* note 45 and accompanying text.

thered by the existing structure and possible reforms of corporate law. At one end of the continuum is the financial well-being of the corporation as manifested in shareholder wealth; at the other end is genuine corporate philanthropy—that is, philanthropy undertaken for reasons not related to buying public will for purposes of generating profit. Occupying the middle ground is some area of social conscience, defined in terms of potential for corporate impact from business more or less in the ordinary course. If we were conceptualizing this continuum in terms of human values or motivations, we might be tempted to express it through an image of concentric rings—self-interest of a certain type at the core (again, manifest in shareholder wealth), rippling out to a consideration of the interests of others immediately impacted, eventually extending to recognition of the interests of those with no obvious relation to the corporation. These conceptualizations can assist in identifying the focus of particular analysts/schools of thought, as well as in discussing proposed legal reforms and the possibility of extending their effects. Their very enunciation, however, tends to reveal the extent to which shareholder interests are taken as a starting point in corporate law and how critically this assumption shapes our thinking.

II. Smoke, Mirrors, and Public Perception

A. *What Did We Know and When Did We Know It?*

There are two stories to be told about the Enron/WorldCom-type debacles.[90] The first story is about what happened inside these companies, which has been the subject of a flood of news articles, congressional investigations, and regulatory reactions.[91] The second has to do with what happened to the price of Enron and WorldCom's stock.[92] Confusion over the two stories in the public mind has contributed greatly to what appears to be a change in focus from broader

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[90] Although there are, of course, subsequent examples, Enron and WorldCom got the ball rolling and will be used as the primary examples for purposes of this discussion.

[91] *See, e.g.*, Richard A. Oppel, Jr., *Enron's Many Strands: The Directors; Harsh Words from Senators to the Board*, N.Y. Times, May 8, 2002, at C7 (following the Enron scandal as part of a continuous series of articles); Simon Romero, *Turmoil at WorldCom: The Overview; WorldCom Facing Charges of Fraud; Inquiries Expand*, N.Y. Times, June 27, 2002, at A1 (following the WorldCom debacle as part of a continuing series of articles).

[92] *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275, 1276–77 (2002) (noting that Enron's share price at its peak in 2000 was around $90.00 per share and at the time of its bankruptcy had dropped to $0.60 per share); Romero, *supra* note 91, at A1 (noting that the NASDAQ suspended trading of WorldCom shares after its announcement that it would file for bankruptcy).

issues of corporate responsibility to an obsessive preoccupation with the integrity of corporate management and financial statements.

As indicated above, others have gone to great lengths to document the "inside story" of the Enron and WorldCom disasters.[93] Succinctly put, in each case, corporate managers engaged in behavior that resulted in a deceptive portrayal of the corporation's financial state. The behavior presumably was motivated by the actors' belief that this portrayal would positively affect the market worth of the corporation in question, as well as the actors' own financial positions. For a substantial period of time, the behavior was either unknown to or misunderstood by regulators and perhaps some members of the board of directors. The behavior eventually was detected and discontinued. End of story.

The narrative of what happened to Enron and WorldCom stock prices is linked to the "inside story," but the link is only a partial one. During the go-go financial markets at the turn of the century, both stocks were high flyers.[94] Of course, so were the stocks of many other companies, including many that were reporting honestly a complete lack of profitability.[95] Traditional formulae relating stock price to company earnings per share simply were not relevant.[96] Stock purchasers, with the exception of rank-and-file company employees[97] acquiring stock through company stock purchase plans, frequently had no intention of holding their shares long enough for the company to realize any earnings.[98] Instead, they often were gambling on being

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[93] *See, e.g.*, Bratton, *supra* note 92, at 1276–81; David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 Geo. Wash. L. Rev. 890, 893–97 (2002).

[94] For a timeline illustrating Enron's dramatic stock plummet for 2001, see Bratton, *supra* note 92, at 1276–77, 1318–19.

[95] *See* David W. Tice, *Big Bear Says, "The Market Is Out of Control": Just Because Stocks Are Soaring Doesn't Mean They Aren't Tremendously Overvalued*, On Wall Street, May 1, 1998, 1998 WL 11649455; David W. Tice, *Remember the Bottom Line: What's Going to Happen When Investors Again Demand Profits?*, On Wall Street, Dec. 1, 2000, 2000 WL 8695162.

[96] *See* Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. Corp. L. 225, 228 (2001); Ron Chernow, *Hard-Charging Bulls and Red Flags*, N.Y. Times, Sept. 2, 1998, at A31; Jack Willoughby, *Gravy Train: Everybody Wants to Be on Board the Express to IPO Riches*, Barron's, Dec. 13, 1999, at 37.

[97] Corporate employees thus compose a group of inevitable bag-holders who have received relatively little regulatory recognition post-Enron. *See* sources cited *supra* notes 13–25; *infra* notes 153–157 and accompanying text.

[98] Day traders are, of course, the quintessential example of shareholders with short-term interests. *See, e.g.*, Steven Mufson, *Master of a New Universe*, Wash. Post, May 16, 1999 (Magazine), at W8 (describing the life of a young day trader).

able to sell to someone making the same bet at a higher price.[99] This meant that market players had little incentive to investigate accounting practices or to be particularly concerned about the quality of earnings before they purchased, and no time or opportunity to investigate or manifest concern before they sold. Traditional gatekeepers such as investment bankers and accounting firms no doubt understood and responded to this lack of incentive.[100] Less sophisticated investors, who might have subscribed to more of a buy-and-hold philosophy once lured into the market by its "New Economy" hype and "can't lose" atmosphere,[101] quite possibly lacked the skills, as well as the time, to detect irregularities.

Of course, when the market deflated, stock prices settled back down, but still lacked a traditional price-to-earnings correlation.[102] At this stage, however, the aura of profitability at Enron and WorldCom presumably prevented their stock prices from settling as far and as fast as might otherwise have transpired. It may well be the case that this was a period in which some of the most dubious internal decisions were made, or when attempts at concealment intensified. It became increasingly clear, however, that the music would stop and that those left standing would have incentives to start looking for someone to blame. This realization provided at least some of the insiders at the affected companies with a reason to disclose the companies' true financial positions. Disclosure led to a precipitous decline in the price of the securities issued by these companies, as well as to declines in market-wide securities prices.

When the financial shenanigans at major companies were disclosed, people realized that they had been playing in a crooked ca-

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[99] *See* Gabaldon, *supra* note 96, at 233 (characterizing this practice as "crowd prediction").

[100] For discussion of regulatory reaction to the failures of traditional gatekeepers, see, for example, Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1189–92 (2003).

[101] For an excellent description of the interaction of media and market price, see ROBERT SCHILLER, IRRATIONAL EXUBERANCE 152 (2000).

[102] *See generally* Tharan L. Cook et al., *Murphy's Law? An Examination of the Growth Flow Valuation Method for Technology Stocks*, 5 J. WEALTH MGMT., Mar. 22, 2003, at 50, 50 (describing alternative valuation method in light of traditional ratio's inability to explain pricing); Dave Flessner & Jamee Smith, *Meltdown Creates Investor Angst*, CHATTANOOGA TIMES FREE PRESS, July 16, 2002, at C1 (describing then-current stockholder despair), LEXIS, News Library; Stephen Foley, *The Investment Column: Vodafone Offers a Bumpy Ride to Wealth*, THE INDEPENDENT (London), Aug. 21, 2001, at 15 (predicting return to traditional pricing), LEXIS, News Library; Alan Goldstein, *"Clever" Isn't Cool Anymore*, DALLAS MORNING NEWS, July 3, 2002, at 1D (same), LEXIS, News Library.

sino—that the odds offered on the Enron and WorldCom games were represented unfairly. The logic of this realization extended into suspicion of other games in the same casino, thus contributing to an overall diminution in market levels. The announcement of the first dishonest game, Enron, had a dramatic impact that was amplified by subsequent announcements with respect to other companies.[103]

The casino analogy is an imperfect one, however, because relatively few people may have been betting on the outcome of corporate profitability. Instead, they often were betting on what other people would bet on what other people would bet, ad infinitum. As indicated above, the Enron and WorldCom disclosures reminded investors that someday the music would stop, and that simple reminder was all that was necessary to actually stop the music for those companies. Investors then realized that what had happened to Enron and WorldCom stocks could happen to other stocks. Soon, as the stock price of the company founded by Martha Stewart demonstrates, any intimation that prospective investors might balk at buying stock tomorrow provided a reason for current investors to sell today.[104]

Seen this way, John Maynard Keynes's famous example of betting on the outcome of a beauty pageant is most apt.[105] Unlike a horse race, where one bets on which horse has a particular attribute (speed), beauty contest bettors wager not on which contestant has the desired characteristic (beauty), but on how the judges will assess that characteristic.[106] Similarly, in the stock market, it recently has not been important to know which companies actually will be profitable, but only which companies will be judged investment-worthy. Therefore, it is important to know something about the judges and their criteria. If it is believed that the judges care whether the contestants' physical attributes are real, and it then becomes apparent that the attributes of one contestant (Enron) are surgically enhanced and the attributes of another contestant (WorldCom) simply are false, then the odds for those contestants change. Moreover, speculators may be-

[103] *See* Michael Goldsmith, *Resurrecting RICO: Removing Immunity for White-Collar Crime*, 41 HARV. J. ON LEGIS. 281, 282 (2004).

[104] *See* Philip F.S. Berg, Note, *Unfit to Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies After the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1872 (2003). Thus, in the months following the first indication that Martha Stewart might be indicted for insider trading, the stock of her eponymous company declined significantly. *See id.*

[105] JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST & MONEY 154–56 (1936).

[106] *See id.*

gin to suspect that the practice of augmentation is widespread. Unless it is shown that it is not, or the judges demonstrate that they are indifferent to the real versus illusion issue, betting enthusiasm will be dampened. Contestants willing to bare all may tend to be favored.

To extend the no doubt tasteless and definitely sexist beauty contest analogy just a bit further, think for a moment about the role of intelligence and personality. Let's face it, no matter the tout of a particular pageant, these simply are not what beauty contests are about. Similarly, the generosity and public-mindedness of corporations have never been particularly important in market assessments of their worth.[107] Presumably, this is because, based on long-term history, we do not believe that the judges (other investors) will ever value these attributes significantly.

Of course, an excellent personality never actually hurts a beauty contestant, and in recent years there has been an increased attempt to showcase and value this attribute.[108] Somewhat similarly, in the flush times of the late 1990s, there were increasing attempts to pay lip service to the subject of corporate conscience.[109] After all, as long as a corporation's other attributes ostensibly were in place, demonstrating a kindness of spirit did not hurt. We suddenly have become panicked, however, at what is inside the swimsuit, and for at least some period of time, we risk losing all focus on characteristics we believe other judges will find less basic.

In times when all the corporations looked pretty, then it seemed possible to do good while doing well. After all, doing well seemed a given, and academics and others were increasingly interested in exploring this possibility. There was enough interest in the subject to prompt at least a few studies suggesting that a minor de-emphasis of shareholder primacy (by, say, adopting more worker-friendly policies) did not necessarily have an adverse impact on either corporate profitability

[107] It is true, however, that social responsibility financial funds have increased in popularity. *See infra* note 173 and accompanying text.

[108] *See, e.g.*, Betty Beard, *Personalities Primped for Scholarship Pageant*, ARIZ. REPUBLIC, Apr. 4, 2003, Chandler Community Section, at 1, 2003 WL 17690919; Marshall Carter, *13-Year-Old Welcomes Invitation to Pageant*, SEBASTIAN SUN (Sebastian, Fla.), June 6, 2003, at A1, http://web.tcpalm.com/sitetools/archives.html.

[109] For example, the percentage of "green" (environmentally friendly) new products in the United States increased from 4.5% in 1989, to 11.4% in 1990, and to 13.4% in 1991. Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 644–45 (2001).

or market value.[110] It does not appear, however, that corporate responsibility ever became a serious factor in market valuation. In other words, it never became something that most investors sought either to invest in or gamble about. This may reflect the attitude that we do not believe our fellow investors are sufficiently high-minded to value corporate character. It is possible, however, to gamble about many things that people do not personally value or actually seek to possess themselves (pork bellies come quickly to mind). From this standpoint, it may be that there simply are not enough established rules about the development or deterioration of corporate conscience to make betting on it (or other people's assessment of it) an interesting game.

As we find ourselves in a time when the quality of earnings reports has captured our attention, and we contemplate ways in which integrity can be assured and/or credibly signaled to markets, it may be useful to raise our eyes a bit, and think about whether some of the same tools we propose to enhance integrity can be employed for other matters of conscience. Recent events suggest that market judges (investors) do place value on truthfulness, and attempts are being made to enhance this virtue. Why not consider meaningful ways in which other virtues may be encouraged, demonstrated, and valued?[111]

B. *Common Cause, Common Remedy?*

Presumably, the primary reason relatively short-term investors care about corporate truth-telling is that they believe that when the true state of financial affairs is revealed *someone* (perhaps themselves) will be placed at risk of loss. This analysis has little relation to concern for corporate conscience. Nonetheless, the lack of corporate truth-telling and the lack of these other virtues may have a common progenitor. Accordingly, it is useful to discuss this progenitor and to think about whether diminishing its stature and effect may have common benefits.

Lack of corporate integrity arguably and plausibly stems from over-preoccupation with stock price, said to be the modern surrogate for shareholder primacy.[112] In other words, managers who are sup-

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[110] *See, e.g.*, Blair & Stout, *supra* note 60, at 288 (arguing that shareholder primacy is merely the recognized norm because of voting rights and derivative suit standing).

[111] *Cf.* Mitchell, *supra* note 73, at 115 (stating that "you manage what you measure. Even if the structure and rules of corporate law weren't such as to keep managements' eyes focused on the daily stock quotations, the simple fact is that the other set of performance measures available to them are the corporations' financial statements.").

[112] *See id.* (linking stock price maximization to numerous examples of unethical corporate behavior).

posed to be putting shareholder interests first do so by increasing the market value of the shares of the corporation.[113] Short-term versus long-term market value is a distinction that tends to be lost in the shuffle for at least two reasons. The first, and most obvious, reason is the competition offered by short-term profit maximizing strategies engaged in by other companies, particularly during euphoric market periods.[114] The second reason is the self-interest of managers in maintaining jobs and reaping the benefits of stock options that can be exercised profitably in the short term if stock prices rise quickly.[115] The existence of option-based compensation programs is justified primarily as a method of aligning management interests with the interests of shareholders, thereby protecting shareholder primacy.[116] The method of alignment is based on a common interest in steadily increasing stock prices.

Shareholder primacy has been the focus of a great deal of recent debate about corporate social responsibility.[117] It is said to be a linchpin of traditional and neoclassical economic corporate analysis.[118] It is also a primary point of attack for those progressive corporate law scholars who wish to expand the realm of corporate stakeholders.[119] It seems obvious, then, to start thinking about corporate integrity, re-

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[113] *See* Millon, *supra* note 93, at 890.

[114] *See* Bratton, *supra* note 92, at 1328–32 (pointing out that Enron's obsession with its stock price may have been a result of its competitive culture and the desire to "win" corporate profits).

[115] *See id.* at 1328. Stock options usually are tied to long-term success, but Enron's management bonus structure was such that it awarded managers based on the performance of the company's stock compared to the market as a whole, as well as their ability to meet various periodic performance criteria. *Id.*

[116] *See* 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, 138 (positing that the problem with executive pay at the beginning of the 1990s was that it had no link to corporate performance). *But see* Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 273–74 (1999) (stating that "while CEOs and their compensation consultants often use the rhetoric of pay for performance to justify higher amounts of compensation, they also may seek to reduce the risk attached by increasing the number of options granted, setting easy performance goals, or repricing underwater options").

[117] For a summary analysis of the ongoing debate, see, for example, D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277, 280 (1998); Stout, *supra* note 53, at 1189–90.

[118] *See* EASTERBROOK & FISCHEL, *supra* note 49, at 36.

[119] *See, e.g.*, Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411–12 (1993); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477, 479–81 (1995).

sponsibility, and philanthropy by asking a few pointed questions about shareholder primacy. The most basic is whether publicly held corporations need shareholders at all.[120]

Various roles might be—and from time to time have been—ascribed to shareholders. They might be seen as the repository of ultimate governing authority, owing to their ability to elect the board of directors, and/or to sell their shares to someone else who is interested in doing so.[121] Although corporate managers traditionally have not owed fiduciary duties to the shareholders, but rather to the corporate entity,[122] shareholders have been granted enforcement authority in the ability to bring derivative causes of action on behalf of the corporation.[123] They might then be viewed as the group ultimately to blame for corporate defalcations.

As a practical matter, these roles may be disposed of rather quickly, leaving only one role (discussed below) for more serious contemplation. First, shareholders of public corporations are notorious for electing the slate of directors that management suggests.[124] Second, there is recent empirical evidence that shareholders of public corporations, who vote with their feet by selling in large numbers to someone who wishes to install new (presumably superior) management, are not disposing of systematically mismanaged firms.[125] Third, the ability to bring derivative causes of action has been so severely restricted,[126] and the liability of officers and directors so lim-

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[120] *See generally* Theresa A. Gabaldon, Like a Fish Needs a Bicycle: Publicly Held Corporations and Their Shareholders (Aug. 15, 2004) (unpublished manuscript under submission and on file with the author). This is a different question from whether privately held corporations need shareholders. *See id.* at 35–36.

[121] *See* Blair & Stout, *supra* note 60, at 248; Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 216–18 (1999).

[122] *See* RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a (1958) (stating that a board of director's "duties are owed to the corporation itself rather than to the shareholders individually or collectively"). The Delaware Supreme Court has stated that the board of directors owes fiduciary duties of care and loyalty to the corporation and the shareholders. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

[123] Blair & Stout, *supra* note 60, at 292–97.

[124] Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 325–26 (1998) (suggesting that management's control over corporate information and proxy solicitation at the corporation's expense allows it to influence a shareholder's voting decision).

[125] *See* Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANAL. 721, 721–22 (2003).

[126] *See* James Cotton, *Another Nail in the Coffin of the Small Investor: The Private Securities Litigation Reform Act of 1995*, 17 TOURO L. REV. 733, 738 (2001) (citing the Private Securities

ited,[127] as to render the right trivial, and quite frequently called into play by self-interested attorneys who are relative strangers to the corporation.[128] When shareholders of a publicly held corporation take an active interest in corporate business, it is newsworthy, and almost exclusively a phenomenon of involvement by institutional investors.[129] We neither expect nor facilitate involvement by individual investors.

Another more descriptively accurate role has been assigned to the shareholders of public corporations. Shareholders have been described as the "residual claimants" vis-à-vis the corporation.[130] Thus, when profits increase, the shareholders benefit from this bounty; if profits decline, shareholders feel the loss.[131] The role, then, amounts to the acceptance of the risk of corporate loss in exchange for the possibility of theoretically unlimited gain.

Of course, given the existence of limited liability, shareholders cannot feel the loss of anything beyond their initial capital input.[132] This is exactly the same kind of risk that a creditor assumes; the only distinction is the extent of the risk. Risk differentials are typically dealt with by adjusting rates of return.[133] In other words, insofar as risk-bearing is concerned, relatively highly compensated creditors would do just as well as shareholders, at least if the maturity of the debt were sufficiently long term.

Litigation Reform Act, Federal Rule of Civil Procedure 11, and various state statutes as limiting small investors' ability to bring a derivative action).

[127] *See* Mae Kuykendall, *Symmetry and Dissonance in Corporate Law: Perfecting the Exoneration of Directors, Corrupting Indemnification and Straining the Framework of Corporate Law*, 1998 COLUM. BUS. L. REV. 443, 469.

[128] *See* Theresa A. Gabaldon, *Free Riders and the Greedy Gadfly: Examining Aspects of Shareholder Litigation as an Exercise in Integrating Ethical Regulation and Laws of General Applicability*, 73 MINN. L. REV. 425, 425–26 (1988) (highlighting the ethical problems that arise by lawyer solicitations of various corporate derivative suits).

[129] *Cf.* Bernard Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed., 1998) (describing phenomenon in institutional investor activism and its lack of effect).

[130] Blair & Stout, *supra* note 60, at 263.

[131] *See id.* at 262–63.

[132] *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89–90 (1985); Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 841 (1988).

[133] According to Frank H. Easterbrook and Daniel R. Fischel, the Coase theorem demonstrates that the risk of a particular investment always is reflected in its price. *Supra* note 132, at 97 n.13; *see also* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2–6 (1960) (explaining theorem and relationship between risk and price).

Must shareholders receive the prospect of unlimited returns to induce them to accept the limited risk of loss of their capital? Of course not. What shareholders require is some signaled assurance that their capital eventually will be repaid along with an adequate return to make forgoing alternative investments worthwhile. The traditional role of shareholders of public corporations, then, with respect to risk-bearing, is to permit some amount of capital raising in which the terms of repayment and return are relatively unspecified. This may be convenient for the corporation, but it surely is not necessary for sophisticated capital providers, who will have a good idea of exactly how these terms might be calculated.[134] Its convenience for the corporation may even be subject to question, given the fact that the corporate debt market is the source of much more capital than the stock market.[135]

Ironically, although it is not necessary for shareholders to be residual risk bearers (and in fact they are not truly residual risk bearers, given limited liability), they are necessary to absorb a corporation's excess profits. Were a motive to benefit shareholders not present, corporations presumably would be managed primarily for the purpose of creating goods and providing services, creating jobs and the like—unless they were managed for the benefit of managers. Providing shareholders with the right to elect the board and to police management activity through derivative litigation is a method of symbolically diverting management from its own interest, but there could be other methods of allocating and rewarding the exercise of these rights without coupling them with the right to residual profits.

One can imagine a structure in which an independent board concerned itself directly with creating goods, jobs, and the like, regarding profitability in excess of costs as doing no more than creating a desirable cushion to assure satisfaction of all legitimate claimants and, perhaps, as a carefully employed tool to motivate management. The cold truth, however, is that to the extent this imagining seems to call for all corporations to be non-profit organizations or to be government run, it coextensively occupies the realm of fantasy. The American political mystique is wedded firmly to America's view of it-

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[134] It does, however, permit unsophisticated capital providers to take respectable gambles.

[135] *See, e.g.*, *Canadian Oil Industry Financings Hit 10-Year High*, Oil & Gas J., Mar. 10, 2003, at 38, 38 (debt comprising $9.98 billion (Canadian) total oil financing in 2002), LEXIS, News Library; *Australia Q3 Current a/c Deficit 7.871 bln aud vs 7.305 Q2; Consensus 7.6*, AFX Eur. Focus, Nov. 29, 2002 (describing $57 billion of equity as opposed $347 billion of debt), LEXIS, News Library.

self as a capitalist nation.[136] The primary, continuing role of the public shareholder may be to symbolize our commitment to that view.

Thus, the foregoing observations should not be understood to call for a transition to some variant of government ownership. Rather, they are meant to indicate that the role of a shareholder is a construct in the case of publicly held corporations, and it is a continuing construct because although economists have separated entrepreneurs and shareholders,[137] public imagery confuses them. We believe that shareholders are necessary for progress to continue, and because we believe this we will not give them up. This does not mean that public shareholders are bad for corporate and social well-being (although they may be), or must be abolished (although perhaps they should be), or even that they must be better understood (although that might be nice). What it does mean is that shareholder primacy is misconceived. Shareholders simply are not more important to the public corporation, as a practical matter, than creditors, employees, or, for that matter, consumers. Profits to be generated for shareholders at the expense of any of these other groups (that is, profits in excess of a reasonable return) are not, in this view, theoretically justified.[138]

Still, the sacred cows of shareholder primacy and stock price maximization have given and continue to give a structure to both corporate law and financial markets that could not be replaced easily. Developing new mission statements and new cultures for boards of directors might take years. Reassigning the ability to elect boards and to bring derivative causes of action would require significant retooling

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[136] *See generally* CAPITALIST PATRIARCHY AND THE CASE FOR SOCIALIST FEMINISM 1 (Zillah Eisenstein ed., 1979) (describing and criticizing the capitalist mystique); MARILYN WARING, IF WOMEN COUNTED: A NEW FEMINIST ECONOMICS 1 (1988) (same).

[137] *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (laying to rest the "attractive concept of the entrepreneur" and distinguishing the separate functions of management and risk-bearing).

[138] With respect to the nonessential nature of public shareholders, the public aftermarkets for equity are equally nonessential. They are, however, traditional repositories for otherwise unused funds, and it would be far too disruptive to abolish them. (Imagine, among other things, what would happen to the price of real estate.) There is, however, no reason related to corporate operations to believe that stock prices that are ungrounded in some sort of reasonable relationship to corporate earnings, or a projection thereof, are a good thing. Once that reasonable relationship is lost, the aftermarket in a particular corporation's stock becomes no more and no less than a casino in which traders are betting on investor psychology and precisely when the game of musical chairs will stop. Measures tailored to affect corporate operations but that also affect this casino atmosphere could be a good thing, were they to prompt movement back to more long-term holding patterns resembling something akin to traditional "ownership." *See generally* Gabaldon, *supra* note 96, at 229 (discussing regulation of gambling as an analogy for investment regulation).

of infrastructure. Mitigating market disruptions during any period of transition would be so difficult (and, in a time of generally downward volatility, so daunting) as to be nearly dispositive.

Tampering with sacred cows without slaughtering them (that is, tinkering at the margins) is quite another matter. From this perspective, a proposal that profits in excess of a reasonable return should be forfeited to the public good would be too extreme; a contention that they should be up for grabs might not be. Accordingly, the proposal made below with respect to tailoring excess profit-based penalties for various acts of corporate misfeasance or nonfeasance might be palatable.[139]

III. The Recent Integrity Initiatives

Regulatory responses to Enron and others have been well-described and debated elsewhere.[140] They are heralded by some as a necessary correction,[141] and regarded by others as an unsettling federal intrusion into corporations' internal affairs.[142] They have been described both as the most important development in corporate law for decades[143] and as ultimately trivial.[144] For purposes of this Article, the recent regulatory responses are important for several reasons.

First, they indicate political willingness to tinker at the margins of well-established principles; at the same time, they reveal a cheerful indifference to theory. For instance, although some of these responses, such as those having to do with audit committees,[145] seem to be based

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[139] *See infra* notes 194–201 and accompanying text.

[140] *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 2 (2002); Note, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 Harv. L. Rev. 2123, 2123 (2003).

[141] *See The A.A. Sommer, Jr. Annual Lecture on Corporate Securities & Financial Law: Post-Enron America: An SEC Perspective*, 8 Fordham J. Corp. & Fin. L. 335, 342–43 (2003) [hereinafter *SEC Perspective*] (including the comments of SEC Commissioner Goldschmid that "the Sarbanes-Oxley Act . . . provides the right fundamental framework for our current healing process").

[142] *See* Ribstein, *supra* note 140, at 3.

[143] *SEC Perspective*, *supra* note 141, at 343 (declaring that "[t]his landmark legislation is the most important securities legislation since the New Deal").

[144] *See* Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 St. John's L. Rev. 953, 953 (2002) (arguing that Sarbanes-Oxley merely confirms recent case law interpretations of managers' fiduciary duties); Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77, 78 (2003) (arguing that regulatory responses to large-scale market breakdowns, such those which occurred after the Enron situation, are unlikely to protect against future occurrences for a number of reasons).

[145] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

on the traditionalist "corporation as fictional human" model, others, such as those focused on auditors and lawyers as gatekeepers of the public interest,[146] do not. The generally manifest concern with preventing fraud is something virtually all analysts, including most economists, can endorse,[147] but some specific measures, such as those prohibiting loans to officers, are more theoretically controversial.[148]

Second, the overall emphasis of recent regulatory responses is on improved disclosure, and thus, is much in keeping with the historic emphasis of the federal securities laws.[149] Nonetheless, these regulatory responses are touted and perceived as having more to do with monitoring managers than with merely facilitating the transactions pursuant to which shareholders begin and end their relationships with the entities in which they invest. The rules prohibiting loans to officers[150] and forbidding trading during periods that employee/shareholders cannot trade[151] are obvious examples of this tendency. When added to the existing federal regime regarding the solicitation of proxies,[152] there seems to be some critical regulatory mass nudging securities law—or at least the perception of securities law—more firmly into the tent of "internal affairs."

Third, the implications of the new rules for the model of shareholder primacy are quite interesting. It may be that the shareholder primacy traditionally manifested in corporate law is best justified as a form of protection of long-term investors, while federal securities law does not discriminate between short- and long-term holders. Still, it is worth recognizing that when contrasted with broader social concerns, investor protection is related to, if not identical to, shareholder primacy cloaked in a federal vernacular. From this standpoint, we may note that

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146 *See id.* §§ 301, 307; *see also* Mitchell, *supra* note 100, at 1199–211 (describing new regulations).

147 *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673–80 (1984); Nicholas Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119, 129–31 (1981).

148 For a discussion of loans to officers and other self-dealing transactions, see Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 831 (2002); Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 655–59 (1992); and Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 954, 954–55 (1993).

149 *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1209, 1227 (1999).

150 *See* Sarbanes-Oxley Act of 2002 § 402.

151 *See id.* § 306.

152 *See supra* note 83.

in connection with recent reforms, there was a great deal of public breast-beating over employees who lost their jobs as well as their investments.[153] Moreover, specific rules were adopted on whistle-blower protection, which was focused clearly on employees,[154] and on blackout periods for insider trading, which were meant to establish parity with employee/investors.[155] Most analysts probably would agree, however, that these turned out to be fairly minor parts of the overall reform package, and would characterize the overall thrust of the actual regulatory reaction as strikingly, if not fanatically, centered on investor protection and reestablishing confidence in publicly held corporations.[156] Thus, but for incidental concern for employees, matters we might describe as social responsibility or philanthropy—matters of corporate conscience—simply were not on the regulatory radar screen.[157]

The final significance to this Article of the various regulatory reactions to Enron-type debacles lies in the determination of whether they present any possibilities for addressing broader concerns. Can we expect reforms predominantly directed toward corporate integrity to have any fallout in corporate conscience? If there is no such fallout, is there nonetheless some way to piggyback integrity initiatives in order to achieve other purposes?

Interestingly, one of the more striking themes of progressive corporate law during the stock market's golden years was corporate transparency and social accounting.[158] The notion, put simply, is that requiring disclosure of decisionmakers, decision-making processes, and consequences in a variety of social impact areas could have payoffs in investor interest and corporate behavior.[159] Implicit was the

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[153] *See, e.g.*, Rick Bragg, *Enron's Collapse: Workers; Workers Feel Pain of Layoffs and Added Sting of Betrayal*, N.Y. TIMES, Jan. 20, 2002, at 1; Theo Francis & Ellen Schultz, *Enron Faces Suits by 401(k) Plan Participants*, WALL ST. J., Nov. 23, 2001, at C1; Ellen E. Schultz, *Enron Workers Face Losses on Pensions, Not Just 401(k)s*, WALL ST. J., Dec. 19, 2001, at C1.

[154] *See* Sarbanes-Oxley Act of 2002 § 806.

[155] *See id.* § 306.

[156] *Cf.* Mitchell, *supra* note 100 (analyzing the Sarbanes-Oxley Act without reference to employee-related provisions).

[157] Even though undue managerial concern with stock price was criticized resoundingly as contributing to the debacles we witnessed, questioning the importance of shareholders vis-à-vis corporations evidently was not on the regulatory mind.

[158] *See, e.g.*, Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 605–06 (2001); David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41, 43 (1999); Jay P. Kesan, *Encouraging Firms to Police Themselves: Strategic Prescriptions to Promote Corporate Self-Auditing*, 2000 U. ILL. L. REV. 155, 165 n.7 (citing Carole Basri, *Corporate Transparency: The Triple Bottom Line Audit*, N.Y. L.J., Sept. 30, 1999, at 5); Williams, *supra* note 149, at 1199.

[159] *See* Williams, *supra* note 149, at 1293–96.

idea that the disclosures would be truthful. This suggests that integrity initiatives could be helpful in achieving other social goals *if* those goals already were the subject of mandatory disclosure. It is this last piece of the puzzle, however, that thus far remains unaddressed. Moreover, one might fear that publicized hysteria over corporate bottom lines has pushed it farther out of reach.

IV. Inside, Outside, Upside Down, or Every Which Way You Can

The distinction between corporate/entity law and other bodies of law is a perplexing one. As I have commented elsewhere,[160] developments in corporate/entity law are at cross-purposes with developments in other private law areas such as tort and contract law. This is illustrated by the enhancement of investor insulation from liability even as entity liability for some types of tortious conduct has increased.[161] Although there may be good reasons to permit and/or encourage this particular distinction, those reasons have not been addressed by public policymakers. Thus, the coherence of the resulting package—if it ever is perceived accurately as a single package—is suspect.

Most certainly, the possibility of disconnects and conflicts between corporate/entity law and various "public" law subjects is just as troubling. Environmental and labor law provide ready examples of attempts to regulate primarily, if not exclusively, corporate conduct for public purposes with no apparent recognition by policymakers that changes in entity law might also be pressed into service. Academic debate, however, has begun to catch up in the field of employment. For example, complementary proposals have been made to enhance the interests of workers by securing board representation for them, by creating a fiduciary duty owed by the board of directors to workers,[162] and by explicit changes in labor law.[163]

The eye-catching vision of the "corporation as fictional human" no doubt has much to do with these historic and traditional divides. Moreover, the public/private distinction may have been preserved, if not augmented, by the attitudes of the law and economics school toward preserving the primacy of private bargaining.[164] It is somewhat

[160] Theresa Gabaldon, *Experiencing Limited Liability: On Insularity and Inbreeding in Corporate Law*, *in* PROGRESSIVE CORPORATE LAW 111–12 (Lawrence E. Mitchell ed., 1995).

[161] *See id.* at 112–15.

[162] Greenfield, *supra* note 61, at 643.

[163] *Id.* at 638.

[164] *See, e.g.*, Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1273–74 (1982).

ironic in this day and age to reflect on the origins and original close tailoring of corporate charters to achieve very public goals.[165]

The analysis that follows will attempt to take account both of the "corporation as fictional human" and "corporation as private bargain" views in proposing a method of dealing with matters of corporate conscience. It will be based on the premise that there is no necessary border between corporate and other types of law. The solution that should be adopted is the solution that works, regardless of whether it disturbs analytic elegance.

A. *The Corporate Jiminy Cricket*

As a matter of traditional conceptualization, the fictional being that is the corporation has a brain, and that brain is the board of directors.[166] When we become concerned with the virtue of the corporation—either its integrity or its fairness—we turn to the board. Thus, if we are concerned with the reliability of financial statements, we see proposals focusing on board audit committees.[167] If we are concerned with whether workers get a fair shake, we may generate proposals, as corporate progressives already have, to create a fiduciary duty owed to workers by the board or proposals to secure board representation for workers.[168]

Charging a committee of the board with overseeing the audit of a company's financials does not magically create a "real" conscience for the fictional entity. It establishes a process that we hope will produce the same results as an integrity-seeking conscience, and it allocates to specific individuals responsibility for seeing that the process is carried out.[169] This type of reform creates a context in which individuals may

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[165] *See generally* EDWIN MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCE TO MASSACHUSETTS (1954) (reviewing early American corporate law); Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 2 (1945).

[166] *See* Mitchell & Gabaldon, *supra* note 48, at 1657.

[167] *See* Mitchell, *supra* note 100, at 1198–202 (describing new statutes and regulations governing the role of the audit committee).

[168] *See, e.g.*, Alfred F. Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941, 952 (1977); Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 MICH. J. L. REFORM 19, 73–77 (1988); Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 158–59 (1988).

[169] Consistent with the notion of fiduciary responsibilities on the part of individual agents, are requirements that particular officers certify the corporation's financial statements. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777–78 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.); Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, Exchange Act Order 4-460 (June 27, 2002).

act, as well as an occasion for them to do so; moreover, it signals a public commitment that may have an acculturating effect on actual behavior. Thus, although this type of reform cannot assure its desired results, it should increase the chances that the desired results will occur.

By analogy, one can imagine the creation of board corporate conscience committees charged with such goals as assuring the fair treatment of workers, good stewardship of the environment, and other goals. Insofar as creation of such committees would institutionalize process, create context and occasion, locate responsibility with individuals, and signal public commitment, it would seem that at least some progress toward the specified goals would be forthcoming.

The conscience committee proposal obviously is inspired by the traditional "corporation as fictional human" imagery—an attempt to bring Pinocchio to life with the help of Jiminy Cricket. It might, with some effort, be made palatable to contractarians in either of two ways. First, contractarian analyses of corporate functioning typically (but not inevitably) concede that corporations should comply with law,[170] and that law external to corporate functioning properly may take account of public goals.[171] If a public goal of worker fairness and the like is articulated and a corporation will be penalized for failure to comply, then implementing a conscience committee proposal could be viewed as not too controversial, particularly if implementation of the proposal is itself enough to avoid the penalty, as is discussed below.

Second, contractarians frequently characterize the "best" corporate law as providing the "best" set of default rules—those that the parties would negotiate for themselves most frequently (but which still may be negotiated around).[172] Surely many corporate constituents would bargain willingly that matters of public interest should be taken into account, at least to the extent consistent with their own interests. Indeed, some evidence of this is provided by the steady growth of social responsibility investment funds.[173] Getting these matters on the table for purposes of examination surely should be acceptable.

If a conscience committee's role is one of gathering information and exposing possibilities, there are still theoretical oxen to be gored

[170] Fischel, *supra* note 164, at 1271.

[171] *Id.* at 1272.

[172] *See supra* note 50 and accompanying text.

[173] *See* Williams, *supra* note 149, at 1287 (describing "dramatic" increase in number of mutual funds using social or environmental screens, and quantifying the assets under professional management in the United States using social screening as nine percent of total).

if constituents are presumed to be basically self-interested.[174] In this view, if one constituency is sure that its current position will not be improved by such considerations, at a minimum it must be assured that there is some grey area to be claimed—areas in which that constituency cannot be hurt but others can be helped. Investors must believe that workers' lives can be improved or the environment saved without necessarily impairing profitability. Workers must believe that the environment could be preserved without resulting in loss of jobs in particular locations or general diminution in wages.

Obviously, behavioral economics has something to say about these matters. Taking the studies and conclusions of this school at face value,[175] it would seem obvious that corporate constituents should not object to the creation of a conscience committee—the insertion of a conscience "step" in corporate process.

Adherents of the team production model similarly should raise few objections. If the interests of all those with team-specific inputs are to be considered by the board,[176] establishing a committee of the board to do so explicitly would seem to be desirable. It is true, however, that the proposal would press the outer limits of the team production model by its grant of standing to the environment, a consideration not usually accommodated specifically by the model.

To the extent that the conscience committee proposal would go further—contemplating consideration of interests even of those without team-specific inputs, two points may be made. First, consideration of those so far removed from the corporation and its operations as to have no discernible team-specific inputs (such as orphans in some other country) is squarely in the realm of corporate philanthropy, the permissibility of which team production scholars claim in support of their postulations.[177] Second, because corporate philanthropy is, in fact, currently the subject of specific consideration of many corporate boards,[178] it is probably unnecessary to put it on the plate of the conscience committee. It is, in fact, the corporation's routine interactions

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[174] As indicated earlier, self-interest of the participants in business enterprise is a basic assumption of the contractarian approach. *See* sources cited *supra* note 49 and accompanying text.

[175] *See* sources cited *supra* notes 67–69 and accompanying text.

[176] *See* sources cited *supra* notes 63–66 and accompanying text.

[177] *See* sources cited *supra* notes 56, 63–66 and accompanying text.

[178] *See generally* Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. Rev. 579, 586–87 (1997) (discussing corporate philanthropy and suggesting its mandatory disclosure).

with workers, environment, and so forth that more often are raised by those with social responsibility concerns.[179]

B. *Point and Counterpoint*

It is entirely possible that the simple addition of a conscience committee could improve both the perception and reality of corporate social responsibility. If people observe a step of corporate process designed to consider responsibility issues it may bring about a change in values and attitudes about the goals of corporate life.[180] It also is possible, however, that creation of a committee will appear so hackneyed and so procedure-bound as to disappoint both the cynical and those in search of inspiration. At this point, both failures and successes in the operation of audit committees will be critical to debate, as will future proposals for enhancing their operation.

There are, moreover, several criticisms to be leveled at a corporate conscience committee proposal. Two are shared with audit committee proposals and some are not. The first criticism to be directed at both types of committee-based reform is that they are sops.[181] They may indeed hold out some promise of progress, but can this progress possibly be enough? If it is not, isn't there some danger that the fanfare associated with the adoption and implementation of these proposals will consume all available energy and attention, while something that might be more far-reaching and ultimately successful is forgone?

The second shared criticism is that by locating responsibility for integrity and other conscience issues with specific individuals, other individuals are relieved of that responsibility.[182] This effect could be countered, perhaps, by requiring reports and other items from line and staff alike, but it is obvious that more work would need to be done.

The most important criticism that is not shared by audit and conscience committee proposals is (no surprise) that conscience committee proposals are not generally in alignment with what is perceived tra-

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[179] *See* sources cited *supra* note 49 and accompanying text.

[180] The roles of structure and nomenclature in shaping human thinking and behavior have been the subject of much examination. *See generally* Theresa A. Gabaldon, *Feminism, Fairness, and Fiduciary Duty in Corporate and Securities Law*, 5 TEX. J. WOMEN & L. 1, 13–16 (1995) (discussing pitfalls and possibilities of symbols in corporate and securities law); O'Connor, *supra* note 148, at 963 (discussing linguistic shaping of moral and social world); Robert L. Palmer, *When Law Fails: Ethics, Commerce, and Tales of Value*, 2 S. CAL. INTERDISC. L.J. 245, 267–71 (1993) (discussing role of stories in shaping thinking and behavior).

[181] *See* Gabaldon, *supra* note 71, at 955.

[182] *See* Gabaldon, *supra* note 180, at 19.

ditionally as the goal of the corporation—to make money for shareholders. The audit committee, by contrast, can be justified as an effort to assess progress toward that goal, even though misstatement of particular financial statements might be useful instrumentally in protecting the interests of shareholders at a particular moment in time.

To the extent that some instances of worker abuse (like some instances of financial misstatement) are taken not for purposes of profitability, but instead due to malignant self-interest, lack of foresight or the like, some reconciliation of a corporate conscience committee proposal with the traditional corporate goal still can be achieved. That is, if the mandate of the committee is to assure fair treatment of workers, good stewardship of the environment and so on, then *consistent with profitability*, inconsistency is definitionally eliminated although a common animating spirit may be lacking.

The obvious method of providing a common spirit is to make conscience profitable—to tie conscience issues squarely to corporate profitability. Monetary penalties, such as those associated with violation of environmental laws,[183] are the most familiar method of accomplishing the linkage. These penalties, of course, are a form of external regulation rather than internal corporate reform.

C. *The Internal/External Paradigm Revisited*

The internal/external line, then, is something to be revisited before moving on. Audit committee suggestions, which are based on the notion that the entity must be truthful in dealing with its current and prospective shareholders (and, incidentally, employees and creditors) easily could take the form of internal regulation. Thus, if such committees were not formed or failed to function, then the shareholders certainly could be given a remedy. If corporate conscience were regarded as an internal concern, because it involves primarily corporate constituents, as redefined, then it could be left an internal matter, with internal enforcement mechanisms or lack thereof. Thus, the primary inside enforcement mechanism presumably would be litigation by constituents, however defined, brought to bear against the members of the committee or the full board who fail in their duties.

When a committee's function is made a matter of external regulatory concern, the line between internal and external regulation is

[183] *See* John W. Bagby et al., *How Green Was My Balance Sheet?: Corporate Liability and Environmental Disclosure*, 14 VA. ENVTL. L.J. 225, 230–31 (1995) (discussing environmental liability and arguing for increased environmental disclosure).

breached, as it was by the reforms contemplated by the Sarbanes-Oxley Act of 2002.[184] Thus, the functioning of audit committees was made a concern of positive law, but shareholders were given no express remedy for their process failures.[185] In the course of this trespass it was relatively easy both to identify a logical regulatory authority and to provide that authority with clear guidelines for what audit committees were to be required to do. In part, this is because the result desired—financial statements that are correct in all material results—is clear, and a matter of traditional SEC concern.[186]

A conscience committee proposal is, from an external enforcement perspective, more challenging. The SEC would have no compelling relationship to the subject matter, and it is not clear exactly what other regulatory authority would. Moreover, because it is difficult to specify *exactly* the outcome desired, specifying what an authority should require the committee to do is problematic. Some amount of fuzziness, such as that surrounding the requirements of fiduciary duty,[187] may be tolerable when it attends a doctrine to be enforced by the self-interested. Permitting the same leeway in the case of official enforcement could amount to a waste of resources.

For a moment, however, let us assume that we could devise a reasonably tailored conscience committee-type proposal enforceable by external authority. The process required presumably would be that each publicly held corporation would have in place a conscience committee charged with responsibility for assessing the impact of corporate action (and inaction) on workers, creditors, consumers, host communities, and society more broadly. It would be charged with reporting to the full board at such times as would be meaningful for the board's consideration of desirable action.

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[184] *See* Mitchell, *supra* note 100, at 1198–99. The concept of corporate conscience committees demands further line crossing, in that such committees would not be charged with matters of direct benefit to the traditional interests of shareholders.

[185] Failure to produce the desired result of accurate financial statements results in strict liability for the corporation and what is akin to negligence-based liability for the directors. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

[186] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 71 (2d ed. 1995).

[187] *See* Gabaldon, *supra* note 180, at 16–21.

D. *An Outsider View*

From the perspective of "outsider" corporate critics, there are strong reasons to believe that creation of such a committee cannot be a complete solution to the perceived need to increase corporate social responsibility. Adoption of a regime mandating corporate conscience committees may not be entirely far-fetched, but meaningful reformation of board composition is much less likely. A proposal that does no more than ritually invoke the services of the same group of middle-aged white male and white male wannabes is, from this standpoint, apt to fall prey to the criticism that it is a counterproductive standard operating procedure.[188]

Given the concerns just expressed, it is appropriate to consider how much further we really could go toward requiring specific results. It is, however, a step to be taken only after pausing to elaborate on why some sort of external result specification is, from an outsider's perspective, important. Quite simply, although outsiders may traditionally have been excluded from political processes leading to the adoption of positive law,[189] at this point in time their exclusion is nowhere nearly as complete as it is from corporate boardrooms.[190]

Suppose, then, that we could create a crime of corporate indifference, the violation of which would result in corporate liability. The elements would be as follows: first, that it be shown that corporate action or inaction has contributed significantly to a state of affairs ("consequence") that we have, in advance, generally agreed as deplorable; second, that the consequence was reasonably foreseeable at a time the corporation could have prevented it.

Specification of triggering consequences would be the first problem to overcome. Notwithstanding the lack of agreement about whether some events are undesirable, there would be at least some clear cases on which virtually everyone could agree. These presumably would include loss of human life in the process of production, loss of

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188 *See* Gabaldon, *supra* note 71, at 955 (explaining criticism that both types of committee-based reform are sops).

189 *See, e.g.*, KENNETH J. ARROWN, SOCIAL CHOICE AND INDIVIDUAL VALUES 2–3 (2d ed. 1963) (describing and criticizing law making process); DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE 23–24 (1991) (same); *see also* Martha Chamallas, *The Market Excuse*, 68 U. CHI. L. REV. 579, 580 (2001) (reviewing ROBERT L. NELSON & WILLIAM P. BRIDGES, LEGALIZING GENDER INEQUALITY: COURTS, MARKETS, AND UNEQUAL PAY FOR WOMEN IN AMERICA (1999) (discussing issues raised by political exclusion)); Mark Strasser, *Unconstitutional? Don't Ask; If It Is, Don't Tell: On Deference, Rationality, and the Constitution*, 66 U. COLO. L. REV. 375, 375–76 (1995) (same).

190 *See* sources cited *supra* notes 74, 77.

human life as the result of product use, widespread loss of employment, and material violation of existing environmental laws.

Almost without doubt there would be at least arguable benefits offsetting or allegedly justifying even these undesirable consequences. For instance, workers' lives may have been lost in constructing a dam bringing hydroelectric power to a community that had no electricity. Similarly, consumption of a vaccine may have led to the death of a few and the survival of many more.

There are at least two ways to approach these arguable offsets. The simplest is to ignore them; in light of the penalty proposed below, this is neither draconian nor likely to bring the wheels of progress grinding to a halt. The second is to permit the corporation a defense of adequate consideration. This would require a showing that a report was presented by the corporate conscience committee and the matter was discussed specifically at a meeting of the board of directors at which a vote was taken and the vote of individual directors recorded. There would be no requirement of any specific cost-benefit analysis; the point is to assure that at least some conscience matters become part of the regular corporate process. Requiring the board to show that it discussed, in advance, the foreseeability of something that had already occurred when the crime was charged, should also help in assuring that conscience issues are not suppressed by "well-meaning" corporate employees and that responsibility/accountability is not diffused by a corporate structure that separates those with enough information to discern the issues from those with responsibility for making decisions.[191]

Mention of corporate agents other than the board of directors is, moreover, an appropriate reminder that the cheese need not stand alone. Individual-based and entity-based approaches are not either/or propositions. Both could be implemented. In other words, charging individuals with conscience responsibilities (somewhat akin to requiring officer certification of financials) could be a useful form of augmentation. Thus, one easily can imagine a dramatic effect to providing that a corporate employee, or director, who becomes aware of

[191] The perils of corporate diffusion have been well described by, for example, Brenda S. Hustis & John Y. Gotanda, *The Responsible Corporate Officer: Designated Felon or Legal Fiction?*, 25 Loy. U. Chi. L.J. 169, 171 (1994); V.S. Khanna, *Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea*, 79 B.U. L. Rev. 355, 359–60 (1999); William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 Emory L.J. 647, 648–51 (1994); Eli Lederman, *Models for Imposing Corporate Criminal Liability: From Adaptation and Imitation Toward Aggregation and the Search for Self-Identity*, 4 Buff. Crim. L. Rev. 641, 668 (2000); and Jennifer A. Quaid, *The Assessment of Corporate Criminal Liability on the Basis of Corporate Identity: An Analysis*, 43 McGill L.J. 67, 69 (1998).

foreseeable undesirable consequences and fails to bring them to the attention of superiors, or to the conscience committee, is guilty of a crime of indifference.

It seems, in fact, that an individually focused approach requiring compliance by rank-and-file employees would be the most likely to assure that issues were identified as an initial matter. Moreover, individual-based approaches have had traditional appeal because the associated penalties have avoided punishing "innocent" shareholders.[192] They have been faulted for their ease of evasion by systems set up to segment information-gathering and decision-making functions.[193] In addition, because they do not connect shareholders to the consequence of wrongdoing, they have no obvious role to play in enlisting the corporate entity and/or market forces in monitoring or coercing compliance with the legal norm in question.

E. *Let the Punishment Fit the Crime*

By contrast, monetary penalties assessed against corporate entities have the effect of diminishing corporate and, presumably, shareholder value.[194] Although this is deemed objectionable by some on the grounds that many of the shareholders affected will not bear any responsibility for the wrongdoing and may not have been shareholders at the time the wrongdoing occurred,[195] such penalties do give the market some incentive to pay attention to whether the wrongdoing has been, or is likely to be, committed by a particular corporation. As a related matter, if a corporation can offer credible assurances that the wrongdoing is less likely to occur there than at similarly situated companies, then its shares rationally would command a relatively higher price.

If the penalty assessed against a corporation for the crime of corporate indifference were forfeiture of all profits in excess of some industry average, then bag-holding shareholders would not be drastically penalized. Moreover, unless a corporation signals that it has a substantially effective compliance program, it would not be rational for purchasing shareholders ever to pay a price that is based on projected earnings in excess of the industry average. One might think that this

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192 *See, e.g.*, John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 401 (1981) (noting that monetary penalties assessed against corporations penalize innocent shareholders).

193 *See generally* sources cited *supra* note 191 (describing possibilities of evasion and related issues).

194 *See* Coffee, *supra* note 192, at 401.

195 *See id.*

would provide a significant incentive for compliance. This is true even though corporations that do not expect to be profitable or do not expect to be super-profitable may be less motivated than others. The danger of this latter phenomenon, however, could be addressed at least in part by coupling entity- and individual-based approaches.

F. *Investing in Ethics*

The excess profit-based penalty described above would be unlikely to have drastic effects on overall market prices.[196] This would, at any rate, be the case if all of the shares traded in the market were subject to the proposal. Given the existence of global markets, however, one easily can imagine an argument that if American corporations were subjected to laws governing criminal indifference, capital would flee to more happily indifferent climes.[197] This presumably would be both because liability itself would be feared and because corporate behavior with respect to non-shareholders actually might change.

In general, the reasons given for American markets' magnetism do not include a lust for extraordinary profits from operations.[198] During bubble times, motivations no doubt included a desire to gamble with respect to profits that did not exist.[199] More often, the explanations given have had more to do with the transparency of American markets and their superior regulatory regime.[200] From these standpoints, a proposal focused on disgorgement of excess profits should offer little to fear.

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[196] At most, it might have an incidental moderating effect on future financial bubbles. For discussion of financial bubbles generally, see, for example, Gabaldon, *supra* note 96, at 235–36 and SCHILLER, *supra* note 101, at 118–32.

[197] *See* James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS. 157, 159–61 (1992) (describing capital flight and international regulatory competition). *Cf.* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440–43 (2001) (arguing that corporate governance structures will converge across developed economies upon the Anglo-American, "shareholder-oriented" model).

[198] The most usual explanation of the relative attraction of the United States capital markets has to do with financial transparency. *See, e.g.*, SEC Commissioner Isaac C. Hunt, Jr., A Securities Regulator's Top Accounting and Auditing Priorities for 1998, Remarks at the National Conference on Current SEC Developments of the American Institute of Certified Public Accountants (Dec. 9, 1997), *at* http://www.sec.gov/news/speech/speecharchive/1997/spch198.txt.

[199] *See generally* Gabaldon, *supra* note 96, at 229 (discussing gambling and the creation of market bubbles).

[200] *See, e.g.*, Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1340–41 (1996).

More problematic is the question of jurisdiction of the proposal. If it applied to corporations chartered in America, it indeed might have the effect of encouraging offshore incorporation.[201] If the proposal applied to those corporations chartered in America, those selling their shares in America, and those doing some dollar amount of business in America, then opportunities for evasion obviously would be reduced. Regulation to this extent might appear to be a financially preclusive undertaking, but it quite arguably could be made self-funding.

Conclusion

The problem addressed by this Article is the lack of corporate regard for the concerns of non-shareholders and the non-financial concerns of shareholders themselves. This is a problem that has been addressed by corporate progressives for over a decade. It renews the call at a time when corporate conscience issues have been submerged in concern for corporate integrity. It extends the call by observing that the prior recommended reforms largely have been appeals to a traditionally empowered group which may have perilously little understanding of the lives of others. Appealing to this group without a careful attempt to structure its exercise of discretion seems perilous at best, perverse at worst. An appeal based on influencing that discretion through risk of disgorgement of excess profit may seem both cynical (in that it makes use of a motivation that at least some unempowered will deplore) and incomplete (in that some details are left to be addressed). It may, in addition, seem impractical, particularly at this integrity-panicked moment in time.

The author pleads guilty on all counts, but recommends, "*Give a little whistle, and always let your conscience be your guide.*"[202]

[201] *See* sources cited *supra* note 197.
[202] PINOCCHIO (Walt Disney Studios 1940).